

May 6, 2023

The Honorable Gary Gensler
Chair, Securities and Exchange Commission
100 F St NE
Washington, D.C. 20549

Re: Safeguarding Advisory Client Assets (RIN 3235–AM32)

Dear Chair Gensler,

On behalf of more than 500,000 members and supporters of Public Citizen, we provide the following comment on the proposed rule titled, “Safeguarding Advisory Client Assets.”¹

Background

This proposed rule follows one of the largest thefts of advisory client assets in history, namely, the alleged heist by Sam Bankman-Fried and his co-conspirators of more than \$8 billion in customer accounts at his crypto exchange FTX. That’s roughly half of the total of \$16 billion in customer accounts at FTX.² Some of these stolen funds went to a sister company also controlled by Bankman-Fried called Alameda Research. An FTX co-founder and the former CEO at Alameda Research have already plead guilty to fraud.³ Other funds went to sports celebrities who endorsed cryptocurrency, charities and politicians.⁴ These alleged conspirators counted among the largest donors of political funds in the last election cycle. While they deployed but a few percent of the \$8 billion to campaigns and dark money super PACs, the enthusiastic, vocal support Bankman-Fried and colleagues received from Capitol Hill prior to exposure of its wrongdoing, was palpable.⁵ This heist follows others, including those (non-crypto) schemes

¹ Securities and Exchange Commission, *Safeguarding Advisory Clients’ Assets*, FEDERAL REGISTER (March 9, 2023) <https://www.govinfo.gov/content/pkg/FR-2023-03-09/pdf/2023-03681.pdf>

² Vicky Ge Huang, *FTX Tapped Into Customer Accounts to Fund Risky Bets, Setting Up Its Downfall*, WALL STREET JOURNAL (Nov. 11, 2022), <https://www.wsj.com/articles/ftx-tapped-into-customer-accounts-to-fund-risky-bets-setting-up-its-downfall-11668093732>

³ Phil Helsel, *An FTX Co-Founder and The Former CEO At Alameda Research Plead Guilty To Fraud*, NBC News (Dec 21, 2022) <https://www.nbcnews.com/business/business-news/ftx-co-founder-former-ceo-alameda-research-plead-guilty-fraud-rcna62891>

⁴ *Riches To Rags: How Did Sam Bankman-Fried Spend His Fortune?*, STYLE (Nov. 28, 2022) <https://www.scmp.com/magazines/style/celebrity/article/3201152/riches-rags-how-did-sam-bankman-fried-spend-his-fortune-bahamas-properties-and-sponsoring-sports>

⁵ Lisa Gilbert, *How Sam Bankman-Fried's Dark-Money Political Donations Fueled His Massive Fraud*, SALON (Dec. 21, 2022) <https://www.salon.com/2022/12/21/how-sam-bankman-frieds-dark-money-political-donations-fueled-his-massive-fraud/>

perpetrated by Bernard Madoff and Allen Stanford, which led to 2009 reforms of the custody rule.⁶ These important changes now deserve supplement.

Proposed Rule

If better rules tightly enforced could have prevented the theft of customer funds, these fraudsters may have been unable to buy the favor of sports celebrities, the blessing of prominent non-profits, and the legal backstop from politicians.

With this proposal on “Safeguarding Advisory Client Assets,” the Securities and Exchange Commission (SEC, Commission) intends to do just that. The rule addresses three major examples of custody relationships between a client and the custodian: (1) possession of client funds or securities; (2) authority to withdraw funds or securities from a client’s account; and (3) any capacity that gives the adviser legal ownership of, or access to, client funds or securities.

Broadly, the SEC proposes that the custodian enter a written agreement with two new explicit provisions. One provision requires the qualified custodian to provide records regarding clients’ assets held in the account to the SEC or an independent public accountant. The other would specify the adviser’s agreed-upon level of authority to make trades in the account. We enthusiastically support these reforms.

Granularly, the commission proposes to add a new rule, titled rule 223–1 under the Advisers Act, which it proposes to describe as the “safeguarding rule.” The SEC says the rule recognizes the evolution in products and services that investment advisers offer to their clients. Importantly, the proposal retains the core purpose of protecting client assets from loss, misuse, theft, or misappropriation by advisors. Public Citizen supports this critical foundation.

First, the rule recognizes increasingly complex and global financial markets that include financial products beyond just mutual funds or securities. The rule would specify the types of assets subject to the safeguarding requirements by defining “assets” as “funds, securities, or other positions held in a client’s account,” as opposed to the current custody rule’s use of “funds and securities.” We support this change, which should end any confusion from opponents’ hollow arguments that cryptocurrency is not like a stock or a bond.

The proposed rule also would explicitly address discretionary authority to trade within the definition of custody. When an adviser under the current regime has discretion to trade client assets, it has an arrangement in which it may instruct the adviser’s custodian to transact with the client’s assets. An adviser with discretion may also have broad authority to direct purchases or sales of client assets that may not currently involve a qualified custodian. An adviser’s authority could place client assets at risk of loss. Like the custody rule, the safeguarding rule would entrust safekeeping of client assets to a qualified custodian. This is because the commission believes it would provide critical buffer for those assets. Unlike the custody rule, however, the safeguarding rule would specify that a qualified custodian does not “maintain” a client asset for purposes of the rule if it does not have “possession or control” of that asset. The proposed rule would further define “possession or control” to mean holding assets such that the qualified custodian is required to sign off in any change in beneficial ownership of those assets. The SEC explains that this change is designed to improve account statement integrity and reliability by eliminating an adviser’s ability to bypass the custodian. We support this safeguard.

⁶ Securities and Exchange Commission, *Safeguarding Advisory Clients’ Assets*, FEDERAL REGISTER (March 9, 2023) <https://www.govinfo.gov/content/pkg/FR-2023-03-09/pdf/2023-03681.pdf>

Further, in a change from the current rule, the proposed rule would require an adviser to enter into a written agreement with and receive certain assurances from the qualified custodian to make sure the qualified custodian provides certain standard custodial protections when maintaining client assets. We support this written statement, which could be useful in litigation.

Under the proposal, the written agreement would require two explicit provisions. One provision would require the qualified custodian to provide promptly, upon request, records relating to clients' assets held in the account at the qualified custodian to the Commission or to an independent public accountant. We support this. Clients of FTX had essentially no information about the status of their funds.

The other provision would specify the adviser's agreed-upon level of authority to make trades in the account. The proposed rule's written agreement requirement would also incorporate, and expand, two components of the current rule: account statements and internal control reports. Under the first, the written agreement must contain a provision requiring the qualified custodian to deliver account statements to clients and to the adviser. Currently, advisers must have only "a reasonable basis" for believing this is done. The other provision would require the qualified custodian to obtain a written internal control report that includes an opinion of an independent public accountant regarding the adequacy of the qualified custodian's controls. This provision expands the internal control requirement to all qualified custodians from the current rule's application to an adviser or a related person that acts as a qualified custodian. In addition to the written agreement requirement, advisers must obtain assurances that the qualified custodian satisfies five additional enumerated items. These include assurances that the custodian will:

- (1) exercise due care in accordance with reasonable commercial standards in discharging its duty as custodian and implement appropriate measures to safeguard client assets from theft, misuse, misappropriation, or other similar type of loss;

- (2) indemnify the client against losses caused by the qualified custodian's negligence, recklessness, or willful misconduct;

- (3) not be excused from its obligations to the client because of any sub-custodial or other similar arrangements;

- (4) clearly identify and segregate client assets from the custodian's assets and liabilities; and

- (5) not subject client assets to any right, charge, security interest, lien, or claim in favor of the qualified custodian or its related persons or creditors, except to the extent agreed to or authorized in writing by the client.

We support these additions.

Importantly, the SEC proposes to require segregation of assets by requiring: (1) titling or registering the assets in the client's name or otherwise holding the assets for the client's benefit, (2) not commingling the assets with the adviser's or any of a related persons' assets, and (3) not subjecting the assets to any right, charge, security interest, lien, etc. This provision, which would apply regardless of whether the client's assets are maintained by a qualified custodian, is designed to prevent the flagrant abuse of customers' funds-- as alleged to have happened with FTX and Sam Bankman-Fried. We certainly support this proposal.

The proposed rule would continue to depend on the protections provided by independent public accountants. The SEC has relied on these third-party gatekeepers to provide "another set of eyes" on

client assets. Ideally, auditors will recognize that cryptocurrency is rife with fraud and demands careful scrutiny.

Conclusion

Currently, cryptocurrency trading takes place in a Wild West willfully flaunting the law and order. FTX is not the only exchange stealing customer funds. The number of bankruptcies and frauds in the cryptocurrency space is legion. We heartily welcome the SEC's effort to bring law and order to this so-called industry.

For questions, please contact Bartlett Naylor at [REDACTED]

Sincerely

Public Citizen