May 8, 2023

Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: File No. S7-04-23; Comments Regarding Proposed New Rule 223-1 "Safeguarding Advisory Client Assets"[1]

Ms. Countryman,

I would like to thank the Securities and Exchange Commission (the "SEC" or "Commission") for the opportunity to comment on proposed new Rule 223-1 (the "Proposed Rule" or "Safeguarding Rule") under the Investment Advisers Act of 1940 (the "Advisers Act").[2]

## I. Introduction

I am, like many others, deeply concerned and share in the views raised by certain members of the Commission that the Proposed Rule's approach "appears to mask a policy decision to block access to crypto as an asset class."[3] As discussed further below, there are many aspects of the Proposed Rule, that when taken together, appear to prohibit or otherwise make it extraordinarily challenging and costly for an investment adviser to recommend or invest in digital assets[4] on behalf of clients. Accordingly, the Proposed Rule would have material, adverse consequences for digital asset trading platforms.

At the outset, I do not believe that the Proposed Rule, if adopted substantially as proposed, complies with the requirements of the Administrative Procedures Act ("APA").[5] I do, however,

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[1] Norman Reed, the author of this comment letter, is General Counsel of BAM Management US Holdings Inc. and BAM Trading Services Inc. ("Binance.US"). However, the views expressed in this letter are provided in a personal capacity and not necessarily those of Binance.US or any of its shareholders, directors, officers or other employees.

[2] *See Safeguarding Advisory Client Assets*, Investment Advisers Act Rel. No. IA-6240 (Feb. 15, 2023) (the "Proposing Release"). References herein to the Proposed Rule or Safeguarding Rule are intended to reflect the rule, if adopted substantially as proposed.

[3] *See, e.g.*, Mark Uyeda, SEC Commissioner, *Statement on Proposed Rule Regarding the Safeguarding of Advisory Client Assets* (Feb. 15, 2023) (noting, in part, that the Proposing Release acknowledges that it would be unlikely that crypto assets can be maintained at qualified custodians or traded on a crypto trading platform in compliance with the Proposed Rule and "deviates from the Commission's long-standing position of neutrality on the merits of investments."); *see also*, Hester M. Peirce, SEC Commissioner, Statement on Safeguarding Advisory Client Assets Proposal (Feb. 15, 2023) (noting a number of statements in the Proposing Release that identify or imply the likelihood of crypto assets as "securities" and suggesting that such sweeping statements "encourage investment advisers to back away immediately from advising their clients with respect to crypto.").

[4] My comment letter refers to both "digital" and "crypto" assets, interchangeably.

[5] *See generally*, 5 U.S.C. § 551 et seq. (1946); 5 U.S.C. § 706(2) (scope of judicial review). The APA was developed to counterbalance the growth and power of administrative agencies that occurred as a result of the New Deal. It

appreciate the Commission's efforts to address (both now and in the future) the unique policy and legal questions presented by digital assets through rulemaking and the notice and comment period, rather than through enforcement actions.[6] The information provided below is intended to ensure that the Commission has an accurate record and the relevant information required to make informed decisions and to appropriately discharge its obligations under the APA.

## II. The Proposed Rule Fails to Meet Its Obligations under the APA

### A. SEC Rulemaking Obligations

Under principles of the APA, the SEC must meet a variety of obligations in adopting new or amended rules. For example, an Agency's action in adopting new or amended rules is arbitrary and capricious if "the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise."[7] The Commission also has a "statutory obligation to determine as best it can the economic implications of the rule."[8] In addition, Section 2(b) of the Advisers Act requires the Commission to consider "the rule's promotion of efficiency, competition, and capital formation."[9] The Commission also has an obligation to assess the current federal and state "baseline" of regulation in determining what impacts a new rule will have on efficiency, competition, and capital formation. The failure to do so properly is a violation of the APA.[10]

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was designed to reflect the legislative values of participation in rulemaking and fair treatment of individuals – in adjudication and enforcement. Congressman Walter, a supporter of the APA, stated that "[d]ay by day Congress takes account of the interests and desires of the American people in framing legislation, and there is no reason why administrative agencies should not do so when they exercise legislative functions which the Congress has delegated to them." Senator Pat McCarran called the APA, "a bill of rights for the hundreds of thousands of Americans whose affairs are controlled in one way or another by agencies of Federal Government. It is designed to provide guarantees of due process in administrative procedure." *See Legal Foundations of Public Administration* 3rd Edition, Donald D. Barry and Howard R. Whitcomb (Rowan and Littlefield 2005) at pp. 32.

[6] *See* Hester M. Peirce, SEC Commissioner, *Kraken Down: Statement on SEC v. Payward Ventures, Inc., et al.* (Feb. 9, 2023) (dissenting regarding the Kraken settlement agreement, stating that "[u]sing enforcement actions to tell people what the law is in an emerging industry is not an efficient or fair way of regulating.")

[7] *See Motor Vehicle Mfrs. Assn. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

[8] *See Business Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (quoting *Chamber of Commerce v. SEC*, 412 F.3d 133, 143 (D.C. Cir. 2005)). The SEC cannot "inconsistently and opportunistically frame[] the costs and benefits of the rule," nor can it "fail[] to respond to substantial problems raised by commenters[.]" *Id.* at 1149.

[9] *See* 15 U.S.C. § 80b-2(c).

[10] *See supra* note 9; *see also*, *American Equity Life Ins. Co. v. SEC*, 613 F.3d 166, 178 (D.C. Cir. 2010) ("The SEC could not accurately assess any potential increase or decrease in competition, however, because it did not assess the baseline level of price transparency and information disclosure under state law."); *see also* Proposing Release, *supra* note 2 at pp. 247 ("The Commission assesses the economic effects of the proposed amendments relative to the baseline of existing requirements and practices of advisers.").

## B. The Safeguarding Rule Drastically Impedes the Development of an Entire Asset Class

The Safeguarding Rule includes a number of provisions that appear intended to prohibit, if not materially limit, the investing and trading in digital assets by persons who wish to rely on the assistance of an investment adviser. The result would be to dramatically impact the operation/feasibility of all digital asset market participants, including trading platforms. Examples include:

- Exponentially expanding the scope of the current custody rule (Advisers Act rule 206(4)-2), applicable to client assets, which would now include not only "funds and securities," but also "other positions held in a client's account." As a result, while there remains significant jurisdictional disputes over digital assets and their classification as "securities" or "commodities," the SEC attempts to make the question moot, asserting jurisdiction over *all* assets (including digital assets that are not securities).

- Clarifying that for a qualified custodian to "maintain" client assets, it must have "possession or control" of the asset. Accordingly, a qualified custodian would generally be required to be involved in any change in beneficial ownership of the client asset–a very challenging requirement to satisfy when investing and trading digital assets.

  Moreover, the Commission acknowledges that digital asset platforms generally operate under a business model that would be inconsistent with the "possession and control" standard required of qualified custodians under the Proposed Rule.[11] As a result, the Proposed Rule would, as a practical matter, remove registered investment advisers from participating on many, if not all, digital asset platforms. The SEC provides no plausible rationale for such a draconian result, when considering (i) securities are not being traded on a number of digital asset platforms to the best of those platforms' determinations; and (ii) the various protections and oversight already in place on a number of digital asset platforms.

- Noting, that, even where a digital asset is determined to be a security, the privately-offered securities exception (providing an exception from the qualified custodian requirement) would not be available where such security is issued on a public, permissionless blockchain.

- Including Commission statements in the Proposing Release and certain elements of the Proposed Rule that will further inhibit the growth of the crypto asset class by, among other things, limiting the universe of entities able and/or willing to serve as qualified custodians with regard to digital assets. For example, the Commission (i) casts doubt on the ability of new entrants to serve as qualified custodians (*e.g.*, questioning the quality of oversight at state-chartered trust companies); (ii) references and publicizes certain

[11] *See* Proposing Release, *supra* note 2 at pp. 67-68 (discussing challenges presented by the Proposed Rule and their particular impact on digital asset trading platforms).

safety and soundness concerns raised by federal banking regulators regarding banks and their digital asset activities (including serving as qualified custodians); (iii) imposes new and onerous requirements/representations that must be agreed upon within contractual agreements between an investment adviser and the qualified custodian; and (iv) tightens the requirements around the ability of other entities that currently may serve as qualified custodians (*e.g.*, "foreign financial institutions").[12]

Viewed in totality, the potential impact of the Proposed Rule veers far away from helping to "ensure that advisers don't inappropriately use, lose, or abuse investors' assets."[13] Rather, the Proposed Rule appears to be a policy decision that investing in digital assets presents an untenable harm to investors and/or the financial markets and it is desirable public policy to make access to digital assets as onerous as possible, if not prohibited entirely. *As discussed below, the Commission does not have the authority to make that proclamation.*

Even if, as discussed below, the SEC were to amend its faulty economic analysis to more realistically estimate the dramatic economic impact the Proposed Rule would have on the digital asset market and its participants, there remains significant concern as to the Commission's authority to (i) become a merit-based securities regulator; and (ii) opine on the merits of assets *that are not securities*. This bold expansion of the SEC's jurisdiction beyond securities to assets that are clearly not investment contracts, and thus not "securities," is not legally supportable and exceeds the authority granted to it by Congress. Judicial scrutiny will almost assuredly apply to a situation, such as here, where the SEC seeks to assert jurisdiction over *all* crypto currencies (well beyond the Agency's mandate as a "securities" regulator).

### C. Rather Than Dismantle the Crypto Asset Eco-System, Provide Much Needed Guidance

The Safeguarding Rule appears to be the means by which the Commission takes aim at solving the challenges associated with the developing digital asset market and how that asset class fits (or perhaps more aptly, does not in the SEC's view, fit) within the existing U.S. financial markets. The Commission's approach does not satisfy its APA obligations, because, among other reasons, its heavy-handed approach seeks to undo the crypto asset eco-system, rather than use its expertise as the Agency responsible for overseeing the U.S. securities markets—to find or offer to find a more tailored and less disruptive alternative solution. Instead of seeking to make it as difficult as possible, if not prohibitive, for financial market participants to gain exposure to digital assets (*e.g.*, by essentially eliminating the ability of investment advisers to include digital assets in their asset allocation decisions), the SEC should provide practical guidance to distinguish when digital assets are securities or commodities.[14] Doing so would go a long way towards improving transparency, clearly establishing regulatory oversight responsibilities, and promoting responsible investing and trading in digital assets.

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[12] *See* Proposing Release, *supra* note 2, at pp. 46-61, 75-76.

[13] *See* Press Release, Securities and Exchange Commission, *SEC Proposes Enhanced Safeguarding Rule for Registered Investment Advisers* (Feb. 15, 2023) (statement of SEC Chairman, Gary Gensler).

[14] *See infra* note 28 and accompanying text.

## D. The SEC's Economic Analysis is Insufficient and Applies the Wrong Baseline

***1. The Proposed Rule's aggregate impact is not sufficiently considered.*** As discussed above, when viewed in its totality, it is clear that the Safeguarding Rule stretches well beyond that of enhancements to the existing custody rule to improve investor protection. It both directly and indirectly adversely impacts the market for investing in digital assets–by making it nearly impossible, if not cost prohibitive, for investment advisers to comply with the Proposed Rule while participating in an emerging asset class for the benefit of U.S. investors. In many places, the Proposed Rule's economic analysis fails to adequately capture the costs and impacts (both quantitatively and qualitatively) that are likely to result from essentially barring registered investment advisers from participating in the digital asset market.

For example, as discussed above, the "possession and control" standard set forth in the Proposed Rule appears to directly target and challenge the ability of entities to serve as qualified custodians for investment advisers who invest and trade digital assets. And, relatedly, this would have downstream deleterious effects for firms who operate digital asset trading platforms, as well as clients of investment advisers who seek to access such markets.

While there may be mechanisms by which a qualified custodian could develop and structure its operations (as related to digital assets) to meet the "possession and control" standard in the Proposed Rule, the Commission's economic analysis does not meaningfully address the challenges and significant costs associated with such structuring (*e.g.*, a qualified custodian may hold a private key in a multi-signature or multi-party computational solution).[15]

Notwithstanding the impact and costs associated with such potential solutions, the Proposed Rule goes a step further—adopting a simple negligence standard for determining a qualified custodian's liability. As a result, the Proposed Rule will likely reduce the number of firms willing to serve in this capacity because of: (i) the integral role the qualified custodian must serve in meeting the "possession and control" standard; (ii) the risks involved in doing so; and (iii) the significant increases in cost (*e.g.*, insurance/indemnification costs associated with a simple negligence standard). This likely reduction in the universe of willing and able qualified custodians (both as noted here, as well as for the reasons described above) is exacerbated by the generally inadequate assessment in the economic analysis of how many and what types of entities would satisfy the Proposed Rule's qualified custodian requirement for digital assets.[16]

[15] The CFTC has approved certain clearing houses to custody digital asset commodities (*e.g.*, Bitcoin and Ether). *See, e.g.*, In the Matter of the Application of Eris Clearing, LLC For Registration as a Derivatives Clearing Organization (Nov. 2, 2020), available at: https://www.erisx.com/wp-content/uploads/2020/11/Amended-Eris-Clearing-Order-of-Registration_Signed.pdf; In the Matter of the Application of LedgerX, LLC For Registration as a Derivatives Clearing Organization (July 24, 2017), available at: https://www.cftc.gov/sites/default/files/idc/groups/public/@otherif/documents/ifdocs/ledgerxdcoregorder72417.pdf.

[16] *See* Proposing Release, *supra* note 2 at pp. 74-76, 256.

In a similar vein, the economic analysis fails to consider other likely structuring costs that an investment adviser and/or qualified custodian would incur to respond to the direct challenges posed to the digital asset market via the Proposed Rule. For example, where an investment adviser might seek to structure a digital asset security transaction and qualify for the privately-offered securities exception, there would likely be significant new costs involved, including costs to engage a parallel transfer agent and create redundant private records of the transaction.

***2. The Proposed Rule's economic analysis uses the wrong economic baseline: The majority of crypto market capitalization is not securities.*** In the Proposing Release, the Commission notes that it understands, with regard to crypto assets, that some investment advisers currently provide advisory services that would generally result in an adviser having 'custody' within the meaning of the custody rule (*e.g.*, serving as the general partner for a private fund that holds crypto and securities). The Commission further states that (i) some of these advisers may not maintain their clients' crypto assets with a qualified custodian, instead relying on self-custody (a practice that is not compliant with the custody rule if those crypto assets are "funds or securities" and do not otherwise meet an exception from the requirement to use a qualified custodian); and (ii) other advisers offering similar advisory services may take the view that crypto assets are not covered by the custody rule at all. Importantly, the Commission directly challenges these points, stating: "[t]his, however, is incorrect because **most crypto assets are likely to be funds or crypto asset securities covered by the current rule."** (Emphasis added.)[17] As discussed below, I have significant concerns regarding the SEC's assertion that essentially all digital assets are "securities." It is important to note, as well, that the SEC's fallback position appears to be that in the event its analysis suggests a digital asset is not a security, the current custody rule also covers "funds." Yet, the SEC provides no legal analysis or support for the proposition that digital assets may be characterized as "funds" under the current custody rule.

I believe, however, that it is incorrect to ground the economic analysis of the Proposed Rule in the belief that "most crypto assets are likely to be funds or crypto asset securities." While how many crypto assets are securities may be an interesting question, the relevant question when examining the potential *economic* consequences of the Proposed Rule is what part of the *market capitalization* of crypto assets are securities. The answer, by the SEC's own admission and inaction, is a significant majority of the market capitalization of crypto assets are *not securities*.

In support, I wish to highlight that the CFTC in enforcement filings has alleged that seven of the top fifteen digital assets based on market capitalization are commodities, representing, in sum approximately 76 percent of the total crypto asset market capitalization.[18] It is noteworthy that

[17] *See generally*, Proposing Release, *supra* note 2 , at pp. 18 and note 29.

[18] The seven digital assets and their respective shares of market capitalization are: Bitcoin (45.3%); Ether (19.0%); Tether (7.0%); USD Coin (2.6%); Dogecoin (1.0%); Binance USD (0.6%); and Litecoin (0.5%). Source: CoinMarketCap, https://coinmarketcap.com/ (last visited Apr. 21, 2023). The CFTC enforcement matters regarding these digital assets include: *CFTC v. Binance*, No. 1:23-cv-01887 (N.D. Ill. Mar. 27, 2023) (Complaint addresses

the CFTC has allowed Bitcoin and Ether-based derivatives products to trade for years on CFTC-regulated markets and the SEC has never asserted that those products should have instead been subject to SEC regulation. Moreover, the SEC has never asserted in either an enforcement action, rulemaking, or other Commission-level statement that any of the above seven digital assets was a security.

Thus, if the SEC maintains this position in the final rule, the rule's economic analysis would be insufficient, grossly underestimating the economic impact on the crypto asset market and, relatedly, its market participants. In my view, the proposed expansion to bring within the custody rule not just "funds and securities," but also "other positions held in the client's account," would result in drastic changes to current market practice. At a minimum, the economic baseline for evaluating the Proposed Rule's impact on efficiency, competition, and capital formation cannot be undertaken with the assumption that the majority of digital assets are already subject to the existing custody rule's scope of "funds and securities"—such a view is unsupported by the facts. And, as discussed above, such costs, including, for example, costs associated with finding a qualified custodian willing and able to take possession or control of such assets, are substantially more impactful when compared to the appropriate baseline.

While the discussion in the economic analysis makes sweeping acknowledgements as to certain costs that may be imposed by the Proposed Rule where an adviser has custody of client crypto assets that are not "funds or securities," it is not sufficient to simply state that such impacts depend on the extent of investors' holdings of crypto assets that are not funds or securities subject to the current rule and otherwise cite to a lack of data to make further estimates.[19] Arguably, this might be acceptable if the SEC were correct as to its characterization of most crypto assets as "funds or securities." But, as discussed above, it is not the number of different digital assets that might be securities that is relevant; it is the market capitalization of digital assets actually traded that is most material. Given that approximately 76 percent of the market capitalization of crypto assets is not currently covered by the current custody rule, I believe, on the contrary, that there is sufficient indication of the market size to estimate and quantify the consequences of the Proposed Rule.

***a. Not all digital assets are securities.*** Characterizing a digital asset as a security *via* the *Howey* investment contract analysis,[20] is not boundless. The SEC has historically attempted to apply the definition of "security" broadly "to encompass virtually any instrument

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Bitcoin, Ether, Tether, Binance, and Litecoin); *CFTC v. Eisenberg*, No. 1:23-cv-00173 (S.D.N.Y. Jan. 9, 2023) (Complaint addresses USD Coin); and *CFTC v. McAfee*, No. 1:21-cv-01919 (S.D.N.Y. Mar. 5, 2021) (Complaint addresses Dogecoin). Even if assumed, for example, that Ether was a "security" under the SEC's current jurisdiction (SEC Chairman Gensler has implied such a possibility; prior SEC Director of Corporation Finance, William Hinman, stated otherwise), I believe without a more formal determination by the Commission, the Proposed Rule's economic analysis must consider the impact using a baseline that does not assume the majority of crypto assets are "securities" and thus currently within the SEC's purview (and not reflective of potentially new costs associated with the Proposed Rule).

[19] *See* Proposing Release, *supra* note 2 at pp. 272-73.

[20] *See SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

that might be sold as an investment."[21] However, the courts have frequently placed limits on the SEC's attempt to use the *Howey* test to label financial transactions it does not like as securities transactions that come within its jurisdiction.[22]

Chairman Gensler and the SEC staff often instruct market participants to look to the *Howey* factors to determine if a particular digital asset is a security.[23] In addition to *Howey*, the SEC Staff has provided guidance via the Framework for Analysis of Digital Assets (the "Framework"),[24] but then immediately undermined its usefulness with the standard caveats noting it does not have the force of law nor can it be relied upon. In truth, applying the *Howey* factors (or the Framework) to particular digital assets does not yield precise answers about whether digital assets are securities, at least not in most cases–even the SEC's Enforcement Staff appears to be unable to do it.[25] And, in a recent appearance before the House Financial Services Committee, SEC Chairman Gensler himself would not answer a direct question whether Ether was a security or not, despite the CFTC's Chairman's prior, unequivocal statement in recent testimony before the Senate Agriculture Committee that Ether is not a security.[26] As a result, companies doing business in the digital asset space are left in a difficult situation. They must do their best to comply with the limited guidance the SEC has provided[27]

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[21] *See Reves v. Ernst & Young*, 494 U.S. 56 (1990).

[22] *See, e.g., Rodriguez v. Banco Centr. Corp.*, 990 F.2d 7, 10 (1st Cir. 1993) ("The term 'securities' we are told, must be flexibly applied to capture new arrangements comprising the essence of securities, however they may be named . . . [b]ut not all property is a security, and fuzzy edges do not mean the concept is unbounded"). *See also, Long v. Schultz Cattle Co., Inc.*, 896 F.2d 85, 88 (5th Cir. 1990) (*en banc*) (recognizing "the importance of a workable definition of the term 'investment contract,' one that fully implements the remedial purposes of the Securities Acts without unduly burdening commercial enterprises that Congress never intended to be covered under the federal securities laws").

[23] *See, e.g.*, Gary Gensler, Chairman of the SEC, Remarks, *Kennedy and Crypto* (Sep. 8, 2022) ("Nothing about the crypto markets is incompatible with the securities laws . . . [w]ithout prejudging any one token, most crypto tokens are investment contracts under the Howey Test").

[24] This framework represents the views of the SEC's Strategic Hub for Innovation and Financial Technology.

[25] I note, ironically, that even the Enforcement Staff seems to have trouble applying the *Howey* Test to individual digital assets (or at minimum, seems to itself, find very few digital assets meet the definition of "security"). A good example of this is the fact that in the recent Bittrex enforcement action (*SEC v. Bittrex*, Inc., No. 2:23-cv-00580 (W.D. Wash. Apr. 17, 2023), the SEC only asserted that six of the approximately 300 digital assets listed on Bittrex are securities. Even though the Bittrex platform offers to trade many of the most popular digital assets with significant market capitalization, the six identified digital assets by the SEC amount to less than 0.20 percent of the total market capitalization for digital assets.

[26] When asked directly whether Ether was a security or a commodity, Chairman Gensler answered, "it depends on the facts and the law." *See Oversight of the SEC: Hearing Before the Fin. Serv. Comm.*, 118th Cong. (Apr. 18, 2023).

[27] *See, e.g., In re: Voyager Digital Holdings Inc.*, Case No. 22-10943 (MEW) (U.S. Bankruptcy Court, SDNY, Mar. 11, 2023) ("Voyager Bankruptcy Proceeding") (Judge Wiles, remarking as to the SEC's failure in his court room to take a clear position on this issue: "Here, I do not know how any party could possibly be expected to address the SEC's comments with the limited guidance that the SEC has provided. The SEC did not explain why the VGX token should be regarded as a security, for example, leaving me only to guess as to what the arguments might have been. Similarly, the SEC did not explain why it thought Binance.US might be operating as a securities broker."). Coinbase recently raised similar concerns regarding the SEC's unwillingness to provide guidance on the issue of whether or not a particular digital asset is a security. In the wake of receiving a Wells Notice from the SEC, Coinbase wrote, "The SEC staff told us they have identified potential violations of securities law, but little more. We asked the SEC specifically to identify which assets on our platforms they believe may be securities, and they declined to do so.

and also cope with a jurisdictional turf war[28]—knowing that after they make a decision based on this limited advice, the SEC may disagree and bring an enforcement action. As discussed above, regulation by enforcement cannot be the answer.

***b. Once a security, not always a security.*** Even if it were true that most crypto assets are securities, the *economic reality* is that most crypto assets do not trade as securities. Despite the fact that a crypto asset may have been a security at the time issued, it does not necessarily follow that trading such an asset today, it remains a security. A digital asset transaction may no longer represent a security offering, for example, when the network on which the token/coin functions is sufficiently decentralized (*i.e.*, the asset no longer fits within the "investment contract" *Howey* analysis).[29]

Moreover, a significant amount of crypto asset transactions are secondary transactions that are not between the issuer of the crypto asset and the purchaser. *Howey* explicitly requires there be an investment contract (*i.e.*, a direct contract) between the issuer or promoter of the digital asset and the purchaser or investor. No such relationship exists with regard to the transactions that occur on digital asset trading platforms; there is no such contract and there are no such direct connections between the purchaser of a digital asset who buys that digital asset on a crypto exchange and the digital asset's issuer or prompter. The digital asset platform matches buy and sell orders of digital assets, facilitating through blind bids one off transactions between people who own digital assets and people who want to buy digital assets. The issuer/promoter of the digital assets being traded is not a party to these transactions and thus there cannot be an investment contract as set forth in *Howey*.

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Today's Wells notice also comes after Coinbase provided multiple proposals to the SEC about registration over the course of months, all of which the SEC ultimately refused to respond to." *See "We Asked The SEC For Reasonable Guidance on Crypto Rules. We Got Threats Instead," available at*: https://www.coinbase.com/blog/we-asked-the-sec-for-reasonable-crypto-rules-for-americans-we-got-legal. Moreover, in declining to specify which digital assets on the Coinbase platform the SEC believed were "securities," the staff, in part, pointed to securities fraud charges the SEC previously filed against a Coinbase employee. Importantly, the SEC chose to settle this case without waiting for a fully-briefed decision on whether the digital assets transactions at issue are, in fact, securities. *See In the Matter of Coinbase, Inc.*, Wells Submission of Behalf of Coinbase Global, Inc. and Coinbase, Inc., File No. HO-14315 (Apr. 19, 2023), at note 12 and accompanying text (noting, further, that "after careful deliberation, the United States Attorney's Office for the Southern District of New York declined to bring securities fraud charges with respect to this same employee's conduct, instead electing to pursue only wire fraud charges.").

[28] "Regulators themselves cannot seem to agree as to whether cryptocurrencies are commodities that may be subject to regulation by the CFTC, or whether they are securities that are subject to securities laws, or neither, or even on what criteria should be applied in making the decision. This uncertainty has persisted despite the fact that cryptocurrency exchanges have been around for a number of years." *See*, Voyager Bankruptcy Proceeding, *supra* note 27 (Judge Wiles statement).

[29] *See, e.g.*, William Hinman, Former Director of the SEC Division of Corporation Finance, Digital Asset Transactions: *When Howey Met Gary (Plastic)*, Remarks at the Yahoo Finance All Markets Summit: Crypto (Jun. 14, 2018) ("[P]utting aside the fundraising that accompanied the creation of Ether, based on my understanding of the present state of Ether, the Ethereum network and its decentralized structure, current offers and sales of Ether are not securities transactions.").

As it stands today, trades on many digital asset trading platforms are secondary transactions, and for the reasons stated above, should not be considered securities.[30] Thus, even if the SEC is correct that most crypto assets are securities (a view I vigorously disagree with), as noted above, the economic reality is that most crypto assets do not trade as securities and accordingly, the SEC must consider in its economic analysis the significant associated impacts and costs when materially altering that economic reality.

***3. The Proposed Rule lacks required specificity and quantification of costs.*** As part of its economic analysis, the Commission states that the global market capitalization for crypto assets in 2021 was $1 trillion and acknowledges that approximately 16 percent of U.S. adults have engaged in some kind of digital asset transaction. The Proposing Release also cites to a Commission analysis of the 50 largest investment advisers, and according to which, a sizable number are currently offering or plan on offering investment advice/services related to digital assets.[31] Notwithstanding the significance of the digital asset market and the Commission's own acknowledgement of the broad use of digital assets by a large portion of the U.S. population, the economic analysis offered by the Commission in the Proposing Release is vague, notably imprecise, and lacks quantification in a variety of key aspects.[32] As a result, absent significant modifications upon adoption, the SEC's economic analysis falls far short of the Agency's legal obligations.

## III. The Proposed Rule Violates the Major Questions Doctrine

As discussed above, on balance, the Proposed Rule appears to suggest that the Commission is now a merit-based regulator and moreover, a merit-based regulator over assets other than securities–the results of which are not only untenable under the APA, but contrary to recent Supreme Court precedent (*West Virginia v. EPA*).[33] The Commission may not arrogate for itself

[30] *See, e.g.*, Motion to Dismiss in *SEC v. Wahi et al.*, Case No. 2:22-cv-01009, Doc. 33 at 13-27 (W.D. Wash. Feb. 6, 2023) (advancing the argument that secondary transactions in digital assets do not fall within the definition of an "investment contract").

[31] *See* Proposing Release, *supra* note 2 at pp. 262-64.

[32] *See, e.g.*, *id.* at pp. 271-72 (discussing, in the economic analysis, the potential costs associated with expanding the scope of the custody rule to include client assets instead of only client funds and securities, but failing to provide any attempt to estimate/quantify the associated costs). *See also id.* at note 478 (referring to the statistics cited in its review of digital asset practices of the 50 largest investment advisers and, in general, summarily dismissing significant impacts, noting that such advisers may cease providing advisory services to pooled investment vehicles that invest in digital assets, without providing any quantifiable estimates of impact). The Proposed Rule's economic analysis similarly acknowledges very significant costs and detrimental impacts to market participants, while failing to quantify such costs and generally dismissing the impacts as potential decreases in fees/profitability and/or possible decisions to shutter otherwise valuable and sustainable businesses and business models. For example, forcing investors in digital assets to withdraw assets from current qualified custodians, who presumably have developed innovative safeguarding procedures for digital assets, only to have such assets moved to lesser-equipped firms that might satisfy the new and more restrictive qualified custodian provisions under the Proposed Rule. *See id.* at pp. 269-74.

[33] *See West Virginia v. EPA*, 597 U.S. __ ; 142 S. Ct. 2587 (2022).

a policymaking function regarding a major sector of the American economy, which is specifically reserved for Congress.[34]

In *West Virginia*, the Supreme Court overturned an EPA rule which would have fundamentally transformed the way in which energy is generated in the United States. "The [EPA's] calculations resulted in numerical emissions ceilings so strict that no existing coal plant would have been able to achieve them . . . The point, after all, was to compel the transfer of power generating capacity from existing sources to wind and solar."[35]

As presented in the Proposing Release, the Proposed Rule appears to be similarly designed to fundamentally alter an industry, in this particular case, to drastically curtail or otherwise limit those companies now operating in the digital assets space. As the Supreme Court has noted,

> Agencies have only those powers given to them by Congress, and "enabling legislation" is generally not an "open book to which the agency [may] add pages and change the plot line." (Omitting citation). We presume that "Congress intends to make major policy decisions itself, not leave those decisions to agencies." (Omitting citation). ... [A]s we put it more recently, we "typically greet" assertions of "extravagant statutory power over the national economy" with "skepticism." (Omitting citation).[36]

In his concurrence, Justice Gorsuch also noted that the major questions doctrine works to protect the Constitution's separation of powers.

> In Article I, "the People", vested "[a]ll" federal "legislative powers ... in Congress." Preamble; Art. I, § 1. As Chief Justice Marshall put it, this means that "important subjects ... must be entirely regulated by the legislature itself," even if Congress may leave the Executive "to act under such general provisions to fill up the details." (Omitting citation).[37]

Finally, the Commission should take note of the significant legislative efforts currently underway in Congress to shape and govern the crypto currency eco-system. It is true that Congress has yet to agree on legislation, which it can submit to the President for his signature. This too, was contemplated by the Court in *West Virginia*. "Admittedly, lawmaking under our constitution can be difficult. But that is nothing particular to our time nor any accident. The

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[34] Note, for example, that when growing concerns arose over penny stock fraud, Congress, through legislation, took action, finding that protecting investors in *new securities* is a critical component in maintaining an honest and healthy market for such securities. *See* Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990) ("Although the Securities and Exchange Commission, State securities regulators, and securities self-regulators have made efforts to curb these abusive and harmful practices, the penny stock market still lacks an adequate and sufficient regulatory structure, particularly in comparison to the structure for overseeing trading in National Market System securities.").

[35] *See West Virginia*, *supra* note 33, Slip op. at 10.

[36] *Id.*, Slip op. at 19.

[37] *Id.*, Slip op. at 3.

framers believed that the power to make new laws regulating private conduct was a grave one that could, if not properly checked, pose a serious threat to individual liberty."[38]

As the primary federal regulator for the U.S. securities markets, a more measured and appropriate response would be for the SEC to coordinate with Congress, share its views and experiences, respond to questions using its particularized expertise, provide data (as requested), and facilitate and promote more clarity and a reasonable regulatory approach capable of promoting capital formation (including the crypto asset market).[39] What is not acceptable is the Commission's current effort, which appears to be a thinly veiled attempt to put its stamp on the merits (or apparent lack thereof) of crypto asset investments.

## IV. Responses to Particular Questions Posed by the Commission

*Response to Question 1:*

The Proposed Rule should not be expanded to include all client assets, even those that are clearly not securities, *e.g.*, artwork, real estate, precious metals, physical commodities like wheat or lumber, and cryptocurrencies that are not securities under the *Howey* test. The Commission's jurisdiction was circumscribed by Congress. Congress intended the SEC to regulate securities transactions, not become the default regulator of all financial transactions that occur in the United States.

*Response to Question 38*:

The Proposed Rule should explicitly allow state-chartered trust companies to act as qualified custodians and as custodians of crypto currencies in general. State-chartered trust companies are created and supervised by state banking departments and are examined regularly. The Proposing Release does not eliminate state-chartered trusts from the "bank" definition incorporated into the Advisers Act and thus retains their eligibility to serve as a qualified custodian. The Proposing Release fails to provide adequate support to exclude or otherwise cast doubt on the ability of these entities to serve as qualified custodians under the Proposed Rule.

*Response to Questions 41 and 42*:

The Proposed Rule should not include the "possession or control" requirement for the following reasons. One of the primary avenues through which the proposal would extend the Commission's reach into the cryptocurrency industry and enable the Commission to practically speaking, dismantle the digital asset market, is rooted in the Proposed Rule's requirement that

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[38] *Id.*, Slip op. at 4 (Gorsuch, J., concurring).

[39] Early in his SEC term, Chairman Gensler acknowledged that Congress should lead in the area of crypto regulation, stating, in part: "I do think that working with Congress, and I think it is only Congress that could really address it . . . because right now the exchanges trading in these crypto assets do not have a regulatory framework either at the SEC, or our sister agency, the [CFTC] . . . Right now, there is not a market regulator around these crypto exchanges. . . ." *See Game Stopped? Who Wins and Loses When Short Sellers, Social Media and Retail Investor Collide*, Part III, 117th Congress 1 at 12 (May 6, 2021), 167 Cong. Rec. 44-837 (2021) (statement of Gary Gensler).

an investment adviser hold clients' crypto assets in a qualified custodian's "possession or control." The SEC points to the possession or control requirement in the broker-dealer customer protection rule, Rule 15c3-3 under the Exchange Act, as support for its proposal.[40] Yet, the SEC ignores one of the main features of that rule as it relates to establishing control of customers' securities – *i.e.*, paragraph (c)(7) of Rule 15c3-3.

Under Rule 15c3-3, a broker-dealer is permitted to establish compliance with its possession or control requirement by holding customers' securities in a "control location," as defined in paragraph (c) of the rule. Like the definition of "qualified custodian," paragraph (c) of Rule 15c3-3 specifies certain acceptable control locations (*e.g.*, a bank). Recognizing the rigidity of the list of acceptable control locations, the Commission provides broker-dealers with flexibility in paragraph (c)(7) of Rule 15c3-3, by permitting a control location to include "such other locations as the Commission shall upon application from a broker or dealer find and designate to be adequate for the protection of customer securities." For over fifty years, the Commission staff has routinely worked with broker-dealers under paragraph (c)(7) to establish acceptable control locations that are not otherwise identified in paragraph (c) of Rule 15c3-3 or interpretations thereof.

The Commission should provide that same level of flexibility in the Proposed Rule, as it has done (and successfully so) under Rule 15c3-3(c)(7). Doing so will enable market participants to maintain client assets at "control locations" that are best suited for safeguarding a client's particular assets. For example, for client assets other than funds and traditional securities, the best custodians may include custodians other than qualified custodians as explicitly defined under the Advisers Act. In the crypto industry, the best solutions for safeguarding clients' crypto and digital assets may very well not include custody platforms offered by qualified custodians, such as banks, broker-dealers, and futures commission merchants.

With respect to Rule 15c3-3, I also note that the Commission and Commission staff have worked proactively to develop regulatory solutions aimed at safeguarding customers' digital assets. For example, the Commission has developed a construct for "special purpose broker-dealers" to maintain possession or control of customers' digital asset securities, which was intended to encourage innovation around the application of Rule 15c3-3 to digital asset securities. I encourage and would support the Commission's efforts toward developing a workable construct involving investment adviser custody of digital assets (including, for example, custody on digital asset platforms).

In addition to the foregoing comments, I do not support the Commission's proposed definition of "possession or control" in paragraph (d)(8) of rule 223-1. As noted above, "possession or control" is a well-established securities law concept, and I believe that if the Commission chooses to use the term in proposed rule 223-1, it should be used consistently with its longstanding meaning under the Exchange Act. Further, I strongly disagree with the Commission's characterization that custodians "effectuate the transactions" in a custodial

[40] *See* Proposing Release, *supra* note 2, at note 117.

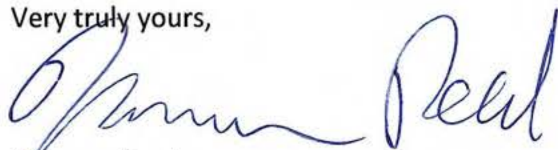
relationship and believe that the proposal redefines the activities of a custodian. Not only do I view these words as mischaracterizing a custodian's role, but I am also concerned that a custodian that effectuates transactions in securities for others runs the risk of being labeled a broker or dealer under existing Commission rules and guidance. I trust that this is not the Commission's intention.

*Response to Question 43*:
As stated above, I believe that it is incorrect to characterize a person solely performing custody services for others as effecting transactions in the assets within its custody. Hallmarks of custody are safekeeping and maintenance, and custodians use their systems and expertise to protect assets in their custody from risk of loss or theft. While a custodian may contractually agree to effect transactions in assets within its custody, movement of client assets to and from a custodian should not, in and of itself, result in a custodian being deemed to effect transactions in the assets within its custody. For example, under the Proposed Rule, the mere act of providing custody services for a client's securities would result in the custodian effecting transactions in securities for the client. This, in turn, would appear to render the custodian to be a "broker" under the Exchange Act definition of that term – *i.e.*, a broker is "any person engaged in the business of effecting transactions in securities for the account of others." Perhaps the Commission intends to use the Proposed Rule to extend its jurisdiction into the custodian space, but I believe that doing so by implying that custody involves "effecting transactions" is inappropriate. If the Commission seeks to increase the scope of custodians within its jurisdiction, I believe such a dramatic expansion of its regulatory authority into an area that has traditionally been the purview of banking regulators should be subject to Congressional approval.

**V. Conclusion**

I appreciate the opportunity to provide comments to the Commission on the Proposed Rule. I welcome the opportunity to discuss my views with you in greater detail and answer any questions that you, your respective staffs, or the Commission staff might have regarding this letter.

Very truly yours,



Norman Reed