THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 57 No. 5 March 6, 2024

POTENTIAL IMPACT OF THE SEC'S RULEMAKING AGENDA ON CRYPTO

The current SEC administration has expressed the view that most crypto assets are offered and sold as securities and has proposed several rules that address "digital asset securities" or "crypto asset securities." In this article, the authors address how certain SEC rule proposals could impact existing crypto market participants if the rules are adopted as proposed and the SEC's view that most crypto assets are offered and sold as securities prevails.

By Tiffany J. Smith and Kyle P. Swan *

Under Chair Gary Gensler, the Securities and Exchange Commission ("SEC") is engaging in an unprecedentedly active rulemaking agenda[1] that includes several rules that address "crypto asset securities." The inclusion of crypto asset securities in the SEC's rulemaking agenda is notable because of the continuing disagreement between the SEC, the crypto industry, and other financial regulators about whether most crypto assets are offered and sold as securities.

SEC officials generally take the view that the vast majority of crypto assets are offered and sold as investment contracts, a type of security.[2] Under this view, both the transaction in which the crypto asset is

[1] According to the Agency Rule List from Spring 2023, the SEC is on track to propose and finalize 63 new rules by the end of the current Chair's first four years in office. This represents a dramatic increase in the pace of rulemaking from the previous two Chairs, Chairs Mary Jo White and Jay Clayton, who finalized 22 rules and 43 rules, respectively, that they had proposed. As of September 20, 2023, of the 63 rules on Chair Gensler's docket, 16 have been proposed and finalized, 33 have been proposed but not yet finalized, and 14 have not yet been proposed. Kenneth E. Bentsen, Jr., *The Unprecedented Speed and Volume of SEC Rulemaking*, SIFMA (Sept. 21, 2023), https://www.sifma.org/resources/news/the-unprecedented-speed-and-volume-of-sec-rulemaking/.

[2] *SEC v. W. J. Howey Co*., 328 U.S. 293 (1946). *See, e.g*., Chair Gary Gensler, *"Partners of Honest Business and Prosecutors of Dishonesty": Remarks Before the 2023 Securities Enforcement Forum* (Oct. 25, 2023), https://www.sec.gov/news/speech/gensler-remarks-securities-enforcement-forum-102523; Comm'r Allison Herren Lee, *Send Lawyers, Guns and Money: (Over-) Zealous Representation by Corporate Lawyers Remarks at PLI's Corporate Governance – A Master Class 2022* (Mar. 4, 2022), https://www.sec.gov/news/ speech/lee-remarks-pli-corporate-governance-030422; Comm'r Jaime Lizarraga, *Digital Assets: Putting Investors First* (Nov. 16, 2022), https://www.sec.gov/news/speech/lizarraga-brooklyn-law-school-20221116.

* *TIFFANY J. SMITH is a partner and co-chair of the Blockchain and Cryptocurrency Working Group at Wilmer Cutler Pickering Hale and Dorr LLP's New York City office and KYLE P. SWAN is a senior associate at the same firm's Washington DC office. Their e-mail addresses are tiffany.smith@wilmerhale.com and kyle.swan@wilmerhale.com. This article was drafted in January 2024 and is current as of that time.*

RSCR Publications LLC Published 22 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $1,197 per year in U.S., Canada, and Mexico; $1,262 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call 609-683-4450; fax 609-683-7291; write Subscriber Services, RSCR Publications, PO Box 585, Kingston NJ 08528; e-mail cri.customer.service@comcast.net; or visit our website at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@gmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail sarah.s.himmelfarb@gmail.com. To submit a manuscript for publication contact Ms. Himmelfarb. Copyright © 2024 by RSCR Publications LLC. ISSN: 0884-2426. All rights reserved. Reproduction in whole or in part prohibited except by permission. For permission, contact Copyright Clearance Center at www.copyright.com. *The Review of Securities & Commodities Regulation* does not guarantee the accuracy, adequacy, or completeness of any information and is not responsible for any errors or omissions, or for the results obtained from the use of such information.

offered and sold and the intermediaries that help facilitate transactions in the asset would be subject to registration under the federal securities laws, unless an exemption is available. The crypto industry, on the other hand, disagrees that the vast majority of crypto assets are offered and sold as securities and has asked the SEC to clarify when a crypto asset is offered and sold as a security.[3] In addition, the crypto industry has described how aspects of the securities registration framework would be "impossible" for crypto companies to comply with, given the differences between crypto assets and traditional securities, and has asserted that there is currently no viable path to register a crypto intermediary with the SEC as a broker-dealer, exchange, or clearing agency.[4] Instead, many crypto firms are licensed at the state level, for example, as money transmitters. To date, the SEC has not acquiesced to the requests for additional clarity[5] or addressed the other registration and compliance concerns articulated by the crypto industry, as SEC officials insist that the law is already clear[6] and that crypto firms need to "come in and register."[7] Indeed, these questions are the crux of several ongoing U.S. federal district court cases.[8] However, the SEC's rulemaking agenda continues to feature crypto asset securities. The focus on promulgating rules for crypto asset securities was highlighted by Chair Gensler when he testified before the House of Representatives Committee on Financial Services on recent regulatory developments, rulemaking, and activities undertaken by the SEC, and in Chair Gensler's statement on the SEC's denial of a petition for rulemaking requesting that the SEC propose and adopt rules for crypto asset securities.[9]

As most relevant for crypto market participants, the SEC has proposed amendments that would further define "exchange" and "dealer," would replace the existing rule governing investment advisers' custody of client assets, and has proposed new rules that would create a federal "best execution" framework, and would govern the use of certain technologies by broker-dealers and investment advisers in investor interactions. This article describes these proposals and highlights the aspects of the proposals that crypto industry members and critics have identified as particularly difficult to implement given the differences between the crypto and traditional securities markets.

[3] *See, e.g.*, Letter from Paul Grewal, Chief Legal Officer, Coinbase Global, Inc., to Vanessa A. Countryman, Secretary, SEC, *Re: Petition for Rulemaking – Digital Asset Securities Regulation* (July 21, 2022), https://www.sec.gov/files/rules/petitions/2022/petn4-789.pdf.

[4] *See, e.g.*, *id.*; Rodrigo Seira, Justin Slaughter, and Katie Biber, Paradigm, *SEC's Path to Registration, Parts I-III*, *available at* https://policy.paradigm.xyz/writing/secs-path-to-registration-part-i.

[5] Chair Gary Gensler, *Statement on the Denial of a Rulemaking Petition Submitted on behalf of Coinbase Global, Inc.* (Dec. 15, 2023), https://www.sec.gov/news/statement/gensler-coinbase-petition-121523.

[6] Ari Levy and MacKenzie Sigalos, *SEC's Gensler says 'the law is clear' for crypto exchanges and that they must comply with regulators*, CNBC (Apr. 27, 2023), https://www.cnbc.com/2023/04/27/sec-chairman-gary-gensler-says-the-law-is-clear-for-crypto-exchanges.html.

[7] Chair Gary Gensler, *Kennedy and Crypto* (Sept. 8, 2022), https://www.sec.gov/news/speech/gensler-sec-speaks-090822.

[8] *See, e.g.*, *SEC v. Payward, Inc. and Payward Ventures, Inc.*, Case No. 3:23-cv-06003 (N.D. Cal. filed Nov. 20, 2023); *SEC v. Coinbase, Inc. and Coinbase Global, Inc.*, Case No. 1:23-cv-04738 (S.D.N.Y. filed June 6, 2023); *SEC v. Binance Holdings Limited et al.*, Case No. 1:23-cv-01599 (D. D.C. filed June 5, 2023); *SEC v. Terraform Labs PTE Ltd. and Do Hyeong Kwon*, Case No. 1:23-cv-01346 (S.D.N.Y. filed Feb. 16, 2023).

[9] Chair Gary Gensler, *Testimony Before the United States House of Representatives Committee on Financial Services* (Sept. 27, 2023), https://www.sec.gov/news/testimony/gensler-testimony-committee-financial-services-092723 ("There is nothing about the crypto asset securities markets that suggests that investors and issuers are less deserving of the protections of our securities laws."); Chair Gary Gensler, *Statement on the Denial of a Rulemaking Petition Submitted on behalf of Coinbase Global, Inc.* (Dec. 15, 2023), https://www.sec.gov/news/statement/gensler-coinbase-petition-121523.

AMENDMENTS REGARDING THE DEFINITION OF "EXCHANGE"

The Securities Exchange Act of 1934 (the "Exchange Act") and the rules thereunder define "exchange" and establish registration and operational requirements for persons operating an exchange as well as the conditions required to meet potential exemptions from registration. Under the view that most crypto assets are securities, the SEC has suggested that many crypto trading platforms should be registered even under the existing definition of "exchange"[10] (and has made this allegation in enforcement actions taken against crypto platforms). However, proposed amendments to that definition in Rule 3b-16 under the Exchange Act would greatly expand the scope of the definition of "exchange" in ways that could encompass activities of several crypto market participants, including where they participate in the development or administration of trading on decentralized finance ("DeFi") systems, and require them to register.

Current Rule 3b-16 specifies that an "organization, association, or group of persons" operates an exchange where they: "(1) [b]ring[] together the orders for securities of multiple buyers and sellers and (2) [u]se[] established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade."[11] Under Section 5 of the Exchange Act,[12] the organization, association, or group of persons operating an exchange is required to register the exchange as a "national securities exchange" pursuant to Section 6 of the Exchange Act.[13] The most common exemption from the registration requirement of Section 5 is Rule 3a1-1 under the Exchange Act,[14] which applies to a person operating an alternative trading system ("ATS") in compliance with Regulation ATS. Regulation ATS requires, among other things, registering as a broker-dealer, becoming a member of a self-regulatory organization ("SRO"), and the filing of initial and ongoing notices with the SEC regarding the operation of the ATS.

[10] Supplemental Information and Reopening of Comment Period for Amendments Regarding the Definition of "Exchange," 88 Fed. Reg. 29448, 29470 (May 5, 2023).

[11] 17 C.F.R. § 240.3b-16(a).

[12] 15 U.S.C. § 78e.

[13] 15 U.S.C. § 78f.

[14] 17 C.F.R. § 240.3a1-1.

In relevant part, the proposal would amend Rule 3b-16 to expand the definition of "exchange" to include certain systems that offer "protocols and the use of non-firm trading interest to bring together buyers and sellers of securities" (termed "communication protocol systems" by the SEC).[15] However, the proposal does little to clarify the types of protocols that would cause a platform to qualify as an exchange.[16] If the proposal is adopted, any communication protocol system would be required to register as a national securities exchange or operate under the ATS exemption from registration.

The potential breadth of this new definition by expanding "order" to "trading interest" and introducing the concept of "communication protocol systems" has led to scoping concerns from dissenters like SEC Commissioners Peirce and Uyeda.[17] "Trading interest" captures a universe of communications broader than just "orders." And "communication protocol system," could capture a number of unregistered market participants that previously were not considered to be engaged in exchange activity — even in the context of traditional securities. At the time the proposal was first published, it was unclear whether the broad definition of "exchange" was intended to capture systems that facilitate trading of crypto asset securities. The proposing release made no mention of crypto or digital

[15] Amendments Regarding the Definition of "Exchange" and Alternative Trading Systems ("ATSs") That Trade U.S. Treasury and Agency Securities, National Market System ("NMS") Stocks, and Other Securities, 87 Fed. Reg. 15496, 15496 n.5 (Mar. 18, 2022).

[16] The term "communication protocol system" is undefined, but the SEC provides a few limited examples of communications protocols in the proposing release, which include: (1) setting minimum criteria for what messages must contain; (2) setting time periods under which buyers and sellers must respond to messages; (3) restricting the number of persons a message can be sent to; (4) limiting the types of securities about which buyers and sellers can communicate; (5) setting minimums on the size of the trading interest to be negotiated; or (6) organizing the presentation of trading interest, whether firm or non-firm, to participants. *Id*. at 15507.

[17] Comm'r Hester M. Peirce, *Dissenting Statement on the Proposal to Amend Regulation ATS* (Jan. 26, 2022), https://www.sec.gov/news/statement/peirce-ats-20220126; Comm'r Mark T. Uyeda, Statement on Supplemental Information and Reopening of Comment Period for Amendments to Exchange Act Rule 3b-16 regarding the Definition of "Exchange" (Apr. 14, 2023), https://www.sec.gov/news/statement/uyeda-statement-ats-041423.

assets, which led to a number of comments questioning the proposal's application to crypto.[18] Of particular concern was the application of the registration requirement to DeFi[19] systems that include protocols to facilitate crypto trading.

A year later, the SEC published a reopening release to address explicitly the application of the proposal to crypto and DeFi systems.[20] In the reopening release, the SEC made it clear that the new definition of "exchange" was intended to be functional and technology-neutral, and that crypto trading platforms, including DeFi systems, could meet the definition of "exchange" by bringing together buyers and sellers of crypto asset securities and therefore could be required to be registered as national securities exchanges or comply with Regulation ATS.[21] The SEC expressed skepticism regarding the extent to which DeFi is decentralized (referring to it consistently as "so-called DeFi") and was resolute in its position that compliance with the registration requirements is necessary for any "organization, association, group of persons" operating an exchange — whether decentralized or not. The reopening release does not specify which DeFi participants would be required to register but also did not rule out any DeFi participant from meeting the definition of "organization, association, group of persons" that could exercise control over an exchange, including "provider(s) of the DeFi application or user interface, developers of [automated market makers] or other [] code, decentralized autonomous organizations ("DAO"), validators or miners, and issuers or holders of governance or other tokens."[22] The SEC stated that registration could be required even where those parties cannot significantly alter or control the protocol they deployed and did not rule out a developer of a protocol from being part of the "group," even when their publicly available code is deployed by someone else.[23] Critics of the proposal have questioned how diffuse and unrelated parties that develop or use these DeFi protocols could feasibly comply with the registration requirement or the ongoing regulatory requirements for exchanges and ATSs, since those requirements inherently require some level of ongoing centralized control over the protocol and its users.[24] At this time, it is unclear whether the SEC will take these concerns into account if the rule is finalized.

FURTHER DEFINITION OF "AS A PART OF A REGULAR BUSINESS" IN THE DEFINITION OF "DEALER"

The SEC also has proposed a further definition of the term "dealer" that could capture persons that engage in crypto trading activities within the registration requirement under Section 15 of the Exchange Act. In relevant part, the Exchange Act defines "dealer" as "any person engaged in the business of buying and selling securities. . . for such person's own account through a broker or otherwise."[25] Absent an exclusion from the definition of dealer or an exemption from registration, a person who meets the definition of dealer is required to register with the SEC under Section 15 of the Exchange Act, become a member of an SRO, and comply with the substantive requirements for registered dealers under the federal securities laws.[26] A person who buys or sells crypto asset securities for their own account therefore could meet the definition of "dealer" and be required to register. However, the current definition of "dealer" excludes certain persons from that definition (and the associated requirements) if they do not engage in buying and selling securities for their own account "as a part of a regular business."[27] This is commonly referred to as the "trader exclusion" from dealer registration.

The SEC has indicated that there are a number of unregistered market participants today that account for a significant share of securities market volume and engage

[18] Supplemental Information and Reopening of Comment Period for Amendments Regarding the Definition of "Exchange," 88 Fed. Reg. 29448, 29449 (May 5, 2023).

[19] DeFi generally refers to peer-to-peer financial services facilitated through public blockchain networks.

[20] Supplemental Information and Reopening of Comment Period for Amendments Regarding the Definition of "Exchange," 88 Fed. Reg. 29448 (May 5, 2023).

[21] *Id*. at 29452-53.

[22] *Id.* at 29455-56 (May 5, 2023).

[23] *Id*.

[24] *See, e.g*., Letter to Vanessa Countryman, Secretary, SEC, from Members of the U.S. House Committee on Financial Services, *Re: File No. S7-02-22, Reopening of Comment Period for Amendments to Exchange Act Rule 3b-16 Regarding the Definition of "Exchange"* (June 13, 2023), https://financialservices.house.gov/uploadedfiles/fsc_gop_letter_on_the_secs_proposed_definition_of_an_exchange_final.pdf; Comm'r Hester M. Peirce, *Rendering Innovation Kaput: Statement on Amending the Definition of Exchange* (Apr. 14, 2023), https://www.sec.gov/news/statement/peirce-rendering-inovation-2023-04-12.

[25] 15 U.S.C. § 78c(a)(5).

[26] 15 U.S.C. § 78o.

[27] 15 U.S.C. § 78c(a)(5)(B).

in activities that traditionally would require registration as a dealer.[28] With respect to crypto, the SEC already has brought and settled an enforcement action alleging unregistered dealer activity under existing interpretations of the "dealer" definition[29]; however, the proposal would specify the scope of liquidity-providing activities intended to be captured within the definition of "dealer." This test would apply whether the trading occurred in traditional securities or crypto asset securities, as the SEC explicitly stated in the proposing release that the proposal would apply to any security, including any crypto asset that is a security.[30]

As relevant here, the proposal would specify the scope of the definition of dealer by establishing a qualitative test for determining when a person is buying and selling securities "as a part of a regular business," since this determination is key to market participants taking the position that they are not required to register as a dealer. Under the qualitative test, a person is a "dealer" where they engage in a routine pattern of buying and selling securities that has the effect of providing liquidity to other market participants by:

(i) routinely making roughly comparable purchases and sales of the same or substantially similar securities in a day;

(ii) routinely expressing trading interests that are at or near the best available prices on both sides of the market and that are communicated and represented in a way that makes them accessible to other market participants; or

(iii) earning revenue primarily from capturing bid-ask spreads, by buying at the bid and selling at the offer, or from capturing any incentives offered by trading venues to liquidity-supplying trading interests.

The proposal would exclude any person that has or controls total assets of less than $50 million, as well as registered investment companies, from the tests that the proposal would establish. However, the SEC makes clear that this $50 million threshold is not a safe harbor from registering as a dealer, which is based on an analysis of the relevant facts and circumstances under existing interpretations and precedent.[31] Moreover, the SEC introduced an aggregation principle that would, for purposes of the threshold tests, aggregate the activity of accounts under common control (capturing, for example, trading activity within a corporate family or advisers managing multiple clients' assets in a way that meets the rule's definition of "control"). As a result, while high net worth crypto traders, trading firms, investment advisers, and private funds would be more likely to meet the $50 million threshold to apply the qualitative test, no one would presumptively be outside of the scope of the dealer definition. The uncertainty in how the rule should be applied could create regulatory risk for crypto liquidity providers or persons engaging with DeFi systems, which can rely on decentralized sources of liquidity, including individuals, to supply the protocol with assets to facilitate trading. Accordingly, there is a risk that even individuals, who do not seem to implicate the same concerns as other unregistered market participants, could, at least theoretically, engage in liquidity-providing or other significant and regular trading activity that would require registration as a dealer.

In addition to the costs associated with operating a registered entity, the existing securities regulatory framework may make it difficult for a crypto asset trader required to register as a dealer to continue doing business. The SEC has published guidance permitting broker-dealers to trade digital asset securities under a non-custodial model,[32] and has published a proposed

[28] Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer, 87 Fed. Reg. 23054, 23054-57 (Apr. 18, 2022).

[29] *SEC v. Beaxy Digital, Ltd., et al*., No. 1:23-cv-1962 (N.D. Ill. filed Mar. 29, 2023) (alleging that firms that provided market-making services for alleged crypto asset securities were operating as unregistered dealers in violation of Section 15(a) of the Exchange Act. Without admitting or denying the allegations in the complaint, the entities engaged in market-making services agreed to permanent injunctions prohibiting them from future violations of the securities laws alleged in the complaint and to pay civil penalties.).

[30] Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer, 87 Fed. Reg. 23054, 23057 n.36 (Apr. 18, 2022).

[31] *Id.* at 23063 ("[T]he question of whether a person that has or controls less than $50 million in total assets is acting as a dealer, as opposed to a trader, will remain a facts and circumstances determination, and to the extent consistent with the Proposed Rules, existing applicable interpretations and precedent will continue to apply.").

[32] Division of Trading and Markets, SEC, and Office of General Counsel, FINRA, *Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities* (July 8, 2019), https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities ("Generally speaking, noncustodial activities involving digital asset securities do not raise the same level of concern among the Staffs, provided that the relevant securities laws, SRO rules, and other legal and regulatory requirements are followed.").

framework to allow a "special purpose broker-dealer" with a custodial model to deal in, effect transactions in, maintain custody of, and/or operate an alternative trading system for digital asset securities.[33] However, these frameworks do not resolve all the questions surrounding broker-dealer trading in crypto asset securities, and the SEC placed limitations on the activities of a special purpose broker-dealer that would make it difficult or undesirable for any crypto trading firm to operate under that framework. For example, a special purpose broker-dealer cannot transact in non-security crypto assets (such as bitcoin), and cannot hold proprietary positions in traditional securities, except for the purposes of meeting its minimum net capital requirement,[34] or hedging risks of its proprietary positions in traditional securities and crypto asset securities. As a result, even if a crypto trading firm successfully registered as a broker-dealer and obtained SRO membership, there are challenges in applying traditional securities law concepts to the trading of crypto assets. For example, a broker-dealer is prohibited from offering or selling securities (including crypto asset securities) in a transaction that is not registered under the Securities Act of 1933 or exempt from registration — registration or common exemptions therefrom generally require the publication of information about an issuer of a security.[35] And Rule 15c2-11 under the Exchange Act[36] prohibits a broker-dealer from publishing quotations for a security absent certain current and publicly available information about an issuer of a security. To date, the vast majority of crypto assets have been offered and sold under the view that they are not securities. As a result, compliance with the offering registration requirements, or any ongoing requirements that would permit a registered broker-dealer to trade them, were not contemplated. The permissible crypto-related activities of a registered broker-dealer therefore would be restricted by the limitations of applying traditional securities rules to crypto assets that were not designed for securities law compliance as well as existing SEC guidance governing crypto asset activities.

REGULATION BEST EXECUTION

A broker-dealer's duty of best execution is a common law concept stemming from the principal-agent relationship between a broker-dealer, as agent, and its customer, as principal, requiring the broker-dealer to exercise reasonable care in executing the customer's order. SROs, such as the Financial Industry Regulatory Authority ("FINRA") and the Municipal Securities Rulemaking Board ("MSRB"), have codified essentially identical standards that members must "use reasonable diligence to ascertain the best market for the subject security and buy or sell [there] so that the resultant price to the customer is as favorable as possible under prevailing market conditions," and have established additional procedural requirements to comply with the duty of best execution.[37] To date, the SEC has not promulgated its own best execution rule but has sought to enforce the duty of best execution under the antifraud provisions of the securities laws.

Although proposed Regulation Best Execution would codify a federal standard for the duty of best execution that is essentially identical to existing SRO standards, it would require broker-dealers to adopt more prescriptive procedures that would add to what already is required of broker-dealers under SRO rules. In the proposing release, the SEC specified that Regulation Best Execution obligations would apply to all securities, including crypto asset securities, and stated that there was significant trading activity in crypto asset securities that may be occurring in non-compliance with the federal securities laws.[38] To the extent that a crypto asset is a security, any person that meets the definition of "broker" or "dealer" for that asset would be required to comply with Regulation Best Execution. The impact could be significant if the rule is adopted as proposed and enforced against crypto market participants, most of which currently take the position that they are not required to become SRO members and therefore are not subject to best execution rules applicable only to SRO members.

To comply with the SEC's best execution standard, broker-dealers would be required to, among other things, have policies and procedures addressing how it would:

(i) obtain and assess reasonably accessible information, including information about price, volume, and execution quality, concerning the markets trading the relevant securities;

(ii) identify markets that may be reasonably likely to provide the most favorable prices for customer orders ("material potential liquidity sources"); and

[33] Custody of Digital Asset Securities by Special Purpose Broker-Dealers, 86 Fed. Reg. 11627 (Feb. 26, 2021).

[34] 17 C.F.R. § 240.15c3-1.

[35] 15 U.S.C. § 77e.

[36] 17 C.F.R. § 240.15c2-11.

[37] FINRA Rule 5310; MSRB Rule G-18.

[38] Regulation Best Execution, 88 Fed. Reg. 5440, 5448-49 (Jan. 27, 2023).

(iii) incorporate material potential liquidity sources into its order handling practices and ensure that the broker-dealer can efficiently access each such material potential liquidity source.

Additionally, those policies and procedures would need to address how the broker-dealer will determine the best market and make routing or execution decisions for customer orders in consideration of factors listed by the rule.

Compliance with Regulation Best Execution would present multiple challenges for crypto market participants satisfying the definition of "broker" or "dealer" due to the differences between crypto assets and the traditional securities markets. Because there is no national market system to collect and disseminate consolidated market data for crypto transactions, as there is for the stock market, it is unclear how crypto firms would assess the markets that are reasonably likely to provide the most favorable price for customer orders. Moreover, for certain "conflicted transactions,"[39] firms would need to obtain and assess additional information to identify and evaluate additional markets, including potential liquidity sources beyond those considered to be "material" that may be smaller, less accessible, and less likely to provide best execution, to find the most favorable price. This requirement could be particularly challenging to meet in crypto markets, where liquidity can be widely dispersed among centralized exchanges, liquidity providers, and DeFi systems, among other venues.

Regulation Best Execution would provide the SEC with a mechanism to enforce more prescriptive best execution requirements on firms that meet the definition of "broker" or "dealer" irrespective of the firm's SRO membership status. Complying with Regulation Best Execution would involve consideration of standards familiar to the traditional securities markets that may not have ready analogs in the crypto markets. For example, much of Regulation Best Execution is focused on obtaining executions at or better than the midpoint price between the best available bid and ask — a concept that is more challenging to apply in the diffuse crypto markets that do not have consolidated market data that identifies the best bid price or best ask price. As a result, Regulation Best Execution threatens to make it more difficult to operate a business permitting trading of crypto assets if the SEC's view that most crypto assets are securities prevails, particularly with respect to crypto trading platforms that offer their services to retail investors, where the standards for complying with the duty of best execution would be more onerous.

SAFEGUARDING RULE

The SEC also has proposed to replace Rule 204-2 under the Investment Advisers Act of 1940 (the "Custody Rule") with new Rule 223-1 (the "Safeguarding Rule"). The Custody Rule currently requires investment advisers to safeguard client "funds and securities" in their "custody" (i.e., where they have possession or where they have authority to obtain possession of such assets). The purpose of the Custody Rule and the Safeguarding Rule is essentially the same: to mitigate the risk of loss, theft, and misappropriation of client assets. However, the Safeguarding Rule would impose several new requirements on advisers that have "custody"[40] of client assets, including crypto assets. Importantly, the Safeguarding Rule could apply to advisers with custody of crypto assets whether or not those assets are securities. While today some advisers might take the position that crypto assets are not covered by the Custody Rule — which covers only client "funds or securities" — the SEC indicated that most crypto assets are likely to be "funds or securities" covered by the Custody Rule, and the Safeguarding Rule would expand that coverage to any client "assets," which more clearly encompasses crypto assets, as it includes "funds, securities, or other positions held in a client's account."[41] The result is, unlike the other rules described in this article, the Safeguarding Rule would encompass crypto assets regardless of whether they are offered and sold as securities.

Subject to certain limited exceptions, the Safeguarding Rule would require that an adviser have in its "possession or control" client assets over which it has custody by holding the assets pursuant to a written agreement between the investment adviser and a qualified custodian such that (1) the qualified custodian is required to participate in any change in beneficial ownership of those assets, (2) the qualified custodian's participation would effectuate the transaction involved in the change in beneficial ownership, and (3) the qualified

[39] A "conflicted transaction" is "any transaction for or with a retail customer, where the broker or dealer executes an order as principal, including riskless principal; routes an order to, or receives an order from, an affiliate for execution; or provides or receives payment for order flow." Proposed Rule 1101(b).

[40] The Safeguarding Rule also would define "custody" to explicitly include where the adviser has discretionary trading authority over client assets.

[41] Safeguarding Advisory Client Assets, 88 Fed. Reg. 14672, 14676 (Mar. 9, 2023).

custodian's involvement is a condition precedent to the change in beneficial ownership.

Demonstrating exclusive possession or control of crypto assets, as required by the Safeguarding Rule, may pose challenges because, unlike traditional assets, crypto assets are held and transferred using digital wallets evidenced on a blockchain network ledger. The SEC identified that today a number of advisers that invest client funds in crypto assets may not maintain their clients' assets at a qualified custodian and instead may seek to safeguard assets themselves through self-custody solutions in a manner that would be prohibited under the Safeguarding Rule.[42] However, few repositories that meet the SEC's definition of "qualified custodian"[43] today are willing or able to custody crypto assets or perform many of the functions that support crypto transactions (e.g., staking, voting on governance proposals, and other network participation), and the Safeguarding Rule may erect additional barriers for acting as a qualified custodian by adding new conditions to maintaining custody of advisory client assets.[44]

Unregistered crypto trading platforms that advisers use to trade customer crypto assets are not qualified custodians — making it difficult to buy, sell, or hold clients' crypto assets in compliance with the Safeguarding Rule. Even in the context of qualified custodians, the SEC has identified challenges in demonstrating exclusive possession or control over private keys that control access to crypto wallets.[45] For example, private keys theoretically could be copied or held by multiple parties, including without the knowledge of other parties. As the SEC attests, demonstrating that a crypto custody arrangement with a qualified custodian meets each of the conditions set forth for "possession or control" therefore may prove challenging.[46] The SEC's concerns are amplified by the inability to reverse transactions on most blockchains, potentially making it difficult or impossible for advisory clients whose assets have been lost, stolen, or misappropriated to recover those assets — all concerns implicated by the Safeguarding Rule.[47] While the SEC sought to address the risks unique to crypto custody, compliance with the Safeguarding Rule as proposed would present significant challenges for registered investment advisers with custody of client crypto assets, as shown by the concerns raised by crypto market participants.[48]

USE OF PREDICTIVE DATA ANALYTICS BY BROKER-DEALERS AND INVESTMENT ADVISERS

The SEC's predictive data analytics proposal would require broker-dealers and investment advisers to establish policies and procedures designed to identify where the firm takes into account the firm's or its associated persons' interests in the use, or reasonably foreseeable use, of certain "covered technologies" in "investor interactions,"[49] and then to eliminate, or

[42] *Id*. at 14740.

[43] "Qualified custodian" generally includes a bank, broker-dealer, futures commission merchant, or certain foreign financial institutions that operate similar custodial businesses. 17 C.F.R. § 275.206(4)-2(d)(6).

[44] Comm'r Mark T. Uyeda, *Statement on Proposed Rule Regarding the Safeguarding of Advisory Client Assets* (Feb. 15, 2023), https://www.sec.gov/news/statement/uyeda-statement-custody-021523 ("[A]n adviser may custody crypto assets at a bank, but banks are cautioned by their regulators not to custody crypto assets. The proposing release further questions whether state-chartered trust companies providing crypto asset custody services – 'offer, and are regulated to provide, the types of protections [the Commission believes] a qualified custodian should provide under the rule….'"). And the SEC Staff has indicated that attempts by state regulators to broaden the definition of "qualified custodian" to facilitate custody of crypto assets are not binding under federal law. *Staff Statement on WY Division of Banking's "NAL on Custody of Digital Assets and Qualified Custodian Status"* (Nov. 9, 2020), https://www.sec.gov/news/public-statement/statement-im-finhub-wyoming-nal-custody-digital-assets.

[45] Safeguarding Advisory Client Assets, 88 Fed. Reg. at 14688-89.

[46] *Id*.

[47] *Id*. at 14691.

[48] Katherine Ross, *Coinbase, a16z, Blockchain Association Push Back on SEC's Proposed Custody Rule*, Blockworks (May 9, 2023), https://blockworks.co/news/coinbase-a16z-push-back-sec.

[49] For broker-dealers, "investor" means "a natural person, or the legal representative of such natural person, who seeks to receive or receives services primarily for personal, family or household purposes." For investment advisers, an "investor" means "any prospective or current client of the adviser or any prospective or current investor in a pooled investment vehicle advised by the adviser." An "investor interaction" means "engaging or communicating with an investor, including by exercising discretion with respect to an investor's account; providing information to an investor; or soliciting an investor; except that the term does not apply to interactions solely for purposes of meeting legal or regulatory obligations or providing clerical, ministerial, or general administrative

neutralize the effect of, those conflicts of interest that place the firm's or its associated persons' interests ahead of investors' interests. Although the proposal purports to address risks posed by conflicts of interest underlying advanced technologies, such as artificial intelligence, machine learning, and natural language processing, the scope of the proposed rules is much broader than that.[50] For example, "covered technology," is defined as "an analytical, technological, or computational function, algorithm, model, correlation matrix, or similar method or process that optimizes for, predicts, guides, forecasts, or directs investment-related behaviors or outcomes,"[51] and can include even mundane technologies like spreadsheets and basic financial modeling tools.[52]

The proposal has the potential to make it difficult for "investor"-facing crypto businesses that the SEC believes meet the definition of "broker," "dealer," or "investment adviser" to operate. The prescribed process for complying with the proposal would require significant operational resources and extensive documentation for firms subject to the rule, particularly for firms that are more technology-focused, as many crypto firms are today. The more technologies used by a firm, the more onerous the proposed rules would become, as firms would be required to identify each technology used directly or indirectly in an investor interaction, categorize each technology as "covered" or not "covered," identify any time the technology takes into account the firm's or its associated persons' interests, assess whether there is a conflict of interest that places the firm's or its associated persons' interests ahead of its customer's interests, and then determine how or if the firm can eliminate or neutralize the effect of the conflict of interest. The SEC conceded that sometimes it may not be possible to comply with the proposal's requirements or to eliminate or neutralize the effect of a conflict of interest and therefore firms may need to stop using certain technologies altogether.[53] As a result of the foregoing, if the rule is adopted as proposed, and the SEC's view that crypto assets are offered and sold as securities prevails, the rule could have a significant impact on the way in which crypto market participants operate.

CONCLUSION

The SEC's proposed rulemaking docket has the potential to significantly impact existing crypto markets if the view that nearly all crypto assets are offered and sold as securities prevails.[54] While there has been much focus on the SEC's enforcement actions, which generally allege violations of registration requirements, the SEC's rulemaking agenda, which could impose additional requirements on crypto market participants, is equally important. Crypto market participants should take note of the SEC's rulemaking agenda, perhaps most importantly because the SEC's recent proposals operate under assumptions that apply to the traditional securities markets. As a result, these rules (if adopted) may be difficult for crypto market participants to apply, given the differences between the crypto markets and the traditional securities markets. Crypto market participants have participated in the comment process for certain of the proposed rules, but it is unclear whether the SEC will make changes to the proposal to address the significant concerns that have been raised by commenters about the proposals' application to crypto. ■

footnote continued from previous page…

support." Proposed Rule 15l-2(a); Proposed Rule 211(h)(2)-4(a).

[50] *See, e.g.*, Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, 88 Fed. Reg. 53960, 53963-65 (Aug. 9, 2023) (referencing machine learning algorithms, such as deep learning, supervised learning, unsupervised learning, and reinforcement learning processes; natural language processing and natural language generation; and artificial intelligence and chatbots as types of complex technologies that could give rise to consequential risks of conflicts of interest that are broad in scope and scale).

[51] Proposed Rule 15l-2(a); Proposed Rule 211(h)(2)-4(a).

[52] Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers, 88 Fed. Reg. at 53977.

[53] *Id*. at 53978.

[54] And the Safeguarding Rule would apply even to crypto assets that are not securities.

The Review of Securities & Commodities Regulation

General Editor
Michael O. Finkelstein

Associate Editor
Sarah Strauss Himmelfarb

Board Members

Jay G. Baris
Sidley Austin LLP
New York, NY

John C. Coffee, Jr.
Columbia Law School
New York, NY

Ralph C. Ferrara
Proskauer Rose LLP
Washington, DC

Roberta S. Karmel
Brooklyn Law School
Brooklyn, NY

Rita M. Molesworth
Willkie Farr & Gallagher LLP
New York, NY

Anna T. Pinedo
Mayer Brown
New York, NY

Norman S. Poser
Brooklyn Law School
Brooklyn, NY

Benjamin P. Saul
GreenbergTraurig, LLP
Washington, DC