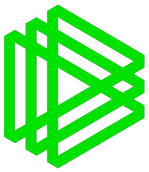

Via Electronic Mail

May 8, 2023

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

Re: File No. S7-04-23 – Safeguarding Advisory Client Assets

Dear Secretary Countryman:

Paradigm Operations LP ("Paradigm" or "we")[1] appreciates the opportunity to comment on the proposal by the Securities and Exchange Commission (the "Commission" or the "SEC") to amend and re-designate Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940, as amended (the "Advisers Act").[2] Paradigm respectfully submits that proposed Rule 223-1 (the "Proposed Rule"), if adopted, would expand the application of the custody requirements beyond what Congress intended and, in contravention of the Advisers Act, effectively prohibit (or significantly curtail) investment advisers from investing in many crypto assets on behalf of their clients.[3] The Proposed Rule would have a particularly detrimental effect

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[1] Paradigm is a registered investment adviser with approximately $8.7 billion of regulatory assets under management. Paradigm manages hedge and private equity funds that are exempt from registration under the Investment Company Act of 1940, as amended (the "Investment Company Act"). The funds invest primarily in crypto assets, crypto-related assets, crypto and crypto-related companies, projects and protocols. More information about Paradigm is available online. *See* Paradigm, https://www.paradigm.xyz/.

[2] Safeguarding Advisory Client Assets, Release No. IA-6240, Fed. Reg. No. 2023-03681 (Mar. 9, 2023) (the "Proposing Release").

[3] A crypto asset is essentially a data packet that operates on a blockchain network in accordance with the network's rules and can be allocated to an account, or "digital wallet," on the network. Each blockchain is a database maintained by a peer-to-peer network of computers, or "nodes," which keeps track of each account's ownership of the crypto assets. The majority of blockchain networks are open and "permissionless." This means that anybody may operate a node, maintain an account to hold and transfer crypto assets, and utilize digitally native decentralized applications and protocols ("dapps") on the network without the approval of any centralized network administrator. Such blockchain networks are designed to support peer-to-peer transactions between users and the disintermediated use of dapps. *See, e.g.*, Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer*

on advisory clients that affirmatively seek crypto asset investment strategies like the ones Paradigm pursues on behalf of its private funds.

For example, the Proposed Rule as written would require crypto assets to be held under the possession or control of qualified custodians. Many investment advisers (including Paradigm) generally custody crypto assets with qualified custodians when possible. At the same time, investment advisers may also exercise discretion, in accordance with their fiduciary duties, to use other custody options when, as a result of technical features, a particular crypto asset cannot be held in custody by a qualified custodian, or the technical features of a particular blockchain activity or strategy (*e.g.*, staking and interacting with dapps) may be incompatible with the services offered by a qualified custodian, or for other logistical and operational reasons. Affording advisers the ability to exercise their discretion in selecting custodial options allows advisers to earn additional returns for their clients and diversify client exposures.[4] The Proposed Rule should not preclude investment advisers from capitalizing on these opportunities.

If adopted as currently drafted, the Proposed Rule would also effectively confine investment advisers to purchasing and selling crypto assets over-the-counter and on certain non-custodial exchanges, as opposed to most centralized crypto asset trading platforms, which generally are not operated through entities that meet the definition of qualified custodian. The Proposed Rule could thus have the effect of ring-fencing investment advisers from some of the largest liquidity pools for crypto assets. The Proposed Rule should not limit investment advisers' ability to determine the most suitable trading venues to purchase and sell client assets in accordance with the duty to seek best execution.

Reducing custody options to centralized intermediaries that meet the Proposed Rule requirements would also make such intermediaries obvious targets for theft or other misappropriation.[5] The use of a few qualified custodians would magnify the impact of a failure of any single custodian's computer systems or facilities.[6] This would endanger investors without

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Electronic Cash System (2008). *See also* Marc Pilkington, *Blockchain Technology: Principles and Applications* (2016).

[4] To engage in certain activities, many blockchain networks and dapps require or incentivize network users to stake crypto assets within a protocol or smart contract, a programmable non-custodial account on the network, in accordance with preprogrammed software code parameters. Because the code of a smart contract is replicated across multiple nodes of a blockchain only if its preprogrammed software code parameters are met, smart contracts are relatively secure, permanent, and immutable, subject to risk of misappropriation or theft only as a consequence of unintended coding errors and resulting exploitations. However, under the Proposed Rule, investment advisers would be severely limited in their ability to lock or stake crypto assets as most types of staking via a qualified custodian would be impermissible. A qualified custodian would not be capable of maintaining possession or control of crypto assets that are locked within a protocol insofar as such crypto assets can only be unlocked by the protocol pursuant to its pre-determined codebase. Moreover, staked crypto assets are subject to "slashing" penalties, or programmatic losses that result from validator operator error or malfeasance but that are enforced by the protocol itself. Limiting the ability to stake crypto assets would subject such investors to dilution as new units of native crypto assets are introduced into circulation but accrue only to holders that participate in staking. *See* Scott A. McKinney, Rachel Landy & Rachel Wilka, *Smart Contracts, Blockchain, and the Next Frontier of Transactional Law*, 13 Wash. J. L. Tech. & Arts 313 (2018). *See also* Vitalik Buterin, *Ethereum: A Next-Generation Smart Contract and Decentralized Application Platform* (2014).

[5] Shlomit Azgad-Tromer, *Crypto Securities: On the Risks of Investments in Blockchain-Based Assets and the Dilemmas of Securities Regulation*, 68 AM. U. L. REV. 69 (2018).

[6] For example, to comply with the Proposed Rule's requirement that a custodian demonstrate possession or control, custodians may be required to maintain private keys offline in cold storage. If, however, crypto assets

concomitantly heightening protections for them. To put it more bluntly, this proposed change would make investors worse off.

Paradigm appreciates the opportunity to address these issues and urges the Commission to reconsider the Proposed Rule as well as the Commission's statement in the Proposing Release that "most crypto assets are likely to be securities" subject to its jurisdiction (the "Crypto Asset Interpretation").[7]

* * *

I. The Proposed Rule Contravenes the Advisers Act and the Dodd-Frank Act

A. The Advisers Act

Taken as currently written, the Proposed Rule's restrictions regarding custody providers would limit secure options for custody, create perverse incentives for crypto asset holders, and restrict access to liquidity in executing transactions. Such limitations could easily result in investment advisers ceasing to provide crypto asset advisory services to pooled investment vehicles and other types of clients.[8] The result is effectively a shadow ban of crypto, which is beyond the Commission's power under the law.

Contrary to the regulatory scheme in the Advisers Act, this effective prohibition would substitute the professional judgment of investment advisers for the judgment of the Commission concerning the suitability of particular investments for clients that have affirmatively sought exposure to those investments. In addition, it would exceed the Commission's statutory authority without a clear legislative mandate from Congress. This kind of authoritarian control of the financial markets is wholly contrary to the purpose and mission of the federal securities laws and the Commission. One shudders to imagine this being applied to other industries, including those disfavored by some future SEC Chair.

1. The Proposed Rule Is Inconsistent with the Fiduciary Nature of the Adviser-Client Relationship

The Proposed Rule does not give due weight to the nature of the regulatory scheme adopted by Congress for investment advisers in the Advisers Act, which affords investment advisers broad discretion to carry out their fiduciary obligations, subject only to the limits of anti-fraud prohibitions and the scope of the contractual duties to which advisers and their clients have agreed.

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must be removed from cold storage for a surprise audit to be conducted, private key material could be exposed and may need to be shared with third parties, which would amplify, not decrease, the risk of loss or misappropriation.

[7] *See id.* at 14676 (stating that "most crypto assets are likely to be funds or crypto asset securities covered by the current rule").

[8] *See* Proposing Release at 14742 n.487 ("To the extent these pooled investment vehicles hold crypto assets that may be outside of the current rule's scope (*i.e.*, they are neither funds nor securities), those assets would be within the scope of the proposed rule. To the extent that it becomes cost-prohibitive for advisers to find a qualified custodian, or otherwise comply with the proposed rule with respect to these newly covered crypto assets, we believe that advisers may choose to cease providing advisory services to pooled investment vehicles holding such assets, implying these pooled investment vehicles may no longer be offered to investors.").

Unlike the prophylactic, rules-based approach to the regulation of investment companies taken by Congress in the Investment Company Act of 1940, the Advisers Act does not aim to regulate the types of investments, transactions, or assets that investment advisers recommend to their clients.[9] The Advisers Act evidences a flexible, principles-based approach to regulating adviser-client relationships.[10] The legislative history indicates that the fundamental purpose of the legislation was to proscribe transactions and practices by investment advisers that served to defraud or deceive clients while preserving the "personalized character of the services of investment advisers."[11] As the Supreme Court has explained, the Advisers Act reflects a congressional recognition "of the delicate fiduciary nature of an investment advisory relationship."[12] More recently, the Commission has said that the principles-based regime in the Advisers Act has provided "sufficient flexibility to serve as an effective standard of conduct for investment advisers, regardless of the services they provide or the types of clients they serve."[13] The Proposed Rule would be at odds with this principle of investor primacy in financial decision-making by dictating what investments and investment advisory services are or are not available in the market, a role Congress never intended the Commission to assume.

Consistent with the principal-agent relationship that exists between client and investment adviser,[14] an investment adviser has a fiduciary duty to "adopt the principal's goals, objectives or ends."[15] This aspect of an investment adviser's fiduciary obligations finds its clearest expression

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[9] *See, e.g.*, 15 U.S.C. § 80a-12(a) ("It shall be unlawful for any registered investment company, in contravention of such rules and regulations or orders as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors—(1) to purchase any security on margin, except such short-term credits as are necessary for the clearance of transactions; (2) to participate on a joint or a joint and several basis in any trading account in securities, except in connection with an underwriting in which such registered company is a participant; or (3) to effect a short sale of any security, except in connection with an underwriting in which such registered company is a participant.").

[10] "The adviser's fiduciary duty is principles-based and applies to the entire relationship between the adviser and its client. The fiduciary duty follows the contours of the relationship between the adviser and its client, and the adviser and its client may shape that relationship by agreement, provided that there is full and fair disclosure and informed consent." *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248, Fed. Reg. No. 2019-12208, 2 (July 12, 2019) (the "Fiduciary Interpretation").

[11] H.R. Rep. No. 2639, 76th Cong., 3d Sess. 28 ("The essential purpose of title II of the bill is to protect the public from the frauds and misrepresentations of unscrupulous tipsters and touts and to safeguard the honest investment adviser against the stigma of the activities of these individuals by making fraudulent practices by investment advisers unlawful. The title also recognizes the personalized character of the services of investment advisers and especial care has been taken in the drafting of the bill to respect this relationship between investment advisers and their clients."). *See also* H.R. Doc. No. 477, 76th Cong., 2d Sess. ("It is the function of the profession of investment counsel to render to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments."). *See also* S. Rep. No. 1775, 76th Cong., 3d Sess. 22.

[12] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 192 (1963) (citing 2 Loss, Securities Regulation, 1412 (2d ed. 1961)).

[13] Fiduciary Interpretation at 9.

[14] *See id.* at 10 ("[T]he specific obligations that flow from the adviser's fiduciary duty depend upon what functions the adviser, as agent, has agreed to assume for the client, its principal.").

[15] *Id.* at 7-8 (quoting Arthur B. Laby, *The Fiduciary Obligations as the Adoption of Ends*, 56 Buffalo Law Review 99 (2008)) (citing Restatement (Third) of Agency, § 2.02 Scope of Actual Authority (2006) (describing a

in the duty to provide advice that is in the best interest of a client "based on the client's objectives."[16]

The consequences are particularly stark in Paradigm's case, where clients have affirmatively requested exposure to the asset class that the Proposed Rule would effectively restrict. The Proposed Rule is thus at odds with the most fundamental requirement of the Advisers Act: to allow investment advisers to determine the merits of investments so long as that determination is consistent with the adviser's fiduciary duties and the client's objectives. It seeks to substitute the views of unelected SEC staff for the enduring text of the "time-tested securities laws," to quote SEC Chair Gensler.[17]

2. The Proposed Rule Exceeds the SEC's Statutory Authority

Paradigm believes that by effectively prohibiting investment advisers from investing in many types of crypto assets, trading crypto assets on the majority of crypto asset trading platforms, staking crypto assets and using crypto assets within many dapps, the Proposed Rule exceeds the Commission's statutory authority under the Advisers Act in violation of the Administrative Procedure Act (the "APA").[18]

When it enacted the Advisers Act, Congress granted the Commission authority to promulgate rules and regulations reasonably designed to prevent fraudulent, deceptive, or manipulative acts, practices, and courses of business.[19] This broad grant of statutory authority to regulate matters pertaining to investment advisers did not, however, give the Commission unfettered discretion to determine the suitability of particular asset classes or the merits of particular investments. The Commission is empowered to implement the Advisers Act, not rewrite it.

The Commission lacks the authority to effectively ban crypto asset investment activities by rendering such investment activities violative of the Proposed Rule. The Commission seeks to assert jurisdiction over crypto assets by restricting investment advisers from engaging in a broad swath of crypto asset investment activities to the extent it is not possible to engage in such activities through a qualified custodian when the fundamental questions regarding the regulation

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fiduciary's authority in terms of the fiduciary's reasonable understanding of the principal's manifestations and objectives)).

[16] *Id.* at 8. *See also* Commissioner Hester M. Peirce, *Statement Regarding In the Matter of Aegis Capital Corporation* (July 28, 2022), https://www.sec.gov/news/statement/peirce-statement-aegis-capital-corporation-072822 (noting in an enforcement action bringing suitability charges that "[c]omplex financial instruments like [Variable Rate Structured Products] undoubtedly are unsuitable for some retail investors. Nevertheless, investors, working with their chosen financial professional, should be free to fashion their investment portfolios in the way that best suits their investment objectives and life circumstances. The Commission's orders should not intimate that certain types of investments are never suitable for particular classes of investors.").

[17] @GaryGensler, Twitter (Dec. 21, 2022), https://twitter.com/GaryGensler/status/1605753564994871297?lang=en.

[18] Under the APA, the Court "shall . . . hold unlawful and set aside agency action, findings, and conclusions" that are "in excess of statutory jurisdiction, authority, or limitations," or "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A), (C)–(D).

[19] 15 U.S.C. § 80b-6(4). For example, the Advisers Act conferred upon the Commission the authority to issue rules and regulations that "classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters. *See* 15 U.S.C. § 80b-11.

of crypto assets (and, specifically, the limits of the Commission's own regulatory jurisdiction over crypto assets) have yet to be resolved.

In *West Virginia v. EPA*,[20] the Supreme Court held that when an agency seeks to resolve a major question of economic and political significance, a "merely plausible textual basis for the agency action" is not enough.[21] Rather, "[t]he agency instead must point to 'clear congressional authorization' for the power it claims."[22] Agency actions have been held to be politically significant if Congress has "engaged in robust debates" over bills concerning the topic.[23]

The *West Virginia v. EPA* decision sheds light not only on the authority of the Environmental Protection Agency ("EPA") to regulate greenhouse gas emissions, but also on the limits of the Commission's regulatory authority. For example, the Commission's proposed rule seeking to enhance climate-related disclosures threatens to "expand its authority in a way that is almost indistinguishable from the EPA's failed attempt to seize more power than it was due."[24] Like the EPA regulation and the Commission's proposed climate change rule, the Proposed Rule would "impose changes on massive swathes of the American economy," "lie beyond the expertise of the issuing agenc[y]" and "assert[] a new understanding of an old statute to justify itself."[25] Still, the Commission's attempt to regulate crypto assets is more expansive than its attempt to regulate climate issues because it threatens to wipe out crypto asset investment activities altogether, as opposed to enhance disclosures around certain activities.

In addition, unlike the proposed climate regulations, which would incorporate measures that Congress already considered and declined to enact, the Proposed Rule attempts to usurp an issue that Congress is actively addressing. Passed in 2021, the Infrastructure and Investment Jobs Act was the first law to impact the crypto asset industry directly.[26] Since then, at least 53 bills have been introduced that seek to establish a regulatory framework for these novel digital products.[27]

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[20] 142 S. Ct. 2587, 213 L. Ed. 2d 896 (2022).

[21] *Id.* at 2609.

[22] *Id.* (quoting *Utility Air Reg. Grp. v. EPA*, 573 U.S. 302, 324, 134 S. Ct. 2427, 189 L. Ed. 2d 372 (2014)).

[23] *Id.* at 2620-21 (Gorsuch, J., concurring). *See, e.g.*, *NFIB v. OSHA*, 142 S. Ct. 661, 662-66, 211 L. Ed. 2d 448 (2022) (finding that the major questions doctrine applied when various vaccine mandate bills considered by Congress had failed, and an agency sought to mandate COVID-19 vaccines for millions of Americans).

[24] Paul Atkins and Paul Ray, *Opinion: The SEC's Climate Rule Won't Hold Up in Court*, Wall Street Journal (July 12, 2022). *See also The Enhancement and Standardization of Climate Related Disclosures for Investors*, 87 Fed. Reg. 21,334 (Apr. 11, 2022).

[25] *Id.* A February 2023 survey suggests that 20% of American adults, which would constitute 50 million people, own crypto assets. *See New survey of 2,000+ American adults suggests 20% own crypto and the vast majority see an urgent need to update the financial system*, Coinbase (Feb. 27, 2023).

[26] Infrastructure Investment and Jobs Act, 117 H.R. 3684 (2021).

[27] *See* Eliminate Barriers to Innovation Act of 2021, 117 H.R. 1602 (2021), Central Bank Digital Currency Study Act of 2021, 117 H.R. 2211 (2021), Eliminate Barriers to Innovation Act of 2021, 117 H.R. 1602 (2021), Ensuring American Global Leadership and Engagement Act, 117 H.R. 3524 (2021), Securities Clarity Act, 117 H.R. 4451 (2021), Digital Asset Market Structure and Investor Protection Act, 117 H.R. 4741 (2021), Blockchain Regulatory Certainty Act, 117 H.R. 5045 (2021), Cryptocurrency Tax Clarity Act, 117 H.R. 5082 (2021), Cryptocurrency Tax Reform Act, 117 H.R. 5083 (2021), Capital Gains Inflation Relief Act of 2021, 117 H.R. 5838 (2021), Capital Gains Inflation Relief Act of 2021, 117 S. 3153 (2021), Keep Innovation in America Act, 117 H.R. 6006 (2021), 117 S. 3206 (2021) (no official title given), 117 S. 3249 (2021) (no official title given), Adopting Cryptocurrency in Congress as an Exchange of Payment for Transactions Resolution, 117 S.

In the face of Congress's efforts to meaningfully regulate an evolving industry, the Commission's Proposed Rule is "a sign that an agency is attempting to work around the legislative process to resolve for itself a question of great political significance."[28] The Commission has yet to point to clear congressional authorization permitting it to regulate crypto assets and the use of crypto assets within blockchain network ecosystems. Since Congress has demonstrated that it remains committed to developing a regulatory framework for crypto assets, the Commission must not attempt to work around the legislative process to hastily resolve on its own the politically significant questions characterizing the crypto asset industry.

B. The Dodd-Frank Act

The Proposed Rule seeks to expand the scope of the Custody Rule from client "funds and securities" to include all client "assets" over which an investment adviser has custody. The Commission bases its expansion of the scope of the Custody Rule on the purported intent of

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Con. Res. 18 (2021), Closing Loopholes in Russia Sanctions Act of 2022, 117 H.R. 7067 (2022), Special Measures to Fight Modern Threats Act, 117 H.R. 7128 (2022), National Computer Forensics Institute Reauthorization Act of 2022, 117 H.R. 7174 (2022), Stablecoin Transparency Act, 117 H.R. 7328 (2022), Stablecoin Transparency Act, 117 S. 3970 (2022), Russia Cryptocurrency Transparency Act, 117 H.R. 7338 (2022), Russian Digital Asset Sanctions Compliance Act of 2022, 117 H.R. 7429 (2022), Digital Commodity Exchange Act of 2022, 117 H.R. 7614 (2022), Digital Commodities Consumer Protection Act of 2022, 117 H.R. 8730 (2022), Digital Commodities Consumer Protection Act of 2022, 117 H.R. 8950 (2022), Digital Commodities Consumer Protection Act of 2022, 117 S. 4760 (2022), National R & D Strategy for Distributed Ledger Technology Act of 2022, 117 H.R. 8065 (2022), National R & D Strategy for Distributed Ledger Technology Act of 2022, 117 S. 4109 (2022), 117 H.R. 8498 (2022) (no official title given), Department of State Authorization Act of 2022, 117 H.R. 8788 (2022), Combatting Financial Conflicts of Interest in Government Act, 117 H.R. 8990 (2022), Websites and Software Applications Accessibility Act, 117 H.R. 9021 (2022), Websites and Software Applications Accessibility Act, 117 S. 4998 (2022), Retirement Savings Modernization Act, 117 H.R. 9066 (2022), Retirement Savings Modernization Act, 117 S. 4973 (2022), Preventing Opportunistic Returns on Trades and Futures by Officials, Leadership, and Individuals in Office Act, 117 H.R. 9216 (2022), Crypto-Asset Environmental Transparency Act of 2022, 117 H.R. 9457 (2022), Crypto-Asset Environmental Transparency Act of 2022, 117 S. 5210 (2022), Equal Opportunity for all Investors Act, 117 S. 3921 (2022), Special Measures to Fight Modern Threats Act, 117 S. 3876 (2022), Digital Asset Sanctions Compliance Enhancement Act of 2022, 117 S. 3867 (2022), Lummis-Gillibrand Responsible Financial Innovation Act, 117 S. 4356 (2022), 117 S. 4751 (2022) (no official title given), North Korea Policy Oversight Act of 2022, 117 S. 4824 (2022), Innovative Agricultural Technology Act of 2022, 117 S. 4971 (2022), Cryptocurrency Cybersecurity Information Sharing Act, 117 S. 4985 (2022), Digital Trading Clarity Act of 2022, 117 S. 5030 (2022), Digital Asset Anti-Money Laundering Act of 2022, 117 S. 5267 (2022), Responsible Self-Regulation Act of 2022, 117 S. 5286 (2022), Venezuelan Democracy Act, 117 S. 5317 (2022), Stablecoin Transparency of Reserves and Uniform Safe Transactions Act of 2022, 117 S. 5340 (2022), Preventing Opportunistic Returns on Trades and Futures by Officials, Leadership, and Individuals in Office Act, 118 H.R. 389 (2022), and OFAC Outreach and Engagement Capabilities Enhancement Act, 118 H.R. 1164 (2022).

See also Forbes, Congress Has Introduced 50 Digital Asset Bills Impacting Regulation, Blockchain, And CBDC Policy (2022), https://www.forbes.com/sites/jasonbrett/2022/05/19/congress-has-introduced-50-digital-asset-bills-impacting-regulation-blockchain-and-cbdc-policy/?sh=2f26019b4e3f.

[28] *See Brown v. United States Dep't of Educ.*, 2022 U.S. Dist. LEXIS 205875, *29 (quoting *West Virginia*, 142 S. Ct. at 2620-21 (Gorsuch, J., concurring)).

Congress by including the term "assets" in Section 223 of the Advisers Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[29]

The legislative history of the Dodd-Frank Act, however, does not suggest that Congress intended to grant the Commission newfound authority to regulate additional client assets beyond the "funds" and "securities" covered by the existing rule. Rather, the legislative history indicates that Congress expressed a desire for investment advisers to enhance their custody practices with the Commission's supervision, an authority investment advisers had under the Advisers Act long before the Dodd-Frank Act was enacted. For example, a report by the Congressional Research Service on the rulemaking requirements in the Dodd-Frank Act casts doubt on whether the Commission was granted any new authority to regulate custody by investment advisers. The report notes that although the Dodd-Frank Act instructed investment advisers to take steps to safeguard client assets, the "SEC appears to have had this authority before the Dodd-Frank Act was enacted. Because the agency's rulemaking authority in this area has not changed, the SEC may decide not to issue any new rules. On the other hand, the agency may decide to issue new rules . . . that are the same as, or similar to, rules that the agency would have issued even if the Dodd-Frank Act had not been enacted."[30]

The lack of an express congressional mandate to expand the coverage of the existing rule to a broad new category of "assets" further supports the view that the Dodd-Frank Act was intended to leave unchanged the scope of client "funds or securities" subject to the Commission's authority under the Custody Rule. In the slew of Dodd-Frank congressional mandates ordering the Commission to promulgate rules and regulations, in each instance where a new meaning was intended to be ascribed to a term, Congress authorized the Commission to make adjustments to a definition of the term by notice and comment rulemaking or authorized the Commission to redefine the term.[31] For example, Section 413(b)(1)(B) of the Dodd-Frank Act authorized the Commission to adjust the definition of the term "accredited investor . . . by notice and comment rulemaking."[32] In addition, Section 941(a) of the Dodd-Frank Act stated, "[a]n 'asset-backed security' means (among other things) 'a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section.'"[33] By contrast, in adding Section 223 to the Advisers Act, Congress instructed not the Commission but "investment adviser[s] registered under this title [to] take such steps to safeguard client assets over which such adviser has custody." That Congress neither instructed the Commission to conduct notice and comment

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[29] *See* Section 411 of the Dodd-Frank Act, amending the Advisers Act ("An investment adviser registered under this title shall take such steps to safeguard client assets over which such adviser has custody, including, without limitation, verification of such assets by an independent public accountant, as the Commission may, by rule, prescribe.").

[30] Congressional Research Service, *Rulemaking Requirements and Authorities in the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 4 (Nov. 3, 2010), https://www.llsdc.org/assets/DoddFrankdocs/crs-r41472.pdf.

[31] *Id.* at 59-87.

[32] *Id.* at 64. *See also id.* at 72 (highlighting that Section 761(b) of the Dodd-Frank Act authorized the Commission to "by rule, further define (1) the term 'commercial risk'; (2) any other term included in an amendment to the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) made by this subtitle; and (3) the terms 'security-based swap,' 'security-based swap dealer,' 'major security-based swap participant,' and 'eligible contract participant'").

[33] *Id.* at 78.

rulemaking to define "assets" nor authorized the Commission to make such a determination on its own suggests that Congress did not intend to alter the scope of assets (*i.e.*, client "funds or securities") subject to the Custody Rule.

The legislative history also suggests that there was no discussion related to the use of the term "assets" in lieu of the phrase "funds or securities." The official report to the Senate from the committee chaired by one of the architects of the final legislation makes no mention of the revision.[34] Rather, the Senate report reflects a legislative focus on enhancing custodial protections for private funds to prevent fraud and misappropriation.[35] Had Congress intended to expand the scope of assets within the Commission's authority, discussion of the topic likely would have been reflected in the legislative history.

In the absence of persuasive legislative history to the contrary, the Commission should reconsider the weight given in the Proposing Release to a statutory term ("assets") put in place of another phrase with legal meaning ("funds or securities").[36] It seems no less likely that the difference does not reflect a congressional desire to dislodge a long-standing legal term of art but merely an economy of language and legislative draftsmanship. Prior to the issuance of the Proposed Rule, the Commission took care to preserve the common understanding of funds or securities subject to the Custody Rule established over time. For example, when the Custody Rule was amended pursuant to the Dodd-Frank Act, the Commission clarified that any use of the term "client assets" in the adopting release was "solely for ease of reference" and did not "modify the scope of client funds or securities subject to the rule."[37]

The inclusion of crypto assets in the proposed definition of "assets," even in instances where such assets are neither funds nor securities, would represent a substantial expansion of the Commission's jurisdiction to regulate non-security crypto assets. Yet an expansive reading of the term "assets" is not warranted in light of the legislative history of the Dodd-Frank Act. It is not clear that Congress considered crypto assets to be "assets" at the time. Bitcoin was in existence when the Dodd-Frank Act was enacted, yet Congress declined to extend the scope of assets under the Commission's jurisdiction to include this novel digital product. Congress did not demand a study of crypto assets as it did with other nascent technologies.[38] Further, there were no investment advisers with custody of crypto assets when Congress made amendments to the Advisers Act in 2010, which suggests that Congress did not envision the Commission regulating such assets under the existing framework. At the very least, the Commission should now consider the unique characteristics of crypto assets rather than treat them like securities or funds.

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[34] S. Rep. No. 111-176, 76-77 (2010).

[35] *Id.* (noting the provision attempted to reduce the risks of Ponzi schemes and theft by requiring money managers to keep client assets at a qualified custodian, which requirement sought to eliminate the manager's ability to "recycle" funds from new to old investors).

[36] A. Scalia & B. Garner, Reading Law: The Interpretation of Legal Texts 74 (2012) ("Words are to be understood in their ordinary, everyday meanings—unless the context indicates that they bear a technical sense.").

[37] Custody of Funds or Securities of Clients by Investment Advisers, Release No. IA-2968, 75 FR 1456, 1456 n.2 (Jan. 11, 2010), https://www.govinfo.gov/content/pkg/FR-2010-01-11/pdf/2010-18.pdf.

[38] *See* Dodd-Frank Section 967(a)(2)(D): "The study required under paragraph (1) shall, at a minimum, include the study of— . . . (D) the effect of high-frequency trading and other technological advances on the market and what the SEC requires to monitor the effect of such trading and advances on the market."

II. The Crypto Asset Interpretation

In view of the substantive, industry-wide consequences of the Commission's assertion that "most crypto assets are likely to be funds or crypto asset securities covered by the current rule," Paradigm believes that the Crypto Asset Interpretation amounts to an agency action subject to judicial review under the APA.[39] The Crypto Asset Interpretation suffers from flaws that, in Paradigm's view, result in it being an arbitrary and capricious exercise of administrative power under the body of case law interpreting the APA.[40]

The Crypto Asset Interpretation arguably constitutes a rule, rather than a mere policy statement, for purposes of the APA.[41] Whether an agency action constitutes a rule or a policy statement is determined not by reference to the label given the action by the agency, but rather by the substance of the action itself and its practical effects on affected parties.[42] Instead of expressing an interpretation of a statute or regulation as a policy statement would do, the Crypto Asset Interpretation seeks to establish a standard of conduct for the crypto asset industry as a rule does. As Commissioner Peirce observed in her statement on the Proposed Rule, "[s]uch sweeping statements in a rule proposal seem designed for immediate effect, a function proposing releases should not play. These statements encourage investment advisers to back away immediately from advising their clients with respect to crypto [and] seem to be part of a broader strategy of wishing complete jurisdiction over crypto into existence."[43] Accordingly, the manner in which the Crypto Asset Interpretation was promulgated was insufficient under the APA, which requires notice of proposed rules to be issued for public comment.[44]

In addition, the lack of explanation of the Commission's reasoning in the Crypto Asset Interpretation risks stripping the Commission of the deference typically afforded to agency actions.[45] While arbitrary and capricious review generally only requires that an agency provide a

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[39] *See* 5 U.S.C. § 551(13) (defining "agency action" to include "the whole or a part of an agency rule, order, license, sanction, relief, or the equivalent or denial thereof, or failure to act").

[40] The APA empowers courts to set aside agency actions that are found to be arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law. 5 U.S.C. § 706(2)(A).

[41] 5 U.S.C. § 551(4) expansively defines a rule as "the whole or a part of an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing the organization, procedure, or practice requirements" of the agency. Interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice are not considered to be rules for purposes of the APA. 5 U.S.C. § 553(b)(A).

[42] *See Pacific Gas & Elec. Co. v. FEC*, 506 F.2d 33, 38 (1974) ("The critical distinction between a substantive rule and a general statement of policy is the different practical effect that these two types of pronouncements have in subsequent administrative proceedings. . . . A properly adopted substantive rule establishes a standard of conduct which has the force of law . . .[By contrast, a] general statement of policy, on the other hand, does not establish a 'binding norm.' It is not finally determinative of the issues or rights to which it is addressed. The agency cannot apply or rely upon a general statement of policy as law because a general statement of policy only announces what the agency seeks to establish as policy. A policy statement announces the agency's tentative intentions for the future.").

[43] Commissioner Hester M. Peirce, *Statement on Safeguarding Advisory Client Assets Proposal* (Feb. 15, 2023), https://www.sec.gov/news/statement/peirce-statement-custody-021523.

[44] 5 U.S.C. § 553 (establishing default notice and comment requirements for "rulemaking").

[45] *See, e.g.*, *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 468 U.S. 837 (1984). *See also Encino Motorcars, LLC v. Navarro*, 136 S. Ct. 2217, 2125 (2016) ("Agencies are free to change their existing policies as long as they provide a reasoned explanation for the change."); *Pacific Gas*, 506 F.2d at 38-39 ("An

reasoned analysis for a change in policy (which the Commission did not provide in this instance), where there has been serious industry reliance on a prior policy, an agency must present a "more reasoned explanation" for "why it deemed it necessary to overrule its previous position."[46]

Notwithstanding the Commission's acknowledgement in a footnote of the applicability of *Howey* to any determination about the status of particular crypto assets, the Crypto Asset Interpretation sidesteps the prior position of its staff and the position expressed by the Commission in numerous enforcement actions that applying the *Howey* or *Reves* tests on a case-by-case basis is required to determine the "threshold issue" of whether a crypto asset is a security under the federal securities laws.[47] The Commission provides no reasoned explanation as to why it departed from its previous approach to evaluating the facts and circumstances unique to individual crypto assets to assess whether they are subject to the federal securities laws.[48] An explanation is particularly needed since the crypto asset industry has relied on the Commission's prior approach to date. The Commission's novel and sweeping statement also implies that the vast majority of crypto asset issuers, which have chosen not to register their crypto asset issuances as securities offerings, are in violation of the federal securities laws.

The Commission should explain the basis for its conclusions, including the data and legal precedent that it relied upon and its reasoning.[49] Given the tens of thousands of crypto assets in circulation, it appears unlikely that the Commission would have solid legal grounds for its assertion that "most" are likely to be funds or securities. At the very least, the Commission should analyze the facts and circumstances of a sufficient sample size of crypto assets on the market and publish its findings in the Federal Register to justify this sweeping statement. If the Commission does not provide a basis for its conclusory statement, a court may withhold the

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agency cannot escape its responsibility to present evidence and reasoning supporting its substantive rules by announcing binding precedent in the form of a general statement of policy.").

[46] *Encino Motorcars*, 136 S. Ct. at 2126. *See also FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 515 (2009) (stating that an agency must provide a detailed justification for a new policy when the "new policy rests upon factual findings that contradict those which underlay its prior policy.").

[47] *See* Proposing Release at 14676 n.29. *See* Framework for "Investment Contract" Analysis of Digital Assets (the "Framework") ("A digital asset should be analyzed to determine whether it has the characteristics of any product that meets the definition of 'security' under the federal securities laws. In this guidance, we provide a framework for analyzing whether a digital asset has the characteristics of one particular type of security—an 'investment contract.' Both the Commission and the federal courts frequently use the 'investment contract' analysis to determine whether unique or novel instruments or arrangements, such as digital assets, are securities subject to the federal securities laws."). The definitions of "security" in the federal securities laws have been subject to substantial judicial interpretation over time, most notably by the Supreme Court in *SEC v. W.J. Howey Co.* and *Reves v. Ernst & Young*, which established judicial tests to assess whether an asset or instrument is an "investment contract" or "note," respectively. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946); *Reves v. Ernst & Young*, 494 U.S. 56 (1990). Both *Howey* and *Reves* establish that the determination of whether a given asset or instrument falls into one of these types of security depends on the relevant facts and circumstances.

[48] *See, e.g.*, *SEC v. Avraham Eisenberg*, No. 1:23-cv-00503 (S.D.N.Y. Jan. 20, 2023), *SEC v. Kik Interactive*, No. 19-cv-5244 (S.D.N.Y. June 4, 2018), *SEC v. Ripple Labs, Inc. et al.*, No. 1:20-cv-10832 (S.D.N.Y. Feb. 18, 2021), and *SEC v. LBRY, Inc.*, No. 1:21-cv-00260-PB (D.N.H. Feb. 7, 2022).

[49] *See Connecticut Light & Power Co. v. NRC*, 673 F.2d 525, 530 (D.C. Cir. 1982) (explaining that the "purpose of the comment period is to allow interested members of the public to communicate information, concerns, and criticisms to the agency during the rule-making process. If the notice of proposed rule-making fails to provide an accurate picture of the reasoning that has led the agency to the proposed rule, interested parties will not be able to comment meaningfully upon the agency's proposals.").

deference usually afforded to actions by administrative agencies if the position is challenged in litigation because the Commission's categorical statement that "most crypto assets are likely to be funds or crypto asset securities" is unmoored from any legal analysis.[50]

III. Policy Considerations

When engaged in rulemaking, the Commission must consider whether an action will promote efficiency, competition, and capital formation.[51] Contrary to these purposes, the Proposed Rule would result in concentration of service providers and stifle the development of new technologies. As a consequence, the Proposed Rule poses serious threats to competition and innovation in the crypto asset industry, contrary to the explicit pro-competition goals of the Biden Administration.

The Proposed Rule imposes rigid standards that do not account for the fact that certain crypto assets may not be supported by qualified custodians, or that qualified custodians often require a period of weeks or months to implement technology that facilitates custodial services for newly launched crypto assets. Similarly, the Proposed Rule does not account for the fact that certain technical features of a particular blockchain activity or strategy, such as staking and interacting with dapps, may be incompatible with the services offered by a qualified custodian. The Proposed Rule would thus restrict an adviser from exercising its fiduciary duties to invest crypto assets or engage in activities that are in their clients' best interests – particularly those that certain clients may specifically request. Paradigm encourages the Commission to instead adopt principles-based guidelines that preserve an adviser's ability to invest in crypto assets and participate in emerging crypto protocols that are evolving at a pace that exceeds the development of custodial practices.

In addition, rather than incur the additional expense of complying with heightened requirements just to service registered investment advisers, we fear that many custodians in the crypto asset industry, such as state-chartered trust companies, state-chartered limited purpose banking entities and other entities providing platform users with the ability to transact in crypto assets, may simply decline to offer services to investment advisers. As a consequence, investors may be forced to transfer their assets to an entity that is willing to incur the additional costs of obtaining and maintaining the necessary technology but lacks the expertise associated with custodying crypto assets. In addition, it would cause custodians to incur the additional costs of developing custody services that comply with the Proposed Rule, which would then be passed on to registered investment advisers and investors.

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[50] *See American Securities Association v. Department of Labor*, No. 8:22-cv-330, 2023 U.S. Dist. LEXIS 24076 (M.D. Fl. Feb. 13, 2023) (finding arbitrary and capricious agency subguidance published in a frequently asked question that the court found inconsistent with the underlying statute and previous guidance issued by the agency). The Commission's failure to provide support for its assertions characterizing crypto tokens as securities has led at least one court to disregard the Commission's position. In a hearing concerning Voyager Digital's Chapter 11 bankruptcy plan following the collapse of FTX, Judge Wiles noted he was "absolutely shocked" by the Commission's lack of legal analysis in arguing that the plan violated securities laws without stating how. The judge noted in an order that the Commission stated that it "did not intend to offer any evidence or any further explanation as to what exactly the staff's concerns were." *In re Voyager Digital Holdings, Inc. et al.*, Case No. 22-10943-MEW (Bankr. S.D.N.Y. Mar. 15, 2023).

[51] 15 U.S.C. § 77b(b). *See also* Executive Order on Promoting Competition in the American Economy, Executive Order No. 14036 (July 9, 2021), 86 FR 36987 (July 14, 2021).

Shrinking the amount of digitally-native crypto asset custodians who have years of experience developing innovative custodial practices and forcing advisers to retain custodians who have not spent the requisite time to develop the technology needed to custody such assets would increase (rather than decrease) investors' risk of loss.[52] Such a result would contravene the stated purpose of the Proposed Rule to protect advisory clients from the misuse or misappropriation of their funds and securities by making client assets more susceptible to the risk of loss.

As a consequence, the Proposed Rule may heighten systemic risk if investment advisers must concentrate custody of crypto assets with a small number of custodians. The concentration of crypto asset custody services in the hands of only a few financial institutions, which have been less adept than digital natives at adapting to the rapid technological innovation brought about by the development of crypto assets, could hamper the creation and adoption of new custody solutions, ultimately resulting in fewer safeguards designed to meet the unique needs of crypto assets.[53] Such a result would codify discrimination against new technologies (*e.g.*, multi-party computation or "MPC") and is inconsistent with the Commission's assertions of a technology-neutral approach.[54] The Proposing Release does not indicate whether the Commission consulted with federal or state banking authorities with regard to this issue in crafting the Proposed Rule.

Moreover, as noted above, the proposed possession or control requirement likely would eliminate the ability of investment advisers to stake crypto assets on behalf of their clients. In particular, the requirement could have the unintended consequence of forcing a large amount of staked assets to be unstaked, which would make proof-of-stake blockchains less secure. This could put the crypto assets of an investment adviser's clients as well as crypto assets owned by other network participants in jeopardy by making it easier for malicious actors to orchestrate attacks on proof-of-stake networks.

Additionally, the Proposed Rule's possession or control requirement would serve to make custodians gatekeepers for the types of investments advisers can and cannot make on behalf of their clients. For example, the Proposed Rule would require qualified custodians to participate in

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[52] Proposing Release at 14741-42. For example, Coinbase Custody was launched in 2018 and has been working to address the security, regulatory, and operational challenges posed by the crypto asset market for more than six years. Coinbase Custody has custodied more than $20 billion in crypto assets for retail customers using cold storage. *See Introduction to Coinbase Custody*, https://custody.coinbase.com/Introduction-to-Coinbase-Custody.pdf. Similarly, Anchorage Digital began offering custodial services in 2017 and has devoted substantial resources to building innovative custody practices. After its $350 million Series D raise in December 2021, Anchorage Digital devoted further time and resources to developing partnerships with five of the largest institutional market participants in Asia. *See 2022: A Year of Progress—and a Decade of Maturation* (Oct. 24, 2022), https://www.anchorage.com/insights/2022-a-year-of-progress-and-a-decade-of-maturation.

[53] Proposing Release at 14742 (noting that the Proposed Rule "could cause investors to remove their assets from an entity that has developed innovative safeguarding procedures for those assets, possibly putting those assets at a greater risk of loss"). *See also* Bloomberg Law, SEC's 'Hammer' Approach to Custody Revamp Worries Money Managers (Feb. 27, 2023), https://www.bloomberglaw.com/product/securities/bloomberglawnews/bloomberg-law-news/ (noting that "the safeguarding rule may chase advisers and potentially innovative custody solutions out of the crypto space.").

[54] Paradigm further notes that the underlying policy behind the exemption from the qualified custodian requirement for "privately offered securities" is to facilitate unique forms of custody.

any change in beneficial ownership.[55] Further, if a custodian chooses not to support a particular blockchain, crypto asset type, token standard, or non-fungible token, or "NFT," collection, then an investment adviser with custody of client assets could not invest in any such out-of-scope assets for clients. This may create perverse incentives for collusion between crypto asset issuers and custodians with regard to the support of crypto assets.

The Proposed Rule also would limit the investment options available to investors, which is contrary to the core aims of both the Biden Administration and the Commission. In addition to the shrinking of domestic markets that may result if the Proposed Rule is adopted, the proposed conditions for foreign financial institutions would limit the markets available to investors who seek professional management from an investment adviser.[56] Investors will be forced to forgo investment opportunities in markets with the highest potential for growth and have less diversified portfolios overall, which is incompatible with the Biden Administration's goal of increasing competition in industries and reducing consolidation.[57]

The Proposed Rule is at odds with the Administration's promise to restore vitality and fairness to the U.S. economy.[58] President Biden specifically called on "federal agencies . . . to help restore competition" in his remarks on the Executive Order Promoting Competition in the American Economy, which called on the White House Competition Council to drive forward the Administration's effort to promote competition.[59] SEC Chair Gensler, a member of the White House Competition Council, also recognized the importance of financial intermediaries such as market makers, exchanges, and asset managers to fulfill the government's vision regarding competition.[60] Yet the Proposed Rule would consign a nascent industry to a monopoly in its infancy.

In addition, the impact will be felt most acutely in emerging markets, which generally have less developed legal and regulatory frameworks than more developed markets. Indeed, the disintermediated solutions, such as decentralized finance and other non-custodial financial applications that reduce counterparty risk and provide broad access to financial services, could be most helpful in such markets where a person may otherwise not be able to access a loan through a bank account.

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55 Proposing Release at 14689.

56 The Commission did not provide an estimate in the Proposing Release of the number of foreign jurisdictions where SEC judgments cannot be enforced.

57 White House Competition Council Homepage (July 9, 2021), https://www.whitehouse.gov/competition/.

58 "A fair, open, and competitive marketplace has long been a cornerstone of the American economy, while excessive market concentration threatens basic economic liberties, democratic accountability, and the welfare of workers, farmers, small businesses, startups, and consumers." Executive Order on Promoting Competition in the American Economy (July 9, 2021), https://www.whitehouse.gov/briefing-room/presidential-actions/2021/07/09/executive-order-on-promoting-competition-in-the-american-economy/.

59 Remarks by President Biden At Signing of An Executive Order Promoting Competition in the American Economy (July 9, 2021), https://www.whitehouse.gov/briefing-room/speeches-remarks/2021/07/09/remarks-by-president-biden-at-signing-of-an-executive-order-promoting-competition-in-the-american-economy/.

60 Chair Gary Gensler, "*Competition and the Two SECs*," *Remarks Before the SIFMA Annual Meeting* (Oct. 24, 2022), https://www.sec.gov/news/speech/gensler-sifma-speech-102422.

IV. Recommendations and Alternative Considerations

The Commission should consider tailoring the Proposed Rule to better suit the unique characteristics of crypto assets.

In particular, the Commission should consider providing an alternative compliance approach for crypto assets by expanding the exception for certain privately offered securities and physical assets, subject to heightened controls.[61] Whereas the Commission acknowledges that it may be impossible for advisers to custody certain "physical assets, such as precious metals, physical commodities and real estate," with a qualified custodian due to the "inherent physical characteristics" of the assets, the Commission does not consider that the unique features of crypto assets may present similar challenges for advisers.[62] Moreover, the Commission reasons that certain physical assets by "their very nature . . . may not easily be subject to theft or loss," and, as a result, need not be custodied with a qualified custodian.[63] However, the Commission does not acknowledge that the design of a custody solution or blockchain protocol may similarly reduce or even eliminate the risk of theft. We urge the Commission to reconsider whether certain crypto assets issued on public, permissionless blockchains could be treated similarly to "privately offered securities" that qualify for an exemption from the requirement to maintain client assets with a qualified custodian. The Commission also should reevaluate whether certain crypto assets unable to be maintained with a qualified custodian are sufficiently analogous to "physical assets" that qualify for an exemption from that requirement.

Paradigm also urges the Commission to permit arrangements through which an investment adviser can custody assets with a qualified custodian and execute transactions through a non-qualified affiliate of the custodian, subject to certain conditions. Such conditions could include requiring the custodian to prepare and disseminate an internal control report. In addition, such conditions could require the investment adviser, the custodian, and the trading platform to enter into a tripartite agreement that meets certain standards and contains undertakings similar to those that the Commission has proposed for traditional arrangements with qualified custodians under the amended rule.

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[61] The Proposed Rule would expand the "privately offered securities" exception to include certain "physical assets." The Proposed Rule would provide an exception to the requirement to maintain client assets with a qualified custodian if an adviser has custody of privately offered securities or physical assets provided the adviser meets the following conditions: (i) the investment adviser reasonably determines and documents in writing that ownership cannot be recorded and maintained (book-entry, digital, or otherwise) in a manner in which a qualified custodian can maintain possession or control transfers of the beneficial ownership of such assets; (ii) the investment adviser reasonably safeguards the assets from loss, theft, misuse, misappropriation, or the adviser's financial reverses, including the adviser's insolvency; (iii) an independent public accountant, pursuant to a written agreement between the adviser and the accountant (a) verifies any purchase, sale, or other transfer of beneficial ownership of such assets promptly upon receiving notice from the adviser of any purchase, sale, or other transfer of beneficial ownership of such assets; and (b) notifies the Commission's Division of Examinations within one business day upon finding any material; (iv) the adviser notifies the independent public accountant engaged to perform the verification of any purchase, sale, or other transfer of beneficial ownership of such assets within one business day; and (v) the existence and ownership of each of the client's privately offered securities or physical assets that are not maintained with a qualified custodian are verified during the annual surprise examination or as part of a financial statement audit during the course of performing its procedures. *See* Proposed Rule 223-1(b)(2).

[62] Proposing Release at 14704.

[63] *Id.*

Further, we urge the Commission, before finalizing any version of the Proposed Rule, to engage with crypto asset ecosystem participants, nonprofits, other financial regulators, and the general public through a series of roundtables and staff visits across the country to consider the potential implications of the rulemaking for the industry.

Finally, should the Commission adopt the Proposed Rule in some form, numerous interpretive questions will need to be resolved during the implementation period with help in the form of guidance from the Commission and its staff. For example, investment advisers will need detailed guidance specific to crypto assets about the following:

- How to reasonably safeguard crypto assets over which they would be deemed to have custody, including crypto assets that cannot be reduced to traditional forms of custody;
- How to make a reasonable determination that ownership of a crypto asset cannot be recorded and maintained in a manner in which a qualified custodian can maintain possession or control of such assets; and
- How to comply with the prohibition against commingling client assets in instances in which client crypto assets may be commingled, among other circumstances, when: (i) staking through a validator to generate larger and/or more consistent network rewards, or (ii) temporarily moving crypto assets from a custody account to facilitate trading activity.

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Paradigm appreciates the Commission's consideration of our comments and would be pleased to engage with the Commission and its staff as the Proposed Rule develops. If you have questions or would like to discuss these comments further, please reach out to us at reena@paradigm.xyz or justin@paradigm.xyz.

Sincerely,

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