

# Proposed SEC Rule Would Place Cryptocurrency Trading Platforms Under SEC Jurisdiction

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On April 14, the Securities and Exchange Commission (SEC) reopened the comment period for a January 2022 proposal that would subject cryptocurrency exchanges and decentralized finance (DeFi) platforms to the Securities Exchange Act's registration requirements. Initially, the proposed rule failed to mention cryptocurrencies at all, leading commenters during the initial comment period to inquire about the rule's applicability to digital assets. As discussed below, the SEC's reopening release provides new information regarding the proposed rule's application to cryptocurrency exchanges and DeFi platforms.

Comments to the proposed rules are now due the later of June 13, 2023, or 30 days after the SEC's proposal is published in the *Federal Register*.

## What Is a Cryptocurrency Exchange?

A cryptocurrency exchange is a marketplace that allows users to exchange cryptocurrencies for other assets, such as conventional fiat money or other digital assets. Cryptocurrency exchanges may be operated by a single entity (*i.e.*, it may be centralized) that acts as a market-maker or matches buy and sell orders.

In contrast, DeFi is an umbrella term for peer-to-peer financial services, including exchange services, that occur on a public blockchain and allows individuals to exchange goods, services, data, and funds *without* having to rely on a centralized third-party. DeFi services are provided by smart contracts that a developer (or team of developers) publishes to a blockchain. Once published, counterparties can interact with these smart contracts to facilitate transactions that are legitimate, transparent, and trustless.

## Current Rule 3b-16

The SEC's January 2022 proposal sought to amend Rule 3b-16<sup>[1]</sup> of the Exchange Act of 1934, as amended (Exchange Act), that defines when an organization, association, or group of persons meet the definition of an "exchange," as defined by section 3(a)(1) of the Exchange Act.<sup>[2]</sup>

Currently, the Rule 3b-16 states that an "organization association or group of persons" shall meet the definition of an "exchange" if such "organization, association, or group of persons (1) brings together orders for securities of multiple buyers and sellers; and (2) uses 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.”<sup>[3]</sup>

As such, Rule 3b-16 sets forth the parameters for determining whether a trading platform meets the definition of an exchange. Rule 13b-16 also gives the SEC the authority to “conditionally or unconditionally exempt any organization, association, or group of persons” from the rule’s definition. If the platform satisfies Rule 3b-16’s definition of an exchange, Section 5 of the Exchange Act requires the platform to register as a national securities exchange, unless an exemption applies.

Finally, Rule 3b-16(b) provides exemptions for when certain activities would not constitute acting as an exchange.

### **The January 2022 Proposed Amendments to Exchange Act Rule 3b-16**

The SEC’s proposal would further expand when a person may be operating as an exchange by amending Rule 3b-16 to state that such persons would be operating as an exchange when such person: “(1) brings together buyers and sellers of securities using trading interest; and (2) *makes available* established, non-discretionary methods (whether by providing a trading facility *or communication protocols*, or by setting rules) under which buyers and sellers *can interact and* agree to the terms of a trade” (newly proposed text in italics).

The proposal would also provide an additional exclusion from activities that cause a person to be acting as an exchange by adding an exemption for systems that allow an issuer to sell its securities to investors.

In the proposal, the SEC explained that communication protocols offer a nondiscretionary method for buyers and sellers to interact and agree upon the terms of a trade.<sup>[4]</sup> Such protocols, the SEC submitted, are often offered alongside a non-firm trading interest (as opposed to firm orders) to facilitate transactions between buyers and sellers of securities, thereby constituting a nondiscretionary method under Exchange Act Rule 3b-16(a).<sup>[5]</sup> Practically speaking, the addition of the term would result in cryptocurrency trading platforms becoming subject to the Exchange Act’s registration requirements.

### **The Industry’s Response to the January 2022 Proposal**

In response to the initial proposal, the SEC received many comments inquiring about the application of the proposed rule to trading systems for cryptocurrencies and DeFi. One group [noted](#) that the proposal fails to mention cryptocurrency, blockchain technology generally, or how such technology applies. Others [disputed](#) the applicability of the Exchange Act to trading activities in the absence of clear guidance as to which cryptocurrencies are securities. A separate group [commented](#) on the rule’s potential inclusion of DeFi platforms when the central feature of these platforms is that they enable peer-to-peer transactions.

On April 14, a divided SEC voted 3-2 to approve a response to the comments and reopen the comment period to solicit additional feedback to 75 specific questions about the impact and application of the proposed rules. Significantly, the commission’s reopening comment directly addresses the proposed rule’s potential application to DeFi platforms. The decision to re-open the comment period drew a sharp dissenting [statement](#) from Commissioner Hester Peirce who criticized the SEC for “doubl[ing] down on the defects identified by commenters” “rather than responding” to serious concerns.<sup>[6]</sup> Commissioner Peirce’s dissent also highlighted First Amendment concerns raised by the proposed rule, discussed further below.

## Comment Reopening Release Addresses Cryptocurrency Exchanges and DeFi

In its reopening release, the SEC addressed commenter concerns with applying the Exchange Act to cryptocurrency exchanges and DeFi platforms. With respect to cryptocurrency exchanges, commenters inquired about the applicability of the Exchange Act to cryptocurrency platforms in the absence of a clear definition of which cryptocurrencies constitute a security. In response, the SEC reiterated its view that most cryptocurrencies are securities, stating that the “section 5 of the Exchange Act[] appl[ies] to all securities” and that it is “unlikely that systems trading a large number of different crypto assets are not trading ... securities.”<sup>[7]</sup> As such, a platform facilitating cryptocurrency trades, according to the SEC, falls under the Exchange Act’s and current Rule 3b-16’s definitions of an exchange.

The question of which digital assets constitute a security is part of a longstanding debate between the SEC and crypto-industry participants. Since the initial coin-offering boom of 2017, the SEC has repeatedly brought enforcement actions against cryptocurrency offerings, alleging that the subject cryptocurrencies met the long-established definition of a security set forth in the “*Howey*<sup>[8]</sup> test,” which states that the definition of a security necessarily requires flexibility and defines a security as an “investment contract” that exists when “there is the investment of money in a common enterprise with an expectation of profits to be derived from the efforts of others”<sup>[9]</sup>. Except for bitcoin, SEC Commissioner Gary Gensler has stated his view that he considers most cryptocurrencies to be a security. This view is consistent with statements from past-Chairman Jay Clayton.<sup>[10]</sup> However, cryptocurrency proponents have also accused the SEC of failing to provide clear regulatory guidance as to what properties render a digital asset as a security and have accused the SEC of a regulation-by-enforcement approach to digital assets.<sup>[11]</sup>

The SEC also responded to commenters’ suggestions regarding DeFi platforms, including suggestions that DeFi should be excluded under the rule on account of its decentralized ownership structure. In response, the SEC submitted that the Exchange Act’s framework “is based on the functions performed by a trading system, not on its use of technology.”<sup>[12]</sup> And “because DeFi trading systems ... rely on electronic messages that are exchanged between buyers and sellers so that they can agree upon ... a trade without negotiations,” these messages could constitute a firm willingness to buy or sell a security, meeting the definition of an “order” under Rule 3b-16(c).<sup>[13]</sup> The implication is that if multiple buyers and sellers interact in such a manner on a DeFi platform, their activities would make the platform fall within Rule 3b-16(a)’s definition of an exchange.

Responding to commenters’ concerns that DeFi lacks a central administrator capable of satisfying the Exchange Act’s registration requirements, the SEC asserted that smart contracts on a blockchain require human activity that humans deploy and emphasized that an exchange exists where “a group of persons” facilitates the bringing together of buyers and sellers of securities.<sup>[14]</sup> Critical to the SEC’s assessment of whether such a group of persons performs this function is whether the persons agree, formally or informally, to act in concert in establishing, maintaining, or providing a marketplace for the purchase and sale of securities, or sharing control over aspects of a market that function like a stock exchange.<sup>[15]</sup> This group, according to the SEC, may designate a registrant for the organization, but each member is collectively responsible for ensuring that the designated member of the group fulfills its regulatory responsibilities.<sup>[16]</sup>

## Industry Reaction

The crypto industry has criticized the SEC's proposed rule on several fronts, many of which Commissioner Peirce identified in her dissent. Chief among the criticisms is that the proposed rule fails to state which cryptocurrencies constitute a security. Rather, the SEC leaves the question of which cryptocurrencies may constitute a security open, citing to both the *Howey* test and its 2017 "DAO Report,"<sup>[17]</sup> which detailed the process by which it found certain digital assets to be securities. Thus, each cryptocurrency is left to its own facts and circumstances analysis under the *Howey* test, leaving uncertainty as to which cryptocurrencies may permissibly be traded on a trading platform without becoming subject to the Exchange Act's registration requirements. Without a clearer definition of when a cryptocurrency or digital asset may be a security, the industry has argued that it cannot know when a digital asset must be registered and that this uncertainty will stifle innovation and choke the market.

The proposal also relies on the undefined term "communication protocol." As noted by Commissioner Peirce, such a term could be overbroad and creates regulatory risks for firms, which disincentivizes participation and advancement in the industry.

The proposed rule also struggles to detail how the Exchange Act's registration requirement will apply to a DeFi trading platform where there is no single point of control. This raises questions as to whether compliance with the Exchange Act is even possible. Moreover, the proposed rule applies indiscriminately to a group acting "in concert" to establish or maintain a DeFi platform, regardless of whether group members are aware of each other, and regardless of the nature of the actor's (possibly unknowing) participation in the platform's ecosystem.

Finally, the proposed rule arguably raises First Amendment concerns. Commenters [argue](#) that smart contracts, which consist of code, are protected speech, and the proposed rule's definition of an exchange creates an "inappropriately broad standard for registration." Such a broad definition, commenters argue, requires developers to self-censor, resulting in the rule operating as an "unconstitutional content-based prior restraint on speech."

The industry has argued that the collective implication of the rule, as drafted, is that it does little to increase regulatory clarity for industry participants, yet it would simultaneously require cryptocurrency platforms to comply with registration requirements, which may not be possible.

## Conclusion

The SEC has broadly indicated that it intends to continue to act against what it views as unregistered crypto asset securities and has recently [doubled](#) the size of its cryptocurrency enforcement team. As the recent enforcement action targeting former crypto exchange Bittrex<sup>[18]</sup> demonstrates, unregistered cryptocurrency platforms and contributors to DeFi platforms alike are likely to see increased enforcement activity.

As the rule is sure to continue to be hotly debated, interested parties should submit any comments on the proposal to the SEC by the closing of the comment period.

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<sup>[1]</sup> 17 C.F.R. § 240.3b-16.

[2] 15 U.S.C. 78c(a)(1): The term “exchange” means any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange.

[3] Section 240.3b-16(a).

[4] Supplemental Information and Reopening of Comment Period for Amendments to Definition of “Exchange,” Rel. No. 34-97309 (Apr. 14, 2023), <https://www.sec.gov/rules/proposed/2023/34-97309.pdf>.

[5] *Id.* at 42.

[6] Statement, Commissioner Hester M. Peirce, Securities Exchange Commission, Rendering Innovation Kaput: Statement on Amending the Definition of Exchange (Apr. 14, 2023), [https://www.sec.gov/news/statement/peirce-rendering-innovation-2023-04-12#\\_ftnref6](https://www.sec.gov/news/statement/peirce-rendering-innovation-2023-04-12#_ftnref6).

[7] Rel. No. 34-97309 (Apr. 14, 2023) at 10-11.

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

[9] *Id.* 298-299.

[10] See “Governance and Transparency at the Commission and in Our Markets,” Chairman Jay Clayton, Remarks at the *PLI 49th Annual Institute on Securities Regulation* – New York, NY, available at, <https://www.sec.gov/news/speech/speech-clayton-2017-11-08> and “Statement on Cryptocurrencies and Initial Coin Offerings,” Chairman Jay Clayton, December 11, 2017, available at, <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>.

[11] See, for example, the [recent action by Coinbase against the SEC over inaction on a rulemaking petition](#).

[12] Rel. No. 34-97309 (Apr. 14, 2023) at 17.

[13] *Id.* at 18.

[14] *Id.* at 22.

[15] *Id.* at 24.

[16] *Id.* at 126.

[17] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Release No. 81207, July 25, 2017, available at <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

[18] See “SEC Targets Bittrex, Fallen Giant of U.S. Crypto Exchanges,” *The Wall Street Journal*, April 16, 2023.

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