

## SEC's Redefinition Of 'Exchange' Would Mean More Confusion

By **Kelley Howes, Jeff Silberman and Malka Levitin** (June 5, 2023, 6:07 PM EDT)

On April 14, the U.S. Securities and Exchange Commission reopened the comment period on proposed amendments to Rule 3b-16 under the Securities Exchange Act.[1]

These amendments would significantly expand the number and type of platforms that would be subject to registration with the SEC as exchanges or broker-dealers.

An "exchange" is defined in Section 3(a)(1) of the Exchange Act to include any group of persons that "constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities ... and includes the market place and the market facilities maintained by such exchange." [2] Rule 3b-16 defines terms used in the statutory definition.

If finalized, the proposed amendments would expand certain of these terms to include systems that offer the use of communication protocols and nonfirm trading interests to bring together buyers and sellers of securities.[3]

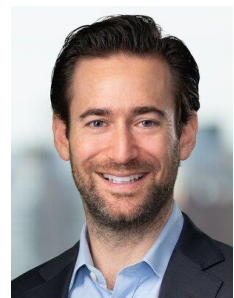
According to the SEC, such communication protocol systems, or CPSs, function similarly to marketplaces operated by registered exchanges and alternative trading systems, or ATs — but without any current obligation to register as an exchange or comply with applicable federal securities laws.

Under the proposed amendments, CPSs would be required to register with the SEC as exchanges or broker-dealers. This, the SEC believes, would extend investor protections to CPS market participants, enhance regulatory oversight, promote fair and orderly market principles, and level the regulatory disparity between like marketplaces for securities.

Stakeholders facing regulation under the amendments see them as a drastic expansion of the SEC's jurisdiction, particularly within the cryptocurrency and decentralized finance, or DeFi, space.



Kelley Howes



Jeff Silberman



Malka Levitin

## Background



The proposed amendments stem from prior amendments proposed by the SEC in 2020, which were far more limited in scope.[4] The 2020 proposal, issued under former SEC Chair Jay Clayton, was aimed at the fixed-income market for U.S. government and Treasury securities.

Among other things, the 2020 proposal would have removed the exemption from Regulation ATS for ATSs trading government securities, subjecting them to oversight by the SEC, and requiring adoption of certain investor protections — including written safeguards and procedures to protect confidential subscriber information.[5]

The 2020 proposal would have also imposed measures to increase transparency in the government securities markets, including by requiring government securities ATSs to file comprehensive public disclosures.

## Backlash

The more recent proposed amendments would extend Regulation ATS not only to government securities ATSs, but also to CPSs, which would need to either register as exchanges or register as broker-dealers and comply with Regulation ATS.

The amendments were proposed by a commission led by current SEC Chair Gary Gensler, who has been outspoken in his approach to cryptocurrency regulation. Although, in their hundreds of pages, the amendments make no mention of crypto, blockchain or DeFi, that has not stopped the crypto industry from highlighting the amendments' unmistakable subtext.

In the initial tranche of comments, many commenters called out the broad scope of the new exchange definition, its vagueness and its potential damage.[6] Commenters noted that "exchange" has long been understood to refer to marketplaces that bring together firm orders of securities buyers and sellers, using established, nondiscretionary rules to execute orders.

But the proposed amendments could capture a much wider swath of systems — including internal systems of market participants, messaging systems, request-for-quote systems, order and execution management systems, and third-party technology platforms that do not perform marketplace functions.

Many commenters requested clarity on how the existing rule applies — and how the amendments would apply — to systems trading digital asset securities, or systems using distributed ledger or blockchain technology. Moreover, while the SEC proposed to regulate CPSs, the agency neglected to define "CPS" in the proposed amendments.[7]

Commenters called on the SEC to explain the policy rationale behind the amendments, emphasizing that

their impact would be to stymie innovation and increase regulatory uncertainty for the crypto industry.[8]

The initial comment period was open for 30 days, but was reopened for an additional 30 days in May 2022, in response to significant public interest.[9]

### **The Rules Reopen**

On April 14, the SEC again reopened the comment period for the proposed amendments.

This time, the SEC issued supplemental information regarding DeFi trading systems that are currently considered exchanges, and those that would be exchanges under the amendments. The supplemental release reaffirms the SEC's well-known position that federal securities laws apply to digital assets that are securities.

According to the supplemental release, systems currently trading many digital asset securities likely qualify as exchanges, and are therefore required either to register with the SEC as national securities exchanges or to comply with the conditions of Regulation ATS. The SEC makes clear that the amendments do not affect this existing obligation.

The supplemental release also confirms that the proposed amendments to Rule 3b-16 would likely apply to some crypto trading platforms and DeFi trading systems. The SEC requests comments on how these platforms and systems could comply with the new regime that would exist under the amendments.

The SEC requests input on other items as well — including its proposal to replace the language "uses established, non-discretionary methods" with "makes available established, non-discretionary methods."

In a rousing dissent, Commissioner Hester Peirce asserted that the proposed amendments would render innovation "kaput." [10] She warned that the amendments suggest miners, validators, DeFi app providers and software developers would need to register as exchanges, and questioned whether registration is practical or possible for all of the captured categories.

Peirce further argued that the requirement to obtain SEC approval to form a group is a First Amendment violation. In a separate statement, Gensler hailed the proposed amendments as a tool to modernize the SEC's regulations.[11]

### **The Bigger Picture**

Gensler's determination to regulate the crypto industry is old news. In June 2022, he nearly doubled the size of the SEC's Cyber Unit and renamed it the Crypto Assets and Cyber Unit. That unit has continued to expand the number and kinds of cases the SEC pursues in the crypto space.

For example, in March, the SEC served a subpoena to Sushi, a decentralized autonomous organization that runs the SushiSwap decentralized exchange.[12] And on April 17, the SEC charged Bittrex, a crypto trading platform, with acting as an unregistered exchange.[13]

The proposed amendments, as currently drafted, would significantly expand the types and number of systems captured by the definition of "exchange," increasing the SEC's oversight to reach market

participants that may currently believe they are outside the bounds of SEC regulation.

But it would do so without defining what a CPS is, or providing examples of such a system — thereby exposing market participants to unnecessary regulatory risk and increased operational confusion.

This perpetuates, rather than resolves, the lack of regulatory clarity available to issuers and users of digital asset securities in the U.S. market, and further increases the likelihood that issuers and users will seek to operate outside the U.S. capital markets. Indeed, the release notes that the proposed amendments may "raise barriers to entry ... or create incentives to exit the market."<sup>[14]</sup>

While acknowledging the potential adverse impact on innovation and competition, the SEC contends that such adverse effects may be mitigated, and, in any event, are outweighed by the additional protections for investors and markets. However, additional compliance costs, together with the regulatory risk and attendant exposure to SEC enforcement, may stifle innovation.

Stakeholders may therefore want to consider commenting on the amendments to try to get additional clarity through the rulemaking process before the SEC comes calling with a subpoena. Comments will be accepted until June 13.

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*Kelley Howes is a partner and co-chair of the investment management group at Morrison Foerster LLP.*

*Jeff Silberman is a partner and co-chair of the financial services group at the firm.*

*Malka Levitin is an associate at the firm.*

*Morrison Foerster partners Michael Birnbaum and Haima Marlier and senior of counsel Hillel T. Cohn contributed to this article.*

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[1] <https://www.sec.gov/news/press-release/2023-77>; <https://www.govinfo.gov/content/pkg/FR-2022-03-18/pdf/2022-01975.pdf>.

[2] See 15 U.S.C. 78c(a)(1).

[3] See 87 Fed. Reg. 15498. The SEC also proposed conforming amendments to Regulation ATS to account for systems that would be newly captured by the definition of "exchange" and would operate as ATSS.

[4] <https://www.sec.gov/news/press-release/2020-227>.

[5] Regulation ATS allows an ATS to register as an exchange under Section 6 or as a broker-dealer under Section 15(b). Given the burdens of exchange registration, most ATSS opt to register as broker-dealers.

[6] <https://www.sec.gov/comments/s7-02-22/s70222.htm>.

[7] See, e.g., comments from the Global Digital Asset & Cryptocurrency Association, Coinbase Global Inc. and Fidelity Capital Markets.

[8] See, e.g., comments from the Crypto Council for Innovation, Bloomberg LP, the Investment Company Institute, and the Securities Industry and Financial Markets Association.

[9] <https://www.sec.gov/news/press-release/2022-82>.

[10] <https://www.sec.gov/news/statement/peirce-rendering-innovation-2023-04-12>.

[11] <https://www.sec.gov/news/statement/gensler-statement-ats-041423>.

[12] <https://www.coindesk.com/policy/2023/03/21/sushi-dao-key-contributor-served-with-sec-subpoena/>.

[13] <https://www.sec.gov/litigation/complaints/2023/comp-pr2023-78.pdf>.

[14] Supplemental Information and Reopening of Comment Period for Amendments to Exchange Act Rule 3b-16 Regarding the Definition of "Exchange," SEC Rel. No. 34-97309 (April 14, 2023), at p. 139.