



BETTER MARKETS

Electronically Filed

June 13, 2023

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

Re: Supplemental Information and Reopening of Comment Period for Amendments Regarding the Definition of “Exchange” (File No. S7-02-22); 88 Fed. Reg. 29,448 (May 5, 2023) (“2023 Proposal”)

Dear Ms. Countryman:

Better Markets¹ appreciates the opportunity to provide additional comment on the reopening of the comment period for amendments regarding the definition of “exchange” and Alternative Trading Systems (“ATs”), which was originally published by the Securities and Exchange Commission (“SEC” or “Commission”) in the Federal Register on March 18, 2022 (“2022 Proposal”).² The 2022 Proposal is now being reopened for comment to include supplemental information and economic analysis regarding trading systems that trade crypto asset securities and the definition of “exchange.”³

The supplemental information and economic analysis provides additional information in response to requests by several commentors about the application of the 2022 Proposal to cryptocurrency securities exchanges as well as trading systems that utilize distributed ledger or

¹ Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans’ jobs, savings, retirements, and more.

² Amendments Regarding the Definition of “Exchange” and Alternative Trading Systems (ATs) That Trade U.S. Treasury and Agency Securities, National Market System (NMS) Stocks, and Other Securities, 87 Fed. Reg. 15,496 (Mar. 18, 2022).

³ Supplemental Information and Reopening of Comment Period for Amendments Regarding the Definition of “Exchange,” 88 Fed. Reg. 29,448 (May 5, 2023).

blockchain technology, including decentralized finance (“DeFi”).⁴ The 2023 Proposal reiterates the standing position of the Commission, repeatedly expressed on numerous occasions,⁵ that trading systems that bring together multiple buyers and sellers of cryptocurrency securities using established, non-discretionary methods meet the definition of an “exchange” under Section 3(a)(1) of the Exchange Act and Exchange Act Rule 3b-16(a) and are therefore subject to the exchange regulatory framework.⁶ Further, the 2023 Proposal clearly finds that the proposed amendments in the 2022 Proposal would not change any existing obligation of these cryptocurrency securities exchanges “to register as a national securities exchange or comply with the conditions to an exemption to such registration, such as Regulation ATS.”⁷ However, the 2023 Proposal does acknowledge that the amendments to Regulation ATS in the 2022 Proposal would potentially require additional cryptocurrency securities exchanges to register as a national exchange, specifically those that “offer the use of non-firm trading interest and provide non-discretionary protocols to bring together buyers and sellers of crypto assets securities.”⁸

As we state in our original letter⁹ in response to the 2022 Proposal, which we fully incorporate herein by reference, we believe the Commission has developed a strong proposal that would represent another important enhancement and incremental step in the oversight of exchanges and ATSs. If adopted, it will help the Commission’s regulatory framework keep pace with the increased use of electronic trading venues and innovations in facilitating the purchasing and selling of securities in our markets. The Proposal will move our regulatory regime another step closer to full transparency, fair competition, and above all, stronger investor protections in the realm of exchanges, ATSs, and the associated activities of their broker-dealer operators. And to the extent the 2022 Proposal brings more cryptocurrency platforms within the scope of the

⁴ Release at 29,449.

⁵ SEC, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (2017); Zachary Coburn, Exchange Act Release No. 84553 (Nov. 8, 2018); Poloniex, LLC, Exchange Act Release No. 92607 (Aug. 9, 2021); *SEC v. Beaxy Digit., Ltd., et al.*, No. 1:23-cv-1962 (N.D. Ill. Mar. 29, 2023); *SEC v. Bittrex, Inc., Bittrex Glob. GmbH, and William Hiroaki Shihara*, No. 2:23-cv-00580 (W.D. Wash. April 17, 2023); *SEC v. Binance Holdings Ltd., BAM Trading Servs. Inc., BAM Mgmt. US Holdings Inc., and Changpeng Zhao*, No. 1:23-cv-01599 (D.C. June 5, 2023); *SEC v. Coinbase, Inc. and Coinbase Glob., Inc.*, No. 1:23-cv-4738 (S.D.N.Y. June 6, 2023).

⁶ Release at 29,450 – 29,451, *citing* DAO 21(a) Report at 17 (“The Platforms that traded DAO Tokens appear to have satisfied the criteria of Rule 3b-16(a) and do not appear to have been excluded from Rule 3b-16(b).”); In the Matter of Zachary Coburn, Securities Exchange Act Release No. 84553 (Nov. 8, 2018) (settled cease-and-desist order); In the Matter of Poloniex, LLC, Securities Exchange Act Release No. 92607 (Aug. 9, 2021) (settled cease-and-desist order).

⁷ Release at 29,451.

⁸ Release at 29,451.

⁹ Better Markets Comment Letter to the SEC on 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. 15,496 (Mar. 18, 2022) (“Better Markets 2022 Letter”), <https://www.sec.gov/comments/s7-02-22/s70222-20124015-280146.pdf>.

securities laws governing exchanges, it will provide especially important protections, as the crypto marketplace continues to be “rife with fraud, abuse, and noncompliance.”¹⁰

Accordingly, we again urge the Commission to complete this rulemaking and not be swayed by the often-hyperventilated arguments from those commenters representing the cryptocurrency industry and their apparent sense of entitlement to a perpetual regulatory sandbox or immunity from well-established, long-standing securities laws and regulations.

COMMENTS

The U.S. capital markets are the broadest, deepest, and most liquid capital markets in the world. Their success is due largely to foundational securities laws and the extensive regulatory framework that has grown out of those laws over the past 90 years, bringing vitally important investor protection, transparency, and stability to the securities markets. Despite illusory claims by the cryptocurrency industry to the contrary, the Commission has routinely made it clear that a majority of cryptocurrency assets meet the definition of a “security” under U.S. securities law.¹¹ Therefore, any organization, association, or group of persons that facilitates the purchasing and selling of securities on their platform appropriately falls under the definition of an “exchange” and must register with the Commission, unless an exemption such as Regulation ATS is appropriate. The approach taken by the Commission, and reiterated in the 2023 Proposal, is consistent with the well-established, long-standing securities laws and regulations. Any attempt to carveout cryptocurrency securities from securities laws and regulations would violate the congressionally mandated mission of the Commission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.

1. The Exchange Act’s definition of an exchange is intentionally broad to encompass new technologies such as digital assets

The Securities Exchange Act of 1934 is a foundational securities law that has governed our securities markets for the last 90 years, in part, because it was drafted broadly to encompass innovation in the financial markets. The 2023 Proposal, consistent with past findings of the

¹⁰ Gary Gensler, Chairman, SEC, ‘We’ve Seen This Story Before’ Remarks before the Piper Sandler Global Exchange and Fintech Conference (June 8, 2023), <https://www.sec.gov/news/speech/gensler-remarks-piper-sandler-060823>.

¹¹ See, e.g., SEC, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (2017); SEC Strategic Hub for Innovation and Financial Technology, Framework for ‘Investment Contract’ Analysis of Digital Assets (Mar. 8, 2023), <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets>; *SEC v. Telegram Group Inc., and TON Issuer Inc.*, No. 1:19-cv-9439 (S.D.N.Y. 2020); *SEC v. LBRY, Inc.*, No. 1:21-cv-00260-PB (D.N.H. 2021); *SEC v. Kik Interactive Inc.*, 1:19-cv-5244 (S.D.N.Y. 2019); see also Jesse Coghlan, *SEC Lawsuits: 68 cryptocurrencies are now seen as securities by the SEC*, COIN TELEGRAPH (June 6, 2023) (The article lists a compilation of 55 crypto tokens that the SEC has found or alleged through various enforcement actions as “securities” for purposes of securities law. Additionally, the article cites an additional 13 Mirror Protocol mAssets that the SEC has found or alleged meet the definition of a “security”), <https://cointelegraph.com/news/sec-labels-61-cryptocurrencies-securities-after-binance-suit>.

Commission, appropriately recognizes and reiterates that many cryptocurrency security trading systems, including self-proclaimed DeFi systems, operate like an exchange as defined under the Exchange Act and are subject to the securities exchange regulatory framework.¹² Additionally, the Commission appropriately recognizes that the amendments to Rule 3b-16(a), as proposed in the 2022 Proposal, “do not change the obligation for these systems to register as a national securities exchange or comply with the conditions to an exemption to such registration, such as Regulation ATS.”¹³ These conclusions by the Commission are consistent with the plain text of the Exchange Act and the intent of Congress to use broad and flexible terms in the provisions of the Act.

A plain text reading of the Exchange Act’s definition of an “exchange” makes it clear that most cryptocurrency securities trading systems must register as an exchange or comply with an exemption such as Regulation ATS. The term “exchange” is defined in the Exchange Act as:

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.¹⁴

Further, Section 5 of the Exchange Act requires any organization, association, or group of persons that meet the definition of an “exchange” to register with the Commission as such, unless otherwise exempt.¹⁵ Thus, any platform or protocol that provides a marketplace for the purchasing and selling of *any security*, including cryptocurrency securities, should be required to register with the Commission. Any carveouts from the requirement to register as an exchange, or comply with Regulation ATS, for cryptocurrency securities would violate the plain text of the statute.

When it passed Exchange Act, Congress clearly foresaw the need to deploy flexible rather than rigid concepts, to accommodate changes in the securities markets and to thwart the ever-present desire among some to evade the law. Congress thus envisioned that some promoters would seek to exempt new asset classes, such as cryptocurrency securities, from the exchange regulatory framework simply on the basis they were somehow too novel or innovative to fit into existing securities law. In the Senate report language accompanying passage of the Exchange Act, the authors of the bill saw the need to address these challenges:

From the outset, [The Committee on Banking and Currency] has proceeded on the theory that so delicate a mechanism as the modern stock exchange cannot be regulated efficiently under a rigid statutory program. Unless considerable latitude is allowed for the exercise of administrative discretion, it is impossible to avoid, on the one hand, unworkable ‘strait-jacket’ regulation and, on the other, loopholes which may be penetrated by slight variations in the method of doing business.

¹² Release at 29,450.

¹³ Release at 29,451.

¹⁴ 15 U.S.C. § 78c(a)(1).

¹⁵ 15 U.S.C. § 78e.

Accordingly it is essential to entrust the administration of the act to an agency vested with power to eliminate undue hardship and to prevent and punish evasion.¹⁶

If Congress had intended the definition of an exchange to be narrowly construed, then the Commission would never have been able to apply the law to the many platforms for trading securities that have developed over the last 90 years. If the definition of “exchange” were a rigid, “strait-jacket” regulatory concept, it would only apply to the physical trading of stock certificates on the floor of exchanges. It is for this reason that the definition of exchange within the Exchange Act gave wide latitude for administrative discretion, to account for the inevitable and foreseeable variations in the methods of trading securities.

The Commission must not be dissuaded from applying the broad statutory definition of an exchange to a variety of emerging platforms that perform what is in reality an exchange function. The simple fact bears repeating that most cryptocurrencies meet the definition of a security; hence cryptocurrency trading systems that facilitate the trading of such cryptocurrency securities must register with the Commission as an exchange or comply with Regulation ATS.

2. The SEC should carefully review claims of “decentralized finance” blockchains

One of the hallmarks of the creation of Bitcoin, the first cryptocurrency and largest in terms of market cap, was that it could enable peer-to-peer transfers of electronic cash without the need of financial intermediaries.¹⁷ However, over time, many other cryptocurrency tokens seeking to duplicate Bitcoin’s decentralized dream have coopted and corrupted the term “decentralized” within the context of DeFi. Today, there are countless cryptocurrency projects that claim to be decentralized, yet upon closer inspection, require numerous persons and organizational structures to carryout day-to-day functions of the enterprise. The Commission must not simply accept the thinly-veiled claims of decentralization by DeFi cryptocurrency proponents, but should rigorously apply the plain text of the securities laws and regulations in determining if they meet the definition of “exchange” on a facts and circumstances basis.

In the 2023 Proposal, the Commission appropriately recognizes and makes clear that the exchange regulatory framework is technologically neutral, stating that the “exchange framework is based on the functions performed by the trading system, not on its use of technology.”¹⁸ From the early days of trading physical stock certificates on the floor of the stock exchange to the automated electronic portal trading on the internet to the algorithmic trading of high-frequency trading, the securities laws have remained essentially agnostic to the specific type of technology used to bring purchasers and sellers together. The use of DeFi trading systems and smart contracts should be subject to the same standards as every other trading system that has been developed in the last 90 years for trading securities. Accordingly, the Commission should firmly maintain its facts and circumstances approach to determine, based on economic realities and not labels, whether

¹⁶ S. Rep. No. 73-792, at 5 (1934).

¹⁷ See generally Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* (Oct. 31, 2008).

¹⁸ Release at 29,452.

or not a specific platform meets the definition of an “exchange” under the Exchange Act and requires registration with the Commission.

Too often cryptocurrency projects’ claims of decentralization are simply an illusion. A cursory review of many DeFi trading systems often finds that an organization or foundation has been set up to maintain the functioning of the project or that the governance tokens associated with the project are held by a select few digital wallets with outsized corporate governance power. For example, more than 96% of the governance tokens of one of the most popular decentralized cryptocurrency exchanges, Uniswap, are held by the top 1% of addresses.¹⁹ Can a project be “decentralized” if 96% of the governance power, in the form of tokens, rests with such a small number of wallets? Even Bitcoin—regarded by some as “decentralized”—still requires at least some coordination between a close group of “maintainers” who are empowered to write code into the software that underpins the network.²⁰ Hence, the Commission must perform rigorous analysis, based on the facts and circumstances and the underlying economic realities, to determine whether or not the level of decentralization is truly sufficient to remove the platform or system from the statutory definition of an exchange.

The fundamentally centralized nature of supposedly DeFi platforms is also apparent from their vulnerabilities. For example, a study commissioned by the Defense Advanced Research Projects Agency (DARPA) and conducted by Trail of Bits, laid out the vulnerabilities of decentralized blockchains.²¹ Specifically, they found that despite claims of decentralization, it would only take a relatively small number of entities to disrupt a blockchain, “four for Bitcoin, two for Ethereum, and less than a dozen for most Proof-of-Stake networks.”²² This is further evidence that “decentralized” trading systems still concentrate enough power or control in a select group of individuals to render them vulnerable to disruptions affecting the entire network. It is necessary and appropriate for the Commission to consider all the facts and circumstances when determining if a DeFi project is sufficiently decentralized to fall outside the definition of an “exchange” under the Exchange Act and the accompanying requirements designed to protect investors and maintain the integrity and stability of the markets.

¹⁹ Glassnode, metrics for Uniswap’s UNI token: Percent of Supply Held by Top 1% of Addresses, <https://studio.glassnode.com/metrics?a=UNI&category=&m=distribution.Balance1PctHolders&modal=loginForm>. Glassnode notes that “[e]xchange addresses, smart contract addresses, and other special asst-specific addresses (e.g. team funded addresses) are excluded.”

²⁰ Paul Kiernan, *Bitcoin’s Future Depends on Handful of Mysterious Coders*, WALL S. J. (Feb. 16, 2023). This group of coders are so necessary to the operation of Bitcoin that “[a]t least once, the maintainers secretly patched a bug that bitcoin proponents say could have destroyed the cryptocurrency’s value.” Additionally, even though Bitcoin Core is open-sourced and thereby anyone can propose changes to the code, “[w]hat sets maintainers apart from other developers is their ability to approve those changes.”

²¹ Evan Sultanik et al., *Are Blockchains Decentralized? Unintended Centralities in Distributed Ledgers*, TRAIL OF BITS (June 2022), https://blog.trailofbits.com/wp-content/uploads/2022/06/Unintended_Centralities_in_Distributed_Ledgers.pdf.

²² *Id.* at 4.

CONCLUSION

We hope these comments are helpful as the Commission finalizes the 2022 Proposal.

Sincerely,



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