**IN THE UNITED STATES DISTRICT COURT**
**FOR THE NOTHERN DISTRICT OF TEXAS**
**FORT WORTH DIVISION**

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| CRYPTO FREEDOM ALLIANCE OF TEXAS and BLOCKCHAIN ASSOCIATION,<br><br>Plaintiffs,<br><br>v.<br><br>SECURITIES AND EXCHANGE COMMISSION and GARY GENSLER in his Official capacity as Chairman of the Securities and Exchange Commission,<br><br>Defendants. | C.A. No. 4:24-cv-00361-O |

**BRIEF OF BETTER MARKETS, INC. AS *AMICUS CURIAE***
**IN SUPPORT OF DEFENDANTS SECURITIES AND EXCHANGE COMMISSION AND GARY GENSLER**

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## IDENTITY AND INTEREST OF *AMICUS CURIAE*

Better Markets, Inc. ("Better Markets")[1] is a nonprofit, nonpartisan organization that promotes the public interest in the financial markets through comment letters on proposed rules, independent research, *amicus curiae* briefs, public advocacy, and Congressional testimony. It advocates for reforms that stabilize our financial system, prevent financial crises, and protect investors from fraud and abuse. Better Markets has filed hundreds of comment letters with the federal financial regulators, including the Securities and Exchange Commission ("SEC" or "Commission"), and dozens of *amicus* briefs in the federal courts supporting strong financial regulation. *See generally* www.bettermarkets.org. Better Markets filed an extensive comment letter in support of the dealer definition rule[2] at issue here ("Rule"). *See* Better Markets, Comment Letter to SEC (May 27, 2022), https://tinyurl.com/2lf7ybdk.

Better Markets has a strong interest in this case because a decision from the Court vacating the Rule would undermine important goals that Better Markets seeks to advance through its advocacy. The Rule will require firms, including those heavily engaged in high-frequency trading and crypto securities transactions, to register with the SEC as dealers if they supply market liquidity in certain ways. It will thus strengthen protections for investors, reduce the risk of major market disruptions, and give the SEC the tools it needs to monitor these market participants. Nullifying the Rule will remove these safeguards. In addition, of particular importance in this case is dispelling the notion that the cryptocurrency industry should be carved out from the

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[1] Better Markets has no parent corporation, and no publicly held corporation owns 10% or more of its stock. No counsel for any party authored this brief in whole or in part, and no party, party's counsel, or any other person—other than Better Markets—contributed money that was intended to fund the preparation or submission of this brief.

[2] Securities and Exchange Commission, *Further Definition of "As Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer in Connection with Certain Liquidity Providers*, 89 FED. REG. 14,938 (Feb. 29, 2024) ("Release"), https://tinyurl.com/2zbmleyy.

requirements of the Rule. Any market sector characterized by such widespread illegality, investor abuse, and facilitation of criminal activity requires more, not less, oversight, transparency, and accountability. For these reasons, Better Markets is seeking to defend the Rule, including its application to those who trade cryptocurrency securities and those who rely on high-frequency trading strategies.

## SUMMARY OF ARGUMENT

Better Markets makes three arguments in this brief. First, the Rule is necessary to address the emergence of new market participants and trading patterns that pose significant and demonstrable risks both to investors and to market stability. They include proprietary or principal trading firms ("PTFs") that employ high-frequency trading ("HFT") strategies, as well as members of the crypto securities industry. The HFT trading model is a predatory one that takes advantage of retail investors by filling their orders but leaving them with inferior execution prices. History has also shown that HFTs can trigger or exacerbate episodes of sudden and extraordinary volatility that harm investors and also create potentially catastrophic market disruptions. For its part, the rapidly expanding cryptocurrency industry has been dominated by lawless conduct over its comparatively short lifespan, ranging from widespread market manipulation and fraud to the persistent refusal to abide by the foundational registration requirements in the securities laws. Rather than demonstrate any genuinely useful role in finance, it has become a favored tool among criminal enterprises engaged in ransomware, terrorism, tax evasion, and other illegal activity. The Rule will help address these threats from HFT and crypto securities purveyors by requiring more members of these industry sectors to register as dealers, ensuring their own financial stability, better protecting investors, and giving the SEC the regulatory tools it needs to more effectively oversee these firms.

Second, while many members of the crypto industry are engaged in a concerted effort to set themselves apart as innovators who deserve to be spared from securities regulation, including the Rule, there is no valid justification for the exemptive treatment they seek. The widespread illegality in the crypto markets makes abundantly clear that stronger regulatory safeguards are necessary, especially for the major participants who trade heavily. Moreover, the plaintiffs' insistence that the Rule will stifle valuable innovation lacks credible support, given the paucity of genuine innovation so far derived from the crypto markets or even lurking on the horizon. Finally, even *if* members of the crypto industry were pursuing genuinely valuable innovations in finance, the Rule poses no threat to whatever advances they may be incubating. The Rule simply requires the largest participants in the market to *register as dealers*, not desist from trading, innovating, or pursuing any other activity that is permitted under the securities laws.

Finally, the SEC fulfilled its duty under the securities laws, properly understood, to evaluate the economic impacts of the Rule. In accordance with its statutory duty, it considered whether the Rule would promote efficiency, competition, and capital formation. The Rule's impact on competition will be unreservedly positive, as it will require more firms engaged in *de facto* dealing activity to abide by the same regulatory requirements that registered dealers observe. With respect to efficiency and capital formation, the SEC acknowledged that the Rule might negatively impact liquidity, in turn dampening efficiency and capital formation to some degree. However, it also explained with respect to each factor that the Rule would tend to offset these effects through heightened market stability, investor confidence, and regulatory oversight. Finally, the SEC's analysis of the Rule's costs and benefits went above and beyond its obligation, as the agency considered all potential costs and benefits, even quantifying them where feasible.

## ARGUMENT

### I. THE RULE IS A NECESSARY AND APPROPRIATE RESPONSE TO CHANGES IN THE SECURITIES MARKETS THAT POSE GROWING THREATS TO INVESTORS AND MARKET STABILITY.

#### A. The steady increase in high-frequency trading activity by PTFs poses threats to investors and markets.

The securities markets are rapidly evolving in ways that pose new threats to investors and market stability. A prime example is the huge increase in high-frequency trading by PTFs, which use advanced, automated trading algorithms to gain pricing advantages over other investors, generating near-certain profits over a large volume of trades. Today, this is one of the dominant forms of trading in our markets, representing roughly 50 percent of the trading volume in both the U.S. equities markets and the U.S. Treasury interdealer market and creating significant liquidity.[3] Yet many of these market participants are not registered as dealers, depriving investors and the SEC with the safeguards and transparency tools necessary to prevent investor harm and market disruptions.

PTFs pose significant threats both to investors and to market stability. They have been justly criticized for depriving retail investors of best execution prices on their trades, engaging in front-running, and manipulating markets.[4] They also have contributed to incidents of potentially

[3] Johannes Breckenfelder, *Competition among high-frequency traders and market liquidity*, VOXEU (Dec. 17, 2020), https://tinyurl.com/2k2fd8m8; Scott Patterson & Geoffrey Rogow, *What's Behind High-Frequency Trading*, WALL ST. J. (Aug. 1, 2009), https://tinyurl.com/yaaqct8l; *see also* Release at 14,968, P.App. 84 ("In 2020, staff at the Board of Governors of the Federal Reserve published a paper estimating that PTFs account for 61 percent of the trading activity on interdealer broker platforms.").

[4] *See US Equity Market Structure: An Investor Perspective*, BlackRock (Apr. 2014), https://tinyurl.com/2otssqgy ("BlackRock is firmly opposed to predatory High Frequency Trading (HFT) practices which seek to manipulate the market or disadvantage end-investors. These practices constitute market abuse and should be treated as such in law."); *see also* Press Release, *SEC Charges Robinhood Financial With Misleading Customers About Revenue Sources and*

catastrophic market volatility. For example, on May 6, 2010, the U.S. equities markets experienced the largest intraday point decline in its history, sending the markets and regulators into a frenzy ("2010 Flash Crash"). In a post-mortem report issued by the SEC and the Commodity Futures Trading Commission, the agencies concluded that the event was initiated by an unusually large sell order, which immediately triggered further waves of selling by PTFs.[5] At the time of the 2010 Flash Crash, high-frequency trading firms accounted for roughly 40-50 percent of the total trading volume in terms of dollars.[6] It is well established that these firms played a significant role in the 2010 Flash Crash by exacerbating downward pressure on the markets with their algorithmic, electronic trading.

High-frequency trading firms also account for more than 50 percent of the total trading volume in the U.S. Treasury cash and futures markets on any given day.[7] And history shows that these firms have also contributed to episodes of dramatic instability in those markets. For example, algorithmic, electronic trading in the U.S. Treasury securities market by high-frequency trading firms caused a volatile round trip in prices on October 15, 2014, which was swift and

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*Failing to Satisfy Duty of Best Execution* (Dec. 17, 2020), https://tinyurl.com/2mmhtmsc (describing enforcement action in which SEC found that Robinhood's practice of routing retail trades to HFT firms resulted in inferior trade execution, even accounting for the savings from zero commissions).

[5] REPORT OF THE STAFFS OF THE CFTC AND SEC TO THE JOINT ADVISORY COMMITTEE ON EMERGING REGULATORY ISSUES, FINDINGS REGARDING THE MARKET EVENTS OF MAY 6, 2010 (Sept. 30, 2010); *see also* Speech, Gregg E. Berman, SEC, *Market Participants and the May 6 Flash Crash* (Oct. 13, 2010) ("So while it does not seem that HFTs directly caused a wave of selling, HFTs did ride that wave down as prices declined"), https://tinyurl.com/256k4j9p.

[6] Speech, Gregg E. Berman, SEC, *Market Participants and the May 6 Flash Crash* (Oct. 13, 2010).

[7] U.S. Department of Treasury, JOINT STAFF REPORT: THE U.S. TREASURY MARKET ON OCTOBER 15, 2014 (July 13, 2015), https://tinyurl.com/28tt45rz.

unprecedented ("2014 Flash Crash").[8] A joint staff report published by the federal financial regulators observed that:

> Before 2014, many did not believe that an event of this type was likely to occur in the Treasury market. This disruption made clear that the rise of electronic trading in the Treasury market meant that market liquidity provision had become more short-term in nature, some liquidity providers were backed by less capital, and liquidity was more vulnerable to shocks as a result of the change in the composition of liquidity providers. In addition, electronic trading permitted rapid increases in orders that removed liquidity.[9]

As to identifying the exact causes of the 2014 Flash Crash, the report went on to highlight the lack of transparency and regulatory access to data:

> Following the October 2014 disruption, analysis found that diversity in trading venues and participants and fragmented and incomplete data reporting had left market participants and individual regulatory agencies with only a very limited view of Treasury risk transfer and price discovery. These gaps posed challenges to understanding the causes of the flash rally.[10]

Finally, in March 2020, the Treasury market experienced illiquidity after PTFs, many of whom were not registered as dealers, appeared to pull back from providing liquidity, possibility because "their lower capitalization relative to dealers may [have left] them with less capacity to absorb adverse shocks."[11] These incidents show that the rise of electronic trading poses new

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[8] U.S. DEPARTMENT OF TREASURY, RECENT DISRUPTIONS AND POTENTIAL REFORMS IN THE U.S. TREASURY MARKET: A STAFF PROGRESS REPORT 18 (Nov. 8, 2021), https://tinyurl.com/25uekzq7.
[9] *Id.*
[10] *Id.*
[11] Release at 14,976, P.App. 92 (*citing* Inter-Agency Working Group for Treasury Market Surveillance Joint Staff Report, Recent Disruptions and Potential Reforms in the U.S. Treasury Market: A Staff Progress Report prepared by the U.S. Department of the Treasury, Board of Governors of the Federal Reserve System, Federal Reserve Bank of New York, U.S. Securities and Exchange Commission, U.S. Commodity Futures Trading Commission (Nov. 8, 2021); Annette Vissing-Jørgensen, Bank for International Settlements, *The Treasury market in spring 2020 and the response of the Federal Reserve* (Oct. 2021); Alex Aronovich, Dobrislav Dobrev, & Andre Meldrum, *The Treasury Market Flash Event of February 25, 2021*, FEDS Notes, Washington: Board of Governors of the Federal Reserve (May 14, 2021).

challenges, including trading strategies that trigger or intensify sudden and dangerous fluctuations that can inflict investor losses and cause crippling market volatility.[12]

### B. The dramatic rise in digital asset securities trading also poses threats to investors and markets.

Digital asset securities, including crypto offerings, have experienced a meteoric rise.[13] Since the initial appearance of crypto just 15 years ago, the market has been flooded with tens of thousands of ledger-based cryptocurrency offerings, most of which are regarded as securities.[14] Because they have no inherent value, they are extraordinarily volatile. Consequently, their market cap has swung wildly, at the expense of countless investors and auguring potentially systemic instability across financial markets. In 2021, the cryptocurrency market cap reached highs of approximately $3 trillion dollars before plummeting back down to approximately $1 trillion in mid-2022. Today, cryptocurrency assets have a market value of approximately $1.8 trillion.[15]

Along with their intense volatility, the cryptocurrency markets have been characterized by widespread illegality, including failure to register under the securities laws, wash trading,[16] fraud,

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[12] Andrei Kirilenko, Albert S. Kyle, Mehrdad Samadi, & Tugkan Tuzun, *The Flash Crash: High-Frequency Trading in an Electronic Market* (May 14, 2014), https://tinyurl.com/2zel9k24.

[13] This brief uses the terms "digital asset securities" and "crypto asset securities" interchangeably.

[14] Coryanne Hicks, *Different Types of Cryptocurrencies*, FORBES ADVISOR (MAR. 15, 2023), https://tinyurl.com/2mlqpgax; Tobi Opeyemi Amure, *Most Cryptocurrencies Are Securities, Says SEC Chair*, INVESTOPEDIA (Sept. 08, 2022), https://tinyurl.com/24n6g76q.

[15] Anshu Siripurpu & Noah Berman, Council on Foreign Relations, *The Crypto Question: Bitcoin, Digital Dollars, and the Future of Money* (Jan. 17, 2024), https://tinyurl.com/yteuhq8l.

[16] Lin William Cong *et al.*, *Crypto Wash Trading*, NATIONAL BUREAU OF ECONOMIC RESEARCH (Dec. 2022), https://www.nber.org/papers/w30783 ("We find that the wash trading volume, on average, is as high as 77.5% of the total trading volume on unregulated exchanges. . . . [T]hese estimates translate into wash trading of over 4.5 trillion USD in spot markets and over 1.5 Trillion in USD in derivatives markets in the first quarter of 2020 alone"); *see also* Javier Paz, *More than Half of All Bitcoin Trades Are Fake*, FORBES (Aug. 26, 2022), https://tinyurl.com/2grwpa46.

manipulation,[17] and outright theft, with SEC Chairman Gary Gensler referring to it as the "Wild West."[18] For example, numerous studies have concluded that for two of the most prominent cryptocurrencies, Bitcoin and Ether, "most of the reported trading volume" is attributable to wash trading."[19] One study that focused on the most widely recognized and heavily traded cryptocurrencies, including Ether, found that "the volume of wash trading is, on average, as high as 77.5% of the total trading volume on unregulated exchanges."[20] This is because "cryptocurrencies are particularly susceptible to wash trading under limited regulatory oversight," which makes wash trading an "industry-wide phenomenon."[21] Wash trading is prevalent in the Ethereum ecosystem in particular. A recent study found that "price manipulation is ***rampant*** on Ethereum-based decentralized exchanges."[22] According to the study, wash trading "amounted to at least $2 billion worth of cryptocurrencies since September 2020."[23] Other analyses have reached similar conclusions regarding the Ethereum marketplace.[24]

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[17] *See* Deloitte, *Market Manipulation in Digital Assets* (Mar. 2021) (estimating that up to 90% of the trading volume in cryptocurrency could be subject to manipulation including, but not limited to, pump-and-dump schemes, spoofing, and layering to wash sales), https://tinyurl.com/2krj5asb.

[18] Gary Gensler, Remarks Before the Aspen Security Forum (Aug. 3, 2021), https://tinyurl.com/2qt6ymme.

[19] Guenole Le Pennec, Ingo Fiedler, & Lennart Ante, *Wash Trading at Cryptocurrency Exchanges*, SCIENCEDIRECT (Nov. 2021), https://tinyurl.com/2lcn5bgx.

[20] Lin William Cong, Xi Li, Ke Tang, & Yang Yang, *Crypto Wash Trading*, at 5, 7 (Aug. 2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3530220. The study did not find evidence of wash trading on regulated exchanges, but it noted that, as of mid-2022, regulated exchanges covered less than 3% of spot market transactions. *Id.* at 2.

[21] *Id.* at 3.

[22] Olga Kharif, *Wash Trading is Rampant on Decentralized Crypto Exchanges*, BLOOMBERG (Sept. 12, 2023) (emphasis added), https://tinyurl.com/2ogzzbmb.

[23] *Id.*

[24] Andrew Hayward, *Hot Ethereum NFT Platform LooksRare is Rife with Wash Trading—And Ok With It*, DECRYPT (Jan. 12, 2022), https://tinyurl.com/yb96nv2k.

The cost of crypto scams to investors continues to rise. One report estimates that fraud schemes involving cryptocurrencies received over $9 billion in 2022 alone.[25] Of that amount, $7.8 billion involved pyramid or Ponzi schemes.[26] The FBI also estimates that investment fraud involving cryptocurrencies rose by nearly 200% from $907 million in 2021 to $2.57 billion in 2022.[27] These schemes often involve the same, now-classic crypto tactics designed to take investors' money while enriching the promotors: the sale of unregistered securities; the false promise of huge returns; phony trading to manipulate prices; and a failure to protect and segregate investor funds, leading to outright theft. As a result, it's no wonder that the chair of the SEC has also described cryptocurrency investments as "rife with fraud, scams, and abuse."[28]

The result has been inestimable investor harm. Indeed, crime and fraud have always been a characteristic of the cryptocurrency market given its promised anonymity; it is therefore no surprise that Bitcoin rapidly evolved into "the preferred currency for criminal activities."[29] Far from being "innovators," crypto is the financial product of choice for criminals worldwide, including for blackmailers using ransomware, money launderers, sex traffickers, terrorists, drug dealers, rogue states, tax evaders, and many others.[30]

The SEC has filed dozens of enforcement actions against crypto securities firms and their principals, including this sampling of prominent cases:

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[25] TRM LABS, ILLICIT CRYPTO ECOSYSTEM REPORT (June 2023), https://www.trmlabs.com/report.
[26] *Id.*
[27] *Id.*; Federal Bureau of Investigation, *Internet Crime Complaint Center Releases 2022 Statistics* (Mar. 22, 2023), https://tinyurl.com/27cfm9at.
[28] Gary Gensler, Remarks Before the Aspen Security Forum (Aug. 3, 2021), https://www.sec.gov/news/publicstatement/gensler-aspen-security-forum-2021-08-03.
[29] Eswar Prasad, *The Brutal Trust About Bitcoin*, N.Y. TIMES (Jun. 14, 2021), https://www.nytimes.com/2021/06/14/opinion/bitcoin-cryptocurrency-flaws.html.
[30] *See* Alex Wickham, Jennifer Jacobs, & Alberto Nardelli, *US and UK Probe $20 Billion of Crypto Transfers to Russian Exchange*, BLOOMBERG (Mar. 28, 2024), https://tinyurl.com/2l2hcuu8.

- In December 2022, after FTX spectacularly collapsed, the SEC filed an enforcement action against FTX's former CEO Sam Bankman-Fried ("SBF") for defrauding investors by raking in billions of dollars in investor funds and diverting much of it to a privately controlled hedge fund.[31] After trial in a parallel criminal proceeding brought by the Department of Justice,[32] SBF was sentenced to 25 years in prison for his crimes and ordered to pay $11 billion in forfeiture for his "orchestration of multiple fraudulent schemes."[33] SBF was well-known for his ad campaigns proclaiming that he was revolutionizing finance for the good of global finance.
- In *SEC v. Binance*, No. 1:23-cv-01599 (D.D.C. filed June 5, 2023), the SEC alleges that Biannce Holdings Ltd. ("Binance"), which operated the largest crypto asset trading platform in the world (Binance.com) and its founder, Changpeng Zhao ("Zhao"), committed a variety of securities law violations. Among other things, the SEC alleges that Zhao and Binance exercised control of customers assets, permitting them to commingle or divert them as they pleased, including to an entity Zhao owned and controlled. On June 28, 2024, the District Court for the District of Columbia ruled that the bulk of the SEC's case under the securities laws could move forward. And last year, Binance and Zhao pled guilty to criminal charges and agreed to pay over $4.3 billon for violating the Bank Secrecy Act by failing to implement anti-money laundering policies.[34]

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[31] *SEC v. Samuel Bankman-Fried*, No. 22-cv-10501 (S.D.N.Y. filed Dec. 13, 2022).
[32] *U.S. v. Samuel Bankman-Fried*, No. 22-cr-0673 (S.D.N.Y filed Dec. 13, 2022).
[33] Press Release, U.S. Department of Justice, *Samuel Bankman-Fried Sentenced to 25 Years for His Orchestration of Multiple Fraudulent Schemes* (Mar. 28, 2024), https://tinyurl.com/29zvbwnc.
[34] Press Release, U.S. Department of Justice, *Binance and CEO Plead Guilty to Federal Charges in $4B Resolution* (Nov. 21, 2023), https://tinyurl.com/2oawxpm7.

- In June 2023, the SEC filed an enforcement action against Coinbase, Inc. According to the SEC's complaint, since at least 2019, Coinbase has made billions of dollars unlawfully facilitating the buying and selling of unregistered crypto asset securities. The SEC alleges that Coinbase intertwines the traditional services of an exchange, broker, and clearing agency without having registered any of those functions with the SEC as required by law. In March, 2024, the district court squarely held that the Coinbase offerings were securities subject to regulation under the securities laws pursuant to the *Howey* test.[35]

These investments also pose systemic threats, not just investor losses. The SEC's recent decision to authorize the trading of securities in the form of Bitcoin and Ether exchange-traded products ("ETPs") promises to accentuate these dangers, attracting more retail investors by cloaking these crypto investments with an aura of legitimacy and safety[36] and more closely interconnecting them with the traditional financial and banking systems. That has "deepen[ed] ties between the volatile world of cryptocurrencies and the traditional finance system, potentially creating new unforeseen risks."[37]

Even prior to the approval of spot bitcoin ETPs, the International Monetary Fund warned that crypto assets "'could potentially pose financial stability risks due to their extreme volatility.'"[38] These products, if widely adopted, "could pose risks to other parts of the financial

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[35] *SEC v. Coinbase*, No. 23-cv-4738, 2024 WL 1304037, at *20-21 (S.D.N.Y. Mar. 27, 2024).

[36] "[B]itcoin is primarily a speculative, volatile asset that's also used for illicit activity including ransomware, money laundering, sanction evasion, and terrorist financing." Chair Gary Gensler, *SEC Statement on the Approval of Spot Bitcoin Exchange-Traded Products* (Jan. 10, 2024), https://www.sec.gov/newsroom/speeches-statements/gensler-statement-spot-bitcoin-011023.

[37] Elizabeth Howcroft & Hannah Lang, *US bitcoin ETFs raise questions over broader financial system risks*, REUTERS (Jan. 31, 2024), https://tinyurl.com/2kazlc25.

[38] Arthur E. Wilmarth, *We Must Protect Investors and Our Banking System from the Crypto Industry*, 101 WASH. U. L. REV. 235, 245 (2023), https://tinyurl.com/2f6cl5q3 (*quoting* Tara Iyer, IMF, *Cryptic Connections: Spillovers Between Crypto and Equity Markets*, at 3, Global Financial Stability Notes No. 2022/01 (Jan. 2022), https://tinyurl.com/2ef3p4de.

system during times of market stress by exacerbating bitcoin price volatility, or creating dislocations between the price of the ETF and bitcoin."[39] That can "cause stress for institutions heavily exposed to the products or which rely on them for liquidity management."[40] If another crypto "winter" descends on the digital asset markets, the cascading impact on investors and sponsors of these ETPs promises to be more widespread than in the past.[41]

### C. **The Rule will enhance regulatory oversight, protect investors, and help preserve market stability.**

Despite the already large and ever-increasing volume of trading represented by PTFs, crypto securities, and others, many are not registered as a dealer or government securities dealer. The Rule will help close these gaps, enabling the SEC to better protect investors and market stability. As the SEC noted, "The dealer regulatory regime is a cornerstone of the U.S. Federal securities laws and helps to promote the Commission's longstanding mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[42] Far from representing an overreach, the Rule is a model of appropriate rulemaking in the face of abundant evidence of significant and growing gaps in a vital regulatory framework.

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[39] *Id.*

[40] *Id.*

[41] *See* Hilary J. Allen, *The Superficial Allure of Crypto*, INTERNATIONAL MONETARY FUND: FINANCE & DEVELOPMENT 27 (Sept. 2022) ("Unfortunately, crypto does not live up to its claims of decentralization, and crypto's booms and busts could have broad economic consequences if it is integrated with the traditional financial system and able to interrupt the flow of capital to the real economy."), https://tinyurl.com/2o7gpkzw; s*ee also* Hillary J. Allen, *$=€=Bitcoin?*, 76 MD. L. REV. 877 (2017) (arguing that if virtual currencies become "ubiquitous," it would "pose threats to the stability of the financial system—threats that have been largely unexplored to date. Such threats will arise because the ability of a virtual currency to function as money is very fragile . . . .), https://tinyurl.com/2lev7wwf.

[42] Release at 14,938, P.App 54, *citing Eastside Church of Christ v. National Plan, Inc.*, 391 F.2d 357 (5th Cir. 1968) ("The requirement that brokers and dealers register is of the utmost importance in effecting the purpose of the [Exchange] Act.").

The Rule satisfies all the criteria for reasonable and reasonably explained rulemaking. It falls well within the letter and spirit of the statutory definition of a "dealer," which broadly encompasses *anyone* "engaged in the business of buying and selling securities for such person's own account . . . as a part of a regular business."[43] It rests squarely on the SEC's authority to define terms.[44] It provides clarity for market participants by elucidating two specific circumstances under which entities engaged in certain types of market activity will be deemed engaged in buying or selling securities "as part of a regular business"—one framed in terms of *expressions of trading interest* that are accessible to other market participants and the other in terms of *revenue earned from bid-ask spreads* or incentives offered by trading venues. Further, it benefits market participants by ensuring fair competition among those firms that are registered as dealers and those who should be registered but are not. The Rule is also appropriately limited by a number of exclusions, including those for central banks, investment companies already subject to a comprehensive regulatory framework, and smaller market participants with less than $50 million in assets. Finally, in the rulemaking process, the SEC considered and addressed all significant comments, along with the anticipated economic impacts of the Rule, as discussed below.

Regulation of these firms as dealers will confer numerous benefits in terms of transparency, market stability, and investor protection. As explained in the Release, dealers are required to

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[43] Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)5. The statutory definitions of ''dealer'' and ''government securities dealer,'' and the accompanying registration requirements of the Exchange Act, were drawn broadly by Congress to encompass a wide range of activities involving the securities markets and their participants. Release at 14,938, P.App. 54.

[44] Pursuant to Section 3(b) of the Exchange Act, the SEC has authority to define terms used in the Exchange Act, consistent with the provisions and purposes of the Exchange Act. 15 U.S.C. 78c(b)). Release at 14,939 n.7, P.App. 55 n.7.

register with the SEC, join an SRO, and adhere to a comprehensive set of rules.[45] That framework includes provisions that limit risk and promote financial responsibility through net capital requirements; promote transparency through reporting and disclosure requirements; facilitate regulatory oversight through books and records requirements and the examination process; and curb abusive conduct through dealer-specific anti-manipulation and anti-fraud rules. Moreover, registered dealers are subject to the rules and enforcement authorities of the SROs, and Government securities dealers are further subject to rules issued by the Treasury that concern financial responsibility, capital requirements, recordkeeping, reports and audits, and large position reporting.

## II. APPLICATION OF THE DEALER FRAMEWORK TO DIGITAL ASSETS IS NECESSARY, IT POSES NO THREAT TO GENUINE "INNOVATION," AND IT IS ENTIRELY WORKABLE.

### A. The widespread illegality and systemic risk posed by digital asset securities justify greater oversight.

The plaintiffs claim that dealer regulation is unnecessary in their digital asset markets. However, there is ample reason to apply dealer regulation to digital asset securities in light of the unprecedented degree of fraud, theft, and manipulation that pervades those markets, as described above. And the need for stronger safeguards and oversight in these markets is evident regardless of the extent to which intermediaries play a role. For example, dominant traders acting as dealers can still engage in manipulation absent intermediaries. The plaintiffs' brief actually supports the point. They explain that in the liquidity pools, prices are reset automatically, but they nevertheless "increase or decrease after each transaction according *to supply and demand*." Plaintiffs' Brief at

[45] Release at 14,941, P.App. 57.

10 (emphasis added). In other words, the level of trading activity determines prices, even without intermediation, thus creating opportunities for market manipulation.

Moreover, as shown above, these markets present systemic risks that justify the greater regulatory transparency and oversight that comes with dealer registration. Even if the systemic threats of crypto have yet to materialize in alarming or stark form, they undoubtedly loom large, especially with the advent of the crypto ETPs now beginning to trade. The SEC is therefore prudent, and within its regulatory authority, to fend off problems before they occur. As the courts have explained, "an agency has the latitude to 'adopt prophylactic rules to prevent potential problems before they arise'—that is, '[a]n agency need not suffer the flood before building the levee."[46]

### B. **Dealer regulation will not stifle meaningful innovation.**

The plaintiffs' brief is infused with claims that the Rule will stifle the supposed innovation offered by cryptocurrencies and the various platforms and technologies associated with them, ultimately hurting "everyday Americans." *See, e.g.*, Plaintiffs' Brief at 1, 9, 35. Plaintiffs' "innovation" argument fails for multiple reasons. First, it is beside the point: If a person falls under the provisions of the securities laws, including those regulating dealers, it is fair and appropriate to insist that they abide by the applicable requirements. There is no "we're innovative" defense to compliance with the securities laws and rules. Indeed, "innovative" investment products and platforms are precisely the ones that are most in need of the safeguards and transparency that regulation provides for the benefit of investors and markets.

[46] *Nasdaq Stock Mkt. LLC v. SEC*, 38 F.4th 1126, 1143 (D.C. Cir. 2022) (citation omitted); *cf. Sid Peterson Mem'l Hosp. v. Thompson*, 274 F.3d 301, 313 (5th Cir. 2001) (agencies have authority to promulgate prophylactic regulations to effectuate the purposes of the enabling legislation).

More fundamentally, the plaintiffs' argument rests on a false premise. The claimed benefits from digital assets and the securities built upon them, so often touted by crypto advocates in technospeak, are a fiction. Since crypto's inception 15 years ago, crypto has yet to show that it has any truly legitimate and valuable role in finance. Rather, as detailed above, it has served primarily as a tool for those taking investors' money, creating a new form of gambling unhinged from fundamental asset values, and facilitating criminal enterprises engaged in ransomware, money laundering, tax evasion, and terrorism. From an investor standpoint, the reality so far is that digital asset investments are essentially just orange groves and payphones in a new wrapper—or worse. *See, e.g.*, *SEC v. J.W. Howey & Co.*, 328 U.S. 293 (1946); *SEC v. Edwards*, 540 U.S. 389 (2004) (holding that a payphone sale and leaseback investment scheme promising a fixed rate of return was an "investment contract" and thus a "security").

Even the notion that the blockchain technology underlying crypto assets provides revolutionary benefits to the financial markets remains hollow. For example, it has not proven to be a transparent medium that can assist law enforcement and thwart criminals.[47] That is why crypto remains the favored tool of criminals worldwide. While some mainstream financial institutions are evaluating the potential utility of "tokenizing" a wide range of asset classes using blockchain technology,[48] that application remains unclear; more to the point, it has nothing to do with whether or not prominent traders in the digital asset securities markets should be registered as dealers if they satisfy the Rule's criteria.

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[47] Better Markets, *The Reality Behind the Myth of Transparent Blockchains* (Oct. 25, 2023), https://bettermarkets.org/wp-content/uploads/2023/10/Fact-Sheet-Blockchains-10.25.23.pdf.

[48] Fidelity, *Exploring Institutional Interest in Blockchain Applications and Digital Asset Uses* (Apr. 2023), https://tinyurl.com/2fn7737q.

Third and finally, *even if* the digital asset markets promised some legitimate and useful innovation, there is no credible evidence showing that a dealer registration requirement would somehow inhibit that innovation. The Rule does not ban or curtail crypto securities trading, beyond illegal activity. The major participants in those markets simply have to *register* and comply with the applicable conduct standards, reporting requirements, and financial stability measures—as they go about their innovative ways.

### C. **Dealer regulation is compatible with the digital marketplace.**

Plaintiffs claim that registration as dealers is fundamentally incompatible with the business models seen in at least some of the digital asset markets. Plaintiffs' Brief at 12-13. On the front end of this argument is the complaint that the SEC has not specified which digital asset transactions are subject to the Rule. Plaintiffs' Brief at 11, 30. The straightforward answer is that the Rule applies to any digital asset that is a security as defined in the Exchange Act, the SEC's rules, and the caselaw. The SEC made this clear. In its Release, the SEC explained that it was "not excluding certain types of securities, specifically crypto asset securities, from the application of the final rules" because "[t]he dealer framework is a functional analysis based on the securities trading activities undertaken by a person, not the type of security being traded."[49] Accordingly, the Rule will apply with respect to any crypto asset that is a ''security'' or ''government security'' within the meaning of the Exchange Act.

In any event, there cannot be any serious doubt on the status of crypto offerings as securities. The catchall test for whether a product is a security was established in *SEC v. J.W. Howey & Co.*, 328 U.S. 293, 295-96 (1946). It remains the bedrock legal principle for whether a

[49] Release at 14,944, P.App. 60.

wide assortment of financial products are "investment contracts" and therefore securities.[50] A series of recent court decisions in SEC enforcement actions has confirmed its application to crypto offerings. For example, in *SEC v. Terraform Labs Pte. Ltd.*, No. 1:23-cv-01346, 2023 WL 8944860, at *12-13 (S.D.N.Y. Dec. 28, 2023), the court squarely applied the *Howey* test to four crypto assets being offered by Terraform and found that there was no genuine dispute and that they were, in fact, "investment contracts" and thus, securities. The court explained that:

> Defendants' . . . argument in effect asks this Court to cast aside decades of settled law of the Supreme Court and the Second Circuit. In the seminal decision of [*Howey*] the Supreme Court held in no uncertain terms that "an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." Defendants urge this Court to scrap that definition, deeming it "dicta" that is the product of statutory interpretation of a bygone era. The Court declines defendants' invitation. *Howey's* definition of "investment contract" was and remains a binding statement of the law, not dicta.

*Id.* at *13 (internal citations omitted);[51] *see also SEC v. Coinbase*, No. 23-cv-4738, 2024 WL 1304037, at *20-21 (S.D.N.Y. Mar. 27, 2024) ("the SEC has adequately alleged that purchasers of certain crypto-assets on the Coinbase Platform . . . invested in a common enterprise and were led to expect profits solely from the effort of others, thereby satisfying the *Howey* test for an investment contract"). These decisions make fundamental sense, as crypto investment offerings

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[50] *United States v. Leonard*, 529 F.3d 83, 88 (2d Cir. 2008); *accord* Eric D. Chason, *Crypto Assets and The Problem of Tax Classifications*, 100 WASH. U. L. REV. 765, 783 (2023); *see also* Chris Brummer & Yesha Yadav, *Fintech and the Innovation Trilemma*, 107 GEO. L. J. 235, 238 (2019) (explaining that the *Howey* test is the "long-established yardstick for determining whether a non-conventional financial product is a security").

[51] After a subsequent jury trial where Terraform and its founder, Do Hyeong Kwon ("Kwon"), were found guilty of violating the federal registration and antifraud provisions of the securities laws, the SEC recently settled the *Terraform* case as to the company and Kwon. The result was an injunction, monetary sanctions exceeding $4.5 billion, and other relief. *See* June 12, 2024 Letter from SEC to the Honorable Judge Jed S. Rakoff of the United States District Court for the Southern District of New York, *SEC v. Terraform Labs et al.,* No. 1:23-cv-1346 (S.D.N.Y.) (Doc. No. 272).

promise profits based on the efforts of others.[52] It is also especially appropriate as applied to cryptocurrency offerings, because the Supreme Court in *Howey* foresaw the need for a broad definition, one that "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Howey*, 328 U.S. at 299; *see also Edwards*, 540 U.S. at 389-90.

The plaintiffs also argue that they are not "dealers" because they do not have customers, and that the dealer regime is therefore inapt. Plaintiffs' Brief at 2-3. The SEC persuasively responded to this as well:

> There is no requirement in the statutory text of either section 3(a)(5) or section 3(a)(44) that dealers have customers. In comparison, the Exchange Act's definition of ''broker'' is ''any person in the business of effecting transactions in securities for the account of others,'' which includes (but is not limited to) customers. The dealer definition includes no such limiting language and, since its enactment, the dealer definition was understood to cover ''the operations of a trader . . . who has no customers but merely trades for his own account through a broker'' so long as those operations ''are sufficiently extensive to be regarded as a regular business . . . ''[53]

Finally, the plaintiffs describe their crypto platform in some technical detail, with references to its "novel" trading model of decentralized finance that includes blockchains, smart contracts, liquidity pools, and peer-to-peer trading. Plaintiffs' Brief at 1-2, 7. The SEC succinctly addressed the notion that this technology eliminated dealing activity within the meaning of the statute or the Rule: "There is nothing about the technology used, including distributed ledger technology-based protocols using smart contracts, that would preclude crypto asset securities

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[52] Thomas Lee Hazen, *Tulips, Oranges, Worms, and Coins—Virtual, Digital, or Crypto Currency and the Securities Laws*, 20 N.C. J. L. & TECH. 493, 503 (2019).
[53] Release at 19,944, P.App. 60 (citations omitted).

activities from falling within the scope of dealer activity."[54] Nor, by the same token, would it prevent those who trade in this context from complying with the registration Rule. Indeed, complying with the SEC's rules is entirely possible and done every day by hundreds if not thousands of legitimate companies, individuals, and financial firms, including at least some crypto enterprises.[55]

## III. THE SEC'S ECOMOMIC ANALYSIS FULLY COMPLIED WITH THE AGENCY'S DUTY UNDER THE LAW.

### A. The SEC considered whether the Rule would promote efficiency, competition, and capital formation.

The SEC's obligation to conduct economic analysis for its rules is specific and limited, as set forth in two statutory provisions. Section 3(f) of the Exchange Act requires the SEC to "*consider*, in addition to the protection of investors, whether [its rule] will promote efficiency, competition, and capital formation." 15 U.S.C. § 78c(f) (emphasis added). In addition, Section 23(a)(2) of the Exchange Act requires the SEC to "consider among other matters the impact any such rule or regulation would have on competition," and to refrain from adopting a rule "which would impose a burden on competition not necessary or appropriate in furtherance of the purposes of this chapter." 15 U.S.C. § 78w(a)(2).

It is now well-established that in fulfilling these requirements, the SEC need not attempt "to measure the immeasurable," nor must it "conduct a rigorous, quantitative economic analysis" unless its organic statute "explicitly directs it to do so"—something Congress refrained from doing in the securities laws. *See Nat'l Ass'n of Mfrs. v. SEC*, 748 F.3d 359, 369 (D.C. Cir. 2014) (quotation marks omitted), *overruled on other grounds by Am. Meat Inst. v. USDA*, 760 F.3d

[54] Release at 14,960, P.App. 76.

[55] Bradley Dale, *The Few Crypto Firms That Have Registered With The SEC*, AXIOS (Mar. 6, 2023), https://www.axios.com/2023/03/06/crypto-register-sec-securities-exchange-commission.

18 (D.C. Cir. 2014) (*en banc*). The Fifth Circuit agrees, explaining that as a general matter, the SEC "it is not required to undertake a quantitative analysis to determine a proposed rule's economic implications. The relevant statutory provisions providing the SEC with rulemaking authority do not stipulate such a requirement—they merely command the SEC to 'consider ... whether the action will promote efficiency, competition, and capital formation.'" *Chamber of Commerce of United States v. SEC*, 85 F.4th 760, 773 (5th Cir. 2023).

Congress's decision simply to require the SEC to "consider" these discrete economic factors, without more, gives the SEC wide discretion in how to conduct its analysis. That principle was made clear decades ago by the Supreme Court: It recognized that statutorily mandated *considerations* "imply wide areas of judgment and therefore of discretion" as an agency fulfills its statutory duty. *Sec'y of Agric. v. Cent. Roig Ref. Co.,* 338 U.S. 604, 611 (1950). The Fifth Circuit has recently affirmed this principle, observing that the SEC:

> is only told to "consider," and that term—shorn of modifiers or limiters —does not restrict the universe of otherwise permissible methods by which the SEC can analyze the economic implications of a proposed rule . . . . A rigorous quantitative cost-benefit analysis is one way—but not the only way—to determine whether a proposed rule "promote[s] efficiency, competition, and capital formation [citation omitted]. Accordingly, there is no textual basis to conclude that the SEC must analyze economic impacts using quantitative methods whenever it is feasible.

*Chamber of Commerce*, 85 F.4th at 773. A flexible and qualitative assessment of economic impact in the realm of financial regulation is the only feasible approach, as the predicted costs and benefits of new rules are impossible to quantify accurately.[56] Moreover, the many benefits of financial regulation, including the Rule in this case, are enormous yet especially difficult to render in quantitative terms, as they come in the form of investor protection, fraud and manipulation that is

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[56] *See* John C. Coates, IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L. J. 882 (2015), http://nrs.harvard.edu/urn-3:HUL.InstRepos:30000102.

*prevented*, market transparency, maintenance of market liquidity, confidence in the integrity of the markets, and other vital enhancements.

The SEC complied with the economic analysis duties that the law *does* impose. It considered the expected impact of the Rule on each of the three factors and articulated its conclusions.[57] For example, as to competition, the SEC explained that the Rule would clearly promote fair competition "among entities that regularly provide significant liquidity by applying consistent regulation to these entities, thus leveling the competitive playing field between liquidity provision conducted by entities that are currently registered as dealers and government securities dealers and by entities that are not."[58] As to efficiency, the SEC explained that the Rule could have a small negative effect on liquidity and therefore on efficiency.[59] But as an offsetting factor, the SEC explained that firms which are better capitalized because of the Rule can be expected to be "less sensitive to sudden market disruptions" and therefore better able to sustain their capacity to provide liquidity and promote efficiency.[60]

Finally, as to capital formation, the SEC pointed out that because the Rule might have a small negative impact on market liquidity and efficiency, it might in turn have a corresponding negative impact on capital formation "by reducing security prices and raising yields."[61] The SEC then recited the numerous benefits that would counterweight any impairment in capital formation that might result from the Rule:

> The final rules will also promote market stability, resiliency, and investor confidence by helping to ensure that dealing activity is adequately capitalized, subject to regulatory oversight, and accompanied by regulated internal controls and deterrents to deceptive behaviors. More stable markets and strengthened investor

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[57] *See, e.g.*, Release at 14,996-97, P.App. 112-113.
[58] Release at 14,996, P.App 112.
[59] *Id.*
[60] Release at 14,978, P.App. 94.
[61] Release at 14,977, P.App. 93.

> confidence in U.S. markets may promote capital formation by increasing demand for securities issued in U.S. markets, raising security prices, and lowering yields.[62]

The record also makes clear that the SEC has respected the Congressional caution against imposing unnecessary burdens on competition as it seeks to fulfill the purposes of the Exchange Act through the Rule. The Rule will have an entirely favorable impact on competition by ensuring that all market participants engaged in dealing activity are subject to the same regulatory requirements, thus leveling the playing field. While this conclusion would seem indisputable, it is further bolstered by evidence that Congress intended this requirement to be applied flexibly as the SEC considers competition. As explained in the Senate Report accompanying the 1975 amendments that added this duty to carefully evaluate the impact of rules on competition,

> This explicit obligation to balance, against other regulatory criteria and considerations, the competitive implications of self-regulatory and Commission action *should not be viewed as requiring the Commission to justify that such actions be the least anti-competitive manner of achieving a regulatory objective.* Rather, the Commission's obligation is to weigh competitive impact in reaching regulatory conclusions.

S. REP. No. 94-75, at 13 (1975) (emphasis added).

**B. <u>The SEC also evaluated the many benefits of the Rule, as well as its costs.</u>**

The dealer registration requirements are among the most important in the securities laws, described as a "keystone" of the entire regulatory framework and of the "utmost importance."[63] As discussed throughout the Release, requiring those who act as dealers to register as such confers many benefits in terms of transparency, market stability, and investor protection: 1) it promotes fair competition by applying the same set of requirements to anyone engaged in the same dealing activity; 2) it promotes the financial stability of dealers through the application of the Net Capital

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[62] *Id.*

[63] Release at 14967 n.376, P.App. 83 n.376 and cases cited therein.

Rule, which in turn reduces the likelihood of dealer failure, sustains market liquidity, and also protects the interests of counterparties, creditors, and where appropriate, customers of the dealer; 3) it brings to bear a more comprehensive set of conduct requirements applicable to dealers, including those established by the SRO that dealers must join (FINRA), all of which can help deter fraud, market manipulation, and other violations through enforcement actions by the SEC or the SRO; 4) it gives the SEC and the SRO greater authority to oversee and examine dealer conduct; and 5) it promotes transparency through reporting and recordkeeping requirements, which enable the SEC not only to better detect unlawful conduct but also to better understand—and mitigate or prevent—major market disruptions. Government securities dealers are further subject to rules issued by the Treasury that concern financial responsibility, capital requirements, recordkeeping, and reports and audits.

The Rule will impose some compliance costs on firms, essentially amounting to costs arising from registration, reporting, and SRO membership.[64] One of the concerns highlighted by the plaintiffs, and addressed in the SEC's economic analysis, is the potential for the Rule to cause some market participants to curtail their trading activity, thereby decreasing liquidity. But these concerns should be discounted for a number of reasons. As an initial matter, they are inherently speculative, lacking concrete support. Second, the SEC correctly observes that the markets can self-correct for this development if it occurs, as other market participants will have incentives to fill the breach. Moreover, any decrease in liquidity must be counterbalanced by the preservation of liquidity that will come from the Rule itself, as dealers subject to the Rule are more financially durable and able to continue providing liquidity.[65]

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[64] Release at 14,981, P.App. 97.
[65] Release at 14,994, P.App. 110.

Finally, claims about the supposedly crushing impact of new rules and their associated compliance costs should be viewed against the financial industry's long history of inflating concerns about the impact of regulation—regulation that ultimately has allowed that industry to become and remain among the most profitable enterprises in human history. Such predictions are the type of sky-is-falling exaggerations that the financial services industry has launched against new regulation for almost a century. Time and time again, they have ominously warned that new regulatory requirements will have a devastating impact by imposing unbearable compliance costs or creating other disruptions. Yet the financial industry has absorbed those reforms and continued to prosper.[66]

## CONCLUSION

For all the foregoing reasons, the Court should deny the plaintiffs' Motion for Summary Judgment and grant the SEC's Cross-Motion for Summary Judgment.

Dated: July 3, 2024

Respectfully submitted,

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[66] Marcus Baram, *The Bankers Who Cried Wolf: Wall Street's History of Hyperbole About Regulation*, THE HUFFINGTON POST (Jun. 21, 2011), https://tinyurl.com/2gbkp6oz; Paul G. Mahoney, *The Origins of the Blue-Sky Laws: A Test of Competing Hypotheses*, 46 J.L. & ECON. 229, 249 (2003) ("In the 5 years following adoption of a merit review statute [the most stringent type of blue sky law statute], bank profits increased on average by nearly 5 percentage points . . . ."); John Heltman, *Mortgage Rules Not Chilling Market as Feared, Data Shows,* AMERICAN BANKER (Sept. 24, 2015), http://www.americanbanker.com/news/law-regulation/mortgage-rules-not-chilling-market-as-feared-data-shows-1076899-1.html.

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**CERTIFICATE OF SERVICE**

I hereby certify that on July 3, 2024, the forgoing document was filed electronically and is available for viewing and downloading through the ECF system. Notice of this filing will be sent electronically to the registered participants identified on the Notice of Electronic Filing.

Respectfully submitted,

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