

Comment on S7-02-22: Exchange Rule Act 3b-16 Regarding the Definition of Exchange Regulation



Prepared for: United States Securities and Exchange Commission

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The Reason Foundation opposes government action that would unduly stifle the development and use of innovative technologies. This proposed rule change is an example of such an action. It would expand the definition of a “securities exchange” so much that it would likely capture many forums, smart-contracts, and other communications platforms that are not

securities exchanges within the conventional meaning of the term but would nonetheless be exposed to reporting requirements and other regulations.¹ This could inhibit important innovations in a dynamic and highly competitive market without providing commensurate benefits to investors or consumers.

Previously, in order to be considered a “securities exchange,” a platform had to provide some way for buyers and sellers to match “Orders” and provide “Firm” trading interest. The SEC defines such an order as, “any firm indication of a willingness to buy or sell a security, as either principal or agent, including any bid or offer quotation, market order, limit order, or other priced order.”

The proposed rule change would require any communications protocol for buyers and sellers that is used to express “non-firm, trading interest” to register as an exchange or a broker-dealer. This could include things like forums where sellers may post information about a security being offered for sale and where others can effectively communicate and bid on that offer, but *not* execute a trade; in order to execute a trade, the buyer and seller would have to use an actual exchange. Indeed, the new regulation could even impact Ebay, which started facilitating transactions of Non Fungible Tokens last year.² The SEC claims that the securities market has become “more electronic” and that communications systems have become “a preferred method for market participants to discover prices, find a counterparty, execute a trade...” while skirting all the regulations typically surrounding these types of transactions.

To the extent that this rule change has a legitimate target, it is likely communications relating to “dark-pools” of securities, where sellers and buyers can interact anonymously. Dark-pools may indeed pose some risks, but they also serve a valuable market function for knowledgeable accredited investors (especially those that are large buyers and sellers), for whom open discussion of a particular security

¹ <https://www.sec.gov/rules/proposed/2022/34-94062.pdf>

² <https://community.ebay.com/t5/Announcements/eBay-and-digital-collectibles-our-tech-led-reimagination/ba-p/31861893>

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could impact the price of that security. As such, and as noted above, this is a complex securities issue and should be given much more time and attention before being changed.

More concerning is that this rule change will capture many technologies such as forums, decentralized finance, and smart-contracts which are likely not in the intended scope of the rule change. It does exclude “Web Chat Providers” because “such providers are not specifically designed to bring together buyers and sellers of securities or provide procedures or parameters for buyers and sellers to interact.” However, it follows up by noting that if the program is “designed” for buyers and sellers to agree to terms of a trade, it would have to be regulated as an exchange. However, it is unclear what constitutes “specifically designed” for buyers and sellers. This rule may have the effect of transferring what it considers “dark-pool” conversations from platforms designed to handle those conversations to more general communications technologies. It is unclear why this would improve investor safety or market efficiency.

If technologies such as decentralized finance and smart-contracts were intended to be captured by the rule change, they should be explicitly considered. Since they are not, they should be explicitly excluded. If they are not excluded, the rule change will likely capture many smart-contract applications that have little to do with securities and much to do with cryptography. It could entail software engineers and hobbyist developers being required to register with the FCC and to track massive amounts of data on their platforms. This would effectively put many of these people out of business, thereby stifling experimentation and innovation in a novel market.

Furthermore, technologies like smart-contracts do not always have the kinds of data the SEC reporting would require, such as the personal identity of each party. Apart from anything else, smart contracts are not actually contracts, they are rules governing the relationships between two or more computers that self-execute under specified conditions, so it would not be possible to specify the “personal identity” in most cases. In addition, pseudonymity is often a desired characteristic of cryptography and smart contracts (a recent example would be privacy-preserving contact tracing apps). It is unclear what legality or reporting requirements smart-contracts would have under this rule change. There are also many intermediating technologies required to make smart-contracts work and which would technically be captured by this rule but have nothing to do with securities, such as Automated Market Makers. This uncertainty could become a strong dis-incentive for investors, developers, and firms to pursue smart-contract technology.

There is also a first-amendment concern because the rule is so encompassing in the types of communications that it captures. It may be unconstitutional for the federal government to require such extensive tracking of free speech about speculative investments into cryptocurrency or other related technologies.

This concern even applies if the regulation is only applied to government securities ATS providers such as BrokerTec and DealerWeb, the proposed rule has large implications necessitating a longer review. Publicly held Treasury Debt now exceeds \$23.6 trillion dollars³ and is expected to surpass \$30 trillion in

³ <https://fiscaldata.treasury.gov/datasets/debt-to-the-penny/debt-to-the-penny>

2028⁴. Reduced liquidity in this enormous market could result in higher Treasury interest rates which would have substantial budgetary implications.

The proposal in question is roughly 650 pages long, soliciting comments on 220 different areas. The ramifications of so many changes are likely not well understood by all parties involved and could alter the market in unpredictable or unhealthy ways.

⁴ <https://www.cbo.gov/data/budget-economic-data#3>

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