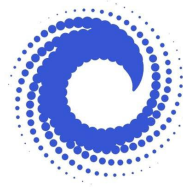

June 12, 2023

Vanessa A. Countryman
Secretary,
Securities and Exchange Commission
100 F Street NE, Washington, D.C. 20549

Re: Supplemental Information and Reopening of Comment Period for Amendments Regarding the Definition of "Exchange" (Release No. 34-97309, File No. S7-02-22), RIN 3235–AM45

Dear Ms. Countryman:

ConsenSys Software Inc. ("ConsenSys") writes to comment on the amendments proposed in the above-captioned rulemaking, and particularly to provide our perspective on what appears to be a broad assertion of regulatory authority over blockchain technology. As the leading programmable blockchain software company helping to build the digital economy of tomorrow, we have a strong interest in the blockchain regulatory environment. We thus had serious concerns when the SEC originally unveiled these amendments regarding the definition of "exchange," starting with the fact that the amendments seemed potentially applicable to blockchain-based systems despite the Proposing Release never mentioning cryptocurrency, blockchain technology, or their applications in its 200-plus pages. We appreciate that the Commission has now issued a Reopening Release that eliminates this ambiguity, but we are troubled to see that the Release erroneously concludes that the amendments—and the underlying Rule—*are* applicable to blockchain-based systems, while also committing other serious errors. We write again to highlight these critical legal and factual errors.

In submitting this letter, we expand on the concerns we expressed during the initial comment period. Our earlier letter, which we attach as an exhibit, details the exciting potential of blockchain technology, ConsenSys's work in the blockchain sphere, and the numerous shortcomings of the Commission's proposal. But apart from taking a more explicit position on the amendments' application to blockchain technology, the Reopening Release fails to correct these shortcomings and indeed goes further down the wrong track.

We discuss our concerns in three parts with the sincere hope that the Commission will reconsider its current proposal and engage earnestly with the blockchain community to arrive at a sensible regulatory framework. *First*, we reiterate the ways in which the proposed amendments are fundamentally flawed, highlighting shortcomings that the Reopening Release does not correct. *Second*, we explain why the new Release underscores and indeed exacerbates these

shortcomings. *Finally*, we discuss how the Release's attempt to provide blockchain-specific analysis only serves to introduce new errors into the SEC's proposal.

Together, these flaws mean that the proposed amendments cannot be lawfully adopted in their current form. As we explain below, the SEC's analysis simply cannot be squared with the Exchange Act of 1934, existing exchange regulations, or an accurate understanding of blockchain technology or the ecosystem as it exists today and is likely to evolve over time. The proposed amendments are not only flawed as a *legal* matter, though; they would have tremendous *practical* consequences for a transformative and fast-growing sector of the economy. The amendments would subject blockchain-based systems to regulatory burdens for which compliance is not only difficult, but also often impossible, and thus throw the broader blockchain ecosystem in the United States into paralyzing regulatory uncertainty. Indeed, the Releases themselves are *already* fostering substantial uncertainty, as the ecosystem tries to determine whether the Commission intends to follow through on its sweeping claims of authority, and, if so, whether those claims are legally sound. Existing entities are increasingly considering whether to relocate outside the United States or shut down entirely, while the uncertainty deters new entrants into the market, stifling growth and innovation.

We respectfully request that the Commission withdraw the proposed amendments—either generally or at least as applied to blockchain-based systems. Such caution would be particularly appropriate because, as the Commission is undoubtedly aware, Congress is currently crafting comprehensive legislation for regulating blockchain technology and has been considering various legislative proposals concerning a regulatory framework for several years.[1] The high likelihood that legislation will be passed in due course means that the SEC will soon need to adopt implementing regulations under a new legal framework. Given the fundamental questions about the Commission's authority to regulate in this space *at all*—including questions being asked by members of the Commission itself—we respectfully submit that the Commission should proceed with care and prudence.

DISCUSSION

I. The Reopening Release Fails to Correct Key Legal Deficiencies in the Proposed Amendments.

During the initial comment period, ConsenSys and other commenters identified a host of shortcomings with the proposed amendments. The SEC is no longer silent on the amendments' application to blockchain technology, which is certainly an improvement to the extent the intent of the amendments has always been to apply to blockchain, as the Reopening Release essentially admits. But the Release fails to meaningfully correct other deficiencies. In the interest of brevity, we do not restate the full analysis in our earlier letter, but we reiterate that—as currently formulated—the proposed amendments cannot be squared with the '34 Act, the Administrative Procedure Act, or the U.S. Constitution.

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[1] *See, e.g.*, Press Release, *McHenry, Thompson, Hill, Johnson Release Digital Asset Market Structure Proposal*, House Fin. Servs. Comm. (June 2, 2023), https://bit.ly/3ITPAhx.

First, the proposed amendments seek to expand the regulatory definition of "exchange" beyond what the '34 Act can bear. The Act defines "exchange" as "any organization, association, or group of persons, … 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."[2] As we explained in our earlier letter, this statutory definition is concerned only with intermediary systems that bring together the orders of actual buyers and sellers. And the statutory history reflects that Congress sought to regulate exchanges only insofar as they were *centralized* entities that possess—as a result of their centralization—a uniquely important role in setting market prices and otherwise affecting market conditions. Yet the SEC is now proposing a regulatory redefinition of 17 C.F.R. § 240.3b-16(a) that would treat as exchanges systems that *merely reach* potential buyers and sellers, allowing them to find and negotiate transactions with each other. And it seeks to apply this regulation to blockchain-based systems despite their predominantly decentralized nature—a structure that does not implicate any of the market-setting concerns underlying the '34 Act. The proposed amendments thus violate the basic rule that an agency may not adopt a regulatory definition inconsistent with the statute it is interpreting.[3]

Second, the proposed amendments are impermissibly motivated by "factors which Congress has not intended [the SEC] to consider."[4] When the Commission initially announced the amendments, it made clear that, while their stated purpose was to expand the regulatory definition of "exchange," the amendments would not increase the number of registered *exchanges*. Rather, the amendments would serve to induce new *broker-dealer* registrations by providing so-called "New Rule 3b-16(a) Systems" an easier off-ramp through the Regulation ATS exemption.[5] The issue with this, of course, is that the '34 Act defined the terms "broker" and "dealer" as categories distinct from "exchange,"[6] and the Commission (like all agencies) is bound by that congressional choice.[7] It cannot promulgate a regulation interpreting one statutory provision as a backdoor means of expanding other provisions beyond their text.

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[2] '34 Act § 3(a)(1).

[3] *United States v. Haggar Apparel Co.*, 526 U.S. 380, 392 (1999) ("the regulation will not control" if it is "inconsistent with the statutory language or is an unreasonable implementation of it").

[4] *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

[5] *See* 87 Fed. Reg. 15496, 15618-29 (Mar. 18, 2022) (estimating benefits and costs of the proposed amendments by reference to the benefits and costs of compliance with the broker-dealer requirements).

[6] '34 Act § 3(a)(4)-(5).

[7] *Michigan v. EPA*, 268 F.3d 1075, 1081 (D.C. Cir. 2001).

Third, the proposed amendments are unconstitutionally vague. The amendments sow confusion about the intended scope of "exchange" by replacing the current rule's clear parameters with ones that are nebulous and poorly defined. For example:

- They provide no way for market participants to know whether their actions contribute to the efforts of potential buyers and sellers to transact, or to contemplate a possible future transaction.

- They do not specify the level of causation necessary for a group to be "making available" an established, non-discretionary method for trading.

- They do not specify the level of scienter required for someone to become a part of a "group of persons" that is making such methods available.

- They do not explain the extent to which they apply to platforms and participants that reside in part, substantially, or even entirely in foreign jurisdictions.

- They do not even explain what constitutes a "communication protocol" in the first place.

With these and other questions unresolved, the proposed amendments are riddled with "terms so vague that men of common intelligence must necessarily guess at [their] meaning."[8] This problem leaves everyone who guesses wrong—ranging from companies like ConsenSys to the individual software developers and users who rely on our offerings in their work and personal affairs, and who generally are not sophisticated securities-law experts—to face hefty penalties after the fact. That sort of retroactive punishment on the basis of hopelessly vague rules is precisely what the Due Process Clause forbids.

Fourth, the cost-benefit analysis underlying the proposed amendments is woefully deficient. Agencies may not promulgate regulations "based on arbitrary and capricious cost-benefit analyses."[9] A regulation is "highly capricious" if it purports to solve a problem that does not actually exist,[10] yet in announcing the amendments, the Proposing Release failed to identify any evidence of real-world harm necessitating the amendments, or to provide even a non-conclusory justification for why they would be beneficial.[11] Likewise, a regulation is irrational if the agency fails to give due consideration to the accompanying costs and how they weigh against any benefits.[12] Here, the Release's failure to conduct any meaningful benefits analysis underscores the irrationality of proceeding with a rule that the Commission admits would impose

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[8] *FCC v. Fox Television Stations, Inc.*, 567 U.S. 239, 253 (2012) (quotation marks omitted).

[9] *City of Portland v. EPA*, 507 F.3d 706, 713 (D.C. Cir. 2007).

[10] *Alltel Corp. v. FCC*, 838 F.2d 551, 561 (D.C. Cir. 1988).

[11] 87 Fed. Reg. at 15502-03.

[12] *See Michigan v. EPA*, 576 U.S. 743, 752-53 (2015).

(at least) several million dollars in costs annually; for which it fails to estimate, even just qualitatively, the value of any countervailing benefits; and as to which it neglects to explain how the amendments satisfy cost-benefit analysis.[13] Moreover, the Release takes an improper catch-all approach that fails to distinguish between very different categories of blockchain participants and technologies,[14] while also failing to provide any meaningful analysis of the costs and benefits to efficiency and capital formation—criteria that Congress has specifically directed the Commission to weigh in every rulemaking.[15]

Finally, the proposed amendments would infringe on protected speech in violation of the First Amendment. Under the amendments, whether a system qualifies as an "exchange" turns on the content of the speech it facilitates. Systems that help people communicate about their interest in buying or selling securities would count as exchanges, while systems that facilitate communication about other topics would not. But the Constitution almost always forbids the government from "target[ing] speech based on its communicative content."[16] For such content-based targeting to be permissible, the SEC must show that it is advancing sufficiently important ends and doing so through sufficiently tailored means.

The Proposing Release did not even *acknowledge* that the amendments implicate the First Amendment, much less explain how they would survive any level of First Amendment scrutiny. And as currently formulated, the amendments would fail such scrutiny, given the Commission's failure to explain the need for its proposal or to establish clear boundaries for the scope of its redefinition and thus demonstrate that the amendments are carefully tailored to securing important interests.[17]

II. The Reopening Release Reinforces and Exacerbates the Problems of the Original Proposal.

We are disappointed that the Reopening Release has not reconsidered the broader analysis offered in the Proposing Release, as that sweeping analysis cannot be squared with the SEC's authorizing statute, its constitutional obligations, or basic principles of administrative law. Instead, the Reopening Release appears to double down on these fundamental flaws.

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[13] 87 Fed. Reg. at 15618-39.

[14] *Mich. Wis. Pipe Line Co. v. FPC*, 520 F.2d 84, 89 (D.C. Cir. 1975) ("not reasoned decision-making" to apply the same rule across cases "without recognition of the substantial differences between the two cases").

[15] *See* 15 U.S.C. §§ 77b(b), 78c(f).

[16] *Reed v. Town of Gilbert*, 576 U.S. 155, 163 (2015).

[17] *Compare id.* (generally requiring content-based restrictions to be "narrowly tailored to serve compelling state interests"), *with Cent. Hudson Gas & Elec. Corp. v. Pub. Serv. Comm'n of N.Y.*, 447 U.S. 557, 564 (1980) (for commercial speech, requiring restrictions to be "proportion[ate]" to a substantial state interest).

A. The Reopening Release Overreads the Term "Exchange" in the '34 Act.

To start, the Reopening Release is similarly insistent on expanding the term "exchange" beyond what the '34 Act can bear. In addition to the problems described in Part I, the Reopening Release fails to properly consider either *what* an exchange does under the '34 Act, or *who* may be considered part of an exchange.

1. The '34 Act is clear about the functions necessary for an exchange to exist. It asks whether a group "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."[18] During the original comment period, ConsenSys and other commenters explained that New Rule 3b-16(a) Systems do not qualify because they do not "perform[] with respect to securities the functions commonly performed by a stock exchange."[19]

The Reopening Release tacitly admits the premise of the point: rather than explain how New Rule 3b-16(a) Systems *do* perform functions commonly performed by stock exchanges, it professes only that the SEC is not required to show that they do.[20] The Release reads section 3(a)(1) of the '34 Act to operate in the disjunctive: a group qualifies as an exchange if its market place or facilities (1) "bring[] together purchasers and sellers of securities" *or* (2) "perform[] … the functions commonly performed by a stock exchange."[21] And it asserts that New Rule 3b-16(a) Systems satisfy option (1).

This interpretation fundamentally distorts the statute. Section 3(a)(1) does *not* say that a facility is an exchange if it does "A" or "B"—as a disjunctive requirement would. It instead explains that, to qualify as an exchange, a facility must do "A" or "*otherwise*" "B." And it is a "cardinal principle of statutory construction" that statutory provisions should be read, wherever possible, to "give effect … to every clause and word of [the] statute."[22] The word "otherwise" is a critical statutory term that the Commission simply ignores.

Read properly, the statute creates a single path to becoming an exchange, not two separate ones. The word "otherwise" specifies that the second clause is not some *distinct* mode of qualifying as an exchange. It is, rather, a residual clause that fills any gaps in the specific examples section 3(a)(1) enumerates.

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[18] '34 Act § 3(a)(1).

[19] *Id.*

[20] 88 Fed. Reg. 29448, 29458 (May 5, 2023).

[21] *See id.*

[22] *NLRB v. SW Gen., Inc.*, 580 U.S. 288, 304 (2017) (quotation marks omitted).

The word "otherwise" means "[i]n another way" or "[b]y another means," and thus conveys that the "A" and "B" clauses must be read in conjunction.[23] In particular, "otherwise" "operates as a catchall: the specific items that precede it are *meant* to be subsumed by what comes after the 'or otherwise.'"[24] So, in the context of section 3(a)(1), the inclusion of "otherwise" means that the statute is concerned with "market place[s] or facilities for bringing together purchasers and sellers of securities" *only insofar as* they are performing "functions commonly performed by a stock exchange."[25]

New Rule 3b-16(a) Systems do not perform functions commonly performed by stock exchanges, as the Reopening Release all but admits. They thus do not "bring[] together purchasers and sellers of securities" within the meaning of section 3(a)(1), and so are not exchanges under the '34 Act.

This basic statutory limit not only precludes the proposed rule but also underscores why the Reopening Release's broader effort to apply existing exchange requirements to blockchain-based systems exceeds the Commission's statutory authority. In clarifying that the SEC interprets the proposed amendments to reach the blockchain, the Release declares that the existing regulation *already* applies to many blockchain systems.[26] That is a remarkably broad assertion to casually make in a rulemaking, and it is one that both requires more extensive justification and underscores the capriciousness of the Release's rulemaking approach.[27] But more than that, it is also wrong as a matter of law.

Most blockchain-based systems are partially or entirely decentralized and thus do not perform the functions of a stock exchange as that concept was understood at the time of the '34 Act. For example, "automated market makers"—which the Reopening Release contemplates

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[23] *Otherwise*, *Oxford English Dictionary* (2d ed. 1989).

[24] *Villarreal v. R.J. Reynolds Tobacco Co.*, 839 F.3d 958, 964 (11th Cir. 2016) (en banc).

[25] *See id.* In *Villarreal*, for example, the statute at issue proscribed employers from engaging in age-based discrimination that "would deprive or tend to deprive any individual of employment opportunities or otherwise adversely affect his status as an employee." 29 U.S.C. § 623(a)(1). The Court recognized that, although the "employment opportunities" phrase could be read in isolation to bar discrimination against employment *applicants* in addition to current *employees*, by including the qualifier "otherwise," Congress made "'deprive or tend to deprive any individual of employment opportunities' a subset of 'adversely affect[ing] *his status as an employee*'" and limited both parts of the provision to proscribing discrimination against employees. 839 F.3d at 964.

[26] 88 Fed. Reg. at 29452-53, 29456.

[27] *Cf. Am. Wild Horse Pres. Campaign v. Perdue*, 873 F.3d 914, 923 (D.C. Cir. 2017) (agencies may not depart from "past practices" without "acknowledg[ing] the change and offer[ing] a reasoned explanation for it").

could be part of an exchange—operate through decentralized processes.[28] But as discussed above and as explained at length in our earlier comment, the original understanding of "exchange" extended only to *centralized* entities due to their market-setting capabilities. The '34 Act is governed by the "ordinary meaning at the time Congress enacted" it,[29] and thus precludes any belated attempt by the SEC to expand its authority. Thus, any rulemaking that is faithful to the statute would exclude decentralized systems, including those on the blockchain.

2. In addition to mangling *what* constitutes an exchange, the Reopening Release misunderstands *who* may be *part of* an exchange. The term "exchange" means any "organization," "association," or "group of persons" that "constitutes, maintains, or provides a market place or facilities" for the purposes discussed above.[30] Typically, identifying the pertinent "organization," "association," or "group of persons" is simple; traditional exchanges generally have clear organizational structures. But blockchain protocols and the networks on which they operate often do not, and the Release has no satisfactory answer for how to discern the "group of persons" responsible for a blockchain-based system. Rather than provide a clear definition or standard, it advances a few "important factors" of indeterminate weight.[31]

According to the Release, "important factors" in determining whether a person is part of the relevant "group of persons" that can constitute an "exchange" "would generally include whether the persons act in concert in establishing, maintaining, or providing" the necessary market place or facilities, or whether they "exercise control, or share control, over aspects of such market place or facilities or the performance of functions commonly performed by a stock exchange."[32]

These factors raise countless questions as one digs deeper into what all this actually means for anyone participating in the blockchain ecosystem. For example, the Release states that a group of persons might share a working agreement, but that would be just "one factor to consider, depending on other facts and circumstances."[33] But the Release leaves hopelessly unclear what else it considers relevant, or how important an actual agreement is to the group analysis. Can persons *unwittingly* engage in concerted activity sufficient to constitute a "group of persons," absent an established meeting of the minds? The scant discussion leaves one to guess.

As for control, the Release gives a few examples of when control over market place or exchange functions is alone sufficient to create responsibility over an "exchange." But what

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[28] 88 Fed. Reg. at 29453 n.49, 29477.

[29] *New Prime Inc. v. Oliveira*, 139 S. Ct. 532, 539 (2019) (cleaned up).

[30] '34 Act § 3(a)(1).

[31] 88 Fed. Reg. at 29454.

[32] *Id.*

[33] *Id.*

level of control is actually sufficient is left unsaid. In particular, the Release does not explain the threshold of "significant" token ownership at which blockchain users suddenly obtain sufficient control over the system to assume regulatory responsibilities.[34] Nor does it address the circumstances when a service provider or third-party vendor begins exercising enough control to become responsible—alongside its clients—for registering the "exchange."[35] Absent clarification about these and other questions, regulated parties will not have fair notice of their obligations under the law.

But even setting aside the fundamental ambiguities in the listed "factors," it is clear that they sweep too broadly. Under the text of section 3(a)(1), "[w]hether two or more persons may be acting in concert" is *the* crucial prerequisite for membership in a qualifying "group of persons"—not just one of several factors.[36] And "acting in concert" requires making a conscious choice—*i.e.*, entering an agreement to join together in furtherance of a common objective.[37]

This requirement follows from the text of section 3(a)(1). The statutory phrase "group of persons" that constitutes, maintains, or provides "a market place or facilities" clearly connotes a *bona fide* group of persons that has agreed to come together to form, maintain, or provide an exchange. And even if that were not clear from the statutory text, due process principles require reading this provision narrowly, to ensure that it is "sufficient[ly] definite[] that ordinary people can understand" their regulatory obligations and to limit the risk that the SEC could enforce those obligations in "arbitrary" or "discriminatory" ways.[38] The statute thus precludes including within an exchange persons who are not exercising their purported control in *concert* with others.

The Reopening Release's contrary interpretation is particularly troubling as applied to blockchain-based systems. While it does acknowledge, albeit vaguely, some limits on what constitutes a "group" in general,[39] it fails to give sufficient weight to independence in the blockchain context. Rather than meaningfully address that issue, the Release glosses over

[34] *Id.* at 29455.

[35] *Id.*

[36] *See Intercontinental Exch., Inc. v. SEC*, 23 F.4th 1013, 1024 (D.C. Cir. 2022).

[37] *See, e.g.*, *Concerted Action, Black's Law Dictionary* (11th ed. 2019); *Restatement (Second) of Torts* § 876 cmt. a.

[38] *Kolender v. Lawson*, 461 U.S. 352, 357 (1983); *see also* '34 Act § 32 (imposing criminal liability for willful violations of the '34 Act); *cf. Intercontinental Exch.*, 23 F.4th at 1025 (""the outer boundary of the term 'group of persons' remains murky, and vigilance is necessary to ensure the term is not stretched too far").

[39] For example, the Release acknowledges that "an affiliated entity of an exchange might not be considered a group of persons with that exchange" if there are certain indicia of independence, such as "separation of functions relating to technology, operations and infrastructure" or "avoidance of business links." 88 Fed. Reg. at 29454 n.66. This carve out is unfortunately too generalized and equivocal to afford any ecosystem participant real comfort.

concerns previously raised by commenters about how persons or users involved with "'DeFi' protocols . . . act independently of each other."[40] It instead suggests that all manner of disparate actors—including "validators," "miners," and "holders of governance or other tokens"—could be deemed part of an exchange.[41] Given that these wide-ranging actors are invariably and entirely independent from each other, in terms of both functions and incentives, among other things, the Release's standard for blockchain-based systems—and blockchain-based systems alone—appears to be that persons can be lumped together in a "group" whenever they engage in "related" activities. Not only would that sweeping test conflict with the '34 Act for the reasons detailed above, but it also would lead to a perverse result where blockchain users who are *working at cross-purposes*—like validators competing with each other to earn a limited number of block rewards—could nonetheless be deemed part of a unified group that shares regulatory responsibilities.

Importantly, the Reopening Release also fails to grapple with the fact that—particularly in the blockchain context—a "group of persons" operating a so-called exchange will often if not always include persons based outside the United States. That matters because the '34 Act generally does *not* apply extraterritorially.[42] Yet beyond acknowledging that "some amount of activity in the market for crypto assets discussed in this Reopening Release is conducted outside the U.S.," the Release offers no analysis of how the SEC intends for its proposed amendments to affect groups that include international actors.[43] This is a serious issue that greatly impacts blockchain participants around the world, and the Reopening Release is unquestionably deficient for failing to meaningfully deal with it at all.[44]

These complex issues of extraterritoriality further underscore the need for caution in expanding the scope of "exchange." And more than that, they require a fuller explanation from the SEC about how these rules will operate in the context of blockchain protocols and the global, permissionless computer networks on which they operate, followed by an opportunity for comment from the public, which has not yet had even a "first opportunity … to offer comments" on this important issue.[45]

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[40] *Id.* at 29455.

[41] *Id.* at 29455-56.

[42] *Morrison v. Nat'l Austl. Bank Ltd.*, 561 U.S. 247, 265 (2010).

[43] 88 Fed. Reg. at 29470 n.201.

[44] *State Farm*, 463 U.S. at 43 (agencies may not "fail[] to consider an important aspect of the problem").

[45] *Am. Water Works Ass'n v. EPA*, 40 F.3d 1266, 1274 (D.C. Cir. 1994); *see Horsehead Resource Dev. Co. v. Browner*, 16 F.3d 1246, 1268 (D.C. Cir. 1994).

In short, the Reopening Release adheres to and extends positions that are irreconcilable with the '34 Act and that exceed the Commission's "statutory jurisdiction, authority, or limitations."[46] The analysis underlying these positions likewise conflicts with the APA and its prohibition on arbitrary and capricious agency action. Should the Commission insist on moving forward with the proposed amendments, it must thus substantially narrow them to stay within the bounds of what the statute will permit and the evidence will support. And because such a substantial overhaul would require revisions that take the final rule far afield from the current proposal, the SEC must further allow for public comment on any revised proposal.[47]

B. The Reopening Release Underscores the Improper Aims of the Proposed Amendments.

To the extent the Proposing Release left any doubt about the purpose of the proposed amendments, the Reopening Release confirms that the SEC is using the amendments as a backdoor to expand the applicability of broker-dealer registration requirements. The new Release is predicated on the assumption that no New Rule 3b-16(a) Systems will *actually* register as exchanges, and that they will instead register as broker-dealers under the Regulation ATS option.[48] Most tellingly, although a primary purpose of the Reopening Release is to flesh out the SEC's economic analysis of the proposed amendments[49]—amendments written to expand the regulatory definition of *exchange*—the Release does not add any analysis about the costs or benefits of exchange registration in its pages and pages of supplemental analysis.[50] It, too, addresses only the purported costs and benefits of broker-dealer registration and compliance with Regulation ATS requirements.[51]

But as discussed above, Congress intentionally defined "exchanges" and "broker-dealers" as separate statutory categories, and the Commission may not regulate around Congress's choice.[52] If the Commission believes the regulatory definition of "broker-dealer" or the scope of

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[46] 5 U.S.C. § 706(2)(C).

[47] *Horsehead Resource Dev. Co.*, 16 F.3d at 1268 (requiring additional comment when the final rule was not one of the proposed alternatives in the notice of proposed of rulemaking nor a logical outgrowth of the original proposal).

[48] *See, e.g.*, 88 Fed. Reg. at 29465-66, 29469, 29475 n.259.

[49] *Id.* at 29449 (one aim of the Reopening Release is "supplement[ing] the economic analysis in the Proposing Release").

[50] *See, e.g.*, *id.* at 29475 n.259 ("the costs analyzed here assume that [New Rule 3b-16(a)] Systems will not register as national securities exchanges").

[51] *Id.* at 29475-90.

[52] *See Util. Air Regul. Grp. v. EPA*, 573 U.S. 302, 328 (2014) ("reaffirm[ing] the core administrative-law principle that an agency may not rewrite clear statutory terms to suit its own sense of how the statute should operate").

Regulation ATS to be inadequate, it should amend *those* rules—to the extent it can do so consistent with the '34 Act.

Moreover, the proposed amendments would inevitably chill the development and continuation of New Rule 3b-16(a) Systems and of blockchain-based systems more generally. While we, as a U.S.-based technology provider that employs nearly 900 people, hope that the SEC does not *intend* this result, we can see how others could infer otherwise, particularly against the backdrop of SEC leadership's public hostility towards the blockchain ecosystem. Just last week, for example, Chairman Gensler asserted that "we don't need more digital currency."[53] So too, the Release brusquely dismisses commenters' concerns, including ours, that blockchain-based systems may not be able to comply with exchange regulatory requirements in general, and with the broker-dealer and Regulation ATS requirements in particular.[54] The Release likewise makes clear the SEC's indifference to the fact that the proposed amendments may deter innovation and drive market participants either to move outside the United States or to shut down entirely.[55] And finally, given that the proposed amendments are replete with vague interpretations, requirements, and standards, they only increase regulatory confusion.

This confusion is further compounded by the SEC's apparent use of the Reopening Release as a vehicle to make highly contestable pronouncements about the scope of its *current* regulation—namely, how the current definition of "exchange" in Commission regulations already applies to blockchain protocols. This almost off-handed pronouncement raises fundamental questions for stakeholders as to whether and how they are *already* regulated, or just at risk of *future* regulation, or somewhere in between. As Commissioner Peirce aptly put it, the result is a proposal that "embrace[s] stagnation, … urge[s] expatriation, and welcome[s] extinction of new technology."[56] The Commission should make clear that this is not its goal by withdrawing its proposal and including appropriate safeguards in any revised effort.

We would like to believe that broadly chilling blockchain innovation is not actually the Commission's goal, because that is clearly not a legally permissible basis for the proposed amendments. Agencies may not adopt regulations for pretextual or predetermined reasons.[57] Nor, as discussed above, may an agency consider "factors which Congress has not intended it to

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[53] Jack Schickler & Elizabeth Napolitano, *U.S. Doesn't 'Need More Digital Currency' Because It Has the Dollar, Says SEC's Gensler*, CoinDesk (June 6, 2023), https://bit.ly/3p0HPjb.

[54] *See, e.g.*, 88 Fed. Reg. at 29456-57, 29485-87.

[55] *Id.* at 29482, 29486.

[56] Hester M. Peirce, *Rendering Innovation Kaput: Statement on Amending the Definition of Exchange*, SEC (Apr. 14, 2023), https://bit.ly/41cTbxB.

[57] *Dep't of Commerce v. New York*, 139 S. Ct. 2551, 2575-56 (2019) (finding agency action arbitrary and capricious where the agency's stated justification was "incongruent with what the record reveals about the agency's priorities and decisionmaking process"); *Rural Cellular Ass'n v. FCC*, 588 F.3d 1095, 1101 (D.C. Cir. 2009) (an agency must "remain sufficiently open-minded" throughout the rulemaking process).

consider."[58] And the '34 Act Congress—which enacted section 3(a)(1) to create guardrails around the operation of *centralized* systems—could not have intended for the SEC to elaborate on that provision for the purpose of targeting primarily *decentralized* entities, many of which have a greater footprint overseas than in the U.S. Thus, if the Commission believes that certain blockchain-based systems, as currently constituted, should not be permitted to operate, then the proper course is to propose that change directly rather than marshaling the exchange rules as a conduit for doing so.

C. The Reopening Release Exacerbates the Vagueness of the Original Proposal.

The Proposing Release was impermissibly vague, and the Reopening Release only makes the problem worse. As the new Release acknowledges, numerous commenters previously warned that the boundaries of the proposed amendments were too uncertain.[59] The Reopening Release gestures at addressing this problem, such as by proposing the possibility of revising the proposed amendments to cover "negotiation protocols" instead of "communication protocols."[60] But that marginal change would only nibble at the edges. To craft a proposal that is not impermissibly vague, the SEC must revisit *all* of its proposed changes, and provide actual definitions (or at least concrete examples) of the new terms it seeks to adopt so that commenters like ConsenSys can understand what they mean in practice.

The Reopening Release does not do any of this. Even as to "negotiation protocols," it cannot point to specific examples of what kinds of systems it has in mind. Instead, the Release merely repeats that the proposed amendments' application will depend on "facts and circumstances"—a phrase it uses fully a dozen times.[61]

But the Release's discussion of possible "facts and circumstances" only heightens the uncertainty about how broadly the proposed amendments will apply. First, the Release repeatedly makes clear the SEC's view that questions of application will turn on facts and circumstances in the plural. For example, as discussed above, it describes the existence of an underlying agreement as "one factor to consider, depending on other facts and circumstances," "in assessing whether a person would be acting in concert with a group of persons."[62] But here and elsewhere, it provides no hint as to how this factor should be weighed alongside the other facts and circumstances. In what circumstances does the SEC think individuals can act in concert without having agreed to do so? Can concerted action ever be absent even if there is an underlying agreement? The Release does not say.

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[58] *State Farm*, 463 U.S. at 43.

[59] *See, e.g.*, 88 Fed. Reg. at 29482, 29460.

[60] *Id.* at 29459-60.

[61] *Id.* at 29450-57, 29465.

[62] *Id.* at 29456.

Likewise, the Release refuses to identify circumstances that definitively fall outside the proposed amendments' scope, leaving commenters guessing as to where the outer perimeter of these amendments is to be found. For example, even as to a software developer who publishes or republishes code on his own independent volition—*i.e.*, a developer who obviously is not establishing an exchange—the most the Release can say is that the developer "*may be less likely*" to face registration obligations if the code is subsequently repurposed for use by a supposed exchange.[63] This is a critical point to a company like ConsenSys, which among other things develops free, open-source software for a wide variety of purposes. The Release leaves completely unclear to us the circumstances in which our software development might inadvertently venture from "less likely" (which is no real comfort to begin with) to "more likely" to face registration obligations. Any good-faith attempt to stay on the right side of the proposed amendments in this regard would be nothing more than a stab in the dark.

And it is even more disconcerting that the Release does not deny that the various entities commenters fear "might be inadvertently captured by the definition"—such as social-networking sites, messaging applications, and smart-contracting platforms—could, in fact, fall within the scope of the proposed amendments.[64] Instead, the Release attempts to pass the task of resolving the proposal's ambiguities onto commenters, making myriad requests for comment about the proper scope of the rule. For example, the Release asks whether the phrase "directly or indirectly"—which it is seeking to add to Rule 3b-16(a)—should be interpreted to have limiting principles and, if so, what they should be.[65] These questions further confirm that the language in the proposed amendments is open-ended and ambiguous rather than self-defining and clear.

To the extent the SEC leaves gaps like these unresolved in any final rule, it would be unlawful for a host of reasons. Such ambiguity is impermissibly arbitrary because it allows the Commission to apply the amendments without meaningful constraint.[66] It also deprives regulated parties of fair notice because the proposed amendments are "not sufficiently clear to warn [regulated parties] what is expected of [them]."[67] And, just as troublesome, the proposed amendments would unduly burden market participants who are not regulated parties by making them understandably fearful that they might be. Moreover, if and when the SEC offers much-needed regulatory clarity through definitions and examples, it must also provide a specific

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[63] *Id.* (emphasis added).

[64] *Id.* at 29477.

[65] *Id.* at 29459.

[66] *See Lemoyne-Owen College v. NLRB*, 357 F.3d 55, 61 (D.C. Cir. 2004) ("In the absence of an explanation, the 'totality of the circumstances' can become simply a cloak for agency whim—or worse.").

[67] *Trinity Broad. of Fla., Inc. v. FCC*, 211 F.3d 618, 628 (D.C. Cir. 2000).

opportunity for public comment on that new analysis, which like other substantial changes should be "tested by exposure to diverse public comment."[68]

D. The Reopening Release's Economic Analysis Is Deeply Flawed.

The Reopening Release's deficiencies also persist in its economic analysis. The Commission devotes much of the Release to supplementing the analysis of costs and benefits in the Proposing Release.[69] Yet the new Release only repeats and even worsens the flaws in that original analysis.

1. To start, the Reopening Release still makes no effort to show that the benefits of the proposed amendments outweigh their costs—a basic prerequisite to rational agency action.[70] Instead, the Release appears to suggest that the SEC may impose rules without regard to the proportionality of their consequences, reassuring commenters at one point that "the Commission believes that the[] costs [of the proposed amendments] are not impossible to pay."[71] But the relevant question is whether a proposal would do "more good than harm,"[72] and an agency thus may not promulgate rules whose costs "far outweigh any benefits."[73] And given that the Release is simply silent on this proportionality question, it is reasonable to infer that either the Commission cannot actually foresee the consequences of its proposal, or it has concluded that such an assessment would not support the amendments.

Indeed, even if the Commission had wanted to provide a rough weighing analysis, the breadth and ambiguity of the amendments would make doing so impossible. Under the current Release, it is entirely unclear what range of participants may or may not be swept up in this proposed regime. We see this uncertainty in considering the amendments' application to ConsenSys's own products. For instance, ConsenSys offers MetaMask, a client-side, unhosted wallet software program that permits users to maintain secure and exclusive access to their funds, read blockchain data, and send transactions on their own behalf, including ones that leverage the computational logic of DeFi smart contract protocols; Infura, a blockchain node service that processes billions of user and developer queries a day, as people read and write to the blockchain; and Diligence, a smart contract security auditing service often used by DeFi projects to test and improve their code. These programs, and similar ones offered by others located around the world, all perform critical functions in the peer-to-peer blockchain space, but the Release leaves unclear the extent to which these programs—and affiliated developers or

[68] *Horsehead Resource Dev. Co.*, 16 F.3d at 1268 (quotation marks omitted).

[69] *See* 88 Fed. Reg. at 29469-90.

[70] *See Michigan*, 576 U.S. at 752-53.

[71] 88 Fed. Reg. at 29484.

[72] *Md. People's Counsel v. FERC*, 761 F.2d 768, 779 (D.C. Cir. 1985).

[73] *See, e.g.*, *City of Centralia v. FERC*, 213 F.3d 742, 750 (D.C. Cir. 2000).

users—may be implicated by an amended Rule 3b-16(a). And the Release certainly makes no attempt to weigh the costs, benefits, or proportional value of ensnaring these programs.

2. Even if the Reopening Release could justify the proposed amendments by reference to benefits alone, the benefits it identifies are illusory. The new Release, like the Proposing Release, does not identify even a single real-world example of why the proposed amendments are necessary—for instance, it offers no evidence that anyone has been harmed by the absence of the regulations it seeks to impose. The Reopening Release instead offers only a conclusory analysis of the proposal's purported benefits: it makes the unsupported assertion, for example, that the expansion of regulatory oversight is necessarily beneficial.[74] But the SEC may not promulgate a regulation to address a problem that does not in fact exist and then cite the proposed regulation's enhanced application to that non-existent problem as a basis for its legality.[75]

Moreover, to the extent the proposed amendments may generate any meager benefits, the Reopening Release fails to consider how those benefits will vary depending on the nature of the regulated entity. It elides the fact that blockchain-based systems operate very differently from their "TradFi" counterparts, and that the blockchain ecosystem is itself divided between "CeFi" and "DeFi" systems, with only the latter being organized around principles of decentralization.[76] These differences mean that the cost-benefit analysis must be category-specific. For example, the Release touts one benefit of the proposed amendments as their enhancement of investor protection.[77] But the need for such traditional protections in that regard is meaningfully reduced in the DeFi context and varies among different protocols, given the strong investor protections underlying blockchain technology and the variability in how smart contract protocols are composed and function. DeFi platforms are generally noncustodial (*i.e.*, the platforms never take possession of users' funds) and atomic (*i.e.*, the platforms facilitate transactions address-to-address, without risk of error, as address owners either see their transaction processed or simply retain the assets they started with). But some may have different characteristics and functionality. These distinctions matter to a cost-benefit analysis, and on their face, the Release's summary assertion that the benefits of its proposed amendments will be similar for

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[74] 88 Fed. Reg. at 29475.

[75] *Alltel Corp.*, 838 F.2d at 561.

[76] *See, e.g.*, Ekin Genç, *DeFi v. CeFi in Crypto*, CoinDesk (Aug. 15, 2022), https://bit.ly/42pfAZp (contrasting "decentralized finance" systems, which typically run on smart contracts, with "centralized finance" systems, which also run on the blockchain but through more corporate controls in lieu of smart contracts).

[77] 88 Fed. Reg. at 29475.

both blockchain-based and more traditional systems makes little sense.[78] Agencies may not ignore potentially dispositive factual distinctions.[79]

3. In any event, the Reopening Release *also* needs to consider costs, and its consideration here fares no better. By recognizing that blockchain-based systems generally—and particularly decentralized systems, such as those that use smart contracts—are likelier to face higher costs than other New Rule 3b-16(a) Systems, the Release tacitly acknowledges that the cost side of the cost-benefit equation is particularly important here.[80] But the Release makes no attempt to provide a specific estimate, instead admitting that the SEC has no understanding of just how high the costs might rise for either category.[81]

Indeed, to the extent the Reopening Release does discuss costs, it underestimates the likely harms in important ways. For one thing, the Release substantially undercounts the number of entities that will be affected by the proposed amendments. It estimates that there are between 35 and 46 New Rule 3b-16(a) Systems, between 15 and 20 of which trade digital assets.[82] But based on ConsenSys's experience in the blockchain industry, both of those estimates are *far* too low, and neither estimate even attempts to account for the many new entrants likely to join that fast-growing ecosystem in the coming months and years. By way of comparison, one blockchain research and data firm, which is widely relied on in the space, has reported that there are hundreds of protocols that function as "Decentralized Exchanges," and hundreds more "lending protocols"—all of which must now wonder whether they now fall under the Commission's new interpretation of its authority, under either the existing Rule 3b-16(a) or the proposed amendments.[83]

Beyond this underestimation of the *size* of costs, the Reopening Release takes a too-cramped view of the *range* of relevant costs. For example, the Release largely ignores the following important costs:

- **The costs of slowing innovation.** The Release admits that adoption of the proposed amendments could well cause "market participants [to] decrease and slow down the development of new products and technologies," push systems away from operating through decentralized mechanisms, raise barriers to entry in the blockchain space, and even drive some entities out of the blockchain market.[84] But it makes no systematic

[78] *See id.* at 29475-76.

[79] *State Farm*, 463 U.S. at 43; *Mich. Wis. Pipe Line Co.*, 520 F.2d at 89.

[80] 88 Fed. Reg. at 29483, 29485.

[81] *Id.* at 29476, 29483-84.

[82] *Id.* at 29465, 29474.

[83] *See All Protocols*, Messari, https://bit.ly/3J3WKQm (last visited June 12, 2023).

[84] 88 Fed. Reg. at 29482, 29484 n.368, 29486.

attempt to estimate the costs of reduced innovation, despite the disproportionate rate of economic growth and innovation taking place until now in the blockchain ecosystem, which all accrues to the benefit of consumers, retailers, and the public more broadly.[85] Nor does it consider the fact that this stifling of innovation may affirmatively disadvantage the United States by driving innovation overseas.[86]

- **The costs of regulatory uncertainty.** As this letter makes clear, the regulatory uncertainty wrought by the proposed amendments is substantial. Actors in the blockchain sphere must struggle to decipher whether they fall within the new Rule 3b-16(a), whether they can come into compliance, and what (if anything) they can do if not. Yet the Reopening Release acknowledges the fact of regulatory uncertainty only in passing, with no attempt to measure the extent to which such uncertainty will harm these potentially regulated parties and the broader economy.[87]

- **The outsized costs the proposed amendments would impose on smaller or less sophisticated market participants.** While even established companies like ConsenSys will be substantially burdened by the proposed amendments, these burdens are magnified for the ordinary individuals who participate in the blockchain ecosystem—such as validators, DAO members, and liquidity providers—who may now be facing demanding regulatory obligations.[88] It is hard to see how less-sophisticated participants could feasibly comply with the regulatory regime to guard against personal liability, either individually or with other members of a so-called "group of persons" that would invariably include others who are pseudonymous and located in far-flung places around the world. Yet the Reopening Release makes no effort to meaningfully assess these costs either.

Moreover, as discussed above, the Release ignores the actual costs of exchange registration, considering only the costs of broker-dealer and ATS registration. But even if it is right that entities are likely to avail themselves of the Regulation ATS exception if available, the SEC may not reasonably expand the regulatory definition of "exchange" without contemplating the costs *of actually registering as an exchange*, especially when commenters have warned the SEC that many New Rule 3b-16(a) systems would *not* be eligible for the ATS exception.[89] This analysis is particularly necessary because the Release recognizes that the burdens of exchange registration and ATS registration are not interchangeable: the costs of the former are "generally

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[85] *Cf. Today's Cryptocurrency Prices by Market Cap*, Coin Market Cap, https://bit.ly/3IFcoSs (last visited June 12, 2023) (cryptocurrency has a global market capitalization of over $1 trillion).

[86] 88 Fed. Reg. at 29486.

[87] *Id.* at 29482.

[88] *Id.* at 29477.

[89] *Id.* at 29457.

significantly higher."[90] So the Release's analysis of the proposed amendments' costs—like its assessment of benefits—contains "serious flaw[s]" that render it "unreasonable."[91]

4. In sum, the cost-benefit analysis in the Reopening Release is untenable because it "inconsistently and opportunistically frame[s] the costs and benefits of the [proposed] rule," "neglect[s] to support [the SEC's] predictive judgments," and ignores "substantial problems."[92] These flaws are particularly acute because they extend to matters the SEC is statutorily required to consider. Specifically, the SEC must always consider whether a rulemaking "will promote efficiency, competition, and capital formation."[93] But the Reopening Release offers only equivocal and barebones assertions on these grounds, stating that the amendments "could" promote efficiency, competition, and capital formation, while also acknowledging various costs.[94] For any new regulatory burden to be rational, the APA requires more substantiation of benefits than this, and demands that the SEC actually make a predictive judgment about a new rule's effects.[95] It is simply not a legally tenable position that the amendments are too far reaching, flexible, and complex to make such a predictive judgment. And the Commission's reluctance to make a meaningful prediction suggests that—as to efficiency, competition, and capital formation, as more generally—the current record compels a finding that the proposed amendments on balance do more harm than good.

Indeed, the Reopening Release provides every reason to think that the proposed amendments will have seriously negative consequences for each of efficiency, competition, and capital formation. The amendments almost certainly would reduce price efficiency by reducing the availability of innovative tools that make digital-asset transactions and other activities on the blockchain ecosystem more price-efficient.[96] The SEC itself has recognized that the proposed amendments may well reduce competition by driving blockchain-based entities offshore or forcing them to shut down entirely.[97] Likewise, the innovation-stifling and regulatory uncertainty discussed above inevitably will reduce new capital formation, as investors otherwise

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[90] *Id.* at 29472.

[91] *Nat'l Ass'n of Home Builders v. EPA*, 682 F.3d 1032, 1040 (D.C. Cir. 2012).

[92] *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1148-49 (D.C. Cir. 2011).

[93] '34 Act § 3(f); *see also* 15 U.S.C. § 77b(b).

[94] 88 Fed. Reg. at 29485-90.

[95] *See Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 178 (D.C. Cir. 2010) (explaining that the federal securities laws "asks for analysis of whether the [rule] will promote efficiency, competition, and capital formation," and finding analysis arbitrary where "the SEC did not make any finding on the existing level of competition").

[96] 88 Fed. Reg. at 29490.

[97] *Id.* at 29486-87.

interested in backing further development of blockchain-based and other New Rule 3b-16(a) Systems increasingly decline to do so because these regulatory hurdles are impossible to clear.

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In short, the proposed amendments fail to properly weigh costs and benefits to ensure that the benefits outweigh costs—either generally or as to efficiency, competition, and capital formation in particular. And to the extent the costs and benefits can be identified, the sizable costs of the proposed amendments appear to outweigh their minimal-to-nonexistent benefits. Given all this, it is unclear why the Commission is insistent on pushing forward with its proposal. In doing so, the Commission ignores reasonable alternatives readily available to it—indeed, perhaps the *only* reasonable course of action: it can simply retain the current and well-adapted Rule 3b-16(a), and stop trying to extend the Rule to blockchain-based and other previously uncovered entities, as Commissioner Peirce has recognized.[98] That choice marks yet another reason why the Reopening Release cannot pass muster.[99]

E. The Reopening Release Still Fails to Grapple with the Proposed Amendments' Encroachment on the First Amendment.

Finally, the Reopening Release still does not acknowledge that the proposed amendments run headlong into the First Amendment. Its suggestion that the SEC might replace the term "communication protocol" in the amended Rule 3b-16(a) with "negotiation protocol" would not eliminate this problem, as the Release is not proposing to narrow the substantive scope of what that term covers, and it still has not identified any concrete interests that could render the amendments of compelling or even substantial importance.[100]

If anything, the new Release only worsens the First Amendment violation. By expressly suggesting that software developers may be liable under the amendments, including those who develop software for non-business, purely expressive, and very often explicitly political reasons, the Release gives rise to a clear chilling effect, given the long-established fact that computer code is speech.[101] And more generally, the Release exacerbates the First Amendment problem by fostering uncertainty about the scope of the amendments' reach—for instance, whether they apply to certain persons upon electing to participate in a DAO vote—making the amendments even less narrowly drawn. Given that the SEC must show a close fit between means and ends

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[98] Peirce, *supra* note 56.

[99] *Chamber of Com. v. SEC*, 412 F.3d 133, 144-45 (D.C. Cir. 2005) (SEC must consider all alternatives that are not "frivolous nor out of bounds," particularly when dissenting Commissioners and multiple commenters have raised an issue).

[100] 88 Fed. Reg. at 29460.

[101] *See, e.g.*, *id.* at 29456.

under any level of First Amendment scrutiny, the Release underscores the incompatibility of the Commission's proposed changes with the First Amendment.[102]

III. The Reopening Release's Analysis of the Proposed Amendments' Application to Blockchain-Based Systems Rests on Fundamental Misunderstandings of Blockchain.

In addition to repeating the errors of the Proposing Release, the Reopening Release introduces entirely new errors in its blockchain-specific supplemental analysis. These errors raise serious questions about the extent to which the SEC understands nascent and fast evolving blockchain technology, and underscore why any amendments to Rule 3b-16(a) should not reach blockchain-based systems—either generally or, at the very least, for the foreseeable future.

A. The Reopening Release Depends on Flawed Assumptions About the Extent to Which Digital Assets are Securities.

The SEC's attempt to regulate blockchain-based systems under Rule 3b-16(a) depends on the threshold premise that, as Chairman Gensler has pronounced in public fora, nearly all of the digital assets used and traded on such systems are securities. After all, the SEC's jurisdiction spans only the sphere of *securities* regulation, and both the statutory and regulatory definitions of exchange—including under the proposed amendments—are concerned solely with facilities that help facilitate *securities* transactions.[103] Blockchain-based systems thus fall within the Rule's ambit only if the assets whose exchange they help facilitate are actually securities under federal law.

The Reopening Release makes clear that the SEC is proceeding from this assumption, but it offers no meaningful analysis of *why* the SEC believes that many or most digital assets are securities. For example, the SEC asserts, without explanation, that the probability of digital assets being securities is sufficiently high that "it is unlikely that systems trading a large number of different crypto assets are not trading any crypto assets that are securities," such that the SEC finds it reasonable to assume that most such systems likely fall within the current Rule 3b-16(a) and are already liable under the current Rule.[104] And one of the SEC's own commissioners has interpreted the Reopening Release as an apparent "paper exercise" to finalize the Commission's pre-determined view that "nearly all crypto assets are securities and are subject to the

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[102] *Reed*, 576 U.S. at 163; *Cent. Hudson Gas & Elec. Corp.*, 447 U.S. at 564.

[103] *See* '34 Act § 3(a)(1); 17 C.F.R. § 240.3b-16(a).

[104] 88 Fed. Reg. at 29450-51. Even assuming the SEC were correct that most systems trading a large number of digital assets are trading at least one security, it does not follow that these systems would all come within the exchange definition. As discussed above, an exchange must perform "functions commonly performed by a stock exchange" as that term was understood in 1934, and exchanges then (as now) generally facilitated the transaction of far more than a single security. A far higher showing is accordingly required to establish that particular blockchain-based systems are in fact exchanges.

Commission's jurisdiction."[105] But an agency may not engage in such *pro forma* maneuvering; it must instead proceed through the rulemaking process with an open mind and "provide[] a reasoned explanation for [its] policy assumptions and conclusions."[106] Any final rule will be arbitrary and capricious unless the SEC provides a considered antecedent explanation for its assertion of jurisdiction to regulate blockchain-based systems.

Any final rule will also be arbitrary and capricious if the agency is relying on *incorrect* assumptions.[107] Here, there is good reason to think the Reopening Release substantially overestimates the extent to which digital assets are securities. Whether a digital asset is a security turns on whether it is an investment contract,[108] and many, if not most, digital assets function purely as assets rather than as binding contracts for an investment scheme. Most simply, the term "investment contract" requires a binding obligation (a "contract"). But for virtually every digital asset traded on the secondary market via the sorts of systems implicated by the exchange regulations, there are no implied or written contracts. The developers who initially created these secondarily traded tokens have no obligations to those exchanging them in secondary markets. And there is thus no "investment contract" or underlying security.

Moreover, that threshold point is far from the only thing that distinguishes the vast majority of digital assets from federal securities. For example, many digital assets function as utility tokens—allowing for *use* on a platform, rather than *accrual* as an investment—and so generally cannot be investment contracts.[109] Other tokens, like the most widely accessible and used tokens, were created and are indeed technologically essential because their networks do not process transactions unless a transaction sender pays a fee in that native token. Likewise, many tokens accrue value primarily from the vagaries of market forces rather than any particular managerial efforts from the developers or promoters of the token, which likewise prevents them from being considered investment contracts.[110] There is much more that could be said about the distinctions between digital-asset tokens and investment contracts, but for present purposes it is

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[105] Mark T. Uyeda, *Statement on Supplemental Information and Reopening of Comment Period for Amendments to Exchange Act Rule 3b-16 Regarding the Definition of "Exchange*," SEC (Apr. 14, 2023), https://bit.ly/43v0AKM.

[106] *Building & Constr. Trades Dep't v. Brock*, 838 F.2d 1258, 1266 (D.C. Cir. 1988); *see Rural Cellular Ass'n*, 588 F.3d at 1101.

[107] *Friends of Back Bay v. U.S. Army Corps of Eng'rs*, 681 F.3d 581, 589 (4th Cir. 2012).

[108] 15 U.S.C. § 77(a)(1).

[109] *See, e.g.*, Carol Goforth, *Securities Treatment of Tokenized Offerings Under U.S. Law*, 46 Pepp. L. Rev. 405, 429-30 (2019).

[110] *SEC v. Belmont Reid & Co.*, 794 F.2d 1388, 1391 (9th Cir. 1986).

sufficient to say that a lawful justification of SEC regulation of blockchain-based systems would require rigorous analysis of why that regulation does not sweep beyond *bona fide* securities.[111]

Given the complexity of assessing the regulatory status of digital assets, the SEC should at minimum table any application of Rule 3b-16(a) to blockchain-based systems—both under the current Rule and through the proposed amendments—until these antecedent jurisdictional questions are settled. And as discussed above, particular caution is needed because Congress—the appropriate body for resolving major questions of law—is working on legislation clarifying the jurisdictional status of digital assets.[112] But careful resolution of this issue will require the SEC at some point to initiate a separate rulemaking on the matter, given the magnitude and salience of the underlying issues, not to mention the tremendous confusion the SEC has fostered on this issue in recent years.[113] Only then can the SEC give this issue—including the many follow-on questions that it implicates—the necessary attention, priority, and public input.

B. The Reopening Release Contains Serious Misconceptions About Blockchain Technology and the Blockchain Industry.

The proposed amendments are further premature because the blockchain-specific analysis in the Reopening Release reveals little comprehension of how blockchain technology and the blockchain ecosystem actually work. The Release admits that the SEC has limited insight into how blockchain-based systems operate.[114] Perhaps unsurprisingly, then, the result of the Commission's guesswork leaves much to be desired. The Release contains significant errors about blockchain, as reflected in the foregoing discussion about the SEC's undercounting of protocols, and the functional and geographic diversity of participants potentially affected by these amendments. And as detailed below, the errors do not end there. Effective regulation requires that the regulator understand what it is regulating.

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[111] *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). *See generally* Lewis Rinaudo Cohen et al., *The Ineluctable Modality of Securities Law: Why Fungible Crypto Assets Are Not Securities* (Nov. 10, 2022), https://bit.ly/3oFOkYO (discussion draft).

[112] *See generally West Virginia v. EPA*, 142 S. Ct. 2587 (2022).

[113] For example, the SEC has not adopted a consistent position even as to the regulatory status of ether—one of the world's most popular digital assets. *Compare, e.g.*, Maria Grace Santillana Linares, *SEC's Chairman Gary Gensler Implies That Ether Is A Security And Falls Under His Jurisdiction*, Forbes (June 27, 2022), https://bit.ly/42nvHq7, *with* Nikhilesh De, *SEC Chair Gensler Declines to Say If Ether Is a Security in Contentious Congressional Hearing*, CoinDesk (Apr. 19, 2023), https://bit.ly/41bIzPE. The regulatory picture is only more confusing for the many less-prominent digital assets.

[114] *See, e.g.*, 88 Fed. Reg. at 29470 ("The Commission has limited information regarding crypto asset securities."); *id*. at 29471, 29476, 29480, 29482-83 (acknowledging various information the SEC is "unable to provide" in assessing the proposed amendments' application to blockchain-based systems).

Most importantly, the Reopening Release offers a deficient analysis of the ability of decentralized blockchain-based systems to comply with the SEC's envisioned registration requirements. Although it acknowledges that the requirements' burdens may force some New Rule 3b-16(a) Systems to exit the market, the Release insists that all blockchain-based systems would be able to comply with the requirements if they wish to do so, regardless of their technological nuances.[115] But this assertion utterly ignores how "DeFi" platforms actually operate, shrugging off commenters' identifications of systems that could not possibly come into compliance, in no small part due to the pseudonymity and tremendous geographic dispersion of platform participants and the low barriers of entry and exit on these platforms. Here too, the Release's reliance on incorrect assumptions would render any final rule arbitrary and capricious.[116]

For one thing, the Reopening Release fails to recognize that many decentralized systems are not controlled by any "organization, association, or group of persons" and so cannot qualify as exchanges under the '34 Act. Under section 3(a)(1), it is not enough that there be a market place or facility that performs the functions of an exchange; the provision is triggered only by the ongoing existence of an "organization, association, or group of persons . . . which constitutes, maintains, or provides" the market place or facility—*i.e.*, present tense.[117] Because decentralized protocols often run autonomously after being created by developers who relinquish control over their creations, many protocols are *not* being constituted, maintained, or provided by any person or group of people.[118]

Rather than acknowledging that such autonomously operating systems are not exchanges, the Release attempts to ensnare tangentially related persons into possible "groups of persons" that could be ascribed regulatory responsibility for these faux-exchanges. It suggests that software developers could bear *indefinite* legal responsibility for the protocols they create, notwithstanding their current lack of operating control and regardless of the intent with which the protocol was designed.[119] This extension both contravenes the '34 Act's present-tense wording and would be arbitrary and capricious regardless. The SEC may not impose retroactive liability on developers who have relinquished control over their creations without specifically

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[115] *Id.* at 29485, 29457 ("the use of DLT, or any other technology, does not make compliance incompatible with the federal securities laws").

[116] *Friends of Back Bay*, 681 F.3d at 589.

[117] '34 Act § 3(a)(1).

[118] To the extent the Reopening Release's application of the proposed amendments to decentralized systems is based on a dispute about the extent to which they are actually decentralized, this is an "important aspect of the problem," which the SEC must air in full and non-conclusory fashion, with the opportunity for public comment. *State Farm*, 463 U.S. at 43.

[119] 88 Fed. Reg. at 29456.

considering "whether to make [its] new policy prospective or retroactive."[120] And more generally, this aspect of the Release—like its broader analysis—is unsupportable as a matter of weighing costs and benefits. If adopted, it would have outsized costs, as the Commission's effective rejection of the concept of *decentralization* would deter growth and innovation while increasing regulatory uncertainty, all for little-to-no evident benefit.

Nor can the SEC adopt its alternative suggestion that other persons, such as miners, validators, and token holders in a decentralized autonomous organization, could all bear regulatory responsibility. Including such minor market participants in an exchange group defies the '34 Act's scope for the reasons explained above, and it also would have the perverse effect of foisting legal risk on the least sophisticated market participants, who have no realistic means of complying with complex regulatory requirements.[121]

Moreover, the Reopening Release's proposal to assign regulatory responsibility to miners and validators reflects a basic misunderstanding of what those individuals can do. The Release premises its rosy view of market participants' ability to comply with its regulations on the assumption that even immutable smart contracts are not really immutable: miners or validators can always "effect a change to a blockchain through, for example, a fork that would impact interactions with the immutable smart contract."[122] Setting aside that many if not most miners and validators are not located in the United States, and even assuming such forking is always possible, forking serves only to create a *new blockchain*; it does not shut down the previous system.[123] For example, the Release cites the example of a past Ethereum fork, but its own cited source explains that the result is that "[t]here are now two versions of the Ethereum blockchain growing in tandem."[124] This analysis offers no clarity as to whether miners, validators, or other individuals would still be responsible for the original system. But given that the SEC generally enforces securities-law requirements on a strict-liability basis, not even following the SEC's current opinions about compliance would provide a complete safe harbor later.

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[120] *Yakima Valley Cablevision, Inc. v. FCC*, 794 F.2d 737, 745 (D.C. Cir. 1986). Retroactive rulemaking is always "troubling," *id.*, and it is *particularly* troubling here because developers have no current means of coming into compliance.

[121] Given that even ConsenSys and other large companies have found the SEC's regulatory requirements to be often impenetrable, it strains credulity for the SEC to suggest that miners, validators, or tokenholders could successfully comply with this onerous regulatory scheme. *See, e.g.*, 88 Fed. Reg. at 29483-84.

[122] *Id.* at 29483.

[123] Lachlan Keller, *Crypto Miners Plan to Fork Ethereum, Will It Make a Difference to the Merge?*, Forkast (Aug. 25, 2022), https://bit.ly/43JzHlN (quoting a cryptocurrency executive: "I could fork Ethereum tomorrow [but] will people use that fork? That's a different question").

[124] Morgen E. Peck, *Ethereum Blockchain Forks to Return Stolen Funds*, IEEE Spectrum, (July 22, 2016), https://bit.ly/3MOiYqM, cited by 88 Fed. Reg. at 29483 n.361.

Nor are the Release's misunderstandings limited to the direct question of compliance. For example, it asserts that "the majority of [blockchain] platforms typically require crypto assets and fiat currency to be provided to the platform in advance of any trading activity."[125] But this assertion ignores the norm in DeFi systems, which, as discussed above, generally do not take custody of users' funds or otherwise require a prior deposit. Likewise, the Release identifies as one downside of blockchain-based systems that "messages to be appended to a blockchain often end up in a queue that is publicly viewable, which then exposes the marketplace to information leakage."[126] But this view reflects an outdated understanding of the blockchain ecosystem, overlooking innovations that greatly mitigate the information-leakage issue.[127]

These examples are not exhaustive of the Release's technical errors, but they exemplify how the SEC's place on the learning curve has hampered the accurate assessment of costs, benefits, and other considerations in the Reopening Release. In short, when an agency does not even understand the contours of an issue, it has no way to fulfill its obligation to assess all "important aspects" of the issue.[128] The Commission thus has much work to do before it can engage in any kind of reasoned regulation, which includes reengaging with the blockchain ecosystem that has been understandably reluctant to further educate the Staff about cutting-edge technological developments given the frequency with which good-faith interaction has been leveraged solely for enforcement purposes.

CONCLUSION

Given the range of shortcomings in the proposed amendments and the Reopening Release, we respectfully urge the Commission to withdraw its proposal in full. For the reasons discussed in this letter and in our earlier comment, the Commission cannot lawfully promulgate the amendments as currently formulated. And given the absence of any demonstrable harm caused by the scope of the current Rule 3b-16(a), the SEC need not take any action beyond withdrawing the proposed amendments. If it believes that revisions to the Rule remain necessary, though, it must at least issue a new proposal with substantial alterations, subject to further public comment.

Finally, however the Commission proceeds, it should carve blockchain-based systems out of the Rule. For the reasons discussed, such systems fall outside a proper understanding of "exchange" in the '34 Act and so cannot be regulated under it. And SEC regulation in the broader blockchain context is further inappropriate given (1) the unresolved antecedent questions about the extent to which the SEC has jurisdiction at all over blockchain-based systems, and (2) the SEC's limited understanding of blockchain technology and the dynamics of the blockchain

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[125] 88 Fed. Reg. at 29472.

[126] *Id.*

[127] *See, e.g.*, Sam Kessler, *MEV Blocker Wants to Help You Outrun the Front-Runners*, CoinDesk (Apr. 5, 2023), https://bit.ly/3N9Ypq6; Eden Network, *How Private Transaction Pools Work on Ethereum*, Medium (Dec. 9, 2021), https://bit.ly/43ZSjOX.

[128] *State Farm*, 463 U.S. at 43; *cf. Saget v. Trump*, 375 F. Supp. 3d 280, 342 (E.D.N.Y. 2019).

ecosystem. Particularly given Congress's ongoing efforts to enact a comprehensive regulatory framework in this area, which will include specific provisions pertaining to the proper role of the securities laws and the SEC, the Commission should not upend this large and growing economic sector with hasty and ill-conceived regulations that depend on a conclusory assertion of jurisdiction.

Respectfully Submitted,

CONSENSYS SOFTWARE INC.

by:

/s/ William C. Hughes

William C. Hughes
Senior Counsel & Director of Global
Regulatory Matters

EXHIBIT A

April 14, 2022

Vanessa A. Countryman,
Secretary,
Securities and Exchange Commission
100 F Street NE, Washington, D.C. 20549

Re: Proposed Amendments Regarding the Definition of "Exchange" and Alternative Trading Systems (ATSs) That Trade U.S. Treasury and Agency Securities, National Market System (NMS) Stock, and Other Securities, RIN 3235—AM45

Dear Ms. Countryman:

We write to request clarification that the amendments proposed in the above-captioned rulemaking, if finalized, do not apply to the decentralized systems at the heart of the burgeoning blockchain revolution. The proposal does not mention cryptocurrency, blockchain technology generally, or their applications, and rightly so, for the decentralized systems that run on blockchain differ vastly, in purpose and most importantly operation, from securities exchanges. Nor, for that matter, do they have anything to do in most instances with securities. Those networks which may superficially appear most analogous to securities exchanges are, upon closer scrutiny, better characterized as "anti-exchanges" because their functionality and value proposition derives primarily from their decentralization. Nevertheless, even though these systems are far from the exchanges the Exchange Act of 1934 has in mind, and the proposal never actually addresses these systems, some of the proposal's language may be read to cover these systems, probably inadvertently. We therefore request that any final rule make clear that blockchain-based systems do not qualify as exchanges even if certain of the tokens they support were deemed securities as a matter of law.

INTRODUCTION

ConsenSys is the leading programmable blockchain software company building the digital economy of tomorrow. Our suite of products serves millions of users and developers, supports billions of queries, and has facilitated growth and trade in the trillion dollar global market built upon digital assets. Our mission is a grand one that we attempt to undertake humbly: to pave the way for new economic systems that are more open, efficient, and secure.

The foundation of these new economic systems is decentralized protocol technology, of which blockchain technology is currently the dominant example, and the world-changing innovation that began with the invention of Nakamoto consensus. Blockchain's core innovation is the storage of data across a network whose participants collaborate to own, monitor, run, fix, and update the network. This type of network architecture was largely impossible before 2009, when the centralized, read/write internet of the day was hitting its major growth spurt. It means, among other things, that we can have networks where no one person or organization controls the data—and thereby enjoys the power attendant to that control—and that network participants are able to interact on a peer-to-peer basis using trust software performing all middleman services rather than depending on an intermediary.

Blockchain thus offers freedom from the risks of bad action by intermediaries, such as abuse of market power, fraud, censorship, or failure to secure assets and data against inside or outside attack, as well as from costs inherent in intermediation such as delay. It also offers new abilities for communities of businesses, big and small, and individuals, wealthy and not, from around the world to engage in not only the exchange of information but also economic activity directly with each other.

Blockchain is a new technology, but already it has shown its potential to transform our economies, making them both more productive and more just. By getting rid of the intermediaries in many transactions, blockchain frees up value that may be used to lower consumer prices, invest in new ideas, build small businesses, and raise wages. By moving away from systems dependent on a centralized entity which represents a single point of control or failure, blockchain promotes system security and resilience and lowers the risk and hence costs of investment. By mitigating the circumstances that give rise to powerful intermediaries, blockchain redresses the power imbalance that long has favored entrenched, ossified interests over the ingenuity and flexibility of the little guy or the thoughtful innovator. And by potentially making banking more secure, affordable, and accessible, blockchain offers a path toward financial inclusion for the un- and under-banked.

To date, ConsenSys has focused its efforts on the Ethereum protocol, which is the largest programmable blockchain network and ecosystem in the world. Ethereum leads the field in business adoption, developer community, and in the creation and use of new, alternative rails to engage in commercial and financial transactions and build global, online communities.

Our suite of products enable developers, enterprises, and people around the world to build and utilize next-generation web applications, launch novel, community-created and managed financial networks, and access the decentralized web. Our products include MetaMask, which is the world's most popular digital wallet and decentralized web gateway; Infura, which provides instant, reliable, and scalable access to Ethereum and other networks; Truffle, which is the most utilized tool for developing Ethereum applications; Codefi, which allows businesses to digitize assets and decentralized financial instruments; Diligence, which offers comprehensive security audits and tools for decentralized smart contracts; and Quorum, which assists software development businesses to build applications on permissioned implementations of the Ethereum technology. Quorum services many organizations in various industries, including Microsoft and

Starbucks. We also provide class-leading professional services to advise clients around the world on how they might harness this new technology to create new opportunities and to more efficiently address challenges, clients which include many countries currently exploring the functionality of central bank digital currencies.

We write out of concern that some language in the proposed rule may inadvertently designate decentralized systems, such as some of those built on Ethereum, as exchanges within the meaning of the Exchange Act of 1934 (the "'34 Act") if those systems are used to transact in cryptocurrencies that are misconstrued as securities. We do not believe it likely that the Commission intends the proposal to be so broad. After all, as we explain below, the decentralized systems that run on blockchain are in many respects the opposite of the centralized exchanges that Congress set out to regulate in the '34 Act. Moreover, the proposal does not mention cryptocurrency, blockchain, or decentralized finance, let alone explain how the rigorous requirements of the '34 Act could sensibly be applied in the blockchain context. We certainly would never expect or be inclined to believe the Commission would take the extraordinary step of covering blockchain-based systems *sub silentio*. Nevertheless, for the sake of providing regulatory clarity for the burgeoning blockchain sector, we urge the Commission to declare expressly that blockchain-based networks do not fall within the scope of the amendments at issue here.

In the unlikely event that the Commission intends to designate blockchain-based networks as exchanges, we must point out that a regulation finalizing the proposal as written would violate the '34 Act, the Administrative Procedure Act (the "APA"), and the U.S. Constitution. The text and purpose of the '34 Act leave no doubt that Congress intended to treat as exchanges only those places and facilities that match up orders, not those that help potential buyers search for potential sellers, let alone those that might possibly serve that purpose, at least in part, without ever intending to. The Commission offers a different interpretation of the statutory definition of exchange based on its desire to cover certain communication protocol systems ("CPSs") as *broker-dealers*, but that desire is simply irrelevant to the meaning Congress gave the word *exchange*. The proposal would jettison Congress's clear regulatory framework for a poorly-demarcated regime that inflicts meaningful uncertainty costs on software developers and millions of others in the technology sector who build or maintain systems through which the public interacts—all for the sake of speculative benefits that the proposal fails to compare to its admitted costs. And on top of all this, the proposal—without conspicuous self-reflection—regulates speech on the basis of its content in violation of the First Amendment.

DISCUSSION

I. Today's Blockchain-Based Systems Are the Opposite of Exchanges.

A. Centralization Is the Defining Feature of Exchanges under the '34 Act.

The Great Crash of 1929 exposed grave weaknesses in America's financial system. Responding to the Crash, the Senate Committee on Banking and Currency in 1932 launched what became known as the Pecora investigation, so named after the chief investigative counsel

Ferdinand Pecora. The investigation examined many aspects of American finance, with a special focus on securities exchanges.

The investigation's final report explained that securities exchanges (hereinafter "exchanges" in the interest of simplicity) played a critical role in American finance due to their *centrality*. The "primary function" of exchanges is "to furnish[] open markets for securities where supply and demand may freely meet."[1] By bringing together a critical mass of buyers and sellers in auction-type proceedings to match bids with asks, exchanges facilitate price discovery, establishing a market price at which potential buyers and sellers can transact in a given security at a given moment. Innovations in communication technology meant that the "prices established and offered in … transactions" on the exchanges "are generally disseminated and quoted throughout the United States and foreign countries."[2] For this reason the market prices set as a result of exchanges performing their middleman functions "establish[] the prices at which securities are bought and sold" far from the exchanges themselves and affect in real-time the net worth of individuals and institutions.[3] Serving as the intermediaries in transactions that, in aggregate, set securities prices gave the exchanges—and their members—enormous influence, for good or ill, over the national economy. That influence was seen at its most baleful in the 1929 Crash which precipitated the Great Depression.[4] Thus, the exchanges were important not because many people traded on them—to the contrary, the investigation's report explained that "only a fraction of the multitude who now own securities can be regarded as actively trading" on them[5]—but because "the operations of these few profoundly affect the holdings of all."[6]

The exchanges played a central role in another sense: they intermediated between investors across the country, as well as between investors and financial insiders. This intermediating role for distant and unsophisticated investors created possibilities for malfeasance. The investigation discovered that conflicts of interest and manipulative practices were common in exchange operations[7] and that the exchanges themselves showed limited interest in curbing these practices.[8] Indeed, the investigation concluded that the interests of the

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[1] *Stock Exchange Practices: Report of the Committee on Banking and Currency* 81 (June 16, 1934), available at https://fraser.stlouisfed.org/files/docs/publications/sensep/sensep_rpt.pdf?utm_source=direct_download.

[2] '34 Act § 2(2).

[3] *Id.*

[4] *Stock Exchange Practices*, *supra* n.1, at 7.

[5] *Id.* at 5.

[6] '34 Act § 2(2).

[7] *Stock Exchange Practices*, *supra* n.1, at 19-20, 30-54.

[8] *Id.* at 20, 80-81.

exchanges themselves "frequently conflicted with the public interest."[9] Congress concluded that the manipulation of prices for which the exchanges' central intermediating role paved the way, combined with the national dissemination of such prices, gave "rise to excessive speculation, resulting in sudden and unreasonable fluctuations in the prices of securities which … cause alternatively unreasonable expansion and unreasonable contraction of the volume of credit."[10]

The '34 Act made clear Congress's view that the exchanges warranted regulation due to the central operational role they played, finding that they had power to determine securities prices across the country and that manipulation of those prices by exchange insiders could therefore cause widespread harm.[11] It was this uniquely central role of the exchanges that set them apart from private sales of securities from one private person to another, which the Act did not regulate (and which remain unregulated today).

The '34 Act's provisions regulating exchanges, and their members, are tailored to their outsized role in the economic lives of Americans who primarily enjoy access to liquid securities markets only through them. The Act adopts an aggressive, hands-on approach justified only because the exchanges, by acting as intermediaries to securities transactions, set nationwide securities prices and therefore directly affect the good of the whole country in a way that is true for very few other businesses.

Unlike almost any other regulatory regime, the '34 Act requires federal approval before an exchange may begin operations.[12] Recognizing the national interest that attends the establishment of each exchange, the Act demands that the Commission take public comment on each application to register as an exchange.[13] The Act essentially deputizes the exchanges as agents of federal securities policy, predicating registration of an exchange on the Commission's finding that the exchange "has the capacity to be able to carry out the purposes of" the '34 Act.[14] In recognition of the dangers arising from the exchanges' role as intermediators, the '34 Act demands that exchanges take extensive steps to prevent misconduct by exchange insiders, including by designing rules "to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade"[15] and by admitting as members only brokers and

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[9] *Id.* at 81.

[10] '34 Act § 2(3).

[11] *Id.* § 2(2)-(4).

[12] *Id.* § 5.

[13] *Id.* § 19(a)(1).

[14] *Id.* § 6(b)(1).

[15] *Id.* § 6(b)(5).

dealers registered with the Commission and subject to its oversight.[16] And it requires exchanges to secure Commission approval for each change to their rules.[17]

It should come as no surprise that the '34 Act defines the term "exchange" with reference to the central operational role exchanges play in matching buyers and sellers and executing their transactions. An exchange, the Act explains, is a group that provides a marketplace or facilities "for bringing together purchasers and sellers of securities."[18] As we discuss at length below, the definition thus singles out the two features that make exchanges central: 1) the assembly of a critical mass of buyers and sellers that allows exchanges to facilitate efficient price discovery and hence the setting of a market price, and 2) the intermediating function of exchanges. The '34 Act's definition of "exchange" thus tracks Congress's clear focus on the central operational role of exchanges.

From time to time the proposal seems to suggest that the scope of the statutory term "exchange" should be determined on the basis of the number of people who use a particular instrument of trading.[19] But that is not the decisive question, for Congress did not regulate exchanges the way it did because many people use them. To the contrary, as noted above, the Pecora investigation's report explained that most investors do *not* use the exchanges. Rather, what makes exchanges suitable for the intensive regulatory regime of the '34 Act is their *centrality*: they set nationally influential market prices that are susceptible to manipulation by exchange insiders. That is why the '34 Act goes far beyond the kinds of protections typically afforded in the customer protection context to enact one of the most demanding and proactive supervisory regimes known to the law.

Indeed, the question of regulation of a financial instrumentality as an exchange is not about how *important* the instrumentality is at all. Surely among the most important financial instrumentalities is retail banking, but Congress did not choose to regulate it using the framework that it created for exchanges. The reason is that, while tremendously important (and subject to appropriate regulation under other federal and state statutes), retail banking is not *central* in the sense of both creating national market prices and intermediating for the unsophisticated.

B. Decentralization Is the Defining Feature of Blockchain-Based Systems.

Blockchain-based systems are precisely the opposite of exchanges: they operate and attract users because mechanistic, open source computer code has replaced a human-operated entity in the role of intermediary, which is likewise the source of the immense promise they hold

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[16] *Id.* § 6(c)(1).

[17] *Id.* § 19(b)(1).

[18] *Id.* § 3(a)(1).

[19] *E.g.*, 87 Fed. Reg. at 15501-02.

for the future. They are not and cannot be exchanges because they do not operate like exchanges.

As noted above, blockchain's core innovation is that, for the first time in history, people who have no reason to trust each other or even know each other can cooperate to maintain a data set, process transactions that update that data, and collectively control the rules of a computational network. This decentralized architecture replaces the role of a human-operated intermediary with software. Participants who choose to use that software can transact on a peer-to-peer basis, relying on that software to perform any functions a middleman normally would. But decentralization is not just the operative principle of blockchain as a technology; it is also the foundation and animating spirit of the ecosystem, vast and growing daily, that values transparency, equal access, honest dealing, reliability, and security. By operationalizing this value system, blockchain is opening up new ways of business, commerce, community interaction, and finance that more and more people around the globe, particularly Americans, see as the foundation of a more egalitarian, innovative, and prosperous society.

Even in its current nascency, the functional diversity of the ecosystem and the potential it holds to improve the lives of everyday people are remarkable. Take blockchain-based banking, one of the most promising strands of what is known as decentralized finance, or DeFi. Blockchain enables users to store and access economic value without ceding control of their assets to banks or running the risks of data security breaches that plague financial institutions. This stored value can increasingly be brought to bear in day-to-day transactions just as a bank account or a line of personal credit can be, as more merchants and other vendors begin to accept payment in cryptocurrency. For this reason, DeFi offers a less centralized, more individually empowering solution that is developing to perform the same functions as the instruments of consumer banking and credit that traditionally have powered the retail economy.

Or take smart contracts. Blockchain enables parties to reduce their agreements to programming language that automatically effectuates promised performance when the contractual conditions precedent are met. Because the possibility of non-performance is obviated, or often already accounted for, there is no need for judicial or arbitral enforcement that add costs and other inefficiencies.

Or take decentralized lending. Borrowers and lenders, big and small, can rely on code that operates as contracts in which the borrower offers as collateral cryptocurrency or some other asset over which the smart contract can automatically give the lender control if the borrower fails to repay the loan. By eliminating the risk of non-recourse default, peer-to-peer lending thus diminishes the significance of one of banks' major advantages in lending, *i.e.*, the ability to spread loss across a large portfolio of loans. And by increasing the number of potential lenders, decentralized lending has the potential to increase credit availability. Blockchain thus makes lending from one individual to another increasingly viable. These few examples—and we could give many more—illustrate the diversity in decentralized blockchain-based systems.

Importantly, the decentralized nature of these systems avoid or correct for the risks to which the '34 Act responds. They eliminate the risks of bad behavior by intermediaries such as

those the ’34 Act’s rigorous requirements are intended to prevent. They permit anyone to participate rather than relying on gatekeepers, thus avoiding the risk that insiders take advantage of outsiders. And they involve peer-to-peer interactions with individualized negotiations in lieu of the identification of a market price that could affect the national economy; because they cannot set national market prices, these systems do not raise the prospect of creating the financial tsunamis that precipitated the Great Depression.

Our point is not that these systems are not important; they are, and they are becoming more so by the day. Rather, our point is that these systems lack the operational centrality that exchanges have. They do not set centralized authoritative market prices, and they do not depend on central human intermediaries who can abuse their authority.

The ’34 Act’s requirements, tailored as they are to the centralized nature of exchanges, make no sense when applied to decentralized blockchain-based systems. For instance, as we mentioned above, the ’34 Act restricts membership on an exchange to dealers and brokers who are extensively regulated to keep them faithful to the interests of unsophisticated and distant investors. But one of the principal attractions of DeFi networks is precisely that they avoid that risk by not requiring participants to use intermediaries like brokers to transact. Forcing users of DeFi networks to register with the Commission like brokers would (even setting aside the crushing compliance burden) be pointless, because the risks that brokers introduce do not arise from a system where users represent their own interests.

Similarly, the ’34 Act makes the existence and rules of exchanges subject to federal approval in light of the outsized effect that one human-operated entity can have on the market prices. Because decentralized lending networks facilitate peer-to-peer transactions rather than auction-type proceedings, they do not create a market price, let alone a market price able to exert the nationwide influence that prices on exchanges do. For this reason, there is no need to treat these networks as bearers of national policy like exchanges and thus subject to a requirement of federal approval.

C. Any Final Rule Should Clarify That It Does Not Cover Blockchain-Based Systems.

As noted above, we do not read the proposal to cover blockchain-based systems involving transactions in cryptocurrency. First and foremost, that is because the cryptographic tokens that incentivize participation in and provide an exchange medium for commercial transactions on these blockchain networks are generally not securities. But even if they were incorrectly deemed to be securities, we do not read the proposal to apply to the blockchain-based systems people use to transact in them because we do not think that the term “communication protocols,” which the proposal does not define, covers these systems.

As we have explained, blockchain-based systems are decentralized and therefore do not raise the concerns that underlie the ’34 Act; the term “communication protocols” should be read in light of this statutory purpose to exclude blockchain-based systems. Further, many of these systems are designed not for the acquisition of cryptocurrency as an investment but for the carrying on of business, commerce, personal finance, or community interaction. The

communications they involve are therefore not for the sake of "interact[ing] and agree[ing] to the terms of [a] *trade*"[20] as that term is ordinarily understood, but rather for individuals to engage in these other kinds of enterprises.

Moreover, the proposal notably does not refer to, let alone substantively discuss, blockchain-based systems, either in its discussion of examples of CPSs or anywhere else. It would be unreasonable in the extreme to take the drastic step of covering blockchain-based systems without any discussion. That is especially true in light of the President's recent executive order committing the federal government to pursue "responsible development" and "reinforce United States['] leadership" in the burgeoning field of cryptocurrency.[21] That order highlights the need for an extensive intra-executive process to coordinate a carefully calibrated approach to this new field—just the opposite of haphazard coverage of cryptocurrency-related platforms and services in a rulemaking on other topics. It also highlights the need for an earnest and exhaustive engagement with developers of blockchain systems and tools and the public at large, which members of the President's administration are currently beginning. Those early efforts have been met with great appreciation by members of the public keenly interested in promoting blockchain innovation while sensibly addressing any risks through well-tailored regulatory regimes or self-regulatory solutions, including technological mitigation measures. Because we do not impute to the proposal the kind of unreasonability that disregards the process called for in the President's executive order, not to mention the APA, we do not believe that it covers blockchain-based systems.

Notwithstanding that the best reading of the proposal is that it does not cover blockchain-based systems, the text of the proposal remains far too broad. It is important for any final rule to provide complete clarity on this point. In a fast-growing sector like blockchain, regulatory certainty is at a premium; U.S-based developers and funders will be less likely to invest their time, energy, attention, and resources in the infrastructure needed to sustain blockchain's growth and unlock its promises for the future if they believe there is a chance—even if a modest one—that the networks will one day be declared subject to regulatory regimes that were crafted to address the risks posed by centralized structures.

There is no countervailing interest to set against the need for certainty as to the scope of this proposal. Neither the Commission nor anyone else has a valid interest in confusing the public about whether blockchain-based systems are covered by any final regulation. Even if the costs of uncertainty are relatively modest because the best reading of the proposal is as we have described, nevertheless there is no point in imposing those costs for no corresponding benefit. Accordingly, declining to provide the requested clarity would be arbitrary and capricious.

We therefore urge the Commission to clarify in any final rule that the amended definition of "exchange" does not cover blockchain-based systems. That clarification might take the form

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[20] *Id.* at 15646 (emphasis added).

[21] *Executive Order on Ensuring Responsible Development of Digital Assets* (Mar. 9, 2022), https://www.whitehouse.gov/briefing-room/presidential-actions/2022/03/09/executive-order-on-ensuring-responsible-development-of-digital-assets/.

of regulatory text added as a new subsection (3) to Rule 3b-16(b), along the following lines: "Offers access to a blockchain-based system."

D. Any Final Rule That Does Not Exclude Blockchain-Based Systems Could Not Reasonably Be Finalized, for It Would Leave Too Many Unanswered Questions.

If, contrary to our expectation, the proposal is designed to cover blockchain-based systems, the Commission will be unable to finalize that coverage based on the proposal as written. That is because the proposal leaves so many unresolved questions about why coverage of these systems is necessary and how it would work that coverage would be both irrational and unworkable. A small sample of those questions are the following:

- Do decentralized blockchain-based systems pose the dangers that the '34 Act is intended to avert? If so, how and to what extent?

- As we noted above, many blockchain-based systems are designed to facilitate retail commerce, peer-to-peer lending, community building, social interaction, and other non-investment activities. Indeed, the principal reason even for investment interest in cryptocurrency is its potential for non-investment use. Given that the '34 Act is concerned only with investment activities, is it appropriate to carve out non-investment-focused blockchain-based systems from coverage? What would be the effect of applying the '34 Act to blockchain-based systems on commerce, which has increasingly embraced cryptocurrencies as means of payment?

- Is it appropriate to dispense blockchain-based systems from compliance with the requirements of the '34 Act that would be especially unreasonable as applied to them? If so, which?

- The '34 Act requires members of exchanges to register with the Commission. Who are the "members" of a blockchain-based system? Are these members required to register with the Commission as broker-dealers notwithstanding that they do not intermediate for investors? Are all members required to register, even if they number in the hundreds, or thousands, or even greater? If so, why? What would be the effect of requiring such registration? How would reviewing and disposing of those registrations be administratively feasible at high volumes?

- The '34 Act requires exchanges to regulate their members. What would appropriate standards of conduct look like for members of a blockchain-based system, since those members do not intermediate for investors? How are these systems to administer the requisite examinations for these standards?

- Blockchain-based systems generally include users within and without the United States. How are these systems to address inevitable conflicts between the obligations imposed by coverage under the '34 Act and foreign law? How does the Commission

propose to enforce with respect to activities that a system takes with respect to foreign users? How are these systems to address ambiguity as to the location of members who choose to lawfully participate anonymously or pseudo-anonymously?

- Is it appropriate to require blockchain-based systems to receive the Commission's approval before beginning operations, given that these systems do not set nationwide securities prices and therefore do not affect the national interest in the way exchanges do?

- Blockchain and applications built on it constitute one of the fastest-evolving sectors in the technology universe. The rapid pace of innovation requires that systems have flexibility to modify their functionality and internal operating rules, perhaps on short notice. In light of this need for flexibility, is it appropriate to require blockchain-based systems to file for Commission approval before changing their internal rules under '34 Act § 19? What would the effect of this requirement be on the ability of blockchain-based systems to innovate?

- What is the cost of applying the '34 Act to blockchain-based systems, and how does it compare to any benefits of doing so?

- Is the application of the burdens of the '34 Act to blockchain-based systems consistent with the President's recent executive order on promoting U.S. leadership in the digital assets sector?

To finalize coverage of blockchain-based systems as exchanges, the Commission would need to answer these questions and many more. And to answer them, the Commission would first need to propose answers on which the public may comment. We and many others would have much to say about the Commission's proposed answers to these questions, but we have not yet had our "first opportunity … to offer comments" on them.[22] Absent proposed answers to these questions on which we and others can comment, the purposes of the APA's notice-and-comment requirement have not been served, and the Commission therefore lacks logical outgrowth to finalize any set of answers and any rule predicated on them.[23] Before it may finalize any coverage of blockchain-based systems, then, the Commission would be required to reissue the proposal with answers to our questions spelled out for comment.

But for the reasons given, we do not believe the Commission intends to cover blockchain-based systems under the proposed revisions to Rule 3b-16. We therefore do not offer the many additional arguments we would otherwise make to dissuade the Commission from

[22] *Ariz. Pub. Serv. Co. v. EPA*, 211 F.3d 1280, 1299 (D.C. Cir. 2000) (emphasis omitted).

[23] *See, e.g.*, *Horsehead Res. Dev. Co., Inc. v. Browner*, 16 F.3d 1246, 1268 (D.C. Cir. 1994) (holding that the agency failed to establish logical outgrowth because it did not specify adequately in the proposal the details of the standard it eventually adopted).

covering such systems or to persuade it to tailor such coverage and instead proceed to the balance of our comment.

II. Redefining the Term "Exchange" to Include CPSs for Potential Buyers and Sellers Violates the '34 Act, the APA, and the U.S. Constitution.

Were the Commission to cover blockchain-based systems as exchanges, that choice would be unlawful for another reason: the expansion of Rule 3b-16 to cover CPSs that facilitate the communication of mere trading interest, as the proposal seeks to do, is inconsistent with the '34 Act, is arbitrary and capricious in violation of the APA, and impinges on protected speech contrary to the First Amendment.

A. Expanding the Definition of the Term "Exchange" Loses Sight of the Text and Purpose of the '34 Act.

The proposal seeks to redefine the term "exchange" to include systems that assist people to communicate about their potential interest in buying or selling securities at some point in the future and to find other people who share that interest. But this reinterpretation runs afoul of the text of the '34 Act, which defines an exchange as a group offering a place or facilities for the orders of actual (not potential) buyers and sellers to be brought together by intermediaries (not to find and negotiate with each other). Congress selected this definition for a reason: as discussed briefly above, it tracks Congress's focus on the important operational role that intermediaries traditionally play in American finance. The proposal, by contrast, would cover as exchanges instrumentalities of commerce that Congress never intended.

1. An "exchange," according to the '34 Act, is a group which 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."[24] In this sentence, "purchasers and sellers" are the direct objects of the verbal phrase "bringing together." As direct objects, the purchasers and sellers are acted upon by the subject whose action the verb describes; they are not themselves the actors. They are the ones brought together, not the bringers. In other words, the '34 Act defines an exchange as a group providing a place or facilities for someone other than a purchaser or seller to "bring together" purchasers and sellers—that is, to intermediate between them.

This definition makes perfect sense in light of Congress's express concern with the role of the exchanges as central intermediaries of securities transactions. And it is consistent with the Commission's own approach in its 1998 final rule, in which the Commission defined an exchange as a group that itself "[u]ses … methods" to bring together purchasers and sellers.[25]

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[24] '34 Act § 3(a)(1) (emphasis added).

[25] 63 Fed. Reg. at 70918.

The Commission's approach up until the present day, then, has recognized that an exchange must involve intermediation between buyers and sellers.

One reason for the instant rulemaking is that the Commission now wishes to depart from its earlier approach. It proposes to redefine an exchange as a group that "makes available" methods of interaction so that it may cover as exchanges systems that "take a more passive role in providing to their participants the means and protocols to interact, negotiate, and come to an agreement."[26] But there is no "bringing together" of purchasers and sellers who use a system to find each other and negotiate; such buyers and sellers would be the subjects of action, not its objects. The proposal reads the definition as if it said that an exchange is "for purchasers and sellers to come together," but that is not the definition Congress wrote. Nor does the proposal follow Congress's focus on the intermediating role of exchanges.

2. The statute makes clear that an exchange exists to bring together "purchasers and sellers," that is, people *actually engaged* in purchasing and selling securities. A purchaser or seller is not someone who may purchase or sell some day, anymore than a doctor is someone who may one day practice medicine or a soldier is someone who may one day enlist. Rather, purchasers and sellers are those who are engaged in purchasing and selling in the present. Every person is a potential purchaser or seller of securities, but the Act does not cover places or facilities in which are brought together those who have nothing but an interest in transacting someday. Rather, an exchange exists for bringing together those who are actually purchasing and selling securities. To qualify as actually engaged in purchasing or selling, a person must at the least have indicated a firm offer to transact, that is, an order to buy or sell a given quantity at a given price.

This part of the statutory definition also makes good sense in light of Congress's focus in the '34 Act on the central role of exchanges in American economic life. Exchanges have this central role due to their ability to set market prices that ramify throughout the country. They are able to set market prices because buyers and sellers submit firm offers, which the exchanges then match up in an auction-type process that produces the market price. If an exchange were to match people who may one day have an interest in buying or selling (leaving it to the matched people to decide among themselves whether they would like to transact and, if so, on what terms) then the matching process would result merely in a series of individually negotiated prices that do not reflect the price at which a given security may be bought or sold at a given moment and hence that would not set a market price for that security across the country.

Notably, the statutory approach is also the one the Commission previously adopted. In its 1998 rulemaking, the Commission explained that, to qualify as an exchange, a system must bring

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[26] 87 Fed. Reg. at 15506.

together "firm indication[s] of a willingness to buy or sell a security."[27] *Contra* the proposal,[28] this limitation does not merely reflect the state of trading technology at the time of the rulemaking. Rather, that rulemaking shows that the Commission was well aware of systems that matched tentative or potential trading interest yet rejected regulating as an exchange any "system that displays … non-firm indications of interest."[29] The Commission made clear at the time that it drew this limitation on the scope of Rule 3b-16 from the text of the '34 Act.[30]

Now, the Commission proposes to undo the limitation from the 1998 rulemaking, regulating as exchanges systems that merely assist potential buyers and sellers to find each other. But extending the coverage of Rule 3b-16 to systems for matching up non-firm trading interests would read the words "purchasers" and "sellers" out of the statute and would result in "exchanges" on which individualized negotiations fail to yield a market price for securities. For the reasons we have given above, such systems are a far cry from those that Congress intended to regulate in 1934.

3. We note that the second half of the definition of "exchange" reads "for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood", and that the Commission does not argue the second half authorizes coverage of CPSs involving the communication of mere non-firm interest. Rather, the Commission argues that CPSs "today perform similar market place functions of bringing together buyers and sellers as registered exchanges and ATSs."[31] Thus, the Commission invokes, and the proposal must rise or fall on, the first half of the definition.

But even if the Commission had invoked the definition's second half, its proposed amendments would nevertheless be unlawful, for the second half likewise permits regulation as an "exchange" only of a central body that intermediates for investors. That is because, for the reasons set forth above, at the heart of "the functions commonly performed by a stock exchange as that term is generally understood" is service as an operational intermediary for securities transactions. That concept is evident throughout the Pecora investigation's consideration of the exchanges of its day, against the backdrop of which Congress enacted the '34 Act. Likewise, it

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[27] 63 Fed. Reg. at 70849.

[28] 87 Fed. Reg. at 15500.

[29] 63 Fed. Reg. at 70850. The Commission's failure to acknowledge the basis of its own prior rulemaking and its concomitant failure to distinguish its prior reasoning would make any final rule arbitrary and capricious.

[30] *Id.* at 70849.

[31] 87 Fed. Reg. at 15498.

is evident in the statement of policy goals that Congress wrote right into the '34 Act.[32] Indeed, as the 1998 rulemaking shows, the role of central intermediary has been at the core of "the functions commonly performed by a stock exchange" for decades and up until the present day.

B. The Proposal Seeks to Expand the Definition of "Exchange" for Policy Goals Unrelated to Congress's Objectives in Defining That Term.

The proposal admits that its expansion of the term "exchange" is driven by policy considerations rather than required by the text of the '34 Act. For the Commission's redefinition to survive review, those considerations must not go beyond the policies that Congress had in mind in enacting the statute.

In drawing up its definition of "exchange," Congress's goal was clear: to identify those organizations that operate in a manner that warrants the extensive restrictions the '34 Act spells out for exchanges. But remarkably, the proposal does not ask whether the CPSs it seeks to regulate fall within that category. It does not try to show that these CPSs could operate successfully under the framework for exchanges or that that framework is necessary to remedy any dangers CPSs pose, dangers that must be of a kind with those exchanges present. It does not attempt to calculate the costs to these CPSs of complying with the obligations that come with exchange status. Indeed, it does not even deny that the rigorous regulatory framework that Congress enacted for exchanges is a poor fit for these CPSs.

The reason for these omissions is that the proposal takes the position that "many Communication Protocol Systems would not elect to register as an exchange but instead would register as a broker-dealer and comply with Regulation ATS because the regulatory costs associated with registering and operating as an exchange would be higher than those associated with registering as a broker-dealer and complying with Regulation ATS."[33] So confident is the Commission in this prediction that it estimates the benefits and costs for the proposal by reference to the benefits and costs of compliance with the broker-dealer requirements rather than the requirements for exchanges.[34] The proposal's acknowledged effect, then, will be to cover CPSs as broker-dealers rather than exchanges. The proposal does not attempt to show that applying the exchange provisions of the '34 Act to CPSs is necessary or feasible *because the Commission does not plan to apply those provisions to them* (at least, not in the vast majority of cases).

The desirability of covering CPSs as broker-dealers may be relevant to interpretation of the terms "broker" and "dealer" in the '34 Act—but not to interpretation of the word "exchange." That is because Congress, when defining "exchange," did so to identify the organizations that should be subject to the regulatory regime it designed for exchanges. The Commission's desire

[32] '34 Act § 2.

[33] 87 Fed. Reg. at 15618.

[34] *Id.* at 15618-15629.

to cover CPSs as broker-dealers is simply irrelevant to Congress's purposes in defining the term "exchange"—and this purpose, after all, must be the touchstone for the Commission's interpretation of the term.

The Commission's objective is impermissible for another reason: Congress has defined the terms "broker" and "dealer" in the '34 Act,[35] and CPSs are neither (which is presumably why the proposal seeks to redefine the word "exchange" rather than these terms). The Commission, being a creature of statute and endowed only with those powers Congress has given it,[36] is bound by Congress's decision about which persons and entities should be covered as broker-dealers under the '34 Act. It is not free to cover entities Congress has decided are not broker-dealers. That does not change just because the Commission aims to persuade CPSs to "volunteer" for coverage by holding over their heads more onerous regulation as an exchange.

The proposal's approach displays textbook arbitrariness. Long ago the Supreme Court explained that "an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider."[37] Here, the proposal ignores the factors Congress intended to be considered in defining the word "exchange" and instead considers factors Congress did not intend. For these reasons, any rule finalizing the proposal's coverage of CPSs would violate the APA.

C. The Proposal Is Destructively and Pointlessly Vague.

By adhering to the '34 Act's focus on central intermediaries, Rule 3b-16 as currently written achieves the benefit of clarity. The rule limits itself to those who intermediate for investors—who undertake the "bringing together" of buyers and sellers contemplated in the '34 Act—for it applies only to those who "use" established, non-discretionary methods to match up orders. This limitation provides clarity for potentially regulated entities, who can easily determine by reference to their own actions whether they are "using" such methods.

But the proposal would discard this clarity. It would broaden the rule to include entities who do not themselves take an active role in matching up orders but instead simply contribute in some manner to the efforts of buyers and sellers (and even potential buyers and sellers) to match themselves or even to identify each other. Knowing with any reasonable degree of certainty whether one *contributes* to the efforts of others to transact, or even to simply inform themselves in contemplation of perhaps transacting one day, is often a difficult—indeed impossible—task. The proposal offers no help to make it feasible.

If finalized in its current form, the proposal would cover groups that "make available" established, non-discretionary methods for trading. Such a method is "available" when it exists for use by buyers and sellers, and anyone who contributes to its existence for such use—from the

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[35] '34 Act § 3(a)(4)-(5).

[36] *Michigan v. EPA*, 268 F.3d 1075, 1081 (D.C. Cir. 2001).

[37] *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

owners of a system to its designers and programmers to ConsenSys itself with its software platforms—can be said to "make" it available. We do not think that the Commission intends to cover all these groups as exchanges, including us, but the proposal gives no guidance about what kind of causal activity qualifies as "making available" for its purposes. The public will be left to guess, with the risk of stiff penalties handed out at the Commission's unbridled discretion for getting it wrong.

Further, the proposal does not state that coverage as an exchange requires that a group *intends* to make available a covered method for trading, or even that a group *knows* that its action contributes to making such a method available. Does a software development company that designs a multi-purpose program qualify as an exchange if one of its customers uses that program to run a CPS that helps buyers and sellers of securities find each other, even if the developer did nothing to encourage this use? What if the developer never anticipated this use or learned of it only after having licensed its product? The proposal does not say whether developers and others in these situations qualify as exchanges, leaving broad swaths of the developer community to make their best guess as to their obligations under the law.

This confusion is only compounded by the proposal's refusal to define the key term "communication protocols."[38] The proposal gives a few examples of such protocols but makes clear that the list is "not exhaustive" and that the Commission intends to "take an expansive view of what would constitute 'communication protocols'" for purposes of its proposed amendments.[39] Is an app that allows customers to use cryptocurrency to pay for consumer goods a communication protocol? Nothing in the regulatory text says it is not.

Developers such as those that work with ConsenSys, as well as others across the technology universe, would thus be left in an untenable position: the proposal requires them to register as an exchange if they "make available" "communication protocols," but refuses to tell them what either of those phrases means. This vagueness will leave hundreds of thousands of people and businesses uncertain about whether they are covered by the proposal's amendments and impose the costs of regulatory uncertainty on vital sectors of the American economy. The proposal nowhere acknowledges this uncertainty or the costs it creates, let alone shows that these costs are justified by some benefit arising from leaving these key phrases undefined. This vagueness cannot stand under the APA.

Nor is that statute the only law offended by the proposal's approach. The Constitution's Due Process Clause forbids regulating "in terms so vague that men of common intelligence must necessarily guess at its meaning."[40] For the reasons we have given above, if finalized the proposal would leave developers without a way to divine the line between unregulated software development and regulated "making available" of a "communication protocol." Leaving them to

[38] *See* 87 Fed. Reg. at 15507.

[39] *Id.*

[40] *FCC v. Fox Television Stations, Inc.*, 567 U.S. 239 (2012).

guess about whether they fall within the Commission's regulatory authority is not a licit option under our Constitution.

To finalize amendments to Rule 3b-16, the Commission must define the phrases "make available" and "communication protocol." Because the public (ourselves included) would wish for, and are entitled to, the opportunity to comment on these definitions, the Commission must withdraw the current proposal and, if it chooses to proceed with the rulemaking, reissue it with the meaning of these key phrases spelled out and the questions raised in this subsection answered.

D. The Proposal Fails to Show That It Will Do More Good Than Harm.

In the course of its some 200 pages of the Federal Register, the proposal remarkably omits one thing: a single example of a real-world harm that deeming exchanges the CPSs that assist buyers and sellers to find each other would have prevented. The proposal points out that, without amendments to Rule 3b-16, certain CPS "participants cannot avail themselves of the same investor protections, fair and orderly market principles, and Commission oversight that apply to today's registered exchanges or ATSs,"[41] but it fails to offer any evidence that these participants *need* these sorts of protections. And because the proposed amendments would apply to CPSs that are not engaged in the intermediation that in 1934 characterized (and continues to characterize) exchanges, there is no reason to believe that participants in these CPSs are at risk of the harms that the '34 Act is designed to prevent. The Commission thus has failed to show that the proposal, if finalized, would address a real problem—and, of course, a regulation aiming at a problem is "highly capricious if that problem does not exist."[42]

The proposal claims that its amendments are necessary to prevent trading systems that are presently not subject to Rule 3b-16 from receiving an unfair advantage over systems that are.[43] But if these two types of systems pose different risks, they *should* be subject to different regulatory regimes, just as a dangerous chemical is more stringently regulated than (and thus at a competitive disadvantage versus) a harmless one. The question the Commission should ask is not whether systems that present different risks should or should not have advantages over one another, but whether the systems really present different risks. If some of the systems that now qualify as exchanges do not in fact pose risks that are of concern to the '34 Act, then the Commission should consider rescinding coverage of those systems rather than expanding coverage to systems that do not present these risks.

But even accepting for the sake of argument that the proposal responds to a real problem, it does not show that its solution to that problem is worth its considerable costs. Even on the Commission's estimate—which omits the costs of regulatory uncertainty as detailed above—the proposal would cost several million dollars annually, which the users of regulated systems would

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[41] 87 Fed. Reg. at 15502.

[42] *Alltel Corp. v. FCC*, 838 F.2d 551, 561 (D.C. Cir. 1988).

[43] 87 Fed. Reg. at 15503.

presumably bear.[44] But the Commission is unable to estimate, either quantitatively or qualitatively, the value of *any* of the benefits it claims the proposal would produce.[45] It does not opine as to whether those benefits will exceed—or even justify—its costs.[46]

The Supreme Court has made clear that "reasonable regulation ordinarily requires paying attention to the advantages and the disadvantages of agency decisions."[47] A rulemaking that declines to assess whether its benefits are worth its costs is generally arbitrary and capricious, for a regulation that does substantially more harm than good is irrational, and therefore so is the failure to inquire as to the relation of a regulation's costs to its benefits.[48] This failure is all the more egregious because it means the proposal is unable to say whether it would on net help or harm efficiency and capital formation,[49] a question Congress has directed the Commission to answer in each rulemaking.[50]

E. If Finalized, the Proposal Would Infringe Protected Speech in Violation of the First Amendment.

Under the proposal, whether a system is regulated as an exchange turns on the content of the speech it facilitates. The current Rule 3b-16 makes coverage as an exchange turn only on verbal acts, *i.e.*, the consent to buy or sell a particular quantity of a security at a stated price. But the proposed amendments would go further, covering a system as an exchange because it facilitates communication by people about what they might do some day. Such statements are not verbal acts but speech.

The proposal would create a regulation that treats different speech differently. A system that helps people communicate about their interest in the 2022 baseball season or in swapping bikes would not be regulated as an exchange, while a system that helps people communicate about their interest in buying or selling securities is. Laws "that target speech based on its communicative content … are presumptively unconstitutional"; typically they may be upheld only upon surviving strict scrutiny, which requires both a compelling interest and narrow

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[44] *Id.* at 15623.

[45] *Id.* at 15618-23.

[46] *Id.* at 15618-15639.

[47] *Michigan v. EPA*, 135 S. Ct. 2699 (2015).

[48] *Id.*

[49] 87 Fed. Reg. at 15639.

[50] *See* 15 U.S.C. § 77b(b); 15 U.S.C. § 78c(f).

tailoring to achieve it.[51] The Supreme Court has applied a somewhat less demanding standard to restrictions of commercial speech, which may be sustained if "proportion[ate]" to a substantial state interest.[52] (The Court has applied a lesser standard to laws compelling disclosures necessary to prevent consumer fraud, but that is not the nature of the restriction at issue here.[53])

Regardless of whether strict scrutiny or the less demanding commercial speech standard applies, a final rule like the proposal will not satisfy it. The Commission does not show either a compelling or a substantial interest in covering CPSs that involve communication of a non-firm interest, because it does not demonstrate any actual problems that its own 1998 regulation fails to address. Moreover, because the proposal leaves its boundaries vague, it cannot show the precise scope of its application and therefore cannot show that that scope, whatever it may be, is either narrowly or proportionately drawn to achieve its interest.

The proposal does not even discuss these First Amendment issues. Indeed, it does not appear to recognize that it is treading on constitutionally suspect territory, for the words "First Amendment" or "freedom of speech" do not appear in the proposal. This failure to discuss its constitutional implications amounts to a grave defect in its own right, for it deprives the public of any opportunity to comment on whether the Commission's asserted interest is compelling or substantial and its means narrowly- or proportionately-tailored. Accordingly, if the Commission chooses to proceed with this rulemaking, it must first reissue the proposal with a full exploration of the First Amendment issues we have raised here.

CONCLUSION

For the reasons we have given, we respectfully urge the Commission to clarify in any final rule that blockchain-based systems do not fall within the scope of its amendments to Rule 3b-16. We also urge that the Commission address the deficiencies we have identified, which requires that the Commission withdraw the proposal and (if it elects to proceed with the rulemaking) reissue it offering the modifications and analysis we have called for.

At the very least, the Commission should extend the deadline for filing comments in this rulemaking. Executive Order 12866, first issued by President Clinton and endorsed by every President of both parties since, explains that "each agency should afford the public a meaningful opportunity to comment on any proposed regulation, which in most cases should include a comment period of not less than 60 days" from the time the proposed regulation is published in the Federal Register.[54] While shorter comment periods may be justified on occasion by exigent circumstances, the Commission does not suggest that such circumstances are present here. Nor

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[51] *Reed v. Town of Gilbert*, 135 S. Ct. 2218, 2226, 2231 (2015).

[52] *Central Hudson Gas & Elec. Corp. v. Pub. Serv. Comm'n of N.Y.*, 447 U.S. 557, 564 (1980).

[53] *See Zauderer v. Office of Disciplinary Counsel of Supreme Court of Ohio*, 471 U.S. 626 (1985).

[54] E.O. 12866 § 6(a)(1).

could it, as it has failed to adduce a *single instance* of real-world harm in the proposal, let alone urgent injury that will result absent swift action. In a voluminous, complex rulemaking like this one, involving the definition of one of the '34 Act's foundational terms and the intricacies of new and rapidly-evolving technologies, the Commission must afford the regulated public at least the full 60 days for which Executive Order 12866 calls.

Respectfully Submitted,

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by:

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