coinbase

Via electronic submission to rule-comments@sec.gov

June 13, 2023
Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: Supplemental Information and Reopening of Comment Period for Amendments Regarding the Definition of "Exchange," File No. S7-02-22

Dear Ms. Countryman:

Thank you for the opportunity to comment on the U.S. Securities and Exchange Commission's (the **Commission's**) supplemental information and reopening of comment period (the **Reopening**) for the proposed amending of Rule 3b-16 under the Securities Exchange Act of 1934 (the **Exchange Act**) regarding the definition of "exchange" (the **Proposed Rule**).[1] This letter reaffirms and supplements the comments Coinbase Global, Inc. (**Coinbase**) made in our prior comment letter on the Proposed Rule, in which we expressed concerns with the overbreadth of the proposed definitions and scope of the proposal.[2] We continue to be concerned by the scope of the Proposed Rule, particularly in light of the Commission's expansive interpretation discussed in the Reopening. The Reopening seems to continue a Commission effort to interpret the federal securities laws and rules in a manner that is impossible to comply with, attempting to effectively shut down an industry, rather than seeking to appropriately regulate activity in a manner that protects investors, facilitates capital formation, and maintains fair, orderly and efficient markets.

We are further concerned by language in the Reopening implicating, but not addressing, the question of SEC authority to regulate issues of side-by-side trading of crypto asset securities and crypto asset non-securities on the same platform, if at all. If rulemaking depends on a particular answer to this question, then this threshold question should be explicitly considered in the rulemaking process. Yet the Commission has not provided any explanation for the authority it may imply here. The proper allocation of this jurisdiction is also currently a matter of live debate in Congress, and therefore should be addressed with particular care in the rulemaking process. Of course, side-by-side trading could offer important customer benefits but any effort to regulate or, more significantly, allow side-by-side trading of digital asset securities and non-securities must be rooted in authority granted by Congress. Additionally, the Commission's lack of information gathering is evident by the incomplete and inadequate economic analysis that does not accurately reflect the burden of implementing the Proposed Rule.

Finally, we commend the Commission for acknowledging that the trading of crypto asset securities on an alternative trading system (**ATS**) is a viable model, although we note that this is in conflict with positions expressed directly to certain market participants (including Coinbase) and inconsistent with recent public statements by the Chair.

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1 Supplemental Information and Reopening of Comment Period for Amendments Regarding the Definition of "Exchange," Exchange Act Release No. 97309 (Apr. 14, 2023), 88 Fed. Reg. 29448 (May 5, 2023).

2 Letter from Paul Grewal, Chief Legal Officer, Coinbase Global, Inc., dated Apr. 18, 2022 (**2022 Coinbase Letter**).

I. The Commission's role is to regulate, not terminate, securities market developments

In our last comment letter on this subject, we, like many other commenters, noted serious substantive concerns regarding whether and how the Proposed Rule would apply to decentralized exchanges (**DEXs**).[3] The Reopening indeed made explicit our and many others' deep concern that the Proposed Rule would apply to DEXs, without the Commission first developing a workable regulatory regime. Rather than explain *how* the rules would apply to this new paradigm, which appears technically impossible, the Reopening simply states that they would. The Reopening takes this approach despite the compliance impossibility and substantive issues that we and many other commenters identified in prior attempts to work with the Commission.[4]

As the Supreme Court has repeatedly held, an agency's authority to regulate a particular industry does not include the authority to ban that industry, absent clear Congressional authorization.[5] The Commission has received no such authorization and yet its actions would have that effect, making any DEX unlawful by demanding compliance with obligations that simply cannot be met. The Administrative Procedure Act (the **APA**) also prohibits rules that render compliance impossible, specifically, "[i]mpossible requirements imposed by an agency are perforce unreasonable: 'Conditions imposed by [the] order are . . . unreasonable by virtue of being impossible to meet.'"[6]

The proposed rule, as applied to DEXs, would be just such an impossible requirement. As we and many other commenters noted in prior comment letters, it would be *impossible* for a DEX, to the extent it facilitated transactions in securities and met the Commission's proposed revised definition of an exchange, to comply with the existing requirements for a national securities exchange.[7] The Commission states that registration is possible as there typically exists "a single organization" that fulfills the requirement that there be an "organization, association, or group of persons" that "constitutes, maintains, or provides" the DEX.[8] While in some instances there may be services that *purport* to be a DEX or other

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[3] *See e.g.*, 2022 Coinbase Letter; Letter from William C. Hughes, Senior Counsel & Director of Global Regulatory Matters, ConsenSys Software Inc., dated Apr. 14, 2022 (**ConsenSys Letter**); Letter from Sheila Warren, Chief Executive Officer, Crypto Council for Innovation, dated Apr. 18, 2022 (**Crypto Council Letter**); Letter from LeXpunK, dated Apr. 18, 2022 (**LeXpunK Letter**); Global Digital Asset & Cryptocurrency Association, dated Apr. 18, 2022 (**GDCA Letter**).

[4] *See Coinbase Inc.'s Petition for Writ of Mandamus to the United States Securities and Exchange Commission* (3d Cir. No. 23-1779 Apr. 25, 2023) and 2022 Coinbase Letter.

[5] *See e.g.*, *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 126-127 (2000) (rejecting the Food and Drug Administration's claim that its authority over "drugs" and "devices" included the power to ban tobacco products).

[6] *Alliance for Cannabis Therapeutics v. Drug Enforcement Admin.*, 930 F.2d 936, 940 (D.C. Cir. 1991) (quoting *D.C. Transit Sys., Inc. v. Washington Metropolitan Area Transit Comm'n*, 466 F.2d 393, 402 (D.C. Cir. 1972) (MacKinnon, J., concurring)) (alterations in original). For the reasons described in the text, the impossibility of subjecting DEXs to exchange registration and ongoing compliance requirements would be intractable, and thus unreasonable under the APA.

[7] *See e.g.*, 2022 Coinbase Letter, at 6-7 ("the Commission would need to consider how the rule could practically apply to DEX[s]."); ConsenSys Letter, at 3 ("the proposal does not…explain how the rigorous requirements of the '34 Act could sensibly be applied in the blockchain context."); LeXpunK Letter, at 17 ("Given it would be impossible for most DeFi and digital asset projects to comply with such requirements under the current regulatory structure, the requirements set forth in the Proposing Release would stifle competition and increase inequality among operators in financial markets by serving as a de facto ban of substantially all trustless and trust-minimized DeFi protocols and related digital asset technologies.").

[8] *See* the Reopening, at 22.

types of decentralized finance (**DeFi**) applications that actually have centralized operators,[9] truly decentralized systems do in fact exist and have no single organization capable of being responsible for compliance. The fact that an individual or group of individuals may have the ability to provide some information about a DEX does not mean that those persons are acting in concert with each other, or are in an equivalent position to the operators of a centralized exchange, or should (or could) assume the same obligations.

It is no solution to instead require DEX developers to fill this role and bear responsibility for exchange registration and compliance.[10] When creating a DEX, a software developer typically writes the code that creates the DEX and then publishes the code onto a public, permissionless blockchain, along with a mechanism for widely distributing the governance tokens that enable holders to alter select elements of the DEX going forward. It is true that DEX developers often also create so-called "front-end" websites that are useful in interacting with the DEX. But while the developer may have a headstart in creating an attractive interface for accessing the DEX, once released, *anyone* can (and many typically do) build a competing interface or even access the DEX directly on their own. The developer may no longer have the ability to influence the operation of the protocol beyond that of a similarly situated token-holder. Once released, the DEX may only be further modified through consensus among token-holders. And, as with developing the DEX itself, where the protocol is often agnostic as to the underlying nature of the digital assets traded on it, the front-end is typically agnostic as well to the underlying nature of each digital asset, so long as it complies with the relevant technological parameters.

The Commission does not address the practical realities of DEXs. For instance, a Decentralized Autonomous Organization (a **DAO**) is not suited to the "control" role since it has none of the centralized coordination and leadership that would facilitate compliance with securities law obligations.[11] Unfortunately, the Commission does not define "organization, association, or group," but instead lists a non-exhaustive set of "important factors" that include but are not limited to "control," which is also undefined.[12] The Reopening concludes that such a "group" could be found and therefore DEXs could be

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[9] The Commission has in fact charged promoters of purported decentralized finance systems that were, in fact, quite centralized. *See*, *e.g.*, In re Blockchain Credit Partners d/b/a DeFi Money Market, Gregory Keough, and Derek Acree, Securities Act Release No. 10961 (Aug. 6, 2021) (alleging that operators of a so-called "DeFi Money Market" fund violated securities laws where the two promoters made all investment decisions); In the Matter of Zachary Coburn, Exchange Act Release No. 84553 (Nov. 8, 2018) (asserting that Mr. Coburn actually "exercised complete and sole control" over a purportedly decentralized exchange).

[10] *See e.g.*, the Reopening, at 30 (""If, for example, an organization deploys a smart contract that the organization cannot significantly alter or control but constitutes a market place for securities under existing Exchange Act Rule 3b-16 or Rule 3b-16, as proposed to be amended, then that organization would be an exchange and would be responsible for compliance with federal securities laws for that market place. Given that such a market place could be publicly available to bring together buyers and sellers of securities, requiring the organization to be responsible in this case would advance the Commission's policy objectives by ensuring the exchange complies with federal securities laws and regulations…")..

[11] The Reopening notes that "typically . . . a single organization constitutes, maintains, or provides the market place or facilities" of a DEX,".The Reopening, at 22. Not only is the Commission's view of a typical DEX limited to what we have above referred to as services that merely "purport" to be DEXs, but the report that the Commission cites in support of this view acknowledges the very distinction we describe and that the Commission rejects: that "claims about decentralization for many projects may not hold up to scrutiny." *Id*. at n.63. We agree that there are services that claim to be decentralized but are not. The rules, if they are to apply to truly decentralized protocols, must work for those that are actually decentralized.

[12] *Id*.

considered to be exchanges, but for true DEXs there is no "organization" that "controls" the DEX and therefore none that can satisfy the regulatory requirements.

For truly decentralized systems, the only possible "group" that the Commission could seek to regulate would be the dispersed group of unaffiliated governance token holders.[13] However, as we stated in our prior comment letter, there are significant practical challenges with imposing registration and compliance on those token holders.[14] For example, the token holders do not necessarily have any relationship or processes that could support large scale compliance obligations, they cannot individually control the DEX and they are neither considered securities professionals nor represented by corporate officers who could engage in filings with the Commission on behalf of the DEX.

It is not clear that imposing liability on any of these individuals or groups would meet the Commission's regulatory goals. The regulatory purpose in assigning liability is to improve the disclosure of information and compliance with certain practices. This is a legitimate and necessary goal of proper regulation. But imposing liability on someone who has no ability to affect compliance or disclosure does nothing to further this regulatory goal and risks being labeled an arbitrary and capricious exercise of regulatory power.

Given these challenges, we believe the Commission should re-propose, or separately propose, rules that address the practical realities of regulating DEXs. In doing so, the Commission must keep in mind that it cannot regulate a piece of code or protocol that is separately utilized by unaffiliated persons. To regulate the unrelated group of protocol users would be akin to asserting that people who use the same email technology are acting together simply by virtue of using common code to communicate with one another. A first step for the Commission, therefore, could be distinguishing between those services that merely purport to be a DEX from those that are truly decentralized. We agree with Commissioner Peirce's dissent to the Reopening (the **Peirce Dissent**) in which she explains that the Proposed Rule, as is, "offers no clarity as to *how* these systems are to be registered or why registration even makes sense."[15] Since the Commission is unable to articulate how registration is possible or why registration is sensible for DEXs, it is unreasonable under the APA for it to interpret new rules as applying to DEXs.[16]

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[13] Even if one were to assume that a DEX is a person, organization, association or group by virtue of being controlled by a DAO, as has been suggested in one recent decision, the Commission still must explain *how* the DEX could actually comply with its rules, which it has not done. *See Commodity Futures Trading Commission v. Ooki DAO*, No. 3:22-cv-05416-WHO (N.D. Cal. June 8, 2023).

[14] *See* 2022 Coinbase Letter, at 6.

[15] Commissioner Hester M. Peirce, *Rendering Innovation Kaput: Statement on Amending the Definition of Exchange*, (April 14, 2023) (emphasis in original), available at https://www.sec.gov/news/statement/peirce-rendering-inovation-2023-04-12.

[16] As Commissioner Peirce observed, today's Commission should refer back to the Commission's longstanding history of taking a thoughtful approach toward new technology developments, such as with respect to the Commission's treatment of the Delta system and the development of Regulation NMS. *Id*.

II. The Commission may not engage in regulation of side-by-side trading by implication buried in its economic analysis

Any rulemaking that rests on whether or not the Commission has authority to regulate issues of side-by-side trading of digital asset securities and non-securities requires explicit analysis of that threshold question. But here, the Commission sidesteps that required analysis altogether. The Commission does not provide any legal support for its implied conclusion and inherent assumption of authority, including whether the Commission can regulate non-security digital assets at all, as it would be doing if it regulates entities or dictates structures for entities that allow side-by-side trading of digital asset securities and non-securities. Notably, in the economic analysis section of the Reopening, the Commission states that:

> [m]any crypto asset securities are not traded in exchange for fiat currencies but are instead traded for other crypto assets. To the extent that a New Rule 3b-16(a) System [*e.g.* DEXs] enables the trading of crypto asset securities for crypto assets *that are not securities*, that entity may also incur the cost of having to stop enabling such trades, and the resulting loss of revenue.[17] (emphasis added)

And in the questions posed, the Commission specifically references "trading pairs involving non-security crypto assets and crypto asset securities."[18]

Although not explicit, the implication of these statements appears to be that the Commission believes it has the authority to regulate on its own aspects of side-by-side trading on a single platform of crypto asset securities and crypto asset non-securities.

The Commission has the statutory authority to regulate securities market activities, nothing more. Stepping beyond this authority to unilaterally sanction or bar services, including aspects of side-by-side trading, must be prescribed by Congress and within Congressionally-given authority to the agency. To make rules that presume answers to these questions or fail to state the basis for the authority needed to make those rules is particularly problematic when, as now, the proper allocation of that authority is under active consideration by Congress.[19] The Commission should take care not to preempt any contemplated Congressional action.

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[17] The Reopening, at 121.

[18] *Id*. at 15.

[19] *See* Rep. Patrick McHenry and Rep. Glenn Thompson, "Digital Asset Market Structure Discussion Draft," (Jun. 2, 2023) (proposing to allow dual registration of ATSs and digital commodity exchanges) available at https://financialservices.house.gov/uploadedfiles/digital_002_xml.pdf.

III. The Commission's economic analysis fails to actually analyze the costs and benefits of the Proposed Rule's purported application to crypto asset securities

The Commission both asserts that it does not have sufficient information to conduct a full economic analysis, and also that its analysis is sufficient.[20] A lack of data does not relieve the Commission of its obligation to perform a competent analysis.[21] As we have previously noted, the Commission has not visibly engaged in the types of efforts typically used to obtain needed information.[22] It has not released a request for information or held public meetings (such as roundtables) or conducted other activities designed to obtain information that would enable a full analysis. The Commission also does not seem to have availed itself of the extensive publicly available data about the crypto asset market. To the extent that it has questions about the reliability of well-known resources, it could conduct its analysis using its best estimates, as other agencies have been required to do.[23] Regardless of whether the Commission has the data available to support its position, it has a "statutory obligation to determine as best it can the economic implications of the rule it has proposed."[24] It is not clear this obligation has been met.

Given the Commission's stated lack of information, we are concerned that it has not properly considered the burdens imposed by the Proposed Rule. The Commission assesses only what it describes as a "useful lower bound" for such costs.[25] This "lower bound" is still almost $8 million in initial and ongoing compliance costs per registrant and the Commission admits that it cannot say "how much higher costs may be."[26] The Commission acknowledges these costs could be imposed on individual developers, token holders and validators, despite these parties having no ability to ensure compliance.[27] The Commission has not considered, however, how these costs would be multiplied if applied to the disparate individuals that it would include as operators of an exchange under the Proposed Rule. Indeed, these costs would be a death knell for the development of and participation in DEXs. The Commission acknowledges that the imposition of these costs would limit innovation and would cause innovators to leave the U.S. market.[28] However, the Commission again asserts a lack of information and, instead of

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[20] *See e.g.*, the Reopening at 99 ("The Commission is uncertain as to how precise these estimates are because we lack sufficient data on crypto asset securities.").

[21] *See e.g.*, *Chamber of Commerce of U.S. v. SEC*, 412 F.3d 133 (D.C. Cir. 2005) (holding that even when it is "difficult to determine the costs" associated with agency action, the agency must still engage in a detailed economic analysis); *Bus. Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011); *New York Stock Exchange LLC v. SEC*, 962 F.3d 541 (D.C. Cir. 2020).

[22] Paul Grewal, *Re: Petition for Rulemaking – Digital Asset Securities Regulation*, at 28 (Jul. 21, 2022) (describing the Commission's failure to use "requests for comment, concept releases, advisory committees, and public roundtables to obtain useful public input prior to proposing specific rulemaking items").

[23] *See Public Citizen, et al. v. Federal Motor Carrier Safety Administration*, 374 F.3d 1209 (D.C. Cir. 2004) (in the face of uncertainty, an agency must "exercise its expertise to make tough choices about which of the competing estimates is most plausible, and to hazard a guess as to which is correct, even if . . . the estimate will be imprecise").

[24] *Chamber of Commerce*, 412 F.3d at 143.

[25] *See* the Reopening, at 99-100.

[26] *Id*.

[27] *Id*. at 101-103.

[28] *Id*. at 134-138. As we have noted, the Commission does not have the authority, without clear Congressional authorization, to regulate away an entire industry. *See West Virginia v. Environmental Protection Agency*, 597 U.S. __ (2022) (ruling against

considering the actual costs, considers only a crude, theoretical range of costs—one that merely goes from "the lower end" to "the other end."[29] Such a rudimentary economic cost analysis is inadequate to support the imposition of the Proposed Rule and does not assuage concerns that compliance would be effectively impossible.

IV. The Commission rightly recognizes that ATSs are an appropriate model

We commend the Commission for acknowledging the potential viability of ATSs as a model for crypto asset securities markets.[30] We are encouraged by the Commission's acknowledgement of the existence of this legal framework as an existing approach in traditional finance, and hope that its view of ATSs can serve as the foundation for a workable approach to crypto asset markets that is consistent with its approach to traditional securities.

The Commission staff has, however, in direct discussions with industry participants rejected the possibility of an ATS for those participants,[31] the same message that recent statements by the Chair imply as well.[32] We encourage the Commission to consider the benefits to consumers of allowing ATS models within the crypto industry, and the importance of allowing all willing and able crypto entities to participate in such models. Rulemaking to define and ensure that solutions are available to the industry as a whole, rather than select participants only, is critical.

We believe that an ATS model is more appropriate for crypto asset markets due to the fact that platforms serve multiple roles, unlike a traditional exchange. Blockchain-enabled trading platforms make real-time settlement possible.[33] Platforms serve as the location of customer trading but also, if the platform is a broker-dealer, it could provide custody for the customer's cash and securities, which is a

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the EPA's assertion of the authority to "ca[p] carbon dioxide emissions at a level that will force nationwide transition away from the use of coal to generate electricity" without clear Congressional authorization).

29 *Id*. at 135.

30 *See, e.g.*, the Reopening, at page 62 ("the Commission believes that New Rule 3b16(a) Systems would likely choose to register as a broker-dealer and comply with the conditions of Regulation ATS rather than register as a national securities exchange").

31 See Wells Submission on Behalf of Coinbase Global, Inc. and Coinbase, Inc. (April 19, 2023) at 4-5, 16, available at https://assets.ctfassets.net/c5bd0wqjc7v0/2pW56ln6rPJ7koLHlu2L8G/5041e0166c408698b621fde543539d76/2023-04-19_Coinbase_Wells_Submission.pdf.

32 *See, e.g.,* Remarks on Crypto Markets, Penn Law Capital Markets Assoc. Annual Conference (Apr. 4, 2022), available at https://www.sec.gov/news/speech/gensler-remarks-crypto-markets-040422?utm_medium=email&utm_source=govdelivery; House Appropriations Committee Hearing, Fiscal Year 2023 Budget Request for Federal Trade Commission and Securities & Exchange Commission, at 1:24:00 (May 18, 2022) available at https://www.youtube.com/watch?v=ANkpX_GoQZw.

33 There are significant regulatory obstacles that remain in place. As we have discussed elsewhere, the Commission has failed to provide permanent, workable broker-dealer custody rules that are compatible with trading models that leverage real-time settlement. The Three-Step No-Action Letter and recent approval of Prometheum Capital as a special purpose broker-dealer are steps in the right direction, but the Commission must go further to provide targeted relief and resolve the many roadblocks that still prevent crypto asset securities from improving the market for a broader group of investors. For example, the Commission should provide guidance that: provides workable tests for market participants to determine which crypto assets are securities, addresses how an ATS may facilitate trading in crypto asset securities that were offered without registration or exemption, and addresses how ongoing disclosure for a crypto asset security may be provided for tokens that have no central team.

necessary condition for 24/7 real-time settlement. We would encourage the Commission to continue to work with innovators in this field to develop regulatory approaches that fit the realities of innovative new systems rather than attempt to shoehorn new systems into inappropriate regulatory schemes that do not mitigate any risks nor serve consumer interests.

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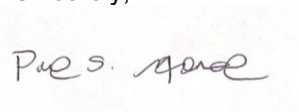
In summary, we support the Commission's continued efforts, as reflected in ongoing regulatory discussions and deliberations, to provide rules for the crypto asset securities ecosystem. We are especially supportive of the Commission's recognition that the trading of crypto asset securities on an ATS is a viable model. However, as outlined above, we believe that (i) the Commission acts beyond the scope of its authority when it effectively bans activities by seeking to apply impossible compliance programs, as it is proposing for DEXs, (ii) the Commission is impermissibly using its economic analysis to prohibit side-by-side trading, which it does not have the authority to do and (iii) the Commission has failed to engage in a real economic analysis and instead used the patina of an economic analysis to justify its policy preferences.

Thank you for the opportunity to comment on the Reopening. If you have any questions on our comment letter, please feel free to contact me at paul.grewal@coinbase.com or Scott Bauguess, Vice President, Global Regulatory Policy, at scott.bauguess@coinbase.com.

Sincerely,



Paul Grewal
Chief Legal Officer
Coinbase Global, Inc.

cc: The Hon. Gary Gensler, Chair
The Hon. Hester M. Peirce, Commissioner
The Hon. Caroline A. Crenshaw, Commissioner
The Hon. Mark T. Uyeda, Commissioner
The Hon. Jaime E. Lizárraga, Commissioner