June 13, 2023

VIA ELECTRONIC SUBMISSION

Ms. Vanessa A. Countryman, Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, D.C. 205499-1090

Re: File No. S7-02-22

Dear Ms. Countryman:

We appreciate the opportunity to provide our views to the Securities and Exchange Commission ("SEC" or "Commission") on its reintroduced rulemaking (the original and reintroduced proposal is referred to herein collectively as the "Proposal") to amend the definition of "exchange" in Rule 3b-16 under the Securities Exchange Act of 1934 ("Exchange Act").[1] As we did in our April 2022 comment letter, we focus our feedback on the proposed application of amended Rule 3b-16—whether with the previously-introduced term "communication protocol systems" or newly introduced term "negotiation protocol"—to computer code deployed on a blockchain (or the people who deploy or maintain that code), which may allow users to purchase, sell or otherwise transact in cryptographically-secured digital assets without an intermediary.[2]

Our previous letter noted that the Original Release's 591 pages contain no mention of crypto, digital assets, blockchain technology, decentralized finance ("DeFi"), peer-to-peer transaction protocols, automated market makers, or any related technology.[3] We argued that, if the rulemaking was intended to cover those things, the SEC should have come out and said it, which would have given market participants the opportunity to grapple with the legal issues that would arise, and members of a potentially regulated class the chance to provide informed views. This we called avoiding "regulation by surprise."

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[1] Supplemental Information and Reopening of Comment Period for Amendments Regarding the Definition of "Exchange", Release No. 34-97309, File No. S7-02-22, available at https://www.sec.gov/rules/proposed/2023/34-97309.pdf ("Supplemental Release"). Amendments Regarding the Definition of "Exchange" and Alternative Trading Systems (ATSs) That Trade U.S. Treasury and Agency Securities, National Market System (NMS) Stocks, and Other Securities, Release No. 34-94062, File No. S7-02-22, available at https://www.sec.gov/rules/proposed/2022/34-94062.pdf ("Original Release"). In an attempt to avoid confusion, we have generally used the term Proposal, except where the use specifically refers to one release or the other.

[2] Gus Coldebella and Gregory Xethalis, Comment to File No. S7-02-22, April 18, 2022, available at: https://www.sec.gov/comments/s7-02-22/s70222-20124026-280152.pdf. In the Supplemental Release, the Staff has inquired whether the term "negotiation protocol" should replace "communication protocols," and otherwise embraced nomenclature in favor of "New Rule 3b-16(a) Systems," but has not meaningfully amended the Proposal.

[3] *Id*. *See also* Original Release.

We appreciate the Commission heeding this call and making it clear that the Proposal is intended to apply to these technologies. However, the problems with the Original Release have not been solved, even with substantive feedback and the additional time the Commission has had to address them. Most notably, neither the proposed rule text—which, despite questions being asked about the rule text, has not been changed at all—nor the Commission's statement about the rule, addresses threshold issues about the SEC's authority under the Exchange Act to promulgate it, or correctly assesses the economic and other effects of the Proposal on this nascent industry. Instead, the Proposal attempts to shoehorn these technologies into the existing exchange registration category and related regulatory framework. In addition to being beyond the scope of the SEC's authority, this approach will cause foreseeable harm to American technological and economic competitiveness, particularly by pushing economic activity and scientific development offshore.

We recommend that the Commission withdraw this proposed rulemaking for the following reasons:

- *First*, the Commission lacks statutory authority to promulgate the proposed rule. The Exchange Act cannot conceivably be stretched to give the SEC this authority.

- *Second*, the Commission—a creature of Congress—is attempting to leap ahead of Congress' prerogatives to regulate this industry.

- *Third*, the rulemaking fails to consider important aspects of the question the regulation seeks to address, namely the unique and distinct factors of DeFi technology. This failure renders the Proposal arbitrary and capricious.

- *Fourth*, the rulemaking needs to distinguish between centralized entities that use non-discretionary methods from ancillary or related functions and make clear software developers are not in scope.

- *Fifth*, the Proposal fails to meet Exchange Act and Paperwork Reduction Act standards because it does not account for the numerous entities that would be in scope, if adopted. Affected parties do not have a reasonable opportunity to provide meaningful comment.

- *Sixth*, the Commission should recognize that advances in technology call for advances in regulation, and create a new regulatory framework applicable to DeFi.

We appreciate your thoughtful consideration of our feedback.

1. Only Congress Can Expand the Scope of the Exchange Definition

The SEC's authority to regulate exchanges is bound by the underlying definition of "exchange" in Exchange Act Section 3(a)(1). Rule 3b-16 enables the Commission to further *clarify* Section 3(a)(1), if and when needed. However, the SEC cannot *expand* its own authority by broadening the reach of Section 3(a)(1), either directly or indirectly. Unfortunately, the latter is precisely what the Proposal attempts to do.

The Supplemental Release frames this endeavor as a simple one: modernizing the description of what it means to be an "organization, association, or group of persons" that maintains a "market place or facilities for bringing together purchasers and sellers of securities" and the "functions commonly performed by a stock exchange as that term is *generally understood*" (emphasis added).[4] This definition describes not only the activity intended to be covered, but also the actor. Inherent in a DeFi system is its removal of a central actor.[5] Where there is no "organization, association, or group of persons," there is no central actor over which the SEC has jurisdiction. Moreover, no "general understanding" of "stock exchange"—or the functions performed by a stock exchange—could conceivably include DeFi smart contracts facilitating the exchange of one digital asset for another.

DeFi smart contracts do not operate similarly to traditional exchanges; they do not implicate commercial relationships that mirror those on a traditional intermediated exchange or alternative trading system. As a result, they raise unique issues and opportunities for both potential users and potential regulators. Principally, most DeFi smart contracts do not involve an administered system or central actor capable of collective action.[6] Rather, DeFi smart contracts generally involve transparent code bases, transaction and asset histories, and commercial interactions. DeFi smart contracts generally operate with immutable rules of behavior that do not require an intermediary to monitor or administer. In these systems, users are empowered to interact with the smart contract directly, in a "peer-to-peer" or "peer-to-protocol" transaction that does not require the participation of any intermediary or exchange. These are important features that demonstrate there is no "organization, association, or group of persons," which results in most DeFi smart contract systems falling outside of the "general understanding" of what it means to be an exchange under Section 3(a)(1).

Further, the transactions that take place on most DeFi protocols generally are non-custodial transactions that are effectuated by the users themselves, through the use of private key authentication that is cleared through the software rules of the network, rather than by any intermediated platform. Accordingly, the generally understood meaning of exchange, absent other factors, does not include "peer-to-peer" or "peer-to-protocol" systems, and therefore any attempt by the SEC to regulate DeFi protocols as exchanges requires authority that it does not have.

Without explicitly saying so, the Commission is attempting to supplant Congress and unilaterally expand its jurisdiction by broadening the notion of what it means to be an exchange. No rulemaking can stretch "exchange" beyond its statutory limits, and the statute limits the SEC's authority to the meaning of exchange as "generally understood." Try as it might, the Commission

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[4] Supplemental Release at 3.

[5] Providing a concise definition of DeFi is challenging due to the potentially broad scope of commercial and financial arrangements that may be engaged in through peer-to-peer and peer-to-protocol technologies; however, modern examples of DeFi include decentralized protocols for payments (e.g., Bitcoin), decentralized protocols to trade one digital asset for another (e.g., Uniswap) and decentralized protocols for over-collateralized "borrowing" (e.g., Compound, although DeFi borrowing lacks many of the characteristics of traditional lending markets). The uniquely fundamental characteristics of DeFi are the removal of intermediaries and reliance on dedicated, typically immutable smart contract protocols that operate in, and may be interacted with through, an IFTTT (if this, then that) ordering. By definition, DeFi smart contracts are generally not administered by any person or group of people, and may not be capable of being administered at all.

[6] *See* footnotes 24 to 26, *infra*, and accompanying text.

cannot expand the general understanding of that term to include software developers, or all services potentially ancillary to exchange activity (such as the examples the SEC provided of a communication protocol system and negotiation protocol). The rulemaking should be withdrawn for this reason alone.

2. Congress Must Act First—The Proposal Directly Contravenes Current Congressional Efforts

There are currently several bills introduced or in discussion in Congress that seek to establish a regulatory framework for digital assets, including defining which are securities. These bills reflect Congress' efforts to determine how best to apply the federal securities laws to the digital asset ecosystem. These bills include:

- The *Digital Asset Market Structure Act* would provide for a comprehensive classification and market structure for digital assets with oversight from both the SEC and the Commodities Futures Trading Commission ("CFTC"). The bill was socialized on June 2, 2023 as a discussion draft by House Financial Services Committee Chair McHenry, House Agriculture Committee Chair Thompson, House Subcommittee on Digital Assets, Financial Technology and Inclusion Chair Hill, and House Subcommittee on Commodity Markets, Digital Assets, and Rural Development Chair Johnson.[7]
- The *R-House Payments Stablecoin Act* and the *D-House Payments Stablecoin Act* would each provide legislation governing the issuance and treatment of various forms of stablecoins, which are a core asset used in many centralized digital asset trading platforms and DeFi smart contracts. While different in parts, the bills share the core mission of providing regulatory certainty for these commercial payment instruments. The *R-House* version was socialized for discussion on April 19, 2023 by Chair McHenry and Chair Hill.[8] The *D-House* version was socialized for discussion on May 15, 2023 by House Financial Services Committee Ranking Member Waters.[9]
- The *Securities Clarity Act* would amend applicable securities statutes to exclude investment contract assets from the definition of a security, clarifying that assets that are the subject of an investment contract should not be treated as the ongoing embodiment of that investment contract. The bipartisan bill was introduced into the 118th Congress on May 22, 2023 by Representatives Tom Emmer and Darren Soto.[10]

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[7] McHenry, Thompson, Hill, Johnson Release Digital Asset Market Structure Proposal, June 2, 2023, available at https://financialservices.house.gov/news/documentsingle.aspx?DocumentID=408838. An updated version of the proposed legislation is available at https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=408851.

[8] Hill Delivers Remarks at Hearing on Stablecoins' Role in Payments and the Need for Legislation, April 19, 2023, available at https://financialservices.house.gov/news/documentsingle.aspx?DocumentID=408714. The most recent version of this proposed legislation is available at https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=408851.

[9] Majority Staff Committee Memorandum, May 15, 2023, available at https://democrats-financialservices.house.gov/uploadedfiles/hhrg-118-ba21-20230518-sd002.pdf. The most recent version of this proposed legislation is available at https://docs.house.gov/meetings/BA/BA21/20230518/115973/BILLS-118pih-Thediscussiondraftdefinesp.pdf.

[10] Emmer and Soto Introduce Bipartisan Bill to Provide Regulatory Clarity for Digital Assets, May 18, 2023, available at https://emmer.house.gov/2023/5/emmer-and-soto-introduce-bipartisan-bill-to-provide-regulatory-clarity-for-digital-assets. Under the proposed bill, investment contract assets that are securities for reasons other than

- The *Keep Innovation in America Act* would explicitly exempt miners and validators, hardware and software developers, and protocol developers from the definition of broker, define the term "digital asset," and mandate clear rules to take advantage of the opportunity presented by digital asset technologies. The bill was introduced into the 118th Congress on March 7, 2023 by Chair McHenry.[11]
- The *Responsible Financial Innovation Act* proposed a comprehensive regulatory framework that addressed securities laws – in particular, by clarifying that investment contract assets or "ancillary assets" would not be treated as securities when traded on secondary markets – and provided for oversight of digital asset trading platforms. The bipartisan bill was introduced into the 117th Congress on June 7, 2022 by Senators Lummis and Gillibrand and its reintroduction is rumored.[12]

These bills are among many that, even if not seeking to regulate digital asset trading platforms (including DeFi protocols) directly, seek to establish legal and conceptual frameworks for digital assets and/or digital asset markets. This stands in contrast to the guidance the Commission has provided to the industry, much of which comes from enforcement actions or limited, dated or non-binding SEC staff guidance.

The Commission should defer to Congress rather than jump in front of the legislative process. In this case, any final rule may ultimately be preempted by statute, or worse, create greater regulatory ambiguity and further complicate this important area of regulation. Members of Congress have voiced their concern about the Commission's actions, or lack thereof, in this area. For example, Republican members of the U.S. House Financial Services Committee noted in an April 2023 letter to Chair Gensler that "the SEC has forced digital asset market participants into regulatory frameworks that are neither compatible with the underlying technology nor applicable," noting specifically that "the current [exchange] framework [is] ill-suited for digital asset trading platforms."[13] The same Members expressed their views on the Proposal earlier today.[14]

Paradoxically, even SEC Chair Gary Gensler recognized the wisdom in allowing Congress to act first. In May 2021 testimony before the House Financial Services Committee, Chair Gensler stated "I do think that working with Congress, and I think it is only Congress that could really address it, it would be good to consider, if you would ask my thoughts, to consider whether to bring greater investor protection to the crypto exchanges. And I think if that were the case, because right now the exchanges trading in these crypto assets do not have a regulatory framework either at the SEC, or our sister agency, the Commodity Futures Trading Commission, that could instill greater

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their being the subject of a security would not be exempted from such other status (e.g., equity securities or oil and gas interests).

[11] Keep Innovation in America Act, 118th Congress, available at https://www.congress.gov/bill/118th-congress/house-bill/1414?s=2&r=21.

[12] Lummis-Gillibrand Responsible Financial Innovation Act, 117th Congress, available at https://www.congress.gov/bill/117th-congress/senate-bill/4356/text. As with the Securities Clarity Act, ancillary assets may be a non-investment contract security.

[13] House Financial Services Committee members, letter to Chair Gensler, April 18, 2023, available at https://financialservices.house.gov/uploadedfiles/2023-04-17_all_fsc_gop_letter_to_sec_on_nse_registration_final.pdf.

[14] House Financial Services Committee members, Comment to File No. S7-02-22, June 13, 2023, available at https://financialservices.house.gov/uploadedfiles/fsc_gop_letter_on_the_secs_proposed_definition_of_an_exchange_final.pdf

confidence. Right now, there is not a market regulator around these crypto exchanges. . . ."[15] The Commission should follow its Chair's advice and allow Congress to address this important area first.

As you know, the U.S. Department of Justice ("DOJ") also recently took the rare step of encouraging the SEC to pause its December 2022 equity "market structure" rulemakings to allow the agency's other numerous proposals to take effect prior to implementing additional changes.[16] While the SEC is an independent federal regulatory agency, important stakeholders—including the cabinet department charged with enforcing the laws of the United States—are suggesting greater prudence on this and several other areas of the agency's agenda, and like the DOJ, we ask for a slowdown. Ultimately, we think a withdrawal of the Proposal is the proper approach.

3. The Proposal is Arbitrary and Capricious—Advancing it Will Annihilate DeFi and the Burgeoning Technology Industry Around Decentralized Systems

Among other factors, an action is arbitrary and capricious if an agency has relied on factors which Congress has not intended it to consider or fails to consider an important aspect of the problem a regulation seeks to address. We have already covered the Commission's lack of statutory authority. But even beyond that, the Commission has neglected to consider important aspects of how the Proposal would apply to DeFi (or more precisely the numerous ways in which it is incompatible) and the technological innovation around decentralized systems.

As one example, the Proposal states "[m]arket places or facilities of, and the functions performed by, national securities exchanges and ATSs trade only securities quoted in and paid for in U.S. dollars."[17] Whether this statement was intentional or simply poorly worded, requiring DeFi protocols to only allow trading in U.S. dollars fails to fundamentally understand how DeFi protocols operate—specifically, that they cannot presently provide for payment in U.S. dollars. Accordingly, requiring payment in U.S. dollars is not regulation of DeFi protocols, it is a de facto ban. Even if a ban is not what was intended, at the very least, such a requirement underscores the

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[15] Transcript: Game Stopped? Who Wins And Loses When Short Sellers, Social Media, And Retail Investors Collide, Part III, May 6, 2021, available at https://www.congress.gov/event/117th-congress/house-event/LC67380/text.

[16] Antitrust Division, DOJ, Comment to File Nos. S7-29-22, S7-30-22, S7-31-22 and S7-32-22, available at https://www.sec.gov/comments/s7-29-22/s72922-20164065-334011.pdf. The DOJ expressed concern that the SEC provided insufficient time to assess the impact of numerous, contemporaneous and interrelated rulemakings, impacting the effectiveness of the comment and response process required by the Administrative Procedure Act. *See also*, Joint Trade Associations' Letter to SEC on the Importance of Appropriate Length of Comment Periods, April 5, 2022, available at https://www.aba.com/advocacy/policy-analysis/ltr-sec-length-of-comment. We note that neither the SEC, nor FINRA has provided a summary of comments received or proposed guidance as a follow-up to the Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities, July 8, 2019, available at https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities ("Joint Staff Statement") (stating, among other things, that a broker dealer could hold only fiat currency and one of traditional securities, digital asset securities or digital asset non-securities) and the request for comment on Custody of Digital Asset Securities by Special Purpose Broker-Dealers, Release No. 34-90788, File No. S7-25-20, available at https://www.sec.gov/rules/policy/2020/34-90788.pdf. While the SEC recently proposed a new rule on investment adviser custody of client assets, no summary of prior feedback or comments was included. See Safeguarding Advisory Client Assets, Release No. IA-6240, File No. S7-04-23, available at https://www.sec.gov/rules/proposed/2023/ia-6240.pdf.

[17] Supplemental Release at 14.

idea that regulation of this space needs to be tailored to it. And even if it were feasible—which it is not—such a step would only compel further isolation of U.S. interests, as has been the steady progression in recent years as innovators have chosen to deploy their innovation and investments increasingly outside of the U.S.

Most DeFi systems are software protocols without any person or group of persons capable of centralized or collective action. Importantly, this means that there is no central actor that can act on behalf of the protocol to "register" with the SEC or unilaterally implement wholesale changes to how a protocol operates. DeFi code can be open-source, contracts can be smart and self-executing, and users can choose whether to use these technologies or choose centralized alternatives. This feels like an area ripe for disclosure, rather than prescription.

In addition, the Commission should not regulate what it cannot define. Although Chair Gensler has publicly stated his belief that most digital assets are securities (though this appears to be a partial reversal of his own prior comments from 2018),[18] market participants and intermediaries are awaiting the courts to provide additional clarity on which digital assets are in fact securities, and if digital assets that are the subject of investment contracts are securities in secondary markets.[19] Accordingly, there continues to be a lack of clarity around when a digital asset is or is not a security. This means that even if an entity registered as a broker-dealer or exchange, it is unclear which digital assets that registrant could trade or match on or through its SEC-regulated platform.[20] Democratic U.S. Rep. Ritchie Torres concisely summed up the effects of these conflicting rules and positions on the market during the April 2023 U.S. House Financial Services Subcommittee Hearing on Digital Asset Market Structure, when he said "the SEC has created a world where project founders are required to register as ice cream while making freezers illegal."[21]

4. Software Developers Must be Exempt—the SEC Must Clarify This

If the Commission ultimately amends Rule 3b-16 as proposed—which we believe it should not—it should maintain the status quo that exchange status rests with the collective actor that (1) engages in the act of "bringing together" buyers and sellers or (2) that "uses" non-discretionary methods for those interactions. The Commission's proposed shift to regulating parties that "make available" technology raises a serious question of whether the Commission seeks to regulate parties that are purely software developers. The SEC must sufficiently clarify that software developers are exempt

[18] *See, e.g.,* SEC's Gensler Seen Telling Hedge Funds That Ethereum And Litecoin Are 'Not Securities' In 2018 Video, June 12, 2023, available at https://fortune.com/crypto/2023/06/12/gensler-video-ethereum-litecoin-not-securities/.
[19] *See*, e.g., Lewis Cohen, et al., The Ineluctable Modality of Securities Law: Why Fungible Crypto Assets Are Not Securities, December 13, 2022, available at https://dlxlaw.com/wp-content/uploads/2022/11/The-Ineluctable-Modality-of-Securities-Law-DLx-Law-Discussion-Draft-Nov.-10-2022.pdf.
[20] We further note that neither the SEC nor FINRA has provided additional guidance or a summary of comments from the Joint Staff Statement, meaning that it remains unclear whether a broker can hold both digital asset securities and digital asset commodities. See footnote 16, *supra*.
[21] U.S. Rep. Ritchie Torres Participates in House Financial Services Subcommittee Hearing on Digital Asset Market Structure, Apr 27, 2023, available at https://ritchietorres.house.gov/posts/video-and-rush-transcript-u-s-rep-ritchie-torres-participates-in-house-financial-services-subcommittee-hearing-on-digital-asset-market-structure.

unless they administer or control the software protocol that is demonstrated to fulfill exchange functions.[22]

The Proposal calls into question whether not just software developers, but even written code itself, would be within the scope of an "exchange." Setting aside First Amendment concerns, it is difficult to imagine a proposed regulation that could have a greater stifling effect on innovation. As Commissioner Peirce noted, the Proposal is so broad that a simple t-shirt printed with the code of a program that buyers or sellers of tokens could use to display non-firm trading interest is plausibly in scope.[23]

The SEC should advance a more precise and prudent approach to scoping that focuses on groups of persons that use technology in a centralized way, as is the case today under Rule 3b-16, rather than those who develop or even deploy the code. The deployment of technology to, for example, the Ethereum blockchain, where others can choose to avail themselves of such technology should not be viewed as bringing together buyers and sellers. The entire point of these decentralized protocols is to obviate the need for an intermediary. In a true "exchange" setting, the SEC regulates the activities of the intermediary. When code is deployed and users choose (or choose not) to *use* the code in a peer-to-peer or peer-to-protocol fashion, there is no intermediary to regulate.

The approach used by the Financial Crimes Enforcement Network ("FinCEN"), a bureau of the U.S. Department of the Treasury, is instructive in this regard. In the FIN-2019-G001 Guidance, *Application of FinCEN's Regulations to Certain Business Models Involving Convertible Virtual Currencies*, FinCEN provided sensible guidance that explicitly exempted software developers from Bank Secrecy Act obligations, and implicitly recognized that different activities require different regulatory approaches.[24] FinCEN distinguishes between regulation of developers of technology and those who use the technology. FinCEN stated that "a developer or seller of either a software application or a new [convertible virtual currency or "CVC"] platform may be exempt from Bank Secrecy Act ("BSA") obligations associated with creating or selling the application or CVC platform,"[25] though noting a developer would have BSA obligations if it subsequently engaged in money transmitter business with the software.

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[22] We acknowledge that there is some uncertainty around how to address systems that are unadministered, or what a lack of administration means. The development of software code appears to be protected speech under the U.S. Constitution; the promulgation of that code to a GitHub repository or even a smart contract network (i.e., publication and/or deployment) may also be – and possibly likely is – protected speech. When we speak of administration here, we refer to the ability to control a smart contract system, though there may be other indicia of note. These difficult questions should be reviewed with deliberate pace to ensure that any potential regulation is developed with appropriate feedback from all interested parties. *See, e.g.*, HM Treasury, Future Financial Services Regulatory Regime for Cryptoassets: Consultation and Call for Evidence, February 2023, available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1133404/TR_Privacy_edits_Future_financial_services_regulatory_regime_for_cryptoassets_vP.pdf (in which the United Kingdom has continued a multi-year consultation to address various issues dealing with the development, taxation and regulation of digital asset ecosystems).

[23] Hester Peirce, Rendering Innovation Kaput: Statement on Amending the Definition of Exchange, April 14, 2023, available at https://www.sec.gov/news/statement/peirce-rendering-inovation-2023-04-12.

[24] Application of FinCEN's Regulations to Certain Business Models Involving Convertible Virtual Currencies, FIN-219-G001, available at https://www.fincen.gov/sites/default/files/2019-05/FinCEN%20Guidance%20CVC%20FINAL%20508.pdf.

[25] *Id.*

The SEC appears to have already recognized this important distinction in its 2018 order against Zachary Coburn, relating to the operation of EtherDelta.[26] In *Coburn*, the SEC focused on functionality offered through a centralized website. The Order Instituting Proceedings and Offer of Settlement did not address or bring charges against the underlying DeFi smart contracts on which the website's activities relied, which smart contracts facilitated "atomic swaps" through which users could trade tokens in a trustless, non-custodial manner. While we do not propose to suggest that this settlement is precedent for the entire industry, it does raise two questions that the Commission should have answered in the Proposal: (i) does the commission believe that immutable, non-administered smart contracts may be an exchange, and (ii) does the Commission consider developing code for a smart contract that others use or administer differently than administering or controlling the actual smart contract code itself? If so, the Commission needs to clarify its views on these topics.

The SEC has supported this developer vs. user/administrator distinction for decades. We understand that there are various existing registered and regulated national securities exchanges, alternative trading systems ("ATSs"), and broker-dealers that do not develop their own matching engines and other trading technology that underpins their markets and businesses, but they instead rely on technology sourced from other providers (sometimes from affiliates, often from unaffiliated third parties, and in some cases even from non-U.S. technology providers). To the best of our knowledge, the SEC has never required those tech providers to register as exchanges, ATSs, or broker-dealers, because they are not the parties that are *using* the code. Instead, they are mere tech vendors/providers. It is the party that uses the code—the SRO or broker-dealer that operates the centralized ATS—that has the registration obligation and that is within the scope of the SEC's jurisdiction. The same should hold true in the context of DeFi.

Another prime example is the FIX Trading Community, which is a group of leading financial institutions around the globe that have developed, maintained, and enhanced the FIX messaging protocol, which is the standard electronic messaging protocol used throughout the entire securities industry. Members each make their own decision to adopt and use the code, but neither the FIX Trading Community nor the FIX Protocol Ltd are registered and regulated as broker-dealers or exchanges. The same should be true for DeFi protocols.

If the Commission ignores these points, we believe there are hundreds (perhaps thousands) of presently unregulated tech providers and consortiums in the U.S. financial services industry (both traditional and decentralized) that will similarly need to register as exchanges under the proposed definition. Let this sink in for a minute: under the Proposal's definition of exchange, FIX Protocol Ltd may need to register as an exchange, as would perhaps every member of the FIX Trading Community. The Commission does not seem to have accounted for these cascading effects, and such an outcome is impracticable to an absolute degree.[27]

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[26] In the Matter of Zachary Coburn, Release No. 84553, November 8, 2018, available at https://www.sec.gov/litigation/admin/2018/34-84553.pdf.

[27] Another question raised is whether these groups need National Market System (NMS) Plans to continue operation. Would those plans, amendments and related pricing be subject to Commission review and approval (not to mention the mire that we have witnessed over the years when Plan governing bodies try to achieve consensus among members)? These potential outcomes also fail to account for how the SEC's December 2022 equity "market structure" proposals would operate in an environment in which several hundred or thousand additional registered

5. The Proposal Fails APA, EA, and PRA Standards—The SEC Should Withdraw the Proposal to Reconsider Its Approach

The Commission gave the public, including those the agency would seek to regulate, a mere 30 days to comment after publishing the 591-page Original Release in the Federal Register on March 18, 2022 (comments were due April 18, 2022). On May 9, 2022, the Commission reopened the comment window to June 13, 2022, noting significant interest from a wide breadth of investors, issuers, market participants, and other stakeholders. This choppy and haphazard approach undermined the ability for stakeholders and the general public to fully understand and respond to the Original Release ahead of the comment deadlines.

The Commission has perpetuated this erratic and patchwork approach with the Supplemental Release. Despite not changing the rule, the Supplement Release proposes a vastly revised scope, essentially serving as a second, similar-but-different proposed SEC rulemaking. Further, the Commission provided no direction regarding whether any aspects of the Original Release are overridden by the Supplemental Release.

The Commission has compounded this problem by including hundreds of questions for consideration. One could take the view that these questions serve as evidence of the Commission's thoughtfulness and deliberative process. Conversely, those the Commission seeks to regulate instead are forced to play a whack-a-mole guessing game of outcomes due to the lack of clear direction around any one particular question or issue. A cynic might even suggest that this is the Commission's intentional strategy of including so many questions that it essentially gives the agency broad latitude to enact thousands of different final rule outcomes as long as the finished product was overtly proposed or mentioned in passing in a question. Moreover, including a large number of questions decreases the likelihood the Commission will see multiple responses to one question, enabling the illusion that the public was not concerned enough with the question to render a response (many questions with a short comment window forces market participants to pick and choose which questions to address, which does not mean that the questions that are not addressed are any less important). The Commission needs to put the public on notice of the potential policy outcomes. Doing so by asking hundreds of questions in this manner is not only insufficient, but it is also obfuscatory.

The revised Economic Analysis ("EA") and Paperwork Reduction Act of 1995 analysis ("PRA") in the Proposal also fail to account for the scope of the rule and the breadth of prospective respondents. Hundreds (and potentially thousands) of presently unregulated tech providers and consortiums in the U.S. financial services industry may need to register as exchanges under the Proposal's definition. The EA and PRA ignore this scope. The Commission even acknowledges that it is "unable to reliably determine the number of platforms operating in the crypto asset

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exchanges are operating. Proposed Regulation Best Execution is one example. Would introducing brokers need to source and deploy code for these DeFi protocols and consider them as "material potential liquidity sources" or as other potential liquidity sources for satisfying what some have dubbed "super best execution" obligations for conflicted retail transactions? *See* Goodwin Procter LLP, Comment to File No. S7-32-22, March 22, 2023, available at https://www.sec.gov/comments/s7-32-22/s73222-20160480-329091.pdf.

market," before it ultimately estimates 15-20 New Rule 3b-16(a) systems.[28] The disparity between the Commission's estimates and the number of potentially affected systems, technology providers, and developers does not provide the public with a reasonable opportunity to provide meaningful comment, nor does it fully account for the costs to prospective respondents, in violation of the Commission's mandate under the Administrative Procedure Act.

6. Create a New Framework for DeFi—The Exchange Category Doesn't Fit or Work

For these reasons, attempting to shoehorn DeFi into the existing framework is impossible. Instead, Congress, the SEC, the CFTC, the Department of Treasury and other applicable agencies should consider establishing a new and distinct framework for DeFi protocols that accounts for the unique features of DeFi, within the context of the principles-based policy rationale and statutory authority for regulation.

Such an approach would be consistent with the Commission's actions in the mid-to-late 1990s, when it recognized that advances in technology called for advances in regulation, culminating in the adoption of Regulation ATS.[29] The Regulation ATS adopting release noted that "[d]uring the past three years, the Commission has undertaken a reevaluation of its regulatory framework for markets *because of substantial changes in the way securities are traded*" (emphasis added).[30] The initial adoption of Regulation ATS followed a concept release "[t]o better understand the questions raised by technological developments in the U.S. markets."[31] The Commission can and should take a similar approach with DeFi.

The next logical question—how? We understand that it is not an easy endeavor and we do not have all the answers, particularly given the multiple jurisdictions potentially implicated and the need to harmonize regulation with other countries. Nevertheless, we are optimistic about the outcome if there is a collaborative and well-planned effort to engage among the industry and relevant government bodies. A concept release would be a thoughtful and prudent start for the SEC. Roundtables could follow, during and after which candid and robust dialogue could ensue. Given the significance of what is at stake, we believe industry would be open to a consultation and negotiated rulemaking process, which seems uniquely suited to the regulatory impasse in which we find ourselves.[32]

If, however, the Commission stays on its current course, the agency will only perpetuate incongruent regulation and further alienation between the regulator and the industry. Doing so also likely means that existing financial industry communication protocols and their members would need to register as exchanges (like the FIX Trading Community), as would existing tech vendors

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[28] Supplemental Release at 81.
[29] In his prepared testimony for a confirmation hearing before the Senate Banking Committee, Chair Gensler extolled the importance of harnessing technical innovation and adapting rules to such innovation, stating that "[m]arkets—and technology—are always changing. Our rules have to change along with them." Gary Gensler, Written Testimony, Nomination Hearing Before Senate Committee on Banking, Housing and Urban Affairs, March 2, 2021, available at https://www.banking.senate.gov/imo/media/doc/Gensler%20Testimony%203-2-21.pdf.
[30] *See* Regulation of Exchanges and Alternative Trading Systems, Release No. 34-40760, File No. S7-12-98, available at https://www.govinfo.gov/content/pkg/FR-1998-12-22/pdf/98-33299.pdf.
[31] *Id*.
[32] 5 U.S.C. § 563.

whose technology underpins significant aspects of the markets without those vendors themselves being registered.

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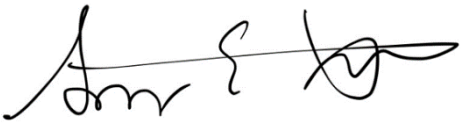
The majority of participants in the crypto and DeFi space seek to develop these technological innovations in a legal and compliant manner. Most do not abhor regulation, but welcome it: they desperately need regulation that recognizes and is appropriately tailored to the novel characteristics of innovative technology. We again welcome the opportunity to join the SEC in advancing that discussion. In the meantime, we strongly and respectfully encourage the Commission to withdraw the Proposal.

Respectfully submitted,



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