June 26, 2023

Via E-Mail: rule-comments@sec.gov

Ms. Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: ***File Number S7-02-22; Amendments to Exchange Act Rule 3b-16 Regarding the Definition of "Exchange"***

Dear Ms. Countryman:

My Name is Scott Scolnick. I am currently a 3L at Hofstra University Maurice A. Deane School of Law.[1] I respectfully submit this letter to the U.S. Securities and Exchange Commission ("Commission" or "SEC") to provide my comments on the above-referenced proposal ("Proposal") [2] in light of the Commission's decision to reopen the comment period of the Proposal for an additional 30 days. I was among the many who was following the swift and damaging collapse of the cryptocurrency *exchange* FTX in late 2022. This historic downfall – which sent shockwaves through the crypto industry – captured my attention, and is what drew me to become interested in securities law. I thus appreciate the opportunity to Comment on this issue which many are considering to be a defining moment for the digital asset industry.

[1] I am currently pursuing my JD degree at Hofstra University Maurice A. Deane School of Law. I have a B.A. in International Business from Stony Brook University. I came to learn of the "Proposal" though my Administrative Law class which centers around the tensions between the need for delegation of power to agencies and the need to limit that power to protect private citizens and companies from government oppression. Over the course of my studies, I have developed a strong interest in securities law – specifically the regulation of securities and how lawyers can assist in navigating our dynamic markets.

[2] The Securities and Exchange Commission reopened the comment period on proposed amendments to the definition of "exchange" under Exchange Act Rule 3b-16. The Commission initially proposed the amendments in January 2022 and reopened the comment period in May 2022. *See* SEC Rule proposal at 34-97309.pdf (sec.gov).

The purpose of this Comment Letter is to express my support, in part, for the SEC's efforts in regulating the market through its amendments to Rule 3b-16 of the Securities Exchange Act of 1934 (the "Exchange Act"). This letter represents my efforts at assessing the SEC Proposal referenced above. Specifically, this letter will address the following points as it relates to the Proposal: (1) regulatory burdens on software developers of decentralized autonomous trading platforms, and (2) transparency concerns for retail and institutional investors of digital currencies. These points stem from the following questions that the SEC has posed to the public on pages 33 and 34 of the Proposal: (1) Would an organization, association, or group of persons that is a New Rule 3b-16(a) System and uses DLT to trade crypto asset securities likely elect to register as a national securities exchange or comply with the conditions of Regulation ATS? and (2) Are there any characteristics that heighten the need for investor protection and market integrity under the exchange regulatory framework?[3] This Comment Letter is divided into a total of five parts: as a preamble, I will start by expressing my thoughts on the current state of the digital currency market. Next, I will address some of the definitional challenges that are impacting both the regulators and the regulated alike. The third and fourth parts will cover the regulatory burdens on software developers and the transparency concerns for investors. Lastly, I will offer up some suggestions for the Commission to consider.

I would like to preface this letter by giving a few thoughts on the current state of the digital currency market as a whole. More precisely, I think it is important to address the recent fallout of crypto giants FTX, Celsius, and Voyager, and what is now being referred to as the "crypto winter". The total valuation of crypto assets reached almost $3 trillion in November 2021 before falling to less than $1 trillion in July 2022.[4] With the current market capitalization of the total crypto market

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[3] *Id.*

[4] *See* "Regulating the Crypto Ecosystem," International Monetary Fund (September, 2022).

cut by more than half, it is clear to me that something needs to be done to plug the regulatory gap that remains wide-open. The volatile nature of cryptocurrencies is not something to take lightly. The aftermath of this most recent crash has left millions of retail investors feeling helpless and cheated. Despite this, some news outlets continue to steer the conversation back to celebrities like Tom Brady and Kevin O'Leary as being part of the group of "high profile" investors who lost big in the collapse. However, we must not let this overshadow the important fact that a majority of these investors and customers were much smaller retail investors who lost significant percentages of their portfolios, and in extreme cases, their life savings. Regardless of your thoughts on the proposed amendments to Rule 3b-16, it would be hard to maintain a position that there should be absolutely *no* regulation of the digital currency market today. To that end, we should afford the Commission, who has a proven track record of protecting investors, an opportunity to repair the public trust in this dynamic industry. After all, the Commission's own Enabling Act provides that the Commission oversee and "regulate secondary financial markets to ensure a transparent and fair environment for investors".[5]

At the outset of this letter, I had stated that the Commission has my support *in part* for its efforts in regulating the market through its amendments to the Exchange Act. The reason for the pause, and why the Proposal does not yet have my unwavering support is quite simple – I believe additional language should be considered. Therefore, while I commend the Commission for re-opening the comment period, I think it is important for them to take these comments and suggestions into consideration before deciding to pass the Proposal. Current Rule 3b-16(a) defines an "exchange" as any organization, association, or group of persons that (1) brings together orders for securities of multiple buyers and sellers; and (2) uses established, non-discretionary methods

[5] *See* Securities and Exchange Act 1934.

(whether by providing a trading facility or by setting rules) under which such orders interact with each other, and through which the buyers and sellers entering such orders agree to the terms of a trade.[6] Critics of the Proposal argue that the additions put forth by the Commission are both too expansive and too ambiguous. I tend to agree. It is important for the Commission, and those in favor of a total overhaul of our current regulatory framework (or lack thereof) to recognize that our economy is in the midst of a technological revolution driven in part by societies desire to eliminate intermediaries between producers and consumers. Perhaps what the Commission has overlooked in its initial draft is that the definitions and terms used in years past may not be as easily transferrable as they once were. This is because the novel and innovative features of digital assets was surely not contemplated by the original drafters of the Exchange Act.

I. Definitional challenges

Defining digital assets as securities

As a threshold issue, I am concerned about the Commissions lack of clarity in defining which crypto assets are considered "securities" and therefore fall under its jurisdiction. In order for the Commission to accomplish its goal to efficiently regulate digital assets, they must first provide some guidance to those who will be regulated. Section 2(a)(1) of the Securities Act of 1933 defined the term "security" as any "note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any

[6] *See* SEC Rule proposal 34-97309 at 3.

interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."[7]

In the subsequent U.S. Supreme Court case *SEC v. W.J. Howey Co.*, the Court held that an "investment contract" exists when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others.[8] Referred to as the "*Howey test*", this applies to any contract, scheme, or transaction, regardless of whether it has any of the characteristics of typical securities.[9] The *Howey* Test is important in this context because certain digital assets and initial coin offerings (ICOs) may be found to meet the definition of an "investment contract" under the test. The application of the *Howey* Test requires a Court to conduct a careful analysis into the facts and circumstances surrounding a particular transaction. The Proposal as it stands is lacking such an analysis. Instead, it appears that the Commission has chosen to paint all digital assets with the same brush stating: "it is unlikely that systems trading a large number of different crypto assets are not trading any crypto assets that are securities these systems likely meet the current criteria of Exchange Act Rule 3b-16(a) and are subject to the exchange regulatory framework."[10]

In my opinion, the decision by the Commission to *presume* that most digital assets are securities should be reconsidered. Digital currencies by their very nature are difficult to categorize. For example, Bitcoin is not considered a security because its open-source origins mean investor

[7] *See* Securities Act of 1933 at §2(a)(1).
[8] *See SEC v. W.J. Howey Co*., 328 U.S. 293 (1946).
[9] *Id.* at 298-299.
[10] *See* SEC Rule proposal 34-97309 at 10.

profits are not dependent on the efforts of others. The digital currencies themselves are simply code. It is how they are sold – as part of an investment to non-users– that most often make them a "security".[11] In *Howey*, the buyers of the Florida citrus groves saw the transactions as valuable because the labor and expertise were provided by others (making them securities under *Howey Test*). According the Commission, in most cases, whether a digital asset qualifies as an investment contract largely depends on whether there is an "expectation of profit to be derived from the efforts of others."[12] For instance, the purchasers of a digital asset may be relying on the joint efforts of others if they are relying on the project's developers to maintain the digital network rather than these tasks being entirely decentralized. However, what happens when these purchasers are no longer *relying* on actions of others? In other words, if the network on which the asset is to function is sufficiently decentralized – where purchasers no longer reasonably expect a person or group to perform essential oversight– the assets may not represent an investment contract under *Howey*.[13]

Most recently, Coinbase, the prominent cryptocurrency company, challenged the Commission on this very issue by denying that the assets listed on their platform are considered securities under *Howey*. Coinbase has been adamant that most cryptocurrencies - which operate on a database shared across a network of computers, known as a blockchain - do not fit the definition of securities under U.S. law. The Commission also sued Binance, another industry player, claiming that the company is engaged in "an elaborate scheme to evade U.S. federal securities laws."[14] Other cryptocurrency companies are looking on closely in hopes that these landmark cases will bring some much-needed clarity to the industry. All of this to say that it may

[11] *See* "Remarks at the Yahoo Finance", William Hinman (June, 2018).
[12] *See* Framework for "Investment Contract" Analysis of Digital Assets, U.S Securities and Exchange Commission, (March, 2023).
[13] *See* "Remarks at the Yahoo Finance", William Hinman (June, 2018).
[14] *See* Coinbase Complaint

be more valuable for the Commission to wait until these major cases play out in Court before making a decision on the Proposal.

Defining Crypto as Securities

Many industry players have come out and said that the Commission has been unclear in determining whether digital assets are securities. I must agree. The actions and words of the Commission have been a bit unclear. I believe that the Commission needs to come out and take a firm stance on which assets are defined as securities and which are not. The Commission itself has stated that the question of whether a crypto asset is a security must be evaluated based on an individualized and fact-based analysis under Supreme Court precedent (referring to *Howey*).[15] However, as referenced above, the Commission, and Chairman Gary Gensler have taken a much broader approach. In a recent interview, Chairman Gensler confirmed that Bitcoin is not a security but a commodity under the Commodity Futures Trading Commission (CFTC) purview, and that "everything else other than bitcoin is a security under the jurisdiction of the Commission. This is an extreme departure from what Chairman Gensler stated back in 2018, when referring to Ethereum, "it's now sufficiently decentralized that we'll consider it not a security". To date, although challenged on the matter, Chairman Gensler has not addressed whether his opinions on Ethereum have changed. I say this not to criticize Chairman Gensler, but rather to show that the Commission may have underestimated the complex nature of these digital assets. It may not be as easy as saying that "everything else" is considered a security, as this would be going against our well-established precedent that the Commission itself has relied. Therefore, I respectfully suggest such that the commission revisit the way in which they analyze and define these digital assets before going forward with the Proposal.

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II. Implications

i. Software Developers

The Commission proposes to broaden the definition of "exchange" to include entities that "make available" methods for trade execution or communications—rather than just those which "use" such systems.[16] My concern is that the "makes available" phrase could effectively treat as exchanges software developers who make available programs or trading platforms for digital assets that are securities. To start, the proposal does not expressly state whether a developer who simply wrote and provided the code would fall under the breadth of this expansion. Some questions that some have raised are: (1) would this aspect of the Proposal require original developers of a software to register as an exchange, even if they have no continuing involvement or control over the transactions using the software? (2) would a vendor who sells the software fall under the Proposal?[17] Software itself cannot comply with such a regulatory framework – only those who have the ability to modify and oversee the software can comply. In other words, only the developers of the software can ensure that the program is following applicable guidelines. However, the Proposal fails to consider that developers of open-source software, for example, no longer have the capability to modify the code once it is made public. Under the Proposal currently, if a developer were found to be operating an "exchange", they would be required to register the platform as either an exchange or an ATS and the software developers themselves would be responsible for regulatory compliance and related costs. Imposing such regulations on software developers could deter them "making available" such software which would stunt the continued growth of the U.S. securities market, and the digital currency industry as a whole.

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[16] *See* SEC Rule proposal 34-97309 at 129.
[17] *See* DeFi Education Fund Comment Letter at https://www.sec.gov/comments/s7-02-22/s70222-202979-407862.pdf.

ii. Decentralized Autonomous Trading Platforms

The Proposal states that a group of persons who play a role in implementing and operating a system may constitute a "market place or facilities for bringing together purchasers and sellers of securities and together meet the definition of exchange."[18] As a result, the Proposal could implicate operators of websites that facilitate the use of a DEX (Decentralized Exchanges), miners or validators on the blockchain where the AMM (Automated Market Maker) is stored. DEXs are distinguishable from traditional exchanges in that they are held directly by the users self-hosted "wallets" rather than by a centralized service provider. [19] The benefits to consumers include lower transaction costs and greater security, to name a few. In the past, the Commission has granted relief from registration, communication providers and software providers which provide administrative or technological support but do not themselves perform the functions of an exchange or ATS. [20] This is due, in part, because service providers have played an important role in supporting financial markets.

What makes DEXs different and more complicated from other exchanges and broker-dealers is that they are typically derived from a single or small group of developers, and then once they are launched, the control is disbursed among a decentralized and disaggregated group of unrelated users. Therefore, it would be nearly impossible to identify which members of that group would be responsible for the regular compliance that Proposal suggests would need to be followed. This is because it is very unlikely that any one person would possess all of the information necessary to fulfill that responsibility. Coinbase, in its more recent comment letter, stated that "the Commission has received no such authorization and yet its actions would have that effect, making

[18] *See* SEC Rule proposal 34-97309 at 3.
[19] *See* "What is a DEX (Decentralized Exchange)", Chainlink, (May, 2023).
[20] See, e.g., 53 Matching Technologies LP, SEC No-Action Letter (July 19, 2012); GlobalTec Solutions, LLP, SEC No-Action Letter (Dec. 28, 2005).

any DEX unlawful by demanding compliance with obligations that simply cannot be met."[21] (*in addressing that an agency's authority to regulate a particular industry does not include the authority to ban that industry, absent clear Congressional authorization*). Further they stated, "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". The Commission simply concludes that there are "groups" that could be found and therefore DEXs can be regulated; however, they fail to provide further insight in to who these "groups" are how they would go about regulating them. In order to properly address these concerns, the Commission should consider re-examining this issue while providing further guidance on how (and to who) these regulations will be applied. Below I will provide a few recommendations that the Commission should consider.

III Transparency Concerns

A Call to Act by Retail Investors

The unprecedented growth (and subsequent crash) in the market capitalization of crypto assets and their creep into the regulated financial system have led to increased calls to regulate them. I share the same concerns as others which is that many functions of our financial system, such as providing leverage and liquidity, lending, and storing value, are now emulated in the crypto world. Therefore, something needs to be done to ensure that investors (just like investors of traditional stock, bonds, etc.) are protected from the predatory practices that undoubtedly exist. Transparency on safeguarding customer assets has become a point of focus after a number of failures and regulatory lawsuits focused on actionable business practices. High-profile cases

[21] *See* Coinbase Comment Letter at https://www.sec.gov/comments/s7-02-22/s70222-205079-412142.pdf

involving companies like FTX and Binance (to name a few) have raised questions about whether some companies are meeting minimum consumer protection standards. Moreover, the ways in which digital currencies have been utilized have caused concern for many. Being as though they are incredibly secure and hard to trace, cryptocurrency transactions are attractive for cybercriminals. Law enforcement has linked various forms of financial crime to cryptocurrencies globally, including money laundering and tax evasion. In addition, many retail investors have fell victim to scams involving cryptocurrencies.

However, those who are in total opposition of the Proposal may be failing to recognize that greater regulation of cryptocurrencies, and digital assets generally, will more likely than not attract a wider pool of investors.

IV Some Suggestions

Looking ahead, I respectfully request that the SEC consider the following suggestions: (1) Carve out an exception for software developers and software engineers who have no continuing control or involvement over the transactions using the software that they create, (2) implement a threshold requirement for platforms that are trading digital assets.

It is important for us to recognize that digital assets are here to stay. By requiring developers of these "exchanges" to comply with these regulations could stifle growth and limit innovation. The point of these regulations is to ensure that consumers are protected. If the Commission approaches these decisions rashly – they risk destroying the market. To that point, the Commission should consider implementing a threshold requirement for exchanges that are operating with a certain number of users. In other words, only those exchanges with assets exceeding a certain amount will be required to register. By implementing such a threshold, the Commission would be allowing smaller platforms – who would have otherwise been unable to afford to register – the

opportunity to continue to operate. Moreover, I believe that a threshold still accomplishes the Commissions goals of regulating the larger and more well-known companies like Coinbase and Binance.

I would like to restate my support for the Proposal and hope that the Commission will consider the suggestions outlined in this Comment Letter. For approximately 90 years, the Commission has continued to work toward ensuring that our markets are free of fraud and manipulation, while holding the wrongdoers accountable. The Proposal is simply doing just that. Thank you for your time and opportunity to comment on this Proposal.

Sincerely,

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