April 19, 2023

SEC Proposes to Require Registration of Decentralized Cryptoasset Trading Platforms

On Friday, the SEC issued a new release and reopened the comment period for its January 2022 regulatory proposal to require that any "communication protocol system" bringing together buyers and sellers of securities must register with the SEC as an exchange or alternative trading system.[1] This marks the SEC's clearest declaration that it views so-called decentralized finance ("DeFi") activity as fully within its regulatory purview, with potentially sweeping implications given the ongoing need for greater clarity about when cryptoassets constitute securities. Functionally, most any DeFi project — including computer software programs made available for U.S. public use on a blockchain, without any sponsor or intermediary — would be required to somehow create or designate a specific entity to be responsible for compliance.[2] This would challenge the very possibility, at least within the U.S., of decentralized software-based systems competing with traditional, centralized financial service providers.

The SEC's stated objective when it first made this proposal was to "bring[] more Alternative Trading Systems (ATS) that trade Treasuries and other government securities under the regulatory umbrella." There was no mention of DeFi activity, such as the trading of digital assets on a peer-to-peer basis through open-source software like Uniswap (as opposed to centralized exchanges like Gemini). But speculation that the proposed rule might deem DeFi platforms to constitute "communication protocol systems" prompted extensive commentary from interested parties.

We continue to laud the SEC for taking seriously its mandate to provide fair and orderly markets for securities and to protect investors, and it is widely understood that DeFi activity is relatively immature, has sometimes manifested deficiencies, including serious market abuse, and is often decentralized in name only. That said, the general thrust of the SEC's reopened proposal (the "Release") is to impose on novel applications of technology the existing regulatory framework for traditionally conducted financial functions.[3] Consequently, the Release poses a number of difficult questions, including the following:

- As we have previously stated, further regulatory consideration is required as to when cryptoassets that lack indicia of equity or debt (as opposed to the arrangements by which they are sold) may constitute securities. Absent regulatory clarity, how can developers and end-users determine when a "communication protocol system" touches securities?
- Can the touted benefits of cryptoassets, which include the ability to transact privately and without reliance on a centralized party, be preserved while requiring ATS registration and other compliance obligations with respect to all protocol users?

[1] According to the SEC, "communication protocol system" means "a system that offers protocols and the use of non-firm trading interest to bring together buyers and sellers of securities."
[2] Among other effects, this requirement would be consistent with the Department of the Treasury's recent recommendation that AML requirements apply to DeFi services.
[3] In a sharp dissent, SEC Commissioner Peirce posits that the SEC "propose[s] to embrace stagnation, force centralization, urge expatriation, and welcome extinction of new technology."

- The Release would impose compliance obligations on DeFi-related "groups," but in the context of a decentralized system where transactions are validated by computer code, group is an amorphous concept. How will the registration process be navigable?
- The Release suggests that liability could even extend to software developers who merely publish code. Is this reconcilable with First Amendment protections?
- To what extent might mere ownership of decentralized autonomous organization (DAO) governance tokens give rise to possible civil or even criminal liability as tokenholders may be deemed responsible for a protocol's legal compliance? If an immutable computer program is deployed to a blockchain and enables trading of cryptoasset securities, will the SEC seek to impose liability on blockchain validators ("miners"), who merely record blockchain transactions in which they did not themselves participate?
- How can non-U.S. developers and users avoid the sweep of U.S. securities laws by excluding U.S. counterparties, given blockchain pseudonymity and the proliferation of virtual private networks that obscure users' locations?

As the SEC and other regulators continue seeking to apply existing regulatory regimes to new technologies with little concession to tailoring for novel business models and with heavy focus on the use of enforcement tools (notable recent examples including the SEC's actions against Kraken's "staking as a service" product and a sweeping complaint against cryptoasset exchange Bittrex), we reiterate our call for regulation that vigorously protects investors, while at the same time fostering innovation.

Intriguingly, the Release does offer the prospect of fostering innovation in an important respect: In acknowledging that blockchain-based software — albeit involving an ATS registrant — could be used to trade actual securities, the SEC seemingly opens the future prospect of approving a registration involving decentralized transacting in *traditional* securities, such as stocks and bonds, in tokenized form. While this would require significant tailoring of the existing regime for how book-entry securities are held and traded, and need not entail reliance on uncurated, "permissionless" blockchain systems, it still signals an initial step on the path to blockchain-driven efficiency gains in matters ranging from proxy plumbing to select corporate functions, such as the administration of transfer restrictions.

Kevin S. Schwartz
David M. Adlerstein
Samantha M. Altschuler