

# LAW OF THE LEDGER

Legal Issues with Blockchain and Cryptocurrency

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## SEC Proposed Amendments Could Significantly Impact DeFi Companies



By Sarah Aberg and Pounch Almasi on March 3, 2022

Posted in SEC

The U.S. Securities and Exchange Commission (SEC) recently issued proposed amendments to the Securities Exchange Act [1] (the “Exchange Act”) that would significantly broaden the definition of “exchange” for purposes of regulation under the Exchange Act (“Proposed Rule”).[2] Designed to address a “regulatory gap,”[3] the Proposed Rule would cover “platforms for all kinds of asset classes that bring together buyers and sellers.”[4] Under the Proposed Rule, communication protocol systems—trading systems that offer the use of non-firm trading interest and provide protocols to bring together buyers and sellers of securities—would have to register with the SEC as an exchange unless otherwise exempt.[5] As we previously reported, this amendment, if passed, likely would have a significant impact on the decentralized finance (“defi”) industry.

### Current Definition of “Exchange”

Section 3(a)(1) of the Exchange Act defines an “exchange” as “any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange.”[6]

The Exchange Act provides a two-step test to assess whether a trading system meets the definition of an exchange:

- does the system bring together the orders for securities of multiple buyers and sellers; and
- does the system use established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade.[7]

“Non-discretionary methods” means the platform “does not exercise any discretion in the matching of buyers and sellers or their orders and buyers and sellers participating on an exchange can use their own discretion in finding and selecting a counterparty.”[8] “Order” means “any firm indication of a willingness to buy or sell a security, as either principal or agent, including any bid or offer quotation, market order, limit order, or

other priced order.”[9]

## Proposed Rule

The proposed amendments would, among others, include “trading interest”, i.e., non-firm indications of a willingness to buy or sell a security, in addition to orders, within the interpretation, swap “uses” for “makes available,” and add “communication protocols” as an established method for bringing together buyers and sellers of securities.[10]

Accordingly, the Proposed Rule would amend the two-part test of Exchange Act Rule 3b-16 to provide that an organization, association, or group of persons would be considered to constitute, maintain, or provide an exchange if (A) it is not subject to an exception under Rule 3b-16(b) and (B) it:

- brings together buyers and sellers of securities using *trading interest*; and
- *makes available* established, non-discretionary methods (whether by providing a trading facility or *communication protocols*, or by setting rules) under which buyers and sellers can interact and agree to the terms of a trade (emphasis added).[11]

The three italicized terms above significantly broaden the definition of an exchange. First, the term “*trading interest*” includes both “orders” and any “non-firm indication of a willingness to buy or sell a security that identifies at least the security and *either* quantity, direction (buy or sell), or price” (emphasis added).[12] This means that trading interest could be as simple as, “I am looking to buy token X”, without even mentioning the price or quantity of token X you want to buy.

Second, the term “*makes available*” is designed to capture established, non-discretionary methods that a platform provides, *either directly or indirectly*, for buyers and sellers to interact and agree upon terms of a trade. [13] This means that, if a platform outsources a function of an exchange to a third party, or provides a means to access and communicate with other buyers and sellers, the platform would still be considered an exchange under Rule 3b-16.[14]

Third, the term “*communication protocols*” would cover “[s]ystems that bring together buyers and sellers of securities [that] function as exchange market places of securities without orders or a trading facility for orders to interact.”[15] The term “communication protocols” applies to “technologies and connectivity” that “generally use non-firm trading interest as opposed to orders to prompt and guide buyers and sellers to communicate, negotiate, and agree to the terms of the trade.” [16] For example, a platform that provides a chat feature that requires certain information to be included in a chat message (*e.g.*, price, quantity) and sets parameters and structure for users to communicate about buying and selling securities “would have established communication protocols.”[17] Even if the communication protocol system itself does not match counterparties’ trading interests, if it provides the platform where buyers and sellers are brought together to “interact . . . and agree to the terms of the trade,” the SEC would deem this an exchange under the Proposed Rule.[18]

As proposed, the SEC would take an “expansive view” of what would constitute “communication protocols” within a system, including:

- setting minimum criteria for what messages must contain;
- setting time periods under which buyers and sellers must respond to messages;
- restricting the number of persons a message can be sent to;
- limiting the types of securities about which buyers and sellers can communicate;

- setting minimums on the size of the trading interest to be negotiated; or
- organizing the presentation of trading interest, whether firm or non-firm, to participants.[19]

On the other hand, the Proposed Rule would specifically exclude “systems that only provide general connectivity for persons to communicate without protocols, such as utilities or electronic web chat providers . . . because such providers are not specifically designed to bring together buyers and seller of securities or provide procedures or parameters for buyers and sellers for securities to interact.”[22] According to the SEC, covered “communications protocols” would not include systems that passively display trading interest, such as industry “bulletin boards,” but do not provide means for buyers and sellers to contact each other and agree to the terms of the trade on the system.[20] Nor would they include a system that displays trading interest but no trading facility to match orders or protocols for participants to communicate and interact because such system “would not be considered to be making available established, non-discretionary methods.”[21]

### *Potential Impacts on DeFi Companies*

Although not specifically called out in the Proposed Rule, the amendments are broad enough to include defi platforms and cryptocurrency exchanges. For example, the transition from “uses” to “makes available” would arguably encapsulate platforms using blockchain technology and software to effectuate transactions on a blockchain (*e.g.* smart contracts, miners, validators), and even companies that merely provide the platform on which buyers and sellers of cryptocurrencies can connect and trade amongst themselves.

Companies that met the new definition would then be required to register with the SEC either as an exchange or, more likely, as an alternative trading system (“ATS”). Both would require the company to adopt and maintain a suite of compliance programs covering disclosure obligations, trade reporting, anti-financial crimes and suspicious activity reporting, as well as passing qualification exams.

The SEC has recognized that, if adopted, compliance with the Proposed Rule would be a significant undertaking for unregistered exchanges. The SEC would grant covered exchanges a grace period, during which they can operate provisionally until the earlier of either: (1) the date the entity registers as a broker-dealer and becomes a member of a national securities association, or (2) 210 calendar days after the effective date of any final rule.[23] The proposed 210 calendar day transition period would provide time for a covered entity to submit its broker-dealer registration application, for FINRA to conduct its review of the application, and for the entity to otherwise comply with the necessary broker-dealer registration requirements under Regulation ATS without disrupting its market or its participants.[24]

The notice and comment period for the Proposed Rule will expire 30 days after publication in the Federal Register. Given the heft of the rule (over 650 pages) and critiques by some commentators, including SEC Commissioner Peirce, faulting the SEC for setting an unreasonable deadline to respond to over 220 unique comment requests, this period may be extended further. Once the SEC has reviewed initial comments, it may reopen the period and request additional comments, which would further extend the process. Once all comments are received, the SEC will review and incorporate the comments into the proposed rule, as it deems appropriate. Once satisfied, the SEC will publish the final rule, which would become effective 30 days after publication in the Federal Register. In this case, it is unlikely the SEC would publish a final rule before October 2022, if then.

[1] 15 U.S. Code §§ 78a-78qq.

[2] U.S. Securities and Exchange Commission, “Amendments to Exchange Act Rule 3b-16 Regarding the Definition of “Exchange,” Jan. 26, 2022, <https://www.sec.gov/rules/proposed/2022/34-94062.pdf>

(“Proposed Rule”).

[3] U.S. Securities and Exchange Commission, “Investor Protections in Communication Protocol Systems and ATSS,” Fact Sheet, [34-94062-fact-sheet.pdf](#) (sec.gov).

[4] See SEC Chair Gary Gensler, “Statement on Government Securities Alternative Trading Systems,” Jan. 26, 2022, <https://www.sec.gov/news/statement/gensler-ats-20220126>.

[5] See Proposed Rule at 33.

[6] 15 U.S. Code § 78c(a)(1).

[7] 17 CFR § 240.3b-16(a).

[8] See Proposed Rule at 42.

[9] 17 CFR § 240.3b-16(c).

[10] Proposed Rule at 34.

[11] *Id.*

[12] *Id.*

[13] *Id.* at 42.

[14] *Id.* at 40.

[15] *Id.* at 43.

[16] *Id.*

[17] *Id.* at 34.

[18] *Id.* at 35.

[19] *Id.* at 44.

[22] *Id.* at 46.

[20] *Id.* at 45.

[21] *Id.*

[23] *Id.* at 60.

[24] *Id.*

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