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Original:
https://www.btcc.com/en-US/academy/research-analysis/a-new-sec-definition-for-exchanges-has-big-implications-for-crypto

A New SEC Definition for 'Exchanges' Has Big Implications for Crypto

The crypto community should seize the opportunity to be heard as the SEC looks to expand its remit.

The U.S. Securities and Exchange Commission issued a proposal to, among other things, require "communication protocol systems" (or CPSs) to register with the agency and thereafter satisfy its many recordkeeping, transaction-monitoring and reporting obligations. These CPSs would be defined as systems or platforms that "make available" the means for buyers and sellers of securities to "interact."

Concern has swept across crypto that this broad and novel regulatory approach would bring crypto, and decentralized finance (DeFi) in particular, into the SEC's regulatory perimeter. In that world, we could see a steady drumbeat of enforcement actions that would dramatically redefine the risk profile of running a U.S.-based crypto project.

Various Concerns

It is imperative that each and every participant in the U.S. crypto market let their voice be heard. The SEC is accepting comments on its proposal through April 18 and cannot finalize the rule until each and every concern is considered and addressed. And concerns abound.

There are, of course, two threshold issues. First, which tokens, if any, are actually securities? On that long-standing issue, this proposal is silent. Second, did the SEC even intend to rope crypto into this proposed regulatory regime? Nothing in the 654-page rule mentions crypto, DeFi or blockchain protocols generally, and so there is room for doubt.

The SEC could resolve all our concerns by simply and expressly disclaiming that crypto is

implicated. One hopes it chooses that path.

Strengthen Oversight

Under Chairman Gary Gensler's leadership, the agency has signaled its intention to take on greater oversight of crypto. The key question has been how. Legislative, rulemaking and even enforcement approaches have been options for pulling crypto within the agency's purview. If this proposal signifies the SEC's first effort at such rulemaking, it presents the industry many bones to pick.

Foremost among these concerns is whether this rule exceeds the SEC's authority. The SEC regulates exchanges, which traditionally has meant platforms where buyers and sellers actually buy and sell, but not ancillary services or platforms. This rule expands that perimeter to platforms where buyers and sellers might merely talk about buying and selling. That's a huge change, and arguably one that the SEC doesn't have congressional permission to make.

Beyond that, the rule is simply impractical. It requires someone who "makes available" a CPS to register. What "makes available" means is a mystery.

The Compounded DeFi Problem

That problem is compounded in DeFi, the crypto subsector that looks to reinvent financial services without middlemen. Decentralized lending, exchange and information platforms are sometimes built by loose, international collectives of coders and maintained by global online communities.

Are we really supposed to believe that software developers who contribute to open-source projects are to register with the SEC because the platform may facilitate buyers and sellers talking? How would a community register or who among its members would register? Who is held accountable for recordkeeping, monitoring and reporting when there is no centralized authority? This proposal highlights the inherent problems with imposing a central-authority-dependent regulatory scheme on

disintermediated systems.

Moreover, rules must be issued according to a specific process, and the process in this instance is deficient in a number of respects.

First, the SEC needs to give adequate notice and opportunity to comment. Mere weeks to comment on a 654-page proposal that massively expands secondary market securities regulation and may also encompass crypto (without ever mentioning crypto) is anything but adequate.

Second, the SEC's proposal must analyze the costs and benefits of the rule, including from an economic perspective. That analysis is missing, which is not hard to believe given the proposal's breadth and ambiguity.

Such analysis would show the costs to the growing U.S. crypto ecosystem are plain. Homegrown DeFi projects would be incentivized to leave the U.S. (which would be the same result as if DeFi projects were explicitly banned). U.S. citizens would lose access to platforms that are proving to be more efficient, fair and accessible than traditional financial services, and the agency would create, perhaps inadvertently, a regulatory moat that shores up the primacy of big financial incumbents.

Seize This Opportunity

If those shortcomings weren't enough, this proposal is also at odds with the First Amendment. As written, the proposal would regulate speech based on its content, which is presumptively unconstitutional. The SEC arguably must have a compelling interest to regulate speech in such a way and must make the regulatory boundaries very bright lines. Neither appears to be the case. This is a fatal flaw. So too is the procedural failure to wrestle anywhere in the proposal with the implications for free speech.

The SEC has a very tough job regulating secondary markets in securities. The effort to address technological developments, to provide legal clarity and to bolster market competition by leveling the regulatory landscape should be applauded.

But when the effort falls short, the problems must be listed and addressed. U.S. law provides us with that opportunity, and between now and April 18, we must seize it by making our voices heard. Clearly, formidably but politely, each of us must ask the SEC to explicitly exclude crypto from the scope of the final rule.