VIA SEC.GOV COMMENT

February 2, 2022

Secretary Vanessa Countryman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

Re: Proposed Amendments to Exchange Act Rule 3b-16
(Release No. 34-94062; File Number S7-02-22)

Dear Ms. Countryman,

I write to express my opposition to the SEC’s proposed amendments to Regulation ATS issued on January 26, 2022 (the “Proposal”). The Proposal includes a revised and vastly expanded definition of “exchange” which could dramatically expand the SEC’s authority to regulate technologists and engineers who publish and “make available” peer-to-peer “communication protocols” used in decentralized finance. These technologists and the systems they create are not and cannot feasibly become regulated securities intermediaries or alternative trading systems (“ATSs”), and thus the proposed amendments amount to a back-door prohibition of actual and potential peer-to-peer finance protocols.

Background

I am an attorney practicing in New York and New Hampshire. Prior to starting my own firm, Hewitt Law PLLC, I worked for years as a securities and commodities litigator at Sullivan & Cromwell LLP. I left to start my own practice focusing on the needs of small to medium web-first businesses, including e-commerce companies, family office trading firms, and web3 innovators. Start-ups and small businesses face challenges that are not always readily apparent to regulators and enforcement authorities. The automated compliance software and systems that are built in-house at large multi-national companies to address new regulatory requirements are out of reach for small firms.

I believe it is vital that decentralized finance systems be kept freely available. Right now, brilliant mathematicians, engineers, software developers, and forward-thinking entrepreneurs are coming up with ways to bring banking directly to the people. Over the past 20 years, your office and your peer regulators at the CFTC, DOJ, OCC, and Federal Reserve have brought countless enforcement actions against the nation’s largest banks, trading firms, and financial institutions for various types of fraud, misrepresentation, market manipulation, customer deception, and other crimes. Rather than face serious adverse consequences, these companies have been given chance after chance to reform without much changing.
What if there was another way? What if people could access permissionless, trustless, trading and banking that isn’t controlled by a centralized profit-making entity? That is exactly what a generation of young developers are building. The SEC’s proposed amendments to Regulation ATS would stop them in their tracks, ensuring that no meaningful competition to the entrenched model of finance ever arises. Rather than protect investors, the SEC’s proposed rule would ensure the unbanked remain unbanked and everyday people who can’t afford a high-end broker at a white shoe investment bank remain excluded from the most dynamic markets.

As a market regulation lawyer, I support reasonable regulations to protect investors. I support a broad and vigorous fraud enforcement program to ensure new institutions are not repeating the mistakes of the past. However, I do not think regulation of an emerging industry should be so burdensome so as to end it before it begins. These companies will simply leave the United States for friendlier jurisdictions, leaving the United States behind its peers in terms of innovation and access to investing tools.

Overview of Peer-to-Peer Communications Protocols:

Peer-to-peer communication protocols may include automatic-market-making “smart contracts” (“AMMs”) which are accessible on Ethereum and other decentralized blockchain systems. These “smart contracts” are machine-readable code that is stored on a distributed ledger and will be executed by miners or validators (on an anonymous, decentralized basis) for users who pay fees as part of cryptographically signed transaction messages (on an anonymous, decentralized basis). Once written and deployed to a blockchain, no person controls or can limit access to such smart contracts. Even the miners—who are necessary to run the smart contract code—do not individually have the power to limit access to these smart contracts nor to surveil the users of these smart contracts.

Unlike a broker/dealer or other securities intermediary, neither the code developers nor the miners have a contractual or fiduciary relationship with the users. In fact, the code developers and miners do not readily know who the users are. A redesign of the system which requires an off-chain relationship between miners/validators, on the one hand, and users, on the other hand, would defeat the entire purpose of this technology by requiring users to have trust in and expose their personal data to the miners/validators.

The point of this new technology is to enable all users to trust the finality of blockchain ledgers and not have to rely on “trusted” intermediaries like brokers and banks. We have seen through the recent CFTC and DOJ enforcement actions surrounding the LIBOR and ISDAFIX reference rates that intermediaries like brokers not only are not always trustworthy, but can affirmatively favor one client over another, or one trade over another. See *In the Matter of ICAP Capital Markets LLC*, CFTC Docket No. 18-33. An anonymous, decentralized ledger that uses anonymous, decentralized transaction messages eliminates the broker model and allows users to transact directly. This is a more fair and just way of transacting that eliminates inherent bias and
discrimination and also eliminates the very real risk of a “bribed broker” who acts to privilege one client over another.

When Congress drafted the Securities Exchange Act of 1934, it was written to address the open-outcry trading system that had established itself in cities around the country. A big part of exchange trading at the time was floor brokers in a trading pit—a system that prevailed until very recently with the development of electronic trading clearance technologies. Only in the past 10 years have most brokerages moved to first phone, and then online, brokering.

The Securities Exchange Act of 1934 addressed the world of trading as it existed at the time. It could not contemplate, as most of the world did not contemplate, a decentralized, anonymized trading system based on smart contracts executed over a blockchain ledger that eliminates the need for a central broker. As this new world of permissionless, trustless trading truly did not exist in 1934, the ’34 Act should not be read to prohibit it or write in brokers that do not exist.

Peer-to-Peer Communications Protocols Encompassed in the Proposal:

The SEC’s proposed amendments to Regulation ATS may inadvertently characterize many people who do not act as intermediaries as intermediaries required to register as broker dealers. It may also require them to collect information that would be impossible for them to collect. We must remember that this new trustless, permissionless peer-to-peer exchange system will not have the traditional intermediaries of banks and brokers that we are all used to dealing with in the financial regulatory world. Instead, investors and traders are choosing to make bids and offers openly through a smart contract on a blockchain that will automatically execute when fulfilled. There is no bank to call if you change your mind, there’s no broker to call to help find the other side of the trade. This is a new technology that does not easily fit in the traditional bank model.

More specifically, in AMMs, users may indicate their “non-firm trading interest” in selling certain digital assets by depositing digital assets into a smart contract (i.e., by cryptographically signing a transaction whereby the smart contract code will release the tokens to new users if specified conditions are met). This facilitates trustless, disintermediated trading of digital assets and ensures that users are not trapped in illiquid positions in their digital asset holdings. When the relevant conditions are satisfied (usually a user on the buy-side sending a transaction message plus a digital asset purchase amount), a trade is automatically executed. Thus, an AMM may resemble “a system that electronically displays continuous firm or non-firm trading interest…to sell or buy [a digital asset]..[which] can….be executed immediately.”

But unlike in a traditional brokerage, the AMM is not controlled by any individual person or firm that “allows” or “prohibits” bids or offers. It is software that is deployed that self-executes according to the code. Users would not register and apply to transact

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with an AMM like they would a traditional exchange. Rather, they would execute software independently to interact with the chain itself, triggering certain events if the conditions of the contract are met.

The difference is not an inconsequential one in terms of what it would mean for developers and engineers who write smart contracts that can be deployed on various blockchains. Since the SEC also maintains that certain digital assets are securities, this means that persons who “make available” AMMs or interfaces for utilizing AMMs may now be required by the SEC to register those AMMs as ATSs or securities exchanges. This may include:

1. Individuals and private entities who write and publish smart contract code as a hobby or business, who may not work for a broker-dealer and may not otherwise be subject to the jurisdiction of the United States;

2. Individuals and private entities who run “miners” or “validators” on the underlying blockchain where the AMM is stored (i.e., persons who have configured computers to automatically perform mining and validation services on the network, with minimal human oversight);

3. Persons who provide liquidity to such AMMs;

4. Persons who run websites which facilitate use of AMMs—including academic “block explorers” with smart contract interaction functionality;

5. Persons who write “blockchain client software” which is run by independent miners/validators and enables general mining, validation and transacting on the blockchain network.

None of these persons are securities professionals or intermediaries as currently understood. What they have in common, in fact, is that they do not intermediate with users or clients! These are software developers, engineers, and the support services needed to run companies in these new industries. None function as a traditional banker, broker, or intermediary responsible for execution or even user happiness. What makes AMMs so unique (no intermediaries!) is also the very thing that may not make them very popular—there’s no broker to complain to, no customer service line to call, no one to help if you make a mistake executing your code.

Furthermore, the non-intermediaries described above would be unable to comply with existing regulations applicable to securities exchanges and ATSs—such as obtaining and maintaining records about the legal identities of “subscribers”—even if they wanted

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to. The AMMs themselves are pseudonymous by virtue of their cryptographic security. As described above, these systems are designed to give users a way to exchange digital assets without hiring a broker/dealer or placing their assets into another person’s custody. Attempting to regulate these systems as “exchanges” would be tantamount to banning them in their current form.

I urge you to reconsider the over-broad provisions in the Proposal. This sweeping expansion to the definition of “exchange” to apply to any communication protocol system (not limited to just autonomous cryptosystems or block explorers) is an impediment to innovation: it would ultimately force builders and users of decentralized finance systems to leave the United States or devote skills and effort to companies and technologies being built outside of the United States.

While the SEC has broad jurisdiction over securities in the United States, it does not have sole jurisdiction to prohibit software publication and the development of new technologies. Attempting to limit what Americans can publish and how they can interact in interstate commerce is a job for Congress as constrained by the Constitution. It is not the job of any one regulator.

The goal of financial regulation is not just to protect investors and encourage an orderly market, but also to improve the products and services offered to investors in the United States. Prohibiting new technologies because they do not fit into the legal and regulatory framework of the last century is counterproductive to that goal. The SEC should not adopt the Proposal but rather continue working with members of the decentralized finance community to develop new rules and regulations properly adapted to the technology at issue.

Thank you for your consideration.

Respectfully Submitted,

Casey Ann Hewitt