DeFi Education Fund

May 27, 2022

Via Electronic Mail: rule-comments@sec.gov

Vanessa A. Countryman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Notice of Proposed Rulemaking to further define the phrase "as a part of regular business" as used in the statutory definitions of "dealer" and "government securities dealer" under Exchange Act 3(a)(5) and 3(a)(44); File No. S7-12-22

Dear Ms. Countryman:

The DeFi Education Fund[1] ("**DEF**") appreciates the opportunity to provide comments to the Securities and Exchange Commission ("**Commission**" or "**SEC**") on its proposed "Further Definition of 'As a Part of a Regular Business' in the Definition of Dealer and Government Securities Dealer," (March 28, 2022) ("**Proposal**").[2] We support the Commission's goal of seeking to keep pace with technological and market structure developments by ensuring an appropriate scope to its regulatory oversight, so as to enhance market stability and promote investor protection.

As we will describe in greater detail, however, the Proposal would have the opposite effect, by foreclosing innovative technological and market structure developments that enhance market stability through expanded participation in the market and that promote investor protection through greater transparency and security. While these developments are perhaps most pronounced in the decentralized finance ("**DeFi**") ecosystem, they are not limited to that context. To avoid these deleterious effects, the Commission should instead take a more tailored and incremental path, one focused on the particular segments of the securities markets

1 DEF is a nonpartisan advocacy group based in the United States with a mission to educate policymakers about the benefits of decentralized finance and to achieve regulatory clarity for the DeFi ecosystem.

2 SEC Release No. 34-94524 (March 28, 2022), 87 Fed. Reg. 23,054 (April 18, 2022).

for which it has data demonstrating the existence of unregulated dealing activity, and which is targeted at the participants engaged in that activity.

OVERVIEW

The Proposal is intended to address concerns that advancements in electronic trading have led to the emergence of significant but unregulated liquidity-providing participants in the securities markets, most notably the markets for U.S. Treasuries and listed equity securities.[3] To address these concerns, the Proposal would adopt three single-factor, qualitative standards for when a person engaged in buying and selling securities for its own account is engaged in such activity "as part of a regular business," such that the person is subject to registration and regulation as a "dealer" under the Securities Exchange Act of 1934 ("**Exchange Act**").[4]

These standards would turn on whether the person's securities trading activity "has the effect of providing liquidity to other market participants" by: (1) routinely making roughly comparable purchases and sales of the same or substantially similar securities in a day; (2) routinely expressing trading interests that are at or near the best available prices on both sides of the market and that are communicated and represented in a way that makes them accessible to other market participants; and (3) earning revenue primarily from capturing bid-ask spreads, by buying at the bid and selling at the offer, or from capturing any incentives offered by trading venues to liquidity-supplying trading interests.[5]

Adopting these standards would upend decades of precedent for distinguishing "dealers" from "traders," which was developed by the Commission through numerous releases, interpretations, no-action letters and enforcement actions, as well as in numerous judicial precedents. This precedent has consistently focused on the nature of a person's interactions with other market participants, including, in particular, interactions with customers. The Proposal, however, would depart completely from this historical approach and focus instead, almost exclusively, on the effect of an entity's trading activity, despite the fact that that effect cannot be foreseen or controlled.

We leave to others to address whether this radical departure is justified and appropriate in the context of the current market structures for U.S. Treasury and listed equity securities, the only two securities markets that the Proposal's economic analysis addresses with any specificity. But the Proposal's scope would extend much more broadly. In particular, in a

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3 *See id.* at 23,054-56.

4 *See* Proposed Rule 3a5-4. The Proposal also would apply these standards to determine "government securities dealer" status, as well as adopt a single-factor, quantitative test for such status. *See* Proposed Rule 3a44-2. This letter focuses on Proposed Rule 3a5-4.

5 Proposed Rule 3a5-4(a)(1).

single footnote, the Proposal states that it also applies to "any digital asset that is a security or a government security within the meaning of the Exchange Act," thereby implicating the unique and developing DeFi ecosystem.[6] The Proposal fails, however, to give any consideration whatsoever to its impact on market participants or market structure for digital asset securities.

Moreover, the Proposal fails to consider the likelihood that subjecting persons to dealer registration merely because their trading has the effect of providing liquidity would act to discourage trading strategies and market structures designed to promote liquidity. The DeFi ecosystem in particular has been innovative in designing execution protocols and market structures that expand the number and diversify the types of participants who trade in ways that have the effect of providing liquidity, without necessitating the involvement of market makers or other dealers to intermediate investors. This "all-to-all" market structure, which can also be employed outside the digital asset context, is consistent with a trend of policymaking initiatives reflected in the Dodd-Frank Act's derivatives reforms, among other places. It is disappointing that the Proposal would undermine this market structure by effectively limiting its participants to those willing to register as dealers.

We see no reason why this result is a necessary byproduct of an effort designed to ensure that Treasuries and equities market participants engaged in the traditional dealer activity of continuously posting bids and offers on electronic order books or in response to electronic requests for quote are regulated as dealers. But rather than targeting that specific activity, the Proposal uses vague and open-ended concepts, such as "roughly comparable" purchases and sales of "substantially similar" securities, "trading interests" that are "at or near the best available prices," and capturing "any incentives" offered to "liquidity-supplying trading interests"—concepts the Commission has never used before. And the Proposal uses them without any consideration at all to the impact that their use would have on different execution protocols or market structures.

Taking these points together, the Proposal presents particular concern for various beneficial DeFi protocols designed to automate liquidity provision among a community of investors without requiring intermediation by one or more dealers. Similar issues may be presented for midpoint crossing platforms, certain auction-based protocols, and other market structures in traditional securities markets. To the extent the Proposal would subject investors to registration as dealers merely because they use these all-to-all protocols, it would have the undesirable impact of forcing greater intermediation and centralization, reducing innovation and market efficiency, and tilting the competitive playing field towards incumbents.

The rest of this letter proceeds as follows. First, we provide some background on the DeFi ecosystem and relevant execution protocols, as an example of the sort of innovative market structure that the Proposal would foreclose. Next, we explain the issues the Proposal would raise for these market structures. Then, we discuss how the Proposal, by departing the longstanding "dealer-trader" distinction, would exceed the Commission's statutory authority.

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6 Proposal at 23,057 n. 36.

We further lay out why the Proposal would fail to live up to the Commission's obligations under the Administrative Procedure Act ("**APA**") or to discharge the Commission's obligations to perform an adequate cost-benefit analysis. We conclude with our recommendations.

DISCUSSION

I. Overview of Decentralized Finance

A. General Background of Decentralized Finance

DeFi refers to decentralized software protocols used to conduct financial activities on open-source software running on distributed ledgers, *i.e.* "blockchains." Public blockchains are permissionless, decentralized, and immutable ledgers that enable all nodes on a network to hold a record of the history of transactions on the network and reach consensus as to the validity of those transactions. No single entity participating in the network has control over, or can alter, that ledger of transactions. Smart contracts are a type of software program that run on public blockchains and can be designed to automatically execute specific actions without the involvement of a third party when certain conditions are met. Smart contracts deployed on a blockchain are transparent and immutable.[7] Two or more parties can use smart contracts to exchange digital assets directly without any financial intermediary's involvement.

Rather than relying on banks, brokers, centralized execution and clearing, or self-regulatory organizations to ultimately exercise discretion and dominion over the marketplace, DeFi establishes trust between counterparties in financial transactions via rules-based, encoded protocols. DeFi protocols are governed by open-source code initially set by protocol developers and later determined by a large number of distributed users holding tokens granting voting power, known as governance tokens. DeFi governance is evolving. The ability for users to vote for and implement proposed changes directly on the blockchain, including the disbursement of governance tokens, is an emerging method for governing protocols fairly and transparently.

DeFi protocols offer a number of benefits compared to traditional finance:

- Increased Transparency: DeFi protocols increase operational transparency about the mechanics of market infrastructures and associated fees by using open-source software, which makes transactions more transparent and auditable by using blockchain-based records.

- Equitable Market Access: DeFi protocols are open and available to anyone in the world with an internet connection, giving them the potential to significantly expand access to

[7] Users may create intermediary or proxy contracts that redirect calls and transactions to a modified contract as a way of updating an earlier contract.

financial services.[8] That access empowers more people to use financial services without having to go through intermediaries that may prevent sectors of the market from participation, either through unavailability, absolute prohibitions, excessive pricing, or unfair or discriminatory treatment.

- 24/7/365 Liquidity: Users can access and use markets at all times of the day without the need for closing markets at the end of each day. Among other things, this eliminates the risk of capital dislocations due to illiquid aftermarket trading in traditional systems.

- Lower Costs and Faster Settlement: DeFi protocols reduce friction and transaction costs for the creation, distribution, trading, and settlement of financial assets with faster settlement times for users.[9]

- Improved Security: Transactions using DeFi protocols are recorded on blockchains, the records of which cannot be manipulated or amended, offering greater security to users.

- Greater Control: The absence of intermediaries in DeFi protocols provides stakeholders greater control and certainty. Additionally, in some instances, market participants can directly develop community-governance standards.

- Greater Uptime: Permissionless blockchains are operationally resilient (the Ethereum blockchain has never gone down), whereas traditional exchanges have had major technology failures, resulting in downtime for securities markets. Additionally, the use of certain DeFi protocols referred to as automated market makers eliminates trading halts that occur at times as a result of buy and sell order imbalances.

- Eliminate Broker Risk: DeFi protocols have no employees to supervise, no financial risk for users from broker activity or custody, and no interaction between a broker and customers that could result in unlawful sales practices or other unfair and discriminatory dealing.

- Eliminate Anti-Competitiveness: Users can easily move their cryptocurrencies from one protocol to another at any time without significant friction, unlike the experience on

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8 *See, e.g.,* Bitange Ndemo, The role of cryptocurrencies in sub-Saharan Africa, Brookings Institution (March 16, 2022), https://www.brookings.edu/blog/africa-in-focus/2022/03/16/the-role-of-cryptocurrencies-in-sub-saharan-africa.

9 To be sure, users of DeFi protocol may pay certain fees, such as gas fees, to facilitate use of the protocol. But any comparison of costs should also account for the fact that DeFi users do not additionally need to compensate other intermediaries such as executing brokers, prime brokers, clearing brokers, or custodians. On balance, this leads DeFi protocols typically to be available to users at lower costs than centralized exchanges. As additional blockchains are created and new technology, such as scaling solutions, are developed, costs for transacting using DeFi protocols likely will continue to decrease.

traditional exchanges where sharing liquidity across exchanges is near-impossible, resulting in a lack of competition.

Academic scholarship observes that DeFi increases efficiency by "significantly decreas[ing] counterparty credit risk"; transparency, by offering more publicly available data during a crisis than the data "scattered across a large number of proprietary databases or not available at all" in traditional financial systems; accessibility, as "the risk of discrimination is almost inexistent due to the lack of identities"; and composability, by creating "an ever-expanding range of possibilities and unprecedented interest in open financial engineering."[10] The Official Monetary and Financial Institutions Forum noted that DeFi has been harnessed for the good of the broader public and spurred banking innovation.[11]

B. Liquidity in Decentralized Finance

DeFi initially struggled to provide liquidity because, as a new market, it had fewer buyers and sellers to match as a counterparty with a user desiring to transact. To remedy this issue, the DeFi ecosystem developed liquidity pools that are decentralized, transparent, and properly incentivized.[12] These pools are "an innovation of the crypto industry, with no immediate equivalent in traditional finance."[13]

A liquidity pool crowdsources cryptocurrency, tokens, and other digital assets, locks them in a smart contract that facilitates trading, and employs mathematical formulas implemented by automated market makers ("**AMMs**") to properly adjust costs and ratio as demand for an asset changes. An AMM is not a market-maker in a traditional sense; rather, it is an execution protocol that, like a market maker, ensures continuous access to trading at a fair value market price. However, rather than relying on individual market participants to set the price, an AMM looks to the aggregation of trading interest across participants in a given liquidity pool. Specifically, the price available via an AMM will increase when an asset is withdrawn from the pool and decrease when it is added to the pool, in a manner that reflects supply and demand and that AMM's particular algorithm. A user who sells one kind of digital asset to buy a different

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10 Fabian Schär, Decentralized Finance: *On Blockchain- and Smart Contract-Based Financial Markets, Federal Reserve Bank of St. Louis Review* (Second Quarter 2021), p. 169, https://research.stlouisfed.org/publications/review/2021/02/05/decentralized-finance-on-blockchain-and-smart-contract-based-financial-markets.

11 Official Monetary and Financial Institutions Forum, *Harnessing Decentralised Finance Innovation for the Public Good* (July 20, 2021), Harnessing decentralised finance innovation for the public good - OMFIF.

12 *See*, Cryptopedia Staff, What are Liqudity Pools?, GEMINI (Nov. 30, 2021), https://www.gemini.com/cryptopedia/what-is-a-liquidity-pool-crypto-market-liquidity.

13 *See* Ekin Genç, *What Are Liquidity Pools? The Funds that Keep DeFi Running*, Decrypt (Apr. 9, 2022), https://decrypt.co/resources/what-are-liquidity-pools-the-funds-that-keep-defi-running.

kind of digital asset using AMM software contributes to and draws from the contributions to the liquidity pool by other users.

A liquidity pool has digital assets on hand because it *incentivizes* contribution. Contributing digital assets to liquidity pools can be a source of passive income. Users that contribute digital assets generally receive liquidity provider ("**LP**") tokens in proportion to the amount of liquidity they have contributed. A liquidity pool proportionally distributes a fractional fee among LP token holders when a user executes an exchange using the software. An LP token is destroyed when its holder reclaims contributions and claims earnings accrued.

Participants in AMMs are generally not themselves market makers. Often, they are mere investors looking to receive a return on idle digital assets by depositing them in liquidity pools, enabling these investors to earn LPs and possibly arbitrage returns. Unlike market makers, they do not set market prices, no one looks to them for liquidity (they are software), and they have no customers.

This market structure has been enormously successful. In 2020, Ethereum-based protocols recorded a total value locked ("**TVL**"), the amount of digital assets entrusted to protocols and the typical measure of liquidity, of only $2 billion. As of April 2022, two years after several liquidity pools became popular in 2020,[14] the TVL in all DeFi was $222 billion.[15]

II. The Proposal Would Inhibit Innovation and Curtail Market Liquidity and Competition

A. <u>The Proposal's Qualitative Standards Are Unduly Broad and Ambiguous</u>

The breadth and ambiguity of the Proposal's qualitative standards would raise many questions about the status of investors who use AMMs, other DeFi protocols, and other all-to-all execution protocols. For example:

- An AMM-style liquidity pool involves an investor depositing two digital assets in proportion to the current ratio of those assets in the pool. As demand and supply for those assets changes, the investor may sell or buy each asset, along with everyone else in the pool. How should the investor evaluate whether these purchases and sales are "roughly comparable"?

- The Proposal indicates that securities are "substantially similar" if (1) the fair market value of each security primarily reflects the performance of a single firm or enterprise or the same economic factor or factors, such as interest rates; and

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14 *See* Nikolai Kuznetsov, *DeFi Liquidity Pools, explained,* CoinTelegraph (Jan. 28, 2021), https://cointelegraph.com/explained/defi-liquidity-pools-explained.

15 *See* Ekin Genç, *What Are Liquidity Pools? The Funds that Keep DeFi Running*, Decrypt (Apr. 9, 2022), https://decrypt.co/resources/what-are-liquidity-pools-the-funds-that-keep-defi-running.

(2) changes in the fair market value of one security are reasonably expected to approximate, directly or inversely, changes in, or a fraction or multiple of, the fair market value of the second security.[16] How should this standard apply to digital asset securities?

- All participants in a liquidity pool are, by leaving their assets in the pool, exposing those assets to sale at the pool's prevailing exchange rate. Does this translate to all participants expressing a "trading interest"? If so, given that a single, fluctuating exchange rate sets the price, would such interest always be "at or near the best available prices on both sides of the market"? Might <u>all</u> participants in a liquidity pool then be engaged in dealing activity?

- Participants in a liquidity pool receive LPs for their participation. Would this constitute an "incentive . . . for liquidity-supplying trading interests"? We further note that whether a DeFi protocol constitutes a "trading venue" is likely to turn on the outcome of the Commission's pending proposal to expand its "exchange" definition,[17] which we strongly oppose.

We naturally have focused on the questions raised in connection with DeFi protocols. We respectfully submit, however, that participants in similar all-to-all market structures, including those that do not involve digital assets, would face similar questions.

B. <u>These Ambiguities Would Discourage Disintermediated or Decentralized All-to-All Market Structures</u>

Investors have choices regarding where and how they trade. As laid out above, if an investor chose to participate in an AMM-style liquidity pool or similar all-to-all protocol, where it necessarily is the case that its trading activity has the "effect" of providing liquidity because the protocol brings investors together to provide liquidity to each other, then the Proposal could very well subject the investor to dealer registration. In addition to registration itself, the investor would then need to satisfy net capital requirements that limit the types of assets it can own with borrowed money, recordkeeping requirements that require use of very specific technologies, trade confirmation and other disclosure requirements, membership in the Financial Industry Regulatory Authority ("**FINRA**"), and registration of its personnel.

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16 Proposal at 23,067.

17 *See* Amendments to Exchange Act Rule 3b-16 Regarding the Definition of "Exchange"; Regulation ATS for ATSs That Trade U.S. Government Securities, NMS Stocks, and Other Securities; Regulation SCI for ATSs That Trade U.S. Treasury Securities and Agency Securities, SEC Release No. 34-94062 (Jan. 26, 2022), 87 Fed Reg. 15,496 (Mar. 18, 2022).

These requirements would be especially daunting for an investor trading in digital asset securities. The Commission and FINRA have provided little to no guidance regarding how their rules apply to digital asset securities. Market participants do not know the net capital treatment of digital assets. There is no guidance regarding how permissibly to keep records of digital assets. Guidance regarding custody of digital assets has raised more questions than answers. There would be no practical way for a broker-dealer to create order tickets for transactions with, or deliver trade confirmations to, pseudonymous counterparties transacting with it through a liquidity pool. These are but a few of the areas where the digital asset industry lacks clear rules of the road.

Faced with the prospect of these burdensome, expensive, and potentially impossible to satisfy requirements, it would be rational for an investor instead to transact through an execution protocol and market structure that did not subject it to dealer registration. For example, the investor might prefer to send a request for quote to a dealer. Or the investor might prefer to hit the bid or lift the offer of a market maker in an order book. In other words, the investor might, to avoid registration under the Proposal, prefer to centralize trading through dealer-centric trading venues.

We also note that the Proposal's exceptions would not sufficiently counteract these incentives. In particular, although the Proposal would except a person that has or controls total assets of less than $50 million, many semi-institutional parties have assets exceeding this threshold. Moreover, it is important for execution protocols to be available to retail and institutional investors alike.

C. The Proposal Would Increase Market Concentration, Volatility, and Systemic Risk

For the reasons laid out above, a key consequence of the Proposal would be to favor market structures that are centralized and intermediated. This incentive would promote market concentration by foreclosing the ability for investors incidentally to provide liquidity to each other, instead necessitating that a relatively smaller group of dealers intermediate trading activity. The consequences of concentrating liquidity provision in this fashion should be obvious: if the smaller group of liquidity providers were to exit the market, then volatility would increase sharply; and if one or more of them were to default, then a far greater number of market participants would be exposed to that default risk. These outcomes are certainly not consistent with the Commission's objectives.

III. The Proposal Exceeds the Commission's Statutory Authority

The Exchange Act defines a "dealer" as any "person engaged in the business of buying and selling securities . . . for such person's own account through a broker or otherwise." The definition provides a "trader exception" for "a person that buys or sells securities ... for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business." The Commission's guidance and no-action letters, spanning a period of decades, have long emphasized that determining whether a person is a dealer or a trader turns on consideration of a wide variety of factors, including issuing or underwriting securities, quoting a market, extending credit, advertising or soliciting customers, among several others.[18]

The Proposal, however, would overturn the entire framework that the Commission has communicated to the public in favor of a reductive focus on whether a person is essentially "acting as a de facto market maker or liquidity provider."[19] Despite highlighting two other factors for a determination that a person is a dealer—"acting as a market maker or specialist on an organized exchange or trading system" or "holding oneself out as buying or selling securities at a regular place of business"—the Proposal does not explore whether or how incorporation of those factors (and perhaps others) could address the particular conditions in the Treasury and equities markets it seeks to address.

As support for this novel approach to a longstanding issue, the Proposal misuses precedent. For instance, the Proposal cites to *River North* to support its arguments that a de facto market maker filling a liquidity-providing role may be subject to dealer registration requirements.[20] Yet, the court in *River North* made clear that other factors were relevant to its analysis besides merely activities that "[have] the effect of providing liquidity," including the extension of credit and advertising on its website.[21] The same holds true for another case the Commission cites, *Keener*, where the court's analysis extended beyond analyzing trading volume, looking to the defendant's multiple offices nationwide, contacts with over a hundred companies, and its advertising activities. Other factors that courts have considered to rule on dealer

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18 *See e.g.*, United Trust Company, SEC Staff No-Action Letter (Sept. 6, 1978); Continental Grain Company, SEC Staff No-Action Letter (Nov. 6, 1987); United States Savings Association of Texas, SEC Staff No-Action Letter (Apr. 12, 1987); Louis Dreyfus Corp., SEC No-Action Letter (July 23, 1987); In the Matter of the Application of Gordon Wesley Sodorff, Jr. for Rev. of Disciplinary Action Taken by the Nat'l Ass'n of Sec. Dealers, Inc., 50 S.E.C. 1249 (Sept. 2, 1992); OTC Derivatives Dealers, Exchange Act Release No. 40594 (Oct. 23, 1998), 63 Fed. Reg. 59,362, 59,370 n.61 (Nov. 3, 1998); Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, 68 Fed. Reg, 8686-01; *Guide to Broker-Dealer Registration,* SEC (April 2008), https://www.sec.gov/reportspubs/investor-publications/divisionsmarketregbdguidehtm.html#II

19 Proposal at 23,059.

20 *Id* at 23,059, n. 51.

21 *Id*.

categorization include hiring agents to engage in soliciting,[22] sponsoring conferences,[23] and business model.[24]

It is clear both from the Commission's own guidance and case law precedent that a simplistic focus on whether a set of actions has the effect of providing liquidity, captured by the Proposal's novel qualitative and quantitative tests, is not only unworkable as applied to DeFi but also inconsistent with the statutory authority granted to the Commission under the Exchange Act.

IV. The Proposal Does Not Provide Fair and Sufficient Notice Under the APA

The Commission is required to provide notice and an opportunity to comment pursuant to its obligations under the APA.[25] An agency must give "interested persons an opportunity to participate in the rule making" and the "affected party should have anticipated the agency's final course in light of the initial notice."[26] Integral to an agency's notice requirement under the APA "is its duty to identify and make available technical studies and data that it has employed in reaching the decisions to propose particular rules."[27] The Proposal falls far short in its failure to consider the extensive number of market participants—potentially hundreds of parties engaged in DeFi ecosystems—that could now be subject to burdensome registration requirements. The Proposal professes that its scope is quite limited, that it would "primarily require registration by [principal trading firms], and potentially some private funds."[28] Indeed, nowhere does the Proposal explore the possibility that it may affect DeFi market participants.

In the entirety of its 194 pages, the Proposal only makes a single reference to digital assets in a footnote,[29] with its bulk ostensibly concerned with U.S. Treasury markets. Yet, the Proposal's adoption of a standard requiring registration of persons' whose activity "has

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22 *SEC* v. *Almagarby*, No. 17-62255-CIV, 2020 WL 4783405 (S.D. Fla. Aug. 17, 2020).

23 *SEC* v. *Fierro*, No., 2020 WL 7481773, at *4 (D.N.J. Dec. 18, 2020).

24 *SEC* v. *Big Apple Consulting USA, Inc.*, 783 F.3d 786, 809 (11th Cir. 2015) ("While evidence of merely some profits from buying and selling securities may alone be inconclusive proof, the defendants' entire business model was predicated on the purchase and sale of securities.").

25 5 U.S.C. § 553(b).

26 *Covad Communications* v. *FCC*, 450 F.3d 528, 548 (D.C. Cir. 2006).

27 *Kern Cty. Farm Bureau* v. *Allen*, 450 F 3d 1072, 1076 (9th Cir. 2006) (internal citation omitted).

28 Proposal at 23,057.

29 *Id.* at 23,057, n. 36.

the effect of providing liquidity" necessarily envelops a much larger population of market participants than principal trading firms and, indeed, directly targets innovative DeFi protocols not housed in those traditional firms. Although the Proposal's treatment of digital assets is less than superficial, its implications—mandating that an entire burgeoning industry be subject to onerous registration requirements on the basis of a single footnote reference—are massive. That the Commission neglects to even discuss the impact on the digital assets space in any significant way is clearly in violation of the APA's requirement that an agency must "provide sufficient factual detail and rationale for the rule to permit interested parties to comment meaningfully."[30] That the Commission sidelines its previous factor-based approach to dealer identification in its no-action letters and guidance, long relied on by the public, only further obfuscates the issue of which parties it intends to reach.

Moreover, under the APA, agencies must provide affected parties "enough time with enough information to comment and for the agency to consider and respond to the comments."[31] But in recent months the Commission has issued a number of highly complex, lengthy, consequential, and interrelated proposals, including a recent 591-page proposal that, as noted above, necessarily affects the scope and impact of this Proposal.[32] That the present Proposal is merely one in a series heightens the inadequacy of the 40-day comment period, which is insufficient even for the current Proposal, let alone taking into account the entire batch of recent proposals by the Commission. Given that there is not only ambiguity concerning the parties actually affected by the Proposal, but also the potential for severe damage to market structure innovation (including the DeFi ecosystem), the comment period is manifestly inadequate to allow parties to analyze and respond to this novel regulatory framework. The Commission must grant the public a comment period commensurate with the wide-ranging nature of its proposals.

V. The Commission Has Not Conducted Adequate Economic Analysis as Required by the Exchange Act

Section 23(a)(2) of the Exchange Act requires the Commission to consider "the impact any such rule or regulation would have on competition" and states that the Commission "shall not adopt any such rule or regulation which would impose a burden on competition not necessary or appropriate." Additionally, the Commission must include in any rule or regulation "the reasons for the Commission's ... determination that any burden on competition imposed by such rule or regulation is necessary or appropriate in furtherance of the purposes of this chapter." Similarly the Commission is required to consider whether its Proposal will "promote efficiency,

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30 *United States Telecom Ass'n* v. *Fed. Commc'ns Comm'n*, 825 F.3d 674, 700 (D.C. Cir. 2016).

31 *Prometheus Radio Project* v. *F.C.C.*, 652 F.3d 431, 450 (3d Cir. 2011); *see also, e.g., Florida Power & Light Co.* v. *U.S.*, 846 F.2d 765, 771 (D.C. Cir. 1988) (affirming that the APA's notice provisions require agencies "not only [to] give adequate time for comments, but also must provide sufficient factual detail and rationale for the rule to permit interested parties to comment meaningfully").

32 *See* note 16, *supra*, and accompanying text.

competition, and capital formation" under Section 3(f) of the Exchange Act. The D.C. Circuit has viewed these provisions, together with the requirement under the APA that Commission rulemaking be conducted "in accordance with law," as imposing on the Commission a "statutory obligation to determine as best it can the economic implications of the rule." Similarly, the court has found certain Commission rules arbitrary and capricious because of the Commission's failure to adequately evaluate a proposed rule's economic impact. Additionally, the Division of Risk, Strategy, and Financial Innovation and the Office of the General Counsel have recognized in their guidance that "high-quality economic analysis is an essential part of SEC rulemaking."

The Commission has not met these obligations. The cost-benefit analysis that the Commission undertakes fails to take into account the harsh consequences to DeFi market participants and other all-to-all market structures that would result from the proposed expansion of the term "dealer." In fact, while the Proposal discusses the potential effects of this rulemaking on other types of entities, it gives no space to DeFi or market structure impact in its economic analysis at all. Moreover, the Commission does very little to substantiate its belief that the Proposal will provide benefits to the market generally, except for asserting that "stable markets could encourage greater market participation."[33] Likewise, the Proposal does not explore the potential harm that it might inflict on the development of software tools and applications designed for DeFi protocols in particular, but also on innovation in U.S. markets in general. The Proposal also fails to account for the resulting indirect costs on end users that will no longer have the same access to innovative execution protocols and may have to revert to using traditional, dealer-centric trading platforms. It is not sufficient to proffer a regulation that could severely damage a thriving, innovative industry without any cost analysis.

As a result of these shortcomings, the Proposal drastically underestimates the number of affected parties, which is far in excess of the "15 or 20 firms" that the Commission suggests are affected by its qualitative test—an estimate that it concedes is "highly uncertain."[34] Although the Proposal provides an exemption for investors holding less than $50 million in total assets, which will protect some retail investors from dealer classification, it provides no protection at all for the multitude of larger investors whose "passive liquidity-providing activity,"[35] the Commission would characterize as "de facto market making." As there is no exemption for these investors, the only conclusion is that they will be subject to costly registration requirements that the Commission estimates at "approximately $600,000 initially and $265,000 annually thereafter to register as a broker-dealer with the Commission, become a member of an SRO, and comply with the associated dealer regulations"[36]—cost estimates that

33 Proposal at 23,091.

34 *Id.* at 23,085.

35 *Id.* at 23,065.

36 *Id.* at 23,089.

themselves are highly suspect given that so few firms conducting digital asset activities have been able to register as broker-dealers, and typically only after multi-year processes.

Needless to say, these costs will be burdensome for the numerous parties who operate in the DeFi ecosystem or otherwise use all-to-all execution protocols. Indeed, the Commission has sent a general signal to market participants to avoid any activities that could be construed as liquidity-providing given the high risk that they will be subject to dealer registration under the Commission's new regime. With sources of liquidity significantly more restricted, the Commission will realize declines in the very market areas that it forecasted could suffer: "market efficiency, market competition, and capital formation."[37] For DeFi market participants especially, the message from the Commission seems clear: they should not operate at all.

Thus, it is difficult for commenters to respond to the Proposal when it is based on flawed data, speculative notions on potential benefits, and very optimistic assessments of the costs to market participants. Most starkly of all, the Proposal omits any discussion of its effects on DeFi protocols or the variety of available execution protocols generally; consequently, it follows that the Proposal's cost analysis is severely insufficient. Nonetheless, the reality is that costs to the DeFi ecosystem and other emerging market structures would be enormous. If the Commission intends to meet its obligations under the APA to fairly assess the impact of regulation on market participants, then we urge it to at least include DeFi—and digital assets generally—in its evaluation, in addition to the broader incentives it is creating around market structure development.

VI. The Commission Should Tailor the Proposal to its Objectives

The Commission has articulated a number of laudable goals in its Proposal to correct gaps in oversight of certain important markets. The Commission should focus on applying its existing interpretations of the "dealer" definition to those market participants in the U.S. Treasury and listed equity markets that it identifies as significant but unregulated liquidity providers, instead of proposing new bright-line rules that result in confusion and inflexibility. We see no evidence why these existing interpretations do not, today, capture the principal trading firms described by the Proposal, but if there is some question whether they do, the Commission should address those questions directly and specifically.

To the extent the Commission considers it necessary to engage in rulemaking to accomplish this objective, it should limit the scope of the rulemaking to persons transacting in the U.S. Treasury and listed equity markets on order book and request for quote platforms, which are the areas for which the Commission has adequate data and can conduct robust analysis to evaluate the potential impact of the rulemaking. The Commission should be clear to exempt from its requirements activities implicating digital assets, as there is no support for this rulemaking to apply to them. To the extent the Commission intends to address digital assets, it

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37 *Id.* at 23,091.

should instead do so as part of the coordinated, deliberate, multi-agency approach President Biden ordered on March 9, 2022 and in consultation with Congress.[38]

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We appreciate the opportunity to provide our comments to the Commission regarding the Proposal, and we would welcome the opportunity to meet with the Commission or its staff to discuss our comments. If the staff has questions or comments, please do not hesitate to contact the undersigned, or David J. Gilberg (212-558-4680), James M. McDonald (212-558-3030), or Colin D. Lloyd (212-558-3040) of Sullivan & Cromwell LLP, outside counsel to DEF.

Respectfully submitted,

Miller Whitehouse-Levine
Policy Director

cc: The Hon. Gary Gensler, SEC Chairman
The Hon. Hester M. Peirce, SEC Commissioner
The Hon. Allison Herren Lee, SEC Commissioner
The Hon. Caroline A. Crenshaw, SEC Commissioner

38 *See* Executive Order on Ensuring Responsible Development of Digital Assets (March 9, 2022).