

## SEC Takes Aim at Crypto Platforms As Unregistered Exchanges

Since April, the United States Securities and Exchange Commission (“SEC”) has ramped up its enforcement efforts in the crypto space, bringing a trio of actions against so-called unregistered national securities exchanges.<sup>1</sup> With its aggressive and seemingly coordinated focus on crypto trading platforms, the SEC poses an existential threat to the crypto industry in the United States. If the SEC prevails in all three of these actions, which are currently litigating, then it may effectively preclude buying and selling of crypto currencies in the U.S., without ever writing a single rule.

Even so, rulemakings are also in the works; these enforcement actions come on the tail of the SEC’s 3-2 party-line vote to reopen the comment period for the SEC’s proposed amendments to Rule 3b-16 under the Securities Exchange Act to significantly expand the definition of an “exchange” (the “Proposed Rules”). In the SEC’s release announcing the reopening of the comment period (the “Reopening Release”), the SEC expressly warned that it believes that some crypto trading platforms, including decentralized finance (DeFi),<sup>2</sup> constitute an “exchange” under current definitions and thus could be the subject of the next unregistered exchange enforcement action:

[C]urrently certain trading systems for crypto assets, including so-called “DeFi” systems, operate like an exchange as defined under federal securities laws . . . [and therefore] likely meet the current criteria of Exchange Act Rule 3b-16(a) and are subject to the exchange regulatory framework.<sup>3</sup>

The SEC’s three enforcement actions following the Reopening Release leave no doubt that the SEC has made it an enforcement priority to police crypto trading platforms that are not already registered as exchanges.

The Reopening Release also forecasts expanded scrutiny of crypto trading platforms, as it expressly states that, if adopted, the definition of “exchange” would be expanded to include additional crypto trading platforms.<sup>4</sup> This came as a surprise to many, as “crypto” trading platforms and “DeFi” were not explicitly mentioned anywhere in the SEC’s nearly 600-page proposing release (the “Proposing Release”) that was issued a year before the comment period was reopened.<sup>5</sup>

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<sup>1</sup> SEC, “SEC Charges Crypto Asset Trading Platform Bittrex and its Former CEO for Operating an Unregistered Exchange, Broker, and Clearing Agency” (Apr. 17, 2023), *available at* <https://www.sec.gov/news/press-release/2023-78>; SEC, “SEC Files 13 Charges Against Binance Entities and Founder Changpeng Zhao” (June 5, 2023), *available at* <https://www.sec.gov/news/press-release/2023-101>; SEC, “SEC Charges Coinbase for Operating as an Unregistered Securities Exchange, Broker, and Clearing Agency” (June 6, 2023), *available at* <https://www.sec.gov/news/press-release/2023-102>.

<sup>2</sup> DeFi is a term for peer-to-peer financial services on public blockchains, primarily Ethereum.

<sup>3</sup> SEC, Release No. 34-97309 at p. 10-11, *available at* <https://www.sec.gov/rules/proposed/2023/34-97309.pdf>.

<sup>4</sup> *Id.* at p. 11-12.

<sup>5</sup> SEC, Release No. 34-94062, *available at* <https://www.sec.gov/rules/proposed/2022/34-94062.pdf>.

As the reopened comment period has now closed, the SEC could adopt the expanded definition of “exchange” any day now, sweeping more crypto trading platforms into its regulatory ambit. Chair Gary Gensler has punctuated this timing by stating that the “runway is running out” for crypto trading platforms.<sup>6</sup>

## I. “Exchanges” and the Consequences of Operating as an Unregistered Exchange

Under the current version of Rule 3b-16, an organization, association, or group of persons is considered an exchange or considered as providing an exchange if it: “(1) [b]rings together the orders for securities of multiple buyers and sellers; and (2) [u]ses 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 a trade.”<sup>7</sup>

If an organization, association, or group of persons qualifies as an exchange, then it must either register with the SEC as an exchange or register as a broker-dealer and comply with Regulation ATS.<sup>8</sup>

To comply with Regulation ATS, an organization must satisfy the definition of an ATS (an alternative trading system).<sup>9</sup> An ATS is an organization, association, group of persons, or system that (1) 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 within the meaning of Rule 3b-16; and (2) does not: (i) set rules governing the conduct of subscribers other than the conduct of such subscribers’ trading on such organization, association, person, group of persons, or system; or (ii) discipline subscribers other than by exclusion from trading.<sup>10</sup>

Failure to register as an exchange or as a broker-dealer may result in operating as an unregistered exchange in violation of Section 5 of the Exchange Act.<sup>11</sup> Where a trading platform has operated as an unregistered exchange, the SEC<sup>12</sup> is empowered to bring a civil action to obtain damages including:

- Disgorgement. This is the amount of ill-gotten gains less any legitimate expenses.<sup>13</sup>
- Civil Penalty. This amount will vary based on whether the alleged wrongdoer is a natural person and whether the alleged wrongdoing involved fraud, deceit, manipulation, or deliberate or reckless

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<sup>6</sup> Reuters, “SEC Chair Gensler slams ‘non-compliant’ crypto industry amid FTX turmoil- CNBC” (Nov. 10, 2022), available at <https://www.reuters.com/technology/sec-chair-gensler-slams-non-compliant-crypto-industry-amid-ftx-turmoil-cnbc-2022-11-10/>.

<sup>7</sup> 17 CFR 240.3b-16(a).

<sup>8</sup> 15 U.S.C. 78f; 17 CFR 242.300–242.304.

<sup>9</sup> 17 CFR 242.300(a); 17 CFR 242.301(a); 17 CFR 242.301(b)(1).

<sup>10</sup> 17 CFR 242.300(a).

<sup>11</sup> Section 5 of the Exchange Act makes it unlawful for any broker, dealer, or exchange, directly or indirectly, to effect any transaction in a security, or to report any such transaction, in interstate commerce, unless the exchange is registered as a national securities exchange under Section 6 of the Exchange Act, or is exempted from such registration. 15 U.S.C. § 78e.

<sup>12</sup> Section 12(a)(1) of the Securities Act enables purchasers to bring a private action arising out of the offering or selling of unregistered securities. 15 U.S. Code § 77l.

<sup>13</sup> *SEC v. Liu*, 140 S. Ct. 1936, 1950 (2020).

disregard of regulatory requirements.<sup>14</sup> For non-natural persons, the maximum civil penalty allowed under statute is the amount equal to “the gross amount of pecuniary gain.”<sup>15</sup>

- Prejudgment Interest. The SEC frequently requires the payment of prejudgment interest on disgorged funds. While the SEC’s formula for calculating prejudgment interest is not public, the amount can run in the millions depending on the size of the disgorged profits.

## II. The Proposed Rules’ Broadened Scope of “Exchange”

The Proposed Rules would make several changes to expand the definition of “exchange,” as illustrated by the following table.

Current Definition	Proposed Amended Definition
An organization, association, or groups of persons that (1) brings together the orders for securities of multiple buyers and sellers; and (2) uses 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 a trade.	An organization, association, or group of persons that (1) brings together buyers and sellers of securities using trading interest; and (2) 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. <sup>16</sup>
<b><i>Redline Showing Proposed Amendments to Definition</i></b>	
An organization, association, or group of persons that “(1) brings together <del>the orders for securities of multiple</del> buyers and sellers of securities <b>using trading interest</b> ; and (2) <del>uses</del> <b>makes available</b> established, non-discretionary methods (whether by providing a trading facility <b>or communication protocols</b> , or by setting rules) under which <del>such orders</del> buyers and sellers <b>can</b> interact <del>with each other</del> , and <del>the buyers and sellers entering such orders</del> agree to the terms of a trade.	

The Proposed Rules define “trading interest” to encompass “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.”<sup>17</sup> By proposing to amend the definition to “include trading interest, and [] no longer limit[] the application of the rule to orders,” the SEC seeks to change “the focus on ‘interaction’” to be “between buyers and sellers rather than orders.”<sup>18</sup> Put differently, the Proposed Rules would alter the definition of “exchange” to capture not only actual orders placed on securities exchanges, but also conditional offers and exploratory solicitations for securities trades. This means that the scope of “exchange” would be much broader as defined by the Proposed Rules.

The Proposed Rules’ inclusion of “communication protocols” as an example of an established, non-discretionary method under which buyers and sellers can interact and agree to the terms of a trade would also broaden the scope of “exchange.” Communication protocols “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

<sup>14</sup> 15 U.S.C. § 77t(d)(2).

<sup>15</sup> *Id.* § 77t(d)(1).

<sup>16</sup> Release No. 34-97309 at p. 32.

<sup>17</sup> *Id.* at p. 32-33.

<sup>18</sup> *Id.* at p. 35.

of the trade.”<sup>19</sup> The Reopening Release provides the following example of a communication protocol: “if an entity makes available a chat feature, which requires certain information to be included in a chat message (e.g., price, quantity) and sets parameters and structure designed for participants to communicate about buying or selling securities, the system would have established communication protocols.”<sup>20</sup>

### III. Crypto Trading Platforms as “Exchanges”

Chair Gensler’s and Commissioner Caroline Crenshaw’s rhetoric accompanying the reopening of the comment period make clear the SEC’s position that the current definition of “exchange” applies to numerous crypto trading platforms:

- “Make no mistake: many crypto trading platforms already come under the current definition of an exchange and thus have an existing duty to comply with the securities laws.” – Chair Gensler.<sup>21</sup>
- “[I]here is significant trading activity in crypto asset securities that may be occurring in non-compliance with the federal securities laws, and certain other trading systems for crypto assets likely already meet the definition of an exchange. For those entities, the proposed amendments would not change any existing obligation to register as a national securities exchange or comply with the conditions to an exemption to such registration, such as Regulation ATS.” – Commissioner Crenshaw.<sup>22</sup>

Chair Gensler further reinforced this view during his recent testimony before the United States House of Representatives Committee on Financial Services, where he stated that “the vast majority of crypto tokens are securities” and, therefore, “many crypto intermediaries are transacting in securities and have to register with the SEC.”<sup>23</sup>

The Reopening Release asserts that certain crypto trading platforms “operate like an exchange” as currently defined under Rule 3b-16 because they “bring together orders of multiple buyers and sellers using established, non-discretionary methods (by providing a trading facility, for example) under which such orders interact and the buyers and sellers entering such orders agree upon the terms of a trade.”<sup>24</sup> “Because it is unlikely that systems trading a large number of different crypto assets are not trading any crypto assets that are securities, these systems likely meet the current criteria of Exchange Act Rule 3b-16(a) and are subject to the exchange regulatory framework.”<sup>25</sup>

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<sup>19</sup> Release No. 34-94062 at p. 41.

<sup>20</sup> *Id.*

<sup>21</sup> Chair Gensler, “Statement on Alternative Trading Systems and the Definition of an Exchange” (Apr. 14, 2023), *available at* <https://www.sec.gov/news/statement/gensler-statement-ats-041423>.

<sup>22</sup> Commissioner Crenshaw, “Statement on Supplemental Information and Reopening of Comment Period for Amendments to Exchange Act Rule 3b-16 Regarding the Definition of ‘Exchange’” (Apr. 14, 2023), *available at* <https://www.sec.gov/news/statement/crenshaw-statement-ats-041423>.

<sup>23</sup> Chair Gensler, “Testimony of Chair Gary Gensler before the United States House of Representatives Committee on Financial Services” (Apr. 18, 2023), *available at* <https://www.sec.gov/news/testimony/gensler-testimony-house-financial-services-041823>.

<sup>24</sup> Release No. 34-97309 at 10.

<sup>25</sup> *Id.* at 10-11.

The Proposing Release estimated the number of trading platforms that would be impacted by the Proposed Rules.<sup>26</sup> The Reopening Release states, however, that upon further consideration, the SEC determined that “[m]any of the entities operating such trading systems . . . may be subject to *existing* federal securities laws and registration requirements, including the requirement to register as an exchange under existing criteria of Rule 3b-16(a) or the requirement to register as a broker-dealer.”<sup>27</sup> As a result, the SEC believes that it may have originally “over-estim[ed]” the number of respondents that may be subject to the Proposed Rules.<sup>28</sup> The Reopening Release ultimately estimates that the Proposed Rules would lead to “15-20 New Rule 3b-16(a) Systems that trade crypto asset securities.”<sup>29</sup> This suggests that the SEC may very well believe that more crypto trading platforms qualify as exchanges under the current version of Rule 3b-16, meaning that such platforms could already be subject to investigations and enforcement actions.

## IV. The Impact of the SEC’s Targeting of Crypto Trading Platforms

As Commissioner Hester Peirce noted in her dissenting statement issued in April 2023, the SEC has ostensibly has taken the position that it will pursue enforcement actions against unregistered crypto trading platforms rather than working with these platforms and helping them figure out how to register as exchanges, accounting for the difference in DeFi technology:

Today’s Commission tells entrepreneurs trying to do new things in our markets to come in and register. When entrepreneurs find they cannot, the Commission dismisses the possibility of making practical adjustments to our registration framework to help entrepreneurs register, and instead rewards their good faith with an enforcement action. Today’s Commission treats the notice-and-comment rulemaking process not as a conversation, but as a threat.<sup>30</sup>

Even assuming the feasibility of registering, there are monetary costs of compliance. The Reopening Release admits that the SEC “has a greater degree of uncertainty in its analysis of the costs that the Proposed Rules would impose on market participants for crypto asset securities than it did in its discussion of costs for non-crypto asset securities.”<sup>31</sup> Consequently, “actual costs may be higher than these estimates and discussions [in the Reopening Release] express, due to the type of technology and operations utilized in trading crypto asset securities.”<sup>32</sup>

There are also implications to the broader market beyond the financial costs borne by individual crypto trading platforms. Commissioner Peirce forecasts that the Proposed Rule will “embrace stagnation, force centralization, urge expatriation, and welcome extinction of new technology.”<sup>33</sup> Multiple commenters on the Proposed Rules share Commissioner Peirce’s fears, voicing concerns such as:

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<sup>26</sup> *Id.* at p. 62.

<sup>27</sup> *Id.* at p. 63 (emphasis added).

<sup>28</sup> *Id.* at p. 63-64.

<sup>29</sup> *Id.* at p. 64.

<sup>30</sup> Commissioner Peirce, “Rendering Innovation Kaput: Statement on Amending the Definition of Exchange” (Apr. 14, 2023), *available at* <https://www.sec.gov/news/statement/peirce-rendering-innovation-2023-04-12>.

<sup>31</sup> Release No. 34-97309 at p. 93.

<sup>32</sup> *Id.* at 99.

<sup>33</sup> Commissioner Peirce, “Rendering Innovation Kaput: Statement on Amending the Definition of Exchange” (Apr. 14, 2023), *available at* <https://www.sec.gov/news/statement/peirce-rendering-innovation-2023-04-12>.

- “Digital Assets and DeFi represent a great opportunity for the United States to lead the world in development and an opportunity to provide more efficient financial services to Americans left out of participating in current markets. This rule as proposed would stymie development in the Digital Asset space and reduce the United States' competitiveness on the world stage.”<sup>34</sup>
- “These regulations are hurried, overly broad, and stifling of emerging technology which stands to benefit millions. Decentralized exchanges and DEFI cannot and should not be held to unreasonable standards and expected to KYC and perform the same functions as centralized exchanges.”<sup>35</sup>
- “This proposal by the SEC can have very detrimental effects to the US being a leader in innovation, capital formation, and markets. If the SEC continues with these unformulated concepts, capital will leave the US markets.”<sup>36</sup>
- “The Proposal’s broad application of exchange regulations to a wide variety of CPSs [Communication Protocol Systems] will likely harm innovation for communication platforms that are enhancing access to securities products and services through technology.”<sup>37</sup>

## V. Key Takeaways

It is crucial to consult legal counsel to determine whether your business, as a crypto trading platform, currently constitutes an exchange or would constitute such under the Proposed Rules. To make this determination, legal counsel can, among other things, assist in determining whether securities are traded on your platform. Importantly, crypto assets are not *per se* securities. Rather, the analysis of whether a crypto asset constitutes a “security” is governed by the four-pronged *Honey* test: (1) investment of money (2) in a common enterprise (3) with an expectation of profits (4) solely on the efforts of others.<sup>38</sup> This means that whether or not a particular transaction involving crypto assets constitutes the offer and sale of a security “will depend on the facts and circumstances.”<sup>39</sup> Legal counsel’s advice is vital to meet the SEC’s expectation that trading platforms properly “analyze whether the crypto assets that [a company] offers for trading meet the definition of a security under the federal securities laws and prior Commission statements.”<sup>40</sup>

Legal counsel can also help crypto trading platforms think creatively about how to structure their businesses in light of Rule 3b-16 and Regulation ATS, as well as the risks and benefits of operating in the United States.

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<sup>34</sup> Larry Pruss, SVP, Practice Lead, Crypto Advisory Services, Comment (Jan. 28, 2022), *available at* <https://www.sec.gov/comments/s7-02-22/s70222-20113086-265649.htm>.

<sup>35</sup> Justin Manganiello, Comment (Jan. 30, 2022), *available at* <https://www.sec.gov/comments/s7-02-22/s70222-20113310-265714.htm>.

<sup>36</sup> Jeff Martinez, CRPC, CEO, Financial Advisor Treveri Capital LLC, Comment (Feb. 23, 2022), *available at* <https://www.sec.gov/comments/s7-02-22/s70222-20117623-270314.pdf>.

<sup>37</sup> Digital Asset Legal and Regulatory Alliance, Global Blockchain Convergence, Global Digital Asset and Cryptocurrency Association, Comment (Apr. 14, 2022), *available at* <https://www.sec.gov/comments/s7-02-22/s70222-20123712-279952.pdf>.

<sup>38</sup> *SEC v. W.J. Honey Co.*, 328 U.S. 293 (1946).

<sup>39</sup> SEC, “Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Securities Exchange Act Release No. 81207” (July 25, 2017), *available at* <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

<sup>40</sup> Release No. 34-97309 at p. 11 n.30.

Finally, it is imperative to not delay in seeking legal counsel's guidance. Among other reasons, the longer a trading platform operates as an unregistered exchange, the more its profits may increase, which could lead to a higher disgorgement amount resulting from any enforcement action. A higher disgorgement amount could, in turn, lead to a higher prejudgment interest figure as well.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to reach out to:

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