Statement

Statement on Supplemental Information and Reopening of Comment Period for Amendments to Exchange Act Rule 3b-16 regarding the Definition of "Exchange"

Commissioner Mark T. Uyeda

April 14, 2023

Thank you, Chair Gensler. Today's recommendation from the staff of the Division of Trading and Markets is to reopen the comment period for proposed amendments to Rule 3b-16 under the Securities Exchange Act of 1934 (Exchange Act) regarding the definition of "exchange" and provide supplemental information relating to trading systems for crypto assets.[1] As I was not a member of the Commission when the proposal was issued, this is my first opportunity to vote on the topic. The Supplement, along with the original proposal, unfortunately raise more questions than they address in terms of highly important definitional terms as to what is, and what is not, an exchange for purposes of the Exchange Act.

Historically, the Commission has carefully defined what constitutes an exchange and an alternative trading system, and appropriately tailored the regulatory protections afforded to investors by the associated requirements. Prior to engaging in a jurisdictional sweep to significantly enlarge the definitional scope of an exchange, the Commission has the responsibility to demonstrate that such an extension will benefit investors. For the Commission simply to posit that there currently exist intermediating activities which resemble what exchanges accomplish is <u>not</u> enough. Innovation and technological change have created new methods for buyers and sellers of securities to interact in a manner that may ultimately result in securities trades. That does not mean that those methods constitute an exchange as contemplated under the Exchange Act nor that the benefits of extending the regulatory scope of exchange regulation will provide net benefits for investors.

Current Rule 3b-16(a) defines an "exchange" as any organization, association, or group of persons that (1) brings together 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 through which the buyers and sellers entering such orders agree to the terms of a trade.[2] The Commission has proposed replacing the word "orders" with "trading interest", and "uses" with "makes available," while adding "communication protocols" as an example of an established, non-discretionary method that would meet the second prong of the test. Two points are notable: the <u>expansiveness</u> of these combined changes and <u>how ambiguous they are</u>. "Trading interest" is a much vaguer concept than an "order." "Communication protocols" imply a vast array of possibilities. “Makes available” appears to encompass anyone providing a service to the exchange that could be outsourced.

Where is the evidence that more entities need to be brought into the regulatory framework for exchanges? It does not follow that regulations designed to cover exchanges—that is, facilities where securities orders are placed and matched in terms of established, non-discretionary methods—should necessarily be extended and applied to innovative platforms that facilitate open-ended communication processes where market participants may find and recognize a mutual interest in specific trading. All of these communications are already subject to securities laws that outlaw false and misleading statements and market manipulation.[3] Indeed, there are specific reasons to take great care within this particular line drawing exercise. From an economic perspective, an “order” is much more vulnerable to adverse selection and information leakage than is an expression of a “trading interest,” especially one placed on a less exposed platform.

It is important to keep in mind that our economy is in the midst of an information revolution characterized by decreasing costs of information processing, storage, and connectivity. Among the many effects is disintermediation, which is the process of bypassing intermediaries who might otherwise impose additional costs between the consumer or client and a preferred connection or outcome. Disintermediation has been widespread across industries, is largely economically beneficial, and explains the success of many current business models. In the context being addressed today, information technology assists those with various trading interests in securities in identifying a corresponding interest by others, while reducing potential transactional costs, including adverse selection and information leakage. Under current law, many communications platforms are not deemed exchanges. If, through technological and institutional innovation, market participants have found other ways to identify mutually shared trading interests, and they prefer this mechanism, this can constitute a valuable benefit that the Commission should not be in a rush to hinder unless there is a clear rationale for so doing.

What are the key questions to be answered prior to extending the scope of exchange regulation to cover these activities? One would expect evidence that there are important unaddressed problems manifesting themselves in this area, and that this particular regulatory construct constitutes the right tool set for addressing those issues.

There is a distinct danger that expanding the scope of the exchange definition in an ambiguous manner might suppress further beneficial innovation. For example, the extent to which order and execution management systems may, or may not, fall within the scope of the proposed rule is unclear.

Moreover, much of the Supplement’s commentary on cypto assets is insufficiently supported. For example, the Supplement states that “it is unlikely that systems trading a large number of different crypto assets are not trading any crypto assets that are securities.”[4] But given that the *Howey* investment contract test requires a careful analysis of facts and circumstances,[5] where is the factual and analytical support for that statement? Indeed, the Supplement’s argument merely parrots a conclusory statement made in a Financial Stability Oversight Council Report as authority on this point, and the Supplement explicitly acknowledges that “[e]ach system should analyze whether the crypto assets that it offers for trading meet the definition of a security.”[6]

The potential unintended consequences of the expansionary and ambiguous language of the proposed amendments to Rule 3b-16 are concerning. Yet the Economic Analysis in the Supplemental Information does not address these concerns. The Supplemental Information represents a missed opportunity to reflect further on the economic impact reflected in the commentary received to date. Instead, one might wonder whether this is simply a paper exercise under the Administrative Procedure Act so the Commission can finalize a decision that has already been made – namely that nearly all crypto assets are securities and are subject to the Commission’s jurisdiction. For that reason, I cannot support the Supplemental Information and Reopening of Comment Period. I do thank the staff in the Divisions of Trading and Markets and Economic and Risk Analysis as well as the Office of the General Counsel, the Strategic Hub for Innovation and Financial Technology and many others within the Commission for their efforts. I have no questions.

[1] Supplemental Information and Reopening of Comment Period for Amendments to Exchange Act Rule 3b-16 regarding the Definition of “Exchange”, Release No. 34-97309 (April 14, 2023), available at https://www.sec.gov/rules/proposed/2023/34-97309.pdf.

[2] *See* 17 CFR 240.3b-16(a).

[3] These provisions generally require the Commission to demonstrate scienter or some other intent requirement in order to prevail in an enforcement action. Violations of the requirement to register as an exchange, however, would not contain any such intent requirement.

[4] Supplemental Information and Reopening of Comment Period for Amendments to Exchange Act Rule 3b-16 regarding the Definition of “Exchange”, supra note 1, at 12.

[5] *See SEC v. W.J. Howey Co.,* 328 U.S. 293 (1946).

[6] Supplemental Information and Reopening of Comment Period for Amendments to Exchange Act Rule 3b-16 regarding the Definition of “Exchange”, supra note 1, at 12.