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June 13, 2023

Via online submission

Secretary Countryman
Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549

Re: File Number S7-02-22 (Supplemental Information and Reopening of Comment Period for Amendments Regarding the Definition of "Exchange")

Dear Ms. Countryman,

Circle Internet Financial, LLC ("Circle") appreciates the opportunity to comment on the Securities and Exchange Commission's ("SEC") proposal to amend Exchange Act Rule 3b-16.[1] Prudent regulation that protects investors, maintains fair, orderly, and efficient markets, and facilitates capital formation must be the product of reasoned deliberation carried out in collaboration with market participants and U.S. investors. It must also be pragmatic, so that it can effectively achieve policy goals, and not stifle innovation that can improve markets. Circle commends the SEC for reopening the comment period to more fully consider the consequences of the proposed amendments, especially as they affect the cryptoasset industry (including financial institutions and businesses that do not deal with cryptoasset *securities*). Circle believes that there are still many items that would benefit from closer SEC-industry cooperation to fully consider, so it welcomes the opportunity to provide background information and recommendations for how the SEC can most effectively regulate the nascent, fast-growing cryptoasset security industry.

Circle is a global financial infrastructure company that provides internet-native payments and treasury infrastructure on public blockchains. Circle issues USD Coin (USDC), the largest U.S.-regulated tokenized cash payment stablecoin. A tokenized cash payment stablecoin is a tokenized form of cash that circulates on a public blockchain. Businesses, investors, and other market participants use payment stablecoins to transact frictionlessly on blockchains, including through the use of blockchain-based smart contract protocols. Circle is commenting on the SEC's proposal in its capacity as an interested stakeholder and provider of financial infrastructure. In

[1] *See* Supplemental Information and Reopening of Comment Period for Amendments Regarding the Definition of "Exchange," 88 Fed. Reg. 29448 (May 5, 2023) ("Reopening Proposal").

particular, Circle is concerned about the effects of the proposal on public blockchain-based financial services, commonly called "DeFi."

I. Executive Summary

Circle strongly believes that the SEC should not finalize the parts of its proposal on which it is seeking additional comment. In Circle's view, redefining "exchange" as proposed would lead to an unclear and likely unworkable regulatory regime, especially for on-chain cryptoasset security exchanges. Circle is concerned that the SEC hasn't fully considered all ramifications of its proposal, and this letter raises several ambiguities, among many that exist, that the SEC should address prior to redefining "exchange."

Circle believes the ambiguities in the SEC's proposal are the result of the SEC's attempt to fit a wholly new technology into a decades-old regulatory apparatus. Instead of taking this approach, the Commission should conduct a wholesale evaluation of what about public blockchain-based financial services is new and what is similar to existing systems. It should then work with Congress to promulgate new, comprehensive rules with explicit congressional authorization, just as it did in the late 1990s in developing Regulation ATS.

Additionally, Circle does not believe that the Commission has conducted the thorough economic analysis required by law and benefiting the broader industry. For example, the Commission can and should establish a baseline for the size of the market it seeks to capture. Likewise, parts of the Commission's proposal make it very difficult for the public to evaluate the economic effects of the proposal. Even without certainty as to what entities the Commission intends to capture, the Commission is likely severely underestimating the effect of its proposal on market participants, including the proposal's effect on small entities, user choice, and competition amongst service providers.

Circle does not believe that the Commission should finalize its proposal. However, if it does move forward, it should ensure that there are no functional or legal barriers that prevent national securities exchanges or alternative trading systems (ATSs) from offering pairs trading, including pairs that contain a non-security. It should also eliminate ambiguity that it does not intend to capture independent software developers in its jurisdiction.

II. The proposal is not workable as written

Circle is concerned that the SEC hasn't fully considered the ramifications of its proposal to expand the definition of "exchange." Because cryptoassets are used for different purposes and operate technically differently compared to securities (which have no other utility other than acting as financial contracts), the SEC should consider all of the follow-on effects of incorporating on-chain cryptoasset security exchanges into its regulatory regime. The reality is that if an exchange facilitates the trading of any cryptoasset securities, it will need to make changes to its

operations for all cryptoassets, even if they are not securities. In this section, Circle explains three areas of ambiguity that are not resolved by the SEC's proposal. These areas are just three examples that represent a host of other questions that market participants have about how on-chain exchanges would fit into the current securities regulatory regime.

A. *By requiring certain smart contract protocols to register as an ATS, the proposal may require smart contract protocols to become custodial, sacrificing a major benefit of blockchain-based finance*

Any entity that complies with Regulation ATS would be required to register with FINRA as a broker-dealer and comply with the Customer Protection Rule.[2] Among other things, the Customer Protection Rule requires broker-dealers to "promptly obtain and shall thereafter maintain the physical possession or control of all fully-paid securities."[3] In addition to existing questions about the practicability of maintaining such possession or control of cryptoasset securities,[4] the regulation would seemingly require *self-custodial* on-chain exchanges to *become custodial*, which would eliminate one of their main beneficial characteristics.

Self-custody of a digital asset is a new technological innovation with significant benefits for users.

Self-custody is an innovation and primary benefit of cryptoassets circulating on public blockchains. Public blockchains enable true digital ownership because cryptoassets circulating on public blockchains are bearer instruments and not the liability of another person, whether corporate or natural. Digital ownership in this way has only recently been made possible by the creation of public blockchain technology, which uses cryptography and a distributed network (i.e., over the internet) to ensure a consistent, redundant, and durable record of ownership.

Self-custody is beneficial for markets and investors. First, self-custody expands user choice. While many narrowly think of self-custody as the ability to hold assets by oneself, the more accurate understanding of "self-custody" is that it allows a user to choose who he/she wants to use for custody services. In some cases, the user may prefer to self-custody, but the user may also ask

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[2] 17 CFR 242.301(b)(1).
[3] 17 CFR 240.15c3-3(b)(1).
[4] *See Joint Statement on Broker-Dealer Custody of Digital Asset Securities*, FINRA and Division of Trading and Markets Staff (Jul. 8, 2019), https://www.finra.org/media-center/news-releases/2019/joint-statement-broker-dealer-custody-digital-asset-securities (discussing the Customer Protection Rule and "Considerations for Digital Asset Securities"). Nearly four years after issuing the joint statement, FINRA approved a special purpose broker-dealer for the custody of digital asset securities. *Prometheum Ember Capital is the First SEC Qualified Custodian for Digital Assets Securities,* Prometheum Ember Capital, LLC., May 23, 2023, https://www.businesswire.com/news/home/20230523005313/en/Prometheum-Ember-Capital-is-the-First-SEC-Qualified-Custodian-for-Digital-Assets-Securities. However, there is no public information about the way in which the approved broker-dealer's custody solution operates or the extent to which the solution substantively uses public blockchain technology.

his/her bank, broker, service provider, attorney, or other trusted party to hold her assets for her (within the scope of any relevant regulations). This is possible because the cryptoassets are controlled by their corresponding private key(s). Therefore, to employ another party to provide custody services, the user merely gives the service provider the private key(s), and the assets are immediately "transferred."[5]

Expanding user choice in this way promotes competition because it means that users can choose whether or which service provider they wish to use for any particular function rather than being forced or obliged to use services that are vertically integrated. When assets are not the liability of a corporation but instead can be moved between service providers, it is trivially easy for a user to use one financial services provider for custody, another for investing services, a different company for a mortgage, and another company for a different credit product such as a credit card. While these effects are broader than the SEC's investor protection mandate, they are important to consider and are a pro-competition benefit that achieves the goals of President Biden's Executive Order on promoting competition.[6]

Additionally, self-custody helps users better manage counterparty risk because it allows users to choose the counterparty to which they are exposed. The SEC's Custody Rule identifies the risks of loss or misappropriation that may stem from holding assets with a registered investment adviser.[7] The SEC's new proposed Safeguarding Rule identifies the risks that may stem from holding assets on an exchange that requires pre-funding;[8] however, smart contract protocols do not expose their users to these risks because they are self-custodial. Users can choose from a diverse array of custodial technologies and custodians which allows them to choose what they believe to be the best option for themselves and their specific situations.[9]

Finally, self-custody allows individuals to participate in the market without having to use a financial institution. In the banking context, 34% of unbanked Americans say they don't have an account in part because avoiding a bank gives more privacy; 33% say they don't trust banks; and,

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[5] This contrasts with the lengthy and often high-friction process of moving funds from one traditional financial institution to another, which often involves the incumbent financial institution trying to keep customer funds in its custody.

[6] Exec. Order No. 14,036, 86 FR 36987 (Jul. 14, 2021) ("The American promise of a broad and sustained prosperity depends on an open and competitive economy… for consumers, it means more choices, better service, and lower prices. Robust competition is critical to preserving America's role as the world's leading economy.").

[7] *See, e.g.,* Custody of Funds or Securities of Clients by Investment Advisers, 75 Fed. Reg. 1455 (Jan. 1, 2010) at 1457 (stating that the rule was "designed to prevent (client) assets from being lost, misused, misappropriated or subject to advisers' financial reverses").

[8] *See* Safeguarding Advisory Client Assets, 88 Fed. Reg. 14672 (Mar. 9, 2023) at 14689 (discussing how moving funds to a cryptoasset exchange platform that requires pre-funding would generally violate the rule as proposed).

[9] Again, an investor's "situation" naturally includes the applicability of any regulations such as the SEC's Custody Rule or proposed Safeguarding Rule.

27% say the fees are too unpredictable;.[10] While these responses were provided in the context of reasons for not having a bank account, they are likely also reasons for why Americans are unable or unwilling to invest in American markets. Self-custody, which can protect privacy, doesn't require trusting a financial institution, and comes with no fees, may help increase access to U.S. markets.

The SEC's proposal would eliminate the benefits of self-custody for on-chain exchanges.

By consequently requiring an on-chain protocol to register as a broker-dealer, the SEC's proposal would eliminate these benefits by requiring on-chain protocols to take "possession or control" of users' cryptoasset securities. This would be a negative outcome for U.S. financial markets and users. Even if this is not the SEC's intention, the incompatibility indicates that the SEC should conduct a more comprehensive evaluation of how DeFi protocols would fit into U.S. securities laws and explain this to the public. Additionally, the SEC should coordinate with FINRA to promulgate new rules that resolve ambiguity prior to, or at least simultaneous with, bringing on-chain protocols into the definition of "exchange" for the purposes of the Exchange Act.

B. The SEC has not explained what entity would be required to register an on-chain exchange as an ATS or provided a pathway to register.

The Commission explains that it expects New Rule 3b-16(a) Systems to register as a broker-dealer and comply with the conditions of Regulation ATS,[11] but it provides little detail about how it expects decentralized protocols to register or what specific entity involved in the operation of a decentralized exchange should register. When it does discuss pathways for registration and compliance, the discussions need additional detail for the regulations to be feasible. The SEC has not fully explained how a protocol could feasibly register in, for example, situations in which different functions of an exchange are provided by unrelated parties which have no ability to influence each other or otherwise coordinate; or situations in which a protocol is controlled via token-based governance and no single entity has control of the protocol.

Situations in which different functions of an exchange are provided by unrelated parties which have no ability to influence each other or otherwise coordinate.

[10] *FDIC National Survey of Unbanked and Underbanked Households | Executive Summary* (Federal Deposit Insurance Corporation, 2021), https://www.fdic.gov/analysis/household-survey/2021execsum.pdf at 7.

[11] Reopening Proposal at 62.

When it comes to decentralized exchange protocols,[12] the SEC should provide clarity about which group of persons it will hold responsible for compliance with the regulations governing national securities exchanges or Regulation ATS. While the SEC briefly discusses compliance options, the discussion is surface-level and incomplete. For example, the SEC suggests that an unincorporated group of persons could designate a member of the group to register and collectively ensure that member's fulfillment of the group's regulatory responsibilities, but persons providing services on a public blockchain may be *unable to coordinate* because of the permissionless nature of the system.

Consider a trade taking place on an automated market maker (AMM) operating on Ethereum. One developer wrote and then released the smart contract code as open source; it was forked by another company and deployed to Ethereum; two other companies developed user interfaces through which users can trade their cryptoasset securities; individuals submit orders by signing a message with their private key; and the message is broadcast by a third-party Ethereum node operator and validated by one of the approximately 600,000 potential transaction validators supporting Ethereum as of May 23rd, 2023.[13] It seems that the Commission intends to capture all of the aforementioned parties and consider them to be a group of persons operating an exchange.[14] However, it's not clear how all persons in the group could coordinate to comply with SEC regulations. Even if a constituent of the group *wanted* the entire group to comply, it would not be able to communicate with or exercise any control over certain other constituents, such as the approximately 600,000 potential transaction validators. If the SEC has fully considered situations such as this, it should clarify what specific entity it envisions will register. If it has not fully considered this common situation, it should not finalize the rule as proposed and instead solicit additional feedback and conduct additional research to evaluate this difficult policy and legal question.

As proposed, enforcement of the new definition would lead to uneven and unfair outcomes that penalize the *most* visible, the *most* onshore, and the *most* legitimate actors who wish to operate in the United States and that have identifiable leadership and a public presence in the market. If

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[12] While it's true that some entities exaggerate claims of decentralization, there are many examples of on-chain protocols and services that *are* truly decentralized. It is then essential for the Commission to consider cases in which protocols are decentralized (and many protocols are moving towards true decentralization as they mature). The Commission must consider these hard questions and make its views on the matter known to the public even if the Commission's enforcement of the Exchange Act would likely focus on more centralized entities. Circle encourages the Commission to consider and solicit comments on an exemption for "decentralized" protocols.

[13] Ethereum Staking, @hildobby, https://dune.com/hildobby/eth2-staking (last accessed May 30, 2023).

[14] Because services may be provided by a group of *unrelated* persons, previous commenters have voiced concerns about the universe of disparate parties that may be captured by the SEC's expansive proposal, which Circle echoes. Imposing onerous regulatory requirements on persons that provide general-purpose services to public blockchain networks, such as the validation of transactions, would be inappropriate, unfeasible, and counterproductive. Instead, the SEC's regulation should be tailored to the strict functions of an exchange in the context of the new paradigm of public blockchain-based financial services, where functions can be disaggregated.

only some members of a group of persons are identifiable and easily accessible, it's likely that those members will be held responsible for the compliance of the entire group, whether possible or not. Industry participants have already expressed concern that engaging with the Commission can lead to scrutiny and legal challenges, which this proposal risks exacerbating. If this is not the SEC's intention or considered anticipation, then the Commission should provide additional policy guidance and work with Congress to ensure the statutes reflect the basis for significantly expanding requirements on constituent parts such as network validators.

Situations in which a protocol is controlled via token-based governance and no single entity has control of the protocol.

The challenge of enforcing the SEC's proposal is also evident in the context of token-based governance. While some projects today may be effectively controlled by a single entity that holds majority voting power over a token-based voting system, many protocols are decentralized in that no single person or no identifiable and coordinated group of persons consistently exercises control over every governance decision. While it's true, as the SEC says, that all analyses require some consideration of "facts and circumstances," this is not a sufficient level of clarity for market participants about what the Commission considers decentralized, or even if the Commission considers that relevant, making it difficult if not impossible for governance token holders to understand their regulatory obligations.[15] The SEC should explain in more detail how it will determine that any particular person "shares" control of an exchange or a function of an exchange. It should define the threshold of governance power above which the SEC will consider a person to be exercising control. Finally, it should clarify that persons below the threshold would not be held responsible for obligations of the person or group of persons operating an exchange under the Exchange Act, similar to other, common small entity exemptions.

C. The SEC has not explained what it would do in situations in which the protocol is immutable.

Finally, the SEC has not explained how a market participant could comply with regulatory obligations if a protocol is totally immutable. On permissionless, public blockchains, users can interact with decentralized smart contracts even if the original smart contract developers don't have control and/or, for example, published a new version of that smart contract in which they do have control. Immutable AMMs exist and are used daily; for example, one AMM protocol that cannot be changed or removed from the blockchain still sees billions of dollars of trading volume per week.[16] Even if a party were assigned responsibility for the protocol under the law because,

[15] For example, even though a single user may control just a small portion of total voting power, what if they vote for a proposal that is passed? What if the other voting entities that hold larger portions of voting power are not identifiable? Will the SEC simply "move down the list" until they find an identifiable entity, which may be a single user?

[16] Uniswap V2, Defi Llama, https://defillama.com/protocol/uniswap-v2?volume=true&groupBy=weekly (last accessed May 30, 2023). The Uniswap V2 core contracts are immutable.

for example, the party wrote the code behind it, it could be impossible for that party to make changes to the protocol or restrict its use in any way. The SEC should clarify whether it would hold any party responsible for a protocol that they are unable to control.

D. These ambiguities in the proposal are the outcome of the SEC attempting to fit a wholly new technology into a decades-old regulatory apparatus.

The disintermediation and disaggregation of financial services is a benefit for investors and U.S. markets.

Public blockchains allow for the disaggregation of financial services. This new paradigm has significant benefits for investors and U.S. markets. First, blockchains enable competition at every level of the financial services stack because users can move their assets between services at will.[17] This advantages consumers by providing greater choice across a variety of service providers. Second, users' ability to choose from different service providers rather than being locked into closed ecosystems tends to reduce vertical integrations and spread responsibilities across many entities, decreasing systemic risk. Third, disaggregation of services minimizes conflicts of interest, which is aligned with the SEC's own rules and principles, and the market structure of the securities market.[18]

The disaggregation of financial services is a genuinely new technological phenomenon.

Ambiguities in the application of the SEC's proposed rule to on-chain cryptoasset exchanges stem from the fundamental novelty of public blockchain-based financial services. In parts of the proposal, the SEC appears to recognize the novelty of public blockchains and their incompatibility with legacy regulatory structures. For example, the Commission proposes to amend the term "uses" to "makes available" in order to "make clear that, in the event that a party other than the organization, association, or group of persons performs a function of the exchange, the function performed by that party would still be captured for purposes of determining the scope of the exchange under Exchange Act Rule 3b-16."[19] This statement highlights the Commission's awareness that blockchain-based financial services can be decentralized, i.e., provided by a group of unrelated persons, even though exchanges have traditionally been centralized. However, other parts of the Commission's proposal do not appear to recognize this novelty.

[17] *See* discussion *supra* Part II.A.
[18] For example, SEC regulations separate the market functions of clearing agent, exchange, broker-dealer, and custodian across different entities.
[19] Reopening Proposal at 37.

While the SEC says it has previously considered situations in which different entities provide functions of an exchange,[20] the example discussed in the proposal imagines different business units of a single brokerage providing functions of an exchange. Such an arrangement would still take place within a single regulated entity sharing beneficial ownership. Additionally, the SEC says it has considered the provision of exchange services by unrelated entities,[21] but Regulation ATS only considers situations in which the provision of services is still explicitly coordinated. For example, Regulation ATS outlines a scenario where, if an organization arranges for separate entities to provide different pieces of a trading system, then the organization responsible for arranging the collective efforts will be deemed to have established a trading facility.[22] However, this is still a situation involving coordination between the parties; indeed, the person the SEC would hold responsible is directing the other entities through service provider relationships and contracts. This proposal does not consider a situation in which the provision of functions of an exchange is carried out by *unrelated* parties that *do not coordinate*.

Instead of attempting to use old rules developed in 1998 to regulate fundamentally new technologies, the SEC should conduct a wholesale assessment of what is new about public blockchain-based finance and what is the same. It should then work with Congress to come up with new rules for the regulation of the exchange of cryptoasset securities. This would be in line with the precedent set and the approach taken in 1996, when Congress provided the Commission with greater flexibility to regulate new trading systems and the Commission subsequently promulgated Regulation ATS. At that time, in the adopting release, the Commission affirmed, "the current regulatory framework, however, designed more than six decades ago, did not envision many of these trading and business functions."[23] Because of this, the Commission, after consultation with (and the receipt of legislative authority from) Congress, implemented a new regulatory framework for alternative trading systems which benefited U.S. securities markets and U.S. investors. These parties would benefit from the Commission doing this again.

III. The Commission's economic analysis is incomplete

The Commission's proposed amendments to the definition of "exchange" would have widespread effects on affected entities, the broader ecosystem of blockchain-based financial services protocols that are related to any affected entities, the investors and market participants which use the affected entities' services, and other stakeholders such as Circle. Circle is concerned that the Commission has not fully considered the economic effects of its considerable proposal. As a policy matter, it is vitally important that the Commission conduct a robust analysis of the economic and policy effects of its proposal; as a legal matter, it is required to do so.

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[20] Release No. 34-94062, 87 Fed. Reg. 15496 (Mar. 18, 2022) at 15506 n. 108.
[21] *Id.*
[22] Regulation of Exchanges and Alternative Trading Systems, 64 Fed. Reg. 70844 (Dec. 22, 1998) ("Regulation ATS") at 70852.
[23] *Id.,* at 70845.

A. The Commission does not provide a baseline estimate despite publicly available data, methods, and research.

The Commission is unable to fully assess the economic impact of the rule because, in part, it declines to provide baseline estimates for the market it implicates. The Commission claims "it is impossible to determine the true market turnover for crypto assets because, among other reasons, the crypto asset market reportedly is characterized by rampant wash trading."[24] It also claims to lack information for a variety of other important metrics, such as the number of legitimate exchanges or the trading volume occurring on legitimate exchanges.[25]

When it comes to trading on centralized platforms, the Commission's response is insufficient relative to the seriousness of its proposal. While wash trading can muddy a measurement of legitimate trading volume, it is simply one variable that must be controlled, just as they exist in any other economic analysis. Researchers have developed methods to detect and assess the magnitude of wash trading. Indeed, the Commission cites one such analysis itself.[26] Likewise, fund administrator Bitwise Asset Management (Bitwise) presented the Commission's Division of Trading and Markets with a rigorous analysis of legitimate trading volume four years ago.[27] Bitwise, using similar methods to Cong et al. (2022), explained its methodology in detail and concluded that the daily spot BTC volume was $270 million at that time.[28] The Commission also has access to publicly available market data from some of the largest cryptocurrency exchanges in the world,[29] but even without using these free and public resources, the Commission could, at the very least, replicate Bitwise's analysis to establish a baseline estimate of the trading volume on centralized exchanges. The mere existence of confounding variables does not diminish the importance of conducting a rigorous economic analysis.

The SEC's justification is even harder to justify when considering the on-chain exchange market, in which all activity is conducted entirely on public blockchains. By definition, trading data from public blockchain exchanges are readable by anyone in the world. Additionally, just like for centralized exchanges, researchers have developed methods for identifying and controlling for

[24] Reopening Proposal at 79.
[25] Reopening Proposal at 79-84.
[26] Reopening Proposal at 79 n. 207 citing Cong et al. (2022).
[27] *See* Lauren Yates, Memo: Meeting with Bitwise Asset Management, Inc., NYSE Arca, Inc., and Vedder Price P.C. (Mar. 20, 2019), https://www.sec.gov/comments/sr-nysearca-2019-01/srnysearca201901-5164833-183434.pdf (last accessed May 30, 2023).
[28] *Id.*, at 62.
[29] For example, Coinbase publishes live market data through an API available at https://docs.cloud.coinbase.com/exchange/docs/websocket-overview, and Gemini publishes live market data through an API available at https://docs.gemini.com/rest-api/.

wash trade data.[30] Because all data are public — *forever* — it is actually much easier to identify wash trading on public blockchains because it is evident when wallets are associated with each other.

Instead of isolating wash trading volume using these straightforward methodologies, the SEC demurs: "the Commission preliminarily believes that a direct analysis of blockchain data would be unable to reliably determine how many crypto assets are actually moving between different entities." First, given it is proposing a *final* rule, the Commission should establish a firm view about its economic analyses. Second, public blockchains provide complete information about the movement of cryptoassets.[31] Therefore, as Chainalysis shows, it is actually uniquely possible, "based on a direct analysis of blockchain data," to determine whether cryptoassets "are actually moving between different entities."

Commercial data providers have figured out how to obtain and produce reliable market data for both centralized and on-chain services. Market participants use these data to inform capital allocation decisions amounting to billions of dollars.[32] For centralized exchanges, market participants use data from Amberdata, Coinalyze, Crypto Data Download, Kaiko, and other data providers. For on-chain services, market participants including Circle use consolidated data from Coinmarketcap, CoinGecko, Google BigQuery, Coin Metrics, Glassnode, Defi Llama, and others, and they also source data directly from self-hosted blockchain nodes. Blockchain data are abundant and reliable, and the SEC should, as a normative matter, and must, as a legal matter, fully understand and publish the analysis of the market it seeks to regulate prior to deciding to change it wholesale.

B. The Commission's definition of a "New Rule 13b-16(a) System" is nebulous, which prevents the public and market participants from being able to fully evaluate the effect of the rule.

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[30] *See, e.g., Crime and NFTs: Chainalysis Detects Significant Wash Trading and Some NFT Money Laundering In this Emerging Asset Class*, Chainalysis (Feb. 2, 2022), https://blog.chainalysis.com/reports/2022-crypto-crime-report-preview-nft-wash-trading-money-laundering/ (explaining how the public can identify wallets that trade between each other in a closed loop, which indicates wash trading). Additionally, other firms publish live dashboards isolating wash trading activity for certain on-chain marketplaces. *See, e.g.,* Ethereum NFTs Wash Trading, @hildobby, https://dune.com/hildobby/nfts-wash-trading (published by a researcher for crypto venture capital firm Dragonfly). The code for these dashboards is publicly available and freely replicable, which means the Commission's economists can easily make adjustments to the investigations as they see fit.

[31] The SEC also says that it cannot obtain reliable data because the affected entities are not registered with the Commission or any SRO. Proposal at 78. However, this is a non sequitur because if on-chain exchanges were regulated, they would report the same blockchain data that is publicly available today.

[32] For example, A16z, a venture capital fund that has raised over $5b for cryptocurrency investments, established an estimate of on-chain exchange volume of $100b per month. The fund used Defi Llama data to make this conclusion. State of Crypto 2023, Andresessen Horowitz, https://api.a16zcrypto.com/wp-content/uploads/2023/04/State-of-Crypto.pdf (last accessed May 30, 2023) at 48.

The Commission estimates the number of affected entities as 35-46 entities, but its estimation is based on the unsubstantiated contention that "it is unlikely that systems trading a large number of different crypto assets are not trading any crypto assets that are securities."[33] Practically, though, the SEC has thus far declined to provide clear and consistent guidance about what specific cryptoassets are securities.[34] Therefore, it's impossible for market participants or the public to know for certain whether the proposal would affect specific entities; as a result, market participants can't know whether this rule affects them, and the public cannot assess the full economic effect of the rule.

C. *Even without a clear definition of affected market participants, the Commission likely underestimates the number of parties affected by the rule as well as the effect of the rule on small entities.*

If the Commission is trying to capture any service that facilitates the trading of any large number of cryptoassets in this rule, then the Commission appears to have significantly underestimated the number of entities affected by the rule. While the Commission estimates that 35-46 entities would be affected, crypto data aggregator Defi Llama identifies 801 exchange protocols as of May 19, 2023.[35] Even if some protocols are inactive or don't serve U.S. users, the quantity of affected entities likely exceeds 46 by a significant margin.

The Commission also likely underestimates the effect of the proposal on small entities. It certifies that "the proposed amendments would not, if adopted, have a significant economic impact on a substantial number of small entities."[36] While this may be true given the definition of "small entity" for the purposes of the Exchange Act as codified at 17 CFR 240.0-10(e), based on its plain meaning, this is unlikely to be true.[37] Of the 801 exchanges listed by Defi Llama, many are startups with small amounts of recorded activity. As an example, 715 exchanges have less than $10 million in "Total Value Locked," a measurement akin to "assets under management." There is no doubt that registration with the SEC or compliance with Regulation ATS would have a significant economic impact on these entities, which will have to hire lawyers, reconfigure

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[33] Reopening Proposal at 10-11.
[34] *See, e.g.,* U.S. House Committee on Financial Services, *Oversight of the Securities and Exchange Commission*, Apr. 18, 2023, https://www.youtube.com/watch?v=A44LPXZ33_E, at 25:25, in which SEC Chair Gensler declined to answer whether ether is a security.
[35] Dexes TVL Rankings, Defi Llama, https://defillama.com/protocols/Dexes (last accessed May 19, 2023).
[36] Reopening Proposal at 65 n. 178.
[37] The definition of "small entity" under the Securities Exchange Act is, in part, whether the exchange "has been exempted from the reporting requirements of § 242.601 of this chapter." 17 CFR 240.0-10(e)(1). However, for this proposal specifically, the definition is circular because the SEC is proposing to incorporate *new* entities into the definition of "exchange." The Commission cannot have exempted entities from their reporting obligations as exchanges if the entities are not yet exchanges in the first place. As such, in this case, the Commission should look to the plain meaning of the term "small entity" in determining whether it has additional obligations under the Administrative Procedure Act and Regulatory Flexibility Act. When it does so, it's apparent that this rule would have a significant economic impact on a substantial number of small entities under any reasonable definition of the term.

operations, and make changes to their user base if the rule is finalized as proposed. The SEC should acknowledge the effect of its proposal on startups and small businesses and prepare a regulatory flexibility analysis pursuant to the requirements of the Regulatory Flexibility Act.

IV. The SEC should not redefine the definition of "exchange" as proposed. But if it does proceed in doing so, it should eliminate ambiguities that might hinder U.S. markets and economic competitiveness.

A. The SEC should explicitly permit national securities exchanges and ATSs to offer pairs trading

The Commission acknowledges the existence of cryptoasset trading pairs, including the revealed market preference for trading pairs on existing cryptoasset exchanges.[38] Later, though, it implies the practice would need to be halted if an exchange registers as a national securities exchange or complies with Regulation ATS.[39] While Circle agrees with the Commission's empirical observation that, so far, "national securities exchanges and ATSs trade only securities quoted in and paid for in U.S. dollars,"[40] it is not aware of any regulation that would require the practice of offering trading pairs to be halted. For example, securities exchanges, designated contract markets, and others may list, trade, or clear securities-based mixed swaps under the joint regulatory structure described at 17 CFR 240.3a68-4. The Commission's statements may cause confusion on behalf of exchanges about their regulatory obligations, and it should endeavor to resolve any confusion.

The SEC should clarify that nothing precludes national securities exchanges and ATSs from listing securities quoted in and paid for in payment stablecoins.

As the Commission says in its proposal, most securities exchanges settle securities trades against U.S. dollars. More precisely, when retail investors pay for a security with "U.S. dollars," as the term is used in the Reopening Proposal, they are paying for the security with a form of private money, usually a dollar-denominated corporate liability of the investor's broker-dealer. Payment stablecoins are likewise a form of private, dollar-denominated money that is a corporate liability of the issuer and are designed for payments. The only difference is the payment rail over which the liability moves; for traditional broker-dealer liabilities, the dollar liabilities move on bank-intermediated payment rails such as Fedwire, and for payment stablecoins, the dollar liabilities move on public blockchains.

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[38] Reopening Proposal at 12-13 and Reopening Proposal at 13 n. 41 (discussing Makarov and Schoar's finding that "most global bitcoin trading is conducted with stablecoins rather than fiat currency").
[39] Reopening Proposal at 121 (under the heading "Costs Associated with Discontinuation of Non-Security-for-Security Pairs Trading").
[40] Reopening Proposal at 14.

Therefore, cryptoasset trades quoted in and paid for in payment stablecoins are also "quoted in and paid for in U.S. dollars." Even so, market participants may be confused, so the SEC should clarify its statement and state that cryptoasset security trades quoted in and paid for in a payment stablecoin would be permissible.

The SEC should clarify that the trading of securities quoted in and paid for with a commodity would be a "security-based swap" under the Exchange Act.

The Commission's contention that its proposal would require the cessation of pairs trading may introduce market confusion about how the Commission would view the quoting in and payment for cryptoasset securities in a commodity such as bitcoin. However, the Exchange Act defines "security-based swap" as including "any agreement, contract, or transaction that is as described in subparagraph (A) and also is based on… commodities…"[41] This describes a pairs trade involving a security and a commodity such as a purchase of a cryptoasset security paid for in bitcoin.

While most centralized exchanges offer cryptoasset trading quoted in a dollar-denominated corporate liability of the exchange, data from Kaiko show that about 70% of trading volume on major centralized trading systems is quoted in cryptoassets.[42] This shows that market participants prefer to settle trades against cryptoassets because they are *more functional* than their non-blockchain equivalents. Cryptoasset payments can be near-instantaneous, cheaper than wire transfers, and programmable through smart contracts. Additionally, atomic settlement on public blockchains significantly reduces settlement risk, as Circle has explained in a comment on a separate SEC proposal.[43] In the context of securities trades, payment for cryptoasset securities in other cryptoassets would allow for much faster settlement than the existing practice of T+1 which could reduce balance sheet constraints for broker-dealers, improve liquidity, and reduce systemic risk. Centralized exchanges will want to offer trading pairs that include non-security cryptoassets if its customers demand the ability to quickly move positions from settled trades from the exchange back onto blockchain payment rails.

Additionally, even if the Commission produces a workable pathway for on-chain, smart contract-based exchanges to operate as ATSs, these exchanges would still need to offer trading quoted and settled in cryptoassets (including cryptoassets that are not securities) because they operate completely on a public blockchain.[44]

Therefore, when finalizing the rule, the Commission should clarify that nothing prevents a national securities exchange or ATS from quoting or facilitating the settlement of trades in a non-security

[41] 15 USC § 78c(a)(68)(d).
[42] Circle internal analysis of Kaiko data.
[43] *Letter Re: File Number S7-04-23 (Proposed Rule on Safeguarding Advisory Client Assets*, Circle Internet Financial, LLC (May 8, 2023), https://www.sec.gov/comments/s7-04-23/s70423-187959-342983.pdf at 8-9.
[44] This is another situation in which the immutability of a smart contract is a relevant and unresolved consideration for the SEC's proposal. For more discussion, *see supra* Part II.B.

asset, provided the venue meets all regulatory requirements as described in 17 CFR 240.3a68-4. It should also commit to the quick and efficient processing of requests for interpretation of mixed swaps and joint orders for the regulation of the same.[45] To date, national securities exchanges and ATSs have *not needed* to offer trading pairs because they have not offered extensive trading in cryptoasset securities, and they have not executed cryptoasset trades on public blockchains.[46] To ensure the smooth functioning of U.S. markets, the SEC should clarify its statements in the Reopening Proposal and prepare to efficiently process any additional requests for clarity.

Once again, the need to offer pairs trading is another example of how blockchain-based finance is fundamentally different from traditional asset exchange. Circle reiterates that the SEC should not finalize its rule as proposed and instead work with Congress to develop laws and regulations appropriate to this novel technology. However, if it does finalize the rule, it should do so in a way that does not impede investor protections and preferences.

B. The SEC should explicitly exclude independent software developers from "a group of persons" that may be running an exchange

While the inclusion of an individual in a "group of persons" requires an analysis of the totality of facts and circumstances and the activities of each individual, the Commission describes two important factors when considering if an individual is part of a "group of persons:" 1) whether the individual acts in concert in the functioning of an exchange and 2) whether it exercises control over aspects of an exchange.[47]

The Commission helpfully covers a hypothetical situation in which "a software developer who, acting independently and separately from an organization, publishes or republishes code without any agreement (formal or informal) with any person for that code to be used for a function of a market place or facilities for bringing together buyers and sellers of securities," but the Commission stops short of providing the clarity developers need, concluding only that the developer "may be less likely" to be acting in concert in the functioning of an exchange.[48]

In the situation described, where the facts and circumstances clearly establish an absence of coordination between the independent software developer and anyone else, it should be evident that the independent software developer is not involved in the functioning of the exchange. Circle encourages the Commission to make this explicit and clarify in the final rule that it would not consider a developer in this situation to be part of a "group of persons" operating an

[45] 17 CFR 240.3a68-2 outlines the process by which any person may submit a request to the Commission and the Commodity Futures Trading Commission to provide a joint interpretation of whether a particular agreement, contract, or transaction (or class thereof) is a swap, a security-based swap, or a mixed swap.
[46] Some ATSs offer trading in cryptoasset securities, but there is minimal trade volume. Circle is not aware of any ATSs that settle cryptoasset securities on a public blockchain.
[47] Reopening Proposal at 23.
[48] Reopening Proposal at 28.

exchange. Such an exclusion would promote U.S. innovation and economic competitiveness by enabling free and open software development, and it will not denigrate the Commission's policy objectives to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.

V. Conclusion

Circle appreciates the SEC's work to begin examining the regulation of cryptoasset securities exchanges, especially on-chain exchanges. Public blockchains are genuinely new technology that provides many benefits for investors and also carries novel risks. Circle believes regulation of the crypto industry, including regulation of on-chain exchanges, is appropriate and needed, and it will continue to engage with the Commission. However, it does not think the SEC's rule as proposed would better protect investors, better facilitate capital formation, or better contribute to fair, orderly, and efficient U.S. markets — the SEC's statutory mandate.

Instead, Circle believes the SEC should work with Congress, just like it did when developing Regulation ATS, to realistically consider what is new about financial services provided via public blockchains. It should then establish a regulatory framework based on those realities. Only with this full consideration of costs, benefits, and consequences can Congress and U.S. regulators jointly develop sensible regulations that promote American capital markets, investor protection, and American competitiveness. As always, Circle is ready and willing to engage on any proposal.