

## **CRYPTOASSET TRADING PLATFORMS CANNOT REGISTER AS SECURITIES EXCHANGES**

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In early 2021, Chair Gensler of the U.S. Securities & Exchange Commission (the “SEC”) acknowledged that cryptoasset trading platforms are not subject to the existing regulatory regime for securities exchanges. For example, in May 2021 Congressional testimony, SEC Chair Gary Gensler stated: “[T]he exchanges trading in these cryptoassets do not have a regulatory framework either at the SEC, or our sister agency, the Commodity Futures Trading Commission [ . . . ] Right now, there is not a market regulator around these crypto exchanges.”<sup>1</sup> Subsequent to these statements, neither the SEC nor any other federal U.S. regulator has attempted to create a regulatory framework that is suitable for cryptoasset trading platforms. Nonetheless, the SEC and Chair Gensler have since changed their stance and now insist that cryptoasset trading platforms can and should register as securities exchanges. For example, in April 2023, Chair Gensler called on the operators of cryptoasset trading platforms to “come in and register” the platforms as securities exchanges.<sup>2</sup>

In this statement, the Committee on Capital Markets Regulation (the “Committee”) explains why the SEC’s own policies in fact make it impossible for cryptoasset trading platforms to do what the SEC now insists that they do – that is, registering and operating in compliance with the regulatory framework for securities exchanges. These reasons fall into two categories. First, registered securities exchanges can only trade securities, but SEC rules and guidance largely prevent cryptoassets from being registered as securities. As a result, there are virtually no cryptoassets that a cryptoasset trading platform registered as a securities exchange could list and trade. Second, even if there were cryptoassets registered as securities, existing SEC rules and guidance make it impossible for cryptoasset trading platforms to register and comply with the requirements applicable to securities exchanges. Sections I and II discuss each of these issues in greater detail.

We note that the House Committee on Financial Services and House Committee on Agriculture released a joint discussion draft bill on June 2<sup>nd</sup>, the *Digital Asset Market Structure Discussion Draft*, that would address many of the concerns raised in this statement, if enacted into law.<sup>3</sup> First, the bill would require the SEC to tailor its disclosure requirements to the issuance of cryptoassets that are securities. Second, it would require the SEC and CFTC to adopt processes for cryptoasset trading platforms to register. Registered cryptoasset trading platforms would be required to adopt customer protections consistent with the trading of other financial assets, including with respect to

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<sup>1</sup> *Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide*, Part III, Virtual Hearing Before the Committee on Financial Services, U.S. House of Representatives 12 (May 6, 2021), <https://www.govinfo.gov/content/pkg/CHRG-117hhrg44837/pdf/CHRG-117hhrg44837.pdf>.

<sup>2</sup> *SEC’s Gensler: The “Runway is Getting Shorter” for Non-Compliant Crypto Firms*, YAHOO FINANCE (Dec. 7, 2022), [https://news.yahoo.com/sec-gensler-runway-getting-shorter-161605453.html?\\_sm\\_au=iHV0VFWZRRZMVWgrFcVTvKQkcK8MG](https://news.yahoo.com/sec-gensler-runway-getting-shorter-161605453.html?_sm_au=iHV0VFWZRRZMVWgrFcVTvKQkcK8MG).

<sup>3</sup> *Digital Asset Market Structure Discussion Draft*, House Committee on Financial Services & House Committee on Agriculture (June 2, 2023), <https://docs.house.gov/meetings/AG/AG00/20230606/116051/HHRG-118-AG00-20230606-SD002.pdf>

the custody of cryptoassets. Registered cryptoasset trading platforms could also trade cryptoassets that are securities as well as cryptoassets that are commodities.

## **I. SEC Policies Prevent Cryptoasset Trading Platforms from Listing Cryptoassets Registered as Securities.**

Part I identifies three significant reasons why a cryptoasset trading platform that attempts to register as a securities exchange would have no cryptoassets to list and trade. First, virtually no cryptoassets are registered as securities. Second, cryptoassets generally cannot register as securities, because the way they are issued and function cannot comply with the existing disclosure requirements applicable to registered securities. Third, even if a cryptoasset could be registered as a security then it would become largely useless to market participants and likely lose much of its value, because securities regulations are presently incompatible with the actual uses of cryptoassets. For example, securities laws would prevent ether or another fungible crypto token from being used by individuals for payments.

### **1. There are virtually no cryptoassets for a cryptoasset trading platform registered as a securities exchange to trade.**

A registered securities exchange can only list and trade securities that are registered with the SEC.<sup>4</sup> An exchange operator is thus reliant on issuers completing the registration process for the exchange to have anything to list and trade.

Although Chair Gensler contends that the “vast majority”<sup>5</sup> of cryptoassets are securities, as of 2023, only nine cryptoassets out of the over 23,000<sup>6</sup> estimated to currently exist have been registered as securities with the SEC. Of these nine, three are out of existence, and one is no longer registered as a security.<sup>7</sup> Those five that remain registered account for virtually 0% of the approximately \$230 billion<sup>8</sup> in current daily global cryptoasset trading volume and 0% of the total \$1.2 trillion<sup>9</sup> global cryptoasset market capitalization. As a result, if a cryptoasset trading platform could actually register as a securities exchange today, then it would immediately be forced out of operation, because it would have nothing to list or trade.

### **2. The SEC has provided no framework for applying securities law requirements to cryptoassets.**

Registered securities must provide ongoing public disclosures about the issuer’s officers and board of directors, the issuer’s business activities, and the issuer’s audited financial statements. In addition, broker-dealers are prohibited from providing quotes for securities unless certain

<sup>4</sup> Securities & Exchange Act of 1934 [the “Exchange Act”], §§ 3(a)(1), 6(b)(1).

<sup>5</sup> SECURITIES & EXCHANGE COMMISSION [“SEC”], Chair Gary Gensler, *Kennedy and Crypto* (Sept. 8, 2022), <https://www.sec.gov/news/speech/gensler-sec-speaks-090822>.

<sup>6</sup> COINMARKETCAP All Cryptocurrencies, <https://coinmarketcap.com/all/views/all/> (last visited May 5, 2023).

<sup>7</sup> Brady Dale, *The Few Crypto Firms That Have Registered with the SEC* AXIOS (Mar. 6, 2023), <https://www.axios.com/2023/03/06/crypto-register-sec-securities-exchange-commission>.

<sup>8</sup> COINMARKETCAP, Top Cryptocurrency Spot Exchanges, <https://coinmarketcap.com/rankings/exchanges/> (last visited May 4, 2023).

<sup>9</sup> COINMARKETCAP, Total Cryptocurrency Market Cap, <https://coinmarketcap.com/charts/> (last visited May 4, 2023).

information about those securities and their issuers is both current and publicly available.<sup>10</sup> But cryptoassets, including those with the highest trading volume and largest market capitalization, such as bitcoin and ether, lack officers or a board of directors, business activities or audited financial assets. The SEC has provided no framework under which the existing requirements could be coherently applied to cryptoassets. It is typically unclear who the “issuer” is and how, for example, financial statement disclosures could possibly be made with respect to a cryptoasset.

It is also unclear whether typical avenues for registration would be available for cryptoassets. For instance, the registration requirements of Exchange Act Section 12(g) apply to issuers with a class of “equity securities” that exceed certain thresholds.<sup>11</sup> However, it is not clear whether a cryptoasset would satisfy the definition of “equity security” under the relevant provision of the Exchange Act, which defines the term to mean “any stock or similar security.”<sup>12</sup> It is therefore also uncertain whether other requirements for equity securities, such as the display, pricing, and reporting requirements of Regulation National Market System would apply to cryptoassets.

### 3. Classifying a cryptoasset as a security would likely mean that market participants would not want to own it.

Existing securities regulations are also incompatible with the fundamental uses of cryptoassets, such that if a cryptoasset were to be registered as a security then it would potentially be rendered functionally useless to its owner (other than as an investment). That is because cryptoassets typically have non-investment functions. For example, they may be intended as mediums for the purchase or sale of physical goods and services, or to facilitate blockchain-based functionalities such as smart contracts. Registering as a security effectively prevents these uses, because the holder of a cryptoasset classified as a security could not exchange it for a good or service or conduct a transaction on a blockchain network, unless it did so through a broker-dealer as only broker-dealers can purchase or sell securities.<sup>13</sup> SEC Commissioner Peirce highlighted these concerns in a recent speech, noting that if the SEC classifies a cryptoasset as a security, “secondary purchasers of the token often are left holding a bag of tokens that they cannot trade or use because the SEC requires special handling consistent with the securities laws.”<sup>14</sup>

<sup>10</sup> 17 C.F.R. 240.15c2-11.

<sup>11</sup> 15 U.S.C. § 78l(g)(1).

<sup>12</sup> 15 U.S.C. § 78c(a)(11).

<sup>13</sup> Note 10, *infra*.

<sup>14</sup> SEC, Commissioner Hester M. Peirce, *Outdated: Remarks Before the Digital Assets at Duke Conference* (Jan. 20, 2023), <https://www.sec.gov/news/speech/peirce-remarks-duke-conference-012023>; see also COINBASE INC., *Petition for Writ of Mandamus to the United States Securities and Exchange Commission* 11-12 (3d. Cir., April 24, 2023), [https://assets.ctfassets.net/c5bd0wqjc7v0/5PWsXaPsqQ61gA9wlFWKEX/d1d3a27d35687082565770589ef9a3ac/Coinbase\\_-\\_Mandamus\\_Petition\\_TO\\_FILE\\_.pdf](https://assets.ctfassets.net/c5bd0wqjc7v0/5PWsXaPsqQ61gA9wlFWKEX/d1d3a27d35687082565770589ef9a3ac/Coinbase_-_Mandamus_Petition_TO_FILE_.pdf). pgs. 11-12 (“If a digital asset itself is registered as a security, it will often be impossible for anyone to use it, defeating the point of registration.”).

## II. SEC Policies Prevent Cryptoasset Trading Platforms from Complying with the Requirements for Securities Exchanges.

Even if there were cryptoassets registered as securities, the SEC’s rules and policies would make it impossible for cryptoasset trading platforms to operate as securities exchanges for three reasons. First, only registered broker-dealers can trade on an exchange, but SEC rules have effectively prevented registered broker-dealers from handling cryptoassets. Second, cryptoasset trading platforms registered as securities exchanges could no longer provide custody services, but SEC guidance largely prevents the custody of cryptoassets by qualified custodians. Third, the SEC has failed to provide a way for a registered cryptoasset trading platform to comply with clearing rules.

### 1. SEC rules have effectively prevented registered broker-dealers from handling cryptoassets.

Cryptoasset trading platforms currently allow market participants to transact directly on the platform without the intermediation of a broker. Trading on securities exchanges is by contrast limited by law to registered broker-dealers.<sup>15</sup> Requiring a cryptoasset trading platform to register as a securities exchange would therefore mean that all trading activity on that platform must now be routed through a registered broker-dealer. However, SEC guidance significantly limits the ability of registered broker-dealers to handle cryptoasset transactions for their customers. SEC guidance currently provides that a broker-dealer trading in cryptoasset securities must limit its business activities solely to cryptoasset securities.<sup>16</sup> A registered broker-dealer therefore cannot handle cryptoasset securities on behalf of its customers unless it refrains from engaging in any other business activities (*e.g.*, transacting in stocks, bonds, and non-security cryptoassets). The broker-dealer could also be subject to unworkable capital requirements resulting from SEC guidance that requires public reporting companies to record a liability for custodied cryptoassets on their balance sheets.<sup>17</sup> And, as we explained in Part I, there are only five cryptoasset securities presently registered with the SEC, so a registered broker-dealer approved to handle cryptoasset securities would have virtually no assets to trade.

Because of these significant restrictions, Prometheus Ember Capital LLC (“Prometheus”) is the only broker-dealer registered as a special purpose broker-dealer for cryptoasset securities.<sup>18</sup>

<sup>15</sup> Exchange Act § 6(c).

<sup>16</sup> SEC, *Custody of Digital Asset Securities by Special Purpose Broker-Dealers* (April 27, 2021), <https://www.sec.gov/rules/policy/2020/34-90788.pdf>.

<sup>17</sup> COMMITTEE ON CAPITAL MARKETS REGULATION [“CCMR”], *Issues with Crypto Asset Custody and SEC Staff Accounting Bulletin No. 121* (Dec. 6, 2022), <https://capmktsreg.org/wp-content/uploads/2022/12/CCMR-Statement-SEC-Staff-Accounting-Bulletin-121-Issues-in-Crypto-Asset-Custody-12.06.22.pdf>.

<sup>18</sup> See BUSINESSWIRE, *Prometheus Ember Capital is the First SEC Qualified Custodian for Digital Assets Securities* (May 23, 2023), <https://www.businesswire.com/news/home/20230523005313/en/Prometheus-Ember-Capital-is-the-First-SEC-Qualified-Custodian-for-Digital-Assets-Securities>. See also FINRA, *BrokerCheck Report for Prometheus Ember Capital* (CRD#312784) (accessed May 31, 2023), [https://files.brokercheck.finra.org/firm/firm\\_312784.pdf](https://files.brokercheck.finra.org/firm/firm_312784.pdf).

However, Prometheus’s broker-dealer will not offer trading in cryptoassets that are not securities, such as Bitcoin, and does not yet appear to be operational, according to media reports.<sup>19</sup>

Therefore, even assuming it had anything to list, a cryptoasset trading platform would still be unable to operate as a securities exchange, because the SEC’s own rules would prevent virtually all registered broker-dealers from intermediating cryptoasset transactions, such that there would be no one that could legally trade on the platform.

## 2. SEC policies restrict the custody of cryptoassets.

Cryptoasset trading platforms commonly retain custody of customer assets. By contrast, securities exchanges cannot custody customer assets, because securities laws require that customer assets be held by a “qualified custodian” and securities exchanges do not meet the requirements to act as a qualified custodian. A cryptoasset trading platform that attempts to register as a securities exchange would therefore be required to relinquish custody of customer cryptoassets.

However, as the Committee has explained in prior statements, a combination of SEC and federal banking regulator guidance makes it effectively impossible for banks and broker-dealers – the principal providers of qualified custodial services in securities markets – to provide custodial services for cryptoassets.<sup>20</sup> If a cryptoasset trading platform were to register as a securities exchange then its cryptoassets would therefore potentially lack a qualified custodian or any custodian capable of satisfying applicable custody requirements, because of a lack of parties available to act as custodians.

## 3. SEC policies do not allow cryptoasset trading platforms to comply with securities exchange clearing requirements.

On securities exchanges, there is generally a two-day period between execution (when the buyer and seller agree to the trade) and settlement (when the agreed exchange occurs). To reduce the risk of default during this period, a third party known as a clearing agency assumes the obligations of buyer and seller and the responsibility for the settlement process. The rules for securities exchanges require that clearing agencies be registered with the SEC. The principal registered clearing agencies in U.S. securities markets are operated by the Depository Trust & Clearing Corporation.<sup>21</sup> Registered clearing agencies are required, among other things, to have membership standards and procedures for measuring market participants’ credit exposure to counterparties.<sup>22</sup>

By contrast, the blockchain technology that underlies cryptoassets allows cryptoasset trading platforms to settle transactions immediately after execution, removing the practical need for a clearing agency. Nonetheless, the definition of “clearing agency”<sup>23</sup> is so broad that a cryptoasset trading platform that attempts to register as a securities exchange could thereby become a “clearing agency” because it is now clearing securities (even though it is doing so instantaneously). The

<sup>19</sup> [https://financialadvisoriq.com/c/4083594/523694/crypto\\_startup\\_gets\\_license\\_support\\_bitcoin\\_reports](https://financialadvisoriq.com/c/4083594/523694/crypto_startup_gets_license_support_bitcoin_reports)

<sup>20</sup> CCMR, *supra* note 17.

<sup>21</sup> SEC, Clearing Agencies, <https://www.sec.gov/tm/clearing-agencies> (last visited May 5, 2023).

<sup>22</sup> 17 C.F.R. § 240.17Ad-22.

<sup>23</sup> Exchange Act § 3(a)(23).

platform would thus be required to register as a clearing agency and comply with the requirements for registered clearing agencies. But the SEC’s clearing rules do not contemplate cryptoasset transactions or the possibility of immediate settlement, so there is no framework for the coherent application of these rules to cryptoasset transactions.

In addition, cryptoasset securities listed on a securities exchange would be required to be “Depository Trust Company (DTC) eligible.”<sup>24</sup> However, cryptoassets generally have not been granted DTC eligibility.

## **Conclusion**

The SEC’s current policy regarding cryptoasset trading platforms places operators in an impossible position by requiring them to register as securities exchanges while depriving them of any possible means of registering and operating as such. On the other hand, other major jurisdictions, including Japan,<sup>25</sup> the EU,<sup>26</sup> the UK,<sup>27</sup> and Hong Kong,<sup>28</sup> have either enacted or taken major steps toward comprehensive cryptoasset regulatory regimes that make it possible for cryptoasset trading platforms to register and operate with legal certainty. The SEC’s policy makes it more likely that platform operators will prefer the relative certainty of these foreign regimes.

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<sup>24</sup> See NASDAQ STOCK MARKET, *Nasdaq Rule 5210(g)* (initially adopted March 12, 2009), <https://listingcenter.nasdaq.com/rulebook/nasdaq/rules/Nasdaq%205200%20Series> (requiring a newly listed security to have “a CUSIP number or foreign equivalent identifying the securities included in the file of eligible issues maintained by a Securities Depository.”)

<sup>25</sup> FINANCIAL SERVICES AGENCY JAPAN, *Regulating the Crypto Asset Landscape in Japan*, <https://www.fsa.go.jp/inter/etc/20221207/01.pdf>.

<sup>26</sup> EUROPEAN PARLIAMENT, *Digital Finance: Markets in Crypto-assets (MiCA)*, [https://oeil.secure.europarl.europa.eu/oeil/popups/ficheprocedure.do?reference=2020/0265\(COD\)&l=en](https://oeil.secure.europarl.europa.eu/oeil/popups/ficheprocedure.do?reference=2020/0265(COD)&l=en).

<sup>27</sup> HM TREASURY, *Future Financial Services Regulatory Regime for Cryptoassets* (Feb. 2023) <https://www.gov.uk/government/consultations/future-financial-services-regulatory-regime-for-cryptoassets>.

<sup>28</sup> HONG KONG MONETARY AUTHORITY, *Conclusion of Discussion Paper on Crypto-assets and Stablecoins* (Jan. 2023), <https://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2023/20230131e9a1.pdf>.