

May 27, 2022

BY ELECTRONIC SUBMISSION

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

Re: File No. S7-12-22; RIN 3235–AN10; Further Definition of “As a Part of a Regular Business” in the Definition of Dealer and Government Securities Dealer

Dear Ms. Countryman:

Andreessen Horowitz (“a16z”) appreciates the opportunity to comment on the Securities and Exchange Commission’s (“Commission”) proposal¹ to expand the definition of “dealer” by further defining what it means to buy and sell securities “as a part of a regular business” under the Securities Exchange Act of 1934 (“Exchange Act”).² We are particularly focused on the potential negative impact that this Proposal may have on the web3 ecosystem and the decentralized finance (“DeFi”) systems upon which web3 is being built.³

In a previous comment letter, a16z explained our concerns about another recent Commission proposal to expand the definition of “exchange” under the Exchange Act and amend Regulation ATS.⁴ We identified three main issues with the Commission’s proposed rule: First, despite its broad scope, it omitted any reference to digital assets or the systems and protocols through which market participants trade them, and as a result stakeholders were left to guess at whether the Commission intended to cover those assets or systems. Second, the proposal risked imposing on those systems regulatory requirements that would be unworkable or impossible to implement in practice. And third, because the Commission did not seem to account for the proposed rule’s effect on those systems—or weigh its potential economic implications for the broader web3 ecosystem—the proposed rule raised serious questions about the Commission’s adherence to the requirements of the Administrative Procedure Act (“APA”).

The Commission’s Proposal to expand the definition of dealer raises similar concerns. It is, perhaps, even more troubling: the new Proposal *does* explicitly apply to digital asset

¹ Further Definition of “As a Part of a Regular Business” in the Definition of Dealer and Government Securities Dealer, 87 Fed. Reg. 23,054 (Apr. 18, 2022) (“Proposal”).

² 15 U.S.C. § 78c(a)(5)(B). The Proposal would also expand the Exchange Act’s definition of “government securities dealer,” *id.* § 78c(a)(44)(A), along similar lines. This comment letter focuses on the consequences of the Proposal’s expansion of the definition of “dealer.”

³ web3 refers to a new kind of internet service that is built using decentralized blockchains and will replace today’s centralized version of the web. Proponents of web3 envision the service transforming the internet as we know it and ushering in a new digital economy that is not reliant on middlemen. See Kevin Roose, *What is web3?*, N.Y. TIMES (Mar. 18, 2022), <https://www.nytimes.com/interactive/2022/03/18/technology/web3-definition-internet.html>.

⁴ a16z Comment on File No. S7-02-22 (Apr. 18, 2022). We respectfully request that the Commission treat those comments as fully incorporated into the Proposal’s rulemaking record.

securities, yet it offers no clarity as to which digital assets fall into this category rather than the category of non-securities. The Proposal also extends burdensome requirements to historically unregulated market participants who trade digital assets, all without examining the likely—and substantial—costs of doing so. The Proposal thus leaves market participants uncertain as to their obligations and imperils the viability of the systems upon which web3 is being built. We therefore respectfully request that the Commission address the issues identified herein, and in comments by other stakeholders, before finalizing a rule that could impair web3 development and American innovation.

INTRODUCTION AND EXECUTIVE SUMMARY

The Exchange Act distinguishes between two categories of market participants that buy and sell securities for their own account. Those that do so “as a part of a regular business” are “dealers”⁵ subject to registration with the Commission as well as a host of rules regulating their conduct.⁶ Those that do not buy and sell securities for their own account “as a part of a regular business” are considered “traders”⁷; traders are not required to register with the Commission nor are they subject to the stringent requirements imposed on dealers.⁸

On April 18, 2022, the Commission published the Proposal, which intends to clarify which market participants are “dealers” by further defining what it means to buy and sell securities “as a part of a regular business”⁹ under Section 3(a)(5) of the Exchange Act.¹⁰ The Proposal specifies that it applies to any digital asset that is a security under the Exchange Act,¹¹ and focuses on market participants that are not currently regulated as dealers “despite engaging in liquidity providing activities similar to those traditionally performed by... ‘dealers.’”¹² These features of the Proposal raise serious concerns. As summarized here, and described in further detail below, the Proposal risks raising costs on all digital asset market participants rather than offering the regulatory clarity that industry stakeholders need.

- First, many digital assets have not been categorized definitively as a security or a non-security. The analysis of whether a digital asset is a security, such as the tests for determining whether an instrument is an “investment contract” or a “note” under *Howey* and *Reves*, involves an inherently difficult assessment of all the relevant facts and circumstances, made only more difficult due to the unique features of digital assets. The

⁵ See 15 U.S.C. § 78c(a)(5)(A) (defining dealer to include “any person engaged in the business of buying and selling securities ... for such person’s own account through a broker or otherwise”); 15 U.S.C. § 78c(a)(5)(B) (excluding from definition of dealer “a person that buys or sells securities ... for such person’s own account ... but not as a part of a regular business”). A similar distinction applies to the definition of “government securities dealer.” 15 U.S.C. § 78c(a)(44).

⁶ For example, dealers are required to become members of a self-regulatory organization (“SRO”) and comply with federal securities laws and regulatory obligations.

⁷ See Proposal at 23,057-58 & n.39.

⁸ 67 Fed. Reg. at 67,498.

⁹ Proposal at 23,054.

¹⁰ The Proposal also addresses what it means to buy and sell securities “as a part of a regular business” for government securities dealers under Section 3(a)(44) of the Exchange Act.

¹¹ Proposal at 23,057 n.36.

¹² *Id.* at 23,054.

Commission staff, with the exception of Bitcoin and Ether, has provided only broad guidance with respect to applying these tests and Commissioners have made broad statements about many digital assets being securities but have not specified which digital assets they believe are or are not securities. Participants in web3 may therefore be unable to assess accurately whether their activity in web3 could make them a dealer, which has historically required that they buy or sell *securities*. Faced with uncertainty over their obligations under the federal securities laws, even market participants not engaged in securities-related activities may stop providing liquidity in digital asset markets altogether rather than risk Commission enforcement action. By requiring domestic market participants to sort out these costly compliance questions that even the Commission has, to date, failed to answer, and possibly undergo the onerous dealer registration process, the Commission risks driving them out of the market altogether. Those that stay will likely find themselves saddled with costs that foreign market participants—including those in jurisdictions that provide greater clarity as to which digital assets are securities or non-securities—can avoid. The Proposal could therefore create a less efficient market, raise transaction costs, and move web3 development and activity outside of the United States.

- Second, the Proposal threatens to incidentally capture individuals trading for their own account but not “as a part of a regular business” because the Proposal does not address the novel ways in which individuals can provide liquidity for digital assets in DeFi systems. As a result, even though individuals do not appear to be the subject of the Proposal, those who fund liquidity pools or contribute to arbitrage bots could be swept up by the Proposal.
- Finally, the Proposal amplifies these concerns because, much like the Commission’s proposed redefinition of “exchange,” the Proposal does not expressly grapple with the economic implications of regulating DeFi systems, including the cost to the entire web3 ecosystem. The Commission therefore falls short of its statutory obligations to engage in reasoned decision-making and analyze the costs and benefits of its proposed rules.

a16z expects the rise of web3 to usher in an economic future built on security, transparency, and equity. But web3 cannot succeed if its most promising innovations are mired in a regulatory landscape that does not account for the novelty or specific attributes of the technology. Instead, ensuring responsible growth in this burgeoning sector will require thoughtful regulation tailored to address the opportunities and pitfalls of decentralization. Accordingly, we have presented a blueprint for oversight of web3, detailed in previous letters to the Commission¹³ and to the U.S. Senate Committee on Banking, Housing, and Urban Affairs.¹⁴ Because the Proposal risks stopping the development of web3 in its tracks, we urge the Commission to carve digital assets out of the Proposal until Congress or the Commission clarifies the status of specific digital assets and the appropriate regulatory structure for digital

¹³ See a16z Comment on File No. S7-02-22, *supra*, note 4.

¹⁴ See Letter from Andreesen Horowitz to U.S. Senate Cmte. on Banking, Hous. & Urban Aff., *Re: Request for Proposals for Clarifying Laws Concerning Cryptocurrency and Blockchain Technologies* (Sept. 27, 2021), <https://a16z.com/wp-content/uploads/2021/10/Andreesen-Horowitz-Senate-Banking-Proposals.pdf>.

assets. We also ask that the Commission assure market participants that they will not be viewed as “engaged in the business” of a dealer merely because they participate in certain novel liquidity-provision activities through the DeFi systems that support the entire web3 ecosystem.

BACKGROUND

Before describing our concerns about the Proposal’s impact on the web3 ecosystem, we provide a brief overview of the roles of market participants in these systems. We then discuss how the Proposal could apply to these actors, threatening the viability of web3.

Decentralized exchanges (“DEXs”), which permit peer-to-peer transactions without the need for a central intermediary, are one of the hallmarks of DeFi.¹⁵ Rather than establishing an order book like a traditional centralized exchange (“CEX”), many DEXs have adopted an automated market maker (“AMM”) model.¹⁶ An AMM is an autonomous trading protocol that uses smart contracts to set prices and execute transactions submitted to a DEX.¹⁷ The liquidity for AMMs is provided by participants referred to as “liquidity providers,” who “deposit” digital assets into liquidity pools (i.e., send digital assets to a designated address). AMMs in turn fulfill orders for other users using the “deposited” digital assets.¹⁸

DEXs are often programmed to incentivize users to act as liquidity providers. When a liquidity provider contributes assets to a liquidity pool, it may in turn receive “LP tokens” from the AMM.¹⁹ LP tokens provide the liquidity provider the right to receive transaction fees from users that have their digital asset orders executed on the DEX. Like a CEX, in return for having their order executed, DEX users pay a transaction fee to the AMM, which is distributed to liquidity providers via the LP token. That transaction fee is based on the amount of assets that the liquidity provider contributed to the pool.²⁰ When liquidity providers wish to exit a liquidity pool, they return their LP tokens to the AMM, and receive the assets that they initially contributed to the pool as well as their share of transaction fees.²¹ This process is orchestrated by the DEX’s smart contracts, which are publicly available code posted to the blockchain; at no point must the liquidity provider enter into an agreement with a central intermediary.²²

¹⁵ See Fabian Schär, *Decentralized Finance: On Blockchain- and Smart Contract-Based Financial Markets*, 103 FED. RESRV. BANK OF ST. LOUIS REV. 153, 160 (2021).

¹⁶ Igor Makarov & Antoinette Schoar, *Cryptocurrencies and Decentralized Finance (DeFi)* 23 (Brookings Paper on Econ. Activity, Conference Draft, 2022) (noting that the majority of DEXs rely on AMMs). Some DEXs, however, continue to use order books. Schär, *supra* note 15, at 161-62 (referring to AMMs as “constant function market maker[s]”).

¹⁷ Schär, *supra* note 15, at 162-63; Makarov & Schoar, *supra* note 16, at 23.

¹⁸ Makarov & Schoar, *supra* note 16, at 23. Liquidity pools generally are non-custodial. This means that the assets are not transferred from a liquidity provider’s digital asset wallet to the liquidity pool but may be “locked” into the liquidity pool via a smart contract.

¹⁹ Andrey Sergeenkov, *What Is an Automated Market Maker?*, COINDESK (Mar 9, 2022), <https://www.coindesk.com/learn/2021/08/20/what-is-an-automated-market-maker/>; Schär, *supra* note 15, at 162-63.

²⁰ Sergeenkov, *supra* note 19.

²¹ *Id.*; Schär, *supra* note 15, at 162-63.

²² See Benjamin Naftalis, Douglas K. Yatter, and Peter E. Davis, *The Limits of Applying Reves v. Ernst & Young to DeFi and the Perils of Regulating Web3 by Enforcement*, LATHAM & WATKINS LLP (Jan. 25, 2022),

One of the most transformative aspects of DEXs is that they allow individuals to serve as liquidity providers. This creates numerous benefits for market participants over a traditional CEX. First, because anyone can serve as a liquidity provider, DEXs create an opportunity for more widespread engagement by market participants who may be closed off from providing liquidity to a CEX. By becoming a liquidity provider, these individuals can deploy their assets in ways traditionally unavailable to them and make these assets productive, rather than idle. Second, the additional liquidity provided by individuals helps ensure continuous cross-platform liquidity that reduces slippage and enhances the trading experience for all DEX users.²³ And third, the broader base of liquidity providers makes DEXs more resilient than CEXs because DEXs do not rely on a concentrated set of liquidity providers. At the same time, institutional market makers play a vital role in ensuring the viability of DEXs. These institutions help provide DEXs with the liquidity necessary for high trading volume, decreasing volatility and creating a more orderly and efficient market.

So-called “arbitrage bots” represent another set of key actors in DEX liquidity pools. Arbitrage bots act on differential pricing for the same assets across markets (both DEXs and CEXs), thereby reducing asset price volatility.²⁴ Arbitrage bot developers may, for instance, program arbitrage bots to purchase assets on one DEX and deposit those assets in another DEX’s liquidity pool, thereby bringing the price of such asset across both DEXs into alignment.²⁵ Arbitrage bots can be funded and deployed by both individual and institutional market participants.

All in all, DEXs reduce transaction costs for market participants by disposing of intermediaries and permitting users to transact directly. Although DEXs also charge transaction fees, they are typically much lower than fees from a traditional CEX or a mark-up from a market maker.²⁶ AMMs set the price for a trade automatically based on the supply of assets in the DEX’s liquidity pool—generally, the less of a particular asset a liquidity pool has, the higher the price, and vice versa. These innovations offer a promising alternative to traditional centralized markets by lowering costs, increasing liquidity and price discovery opportunities, and democratizing participation in the financial markets. More importantly, DEXs enable interoperability across the digital-asset-based systems that will power web3, allowing the entire ecosystem of web3 applications, products, and services to be utilized in a seamless manner. As a real-world parallel, imagine a technology that made it so that every time you traveled to a new

<https://www.fintechanddigitalassets.com/2022/01/the-limits-of-applying-reves-v-ernst-young-to-defi-and-the-perils-of-regulating-web3-by-enforcement/>.

²³ Nikolai Kuznetsov, *DeFi Liquidity Pools, Explained*, COINTELEGRAPH (Jan. 28, 2021), <https://cointelegraph.com/explained/defi-liquidity-pools-explained>.

²⁴ See *A Deep Dive into Arbitrage on Decentralized Exchanges*, NANSEN, <https://www.nansen.ai/research/arbitrage-on-decentralised-exchanges> (last visited May 27, 2022).

²⁵ See *Coding a DeFi Arbitrage Bot*, EXTROPY.IO (Oct. 29, 2020), <https://extropy-io.medium.com/coding-a-defi-arbitrage-bot-45e550d85089>.

²⁶ KPMG, *Crypto Insights #2. Decentralised Exchanges & Automated Market Makers – Innovations, Challenges & Prospects* (Oct. 2021), available at <https://assets.kpmg/content/dam/kpmg/cn/pdf/en/2021/10/crypto-insights-part-2-decentralised-exchanges-and-automated-market-makers.pdf> (KPMG found that in a sample \$100,000 trade, Uniswap, a leading DEX, was charging a 0.05% transaction fee, while CEXs, Binance, Coinbase, and Kraken were charging 0.1%, 0.2%, and 0.2%, respectively).

country, all of the cash in your wallet automatically converted into the currency of that country. Such innovations are the promise of web3.

For all of these reasons, DEXs serve as essential building blocks of web3. As a16z has explained, web3 will be a new version of the internet owned by builders and users, orchestrated with digital assets.²⁷ It will “combine[] the decentralized, community-governed ethos of web1 with the advanced, modern functionality of web2.”²⁸ And the technologies underpinning web3 will unlock new ownership and earning opportunities for creators.²⁹ DEXs are a key component of this transformation.³⁰

DISCUSSION

I. THE PROPOSAL AMPLIFIES COSTLY UNCERTAINTY SURROUNDING WHICH DIGITAL ASSETS CONSTITUTE SECURITIES OR NON-SECURITIES

A. The Proposal Expressly Applies to Digital Asset Securities, But the Commission Has Not Clarified Which Digital Assets Constitute Securities or Non-Securities

The text of the Proposal makes clear that the Commission intends to subject a broad range of currently unregistered market participants to dealer registration. By further defining what it means to buy and sell securities “as a part of a regular business,” the Commission seeks to “capture dealer activity wherever that activity occurs.”³¹ Under the Proposal, dealer status “remains a facts and circumstances determination” subject to the Commission’s discretion.³² This expansive scope is warranted, the Proposal suggests, because “the statutory definition of ‘dealer’ ... and the accompanying registration requirements of the Exchange Act were drawn broadly by Congress in 1934 to encompass a wide range of activities involving the securities markets and their participants.”³³ The Proposal, therefore, explicitly applies to *all* securities, “including any digital asset that is a security or a government security.”³⁴

To capture currently unregistered market participants, the Proposal outlines “qualitative standards designed to more specifically identify activities of certain market participants who assume dealer-like roles” such that their trading activity “‘has the effect of providing liquidity’ to

²⁷ Chris Dixon, *Why Web3 Matters*, A16Z (Oct. 7, 2021), <https://future.a16z.com/why-web3-matters/>.

²⁸ *Id.*

²⁹ Daren Matsuoka, Eddy Lazzarin, Chris Dixon & Robert Hackett, *Introducing the 2022 State of Crypto Report*, A16Z CRYPTO (May 17, 2022), <https://a16zcrypto.com/state-of-crypto-report-a16z-2022/>.

³⁰ Casey Wager, *a16z’s Chris Dixon: Crypto Growth Is Consistent, Despite Downturn*, Blockworks (May 17, 2022), https://blockworks.co/a16zs-chris-dixon-crypto-growth-is-consistent-despite-downturn/?utm_source=Sailthru&utm_medium=email&utm_campaign=Daily%20NL%20Tuesday%205.17.22&utm_term=Daily%20Newsletter.

³¹ Proposal at 23,070.

³² *Id.* at 23,063.

³³ *Id.* at 23,057.

³⁴ *Id.* at 23,057 n.36.

other market participants.”³⁵ Under these qualitative standards, a market participant must register as a dealer if it is:

- (i) routinely making roughly comparable purchases and sales of the same or substantially similar securities in a day; or
- (ii) routinely expressing trading interests that are at or near the best available prices on both sides of the market and that are communicated and represented in a way that makes them accessible to other market participants; or
- (iii) earning revenue primarily from capturing bid-ask spreads, by buying at the bid and selling at the offer, or from capturing any incentives offered by trading venues to liquidity-supplying trading interests.³⁶

For market participants that engage in any one of these activities, “liquidity provision is not incidental to their trading activities;” they are, rather, “providing liquidity as part of a regular business.”³⁷

The Proposal’s express application to digital asset securities, however, compounds the uncertainty faced by market participants who will need to assess whether their activity is dealer activity. Market participants already lack clear guidance for determining which digital assets are securities or non-securities under the Exchange Act. The Proposal ratchets up the pressure they face—making clear that certain digital asset transactions for a person’s “own account” are in the Commission’s crosshairs but failing to distinguish clearly digital asset securities from non-security digital assets.

As noted above, the Commission itself has not provided definitive guidance as to when a digital asset is a security or a non-security. The clearest statement regarding specific digital assets has instead come from the former director of the Commission’s Division of Corporation Finance, who said in a June 2018 speech that he did not view either Bitcoin or Ether as a security at the time.³⁸ A year later, Commission staff published broad guidance for analyzing digital assets under the “investment contract” framework developed by the Supreme Court in the first half of the Twentieth Century.³⁹ While the industry has relied on this guidance, Commission

³⁵ *Id.* at 23,061–62.

³⁶ *Id.* at 23,065.

³⁷ *Id.* at 23,062.

³⁸ See Bill Hinman, *Digital Asset Transactions: When Howey Met Gary (Plastic)*, U.S. SEC. & EXCH. COMM’N (June 14, 2018) <https://www.sec.gov/news/speech/speech-hinman-061418>. Although notable, this position reflected his own views and does not necessarily reflect those of the Commission, the Commissioners, or other members of the Commission staff.

³⁹ See Bill Hinman, *Statement on “Framework for ‘Investment Contract’ Analysis of Digital Assets,”* U.S. SEC. & EXCH. COMM’N (Apr. 3, 2019), <https://www.sec.gov/news/public-statement/statement-framework-investment-contract-analysis-digital-assets>; *Framework for “Investment Contract” Analysis of Digital Assets*, U.S. SEC. & EXCH. COMM’N, <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets> (last visited Mar. 29, 2022) (discussing *SEC v. W.J. Howey Co.*, 326, U.S. 293 (1946)).

staff have not made any updates to account for the tremendous growth in digital assets, DeFi, and web3 in the more than three years since its publication.

In recent years, moreover, regulators have given mixed signals as to whether this guidance continues to apply. Commissioners instead have signaled that they will not offer “blanket definitions” or “proactively label all the specific projects, assets, and activities that are within [the Commission’s] jurisdiction.”⁴⁰ Further, conflicting statements by regulators have called into question whether market participants can rely on guidance offered by the Commission staff. Despite the June 2018 statement that Ether is not a security, in August 2021, Chair Gensler declined to answer when asked to weigh in on the same question.⁴¹ Earlier this month, Commodity Futures Trading Commission (“CFTC”) Chair Rostin Behnam took the opposite view, clearly articulating that Ether is a commodity.⁴² Agency practice has not shed any light on these lingering uncertainties.⁴³ While some officials have criticized this lack of clarity,⁴⁴ market participants must interpret these tea leaves on their own. If the Commission does not clearly articulate which digital assets are securities or non-securities, it is not clear how web3 participants will be able to make this determination.

The lack of guidance as to which digital assets constitute securities or non-securities underscores that the Proposal could lead market participants to fear that their trading activity subjects them to dealer registration requirements even when they are not engaged in “dealer” activity (i.e., engaged in the business of *buying and selling securities*” for their own account “as a part of a regular business.”)⁴⁵ And the Commission’s justification for further defining what it means to buy and sell securities “as a part of a regular business” emphasizes that “it is important that market participants whose *securities activities* fall within the broad definitions of ‘dealer’ ... are registered and regulated under the Exchange Act.”⁴⁶ Importantly, only those who trade securities with some “regularity” are “engaged in the business of buying and selling securities”⁴⁷; dealer registration is not required for those who participate in only a few “isolated

⁴⁰ Comm’r Caroline A. Crenshaw, *Digital Asset Securities—Common Goals and a Bridge to Better Outcomes*, U.S. SEC. & EXCH. COMM’N (Oct. 12, 2021), <https://www.sec.gov/news/speech/crenshaw-sec-speaks-20211012>.

⁴¹ See Aspen Institute, *2021 Aspen Security Forum | The View from the SEC: Cryptocurrencies and National Security*, YOUTUBE (Aug. 3, 2021), <https://www.youtube.com/watch?v=tusQLLCgrDs>.

⁴² Squawk Box, *Bitcoin, Ethereum Are Commodities, Says CFTC Chair Rostin Behnam*, CNBC (May 16, 2022), <https://www.cnbc.com/video/2022/05/16/bitcoin-ethereum-are-commodities-says-cftc-chair-rostin-behnam.html?&qsearchterm=cryptocurrency>.

⁴³ Even in cases where the Commission has settled enforcement actions against alleged operators of unregistered exchanges trading digital asset securities, the Commission has not specified which digital assets transacted in were securities. See *In re Zachary Coburn*, Exchange Act Release No. 84533 (Nov. 8, 2018), <https://www.sec.gov/litigation/admin/2018/34-84553.pdf>; *In re Poloniex, LLC*, Exchange Act Release No. 92607 (Aug. 9, 2021), <https://www.sec.gov/litigation/admin/2021/34-92607.pdf>.

⁴⁴ Commissioners Peirce and Roisman have stated that “[i]n this void [of clear Commission-level guidance], litigated and settled Commission enforcement actions have become the go-to source of guidance.” Comm’rs Hester M. Peirce & Elad L. Roisman, *In the Matter of Coinschedule*, U.S. SEC. & EXCH. COMM’N (July 24, 2021), <https://www.sec.gov/news/public-statement/peirce-roisman-coinschedule>.

⁴⁵ 15 U.S.C. § 78c(a)(5)(A) (emphasis added).

⁴⁶ Proposal at 23,057 (emphasis added).

⁴⁷ *Id.* at 23,058.

transactions.”⁴⁸ That makes “dealer” an ill-fitting label for many participants in the digital asset market since certain government officials have taken the position that the majority of the digital asset market does not involve securities. For instance, CFTC Chair Behnam has stated that at least 60 percent of the digital asset market—including two of the most visible and popular digital assets, Bitcoin and Ether—are commodities rather than securities.⁴⁹ The Proposal could, however, cause market participants to scale back trading activity even when they engage in no security-related trading activity at all.

B. By Compounding the Uncertainty Surrounding Digital Asset Securities and Expanding the Scope of “Dealer,” the Proposal Risks Undermining web3 and Driving Investment Overseas

This uncertainty as to which digital assets are securities or non-securities could negatively affect the market for digital assets. The burden will fall upon market participants to make an inherently subjective assessment—and one that is subject to second guessing—in order to determine whether they transact in digital asset securities and are therefore obligated to register as dealers in order to participate in a DEX’s liquidity pools. Individuals and institutions therefore will face great difficulty in structuring their digital asset trading activity to comply with the Proposal.

Putting aside that the costs related to registration as a “dealer” are likely prohibitive for a substantial proportion of market participants, certain participants may choose to register as dealers despite not clearly meeting the statutory definition as clarified by the Proposal. Other participants may choose not to register, even though the Commission later may decide that they are, in fact, buying and selling *securities* for their own account, and that their trading activity makes them dealers because it “has the effect of providing liquidity” to other market participants.⁵⁰ Others yet may abandon the digital asset market entirely. These varied responses would risk deepening the “inconsistent oversight of market participants performing similar functions” that the Proposal seeks to resolve.⁵¹

The Commission’s failure to define clearly what constitutes a “digital asset security” or a non-security is a significant impediment to available liquidity, as market participants cannot confidently assess their obligations under the Exchange Act or Commission rules. Individual users may have no meaningful way to assess whether the digital assets they are trading could be labeled securities. And if liquidity providers are hesitant to participate in the digital asset market, price volatility and higher transaction costs are likely results. These consequences would be compounded further if the Proposal causes individual and institutional liquidity

⁴⁸ *Id.* at 23,066 & n.134.

⁴⁹ See Squawk Box, *supra* note 42; Nikhilesh De, *CFTC Should Be Crypto’s ‘Primary Cop,’ Acting Chairman Says*, COINDESK (Oct. 27, 2021), <https://www.coindesk.com/policy/2021/10/27/cftc-should-be-cryptos-primary-cop-acting-chair-says/> (CFTC Chair Behnam said that approximately 60 percent of the digital asset market constituted commodities).

⁵⁰ Proposal at 23,061-062.

⁵¹ *Id.* at 23,060.

providers to exit DeFi systems rather than submit to dealer registration requirements or risk an enforcement action.

Leaving the status of digital assets uncertain also could undercut the innovations at DeFi's core, thereby hindering the United States' goal of becoming a leader in web3. President Biden's recent Executive Order on Ensuring Responsible Development of Digital Assets recognized the nation's interest in "ensuring that it remains at the forefront of responsible development and design of digital assets and the technology that underpins new forms of payments and capital flows in the international financial system."⁵² Building a regulatory framework in which DEXs can thrive is essential because DEXs serve as an infrastructure layer for all web3 applications, products, and services. But if market participants cannot easily evaluate their obligations under the Exchange Act and Commission rules, many will pare back their liquidity-providing activities or leave DEXs altogether. That could shift the competitive advantage to foreign jurisdictions where market participants may have greater clarity as to the obligations accompanying digital asset transactions. As a16z has previously explained, if web3 cannot grow here, we risk "driving digital token-related investment out of the U.S. and into competing economies."⁵³

For all these reasons, the Commission should not compound the costs of uncertainty over the status of digital assets through a single sentence in a footnote of the Proposal. As members of Congress have recognized, "regulatory clarity [is] necessary to keep crypto innovation in the United States."⁵⁴ The Commission should provide this much-needed clarity on which digital asset are or are not securities before promulgating a rule that will increase costs for all market participants and stifle growth in this important sector. We therefore request that the Commission revise the rule to clarify that it does not apply to digital asset securities until the Commission or Congress has given the industry clear guidance about which digital assets are in fact securities rather than non-securities.

The Commission also should clarify that, by buying and selling both a digital asset and a pooled investment vehicle holding only that asset, a market participant does not "routinely mak[e] roughly comparable purchases and sales of the same or substantially similar securities."⁵⁵ Unless the Commission clarifies this ambiguity, liquidity providers that participate in DEXs could be concerned that their hedging activities using pooled investment vehicles or their underlying assets could implicate dealer status. That is because, even if a digital asset has not been labeled a security by the Commission, a pooled investment vehicle holding that digital asset is likely a security that must be registered under Section 5 of the Securities Act of 1933 (the

⁵² Executive Order on Ensuring Responsible Development of Digital Assets (March 9, 2022), <https://www.whitehouse.gov/briefing-room/presidential-actions/2022/03/09/executive-order-on-ensuring-responsible-development-of-digital-assets/>.

⁵³ Letter from Chamber of Digital Commerce to President's Working Grp. on Fin. Markets, *Regulatory Framework to Address the Growth and Promise of Stablecoin Payments Systems* (Oct. 18, 2021), https://4actl02j1q5u2o7ouqlymaad-wpengine.netdna-ssl.com/wp-content/uploads/2021/10/Chamber-of-Digital-Commerce-Presidents-Working-Group-Stablecoin-Policy-Recommendations_18-October-2021.pdf.

⁵⁴ Press Release, *Khanna, Thompson, Emmer, Soto Introduce Bipartisan Digital Commodity Exchange Act of 2022* (Apr. 28, 2022), <https://khanna.house.gov/media/press-releases/khanna-thompson-emmer-soto-introduce-bipartisan-digital-commodity-exchange-act>.

⁵⁵ Proposal at 23,065.

“Securities Act”).⁵⁶ The uncertainty regarding whether the digital asset is a security, and therefore could be deemed “the same or substantially similar” to a pooled investment vehicle, could have a chilling effect on the sound risk management practices of market participants. The Commission therefore should clarify that a digital asset security would not be deemed “the same or substantially similar” to a pooled investment vehicle holding that asset.

II. THE PROPOSAL RISKS SWEEPING IN MARKET PARTICIPANTS TRADITIONALLY VIEWED AS TRADERS

A. The Proposal’s Broad Reach May Extend to Individual Market Participants Merely Because They Participate in a DEX

Market participants who buy and sell securities for their own accounts have long relied on the dealer/trader distinction to determine their obligations under the Exchange Act.⁵⁷ By adopting an overly broad construction of the definition of dealer, the Proposal could unlawfully collapse this statutory distinction, rendering it meaningless.

The Proposal aims to extend “dealer” status to a number of unregistered market participants that “play an increasingly significant liquidity providing role in overall trading and market activity.”⁵⁸ The Commission notes that entities not registered as “dealers” now serve as “critical sources of liquidity,” pointing to “their significant presence in the market, the volume of their trading, the magnitude of their impact on the market, the regularity of their participation and ... the nature of their electronic trading strategies.”⁵⁹ After all, the Commission points out, the statutory definition of “dealer” is “drawn broadly.”⁶⁰ It extends to “any person”—whether a natural person, company, government, or political subdivision, agency, or instrumentality of a government⁶¹—“engaged in the business of buying and selling securities ... for such person’s own account through a broker or otherwise.”⁶² By requiring currently unregistered market participants to register as dealers, the Commission seeks to obtain “a more comprehensive view of the markets,” as well as “enhance market stability and investor protection.”⁶³

In expanding the definition of dealer under the Exchange Act, the Commission furthermore relies on broadly defined terms with broad implications. A dealer is “engaged in the business of buying and selling securities” for their own account.⁶⁴ And under the Proposal’s qualitative standards, individuals may qualify as dealers if they are “earning revenue primarily

⁵⁶ See 15 U.S.C. § 77e. See Hugh Son, *Grayscale Tells SEC That Turning Biggest Bitcoin Fund into ETF Will Unlock \$8 Billion for Investors*, CNBC (May 11, 2022), <https://www.cnbc.com/2022/05/11/grayscale-tells-sec-that-turning-biggest-bitcoin-fund-into-etf-will-unlock-8-billion-for-investors.html>.

⁵⁷ See Definition of Terms in and Specific Exemption for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, 67 Fed. Reg. 67,496, 67,498–67,500 (Nov. 5, 2002).

⁵⁸ Proposal at 23,054.

⁵⁹ *Id.* at 23,055.

⁶⁰ *Id.* at 23,057.

⁶¹ 15 U.S.C. § 78c(a)(9).

⁶² Proposal § 78c(a)(5).

⁶³ *Id.* at 23,054.

⁶⁴ *Id.* § 78c(a)(5).

from capturing bid-ask spreads, by buying at the bid and selling at the offer, or from capturing any incentives offered by trading venues to liquidity-supplying trading interests.”⁶⁵ The statutory framework surrounding the Proposal demonstrates that those definitions extend to a wide range of activity: Under the Exchange Act, “buy” and “purchase” include “any contract to buy, purchase, or otherwise acquire”; “sale” and “sell” refer to “any contract to sell or otherwise dispose of.”⁶⁶ The Securities Act provides further gloss on the definitions of “offer” and “sale,” which encompass “every contract of sale or disposition of a security or interest in a security, for value.”⁶⁷

While the Commission frames the Proposal as an effort aimed largely at one class of market participants—proprietary trading firms (“PTFs”)⁶⁸—the expansive regulatory authority that the Commission claims under the Proposal risks extending far more broadly. In particular, the Proposal threatens to sweep in market participants who provide liquidity to DEXs or fund arbitrage bots that operate on a DEX. The Proposal targets PTFs because they often earn revenue primarily from the provision of liquidity, including by capturing any liquidity rebates offered by trading centers to liquidity supplying orders.⁶⁹ The “explicit liquidity-compensation arrangements” of the kind utilized by PTFs, the Proposal notes, represent a “major source of revenue for market makers and other liquidity providers.”⁷⁰

The Commission makes clear, however, that the Proposal is intended to reach beyond PTFs. The Proposal refers broadly to “trading venues” that offer incentives to liquidity providers, and is “designed to capture dealer activity *wherever* that activity occurs, whether on a national securities exchange, an ATS, a Communication Protocol System, or another form of trading venue.”⁷¹ Indeed, “the particular trading venue matters less than the fact that a market participant provides liquidity on it.”⁷² And while the Proposal has a carveout for “[a] person that has or controls total assets of less than \$50 million,” it is not, in fact, a safe harbor: “the question of whether a person that has or controls less than \$50 million in total assets is acting as a dealer, as opposed to a trader, will remain a facts and circumstances determination, and to the extent consistent with the Proposed Rules, existing applicable interpretations and precedent will continue to apply.”⁷³ This means that even if a market participant meets the criteria for this asset-based exception, it still could be deemed to be a dealer.

Individual liquidity providers in DEXs may, therefore, reasonably fear that the Proposal would require them to register as dealers. Because, for the reasons explained above the status of digital assets under the securities laws remains unclear, the Commission may view liquidity providers as engaging in securities transactions. A liquidity provider generally must obtain

⁶⁵ Proposal at 23,065.

⁶⁶ 15 U.S.C. § 78c(a)(13)-(14).

⁶⁷ *Id.* § 77b(a)(3).

⁶⁸ PTFs, the Proposal notes, “often employ automated, algorithmic trading strategies” such as “passive market making,” and account for a high volume of trades in the interdealer market. Proposal at 23,055.

⁶⁹ *See id.* at 23,062 n.88.

⁷⁰ *Id.* at 23,069.

⁷¹ *Id.* at 23,070 (emphasis added).

⁷² *Id.*

⁷³ *See id.* at 23,062.

digital assets to participate in a liquidity pool⁷⁴; they may later sell these assets. They therefore could meet the threshold requirement of buying and selling securities for their own account. The liquidity provider furthermore may deposit assets into a smart contract and receive LP tokens.⁷⁵ Under the qualitative standards announced by the Proposal, these activities could be seen as liquidity-compensation arrangements and thus a hallmark of dealer status.⁷⁶

Individuals who fund arbitrage bots on DEXs likewise could find themselves swept up in the Proposal’s expanded definition of dealer. As noted above, arbitrage bots can mitigate price volatility by buying assets on one DEX and depositing those assets at a different price point in the liquidity pool of another DEX, which again could run the risk of being viewed by the Commission as “buying” and “selling” due to the breadth of these terms. By funding arbitrage bots, individuals may therefore be viewed as performing functions similar to direct liquidity providers.

B. The Proposal Could Devastate the web3 Ecosystem by Extending to the Traditionally Unregulated Activity of Individual Market Participants

As a result of this broad language in the Proposal, a16z is concerned that the Proposal could be read to require individuals trading for their own account (but not as a part of a regular business) to register as dealers merely because they participate in a DEX by providing liquidity or funding arbitrage bots. The Proposal could sweep in these market participants, not because they act like “dealers” in traditional securities markets, but simply due to the way DEXs function from a technical perspective. These concerns are compounded by the scope of the discretion claimed by the Commission, which provides no safe harbor for market participants controlling less than \$50 million and emphasizes that dealer status is “a facts and circumstances determination.” As explained above, the Commission should not adopt the Proposal until there is clarity on which digital assets are securities or non-securities. However, following that clarification, if the Commission intends to require individuals who provide liquidity and contribute to arbitrage bots on DEXs to register as dealers, it would be detrimental to digital asset markets and market participants, as well as all of web3.

First, individual market participants would incur substantial costs in attempting to comply with the dealer registration requirements, including costs associated with registration, SRO membership, compliance with regulatory requirements, and legal costs.⁷⁷ Much like the costs associated with determining which digital assets are securities, these prohibitive costs could lead individual market participants to abandon DEXs. This would result in concentrated and centralized control over DEXs in the hands of fewer market participants—the antithesis of web3. The benefits to a DEX associated with diffuse liquidity and control would cease, and this innovative technology would be pigeonholed into the same traditional framework from which web3 is attempting to depart.

⁷⁴ See *supra* note 18 and accompanying text.

⁷⁵ See *supra* note 19-20 and accompanying text.

⁷⁶ See Proposal at 23,069.

⁷⁷ See *id.* at 23,088.

Second, the chilling effect created by the unpredictable threat of Commission enforcement could lead individual market participants to stop providing liquidity or funding arbitrage bots on DEXs. Individuals who once could trade digital assets confidently could no longer trust that the Commission will view them as traders. Instead, they would be at the mercy of the Commission’s newly adopted interpretation of what constitutes a dealer and might therefore retreat from activity that “has the effect of providing liquidity” to other market participants.”⁷⁸

Third, the Proposal would be detrimental to the entire web3 ecosystem. Individuals who provide liquidity or fund arbitrage bots are essential to the function of most DEXs, and undermining DEXs would harm web3. If users are unable to exchange the digital assets of various web3 systems seamlessly, and instead are forced to use CEXs, the promise of web3 will be significantly diminished. Liquidity is a major limiting factor in the development of many web3 systems, presenting a problem that DEXs are helping to solve, in part through individual market participants. Ensuring continuous cross-platform liquidity enables a better experience for all web3 users. Liquidity lost from the departure of individual market participants could increase prices and price volatility on DEXs, causing DEX trading to dry up and leading market participants back to CEXs. This would devastate the community-based utility and governance that web3 promises, and undermine key benefits of web3, such as reductions in downtime and increased security.

III. THE PROPOSAL’S OMISSION OF ANY DISCUSSION OF THE ECONOMIC IMPLICATIONS OF APPLYING TO DIGITAL ASSETS RAISES CONCERNS UNDER THE APA

The Proposal mentions digital assets only once, in a footnote—and while it expressly extends to digital asset securities, it nowhere accounts for the potential impact of the expanded definition of “dealer” on the market for digital assets or on the entire web3 ecosystem. By warning market participants that certain activity may require dealer registration but offering no further clarity as to when digital assets constitute securities or non-securities, the Commission ratchets up the costs imposed by lingering regulatory uncertainty. And by targeting liquidity providers for dealer registration, the Proposal risks sweeping into the Commission’s regulatory ambit individuals who provide liquidity to DEXs or fund arbitrage bots that operate on DEXs, without accounting for the substantial costs that this will impose on a vital and growing sector of the economy. Instead, the Proposal’s cost-benefit analysis makes zero mention of the uncertain status of many digital assets under the securities laws. And it homes in on PTFs, omitting any reference to the individual DEX participants even while acknowledging that the Proposal “could potentially capture a wide array of persons.”⁷⁹ These deficiencies render the Proposal’s cost-benefit analysis incomplete.

For the reasons stated in our previous comment letter on the Commission’s proposal to expand the definition of “exchange” and amend Regulation ATS (which we fully incorporate here), the Proposal may therefore violate the APA.⁸⁰ Principally, the Commission fell short of its statutory duty to “consider the effect of [its] new rule upon ‘efficiency, competition, and capital

⁷⁸ *Id.* at 23,061-062.

⁷⁹ *Id.* at 23,079.

⁸⁰ *See* a16z Comment on File No. S7-02-22 (Apr. 18, 2022).

formation.”⁸¹ By declining to weigh the costs of expanding the definition of dealer to include market participants who buy and sell digital asset securities, without clarifying when digital assets constitute securities or accounting for the Proposal’s effect on individual users of DEXs, the Commission did not “adequately [] assess the economic effects” of an expanded definition of “dealer.”⁸² To avoid running afoul of the APA, the Commission should refrain from promulgating rules that apply to digital assets before it provides greater clarity as to which digital assets constitute securities or non-securities.

CONCLUSION

Market participants that trade digital assets already face substantial uncertainty as the result of the Commission’s decision not to offer clear guidance as to which digital assets are securities or non-securities. The Commission should not compound this uncertainty, and thereby impose costs on *all* market participants, by adopting a rule that may require those that trade digital assets for their own account, but not as a part of a regular business, to register as dealers. Until Congress or the Commission provides the requisite clarity, the Commission should indicate explicitly that the Proposal is not intended to capture digital assets. Once there is clarity about which digital assets are securities or non-securities, the Commission should explain further that individual market participants who provide liquidity or contribute to arbitrage bots for their own account on DEXs trading digital asset securities may continue serving their vital role without the risk of running afoul of the dealer registration requirement. Failure to address these ambiguities could cause market liquidity to dry up, exacerbate price volatility, and hinder the development of important digital asset infrastructure, as well as the web3 ecosystem that is being built atop it.

Policy questions about the proper regulatory approach to web3 are serious, and they should be addressed openly and based on a complete record of the costs and benefits of regulation, not decided opaquely or implicitly in a broader overhaul of Exchange Act regulations. The opportunities and challenges presented by the growth of web3 require regulations that consider the promises of decentralization. The Commission’s actions in this area must also preserve our nation’s competitive edge—or, as this Administration has recognized, we risk sacrificing American jobs and imperil our national security.⁸³ a16z is ready to serve as a resource in crafting these solutions.

⁸¹ *Business Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (quoting 15 U.S.C. § 78c(f)).

⁸² *Id.*

⁸³ Executive Order on Ensuring Responsible Development of Digital Assets, *supra* note 52.

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