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Insights

SEC ADOPTS EXPANDED EXCHANGE ACT DEALER RULES: WHAT DO THE NEW SEC RULES MEAN FOR DEFI?

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In March of 2022, the SEC proposed rules to include "any market participant that engages in activities as describe in the rules [as] a 'dealer' or 'government securities dealer[.]'"[1]On February 6, 2024, the SEC adopted these rules, modifying Exchange Act Rules 3a5-4 and 3a44-2 to "further define the phrase 'as a part of a regular business'" in Sections 3(a)(5)—for standard "dealers"—and 3(a)(44)—for government securities dealers—of the Securities Exchange Act of 1934.[2]These adopted rules not only broaden the definition of a "dealer" under the Exchange Act, but also potentially place certain Decentralized Finance ("DeFi") parties within the ambits of Exchange Act registration requirements. Given the fluctuating state of digital asset regulation, the SEC's newest adopted rules create even greater levels of ambiguity around registration requirements for DeFi. To that end, this article first explores the rule and its reactions, then analyzes its impact on DeFi, and finally, offers considerations to those potentially impacted by these rule changes.

THE PROPOSED RULES & REACTIONS

The rules as recently adopted were first proposed in March of 2022, and caused much the same reaction amongst members of the digital asset industry. The proposed rule explained that "[a]dvancements in electronic trading across securities markets have led to the emergence of certain market participants that play an increasingly significant liquidity providing role in overall trading and market activity—a role that has traditionally been performed by entities regulated as dealers."[3]Sections 3(a)(5) and 3(a)(44) of the Exchange Act define both the terms "dealer" and "government securities dealer" as, generally, "any person engaged in the business of buying and selling [government] securities," excluding those who "buy[] or sell[] securities . . . for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business."[4]Given the advancement of technology and proliferation of liquidity-providing automated market makers, the SEC proposed these rules to "identify those market participants that are providing an important liquidity provision function in today's securities markets" and require them to register unless an exception or exemption applies.[5]

The SEC noted in its proposed rules release that it would be incorporating qualitative factors for analyzing dealer status "as part of a regular business."[6] As such, the Commission's factors were designed to determine when an party is engaging in a routine pattern of buying and selling securities that has an effect of "providing liquidity."[7]The originally proposed factors were as follows: (1) "routinely making roughly comparable purchases and sales of the same or substantially similar securities in a day"; (2) "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"; and (3) "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."[8]To that end, the Commission noted, "the Proposed Rules focus on activity rather than label or status."[9]However, the SEC also cabined these rules to only market participants that "ha[ve] or control[] more than $50 million in total assets[.]"[10]

Notably, digital assets were only mentioned in the Proposed Rules by way of a footnote,[11]but digital asset industry members were quick to notice that these changes could impact DeFi protocols.[12]Given the potential impact of the rules on DeFi protocols, a number of members of the industry offered comments noting the dilemma a number of DeFi protocols would face: guidance regarding the application of securities laws to digital assets is already ambiguous, and these rules would create even more ambiguity regarding registration requirements.[13]Others explained that "[a]dopting these standards would upend decades of precedent for distinguishing 'dealers' from 'traders,'" and would exceed the SEC's statutory authority.[14]Finally, still more industry members explained that these proposed rules would discourage innovation due to onerous requirements for registration with the SEC or becoming a member of a self-regulatory organization ("SRO").[15]

THE FINAL RULES & RESPONSES

Adopting the Final Rules by a 3–2 vote on February 6, 2024, the SEC provided some adjustments from the Proposed Rules.[16]In its explanation, the Commission noted that it was making modifications to "appropriately tailor the scope of the final rules" such that they would "appropriately require only entities engaging in *de facto* market making activity to register as dealers."[17]In so doing, the Commission eliminated the first qualitative factor it had originally proposed: those "engaging in liquidity provision by routinely making roughly comparable purchases and sales of the same or substantially similar securities in a day[.]"[18]The Commission also deleted a quantitative factor related to trading volume, noting that both deleted factors were potentially overbroad.[19]

As such, the Final Rules incorporate solely two qualitative standards for measuring when an entity is "buying and selling securities for its own account 'as part of a regular business' as that phrase is used in sections 3(a)(5) and 3(a)(44) of the Exchange Act."[20]The qualitative measures are as follows:

1. Regularly expressing trading interest that is at or near the best available prices on both sides of the market for the same security, and that is communicated and represented in a way that makes it accessible to other market participants; or

2. 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 interest.[21]

Given the elimination of the quantitative factor due to its potentially overbroad implications, the Commission noted that it would instead only rely on court precedent and the above two modified qualitative factors to enforce its updated dealer definitions.[22]

Alongside the Exchange Act Release itself, SEC Chair Gary Gensler explained the Commission's rationale in adopting the Final Rules, while Commissioner Hester Peirce offered her own statement, relating an alternative view of the Final Rules.[23]Chair Gensler noted that "[w]hen dealers register, they become subject to a variety of important laws and rules that help protect the public, promote market integrity, and facilitate capital formation. . . . This regime benefits investors, issuers, and markets alike—and has done so for nearly 90 years."[24]He added that "PTFs [principal-trading firms] and other firms are acting in a manner consistent with dealers in the securities markets," and even though "these firms act[] as de facto market makers" and their "buying and selling securities . . . 'as part of a regular business,' a number of these firms have not registered with the Commission as dealers."[25]As such, Chair Gensler reasoned that these Final Rules would help securities markets better function.[26]

SEC Commissioner Hester Peirce's reading of the Final Rules as adopted differs largely from Chair Gensler's presentation: "the rule defines dealer in a way that is inconsistent with the statutory framework within which it sits and will distort market behavior and degrade market quality."[27]Known for her belief in DeFi innovation and dissents,[28]Commissioner Peirce explained that the Final Rules "extend[] the definition of 'dealer' to market participants that run investing and trading businesses, not dealing businesses."[29]She added that the ambiguity of the Final Rules alongside the costs of registration will harm market competition, forcing smaller firms to consolidate.[30]Commissioner Mark Uyeda shared similar views in his statement, noting that "[t]oday's action codifies the Commission's view that the 'dealer' definition is practically limitless. The public should be concerned about the immense scope of this claimed jurisdiction."[31]Commissioner Peirce ended her statement with a series of questions, and one

directly spoke to DeFi: “The Release explains that a crypto automated market maker might have to register as a dealer under the final rules. How can a software protocol register as a dealer?”[32]

IMPACT ON DEFI

Ultimately, these adopted dealer rules create an additional layer of ambiguity for securities law compliance in the digital asset space. The two qualitative factors adopted in the Final Rules explain that a party can be classified as a “dealer” if they (1) regularly express trading interest, and/or (2) earn revenue from bid/ask spreads or other incentives from trading venues for supplying liquidity.[33]These two definitions are extremely broad, and could implicate parties in the DeFi and digital asset ecosystems: first, DeFi protocols and liquidity providers, and second, parties who stake digital assets deemed to be securities.

ARE AMMS DEALERS UNDER THE NEW RULES? LPS?

The Final Rules left unclear whether the SEC considers Automated Market Makers (“AMMs”) or liquidity providers (“LPs”) to be dealers under the additional qualitative factors. To that end, Commissioner Peirce’s question is relevant: “How can a software protocol register as a dealer?”[34]A half-answer came during a February 6 open meeting regarding the Final Rules from staff member Haoxiang Zhu: individuals who deposit assets into liquidity pools could “essentially be acting as dealers because they would have bid-offer prices determined by the bonding curve and they would be making profit and revenue based on the bid-ask spread.”[35]Zhu continued, noting that the rules focus on people rather than technology.[36]Commissioner Peirce then asked for clarification: “[s]o it’s not the AMM that has to register, it’s the people posting liquidity in those pools that have to register?”[37]Zhu then deferred to the necessity of a facts and circumstances inquiry for each case—but did note that *individuals who only write the software for an AMM* “would be unlikely” to have to register, while leaving open the question of registration of actual AMMs as dealers.[38]

The distinction addressed in the open meeting was that of AMMs—software—versus LPs—parties supplying the AMM’s assets. In a very simplified form, LPs allow users to deposit two tokens, such as Bitcoin and Ethereum, into a trading pair on an AMM.[39]The LP will then receive liquidity provider tokens from that AMM, which they deposit into a staking pool on the AMM.[40]From there, parties earn a token from the AMM based on their percentage of liquidity contribution to the pool which is derived from AMM users trading on the AMM in that particular pair.[41]

As such, the Final Rules clearly seek to, at minimum and in part, capture LPs using DeFi protocols. This expansion potentially “obliterates [the] distinction” between a dealer and trader by “extending the definition of ‘dealer’ to market participants that run investing and trading businesses, not dealing businesses.”[42]Professor Louis Loss, grandfather of academic securities regulation analysis, noted that dealers are distinguished from traders because their business is “ordinarily

characterized by a regular turnover," as opposed to a trader who "does not furnish the services which are usually provided by dealers," such as quoting the market, investment advice, and extending credit.[43]The Commission has faced questions regarding this distinction erasure both in the past and the rules' comment period,[44]and sidestepped such questions in its explanations.[45]At base, then, ambiguity surrounding AMM and LP dealer registration requirements has increased under these new rules.

STAKING ISSUES?

Relatedly, the Final Rules create another potentially overbroad consequence: capturing staking parties on blockchain networks. The second Final Rule explains that a dealer could be any party "*capturing any incentives offered by trading venues* to liquidity-supplying trading interest."[46]In its comment letter, the Association for Digital Asset Markets explained that this standard threatens to capture "digital assets earned by acting as a validator to be the type of revenue" contemplated in the above standard.[47]Given that LPs in a DeFi protocol already "stake" their LP tokens in the protocol and are rewarded with tokens,[48]the Commission may view traditional network validator staking[49]as similar for purposes of dealer registration.

The Commission responded directly to this concern in the Final Rules, noting concerns that this factor's "application in the crypto asset securities market may not be clear," such as "activities related to blockchain consensus and validation."[50]To that end, the Commission offered a non-explanation: "[w]hether a particular activity in the crypto asset securities market, including in the so-called DeFi market, gives rise to dealer activity will require an analysis of the totality of the particular facts and circumstances."[51]Its explanation of the term "trading venues" was similarly ambiguous: "the Commission declines to limit the scope of this factor to trading venues that are national securities exchanges or ATSs [Alternative Trading Systems]."[52]Finally, the SEC reiterated its position from the Proposed Rules[53]that all digital assets deemed securities could give rise to dealer registration requirements.[54]When paired with the SEC's already skeptical outlook on staking,[55]these rules create even more ambiguity as to whether staking falls under certain registration requirements within the securities laws.

TAKEAWAY: AMBIGUITY ABOUNDS

In sum, the SEC's new dealer rules appear to apply to DeFi—but to what extent and with regard to which actors remains to be seen. In an industry that has been asking the Commission for clarification regarding digital assets' status as securities,[56]these new rules only add another layer of confusion to the regulatory landscape. As Commissioner Uyeda noted, simply providing more liquidity to the market "does not legally transform traders into dealers. Broadly speaking, any market participant can be a liquidity provider, and it makes no sense to use liquidity provision as the

basis for legally distinguishing between dealers and traders."[57]To that end, the Commission's new rules have the potential to pull in AMMs, LPs, and even network stakers through their ambiguity, eliminating the dealer-trader distinction. Given the rule's potentially negative externalities across industries,[58]the time may be ripe for a legal challenge as other digital asset industry members take the fight to the SEC.[59]

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FOOTNOTES

[1] *SEC Proposes Rules to Include Certain Significant Market Participants as "Dealers" or "Government Securities Dealers"*, Sec. & Exch. Comm'n (Mar. 28, 2022).

[2] SEC Adopts Rules to Include Certain Market Participants as "Dealers" or "Government Securities Dealers", Sec. & Exch. Comm'n (Feb. 6, 2024),

[3] Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer at 2, Exchange Act Release No. 34-94524, 87 Fed. Reg. 23054 (proposed Mar. 28, 2022) (hereinafter "Proposed Rules").

[4] *See* 15 U.S.C. 78c(a)(5), (a)(44).

[5] *See* Proposed Rules, *supra* note 4, at 11.

[6] *See id.* at 30.

[7] *See id.*

[8] *See id.* at 42.

[9] *Id.* at 45.

[10] *See id.* at 86.

[11] *See id.* at 14 n.36 (explaining that the Proposed Rules would apply to securities, "including any digital asset that is a security or government security within the meaning of the Exchange Act").

[12] Cheyenne Ligon, *The SEC's New Proposal to Redefine 'Dealer' Could Spell Bad News for DeFi*, CoinDesk, (May 11, 2023, 12:12 PM) ("Crypto lawyers have sounded the alarm on Twitter, calling the proposal an 'all-out shadow attack on decentralized finance.'").

[13] Comment Letter of The Blockchain Association at 3–4 (May 27, 2022), (hereinafter "Blockchain Association Comment Letter"); *see also* Comment Letter of the DeFi Education Fund at 8–9 (May

27, 2022), https://www.sec.gov/comments/s7-12-22/s71222-20131214-296907.pdf (hereinafter "DEF Comment Letter").

[14] *See* DEF Comment Letter, *supra* note 14, at 9–11.

[15] *See Comment Letter of the Chamber of Digital Commerce at 7* (June 13, 2022), .

[16] *Compare* Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer in Connection with Certain Liquidity Providers, Exchange Act Release No. 34-99477 (adopted Feb. 6, 2024) (hereinafter "Final Rules"), *with* Proposed Rules, *supra* note 4; *see also* Sarah Wynn, *SEC Adopts Rule to Have Stricter Oversight Over Dealers, Looping in Crypto and DeFi*, Block (Feb. 6, 2024, 1:17 PM).

[17] *See* Final Rules, *supra* note 17, at 18 (emphasis in original).

[18] *Id.* at 19.

[19] *Id.*

[20] *Id.* at 26–27.

[21] *Id.* at 28–29.

[22] *See id.* at 61.

[23] *See* Gary Gensler, *Statement on Final Rules Regarding the Further Definition of a Dealer-Trader*, Sec. & Exch. Comm'n (Feb. 6, 2024); Hester M. Peirce, Dealer, No Dealer?: Statement on Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer in Connection with Certain Liquidity Providers, Sec. & Exch. Comm'n (Feb. 6, 2024).

[24] Gensler, *supra* note 24.

[25] *See id.*

[26] *See id.*

[27] *See* Peirce, *supra* note 24.

[28] Eric Martin, *Stumbling Block? What is the Path Ahead for DeFi Through the Eyes of Policymakers?*, BCLP (Jan. 18, 2024).

[29] *See* Peirce, *supra* note 24.

[30] *Id.*

[31] *See* Mark T. Uyeda, *Statement on Further Definition of "As a Part of a Regular Business" in the Definition of Dealer*, Sec. & Exch. Comm'n (Feb. 6, 2024).

[32] *See* Peirce, *supra* note 24.

[33] *See Fact Sheet: Final Rules: Changes to Definition of Dealer and Government Securities Dealer*, Sec. & Exch. Comm'n 2 (Feb. 6, 2024); Final Rules, *supra* note 17, at 20–21.

[34] Peirce, *supra* note 24.

[35] U.S. Securities and Exchange Commission, *2024-02-06-Open-Meeting*, at 45:26, YouTube (Feb. 7, 2024).

[36] *Id.*

[37] *Id.*

[38] *Id.*

[39] Mike Antolin, *What Are Liquidity Pools?*, CoinDesk, (Nov. 16, 2022, 12:25 PM).

[40] *Id.*

[41] *Id.*

[42] *See* Peirce, *supra* note 24.

[43] *See* Louis Loss, 2 Securities Regulation 1297 (2d ed. 1961).

[44] Ignacio A. Sandoval, Steven W. Stone, Michael M. Philipp, John V. Ayanian & Mark D. Fitterman, *Challenges in Requiring High-Frequency Traders to Register as Dealers*, Nat'l L. Rev. (June 10, 2014); *see also* Craig M. Lewis, The SEC's Proposed Rules for Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer at 8, Comment Letter of The Manage Funds Association (Dec. 5, 2022); DEF Comment Letter, *supra* note 14, at 2.

[45] *See* Final Rules, *supra* note 17 ("To the extent that this factor would capture non-dealing, retaining it would require persons who are not dealing to either register as dealers and incur the costs described insection III.C.2., or else to cease certain non-dealing activities."); Gary Gensler, *Statement on the Further Definition of a Dealer-Trader*, Sec. & Exch. Comm'n (Mar. 28, 2022), (noting that the Proposed Rules were designed to target "high-frequency trading firms").

[46] *See* Final Rules, *supra* note 17 (emphasis added).

[47] *See Comment Letter of The Association for Digital Asset Markets* at 16 (May 27, 2022).

[48] *See* Antolin, *supra* note 39. As a note, this is a somewhat simplified statement of how DeFi works.

[49] Krisztian Sandor, *Crypto Staking 101: What Is Staking?*, CoinDesk (Feb. 21, 2023, 1:34 PM) (explaining that staking rewards validators with "rewards denominated in the native cryptocurrency").

[50] Final Rules, *supra* note 17, at 56.

[51] *Id.* at 58.

[52] *Id.* at 57; *see also id.* at 57 n.188 ("Whether a particular structure or activity in the crypto asset securities market, including the so-called DeFi market, involves a trading venue is a facts and circumstances determination.").

[53] *See* Proposed Rules, *supra* note 4, at 14 n.36 ("[The] Proposed Rule[s] would apply to securities . . . including any digital asset that is a security or government security within the meaning of the Exchange Act.").

[54] *See* Final Rules, *supra* note 17, at 22 ("[T]he Commission is not excluding certain types of securities, specifically crypto asset securities, from the application of the final rules.").

[55] Sec. & Exch. Comm'n, *Exercise Caution with Crypto Asset Securities: Investor Alert* (Mar. 23, 2023), ("Moreover, entities and platforms involved in lending or *staking* crypto assets may be subject to the federal securities laws.") (emphasis added).

[56] Arjun Kharpal, *'Can't Get Their Act Together': Crypto Firms Slam SEC, Washington for Lack of Clarity on Rules*, CNBC, (Mar. 24, 2023, 2:19 AM).

[57] *See* Uyeda, *supra* note 32; *see also* Peirce, *supra* note 24 ("The upheaval wrought by the rule's singular focus on liquidity provision creates uncertainty about dealer status for many market participants who rely on the trader exception."); Sec. & Exch. Comm'n, Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker 100 (1936) ("It is important, therefore, not to regard existing liquidity as a fetish[.] . . . [O]veremphasis upon liquidity in our stock markets is fraught with grave dangers to our economic system[.]").

[58] *See* Matthew Bultman, *Private Funds Warn SEC Underestimates Impact of 'Dealer' Label*, Bloomberg L. (Feb. 9, 2024, 4:00 AM).

[59] *See, e.g.*, Jody Godoy, *Texas Crypto Company Sues SEC for 'Overreach' on Digital Assets*, Reuters (Feb. 21, 2024, 3:52 PM); Jake Chervinsky & Amanda Tuminelli, *In Lejilex vs. SEC, Crypto Goes on Offense in the Courts*, CoinDesk, (Feb. 23, 2024, 9:30 AM).

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