NELSON MULLINS

Regulation of Securities Trading Platforms

Richard B. Levin and Bobby Wenner

June 4, 2024

- Introduction
- What is Blockchain Technology?
- What are Digital Asset Securities?
- Exchanges
- Alternative Trading Systems
- Broker-Dealers
- Clearing Agencies
- Digital Asset Trading Platforms
- SEC Enforcement Actions

What is Blockchain Technology?

- The idea of a blockchain was introduced in 2008 as a basis for the virtual currency Bitcoin, which is an example of an unrestricted blockchain.
- Blockchain technology is a distributed list of all transactions across a peer-to-peer network.
- Blockchain is the technology underlying Bitcoin and other digital currencies, and it has the potential to disrupt a wide variety of business processes.
- The blockchain is “authoritative” because every user agrees on it.
- In some blockchain initiatives there are no central, regulated institutions playing any role in the process.
- Advocates of blockchain technology believe it could substantially improve the trading, clearance and settlement of securities.
- Former SEC Commissioner Kara Stein once noted “one could imagine a world in which securities lending, repo, and margin financing are all traceable though blockchain’s transparent and open approach to tracking transactions.”

What is Blockchain Technology?

- The technologies used by the financial services industry have developed over time as a network of mutually trusting institutions, with legal agreements and regulations designed to minimize risks, such as operational and counterparty risk, that are not directly related to the business of a securities issuer.

- Each institution trades with accountable and authorized counterparties, under the supervision and oversight of regulators.

- The adoption of blockchain technology will mean that competing financial institutions will be able to share a common digital representation of asset holdings and keep track of the execution, clearing and settlement of trades outside their legacy proprietary databases, and without the need for a central database management system.

- Blockchain technology enables users to become peers in a shared database, which they can rely on to record transfers of assets and to perform additional related activities involving multiple parties, such as trading, clearance, and settlement.

- Blockchain users can propose new transactions and, depending on the blockchain chosen, they can either contribute to validation collectively or have a subset of users responsible for this task.

- A transaction is validated when a specified proportion of the network's validators have reached a consensus as to its legitimacy.

What is Blockchain Technology?

- Changes to the shared database are then reflected in its digitally signed versions, which users can store locally (either in their entirety or with only a subset of transactions/accounts visible).
- Users can then extract the updated information they need for conducting their respective businesses from these locally stored databases.
- Blockchains allow their users to store and access information relating to a given set of assets and their holders in a shared database of either transactions or account balances.
- This information is distributed among users, who could then use it to settle their transfers of, or for example, securities and cash, without needing to rely on a trusted central validation system.
- In financial markets, the substantial de-materialization of securities and cash has progressively shifted the settlement of a trade from the physical delivery and paper-based recording, to a system of book transfers in digital databases.
- What remains unchanged is the need for an authoritative “golden record” of holdings to be kept by specific financial market infrastructures, and for intermediaries involved in the settlement process to update their individual databases by communicating with the other institutions involved, at the different levels of post-trading, in order to be able to reflect the changes in each other’s records.

What is Blockchain Technology?

- The high cost of this type of reconciliation process has led many market players to consider distributed ledgers as an alternative to central validation systems – currently one per institution (internal records of outstanding positions) or per cluster of institutions (e.g., interoperable market infrastructure) – to keep their reciprocal records updated.

- Blockchains allow their users to reach consensus on a particular version of the distributed ledger, in particular on the sequential order of transactions.

- This means that there cannot be any doubt as to the users' respective holdings.

- Central validation is replaced in a blockchain by a set of cryptographic solutions and economic incentives that combine to prevent illicit updates and reconcile discrepancies.

- The ledger produced can thus be considered authoritative, although its management is shared among users with conflicting incentives.

Permissioned v. Permissionless Ledgers

- Blockchains can be divided into those which are restricted and those which are unrestricted.
- Restricted blockchains are closed systems whose members are identified and accountable entities.
- Updates to the blockchain can only be proposed and validated by authorized participants.
- In unrestricted blockchains, by contrast, any entity can access the database and, depending on the specific validation method used, may be able to contribute to updating the ledger or to submit spam transactions to cause a denial of service.
- In a restricted blockchain the identity of participants is known, at least by its governance body.
- This implies that any wrongdoer can be identified and his misbehavior can be punished in the case of future activity in the ledger.
- Restricted blockchains also expose the conduct of any participants in the blockchain network to the set of rules and law-enforcement measures that typically apply to off-ledger activity.
- By definition, users of unrestricted blockchains cannot be held accountable outside the distributed ledger for their activity in the network.

What are Digital Assets?

- For purposes of this presentation we use the term “digital asset” in the same manner as the SEC to refer to "*an asset that is issued and transferred using distributed ledger or blockchain technology*."
- Statement on Digital Asset Securities Issuance and Trading, Division of Corporation Finance, Division of Investment Management, and Division of Trading and Markets, SEC (Nov. 16, 2018).
- As the SEC has noted, digital assets include, but are not limited to virtual currencies, coins, and tokens.
- A digital asset may in certain instances be deemed a security under the federal securities laws.
- While not defined in the securities laws, the SEC often refers to digital assets that are securities as a “digital asset securities.”
- **The definition of what is a security in the digital asset space has resulted in a considerable amount litigation with the SEC and debate in Congress.**

What are Digital Asset Securities?

- The definitions of "security" under the Securities Act and the Exchange Act are nearly identical and each is broad enough to include the various types of instruments that are used in commercial marketplaces that one might suspect to fall within the ordinary concepts of a security.

- This would include common instruments like stocks, bonds, and notes, as well as the various collective investment pools and common enterprises devised by persons seeking to generate profits from the efforts and investments of others (i.e. investment contracts and instruments commonly known as securities).

- Section 2(a)(1) of the Securities Act defines a "security" as:

  [A]any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, . . . transferable share, ***investment contract***, . . . any put, call, straddle, option, or privilege on any security, certificate of deposit, . . . or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

What are Digital Asset Securities?

- In the SEC's "Framework for 'Investment Contract' Analysis of Digital Assets, the agency detailed its framework for analyzing digital assets as "investment contracts" pursuant to *SEC v. W.J. Howey Co.*, stating:
  - Under the *Howey* test, an "investment contract" exists when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others.
  - Whether a particular digital asset at the time of its offer or sale satisfies the *Howey* test depends on the specific facts and circumstances.
- This legal framework has been the basis of numerous enforcement actions brought by the SEC against digital asset issuers and exchange platforms.
- The SEC has also pursued interest-digital assets in the context of "notes" under the U.S. Supreme Court's holding in *Marine Bank v. Weaver*, in which the Court addressed whether the sale of a certificate of deposit was a security.
- In recent years, "staking" and other interest bearing digital asset products have grown in popularity.
- The SEC has brought enforcement actions citing *Marine Bank* against issuers of interest-bearing products including Celsius, BlockFi, and others.

Exchanges

- Section 3(a)(1) of the Exchange Act defines an "exchange" as "any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange."

- Exchange Act Rule 3b-16(a) interprets the definition to mean any organization, association, or group of persons that: (1) ***brings together the orders of multiple buyers and sellers*** and (2) uses established, nondiscretionary methods (***whether by providing a trading facility*** or by setting rules) ***under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade***.

- Absent an exemption, an exchange must register as a national securities exchange pursuant to section 6 and section 19(a) of the Exchange Act.

- If a blockchain technology platform brings together multiple buyers and sellers of digital assets that are deemed securities, the platform could be required to register as a securities exchange unless it falls within an exclusion from registration.

Alternative Trading Systems

- In 1998, the SEC adopted Regulation ATS, which allows an ATS to choose whether to register as a national securities exchange or to register as a broker-dealer and comply with additional requirements of Regulation ATS.

- An "alternative trading system" means any organization, association, person, group of persons, or system:

  - that constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of Rule 3b-16 under the Exchange Act, and

  - that does not set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such organization, association, person, group of persons, or system; or discipline subscribers other than by exclusion from trading.

- A blockchain technology platform may be required by the SEC to register as an ATS if it maintains a marketplace or facilities for bringing together purchasers and sellers of digital assets that are deemed securities, and it does not set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such platform.

- An ATS must be operated by a broker-dealer registered with the SEC.

Broker-Dealers

- Section 15 of the Exchange Act requires registration with the SEC of all broker-dealers using interstate commerce or the facilities of any national securities exchange to effect transactions in securities (other than exempted securities and certain short-term debt instruments).
- Section 3(a)(4)(A) of the Exchange Act defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others."
  - The Exchange Act and the rules thereunder do not define these terms.
  - The courts and the SEC have taken an expansive view of the scope of these terms.
- The SEC and the courts apply a "facts and circumstances" analysis in evaluating whether a person has acted as a broker, with no single element being dispositive.
- Depending on the circumstances, the operator of a blockchain technology platform may be deemed a broker-dealer if the operator of the platform is deemed to be engaged in the business of effecting transactions in securities for the account of others.

Clearing Agencies

- Section 17A(b) of the Exchange Act generally makes it unlawful "for any clearing agency, unless registered, to make use of the mails or any means or instrumentality of interstate commerce to perform the functions of a clearing agency with respect to any security."

- Section 3(a)(23)(A) of the Exchange Act defines the term "clearing agency" as:

  any person who acts as an intermediary in making payments or deliveries or both in connection with transactions in securities or who provides facilities for comparison of data respecting the terms of settlement of securities transactions, to reduce the number of settlements of securities transactions, or for the allocation of securities settlement responsibilities.

- As well as:

  any person … who (i) acts as a custodian of securities in connection with a system for the central handling of securities whereby all securities of a particular class or series of any issuer deposited within the system are treated as fungible and may be transferred, loaned, or pledged by bookkeeping entry without physical delivery of securities certificates, or (ii) otherwise permits or facilitates the settlement of securities transactions or the hypothecation or lending of securities without physical delivery of securities certificates.

- Registered clearing agencies are subject to comprehensive regulation—including recordkeeping requirements and SEC examination—under the Exchange Act and the rules thereunder, providing important safeguards to investors and market participants, and to the maintenance of fair competition.

- Properly registered clearing agencies must enact a set of rules to govern their and their members' behavior, and these rules are subject to review by the SEC.

Digital Asset Trading Platforms

- Digital asset trading platforms are marketplaces that generally offer a variety of services relating to digital assets, often including brokerage, trading and settlement services.

- Digital asset trading platforms allow their customers to purchase and sell crypto assets for fiat currency (legal tender issued by a country) or for other crypto assets. “Off-chain” transactions are tracked in the internal recordkeeping mechanisms of the platform but do not involve transferring crypto assets from one wallet to another, while “on-chain” transactions involve the transfer of a crypto asset from one blockchain address to another.

- Digital asset trading platforms typically possess and control the digital assets deposited and/or traded by their customers and, thus, function as a central depository. The customers’ entitlements are then typically tracked and maintained on the digital asset trading platform’s internal ledgers.

- The graphic user interfaces employed by digital asset trading platforms—such as on websites, mobile apps, or other software—typically emulate and function like traditional securities trading screens: they show order books of the various assets available to trade, and historical trading information like high and low prices, trading volumes, and capitalizations.

Digital Asset Trading Platforms

- However, unlike in traditional securities markets, digital asset trading platforms typically solicit, accept, and handle customer orders for securities; allow for the interaction and intermediation of multiple bids and offers resulting in purchases and sales; act as an intermediary in making payments or deliveries, or both; and maintain a central securities depository for the settlement of securities transactions.

- By contrast, a registered national securities exchange submits information regarding executed trades to a registered clearing agency that takes responsibility for ensuring settlement finality and safekeeping of the assets being traded and, in doing so, protects investors' interests. Thus, registered national securities exchanges typically do not assume possession or control of the underlying assets being traded.

- Digital asset trading platforms usually settle transactions by updating internal records with each investor's positions, a function typically carried out by clearing agencies in compliant securities markets.

- Likewise, digital asset trading platforms typically perform roles traditionally assigned to broker-dealers in compliant securities markets, without following or even recognizing the legal obligations and restrictions on activities that accompany status as a broker-dealer.

SEC Enforcement Actions

- Recent Investigations/Settlements
  - Bittrex (settled on Aug. 10, 2023 for $24 million) – digital asset trading platform and former CEO to settle SEC charges for operating an unregistered securities exchange, broker, and clearing agency
  - Binance (in litigation) – charged with operating its crypto asset trading platform as an unregistered national securities exchange, broker, and clearing agency.
  - Coinbase (in litigation) – charged with operating its digital asset trading platform as an unregistered national securities exchange, broker, and clearing agency.
  - Poloniex (settled on Aug. 9, 2021) – digital asset trading platform agreed to pay more than $10 million to settle charges for operating an unregistered digital asset exchange.
- SEC Crypto Assets and Cyber Enforcement Actions

SEC v Binance

- On June 5, 2023, the SEC charged Binance, which operates the largest digital asset trading platform in the world, Binance.com, US-based affiliate, BAM Trading Services Inc., which, together with Binance, operates the US based crypto trading platform, Binance.US, and their founder Changpeng Zhao, with numerous securities law violations.

- In its complaint, the SEC alleged that although Zhao and Binance had publicly claimed that US customers were restricted from transacting on Binance.com, Zhao and Binance "subverted their own [risk management and corporate governance] controls to allow high net worth US customers to continue trading on the Binance.com platform."

- In total, the SEC levied 13 charges against Binance and, among other allegations, the SEC alleged that: (1) Binance engaged in fraudulent activity and illegally diverted customer assets; (2) with respect to Binance.com, ***Binance should have registered as an exchange, broker-dealer, and clearing agency***; (3) with respect to ***Binance.US, Binance and BAM Trading should have registered as an exchange and clearing agencies***; and (4) ***BAM Trading should have registered as a broker-dealer.***

- The SEC further charged Binance for the unregistered offers and sales of certain tokens and crypto-lending products.

- On June 17, the SEC and Binance reached an agreement in court to allow Binance to continue to operate in the US despite its ongoing litigation with the SEC on fraud charges.

SEC v. Coinbase

- Following the industry disturbing complaint against Binance, the SEC, on the following day, 6 June 2023, charged Coinbase with operating its crypto trading platform as an unregistered national securities exchange, broker, and clearing agency.
- According to the SEC's complaint, Coinbase has made $ billions since 2019 by unlawfully facilitating the buying and selling of crypto asset securities.
- The complaint alleges that Coinbase acted as an unregistered securities exchange, broker, and clearing agency by: (1) providing a marketplace that matches multiple buyers and sellers using non-discretionary methods (through the use of technology); (2) facilitated securities transactions for its customers; (3) provided securities depository services; and (iv) engaged in unregistered securities offerings through its staking-as-a-service program.
- Of particular interest in the Coinbase complaint is an identification of numerous digital assets that the SEC has identified as securities.
- Among those identified were Cardano, Solana, and Polygon, which, as of July 17, 2023, were the seventh, eighth, and tenth largest digital assets by market cap in the world.
- Subsequent arguments in court have continued to see the SEC argue that digital assets should be viewed as 'investment contracts' under Howey while Coinbase argues the contrary.

Presenter Biographies

RICHARD B. LEVIN

Richard is chair of the FinTech and Regulation Practice and was one of the first lawyers to focus on the regulation of blockchain and digital assets. He is considered a thought leader in the FinTech space. Richard brings his experience as a senior legal and compliance officer on Wall Street and in London to bear in advising clients on corporate, FinTech, securities, and regulatory issues. A problem-solver by nature, he has been advising FinTech clients on legal and regulatory issues since the start of electronic trading in the late 1990s. His practice focuses on helping financial services and technology clients identify and address regulatory issues as they build their businesses.

Richard's practice focuses on the representation of early stage and publicly traded companies in the FinTech space, including investment banks, broker-dealers, investment advisers, peer-to-peer lending platforms, digital currency trading platforms, alternative trading systems (ATSs), exchanges, and custodians. He represents these firms before the U.. Securities and Exchange Commission (SEC), the U.S. Commodity Futures Trading Commission (CFTC), the Financial Industry Regulatory Authority (FINRA), the U.S. Department of the Treasury, Office of the Comptroller of the Currency (OCC), state regulators, and Congress. Richard has represented clients before regulators in Australia, Canada, France, Germany, Hong Kong, Ireland, Japan, Singapore, South Korea, and the United Kingdom. His current and past clients include leading national financial institutions, multinational financial services holding companies, leading firms in the FinTech space, and institutions engaging in global investment banking, investment management, securities, and other financial services with institutional clients.

Richard has been identified by Chambers and Partners as one of the leading lawyers in the Blockchain and Cryptocurrencies category since the inception of the category. He has been recognized by Chambers for his knowledge on regulatory matters, great relationships with regulators, for helping clients push the boundaries of the FinTech sector, and for his advice on matters such as broker-dealer licensing and alternative trading systems. Richard is routinely quoted by leading publications including Bloomberg, the New York Times, Reuters, and the Wall Street Journal and is a frequent speaker at conferences around the world on the regulation of FinTech, blockchain, and digital assets.

Presenter Biographies

Bobby Wenner

Bobby counsels financial services and technology firms on financial services regulatory and corporate matters. He focuses on the representation of financial technology companies working with blockchain, tokenization, digital assets, and cryptocurrencies, including broker-dealers, alternative trading systems (ATS), digital asset and currency trading platforms, digital asset issuers and custodians, securities exchanges, and derivatives trading platforms including swap execution facilities.

Bobby represents these clients before Congress, the Securities Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), the Commodity Futures Trading Commission (CFTC), and state financial services regulators. He also represents banks, money services businesses, and payment processors before the federal banking regulators, including the Office of the Comptroller of the Currency, the Financial Crimes Enforcement Network (FinCEN), and state banking regulators.

Before joining Nelson Mullins, Bobby served as the Chief Legal Officer of a FINRA-member broker-dealer and ATS designed for trading digital asset securities, as well as the Associate General Counsel of the holding company, and the company's digital asset trading and issuance ecosystem. In these roles, Bobby led various state and federal financial services licensure applications, interfaced with regulators, provided counsel on a wide range of securities, commodities, and derivatives product development efforts, and helped develop a regulatory compliant business model and launch strategy. Prior to his positions in-house, Bobby was an associate in the FinTech and Regulation practice of a national law firm.

Contact Details

To learn more about our FinTech and Regulation practice, or to contact a member of our team, click here or visit our website at nelsonmullins.com.

To learn more about this presentation, please contact:

Richard B. Levin
Chair FinTech and Regulation Practice
1400 Wewatta Street
Suite 500
Denver, CO 80202
Tel. 303.583.9929
richard.levin@nelsonmullins.com

Bobby Wenner
Of Counsel
1400 Wewatta Street
Suite 500
Denver, CO 80202
Tel. 303.583.9907
bobby.wenner@nelsonmullins.com

About This Publication

- Nelson Mullins provides this material for informational purposes only.
- The material provided herein is general and is not intended to be legal advice.
- Nothing herein should be relied upon or used without consulting a lawyer to consider your specific circumstances, possible changes to applicable laws, rules and regulations and other legal issues.
- Receipt of this material does not establish an attorney-client relationship.
- Nelson Mullins is very proud of the results we obtain for our clients, but you should know that past results do not guarantee future results; that every case is different and must be judged on its own merits; and that the choice of a lawyer is an important decision and should not be based solely upon advertisements.