coinbase

Via electronic submission to rule-comments@sec.gov

August 12, 2024
Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: Supplemental Information and Reopening of Comment Period for Amendments Regarding the Definition of "Exchange," File No. S7-02-22

Dear Ms. Countryman:

Thank you for the opportunity to comment on the U.S. Securities and Exchange Commission's (the **Commission's**) supplemental information and reopening of comment period (the **Reopening**) for the proposed amendment of Rule 3b-16 under the Exchange Act of 1934 (the **Exchange Act**) regarding the definition of "exchange" (the **Proposed Rule**).[1] Coinbase remains concerned about the Commission's proposed expansion of the term "exchange"—which the SEC's Reopening has confirmed was designed in part to target decentralized exchanges (**DEXs**) that facilitate trading in digital assets.[2] In its previous comment letter on the Proposed Rule, Coinbase raised several concerns about that expansive definition. Among other things, Coinbase explained that the Proposed Rule would have the effect (and perhaps even had the purpose) of terminating innovation in crypto markets in various ways, such as by saddling DEXs with anachronistic and impossible-to-satisfy requirements, by inexplicably banning side-by-side trading of digital assets and purported "crypto asset securities," and by failing to conduct an adequate cost-benefit analysis of the Proposed Rule's likely effects.[3] The recent demise of *Chevron* deference only underscores how unlikely it is that reviewing courts will agree with the Commission's sweeping attempt to stretch the Exchange Act's key terms far beyond their original meaning. *See Loper Bright Enters. v. Raimondo*, 144 S. Ct. 2244, 2273 (2024) ("*Chevron* is overruled.").

Coinbase submits this supplemental comment letter to highlight additional flaws with the Commission's cost-benefit analysis. The Administrative Procedure Act (**APA**) and the Exchange Act mandate rigorous consideration of the Proposed Rule's economic effects on "efficiency, competition, and capital formation."[4] That inquiry can be rationally conducted only when the agency has first obtained sufficient information about a

[1] Supplemental Information and Reopening of Comment Period for Amendments Regarding the Definition of "Exchange," 88 Fed. Reg. 29,448 (May 5, 2023).

[2] *Id.* at 29,452/3-53/1-2.

[3] Coinbase, Inc., Comment Letter on Supplemental Information and Reopening of Comment Period for Amendments Regarding the Definition of "Exchange," File No. S7-02-22 (June 13, 2023), https://www.sec.gov/comments/s7-02-22/s70222-205079-412142.pdf (2023 **Coinbase Letter**); see also Coinbase, Inc., Comment Letter on Proposed Rule on Amendments Regarding the Definition of ''Exchange'' and Alternative Trading Systems (ATSs) That Trade U.S. Treasury and Agency Securities, National Market System (NMS) Stocks, and Other Securities, RIN 3235–AM45 (Apr. 18, 2022), https://www.sec.gov/comments/s7-02-22/s70222-20123940-280077.pdf.

[4] 15 U.S.C. § 78c(f).

proposed rule's economic effects and then uses that information to conduct an objective, genuine balancing of the Proposed Rule's likely burdens against its purported benefits. Here, however, the Commission has cast off any pretense of seriously conducting that inquiry. To the contrary, in the Proposed Rule the Commission conceded—more than a dozen times—that it lacks fundamental information about critical issues such as how DEXs operate, whether they could even comply with the Proposed Rule, the compliance costs they would have to incur even if they could, whether they could afford to defray those costs, and the broader ramifications to American innovation that the Commission's proposed regime would threaten. On the other side of the ledger, the Commission hypothesizes vague and subjective benefits that it says could potentially accrue to American users of DEXs—but which in fact would be unlikely to materialize, particularly if DEXs are practically extinguished from the U.S. market by the Proposed Rule itself.

These concerns confirm that the Commission should abandon its effort to apply the Proposed Rule to DEXs. At a minimum, the Proposed Rule should be withdrawn and re-noticed to permit meaningful stakeholder input *after* the Commission has gathered and rationally assessed the critical information related to the economic effects of the Proposed Rule that the agency now concededly lacks.

I. The APA and the Exchange Act Mandate Rigorous Consideration Of The Rule's Economic Impacts

"Federal administrative agencies are required to engage in 'reasoned decisionmaking.'"[5] Thus, "[n]ot only must an agency's decreed result be within the scope of its lawful authority, but the process by which it reaches that result must be logical and rational" and must rest "on a consideration of the relevant factors."[6] One aspect of that obligation is to consider the costs that agency action imposes. It would not be rational, for example, to "impose billions of dollars in economic costs in return for a few dollars in … benefits."[7] Agencies therefore "have long treated cost as a centrally relevant factor when deciding whether to regulate," given that agencies must "pa[y] attention to the advantages *and* the disadvantages" of proposed policies.[8]

The Exchange Act amplifies the Commission's burden to rigorously consider the potential economic impacts of its proposed action. The Exchange Act requires that where, as here, "the Commission is engaged in rulemaking" pursuant to Section 78c, it must "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[9] In discharging this obligation, the SEC cannot merely assert that it was "unable to determine *ex ante*" a proposal's effects on efficiency, competition, and capital formation; Section 78c does not authorize "this aimless regulatory approach."[10] Nor may the SEC "inconsistently and opportunistically fram[e] the costs and benefits of [a] rule," "fai[l] adequately to quantify the certain costs or to explain why those costs could not be quantified," "neglect[t] to support its predictive judgments," or "contradict[t] itself."[11]

On-point Executive Orders likewise underscore the Commission's obligation to rationally assess those economic effects. For "significant regulatory action[s]" with an impact of $100 million or greater on the economy, or that raise "novel legal or policy issues," Executive Order 12,866 mandates that the Commission weigh costs and benefits

[5] *Michigan v. EPA*, 576 U.S. 743, 750 (2015).

[6] *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

[7] *Michigan*, 576 U.S. at 750.

[8] *Id.* at 752-53.

[9] 15 U.S.C. § 78c(f).

[10] *N.Y. Stock Exch. LLC v. SEC*, 962 F.3d 541, 555 (D.C. Cir. 2020).

[11] *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1148-49 (D.C. Cir. 2011).

and use the best reasonably obtainable information to do so.[12] Executive Order 13,563 "reaffirms" that command.[13] Those directives are fully applicable to the Commission.[14]

Thus, the Commission must rigorously evaluate the economic impacts of the Proposed Rule, including the costs that it entails, and do so based on the best possible information it can obtain. The Commission cannot merely postulate that certain critical details are unknown or unknowable and forge ahead anyway.

II. The Commission's Cost-Benefit Analysis Lacks Critical Information And Rests On Irrational Assumptions

The Commission does not even attempt to discharge these statutory and procedural obligations in the Proposed Rule. To the contrary, it repeatedly concedes that it lacks basic information about the DEXs that the Proposed Rule is designed to target. And to try to fill those gaps, it illogically assumes that *non-DEX* entities provide a baseline for assessing potential costs to *DEXs*—which operate in a fundamentally different way and thus will incur fundamentally different (and far greater) compliance costs.

A. The Commission Repeatedly Concedes That It Lacks The Basic Data Needed to Rationally Regulate

Despite the Commission's "unique obligation" to "support its predictive judgments," the Proposed Rule is chock-full of disclaimers about how little the Commission actually understands the area it now seeks to regulate.[15] To take just a few examples, the Commission admits that it either lacks information or is uncertain about key inputs to its cost-benefit analysis, including:

- "[C]rypto asset securities" in general (a term the Commission has never defined);[16]
- The "number of platforms operating in the crypto asset market;"[17]
- The "amount of trading in crypto assets that takes place through platforms, or to quantify their share of the market for trading services in crypto assets;"[18]
- How many "entities" are "involved [in] providing New Rule 3b-16(a) Systems in the market for crypto asset securities;"[19]

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[12] Exec. Order No. 12,866, 58 Fed. Reg. 51,735 (Sept. 30, 1993).

[13] Exec. Order 13,563, 76 Fed. Reg. 3,821 (Jan. 18, 2011) ("reaffirm[ing]" Executive Order 12,866); *La. Forestry Ass'n Inc. v. Dep't of Labor*, 745 F.3d 653, 678 (3d Cir. 2014) ("economic analysis [is] required by Executive Order 12866").

[14] *See Extending Regulatory Review Under Executive Order 12866 to Independent Regulatory Agencies*, 43 Op. O.L.C. __ (Oct. 8, 2019) (slip op. 2, 13) (concluding that nothing bars application of Executive Order 12,866 to independent agencies).

[15] *Bus. Roundtable*, 647 F.3d at 1148-49; *N.Y. Stock Exch. LLC*, 962 F.3d at 555.

[16] 88 Fed. Reg. at 29,470/1 ("The Commission has limited information regarding crypto asset securities.").

[17] *Id.* ("The Commission is also unable to reliably determine the number of platforms operating in the crypto asset market.").

[18] *Id.* at 29,471/2 ("The Commission is unable to reliably determine the amount of trading in crypto assets that takes place through platforms, or to quantify their share of the market for trading services in crypto assets.").

[19] *Id.* at 29,474/1 ("The Commission lacks information on the entities involved providing New Rule 3b–16(a) Systems in the market for crypto asset securities, and consequently, is uncertain as to the precise number of such entities.").

- "[T]he range of specific communication protocols used for trading crypto assets;"[20]
- "[T]he costs that the Proposed Rul[e] would impose on market participants for crypto asset securities;"[21]
- "[T]he benefits that the Proposed Rul[e] would provide to market participants in the market for crypto asset securities;"[22]
- "Aggregate compliance costs;"[23] and
- Whether those costs are so "high [ ] that the group of persons responsible for the exchange [will] choose to exit the market for crypto asset security trading services rather than continue operations."[24]

It is difficult, given that list of admissions, to say what the Commission *does* know about the area that it now claims authority to regulate. And it is accordingly impossible to see how the Commission could possibly have discharged its statutory and procedural obligations to regulate in light of the best available information when the Commission admits that on many key issues it has little or no information at all.

The Commission attempts to excuse its failure to conduct even minimal due diligence by pointing to "the fact that only a small portion of crypto asset security trading activity is occurring within entities that are registered with the Commission," and by claiming that "significant trading" in digital assets "may be occurring in non-compliance with the federal securities laws."[25] But those purported impediments improperly assume the correctness of Commission's mistaken (yet opaque and shifting) understanding of the securities laws. In any event, those supposed obstacles do not prevent the Commission from discharging its duty to inform itself *before* regulating by obtaining information from *other* sources, such as public reporting by digital-asset companies (like Coinbase) or reports from blockchain-analytics forums or other market analysts. The Commission also claims that "rampant" "wash trading renders [trading] volume data unusable."[26] But the Commission's concern is vastly overstated. Coinbase and most other digital-asset exchanges prohibit wash trading and other manipulative trading practices

[20] *Id.* ("The Commission is uncertain as to the range of specific communication protocols used for trading crypto assets.").

[21] *Id.* at 29,474/3; 29,476/2 ("Throughout the discussion in this Reopening Release, the Commission has a greater degree of uncertainty in its analysis of the costs that the Proposed Rules would impose on market participants for crypto asset securities than it did in its discussion of costs for non-crypto asset securities. This is because the Commission has less data on the functioning of the market for crypto asset securities.").

[22] *Id.* at 29,475/1 ("However, throughout the discussion in this Reopening Release, the Commission has a greater degree of uncertainty in its analysis of the benefits that the Proposed Rules would provide to market participants in the market for crypto asset securities than it did in its discussion of benefits for non-crypto asset securities. This is because the Commission has less data on the functioning of the market for crypto asset securities.").

[23] *Id.* at 29,475/3 ("The Commission is uncertain as to how precise these estimates are because we lack sufficient data on crypto asset securities.").

[24] *Id.* at 29,484/2 n.368. In addition, the Commission also admits that is unable to determine (1) the "baseline" for the amount of trading in "the crypto asset market," *id.* at 29,470/3; (2) the "true market turnover for crypto assets," *id.*; (3) the "share of trading that takes place on various types of platforms," *id.* at 29,471/1; (4) the "amount of concentration in volume among various exchanges," *id.*; and (5) "[c]urrent crypto asset market practice" related to trading through "electronic chat messaging," *id.* at 29,474/2.

[25] *Id.* at 29,470/1-2.

[26] *Id*. at 29,471 n.210.

and employ trade-surveillance teams to enforce those prohibitions.[27] Moreover, many data aggregators—including those relied on by other countries' securities commissions—publish data that adjust for potential wash trading, belying the Commission's view that accurate information is simply unknowable.[28] If the Commission believes that wash-trading is a significant problem at certain particular digital-asset exchanges, a more rational approach would be promulgation of a rule explaining the Commission's purported authority to regulate *those* exchanges—not a sweeping redefinition of key terms affecting *all* exchanges. And at a minimum, the Commission must make an effort to quantify its effect on trading volumes. It cannot simply throw up its hands.

B. The Commission Irrationally Assumes That Compliance Is Possible For DEXs

The Proposed Rule purports to subject DEXs to its existing registration and disclosure rules rather than simply ban DEXs. In order to rationally regulate DEXs, the bare minimum the Commission must do is explain how DEXs can comply with its existing rules. Yet the Commission nowhere does so. And as Coinbase and others have previously explained, "it would be *impossible* for a DEX, to the extent it facilitated transactions in securities and met the Commission's proposed revised definition of an exchange, to comply with the existing requirements for a national securities exchange."[29] Indeed, as Coinbase has explained to the Commission in a rulemaking petition, the Commission's existing registration and disclosure rules are unworkable even for *centralized* digital-asset trading platforms.[30] The problem is only magnified for DEXs. Among other issues, DEXs cannot comply with registration and disclosure requirements designed for legacy financial exchanges managed by centralized companies. And even if DEXs could somehow comply with existing registration and disclosure rules, the Commission does not explain how SEC-registered DEXs could facilitate the trading of digital assets. The SEC currently limits a registered exchange to offering *only* securities. But there are almost no registered digital-asset securities, because digital-asset developers separately cannot comply with the Commission's inapt issuer regulations.[31] The Commission's insistence on sweeping new entities into its existing regulatory framework without addressing these workability concerns is arbitrary and irrational.

At times, the Commission seems to acknowledge the impossibility of compliance by suggesting that DEXs may simply "exit the market for crypto asset security trading services rather than continue operations."[32] Yet the Commission also fails to consider the enormous costs associated with extinguishing DEXs from the U.S. market. Doing so would have many undesirable knock-on effects. Not only would the Proposed Rule crush a valuable

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[27] Coinbase, Trading Rules, https://www.coinbase.com/legal/trading_rules (last accessed Aug. 5, 2024) ("Traders are prohibited from directly or indirectly engaging in Market Manipulation on the Trading Platform, including any Market Manipulation that may harm a Connected Trading Venue…. Market Manipulation specifically includes, without limitation: front-running, wash trading, spoofing, layering, churning, and quote stuffing.").

[28] *See, e.g.*, *Policy Recommendations for Decentralized Finance (DeFi) Consultation Report*, The Board of the International Organization of Securities Commissions (Sept. 2023), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD744.pdf.

[29] 2023 Coinbase Letter at 2-4.

[30] *See* Coinbase, Petition for Rulemaking, SEC File No. 4-789 (July 21, 2022), https://tinyurl.com/4mt2evcz; Coinbase, Supplemental Comment Letter, SEC File No. 4-789 (Dec. 6, 2022), https://tinyurl.com/36zmapuw; *see also*, *e.g.*, "Lessons from Crypto Projects' Failed Attempts to Register with the SEC," Paradigm Policy (March 23, 2023), https://policy.paradigm.xyz/writing/secs-path-to-registration-part-ii (noting that "the SEC has refused to license intermediaries [for digital-asset trading] such as broker-dealers and exchanges").

[31] Moreover, the SEC has permitted the handful of digital assets that *are* registered as securities to be registered only as a condition of cease-and-desist orders imposed on companies against which it has taken enforcement actions. *See, e.g.*, Blockchain of Things, Inc., Release No. 10736, SEC (Dec. 18, 2019), https://www.sec.gov/files/litigation/admin/2019/33-10736.pdf; CarrierEQ, Inc., d/b/a Airfox, Release No. 10575, SEC (Nov. 16, 2018), https://www.sec.gov/files/litigation/admin/2018/33-10575.pdf.

[32] 88 Fed. Reg. at 29,484 n.368.

market for DEXs' service providers, but it would also stamp out the economically productive trading activities that DEXs facilitate, while stunting broader innovation and growth in other consumer and financial-market fields that rely on blockchain settlement technology.

C. The Commission Irrationally Assumes That Non-DEXs Provide A Relevant Cost Baseline

Rather than do the work of collecting the key information needed to rationally regulate, the Proposed Rule takes a shortcut: It posits that the costs the Proposed Rule will impose on *non-DEX* entities—costs the Commission apparently found easier to discern—provide a baseline for the costs imposed on *DEXs*. In that way, the Commission attempts to assess the economic impacts of the Proposed Rule on DEXs in the absence of any real information about them.

The Commission attempts to justify that baseline assumption by claiming that DEXs "are broadly similar to the functioning of other New Rule 3b-16(a) Systems discussed in the Proposing Release."[33] But the Commission provides no evidence or analysis to support that illogical claim. The non-DEX entities that the original Proposed Rule expressly targeted (such as interdealers) represent already-established, highly centralized, and often already-regulated businesses and banks that facilitate trading in government securities, such as Treasury Bonds.[34] These entities already constitute discrete "associations" or "organizations," but either fall just outside the current "exchange" definition or constitute Alternative Trading Services (and are registered as such) because they do not deal in firm offers.[35]

These non-DEX businesses offer little insight into how DEXs operate, and nothing supports the Commission's conjecture that these entities' likely compliance costs even approximate DEXs' likely compliance costs. Again, these entities are already established and highly centralized businesses that simply happen to fall at the margins of the SEC's current "exchange" definition because of certain technicalities. DEXs are fundamentally different. They employ new technology that permits non-intermediated trading between buyers and sellers. Unlike with the SEC's non-DEX comparators, there is no preexisting, centralized "group of persons" that can easily spin up an SEC compliance program. Indeed, the SEC admits that DEXs would have to *become centralized* for the first time to even be able to achieve compliance with the proposed rule.[36] DEXs' initial compliance costs therefore would be profoundly higher than the initial compliance costs of non-DEXs, even assuming that compliance were possible at all.

The Commission's baseline analysis is also self-contradictory. The Commission claims in one portion of the Proposed Rule's preamble that non-DEXs provide a cost comparator for DEXs, yet it admits in another part of the preamble that DEXs fundamentally lack the preexisting centralization exhibited by the non-DEXs.[37]

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[33] *Id.* at 29,476/1.

[34] *See generally* Amendments Regarding the Definition of "Exchange" and Alternative Trading Systems (ATSs) That Trade U.S. Treasury And Agency Securities, National Market System (NMS) Stocks, and Other Securities, 87 Fed. Reg. 15,496 (Mar. 18, 2022).

[35] *Id.* at 15,498/1.

[36] 88 Fed. Reg. at 29,483/2.

[37] *Compare id.* at 29,476/1 (purporting "that the functioning of New Rule 3b-16(a) Systems that trade crypto asset securities are broadly similar to the functioning of other New Rule 3b-16(a) Systems discussed in the proposing release."), *with id.* at 29,483/2 (recognizing that because DEXs are decentralized, "the holders of the relevant tokens could *choose to form* an organization or association, or to designate a member of a group of persons, which would be responsible for undertaking the activities necessary" for compliance (emphasis added)).

In failing to grapple with the conceptual distinction between DEXs and non-DEXs, the Commission has "entirely failed to consider an important aspect of the problem."[38] And the Commission's faulty assumption corrupts the Commission's entire cost-benefit analysis for DEXs. The Commission must acquire the relevant information needed to actually assess compliance costs for DEXs; it cannot use baseless assumptions derived from projected costs for fundamentally distinct entities as a substitute. And if the Commission concludes that it cannot acquire that necessary information, it must forgo regulating.

D. The Commission Cannot Rationally Assess The Costs And Benefits Of The Proposed Rule Until It Clarifies When Crypto Assets Become "Securities"

For years, the Commission has refused to explain, through rulemaking or otherwise, *which* digital assets it believes are subject to the securities laws (much less how digital-asset firms could comply with the Commission's inapt regulatory framework). Instead, it has proceeded on a "case by case, coin by coin" litigation campaign across the federal courts.[39] This regulation-by-enforcement approach is "not an efficient way to proceed," "risks inconsistent results," and "leave[s] the relevant parties and their potential customers without guidance."[40] As a federal district court recently noted during an enforcement proceeding, for example, the Commission (through its attorneys) spoke "out of both sides of its mouth" about whether digital assets are *themselves* "investment contracts" (and thus "securities"), and if so, whether they permanently retain that status even despite successive resales on the secondary market.[41] The Commission's incoherent, shifting positions have left courts, "the industry, and future buyers and sellers with no clear differentiating principle between tokens in the marketplace that are securities and tokens that aren't."[42]

The Proposed Rule only aggravates that uncertainty by cryptically stating that "[a] digital asset *may or may not* meet the definition of a 'security' under the federal securities laws."[43] Without any definition or a coherent framework to discern when digital assets are subject to the securities laws, the Commission has no rational way to determine the real-world scope of the Proposed Rule. A DEX is an "exchange" *only* if it facilitates the trading of digital assets "securities." But because the Commission cannot even articulate a coherent test for when digital assets are subject to the securities laws, the number of affected DEXs is unknowable.

Even if and when Commission eventually settles on a definition, there is no guarantee that its definition will be the same as whatever (unstated) definition the Commission was contemplating in the Proposed Rule when attempting to conduct its cost-benefit analysis. And regardless of whether the Commission's eventual definition is narrower or broader, the Proposed Rule's cost-benefit analysis will necessarily be unreliable, on top of the other deficiencies catalogued throughout this comment. If whatever test the Commission ultimately adopts sweeps in *fewer* DEXs than was assumed here, the agency will have understated costs, but overstated the supposed benefits. And if it sweeps in *more* DEXs, the SEC will have understated supposed benefits, but also understated the costs. The SEC cannot rationally make these calculations without a single, stable view on which digital assets are subject to the securities laws.

The Commission also has entirely failed to consider another important and related aspect of the problem: the separate category of compliance costs that will be newly inflicted on DEXs as a result of the Commission's failure to explain its understanding of when digital assets are subject to the securities laws. Because of the Commission's incoherence to date, DEXs will have to incur significant compliance costs just to determine *which* digital assets they

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[38] *State Farm*, 463 U.S. at 43.

[39] *SEC v. Binance Holdings Ltd.*, 2024 WL 3225974, at *1, *11 (D.D.C. June 28, 2024).

[40] *Id.*

[41] *Id.* at *21 n.15.

[42] *Id.* at *22.

[43] 88 Fed. Reg. at 29,450 n.26 (emphasis added).

trade (if any) the agency will deem to be securities—which in turn will entirely determine whether some DEXs (but not others) constitute "exchanges" bound to comply with the Rule's requirements. The Commission's opaqueness about the governing legal standards directly aggravates these inefficiencies. Yet the Commission nowhere grapples with these costs in the Proposed Rule.

E. The Commission Must Re-Propose The Rule

The Proposed Rule cannot proceed given the Commission's current admissions about the pervasive evidentiary gaps in its cost-benefit analysis and the flawed assumptions on which it is based. The agency implores commenters to fill in the missing data.[44] But this attempt to crowdsource critical information merely illustrates why the Proposed Rule cannot proceed in its current form and must be re-noticed for another round of stakeholder comment. As part of the APA's notice-and-comment requirements, all agencies have the "duty to identify and make available technical studies and data that [they] ha[ve] employed in reaching the decisions to propose particular rules."[45] And when an agency omits that "critical factual material" from a proposed rule, it must disclose it and provide further "opportunity to comment."[46] Failure to do so is a "serious procedural error."[47] If stakeholders do not know what data the agency employed, they lose their chance to identify and make "credible challenge[s]" to that data's flaws, rendering the notice-and-comment requirement meaningless.[48] When—or if—the Commission obtains the missing data, therefore, it must publish that data, correct its flawed assumptions, and permit a further round of stakeholder comment.

III. The Commission Fails To Consider Critical Costs And Understates The Magnitude Of Costs That It Does Purport To Consider

Besides lacking critical information, the Commission reaches irrational conclusions from the limited information that it does purport to assess. In particular, the Commission systematically understates or ignores the costs that the Proposed Rule is likely to impose.

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[44] *See, e.g.*, 88 Fed. Reg. at 29,474/1-2; *id.* at 29,483/1; *id.* at 29,484/1.

[45] *Owner-Operator Indep. Drivers Ass'n v. FMCSA*, 494 F.3d 188, 199 (D.C. Cir. 2007) (quotation marks and citation omitted).

[46] *Chamber of Commerce v. SEC*, 443 F.3d 890, 900-01 (D.C. Cir. 2006).

[47] *Owner-Operator Indep. Drivers' Ass'n*, 494 F.3d at 199, 203.

[48] *Id.*

A. The Commission Ignores Entire Categories Of Costs

The Commission entirely fails to consider the downstream economic impacts that its proposed Rule would have on technology providers to DEXs, such as Coinbase. Coinbase, for example, created and maintains Base, an Ethereum Layer 2 network that provides a secure, low-cost, and developer-friendly way for building and using decentralized applications, including DEXs.[49] Coinbase also offers a Wallet service that allows users to communicate with DEXs. If the Proposed Rule goes forward, however, it would significantly harm Coinbase's DEX-based market for these services. The Commission admits that the Rule's requirements may prove so onerous or impossible to comply with that DEXs may simply "exit the market for crypto asset security trading services rather than continue operations."[50] The Proposed Rule accordingly threatens to strip service providers like Coinbase (and other technology providers) of a valuable market employing their technologies. And despite its statutory mandate to consider the economic effects of its proposed action, the SEC nowhere takes into account this discrete harm.

The Commission also fails to consider the particularly severe impacts that the Proposed Rule would have on nascent or smaller DEXs trying to enter the market. Even if some existing, larger DEXs could comply with the Proposed Rule—and they cannot, as Coinbase has explained and discusses below—smaller DEXs would lack the resources to comply with the Commission's burdensome registration and disclosure requirements. That disparate impact is antithetical to "competition" and would create a perverse incumbent bias that stifles innovation.[51]

The Commission also fails to grapple with the compliance costs that entities would incur when simply attempting to discern whether their activities even fall within the Proposed Rule, given the rule's loose and vague terminology. For instance, the SEC apparently agrees that certain entities, like communications platforms, do not constitute DEXs (or otherwise constitute "exchanges"), and it has codified an exception for such platforms in the Proposed Rule.[52] But the Proposed Rule then caveats that exception with a disclaimer that such entities are not exchanges "*except* to the extent that they also engage in activity that meets the definition of exchange as proposed to be amended in the Proposed Rules."[53] That circular standard only underscores the very problem with the Proposed Rule: It is so vague and overbroad about what constitutes an "exchange" that it will be extremely difficult for even genuine non-"exchanges" to determine what conduct they permissibly may engage in without becoming "exchanges" subject to the Proposed Rule. Yet the Commission never recognizes, much less accounts for, this distinct category of compliance costs.

This omission is particularly arbitrary and inexplicable given the Commission's recognition of this distinct category of compliance costs in other contexts. For example, the Commission has previously termed the costs that arise from ambiguities in the Commission's own regulations so-called "assessment costs," and has analyzed those costs as a distinct category of compliance costs during rulemaking. *See, e.g.*, Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities; Republication, 79 Fed. Reg. 47,278, 47,296 (Aug. 12, 2014) (noting "166 entities engaged in single-name CDS [credit default swaps] at a sufficiently high level that they would be expected to incur assessment costs to determine whether they meet the 'security-based swap dealer' definition."). That the Commission recognizes these assessment costs in other contexts yet ignores them here underscores the arbitrariness of the Rule's cost analysis.

B. The Commission Understates The Costs That It Does Purport To Consider

[49] Will Robinson, *Introducing Base*, Coinbase (Feb. 23, 2023), https://www.coinbase.com/blog/introducing-base.

[50] 88 Fed. Reg. at 29,484 n.368.

[51] 15 U.S.C. § 78c(f).

[52] 88 Fed. Reg. at 29,486/1, 29,487/2.

[53] *Id.* (emphasis added).

Even where the Commission does purport to consider certain costs, its methods for doing so exhibit numerous flaws. For example, the Commission repeatedly notes that its cost-benefit analysis hinges on the *lower* bounds of the costs that the Proposed Rule would incur.[54] Yet the Commission may not "opportunistically fram[e] the costs and benefits of [a] rule" to enhance the attractiveness of its desired policy outcome; it instead must rationally contend with the full range of relevant facts.[55] And a rational decisionmaker would also consider the *upper* bounds of potential costs, which would help produce a more realistic assessment of whether compliance is genuinely feasible. The Commission cannot load the dice at the front end by incorporating solely lower-bound cost estimates into its cost-benefit analysis and then pronounce costs to be non-excessive on the back end.

There is also reason to believe that the Commission has radically understated the number of entities that would be newly required to register under the proposed Rule, leading it to systematically understate potential industry-wide compliance costs. The Commission estimates that there would be perhaps "15-20 New Rule 3b-16(a) Systems that trade crypto asset securities."[56] In reality, however, there may be several *hundred* DEXs that would fall within the Proposed Rule, and that therefore would bear the compliance costs of registration. One source, for example, recently catalogued "823 decentralized crypto exchanges,"[57] while another (without purporting to be a comprehensive list) tracked activity on "149 Decentralized Exchanges (DEXs)."[58] The Commission therefore cannot possibly have accurately estimated industry-wide compliance costs based on its wildly underinclusive estimate of the number of affected DEXs.

The Commission also likely has substantially understated the compliance costs associated with affected DEXs' compliance with the rules and requirements of the Financial Industry Regulatory Authority (**FINRA**). The Commission anticipates that the Proposed Rule will cause $1.4 million of implementation costs *for the industry*.[59] A more realistic assessment of FINRA-related costs, however, would have more than a million dollars *for each registrant*—rendering the Commission's projection of those costs too low by orders of magnitude. Obtaining FINRA's approval of a New Membership Application and obtaining the SEC's approval of Form ATS are both time-consuming and expensive processes. Additionally, whatever "group of persons" the Commission deems to constitute a DEX would have to comply with the Commission's "fair access" requirement,[60] hire FINRA-registered personnel (or having existing personnel—to the extent they have personnel—become FINRA-registered), and meet books-and-records requirements.

Finally, although the Commission briefly notes that the Proposed Rule would affect international competition for crypto businesses,[61] it does not seriously grapple with the competitive setback that the Proposed Rule would cause to the United States. For example, the United Kingdom and Switzerland have announced policies to foster the use

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[54] *See, e.g.*, 88 Fed. Reg. at 29,476, 29,478, 29,480, 29,483.

[55] *Business Roundtable*, 647 F.3d at 1148-49.

[56] 88 Fed. Reg. at 29,465.

[57] *See, e.g.*, *Top Decentralized Exchanges Ranked by 24H Trading Volume*, Coin Gecko, https://www.coingecko.com/en/exchanges/decentralized (last accessed June 24, 2024) (tracking "823 decentralized crypto exchanges").

[58] Alchemy, https://www.alchemy.com/best/decentralized-exchanges-dexs (last accessed June 24, 2024) (listing "149 Decentralized Exchanges (DEXs)").

[59] 88 Fed. Reg. at 29,476.

[60] *See* Responses to Frequently Asked Questions Concerning Rule 301(b)(5) under Regulation ATS "Fair Access Rule," SEC.gov, https://www.sec.gov/rules-regulations/staff-guidance/trading-markets-frequently-asked-questions/faq-regulation-ats-fair (last accessed Aug. 5, 2024).

[61] 88 Fed. Reg. at 29,486/2.

of decentralized-finance (**DeFi**) protocols like those employed by DEXs.[62] Given the Hobson's choice of either complying with the Commission's unworkable requirements or offshoring their operations, rational DEX developers will simply choose to operate outside the United States. The Commission acknowledges that such offshoring will occur but responds that DEXs could adapt by "restructur[ing]" themselves "to make less extensive use of these novel technologies."[63] That argument is non-sensical. It does not "mitigat[e]" the cost of the Proposed Rule to tell DEXs that all they have to do to comply with the Proposed Rule is stop being DEXs. And it is antithetical to the goal of retaining technological competitiveness to tell regulated entities that they should simply discontinue their use of emerging technologies. The Commission's admission that its Proposed Rule will stunt U.S. competitiveness vis-à-vis global competitors underscores that the agency is acting directly contrary to its statutory mandate to promote competition.

IV. The Commission Fails To Show That There Is Any Problem In Need Of Regulation And Overstates The Rule's Purported Benefits

In addition to substantially understating the Proposed Rule's costs, the Commission also overestimates the purported benefits that the Proposed Rule would likely produce. The Commission posits vague, qualitative benefits but fails to establish that the industry has problems in need of correction in the first place (aside from the lack of a viable registration pathway—a problem of the Commission's own creation), and likewise fails to account for the exceedingly hypothetical nature of these asserted benefits, given that DEXs simply cannot comply with the Proposed Rule.

A. The Commission Fails To Establish Any Problem In Need Of SEC Regulation

The Commission starts from an assumption that there is some problem with the industry in need of correction—and yet fails to substantiate that problem's existence. For instance, the Commission does not offer a single real-world example of someone who was harmed by a DEX, or how the Proposed Rule would remediate that specific harm. This dearth of empirical support is unsurprising, given the Commission's admissions that it knows virtually nothing about how DEXs operate.[64] The Commission also fails to consider the reasons why the need for traditional registration and disclosure rules are reduced in the context of DeFi platforms. For example, DEX platforms are generally non-custodial, meaning that they do not take possession of users' funds.[65] Likewise, they are atomic, meaning that they facilitate address-to-address transactions that the address owners can see processed in real time.[66] There is accordingly no need for a centralized intermediary to facilitate clearing and settlement, as is

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[62] *See, e.g.*, *United Kingdom: HMRC takes positive steps on DeFi*, Baker McKenzie (May 11, 2023), https://insightplus.bakermckenzie.com/bm/tax/united-kingdom-hmrc-takes-positive-steps-on-defi-hmrc-opens-consultation-on-the-taxation-of-decentralised-finance; *The taxation of decentralized finance (DeFi) involving the lending and staking of crypto assets*, HM Revenue & Customs (Apr. 27, 2023), https://www.gov.uk/government/consultations/the-taxation-of-decentralised-finance-involving-the-lending-and-staking-of-cryptoassets/the-taxation-of-decentralised-finance-defi-involving-the-lending-and-staking-of-cryptoassets--2 (proposing favorable tax treatment for DeFi transactions); *Blockchain / DLT*, Schweizerische Eidgenossenschaft, (last modified Sept. 20, 2023) https://www.sif.admin.ch/sif/en/home/finanzmarktpolitik/digitalisation-financial-sector/blockchain.html (explaining Switzerland's DeFi-friendly regulatory measures).

[63] 88 Fed. Reg. at 29,486/3.

[64] *See supra* 3-4.

[65] *See, e.g.*, Guneet Kaur, *What are decentralized exchanges, and how do DEXs work?*, Cointelegraph (Aug. 10, 2023, updated Mar. 14, 2024), https://cointelegraph.com/learn/what-are-decentralized-exchanges-and-how-do-dexs-work.

[66] *Atomic Swaps | The Future of Decentralized Exchanges (DEX)*, Medium (Apr. 6, 2023), https://medium.com/@marketing.blockchain/atomic-swaps-the-future-of-decentralized-exchanges-dex-oodles-blo

required with traditional securities. And all transactions occur in public view on the blockchain, making them *more* transparent than transactions on centralized custodial exchanges.[67] The ability to retain control of funds (rather than surrender them to an intermediary) and to execute these quick, transparent transactions obviates the need for the regulations the Commission has historically imposed on traditional intermediaries. Absent any showing by the Commission that DEXs impede transparency or threaten consumers' funds, the Proposed Rule is simply a classic "solution in search of a problem."[68]

B. The Commission Irrationally Assumes That Non-DEXs Provide A Baseline To Assess Benefits

As with its admission that the Commission has virtually no way to reliably assess the costs that the Proposed Rule would impose, the Commission likewise concedes that it has no real information about its purported benefits. The Commission thus assumes, again, that *non-DEX* entities provide a baseline to assess benefits that will accrue from applying the Proposed Rule to *DEXs*, given that they are supposedly "broadly similar in their functions" to DEXs.[69] But as with the Commission's costs analysis, this driving assumption has no basis in fact. Again, the Commission "entirely failed to consider" the fundamental differences in how DEXs and the non-DEX entities subject to the Proposed Rule operate—undoubtedly "an important aspect of the problem."[70] Whereas non-DEXs likely can comply with the Proposed Rule, DEXs cannot and therefore may discontinue their operations (as the Commission admits elsewhere in the preamble).[71] It is irrational to assume that the purported benefits from regulating non-DEXs translate to DEXs when their technologies and operations are fundamentally distinct.

C. The Benefits The Commission Posits Rest On The Dubious Assumption That DEXs Will Continue To Be Available To U.S. Users

The Commission speculates in broad brushstrokes that the Proposed Rule could have various qualitative benefits for American users of DEXs—which the Commission never attempts to quantify. Those supposed benefits included that the Proposed Rule could "enhance operational transparency, reduce trading costs, and improve execution quality," and enhance "price discovery," and "improv[e] the usability, accessibility, and reliability of the new disclosures" that DEXs purportedly must make.[72] The implicit but linchpin assumption of these purported benefits is that DEXs *will continue to remain available to U.S. users*. Yet there is no guarantee that this will occur. To the contrary, as discussed above, and as the Commission admits, the Proposed Rule very well may cause DEX developers to offshore their operations or simply "choose to exit the [U.S.] market" entirely, given the unworkable and onerous nature of the proposed regime.[73] If those continued operations cease, however, then *none* of the benefits the Commission propounds for American users would materialize. The Proposed Rule cannot enhance American consumers' experience on DEXs if there are no DEXs that they can legally use. The Proposed Rule thus threatens to impose massive costs to the industry and stifle innovation and competition, all in return for potentially

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ckchain-931d40578205 (explaining that atomic swaps on DEXs "eliminat[e] vulnerabilities related to centralized exchanges" because transactions can be executed quickly and party-to-party).

[67] Robert Stevens, *Custodial vs. Non-Custodial Crypto Exchanges: What You Need to Know*, CoinDesk (Nov. 29, 2022), https://www.coindesk.com/learn/custodial-vs-non-custodial-crypto-exchanges-what-you-need-to-know/ (noting that "due to the transparency of the blockchain," transactions on DEXs "are less private than on a centralized custodial exchange").

[68] *District of Columbia v. Dep't of Agric.*, 444 F. Supp. 3d 1, 31 (D.D.C. 2020).

[69] 88 Fed. Reg. at 28,475/1.

[70] *State Farm*, 463 U.S. at 43.

[71] 88 Fed. Reg. at 29,484/2 n.368.

[72] *Id.* at 29,475/3.

[73] *Id.* at 29,484/2 n.368.

zero gain if the shutdowns that the Commission itself realizes are a likely reaction to the Proposed Rule eventually occur. Irrationally overstating benefits in this manner is the opposite of rational policymaking.

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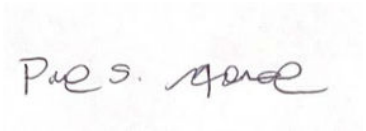
In sum, despite the Commission's legal obligations to exercise reasoned decisionmaking, appropriately weigh economic effects, and use the best information available, the Proposed Rule systematically defaults on those duties. The Commission should decline to extend the Proposed Rule to DEXs. At a minimum, the Commission must withdraw the proposal, gather the information necessary to conduct a rational cost-benefit analysis, attempt to correct its existing faulty assumptions and analysis, and permit a further round of comment on any modified proposal the Commission may advance.

Thank you for the opportunity to further comment on the Reopening. If you have any questions on our comment letter, please feel free to contact me at paul.grewal@coinbase.com, or Scott Bauguess, Vice President, Global Regulatory Policy, at scott.bauguess@coinbase.com.

Sincerely,



Paul Grewal
Chief Legal Officer
Coinbase Global, Inc.

cc. The Hon. Gary Gensler, Chair
The Hon. Hester Peirce, Commissioner
The Hon. Carolina A. Crenshaw, Commissioner
The Hon. Mark T. Uyeda, Commissioners
The Hon. Jaime E. Lizárraga, Commissioner