

## SEC Takes Enforcement Action and Issues Statement on Digital Asset Trading Platforms

***Crypto trading platforms worldwide should be aware of recent SEC actions if they provide access to US persons or persons within the US for trading.***

Global financial regulatory authorities have begun to take action and release guidance regarding the emerging cryptocurrency markets, including the sale and trading of tokens, coins, or other digital or crypto assets. Some regulatory authorities, such as those in the United Kingdom, Germany, Switzerland, Hong Kong, and Singapore, have issued statements or guidance to alert market participants that digital or crypto assets may be qualified as regulated financial instruments (for example, securities) and must comply with existing rules applicable to such instruments. Along this line, the Chairman of the Securities Exchange Commission (SEC) in the United States, has stated that many tokens are, in substance, securities and the offerings and sales of tokens that are securities must comply with the US securities laws.<sup>1</sup> Similarly, if digital assets are viewed as securities, the question arises of what the ensuing regulatory implications are for a digital asset trading platform, including how such trading platform facilitating secondary market trading would be regulated. In a recent development, the SEC brought an enforcement action<sup>2</sup> and, through its Divisions of Enforcement and Trading and Markets, issued a public statement.<sup>3</sup> Together these actions provide insight into the agency's views on how the US federal securities laws apply to crypto or digital asset trading platforms that facilitate trading in assets that are securities.

### General Rules Applicable to Trading Platforms

Generally speaking, whether a digital asset trading platform would be regulated depends on the nature of the crypto assets traded on the platform (e.g., pure cryptocurrencies or tokenized securities), as well as the nature of the system (e.g., bulletin board style system, single-dealer request for quotes, or automated matching engine). Many market regulators would require a securities trading system that enables multiple buy and sell orders to interact and employ non-discretionary algorithmic methods in matching buy and sell orders to be regulated as a trading venue. For example, in the EU, a platform that trades securities, including tokenized securities, utilizing an automated matching engine would be regulated as a trading venue, which would require the trading venue to be licensed by the competent authority in the home member state of the platform, as well as require compliance with detailed organizational, systems-related, and conduct of business requirements. In addition, regulated trading venues are subject to detailed transparency requirements.

In the US, crypto asset trading platforms may need to register with the SEC as an exchange or must operate as an Alternative Trading System (ATS) pursuant to Regulation ATS if (a) the digital or crypto assets traded on their platforms are securities and (b) the platform engages in the “activity of a national securities exchange.”

## **Applicable US Regulatory Requirements to Digital Asset Trading Platforms**

- **A crypto asset trading platform may be subject to the US exchange registration requirements (unless an exemption is available) if the platform allows US persons or persons located in the US to access the platform and participate in trading digital assets that are viewed as securities by the SEC.**

In a recent enforcement action, the SEC alleged that the digital assets traded on the platform were securities, and by characterizing the digital assets traded as securities, the SEC looked into the platform’s operations in light of the legal definition of an “exchange” under the US Securities Exchange Act of 1934, as amended (Exchange Act).

Under the Exchange Act, any organization, association or group of persons that maintains or provides a market place or facilities for bringing together buyers and sellers of securities or otherwise performing the functions commonly performed by a stock exchange would fall within the definition of an exchange, and would be required to register with the SEC.<sup>4</sup> The SEC determined that the system operated by the platform charged in the enforcement action met the exchange definition based on the following findings:

- The platform used an electronic system that allowed multiple users to post bids and offers for listed digital assets that users obtained in an initial offering.
- Users could buy or sell digital assets by entering limit orders or market orders on the platform on an anonymous basis, which would then match against orders resting on the system from other users according to pre-programmed order interaction protocols based on price and time priority that the platform operator established.
- Upon a match, the platform would automatically execute the orders.
- The platform publicly displayed all its quotes, trades, and daily trading volume in all of its listed digital assets on its website. It did not receive orders for any digital assets from anyone other than its users and it did not route its users’ orders to any other trading venue.

Operators of global digital asset trading platforms that provide access to US persons or persons in the US should consider how the SEC determined that the digital asset trading platform met the definition of an exchange and determine whether the trading platforms they operate would also meet the definition of exchange. If the operators of a digital or crypto asset trading platform determine that the platform meets the exchange definition, the platform would be required to register with the SEC as a national securities exchange unless the platform can rely on an exemption from registration. Practically speaking, this means that the platform must either register as an exchange or rely on the exemption from exchange registration available to an ATS pursuant to Regulation ATS.<sup>5</sup> Under Regulation ATS, an ATS must register as a broker-dealer and file Form ATS with the SEC to provide non-public notice of the ATS’ operations prior to commencement of its operations.

- **A crypto asset trading platform that provides access to US persons or persons in the US should consider disclosing material cybersecurity breaches to users.**

The recent enforcement action by the SEC also makes clear that the SEC believes cyber theft is material to investors in tokens deemed securities that are traded on a crypto platform. The SEC expects prompt disclosure to investors of all material facts related to their investments, which includes disclosure of cyber theft.

- **Operators of crypto platforms that permit trades in securities need to assess the quality of their current systems and risk management and determine whether the systems and governance of risk management need to be enhanced to come into compliance with the regulatory requirements under the US securities laws if the platforms provide access to US persons or persons in the US.**

US market infrastructure entities like national securities exchanges and ATS are subject to extensive SEC regulation, including a host of requirements related to cybersecurity. The US regulatory requirements for exchanges and certain ATS impose system requirements regarding capacity, integrity, resiliency, security, and compliance. These requirements may be unfamiliar territory to the existing crypto asset trading platforms, including those providing US persons or persons in the US with access to trading from outside the US, as none of the platforms are yet registered as a national securities exchange or operating as an ATS. As a result, crypto platforms may not yet be compliant with technology systems requirements imposed by the securities regulations. Since the blockchain technology that creates and enables crypto assets is nascent, the crypto trading market currently lacks a resilient market infrastructure similar to the securities market infrastructure. The current securities market infrastructure includes a central securities depository for immobilized and dematerialized securities, and clearing banks and clearing agencies for making payments and delivering securities. The developing technology used by crypto trading platforms also appears to be vulnerable to cyber attacks and other operational risks that can expose digital wallets used to custody securities tokens and bitcoins to theft and misappropriation, resulting in loss of investor funds. In addition, if the platform's user on-boarding requirements do not encompass a robust "know-your-customer" and operational risk management process, the crypto asset trading platform and the custody of crypto assets are exposed to open entry points, which, if breached, would pose a security threat to the trading platform and custodian of crypto assets, and subject the assets to theft. The SEC's latest enforcement action highlights the potential compliance obligation of digital asset trading platforms with respect to systems security, resilience, and integrity.

- **Individuals who control a crypto asset trading platform subject to the US securities law requirements may have personal liability for the platform's violations of the US securities laws.**

The SEC illustrated its commitment to "individual accountability" in its recent enforcement action by suing the platform operator as a control person liable for the platform's violations of the US securities laws. Under the Exchange Act, a person who directly or indirectly controls an entity liable under any provision of the Exchange Act, or the SEC's rules promulgated under the Exchange Act, may be liable jointly and severally with, and to the same extent as, the entity under such person's control, unless the controlling person acted in good faith and did not directly or indirectly induce the controlled entity's violation.<sup>6</sup> Therefore, individual operators of crypto platforms should be aware of their potential personal liability if the trading platform violates the US securities laws.

The SEC's latest action and statements make clear that the agency will apply the existing securities regulatory framework to the crypto market and will not hesitate to use the agency's enforcement power to hold platforms and the individuals who operate them accountable under the US securities laws. Operators

of crypto trading platforms that may fall within the SEC's purview need to be aware of the SEC's regulatory framework and take steps to ensure compliance with the US securities laws.

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## Endnotes

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- <sup>1</sup> See SEC Chairman Jay Clayton Statement on Cryptocurrencies and Initial Coin Offerings, December 11, 2017, available at <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>.
- <sup>2</sup> See, e.g., Securities and Exchange Commission against Jon E. Montroll and BitFunder, 1:18-cv-01582, filed February 21, 2018, available at <https://www.sec.gov/litigation/complaints/2018/comp-pr2018-23.pdf>.
- <sup>3</sup> See Statement on Potentially Unlawful Online Platforms for Trading Digital Assets, March 7, 2018, available at <https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading>.
- <sup>4</sup> See Sections 3(a)(1) and 5 of the Exchange Act, 15 USC. §§ 78c(a)(1) and 78e. Specifically, Rule 3b-16(a) under the Exchange Act, 17 CFR 240.3b-16(a), provides that an organization, association, or group of persons would be viewed as maintaining or providing a market place or facilities for bringing together buyers and sellers of securities if such organization, association, or group of persons operate a system that brings together the orders of multiple buyers and sellers for securities and uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which the orders interact with each other, and the buyers and sellers entering the orders agree to the terms of a trade.
- <sup>5</sup> Rule 3a1-1(a)(2), 17 CFR 240.3a1-1, exempts from the definition of exchange under Section 3(a)(1) an ATS that complies with Regulation ATS. Therefore, an ATS that operates pursuant to the Rule 3a1-1(a)(2) exemption and complies with Regulation ATS would not be subject to the registration requirement of Section 5 of the Exchange Act.
- <sup>6</sup> Section 20(a) of the Exchange Act, 15 US C. § 78t.