

# SEC Should Rethink Investor Protection In Digital Asset Space

By **Robert Rosenblum, Amy Caiazza, Taylor Evenson and Katherine Mann**

The U.S. Securities and Exchange Commission's mission has three principal components: investor protection; maintaining fair, orderly and efficient markets; and facilitating capital formation.[1] The SEC's regulation of digital assets arguably is not effectively achieving any of these three components.

Consider the following:

- It is estimated that in the first quarter of 2019, the U.S. trading volume of cryptocurrencies was \$450 million, which more than doubled in the second quarter of 2019 to \$1.1 billion.[2] Not a single one of those trades occurred on an SEC-regulated exchange or alternative trading system, because the SEC and Financial Industry Regulatory Authority, or FINRA, have not approved any.
- At least one recent survey suggests that in 2019, 14.4% of Americans, or 36.5 million people, owned some form of cryptocurrency.[3] None of those people have had the benefit of a registered investment adviser to provide advice about those investments, or a registered fund that could offer professional investment management and a diversified portfolio of digital assets — because the SEC has not approved any registered investment advisers, registered funds or registered exchange traded funds to trade in digital assets. Similarly, neither the SEC nor FINRA has approved even a single broker-dealer application that would permit a professional intermediary to execute trades on behalf of customers in many types of digital assets.[4]
- The SEC has brought nearly two dozen enforcement actions against allegedly fraudulent digital asset issuers and intermediaries. The SEC also has appropriately warned digital asset investors of significant risks that currently exist for investors in digital assets, including potential fraud, lack of regulated trading markets, potentially misleading claims by promoters, and other potentially illegal behavior by digital asset issuers, markets and intermediaries.[5] However, as discussed above, the SEC has not approved a single trading venue or market intermediary that can significantly reduce any of these risks to investors.
- In the first quarter of 2018, there was a reported \$6.9 billion raised in initial coin offerings; in the first quarter of 2019, there was a reported \$118 million in initial coin offerings, under 2% of the amount raised a year earlier.[6] Notwithstanding that dramatic decrease, the SEC has taken virtually no



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actions designed to facilitate or streamline public or private offerings of digital assets; conducted no public studies of whether its regulatory approach has meaningfully and perhaps unnecessarily contributed to this decline; and to date has approved only two public distributions of digital assets that are securities.

The SEC should reexamine how it thinks about the core components of its mission relative to the digital asset space. Is the SEC really protecting investors by its refusal to approve digital asset investment advisers, broker-dealers, registered funds and registered ETFs?

No doubt there are significant valuation, custody, liquidity and other issues involved in operating any of these types of entities. But from an investor protection standpoint, a key issue is that digital asset investors are today subject to all these risks, and many others. Even if a registered entity in the digital asset space cannot yet fully address all these risks, aren't investors still better protected by professionals who can mitigate at least some of the risks?

Is the SEC really fostering or maintaining fair, orderly and efficient digital asset markets when the only markets in which U.S. investors can trade digital assets are unregulated exchanges and trading platforms — many of which are offshore, a number of which probably are publishing fictitious quotes and trade information,[7] and at least some of which may be operating illegally?[8]

Again, a registered and regulated U.S. market would not be able to immediately address all custody, valuation and similar concerns. But such a market almost certainly would provide fairer, more orderly and more efficient digital asset trading than currently is available to U.S. investors on many unregulated markets today.

Similarly, is the SEC really facilitating capital formation by not approving any brokers or underwriters that could help digital asset issuers sell those assets, and that could help digital asset purchasers buy those assets?

Capital formation prospects for digital asset issuers are almost certainly hurt when there are no regulated trading platforms on which investors can resell their digital assets; when the SEC has approved only two public offerings of digital assets (and both of those took many months and were very expensive); and when the primary source of information about the SEC's substantive views on the regulation of digital assets comes from SEC enforcement actions against digital asset issuers and intermediaries who the SEC believes have acted improperly.

As one observation, the SEC's Division of Corporation Finance can and should issue affirmative guidance as to how digital asset issuers can efficiently register or qualify digital assets for public sale. And it can and should provide more specific and actionable guidance about when a digital asset is sufficiently decentralized so that it no longer should be treated as a security.[9]

More generally, the SEC is currently applying the same registration standards to digital asset entities and professionals as it applies to traditional securities entities and professionals. This is almost certainly the wrong approach.

It is perfectly reasonable for the SEC to make sure, for example, that a new equity securities trading platform provides protections comparable to the many other equity securities trading platforms that it and FINRA previously have approved. Because other equity platforms are providing those protections — and because the custody, clearance and

settlement, trade reporting and similar functions in the equity markets are so well developed — it is therefore possible and appropriate for a new equity trading platform to be measured against the protections provided by existing equity trading platforms.

This framework falls apart in the digital asset space. There likely are no digital asset trading platforms that provide protections comparable to all of those that exist in the equity markets. There is not a well-developed system for providing digital asset custody services, clearing and settlement, trade reporting and similar services.

And in any event, there are no such systems in the digital asset space that are necessarily comparable to those in the equity markets. In fact, given the unique nature of blockchain technology and digital assets, it is likely that for some time there will be risks in custody, clearance and settlement, trade reporting and other digital asset trading aspects that are significantly different than the risks presented by equity trading.

The test should not be, though, whether a digital asset exchange (or investment adviser, or broker-dealer, or registered fund) meets the same high standards that the SEC now imposes and can impose on equity exchanges (and other registered entities) after more than 85 years of regulation of the equity markets. Obviously, digital assets — which are still nascent, still novel and still evolving — can't meet precisely those standards.

The test should be whether a digital asset exchange (or other registered entity) can materially improve investor protection, fair trading and capital formation, as compared to the options that now exist for digital asset investors.

There is little doubt that a registered and regulated digital asset exchange — as well as registered and regulated digital asset investment advisers, broker-dealers, funds and ETFs — could provide digital asset investors with dramatically more protections than they often receive today; could dramatically increase the fairness, orderliness and efficiency of digital asset trading as compared to many existing digital asset trading platforms; and could dramatically improve capital formation in the digital asset space as compared to the lethargic financing opportunities now available.

No doubt, the SEC and industry participants would have to clearly warn digital asset investors and others of the increased risk of trading in digital asset markets as compared to trading in traditional equity markets. However, permitting regulated digital asset markets and institutions to operate also likely will spur technological and other developments that will, over time, increase the protections available to investors.

In fairness, it is possible that the SEC has concluded that digital asset trading and investing is so fraught with risk; poses such significant fraud, terrorism or other risks; or is otherwise so against the public interest that the SEC believes it is required to prevent virtually any public digital asset trading, investing platforms or professionals from operating in the United States. If that is the SEC's current posture, it should plainly and publicly state that.

That type of decision, though, is really one for Congress, and not for the SEC. Notably, whether that is in fact the SEC's current posture, its actions in the digital asset space to date are almost fully consistent with such a posture.

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[1] See, e.g., SEC Chairman Jay Clayton, Statement on Proposed Amendments to the Volcker Rule (Jan. 30, 2020) ("The Commission's three-part mission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation").

[2] A. Muehlemann, Blockchain at Berkeley, The Evolution of the Digital Asset Market in 2019 – Q2 Update, <https://medium.com/blockchain-at-berkeley/the-evolution-of-the-digital-asset-market-in-2019-q2-update-fa89e509dc22> (July 25, 2019).

[3] Finder, A rising number of Americans own crypto, <https://www.finder.com/how-many-people-own-cryptocurrency> (Nov. 20, 2019).

[4] In September 2019, FINRA granted a broker-dealer license to Harbor Square Investments to provide certain brokerage services for digital representations of traditional securities, such as digital representations of common stock or preferred stock, and participation interests in real estate and other assets. See The Tokenist, Harbor Receives Broker-Dealer License from FINRA, <https://thetokenist.io/harbor-receives-broker-dealer-license-from-finra/> (Sept. 28, 2019). Several other broker-dealers also claim to have this authority based on broad language included in their FINRA approval orders. FINRA has not granted any broker-dealer licenses to brokers or dealers seeking to provide services for cryptocurrency and digital assets that, like bitcoin and ether, are not digital representations of traditional securities or participation interests in assets.

[5] See, SEC, Spotlight on Initial Coin Offerings (ICOs), 5 Things you Need to Know About ICOs, <https://www.sec.gov/ICO> (as of Feb. 10, 2020).

[6] A. Zmudzinski, Cointelegraph, Report: ICOs Raised \$118 Million in Q1 2019, Over 58 Times Less Than in Q1 2018, <https://cointelegraph.com/news/report-icos-raised-118-million-in-q1-2019-over-58-times-less-than-in-q1-2018> (April 1, 2019).

[7] See, Bitwise Asset Management, Presentation to the U.S. Securities and Exchange Commission, <https://www.sec.gov/comments/sr-nysearca-2019-01/srnysearca201901-5164833-183434.pdf> (March 19, 2019).

[8] See, Divisions of Enforcement and Trading and Markets, SEC, Statement on Potentially Unlawful Online Platforms for Trading Digital Assets, <https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading> (March 7, 2018).

[9] Commissioner Peirce's recent proposal to give certain token issuers a three-year safe-harbor from substantive securities law regulations is a thoughtful and welcome step in this direction. See, Commissioner Hester M. Peirce, SEC, Running on Empty: A proposal to Fill the Gap Between Regulation and Decentralization, <https://www.sec.gov/news/speech/peirce-remarks-blockress-2020-02-06> (Feb. 6, 2020).