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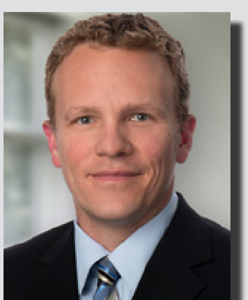

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The Devil Is in the Details: SEC Regulation of Blockchain Technology

by Richard B. Levin and Peter Waltz

Blockchain technology has captured the imagination of the financial services industry. Unfortunately, the adoption of the technology is impaired by a lack of clarity from regulators including the U.S. Securities and Exchange Commission ("SEC") as to how the technology will be regulated. Many firms in the financial services industry believe blockchain technology can be adapted for use in traditional financial services transactions in a way that can reshape the industry. Unfortunately, the success of blockchain technology will be impacted in large part by how the SEC elects to regulate platforms that use the technology. The devil will be in the details.

I. What is Blockchain Technology?

Goldman Sachs provided a useful summary of blockchain technology in a note to clients:

> In its most basic form, the **blockchain records ownership of bitcoin and transactions involving the crypto currency across a wide network of computers, as opposed to a centralized ledger.** Transactions are signed off by the parties involved using the software, checked by the network or the "crowd," then added to the blockchain — a long string of code that records all activity. Encryption in the software ensures these "blocks" cannot be tampered with or altered. And the decentralized nature means the "crowd" police the whole system. **The software cuts out the need for a "trusted middleman" to sit in between parties in a transaction, such as a bank or clearinghouse.** [Emphasis added.]

Supporters in the financial services industry believe blockchain technology can be adapted for use in traditional financial services transactions in a way that could reshape the trading and clearance and settlement of equities, futures, and derivatives, and the processing and management of loans and mortgages. Blockchain technology has the potential to reduce transaction costs, improve efficiency, and reliability.

The focus of the financial services industry on blockchain technology has attracted the attention of the SEC which hosted a FinTech Forum in 2016 that included a panel discussion on blockchain technologies.

II. SEC Regulation of Blockchain Technology

Former SEC Chair Mary Jo White noted in a speech at the SEC FinTech Forum, *"[b]lockchain technology has the potential to modernize,* ***simplify, or even potentially replace,*** *current trading and clearing and settlement operations." However, as White noted in the same speech: "****One key regulatory issue is whether blockchain applications require registration under existing [SEC] regulatory regimes . . .*** *"* [Emphasis added.]

While there is tremendous potential for blockchain technology in the financial services industry, it is less clear how the SEC will treat platforms that use blockchain technology. It is unclear if those platforms must register with the SEC as an exchange, an Alternative Trading System ("ATS"), or a broker-dealer. Before regulators can address this issue, they must better understand in what instances blockchain technology involves transactions in securities.

A. What is a Security?

The definitions of "security" under the Securities Act of 1933 and the Securities Exchange Act of 1934 ("Exchange Act") are virtually 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. The definition of "security" under U.S. securities law does not expressly include blockchain technology. The SEC argued in the BTC Trading Corp. case, that investments in Bitcoin related schemes that make use of blockchain technology are investment contracts - a contract, transaction, or scheme involving: (i) an investment of money, (ii) in a common enterprise, (iii) with the expectation that profits will be derived from the efforts of the promoter or a third party – and hence should be regulated as securities.

Assuming in certain instances blockchain technology platforms are deemed to be facilitating the trading of securities, the next issue is whether such platforms must register as a broker-dealer, an ATS, or an exchange.

B. 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). A "broker" is defined in Section 3(a)(4)(A) of the Exchange Act as "any person engaged in the business of effecting transactions in securities for the account of others." 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.

C. Securities 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.**

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 may claim an exemption from such registration.

D. <u>ATS</u>

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. Under Rule 300(a) of Regulation ATS, an "alternative trading system" includes any organization, association, person, group of persons, or system: (1) 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 (2) 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 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 subscribers' trading on such platform. If the platform is not required to register as an ATS, the operator of the platform may be required to register as a broker-dealer.

III. Conclusions

Silicon Valley and Wall Street are betting blockchain technology can change everything. While the technology is not fully mature, blockchains represent an attractive option for financial institutions to improve the efficiency of trading. However, there are a number of technological and regulatory barriers to widespread adoption of the technology. Before blockchain technology can be deployed across various sectors of the financial services industry, it is imperative the SEC provide meaningful guidance to the industry on whether the use of blockchain technology requires such platform to register as brokers, dealers, ATSs, or exchanges. The devil will be in the details.

For More Information

For questions regarding this alert or to learn more about how it may impact your business, please contact one of the authors, a member of our Financial Technology (FinTech) and Regulation practice, or your Polsinelli attorney.

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