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Registration Requirements for "Decentralized" Exchanges under the Federal Securities Laws: The Case of EtherDelta

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On November 8, the SEC announced that it settled charges against Zachary Coburn, founder of EtherDelta, a type of non-custodial digital asset trading platform commonly referred to as a "decentralized exchange" or "DEX." Coburn was charged with causing EtherDelta to operate as an unregistered securities exchange in violation of Section 5 of the Securities Exchange Act of 1934 (the "Exchange Act") during the period between July 12, 2016 (the date Coburn launched EtherDelta's website) and December 15, 2017 (the date Coburn ceased collecting fees from EtherDelta users following its sale to foreign buyers).

The conclusions set forth in the SEC's order contain several key components, including that, during the relevant period:

1. EtherDelta operated as an "exchange" within the meaning of the Exchange Act;
2. Coburn "caused" EtherDelta to violate the Exchange Act; and
3. At least some of the digital assets bought and sold on EtherDelta were "securities."

We analyze these findings in more depth below.

EtherDelta as an "Exchange"

Section 5 of the Exchange Act makes it unlawful for a securities "exchange" to operate as such unless it is registered with the SEC as a national securities exchange or operates pursuant to an exemption from registration. Under Section 3(a)(1) of the Exchange Act, an "exchange" includes 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 the functions performed by a stock exchange*.

Rule 3b-16(a) under the Exchange Act provides a functional test for determining whether the definition set forth in Section 3(a)(1) is satisfied, and requires both: (1) the bringing together of orders for securities of multiple buyers and sellers and (2) the use of established, non-discretionary methods under which these orders interact with each other, and the buyers and sellers entering these orders agree to the terms of the trade.

The SEC found that EtherDelta satisfied both prongs of this test, stating:

EtherDelta brought together orders by receiving and storing orders in tokens in the EtherDelta order book and displaying the top 500 orders (including token symbol, size and price) as bids and offers on the EtherDelta website. EtherDelta provided the means for these orders to interact and execute through the combined use of the EtherDelta website, order book, and pre-programmed trading protocols defined in the EtherDelta smart contract. These established non-discretionary methods allowed Users to agree upon the terms of their trades in tokens.

The SEC's analysis emphasized the similarities between EtherDelta and other trading platforms typically required to register or qualify for an exemption under the Exchange Act. Notably, the order quotes a Reddit post from Coburn where he states that, "At a high level, EtherDelta functions just like a normal exchange."

Unlike other "normal" online trading platforms, however, trades on EtherDelta are self-executed through an Ethereum-based smart contract that allows for peer-to-peer trading in any ETH/ERC-20 token pair without centralized custodianship of users' digital assets. Which raises the following questions:

- Does the non-custodial nature of EtherDelta provide a principled basis for distinguishing it from exchanges subject to Section 5 of the Exchange Act? The SEC appeared focused on highlighting the aspects of EtherDelta's operations which remained centralized under the control of Coburn.
- Would a more decentralized "decentralized exchange" fall subject to the same registration requirements?

SEC Cyber Unit chief Robert Cohen's response to these questions was pointed, telling *Forbes* that, "The focus is not on the label you put on something or the technology you're using. The focus is on the function, and what the platform is doing. Whether it's decentralized or not, whether it's on a smart contract or not, what matters is that it's an exchange."

Violations "Caused" by Coburn

Importantly, the SEC's action was brought against Coburn, in his individual capacity, for "causing" EtherDelta's violations of Section 5. According to the SEC, Coburn was personally liable under Section 21C(a) of the Exchange Act because he "should have known" that his actions – writing and deploying the EtherDelta smart contract and exercising "complete and sole" control over EtherDelta's operations – would contribute to EtherDelta's violations of Section 5.

The SEC's approach to this proceeding echoes public statements by CFTC Commissioner Brian Quintenz this past October, in which he grappled with the conceptual and practical challenges in applying regulatory oversight to unlawful activity effectuated through smart contracts running on decentralized blockchain networks, and posited that smart contract developers could potentially be held liable for how the smart contract is used if they could reasonably foresee a violation at the time they created the code.

Coders' exposure to liability for the code they put out into the world is a critical legal and policy question within and beyond the context of blockchain-based networks. The limits of a court's or regulator's ability to exercise jurisdiction over software developers in this manner is something that market participants should keep a close and careful eye on.

EtherDelta as a Marketplace for "Securities"

The SEC did not identify the particular digital assets trading on EtherDelta that they found to be securities. Instead, alluding to their application of the *Howey* test in the DAO Report, the SEC order summarily stated that the digital assets traded on EtherDelta included securities and "purchasers of such digital tokens invested money with a reasonable expectation of profits, including the increased value of their investments in secondary trading, based on the managerial efforts of others."

According to the SEC, EtherDelta had approximately 500 digital assets officially listed during the relevant period.

Closing Thoughts

The order against Coburn is the SEC's first enforcement action relating to a digital asset trading platform's failure to register as an exchange. The SEC's order suggests that related enforcement actions could follow. Developers and operators of digital asset trading platforms, or the smart contracts upon which they depend, may consider revisiting whether their activities subject them to Section 5 and whether to pursue registration as a national securities exchange – or more practically, an exempt alternative trading system pursuant to Regulation ATS.

In the context of the SEC's overall enforcement scheme, the Coburn order, together with the SEC's recent settlement orders against TokenLot, LLC (for operating as an unregistered broker-dealer) and Crypto Asset Management LP (for causing violations of the registration provisions of the Investment Company Act), indicate that the SEC's focus in the digital asset ecosystem extends far beyond just ICO issuers.

As part of his settlement with the SEC, Coburn will pay a $300,000 disgorgement, $13,000 in prejudgment interest and a $75,000 penalty. His civil penalties were limited based upon his cooperation in an SEC investigation and agreement to testify in any related enforcement action. Coburn neither admitted to nor denied the SEC's findings in the settlement order.

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