We Need Regulatory Clarity to Keep Crypto Exchanges Onshore and DeFi Permissionless

The lack of clear crypto regulation risks sending companies overseas. Congress must bring regulatory clarity to crypto market structure, defining the bounds and appropriate legal treatment of crypto securities, commodities, and exchanges, say Jack Solowey and Jennifer J. Schulp.

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At Consensus 2023, Senator Cynthia Lummis (R-WY) and Congressman Patrick McHenry (R-NC) voiced their goals of developing legislation to clarify crypto market structure in the United States, with a House proposal expected in the next two months.

Today, in a joint hearing of the digital assets subcommittees of the House Agriculture and House Financial Services committees, work proceeds to resolve what Congressman French Hill (R-AR) has referred to as "an impossible situation, where the same firms are subject to competing enforcement actions" by the Securities Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC), "pushing entrepreneurs, developers, and job creators offshore."

This is an impossible situation and it is manifestly unwise for the U.S. to show the door to those working on what may be the next generation of global financial infrastructure. Congress must bring regulatory clarity to crypto market structure, defining the bounds and appropriate legal treatment of crypto securities, crypto commodities, and the exchanges – both centralized (CEXs) and decentralized (DEXs) – over which they trade.

Notwithstanding the skepticism and evasions of SEC Chair Gary Gensler, crypto's core innovation – decentralization – is the proper criterion by which to rationalize digital asset market structure and determine whether applying traditional financial regulations to crypto tokens and exchanges makes sense.

The phrase "same activity, same risk, same regulation" is oft-repeated by financial regulators. But as applied to crypto it raises the question: are the risks the same?

Specifically, do crypto projects present the risks that issuers (in the primary market) or intermediaries (in the secondary market) can exploit their position to harm token purchasers – by, for example, abusing nonpublic information, misleading market participants, breaking promises, or otherwise engaging in fraud?

When projects are truly decentralized – where there is no creator promising performance but simply an open-source protocol executing transactions – the answer tends to be "no."

Accordingly, legacy financial regulations must be adapted to crypto projects' actual risk profiles, through tailored compliance pathways and the removal of inappropriate obligations.

Secondary market regulation traditionally seeks to address "intermediary risks" – for example, will middlemen safely custody customer assets, are transactions and trading practices transparent, and are market participants protected from fraudulent and deceptive market manipulation? Centralized and decentralized exchanges do not present the same risks on these fronts.

Centralized exchanges typically custody customer assets, settle transactions off-chain, and have opaque transaction records. Therefore, CEX users may reasonably ask how an exchange will custody assets, secure data, share best price information, and protect them from fraudulent and deceptive trading practices. Yet, instead of addressing these issues with a straightforward compliance path, U.S. regulators have created a Kafkaesque trap, refusing to provide a practical registration option while nonetheless threatening legal action against those who don't register.

A new framework

Our proposed framework for centralized exchanges would directly target these problems. We propose a tailored registration path for crypto commodity CEXs administered by the CFTC, whereby CEXs provide price transparency and disclose their custody, cybersecurity, and anti-manipulation policies. These disclosures, subject to CFTC antifraud authority, will allow consumers to choose the exchanges that best suit their needs.

For crypto securities exchanges, we propose amendments to the Securities Exchange Act's broker-dealer registration requirements, a new crypto-specific alternative trading system rule, and a free-market oriented cost-benefit framework for SEC rulemaking. Combined, these updates seek to modernize securities regulations to suit the reality of crypto marketplaces dealing directly with retail customers, as well as remove the SEC's perennial Sword of Damocles – regulation by enforcement – which stymies good-faith developers in the U.S.

DEXs face a different regulatory challenge beyond the typical SEC gaslighting on registration. Specifically, 20th century financial regulations designed for financial intermediaries are inapt when applied to disintermediated software protocols.

Unlike centralized exchanges, DEXs leverage self-executing smart contracts to remove the middleman from essential exchange functions. While some can be accused of "decentralization theater,"in their purest form, DEXs operate without the discretionary control of a single person or unified group, do not custody the assets of users trading tokens, and settle transactions on open and auditable public blockchains. Therefore, applying traditional custody and market transparency rules to DEXs is at best unhelpful, and, at worst, counterproductive.

With that said, DEXs do face market manipulation risks, including practices like wash trading, spoofing, and layering. But the costs of requiring DEXs to implement pre-cleared anti-manipulation measures outweigh the potential gains. Because DEXs are public, regulators and others have access to transaction data without relying on a DEX to police the marketplace. Moreover, permissionless DEX iteration itself should be allowed to drive competition and enhance consumer protection.

Therefore, our framework calls for strictly voluntary, not mandatory, DEX registration to embrace the competitive benefits of rapid DEX development without prior restraint. DEXs that want to signal their compliance with the same standards as CEXs – for example, through automated controls – can do so with voluntary registration. But making registration optional allows for greater experimentation in consumer protections, as DEXs need not seek pre-approval from inherently risk-averse regulators before launching novel technical safeguards. In addition, voluntary registration avoids creating adverse selection, where low natural barriers to entry in an open-source software ecosystem could allow rogue DEXs to gain first mover advantages while compliance-oriented projects are stalled by a regulatory approval process.

Furthermore, optional registration keeps DeFi truly permissionless – not simply as a technical matter, but also as a regulatory one – recognizing the creative potential of an open and maximally interoperable ecosystem to deliver a greater variety of products and services. Permissionless innovation is not merely a buzzword. It's an integral component of the original U.S. builder culture that organized solutions to practical challenges without the prior authorization or direction of authorities and made the U.S. an economic juggernaut.

As the economic historian Niall Ferguson wrote of the risks posed by overly constricting crypto regulation: "If we have learned nothing else from the past half-century, it is surely that the best way to win a race with totalitarian rivals is not to copy them, but to out-innovate them" and "[t]he American way is to let innovation rip."

Hear, hear.

U.S. policymakers ought to let crypto innovation rip by providing realistic registration pathways for centralized exchanges to operate onshore and allowing permissionless competition to deliver the benefits of decentralized exchanges. Regulators should not fear American markets' creative potential. They should fear extinguishing it with impossible regulation.

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