

Uniswap Gets DeFiant: What the SEC's Latest Wells Notice Means for Crypto

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In the midst of a flurry of crypto industry litigation, Uniswap was served with a Wells Notice by the U.S. Securities and Exchange Commission (SEC) on April 10, 2024. A Wells Notice is a preliminary warning that informs entities of charges that the regulator is considering bringing against them, and often leads to enforcement actions. The blockchain industry is no stranger to this term – in the months prior to the SEC's lawsuit against Coinbase, a Wells Notice was also served against the cryptocurrency exchange platform.¹

In this article we will examine the significance of the Wells Notice, the SEC's targeting of decentralized financial services (DeFi) or decentralized financial exchanges (DEX), and what the latest SEC action could mean for the crypto industry.

What is DeFi and DEX?

Decentralized finance aims to provide users with financial services without the need for a traditional intermediary. Typical transactions between parties require an intermediary to act as a custodian for the collateral associated with the agreement. An example of this is a bank holding funds in escrow pending the execution of an agreement.

However, most DeFi platforms seek to replace the need for an intermediary with a "smart contract," which refers to code-based mechanisms capable of self-execution based on pre-set conditional logic.² Using the previous example, instead of having a bank come in as a third party to effectuate an agreement, funds can travel from a buyer into the smart contract protocol, be held in escrow, and be released upon the seller transferring their asset. Through DeFi platforms, users trade with each other in a peer-to-peer fashion and are not reliant on third party intermediaries to conduct business. Proponents of DeFi believe this increases the efficiencies of transactions by removing bureaucratic and administrative barriers.

DeFi platforms have utilized smart contracts to remove intermediaries in different ways. Organizations have released decentralized stablecoins (e.g., Dai) to facilitate payments; decentralized exchanges (e.g., Uniswap) to enable asset trading; decentralized lending protocols (e.g., Aave) to provide funding; and decentralized asset management platforms (e.g., Yearn) to manage their crypto portfolios.³ Of these uses, we will be focusing on decentralized exchanges (DEXs, as mentioned above), such as Uniswap, which is the largest DEX operating on the Ethereum blockchain.⁴

The Pending Enforcement Action Against Uniswap

Uniswap is a decentralized cryptocurrency exchange that uses smart contracts to execute trades, and whose business mandate it is to enable cheap, accessible, global economic participation. The Wells Notice from the SEC focuses on Uniswap as an unregistered securities broker and unregistered exchange, but it is unclear whether Uniswap's native token, UNI, is implicated as a potential security in this investigation. In a press release and blog post on April 10, 2024, Uniswap said that it believed that it did not meet the SEC's current definition of an exchange and in addition, it denies that the tokens it offers are securities.⁵

In a series of tweets, Uniswap said they would be "ready to fight." Uniswap argues that despite the SEC claiming that most tokens, except for Bitcoin, are securities, the reality is that tokens are just a digital file format of stablecoins, community tokens, and commodities. The Chief Legal Officer of Uniswap also tweeted that they welcome "sensible regulations for crypto – and clear rule of law that [is expected] in the US," but noted that this Wells Notice and the impending SEC action against Uniswap is arbitrary enforcement and a continued abuse of power. While it is still unclear how exactly the enforcement against Uniswap will proceed, Uniswap has indicated that it intends to fight to defend DeFi from regulatory overreach. Many stakeholders in the industry have shown their support, including the co-founder and CEO of Coinbase tweeting #StandWithCrypto in response to a chain by the inventor of the Uniswap protocol, and others championing Uniswap as a leader in DeFi and noting their belief that the potential Uniswap and SEC case could be a landmark in crypto litigation and regulation.

The SEC and DeFi/DEX

The SEC's highest profile cases against crypto platforms thus far have involved centralized institutions such as Coinbase and Ripple. With a Wells Notice now served on Uniswap, it appears that the SEC is now targeting a decentralized financial service platform. This is a significant development for the crypto community as the SEC has not previously focused its enforcement efforts on decentralized protocols. With the recent collapse of FTX and Binance, investors currently have \$50 billion of total value locked in DeFi, which is the highest level of investment in this sector since before FTX's bankruptcy.⁶ The high level of investment coupled with the number of scams and fraud that have occurred over the past few years may be the motivation in the SEC's actions.

The SEC and Uniswap

This is not the first time that Uniswap has crossed paths with the SEC, as SEC investigations have been conducted against Uniswap since 2021. These previous investigations resulted in the delisting of numerous tokens from the DEX. However, stakeholders have speculated that this new investigatory push by the SEC

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into DeFi and DEX is part of a larger plan to mandate DeFi reporting.⁷

Uniswap emerged early on as one of the first DeFi platforms to establish itself on the Ethereum blockchain. The DEX quickly gained popularity through pioneering the “Automated Market Maker” model, which incentivized outside users to provide liquidity in the form of cryptocurrency into a “liquidity pool” in exchange for a share of the transaction fees and free tokens provided over the course of a transaction on a DEX. This “liquidity pool” was backed by a smart contract that was tied to particular cryptocurrencies, ensuring that buying and sellers were able to connect automatically for lower fees and without the need for intermediaries.⁸

With the Automated Market Maker model, DEXs like Uniswap became extremely popular because they were safe, global, permissionless, easy to use, and pseudonymous.⁹ However, this last point appears to be the target of the SEC’s Wells Notice.

What Does an Action Against a DEX Mean for Crypto?

Stakeholders in the crypto industry have noted that the SEC’s filings have increasingly pushed for transparency and mandated reporting from crypto asset platforms. The Wells Notice served to Uniswap indicates that DeFi and DEXs are next up in the push for transparency. Stakeholders have also noted that responding to the SEC’s Wells Notice and potential future actions will require providing customer information, similar to the data that Coinbase had to turn over during their legal battles with the SEC. This is coupled with the upcoming changes to IRS codes that seek to gather more information from crypto asset platforms, indicating that regulators across the board are pushing for greater transparency.¹⁰

Anonymity and pseudonymity have been central tenets of blockchain technology since their inception, but it appears that the only way that the SEC will continue to let decentralized technology thrive in the U.S. market may be to increase the level of transparency. While this undermines one of the core reasons that DEXs like Uniswap became popular, it seems to be the reality that crypto asset platforms are heading towards with the SEC’s varied lawsuits beginning to indicate the SEC’s underlying policy objectives.

In addition to the commercial concerns associated with increased transparency in the DeFi and DEX space, there is also a significant practical concern. As mentioned above, the IRS is looking to mandate both centralized and decentralized crypto asset exchanges to report user transactions. Currently, the IRS employs several methods to track whether a US tax-paying entity has engaged in crypto asset transactions and will base their assessment accordingly.¹¹ However, the crypto asset information gathered by the IRS is tracked closer to centralized exchanges, such as Coinbase, which are subject to KYC, AML, and KYP standards that require users to provide the exchange with relevant documentation. Assumedly, this is also the type of information that the SEC is looking to gather from DeFi platforms and DEXs. However, in contrast, DEXs are meant to be non-custodial (the DEX does not hold any assets directly) and

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permissionless (users on the DEX require no permission to trade), which means that the same documentary standards that apply to centralized exchanges should not apply to DEXs. As such, there would be no documentary evidence on users that Uniswap could provide to the SEC.

Moreover, it is unclear who would collect trader information and where it would be stored. Using Uniswap as an example, the DEX does not “maintain user accounts and [does] not collect and store personal data, such as [the user’s] name or internet protocol (“IP”) address.”¹² The only data that Uniswap collects is, “Publicly-available blockchain data.”¹³ This goes to the heart of the issue – if Uniswap does not collect or store any significant user data, there is no possible way to comply with potential SEC requests for transparency. Uniswap does openly publicize all transactions on the platform, but the only pseudo-personal information associated with these transactions are the wallet addresses of traders. Practically speaking, Uniswap, amongst other DEXs, simply does not have anything to show the SEC or anything to hide. The Automated Market Maker protocol that underlies most DEXs is meant to function in a manner that does not require data collection. As a result, the SEC’s push for transparency in this sector cannot be fulfilled past what is already publicly available.

If the SEC is suggesting that DEXs begin the collection of user data, then this defeats the entire purpose of a DEX, and could effectively eliminate this market in the US, as the permissionless and pseudonymous nature of DEXs is a significant aspect of their appeal. This puts DEXs such as Uniswap in an impossible position; they must either pivot their platform and risk losing their userbase or potentially fight a lengthy, and expensive, legal battle with the SEC to mitigate this seemingly impending regulatory overreach. As the Wells Notice does not definitively signal the route that the SEC intends to take with respect to the regulation of DeFi and DEXs, there is still room for the regulators to change trajectory. However, until more clarity is provided by the SEC, many stakeholders in the crypto space are concerned for what this could mean for the future of DeFi.

Conclusion

The SEC’s push for transparency, albeit in a roundabout fashion, mirrors the Canadian approach of registration and information sharing with regulators. While there has not been any direct correspondence from regulators regarding the Canadian approach to DEXs, the SEC’s potentially impending action against Uniswap demonstrates that regulators are willing to target DEXs as well. In turn, this signals that Canadian DEXs, or more particularly, Canadian individuals or organizations that seek to deploy DeFi protocols, should seek out legal counsel for proactive advice in light of potential sanction by regulators.

At Cassels, we will be keeping a keen eye on the progression of the SEC’s actions against DeFi platforms and DEXs in order to stay ahead of potential regulatory changes that may be adopted in Canada. For more information on how this may impact you or your business, or for more information on preparing disclosure documentation, we invite you to contact our Blockchain & Digital Assets Group.

¹ Allyson Versprille, Yueqi Yang & Sonali Basak, "Coinbase Gets SEC Notice Signaling Intent to Sue Over Crypto Offerings" (22 March 2023), online: <[bloomberg.com/news/articles/2023-03-22/coinbase-coin-gets-sec-wells-notice-over-crypto-offerings](https://www.bloomberg.com/news/articles/2023-03-22/coinbase-coin-gets-sec-wells-notice-over-crypto-offerings)>.

² Jonathan Chiu & Hanna Yu, "Decentralized finance: Innovations and challenges" (October 2023), online: <bankofcanada.ca/2023/10/staff-analytical-note-2023-15/>.

³ Chiu, *supra* note 2.

⁴ Andrey Sergeenkov, "What Is an Automated Market Maker?" (13 January 2023), online: <coindesk.com/learn/what-is-an-automated-market-maker/>.

⁵ Uniswap, "Fighting for DeFi" (10 April 2024), online: <blog.uniswap.org/fighting-for-defi>.

⁶ Sean Stein Smith, "What the Uniswap Lawsuit Means for Crypto Investors" (14 April 2024), online: <forbes.com/sites/digital-assets/2024/04/14/what-the-uniswap-lawsuits-means-for-crypto-investors/?sh=297338f34ee0>.

⁷ Stein Smith, *supra* note 6.

⁸ Sergeenkov, *supra* note 4.

⁹ Coinbase, "What is Uniswap?" (last accessed 22 April 2024), online: <coinbase.com/en-ca/learn/crypto-basics/what-is-uniswap>.

¹⁰ Stein Smith, *supra* note 6.

¹¹ Cheyenne DeVon, "The No. 1 mistake cryptocurrency traders make when filing their taxes, according to a CPA" (22 March 2024) online: <cnbc.com/2024/03/22/cpa-no-1-mistake-cryptocurrency-traders-make-when-filing-taxes.html>.

¹² Uniswap, "Privacy Policy" (last accessed 23 April 2024), online: <uniswap.org/privacy-policy>.

¹³ Uniswap, *supra* note 12.