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FINTECH SANDBOX: PAXOS RECEIVES NO-ACTION LETTER TO TEST BLOCKCHAIN-BASED SETTLEMENT SERVICE

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On October 28, 2019, the Division of Trading and Markets of the Securities and Exchange Commission (the “SEC”) granted Paxos Trust Company, LLC (“Paxos”) no-action relief to test its blockchain-based settlement platform in a production environment without registering as a clearing agency. While the no-action letter is the third instance of no-action relief being granted by the SEC in the blockchain space, it is the first to delve into the use of blockchain technology with broader applications outside the context of the securities law implications of issuing blockchain-based tokens. The no-action relief is also a landmark interaction between the SEC and the blockchain space, as the SEC has greenlighted a regulatory sandbox to allow the small-scale testing of the settlement service.

Paxos

Paxos is a New York-based limited purpose trust company, a type of financial institution regulated by the New York Department of Financial Services (“DFS”). Paxos has taken a regulator-friendly approach in its business and has sought DFS approval for its various platforms and products in the blockchain space, including its DFS sanctioned institutional trading platform, itBit Digital Asset Exchange. A qualified custodian by virtue of its trust charter, the company also offers custodial services for digital assets and has sponsored the launch of a number of stablecoin products, including Paxos Standard or PAX, a dollar-backed stablecoin, and Paxos Gold or PAXG, a gold-backed stablecoin.

The Proposed Settlement Service

Paxos is currently a participant of The Depository Trust Company (“DTC”), a registered clearing agency that serves as a securities depository. Through its settlement service, Paxos is now seeking to compete with DTC in facilitating stock trades for broker-dealers. The proposed Paxos settlement service is a blockchain-based platform-as-a-service (PaaS) solution for broker-dealers that operates on “a private and permissioned distributed ledger system that records changes in ownership of securities and cash resulting from settlement of securities transactions between participants.” According to the no-action letter, the service “is designed to conduct simultaneous delivery versus payment settlement of securities and cash for trades.” Specifically, the service operates by:

- **Creating Digital Embodiments of Securities:** (i) taking deposits of eligible securities in the Paxos DTC account, (ii) creating a digitized security entitlement (“DSE”), a digital embodiment of the security that was deposited into the DTC account, and (iii) crediting those DSEs to the participant’s account on the ledger.

- **Creating Digital Embodiments of Cash:** (i) taking deposits in USD in a designated Paxos bank account, (ii) creating a DSE representing those USD, and (iii) crediting those DSEs to the participant's account on the ledger.
- **Automatically Settling Trades:** once the DSEs are created, participants transact on a peer-to-peer ("P2P") basis by giving instructions and the service, in accordance with those instructions, will automatically settle obligations on the settlement date by causing DSEs for the securities and cash to be simultaneously transferred between the participants' accounts on the permissioned ledger (provided each party has sufficient cash and securities on deposit to effect the contemplated transaction).

The proposed service is a step forward from the legacy system in that it is designed to update existing market infrastructure to provide real-time settlement without the use of an intermediary. That is, the participants to the transaction can settle trades of securities directly with one another via P2P without a middleman or back office process, making for a more efficient and less costly transaction.

No-Action Relief

Paxos sought no-action relief because the company is not registered as a clearing agency nor has it been granted an exemption from registration. However, by operation of its settlement service, Paxos would be performing the functions of a clearing agency by acting as "an intermediary in making payments or deliveries or both in connection with transactions in securities" and "providing facilities for comparison of data respecting the terms of settlement of securities."

Specifically, Paxos requested a regulatory sandbox to test the feasibility of its settlement service in a controlled environment for a period of twenty-four (24) months before registering with the SEC as a clearing agency. The SEC granted no-action relief for purposes of the feasibility study, provided that the settlement service operated under certain parameters during the test period, including set limits on the number of participants, the volume of shares settled, and the types of securities eligible for settlement. Furthermore, Paxos is to establish certain monitoring procedures, provide notification of certain events, and to conduct quarterly and ad hoc reporting, all of which ensure SEC transparency into the operations of the service during the feasibility study.

Takeaways

To date, initial coin offerings (ICOs) and other token distribution models have taken up most of the airtime in discussions around blockchain technology. The blockchain industry continues to see regulatory responses to these token issuances, including recent SEC enforcement actions involving Kik and Telegram as well as its settlement with Block.One (EOS). In the context of the SEC's interactions with the blockchain industry to date, this no-action letter is significant because it indicates a willingness on the part of the SEC to sanction innovative market infrastructure products using a sandbox approach. This approach balances the competing interests of facilitating the adoption of new technology and products while protecting the market from the potential consequences of a product or technology failure. Paxos now has SEC approval to test out the promise of its blockchain-based product while doing so in a controlled environment.

All quotes appearing in this article have been taken from the text of the no-action letter, a copy of which is available on the SEC's website [here](#). If you would like more information regarding our [Securities and Capital Markets](#) group and the services we offer, please contact us at 716.853.1616, 585.232.6500, or visit www.hselaw.com.

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