



DIVISION OF
TRADING AND MARKETS

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

October 28, 2019

Charles G. Cascarilla & Daniel M. Burstein
Paxos Trust Company, LLC
c/o Andrew Blake, Partner
Sidley Austin LLP
1501 K Street, NW
Washington, DC 20005

**Re: Clearing Agency Registration Under Section 17A(b)(1) of the Securities
Exchange Act of 1934**

Dear Mr. Cascarilla and Mr. Burstein:

In your letter dated October 25, 2019 (the "Request"),¹ on behalf of Paxos Trust Company, LLC ("Paxos"), you request that the Division of Trading and Markets (the "Staff") not recommend that the Securities and Exchange Commission (the "Commission") take enforcement action against Paxos under Section 17A(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act")² if Paxos fails to register with the Commission as a clearing agency in connection with its operation of a securities settlement system referred to in the Request as the "Paxos Settlement Service."

Based on the Request, we understand the facts to be as follows:³

- Paxos is a New York limited purpose trust company that is regulated by the New York State Department of Financial Services and is a participant of The Depository Trust Company ("DTC").
- Paxos states that the Paxos Settlement Service is a private and permissioned distributed ledger system that records changes in ownership of securities and cash resulting from settlement of securities transactions between participants of the Paxos Settlement Service. In so doing, the Paxos Settlement Service is designed to conduct simultaneous delivery versus payment settlement of securities and cash for trades submitted to the Paxos Settlement Service for clearance and settlement.

¹ A copy of the Request is attached.

² 15 U.S.C. § 78q-1(b)(1).

³ This list is not intended to capture or describe every aspect of the Request but rather highlight key aspects of the Request.

- Each participant may hold cash and securities in its Paxos Settlement Service account (“PSS account”). A participant will deposit an eligible security into its PSS account by using free of payment delivery instructions through DTC to transfer the security from the participant’s DTC account to Paxos’s DTC account. Upon receipt of a security into Paxos’s DTC account, Paxos will create a digitized security entitlement, which is a digital representation of the security deposited into Paxos’s DTC account. This security entitlement will be credited to the participant in its PSS account on the Paxos ledger. Similarly, a participant will deposit funds in U.S. dollars by initiating a wire transfer from its bank account to the specified Paxos bank account. Upon receipt of cash into a Paxos bank account, Paxos will create a digitized security entitlement representing U.S. dollars credited to the participant in its PSS account on the Paxos ledger.
- To meet its settlement obligations, each participant must have the required securities or operating cash in its PSS account by each trade’s settlement date; however each participant is not required to fund its securities or operating cash in advance of settlement. In accordance with instructions from the participant and provided that each participant has sufficient operating cash and securities in its PSS account, the Paxos Settlement Service will automatically settle the obligations on the settlement date, between two participants by causing the security entitlements to the cash and securities, as applicable, to be simultaneously transferred between the relevant participants’ PSS accounts on the Paxos ledger. All trades submitted to the Paxos Settlement Service, regardless of the settlement cycle with which each trade is submitted, will be settled bilaterally on a gross trade-by-trade basis without any netting of the gross trades.
- To manage the risk of financial loss associated with replacing a transaction scheduled for settlement in the event that a participant fails to meet its settlement obligations, the Paxos Settlement Service will calculate a mark-to-market margin on each business day and require the funding of a sufficient margin cash balance in the PSS account of each participant to meet the greater of daily margin or the highest calculated daily margin over a ninety day look back period. Daily margin will be assessed for each unique pair of participants settling trades against one another in the Paxos Settlement Service.
- As the operator of the Paxos Settlement Service, Paxos believes that it will be acting as a clearing agency under the definition of such in Section 3(a)(23) of the Exchange Act because Paxos will be an intermediary in making payments or deliveries or both in connection with transactions in securities and will also be providing facilities for comparison of data respecting the terms of settlement of securities transactions.⁴ Section 17A(b)(1) of the Exchange Act states in relevant part that it shall be unlawful for any clearing agency, unless registered in accordance with this subsection, directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce to perform the functions of a clearing agency with respect to any security.
- At present, Paxos has not been registered as a clearing agency nor granted an exemption from registration as a clearing agency. To evaluate the potential benefits of the Paxos Settlement Service, Paxos plans, for a limited period of twenty-four months, to operate

⁴ 15 U.S.C. § 78c(a)(23).

the Paxos Settlement Service in a production environment for the clearance and settlement of listed U.S. equity securities trades, without being registered as a clearing agency (the “Feasibility Study No-Action Phase”).

Response:

Based on the facts and circumstances described in the Request, and without necessarily concurring with your conclusions and analysis, the Staff would not recommend enforcement action to the Commission against Paxos if Paxos engages in the proposed activities described in your Request without registering with the Commission as a clearing agency pursuant to Section 17A(b)(1) of the Exchange Act.

In taking this position, staff notes that the Paxos Settlement Service will be: (i) operated during the Feasibility Study No-Action Phase only for a limited period of time, and (ii) reasonably designed to ensure that activity remains de minimis through operating parameters designed to limit the scope of operations and manage financial and settlement risk using, among other things, participation requirements and limits, securities eligibility criteria, margin collection, volume limits, ongoing monitoring, and regular reporting to the Staff.

In particular, staff notes that:

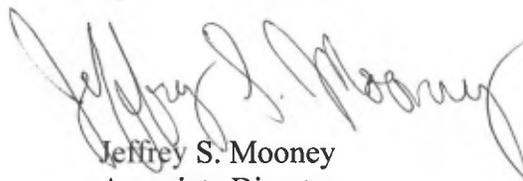
- The Feasibility Study No-Action Phase will be conducted in a “de minimis” manner with “well-defined” parameters and limits on the volume of shares settled through the Paxos Settlement Service, including as follows:
 - No more than seven (7) participants will be eligible to use the Paxos Settlement Service for clearance and settlement and the participants will be required to satisfy the criteria for participation, as described more fully in the Request.
 - Securities eligible for settlement on the Paxos Settlement Service will include only publicly traded equity securities that are registered pursuant to Section 6 of the Securities Act of 1933, as amended, and Section 12 of the Exchange Act and that remain eligible at all times for listing and trading on a national securities exchange registered under Section 6 of the Exchange Act.
 - Securities eligible for the Paxos Settlement Service must satisfy the eligibility criteria, as described in the Request, and must be one of the securities listed in Exhibit B of the Request. In addition to the eligibility requirements, in order for a security to become active for submission to the Paxos Settlement Service, the security must have an average daily volume of not more than 300 trades executed between each potential counterparty pair on approved trading venues.
 - To avoid exceeding a de minimis level of aggregate share volume settling on the Paxos Settlement Service during the Feasibility Study No-Action Phase, Paxos will utilize the following volume limits as daily targets for the share volume submitted to Paxos Settlement Service: (i) less than 100,000 shares per security, per counterparty pair; and (ii) aggregate shares per security across all counterparty pairs of less than 1% of the total average daily trading volume of the respective security.

- Paxos will establish and implement procedures that are reasonably designed to monitor and maintain ongoing compliance with the operating parameters for the Feasibility Study No-Action Phase. As described more fully in the Request, this includes the monitoring of (i) compliance with participation criteria; (ii) securities eligibility; and (iii) volume limits. As described more fully in the Request, Paxos has also established processes for: stopping the submission of trades for settlement, replacing “ceased” securities, and reinstating “ceased” securities.
- For the duration of the Feasibility Study No-Action Phase, Paxos will provide Staff with prior and same day notifications of certain events as specified in the Request, as well as quarterly and ad hoc reporting, to ensure that the operation of the Paxos Settlement Service is transparent to Staff during the Feasibility Study No-Action Phase and to document findings related to the objectives of the Feasibility Study No-Action Phase.
- No later than the twenty-third month, Paxos will promptly wind-down the Feasibility Study No-Action Phase within not more than thirty business days by ceasing to accept trades for settlement and settling all outstanding obligations of the Paxos Settlement Service in an orderly manner. Once all outstanding obligations are settled, participants will withdraw all cash and securities from the Paxos Settlement Service.

The position of the Staff is based strictly on the facts and circumstances discussed in the Request, and any different facts or circumstances might require a different response. Furthermore, this response expresses the Staff’s position on enforcement action only and does not purport to express any legal conclusions on the questions presented. The Staff expresses no view with respect to any other questions that the proposed activities may raise, including the applicability of any other federal or state laws, or self-regulatory organization rules. This position is subject to modification or revocation by the Staff at any time.

If you have any questions regarding this letter, please call me at (202) 551-5712 or Matthew Lee at (202) 551-5794.

Sincerely,



Jeffrey S. Mooney
Associate Director

Attachment



October 25, 2019

VIA ELECTRONIC MAIL

Mr. Jeffrey Mooney
Associate Director
Office of Clearance and Settlement
Division of Trading and Markets
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

RE: Request for No-Action Relief from Clearing Agency Registration Under Section 17A(b)(1) of the Securities Exchange Act of 1934

Dear Mr. Mooney:

We are requesting that the staff of the Division of Trading and Markets (“Division”) of the U.S. Securities and Exchange Commission (“Commission”) confirm that it will not recommend that the Commission take enforcement action against Paxos Trust Company, LLC (“Paxos”) for violation of Section 17A(b)(1)¹ of the Securities Exchange Act of 1934, as amended (“Exchange Act”) in connection with Paxos’s operation of a securities settlement system (herein, “Paxos Settlement Service”) as described below.

¹ 15 U.S.C. 78q-1(b)(1).

I. Background and Intent to Conduct Feasibility Study

Currently, Paxos is a New York limited purpose trust company that is regulated by the New York State Department of Financial Services (“NYDFS”) and it is a participant of The Depository Trust Company (“DTC”).²

The Paxos Settlement Service is a private and permissioned distributed ledger system developed by Paxos. The Paxos Settlement Service software maintains a distributed ledger (“Paxos Ledger”) to record changes in ownership of securities and cash resulting from settlement of securities transactions between participants (“Participants”) of the Paxos Settlement Service. Paxos believes that the Paxos Settlement Service technology and data processing techniques have the potential to provide unique advancements in the clearance and settlement of securities transactions including facilitation of more efficient settlement, immediacy of access to settlement proceeds, greater data accuracy and transparency, advanced security, and increased levels of availability and operational efficiency. Therefore, Paxos believes that operation of the Paxos Settlement Service will advance Congress’ finding in adopting Section 17A of the Exchange Act that “[n]ew data processing and communications techniques create the opportunity for more efficient, effective, and safe procedures for clearance and settlement.”³ The potential benefits of the Paxos Settlement Service are more fully described in Section II., below.

To evaluate the potential benefits of the Paxos Settlement Service, Paxos is requesting no-action relief for a limited period of twenty-four (24) months to operate the Paxos Settlement Service in a production environment for the clearance and settlement of listed U.S. equity securities trades, without being registered as a clearing agency (the “Feasibility Study No-Action Phase”). To guard against the potential for any negative disruption of the underlying U.S. securities markets, the Feasibility Study No-Action Phase will be conducted in a *de minimis* manner with well-defined parameters and limits on the volume of shares settled through the Paxos Settlement Service and the associated exposures between Participants. These operating parameters and limits are set out in Section IV., below. Paxos believes the Feasibility Study No-Action Phase will significantly enhance its ability to evaluate whether the Paxos Settlement Service functions as intended to facilitate prompt and accurate clearance and settlement of securities transactions and to achieve the benefits outlined in Section II., prior to the prospective deployment of the Paxos Settlement Service on a broader scale, if authorized following the submission of a Form CA-1 that is subsequently reviewed and approved by the Commission.

² DTC is a registered clearing agency with the Commission that operates as a securities depository as that term is defined in Section 3(a)(23)(A) of the Exchange Act.

³ 15 U.S.C. § 78q-1(a)(1)(C).

II. Paxos Settlement Service Benefits

Paxos believes that the Paxos Settlement Service represents an opportunity to provide market participants with the potential clearance and settlement benefits more fully described below.

A. Access to Shorter Settlement Cycles

The Paxos Settlement Service is designed in a manner to facilitate more efficient settlement by expanding access to shorter settlement cycles in addition to the current standard settlement cycle of the second business day after the trade date (i.e., T+2) prescribed by Exchange Act Rule 15c6-1⁴. The Paxos Settlement Service will offer Participants the option to settle any trade on T+0 or T+1, in addition to T+2, with agreement between counterparties. Although T+0 settlement is available through existing clearing agencies, the ability to achieve this is limited to trades submitted prior to an 11:30 a.m.⁵ cut-off time or by handling through non-standard exception processing. In contrast, as a standard service, the Paxos Settlement Service offers the ability to achieve T+0 settlement for all trades submitted throughout the day, up to the Paxos Settlement Service's daily settlement cut-off time of 4:15 p.m.

Expanded access to shortened settlement cycles mitigates the risk of financial losses due to either party becoming unable to meet the financial obligations of the agreed-upon trade due to intervening causes between the trade date and settlement date, and provide market participants more efficient access to securities and cash proceeds.

B. Immediate Access to Settlement Proceeds

Regardless of the trade's settlement cycle, trade settlement through the Paxos Settlement Service and the resulting transfer of ownership of the securities and cash is designed to occur through a simultaneous delivery versus payment process. Thus, trade settlement on the Paxos Settlement Service is irrevocable and unconditional, which the Bank for International Settlements has defined to mean "final settlement"⁶. This increases a Participant's intraday liquidity by providing Participants with immediate access to securities and cash proceeds as settlements occur throughout the day, rather than being limited to a single end of the day cash settlement process.⁷

⁴ 17 C.F.R. § 240.15c6-1.

⁵ Unless otherwise specified, all times used throughout this document are Eastern Time (Eastern Standard or Daylight Time, as applicable).

⁶ A glossary of terms used in payments and settlement systems, Bank for International Settlements (2003), https://www.bis.org/cpmi/glossary_030301.pdf.

⁷ The Paxos Settlement Service provides each Participant with immediate access to its cash proceeds from each settled trade, at the time that settlement happens, which enables each Participant to withdraw its securities or cash from the Paxos Settlement Service, throughout the day, for use in funding liquidity or other obligations external to the Paxos Settlement Service. Each Participant can also deposit securities or cash to the Paxos Settlement Service throughout the day to satisfy its settlement obligations on the Paxos Settlement Service. The process for a Participant to deposit or withdraw securities or cash from the Paxos Settlement Service is described in Section III.A.

C. Data Accuracy and Visibility

The Paxos Ledger is made up of distinct, sequential, and time-stamped records of asset ownership resulting from settlement (“Blocks”). The underlying distributed ledger technology of the Paxos Settlement Service enforces the accuracy of each new Block in relation to both the settling transactions and the previous Block. This technologically enforced sequential recordkeeping provides certainty that settlements recorded on the Paxos Ledger are accurate and independently confirmed in real time by the Participants of the Paxos Settlement Service.

Paxos is responsible for updating the Paxos Ledger through the addition of new Blocks, the contents of which can be reviewed by Participants upon distribution in real time. For each Participant, the copy of the Paxos Ledger provides data regarding the clearance and settlement status of its transactions and resulting securities and cash positions. Over time, this would allow each Participant to use the Paxos Ledger in lieu of maintaining a separate internal ledger, which has the potential to eliminate the need to reconcile differences in settlement records, either with trading counterparties or with the omnibus position in its account at the central securities depository.

Additionally, each Participant could allow its customers (including the end investors) to have direct and individually permissioned access to the Paxos Ledger, providing the potential for enhanced investor protection as it would allow investors to independently confirm their ownership and possession of assets recorded to the Paxos Ledger. This data visibility and accuracy could also be extended to regulators for the fair and consistent enforcement of market rules and regulations.

D. Security and Availability

The underlying technology of the Paxos Settlement Service is highly secure, available, and resilient which minimizes disruptions to clearance and settlement that could be caused by hardware malfunctions or unauthorized access or actions.

To achieve a high level of availability and resiliency, redundant copies of the Paxos Settlement Service software are run in multiple data centers with concurrently replicated data across different geographic locations and power grids. Should any component of the Paxos Settlement Service’s technology experience a malfunction or an externally caused disruption, this redundancy allows for the immediate transition of processing to another location with little to no disruption of service to Participants.

As a private and permissioned distributed ledger system, the Paxos Settlement Service is comprised of known, trusted, and verified Participants, each of which must be approved and onboarded to the Paxos Settlement Service by Paxos and maintain their compliance with the standards outlined in Section IV.A. Each Participant can only access the Paxos Settlement Service and its copy of the Paxos Ledger over encrypted, direct communication channels. This ensures that no unauthorized parties can access the Paxos Settlement Service and provides Participants with a robust level of security. Additionally, the technology that enforces the

accuracy of Blocks described in Section II.C., makes the Blocks immutable, which prevents any unauthorized alteration of the Paxos Ledger.

E. Operational Efficiency

The Paxos Settlement Service is built using modern technological systems and practices that have lower operating costs and thus deliver cost efficiencies to market participants and investors. It is anticipated that over time this modern clearance and settlement infrastructure will enable financial services firms to modernize their own internal technologies to realize even greater operational savings. For example, each Participant would have the opportunity to replace its legacy, siloed, on-site recordkeeping systems with the records of the Paxos Ledger and reorganize its systems and processes around the shared ledger for the achievement of further efficiency gains.

In these ways, Paxos believes that the Paxos Settlement Service represents capabilities that are consistent with Congress' finding in adopting Exchange Act Section 17A(a)(1)(C) that new data processing techniques create the opportunity for more efficient, effective and safe procedures for clearance and settlement.⁸

III. General Description of the Operation of the Paxos Settlement Service During the Feasibility Study No-Action Phase

The Paxos Settlement Service is designed to conduct simultaneous delivery versus payment settlement of securities and cash for trades submitted to the Paxos Settlement Service for clearance and settlement between Participants. The general description in this Section III. describes how the Paxos Settlement Service will operate during the Feasibility Study No-Action Phase.

While Paxos is requesting the Feasibility Study No-Action Phase be approved for a period of twenty-four (24) months, the initial stage of the Feasibility Study No-Action Phase will be a period of twelve (12) calendar months from the date this request for no action relief is approved ("Initial Stage"). Certain functionalities of the Paxos Settlement Service will be implemented incrementally during either the Initial Stage or the remainder of the Feasibility Study No-Action Phase, all cases of which are further described in this Section III., below.

A. Participant Accounts

A Participant will operate a fully segregated account on the Paxos Settlement Service that performs the role that fulfills its specific responsibilities in the clearance and settlement of securities trades on the Paxos Settlement Service ("PSS Account"). Each Participant may hold

⁸ See *supra* note 3 and accompanying text.

cash and securities in its PSS Account, the ownership of which is recorded on the Paxos Ledger by Paxos, acting as a securities intermediary⁹.

A Participant will deposit an eligible security, as described in Section IV.B., into its PSS Account by using free of payment delivery instructions through DTC to transfer the security from the Participant's DTC account to Paxos's DTC account. Upon receipt of a security into Paxos's DTC account, Paxos will create a digitized security entitlement¹⁰, which is a digital representation of the security deposited into Paxos's DTC account. This security entitlement will be credited to the Participant in its PSS Account on the Paxos Ledger. This process is referred to as securities digitization ("Securities Digitization"). In accordance with instructions from a Participant, Paxos supports the withdrawal of a security from a Participant's PSS Account by removing the digitized security entitlement credited to the Participant in its PSS Account on the Paxos Ledger and initiating a free of payment delivery instruction through DTC to remove the security from Paxos's DTC account and deliver such security to the Participant's DTC account.

Paxos maintains two separate omnibus cash custody accounts that have been established for the benefit of Participants ("Paxos Bank Accounts") at a chartered U.S. national bank that is supervised by the Office of the Comptroller of the Currency. The Paxos Bank Accounts are used to hold funds deposited by Participants for two different purposes: the first account is used for funds deposited by Participants to settle obligations to other Participants ("Operating Cash") and the second is used for funds deposited by Participants to fulfill margin requirements ("Margin Cash"). A Participant will deposit funds in U.S. dollars by initiating a wire transfer from its bank account to the specified Paxos Bank Account for the intended purpose of the funds, either Operating Cash or Margin Cash. Upon receipt of cash into a Paxos Bank Account, Paxos will create a digitized security entitlement (this time, representing U.S. dollars) credited to the Participant in its PSS Account on the Paxos Ledger. This process is referred to as cash digitization ("Cash Digitization"). In accordance with instructions from a Participant, Paxos supports the withdrawal of cash¹¹ from a Participant's PSS Account by removing the digitized security entitlement of cash credited to the Participant in its PSS Account on the Paxos Ledger and initiating a wire transfer from the relevant Paxos Bank Account to a bank account designated by the Participant.

B. Trade Submission for Settlement

Purchase and sale transactions that are eligible for settlement on the Paxos Settlement Service will be limited to trades between Participants, as described in Section IV.A., of an eligible security, as described in Section IV.B., and that are executed on an OTC basis or on a

⁹ Paxos would be a "securities intermediary" as defined in Section 8-102(a)(14) of the Uniform Commercial Code ("UCC").

¹⁰ The term "security entitlement" is defined in Section 8-102(a)(17) of the UCC as "the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5 [of Article 8 of the UCC]." In turn, the term "entitlement holder" is defined in UCC Section 8-102(a)(7) as "a person identified in the records of a securities intermediary as the person having a security entitlement against the securities intermediary".

¹¹ The Paxos Settlement Service will allow a Participant to withdraw Margin Cash from its PSS Account that is in excess of the Participant's current required margin as described in Section III.E.

trading venue (e.g., alternative trading system, or ATS) that is duly notice registered with the Commission and approved by Paxos (“Trading Venue”). A trade that has been determined by the trade counterparties to be settled on the Paxos Settlement Service will be submitted to the Paxos Settlement Service in near real-time according to the terms of the operating procedures of the Trading Venue or other agreement between the trade counterparties. The trade submission will contain the contractually executed trade details, including the transacted security, quantity of shares, price per share, net amount of money to be settled, buying trade counterparty, selling trade counterparty, trade date, and settlement date. The Paxos Settlement Service will use the trade details provided in the trade submission without any modification to such details. A trade submitted to the Paxos Settlement Service may be cancelled at any time by the Trading Venue¹² if it is deemed by the Trading Venue to fall under its policy definition of a clearly erroneous trade, or in the case of an OTC trade, cancellation can occur with the consent of both trading counterparties up until the Paxos Settlement Service’s OTC trade cancellation cut-off time of 4:00 p.m. on the day before settlement date .

C. Settlement

To meet its settlement obligations, each Participant must, through Cash Digitization and Securities Digitization, have the required securities or Operating Cash in its PSS Account by each trade’s settlement date, however, each Participant is not required to fund its securities or Operating Cash in advance of settlement date¹³. In accordance with instructions from a Participant and provided that each Participant has sufficient Operating Cash and securities in its PSS Account, the Paxos Settlement Service will automatically settle the obligations, on the settlement date, between two Participants by causing the security entitlements to the cash and securities, as applicable, to be simultaneously transferred between the relevant Participants’ PSS Accounts on the Paxos Ledger. During the Feasibility Study No-Action Phase all trades submitted to the Paxos Settlement Service, regardless of the settlement cycle with which each trade is submitted, will be settled bilaterally on a gross trade-by-trade basis without any netting of the gross trades.

In the event a Participant fails to make sufficient Operating Cash or securities available in its PSS Account on a settlement date to settle any of its obligations on the Paxos Settlement Service by the daily settlement cut-off time at 4:15 p.m., such failure will constitute a settlement failure (“Settlement Failure”). The Paxos Settlement Service will continue to attempt to settle any outstanding Settlement Failure using Operating Cash or securities that become available in the Participant’s PSS Account until the trade has been settled or closed out through a buy-in or sell-out, as applicable and as described immediately below, under the time frames required by Paxos.

The Paxos Settlement Service buy-in and sell-out procedures are designed to allow Participants to manage and promptly close Settlement Failures. To ensure promptness, Paxos will mandate that a Participant that is failing to deliver securities closes each Settlement Failure

¹² Timing of trade cancellations are subject to the operating rules of each Trading Venue.

¹³ Additionally, each Participant is permitted to withdraw its securities or cash from the Paxos Settlement Service at any time, subject to the limitations outlined in Section III.E.

on a timeline that is consistent with the timing found in Rule 204 of the Commission's Regulation SHO¹⁴. Additionally, a Participant that is failing to receive securities or cash ("non-defaulting Participant") will have the right, but not the obligation, to resolve the Settlement Failure by either buying-in or selling-out the relevant security after the point of Settlement Failure and prior to the Paxos mandated close out times.¹⁵ Upon Paxos receiving notice of the buy-in or sell-out execution from a non-defaulting Participant, the Paxos Settlement Service will create a cash settlement obligation ("Liability Obligation") due for settlement on the next business day requiring the Participant responsible for the Settlement Failure to pay the difference, if any, between the net money value of the Settlement Failure and the net money value of the buy-in or sell-out trade.¹⁶

In the event that a Participant has unsettled Liability Obligations, the Paxos Settlement Service will systematically prioritize the use of the Participant's available Operating Cash to settle the Liability Obligations prior to any other settlement obligations that will require Operating Cash. In the event of a Settlement Failure of a Liability Obligation, that Participant will be considered to be in a state of default¹⁷ and Paxos shall have the immediate right to and would, without exception, utilize that Participant's Margin Cash to settle any Liability Obligations outstanding and due.

D. Corporate Actions

When the Feasibility Study No-Action Phase begins, the Paxos Settlement Service will not provide corporate actions processing functionality, such as dividend payment processing or voluntary elections. To avoid impacting the corporate actions processing of Participants' securities and alleviate the need for Paxos to manually process any corporate actions that might occur while securities are in the Paxos DTC account, each Participant will be obligated to transfer all securities from its PSS Account to its DTC account, as described in Section III.A., each day prior to DTC's cut-off for recording ownership positions (e.g., record date). This will allow for corporate actions processing at DTC to occur as it normally does in the Participants' DTC accounts. Each day at 5:30 p.m., while the Paxos Settlement Service is not providing corporate actions processing functionality, if a Participant has not instructed the transfer of its securities from its PSS Account to its DTC account, Paxos will have authorization from each Participant to withdraw all of its securities from the Paxos Settlement Service each day no later than 6:00 p.m., regardless of whether there are pending corporate action events for such securities.

¹⁴ 17 C.F.R. § 242.204.

¹⁵ A buy-in or sell-out by a non-defaulting Participant will not be required to settle through the Paxos Settlement Service.

¹⁶ Each trade has a net money value which is calculated as the executed price per share of the security multiplied by the share quantity of the trade plus or minus any execution costs or fees. The value of a Liability Obligation is the difference between the net money value of the buy-in or sell-out trade and the net money value of the Settlement Failure, which is the total monetary difference between the two trades.

¹⁷ Default, as it pertains to the Paxos Settlement Service, is defined as a Participant's failure to fulfill its Liability Obligation by its settlement date or its failure to fund the Required Margin by its deadline.

Paxos will begin implementing corporate actions processing functionality on the Paxos Settlement Service in an iterative manner such that a Participant will be able to, at its discretion, keep certain securities in its PSS Account overnight rather than transferring such securities to its DTC account each night. When Paxos implements corporate actions processing functionality it will, without delay, automatically pass through any rights and obligations associated with any corporate actions that occur for securities that are eligible to be held and are held overnight by each Participant in its PSS Account to the entitled Participant (“Automated Corporate Actions Processing”). In performing Automated Corporate Actions Processing, Paxos takes on such responsibilities acting as a securities intermediary¹⁸.

The Automated Corporate Actions Processing will be implemented in the following sequence, however, Paxos will collaborate with Participants on the exact timing of the implementation, including testing, and release to production of such functionality.

- i. Build functionality that allows the Paxos Settlement Service to automatically source corporate action events data from DTC and other required sources, including key dates.
- ii. Build functionality that allows the Paxos Settlement Service to read the sourced corporate action events data to determine if securities are eligible to be held in a Participant’s PSS Account overnight because either there is no pending corporate action event or because Automated Corporate Actions Processing is implemented for the pending corporate action event type as described in Sections III.D.iii., III.D.iv., and III.D.v., below. For those securities that are not eligible to be held in Participant’s PSS Account overnight for one of the aforementioned reasons, Paxos will communicate to each impacted Participant by 4:15 p.m. each day the securities that are not eligible to be held overnight in its PSS Account and that are required to be transferred to its DTC account no later than 6:00 p.m.
- iii. Build Automated Corporate Actions Processing functionality on the Paxos Settlement Service to process the most frequently occurring mandatory corporate action event types (e.g., cash dividends, stock dividends, stock splits, etc.).
- iv. Build Automated Corporate Actions Processing functionality on the Paxos Settlement Service to process the most frequently occurring voluntary corporate action event types (e.g., tender offers, rights subscriptions, etc.).
- v. Build Automated Corporate Actions Processing functionality on the Paxos Settlement Service to process less frequently occurring mandatory and voluntary corporate action event types (e.g., scheme of arrangement, bankruptcy, etc.). Paxos anticipates that the Automated Corporate Actions Processing for many of the less frequently occurring corporate action event types will not be implemented during the Feasibility Study No-Action Phase.

¹⁸ See *supra* note 9.

In the event that a corporate action event is processed incorrectly on the Paxos Settlement Service, Paxos will:

- i. take the necessary actions to promptly correct any such incorrect processing, *and*
- ii. should Paxos be the cause of an incorrectly processed corporate action event, Paxos will compensate impacted Participants for any resulting loss.

E. Mark-to-Market Margin

To manage the risk of financial loss¹⁹ associated with replacing a transaction scheduled for settlement in the event that a Participant fails to meet its settlement obligations, the Paxos Settlement Service will calculate a mark-to-market margin on each business day (“Daily Margin”) and require the funding of a sufficient Margin Cash balance in the PSS Account of each Participant (“Required Margin”) to meet the greater of the Daily Margin or the highest calculated Daily Margin over a ninety (90) day lookback period (“Margin High Water Mark”). The eligible transactions for inclusion in the Daily Margin calculation are all open unsettled trades, failed or otherwise, excluding Liability Obligations²⁰ (“Eligible Margin Transactions”).

Daily Margin will be assessed for each unique pair of two Participants settling trades against one another on the Paxos Settlement Service (“Counterparty Pair”) and each Participant’s Required Margin will be calculated by the Paxos Settlement Service using the following procedure.

- i. For each Eligible Margin Transaction, after the market close of each trading day, Daily Margin will be calculated at the trade-level as 105% of the difference between each trade’s execution price and the current day’s closing price at 4:00 p.m. on the security’s primary exchange (“Trade-level Daily Margin”).
- ii. For each Counterparty Pair, each Trade-level Daily Margin (calculated in Section III.E.i. above) will be summed to determine a single Daily Margin amount owed by one Participant in each Counterparty Pair.
- iii. For each Participant, any Daily Margin amounts owed will be summed to calculate the Participant’s current day total amount owed (“Total Daily Margin”).

¹⁹ If a replacement trade’s price is unfavorable compared to the original execution price of the trade, the Participant executing the replacement trade will incur a loss equal to the difference in price multiplied by the number of shares, plus any additional costs associated with replacing the trade. For instance, if the price has increased since the original trade was executed then the buyer will incur a financial loss should the original trade need to be replaced by the buyer.

²⁰ Liability Obligations are cash only and therefore are not applicable to the Daily Margin calculation on the Paxos Settlement Service.

- iv. Each Participant's Required Margin will be calculated as the greater of its current day Total Daily Margin amount (calculated in Section III.E.iii. above) or its Margin High Water Mark.

Each Participant's Required Margin amount will be calculated and communicated to each Participant by the Paxos Settlement Service to each Participant no later than 6:00 p.m. each business day. Each Participant will be required to fund its Required Margin amount by having the Participant's Margin Cash credit balance be greater than or equal to its Required Margin no later than 9:00 a.m. the following business day.

A Participant's Margin Cash will be held by Paxos on behalf of the Participant and is only made accessible to the Participant's counterparties in the event of the Participant's default²¹. Initially, in light of the *de minimis* nature of the Feasibility Study No-Action Phase and to reduce operational burden on Participants, instead of each Participant directly funding the Required Margin, Paxos will pledge \$100,000 of its own cash to fund Required Margin across all Participants. Paxos will be calculating the daily Required Margin as described above and should the balance of \$100,000 not be sufficient for any reason prior to the time when each Participant begins directly funding its own Required Margin, Paxos will be responsible for the additional funding required to fulfill the aggregate Required Margin across all Participants in accordance with the 9:00 a.m. deadline. Paxos expects to require each Participant to fund its own Required Margin prior to the end of the Initial Stage of the Feasibility Study No-Action Phase.²²

Once each Participant is required to fund its own Required Margin, in the event that a Participant fails to fund its Required Margin or the Participant notifies Paxos of its insolvency, Paxos will have a perfected lien²³ on such Participant's Margin Cash to settle any liabilities owed by the defaulting Participant to non-defaulting Participants.

IV. Feasibility Study No-Action Phase Operating Parameters

During the Feasibility Study No-Action Phase, Paxos will operate the Paxos Settlement Service in a manner that is described above in Section III., and it will impose the following operating parameters designed to effectively manage the risks that Paxos believes could arise through the operation of the Paxos Settlement Service. These operating parameters are intended to clearly define and limit Paxos' operation of the Paxos Settlement Service during the Feasibility Study No-Action Phase to reasonably ensure that aggregate share volumes and

²¹ See *supra* note 17.

²² Paxos will require each Participant to fund its own Required Margin no later than when the aggregate Required Margin begins to regularly exceed the \$100,000 pledged by Paxos or the number of Participants is greater than five (5).

²³ Participants will grant Paxos a security interest in the master services agreement for the Paxos Settlement Service, and Paxos intends to perfect its lien on Margin Cash through control pursuant to Sections 8-106 and 9-203 of the Uniform Commercial Code.

Participant exposures will be *de minimis* in nature and will not have any negative effects on the U.S. securities markets or Participants' ability to settle trades in a timely and accurate manner.

A. Participants of the Feasibility Study No-Action Phase

Up to seven (7) Participants will be eligible to use the Paxos Settlement Service for clearance and settlement. Each of the Participants will be required to satisfy all of the following criteria for participation ("Participation Criteria"):

- i. be a DTC participant and be a broker-dealer that is registered with the Commission and is a member of the Financial Industry Regulatory Authority ("FINRA");
- ii. have \$100 million or more in excess net capital²⁴; *and*
- iii. meet Paxos's anti-money laundering and "know your customer" (collectively, "AML/KYC") onboarding requirements that Paxos maintains to comply with Bank Secrecy Act and U.S.A. Patriot Act requirements applicable to it as a limited purpose trust company that is supervised and examined by the NYDFS²⁵.

B. Eligible Securities

Securities eligible for settlement on the Paxos Settlement Service will include only publicly traded equity securities that are registered pursuant to Section 6 of the Securities Act of 1933, as amended²⁶, and Section 12 of the Exchange Act²⁷ and that remain eligible at all times for listing and trading on a national securities exchange registered with the Commission pursuant to Section 6 of the Exchange Act²⁸.

Each Counterparty Pair, together with Paxos, will select securities for settlement on the Paxos Settlement Service that will meet criteria ("Eligibility Criteria") reasonably designed to ensure there will be no negative effects on the U.S. securities markets or on Participants' ability to settle trades in a timely and accurate manner. The Eligibility Criteria were determined by Paxos based on the analysis of market data and actual trading behavior of the first Participants over a six month look back period. Each Counterparty Pair will select up to two (2) securities to

²⁴ 17 C.F.R. § 240.15c3-1(e)(4)(i) (defining the term "excess net capital" as the "amount in excess of the amount required under paragraph (a) [of Exchange Act Rule 15c3-1]...).

²⁵ Paxos has implemented a Bank Secrecy Act and Anti-Money Laundering Compliance Program to comply with applicable laws and regulations relating to anti-money laundering in the United States (31 U.S.C. § 5311 et seq.), including the obligation to file suspicious activity reports (SARs) (31 U.S.C. § 5318(g)), federal laws governing Customer Identification Programs (CIP) (31 U.S.C. § 5318(l) and Section 326 of the USA Patriot Act) and New York State anti-money laundering laws and regulations (3 N.Y.C.R.R. §§ 116 and 504).

²⁶ 15 U.S.C. § 77f.

²⁷ 15 U.S.C. § 78l.

²⁸ 15 U.S.C. § 78f.