MEMORANDUM

TO: File nos. S7-04-23, S7-25-20

FROM: Samantha Ostrom
Policy Counsel, Office of the Chair

RE: Securitize

DATE: May 23, 2023

On May 23, 2023, Chair Gensler, Amanda Fischer, Corey Frayer and Samantha Ostrom met with the following representatives of Securitize:

- Carlos Domingo
- Jamie Finn
- Suzy Mehta
- Jay Proffitt
- Billy Miller
- Tom Eidt
- Brett Redfearn, Panorama Financial Markets Advisory

The participants discussed the Commission's proposal relating to safeguarding advisory client assets and the custody of digital asset securities by special purpose broker-dealers.

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Discussion with

Chairman Gensler and Chairman's Office Staff

May 23th 2023

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Securitize is a compliance-first entity that has embraced regulation

From Day One, Securitize has embraced a "compliance-first" approach to engaging in the *regulated* and compliant digital asset *securities* ecosystem. We only work with regulated securities in a lawful manner.

Solely registered/exempt securities offerings
All digital asset securities offerings for which Securitize provides transfer agent services and/or broker-dealer services are either registered or exempt from registration.

Registered Transfer Agent
Securitize LLC registered as a transfer agent in July 2019.

Registered Broker-Dealer
Securitize Markets LLC is a registered broker-dealer focused solely on compliant digital asset securities.

Registered ATS
Securitize Markets is the broker-dealer operator of Securitize Markets ATS, one of relatively few "Three-Step Process" ATSs.

Global Registrations
Securitize subsidiaries are registering as a BD in Europe, applying to the EU DLT Pilot Regime license, and are seeking to register in Singapore.

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How **Compliant** Digital Asset Securities Work

Lawful digital asset securities (DAS) that have been designed to represent the beneficial ownership of a security on-chain have very different characteristics than their crypto counterparts:

Real-world identity
Every investor wallet in the ecosystem has been associated with a verified identity and is subject to relevant KYC and AML checks. Only the non-personal identifiable information (PII) needed to apply compliance rules is kept on-chain. PII of wallet owners/investors is kept off-chain in a traditional database controlled by the transfer agent.

Smart contracts
DAS are governed by a Smart contract infrastructure that we refer to as the Digital Securities protocol that controls transfers of DAS among wallets. Smart contract rules are created and controlled by the issuer (or its transfer agent), and the regulatory restrictions for a particular security are enforced on-chain.

KYC/AML
The most basic restriction is that a DAS cannot be issued to or transferred to any wallet that is not associated with an off-chain identity and has not passed KYC and AML checks.

Additional Restrictions
Digital asset security protocols also enforce numerous restrictions particular to a given security, like investor status (accredited investors or qualified purchaser); investor location (implementing “flow back” restrictions for Reg S securities), cap table restrictions on investor counts (ensuring that a 3(c)(7) fund never has more than 1,999 investors) or lock-ups (ensuring Reg D securities only trade after meeting applicable Rule 144 holding periods).

Four Points of Discussion from in our "Safeguarding" Comment Letter

1. The Commission should distinguish between unlawful or improperly issued digital assets (so-called crypto assets) and compliant & lawful digital asset securities. They are materially different, raise different policy issues, and pose different risks.

2. The risks faced by advisers and their clients are materially different depending on whether custodied assets are compliant and lawful digital asset securities or non-compliant crypto assets, including those determined to be securities. As such, policy solutions also differ.

3. The Commission should not amend the definition of a privately offered security under the Advisers Act merely because the issuers of certain digital asset securities elect to use permissionless blockchains to maintain the record of ownership of such securities.

4. The Commission should designate transfer agents with sufficient and reasonable policies and procedures to indicate that the transfer agent has possession or control over uncertificated securities, including over digital asset securities issued on a blockchain, as qualified custodians.

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The Commission should distinguish between unlawful or improperly issued digital assets (crypto assets) and lawful and compliant digital asset securities.

- **Many crypto participants largely ignore securities laws.** Most crypto assets ("crypto") that exist today and trade in centralized crypto exchanges or DeFi protocols were issued with little regard to applicable securities laws. As such, they are typically unregistered securities and not suitable representations of securities on a blockchain. Key issues include:
  - **Lack of controls.** These token can be freely and anonymously transferred to any wallet within the same blockchain, no way to control transfers of them across investor wallets.
  - **Bearer assets.** If investors (or custodians) lose the private keys of their wallet due theft or fraud or mismanagement, access to the token is lost and there is no way to recover it.
- **Lawful digital asset securities embrace regulation.** Assets intentionally issued as digital asset securities ("DAS") in connection with the issuance of debt or equity differ significantly from non compliant crypto assets. DAS are created using technology capable of allowing issuers (or transfer agents) to control transfers, to validate wallets, and to freeze, revoke and reassign DAS if necessary.

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The risks faced by advisers and their clients are materially different depending on whether custodied assets are compliant digital asset securities or crypto assets, including those that may be determined to be securities by the Commission.

- The following statement in the Proposed Release is not accurate for lawful digital asset securities:
  - "..This technology generally requires the use of public and private cryptographic key pairings, resulting in the *inability to restore or recover* many crypto assets in the event the keys are lost, forgotten, misappropriated, or destroyed. By design, [distributed ledger technology] finality often makes it difficult or *impossible to reverse erroneous or fraudulent crypto asset transactions,* whereas processes and protocols exist to reverse erroneous or fraudulent transactions with respect to more traditional assets. These specific characteristics could leave advisory clients *without meaningful recourse to reverse erroneous or fraudulent transactions, recover or replace lost crypto assets, or correct errors* that result from their adviser having custody of these assets.
- Erroneous transactions in digital asset securities, such as those facilitated by Securitize, can be corrected after a transaction in those securities has occurred.
  - Securitize Transfer can "burn" the digital asset security from the incorrect recipient and re-issue the digital asset security to the new correct recipient.
  - Because smart contracts prevent erroneous transfers in digital asset securities and can be corrected, they should not be treated the same as crypto assets, where transfers are incapable of being corrected.

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The Commission should not amend the definition of a privately offered security under the Advisers Act merely because the issuers of certain digital asset securities elect to use permissionless blockchains to maintain the record of ownership of such securities.

Digital asset securities issued on a permissionless blockchain are no less secure than digital asset securities issued on a permissioned blockchain.

Permissionless blockchains:

- Allow all individuals to join a blockchain network, send and receive transactions, operate a node, and participate in the consensus process.
- Create a financial disincentive to try to manipulate the network; the cost of running more than 51% of the nodes typically is too high for anyone to execute on. e.g., Ethereum has exceeded 500,000 validators.

Permissioned blockchains:

- Typically controlled by specific individuals or groups, limit who is allowed to participate in activities on the network
- Typically have fewer validators and are more vulnerable to 51% attacks than a permissionless blockchain

Rather than distinguish whether a given blockchain is permissioned or permissionless, the Commission should focus on whether a blockchain has sufficient nodes to make it economically impossible to perform an attack. A permissionless blockchain can nevertheless maintain a controlled environment to satisfy regulatory concerns.

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As acknowledged by the Commission in past guidance, regulated entities can evaluate the potential risks associated with permissionless and permissioned blockchains.

- In the Commission's statement on Custody of Digital Asset Securities (DAS) by Special Purpose Broker-Dealers the Commission explained that, under certain circumstances, a broker-dealer would not be subject to a Commission enforcement action for custodying DAS on the basis that the broker-dealer deems itself to have obtained and maintained physical possession or control of customer fully paid and excess margin digital asset securities

- It is consistent with previous Commission guidance that Commission-regulated entities with reasonable due diligence policies and procedures can be deemed to have physical possession or control over digital asset securities in certain scenarios.
    - BDs may not be able to "control" customer digital asset securities using the same mechanisms for traditional securities, but this provides a path for broker-dealers to maintain custody of digital asset securities while addressing the risks unique to those assets.
    - The ability to reverse or correct erroneous or fraudulent transactions involving digital asset securities is indicia of such possession or control.
    - BDs can maintain sufficient and reasonable policies and procedures to indicate that it has possession or control over digital asset securities issued on a blockchain.

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3 The Commission should not amend the definition of a privately offered security under the Advisers Act merely because the issuers of certain digital asset securities elect to use permissionless blockchains to maintain the record of ownership of such securities.

4 The Commission should designate transfer agents with sufficient and reasonable policies and procedures to indicate that the transfer agent has possession or control over uncertificated securities, including over digital asset securities issued on a blockchain, as qualified custodians.

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The Commission should designate certain transfer agents (i.e., those with sufficient and reasonable policies and procedures to indicate that the transfer agent has possession or control over uncertificated securities, including over digital asset securities issued on a blockchain) as qualified custodians.

Commission staff has recognized Transfer Agents as a good control location for purposes of the Customer Protection Rule (Rule 15c3-3) for transactions that occur on an ATS relying on the so-called "four-step process."[19]

- Commission staff has also indicated that it would not recommend enforcement action if a BD treated a transfer agent for uncertificated securities as a good control location for purposes of 15c3-3.

The Commission should recognize transfer agents as qualified custodians for uncertificated securities, including digital asset securities offered in compliance with the securities laws.

- Securitize Transfer:
  - monitors the blockchains underlying the DAS available for trading and for which it maintains the transaction ledgers.
  - maintains a traditional single master security holder list and also publishes the ownership record using DLT
- Transactions occur in accordance with a compliance protocol consistent with terms agreed to by parties on the Platform.
- Transactions are governed by smart contracts that code and enforce the specific compliance rules of a particular security

Recognizing transfer agents as qualified custodians will promote market integrity, market efficiency, and protection of investors.

Thank you

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