UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
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REGIONAL OFFICE

February 17, 2022

VIA ECF
Hon. Sarah Netburn
United States Magistrate Judge
Southern District of New York

Re: *SEC v. Ripple Labs, Inc. et al.*, No. 20-cv-10832 (AT) (SN) (S.D.N.Y.)

Dear Judge Netburn:

The SEC respectfully submits this motion for partial reconsideration and clarification of the Court's January 13, 2022 order (D.E. 413, the "Order"). This motion is limited to the Court's ruling with respect to Entry 9 of Appendix A to Defendants' motion to compel (D.E. 289), which includes a single, clean draft of a June 14, 2018 speech ("Speech") delivered by Bill Hinman, the then-Director of the SEC's Division of Corporation Finance ("Corp Fin"). After reviewing Entry 9, the Court found that "emails concerning the [S]peech or draft versions are neither predecisional nor deliberative agency documents entitled to protection" under the deliberative process privilege ("DPP"), and ordered the SEC to produce Entry 9 and other documents "previously withheld based on the privilege that would be inconsistent with this order." Order at 15, 22.

Reconsideration of this aspect of the Court's decision is warranted because the Court based its decision on a single document relating to the Speech—one that *Defendants* chose to highlight for the Court—and did not consider the 67 other emails attaching drafts of the Speech that were before the Court on Defendants' motion. These additional documents—along with other matters available to the Court and described below—demonstrate that the Speech was not "merely peripheral to actual policy formation" and was in fact an "essential link in the SEC's deliberative process with respect to Ether." *See* Order at 14–15 (internal quotation marks omitted). The Speech itself—and the many drafts and comments by SEC staff across different SEC divisions and offices deliberating the agency's approach to the regulation of digital assets—show that Director Hinman and other SEC staff used the Speech to provide public guidance as to how Corp Fin would apply the federal securities laws to offers and sales of digital assets including Ether. Indeed, SEC regulations provide that Director Hinman's public statements could be relied upon as representing the views of Corp Fin, the division he led.

When viewed in context, Entry 9 and other drafts and communications related to the Speech are protected by the DPP under the Court's own analysis: They reflect the very types of deliberations that SEC staff "need to be able to conduct . . . with the expectation of candor" (*id.* at 22) and are no different than other documents the Court has already held to be protected (*id.* at 15–17). The SEC thus respectfully asks the Court to reconsider its prior ruling with respect to Entry 9 and to find that all such documents are protected by the DPP. In the alternative, the SEC asks the Court to clarify whether the Order compels production of all Speech drafts and related emails on the SEC's privilege logs—the vast majority of which reflect the views of staff other than Director Hinman on an important policy issue confronting multiple agency divisions and offices.

I. Procedural Background

As part of their motion, Defendants submitted the SEC's privilege logs (D.E. 289-1–289-6), as well as a list of documents they selected, "Appendix A" (D.E. 289-11), and asked the Court to review *in camera* these documents (D.E. 289 at 7), which the Court agreed to do (D.E. 351-1 (Aug. 31, 2021 Hearing Tr.) at 35–36). Though the SEC's privilege logs included 68 entries described as emails attaching drafts of the Speech (D.E. 289-1, 289-2, 289-4), Defendants included only one of those drafts—Entry 9—on their Appendix A.

In its brief explaining the basis for the application of the DPP to each of the 30 documents submitted for *in camera* review, the SEC explained that Entry 9 was "predecisional and deliberative, as Director Hinman was seeking feedback from other SEC personnel about the [S]peech's contents prior to its delivery" (D.E. 351 at 13), and thus reflected "[d]eliberations re: regulation of Ether and re: Hinman Speech" (*id.* at A-4). The SEC also noted it had logged "*dozens of []drafts* of the Hinman Speech." *Id.* at 14 n.11 (emphasis added). The SEC urged the Court to refrain from ordering the production of "similar" documents in the event the Court found that any of the documents in Appendix A were not protected by the DPP, and to instead conduct a document-by-document review of the relevant documents on the SEC's privilege logs. *Id.* at 20.

The Court found that "it appears that this speech was merely peripheral to actual policy formation" and "not an essential link in the SEC's deliberative process with respect to Ether." Order at 14–15 (internal quotation marks omitted). The Court relied on the disclaimer in the Speech; Director Hinman's declaration (D.E. 255-2 ¶ 13) stating that the Speech reflected his own views; and evidence that the SEC has not taken any position on "whether offers and sales of Ether constituted offers and sales of securities." Order at 14.

II. Legal Standard

Courts grant motions for reconsideration when "the moving party can point to controlling decisions or data that the court overlooked—matters, in other words, that might reasonably be expected to alter the conclusion reached by the court." *Homeward Residential, Inc. v. Sand Canyon Corp.*, No. 12 Civ. 5067, 2014 WL 4680849, at *1 (S.D.N.Y. Sept. 17, 2014) (Torres, J.) (granting motion for reconsideration) (quoting *Shrader v. CSX Transp., Inc.*, 70 F.3d 255, 257 (2d Cir. 1995)).

III. All Communications and Drafts Relating to the Speech Are Protected by the DPP

The SEC respectfully submits that, in ruling on Entry 9, the Court did not consider two significant matters. *First*, Director Hinman made the Speech in order to communicate Corp Fin's approach on the regulation of digital asset offerings, as evidenced by the text of the Speech and confirmed by the relevant regulations governing SEC employees' public statements. *Second*, the Speech was the end product of significant collaboration by many staffers across the agency, as evidenced by the 68 drafts and related commentary reflected in the SEC's privilege logs. These communications demonstrate that the SEC staff's deliberations about the contents of the Speech were an essential link in the agency's deliberations about "whether transactions in a particular digital asset involve the sale of a security." Ex. A at 4.

Through these communications, SEC staff were deliberating about what guidance they should provide to market participants—guidance staff should be able to develop through discussions "without fearing that their communications will be subject to public scrutiny." Order at 20. Indeed, "[g]iven the importance in having the SEC 'get it right' on the highly consequential decisions of how (or whether) to regulate digital assets, the need to promote candor to improve agency decisionmaking is critical." *Id.* at 22. The release of the dozens of drafts of the Speech—the vast majority of which reflect opinions and thoughts of staff other than Director Hinman—would result in the very chilling of agency deliberations the Court sought to avoid in its Order.

A. Director Hinman Delivered the Speech as the Director of Corp Fin to Communicate Corp Fin's Framework for Evaluating Digital Asset Offerings.

As reflected in its text, the Speech was intended to communicate the general approach used by Corp Fin in evaluating whether digital asset offerings may be considered securities offerings, and to invite the market to communicate with Corp Fin staff about these issues.[1] Director Hinman began the Speech by noting that the conference "provide[d] a great opportunity to address a topic that is the subject of considerable debate in the press and in the crypto-community – whether a digital asset offered as a security can, over time, become something other than a security." Ex. A at 1. In addressing that topic, Director Hinman stated that he was providing a framework of "some of the factors to consider in assessing whether a digital asset is offered as an investment contract and is thus a security," and that Corp Fin staff were "happy to help promoters and their counsel work through these issues" and "stand prepared to provide more formal interpretive or no-action guidance about the proper characterization of a digital asset in a proposed use." *Id.* at 4.

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[1] Approximately one year before the Speech, Corp Fin and the Division of Enforcement ("Enforcement") issued a statement on the Report of Investigation on the DAO, which similarly encouraged market participants employing new technologies to contact SEC staff "for assistance in analyzing the application of the federal securities laws." Ex. C.

The text of the Speech makes clear that Director Hinman was speaking as the Director of Corp Fin to provide information about what private parties could expect when seeking formal or informal guidance from the staff of the division he led, on a topic (the regulation of the offer and sale of digital assets) within his division's purview. In his deposition, Director Hinman confirmed that the Speech was "intended to share more generally the framework that the division [of corporation finance] was using in thinking about these assets." Ex. B at Tr. 299; *see also* Tr. 131 (Speech intended to "inform the marketplace of how . . . the division of corporation finance and I felt about these topics"). He further confirmed that, following the Speech, Corp Fin generally applied the framework outlined in the Speech when considering whether digital asset transactions involved "securities." Ex. B at Tr. 301 (D.E. 299-1).

The relationship between the Speech and SEC staff guidance is further demonstrated by the April 2019 publication of a "Framework for 'Investment Contract' Analysis of Digital Assets" ("Framework") by the SEC's Strategic Hub for Innovation and Financial Technology. Ex D. Citing the Speech, the Framework provided "additional guidance in the areas that the Commission or staff has previously addressed." *Id.* at 7 n.1. The Framework reiterated many factors relevant to the investment contract analysis that were set forth in the Speech, including the relative centralization of the project, the retention of a stake in the digital asset by the promoter, and the development status of the digital asset's network. *Id.* The Framework elaborated on the Speech by adding specific details regarding each of the cited factors.

The inclusion of the SEC's standard disclaimer in the Speech does not change the privilege analysis. *Any* speech or publication by an SEC employee *must include* the following disclaimer:

> The Securities and Exchange Commission disclaims responsibility for any private publication or statement of any SEC employee or Commissioner. This [article, outline, speech, chapter] expresses the author's views and does not necessarily reflect those of the Commission, the [other] Commissioners, or [other] members of the staff.

17 C.F.R. § 200.735-4. The Framework included the same disclaimer.[2] Ex. D at 7 n.1.

The purpose of this disclaimer is to communicate that the employee delivering remarks is not speaking on behalf of the SEC itself, as the views of one SEC employee cannot bind the agency. And when a division director is speaking, the disclaimer reminds the audience that those views may or may not be shared by other divisions or offices. Still, it remains true that a statement by an SEC division director communicates that director's views and those of the division he or she leads:

> The informal procedures of the Commission are largely concerned with the rendering of advice and assistance by the Commission's staff to members of the public dealing with the Commission. While opinions expressed by members of the staff do not constitute an official expression of the Commission's views, they represent the views of persons who are continuously working with the provisions of the statute involved. And *any statement by the director*, associate director, assistant director, chief accountant, chief counsel, or chief financial analyst *of a division can be relied upon as representing the views of that division.*

17 C.F.R. § 202.1(d) (emphasis added).[3]

Accordingly, the inclusion of the SEC's standard disclaimer (or Director Hinman's declaration explaining the disclaimer (D.E. 255-2 ¶ 13)) cannot somehow change the analysis with respect to whether the DPP applies to the internal communications and drafts leading up to the Speech. Instead, those materials reflect the same type of internal policy debates as the deliberations relating to public statements by SEC officials that the Court has already deemed to be protected by the DPP—Entries 11 to 14 of Appendix A. Order at 15–16.[4]

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[2] The SEC respectfully refers the Court to speeches and remarks posted on its website by the Chair, Commissioners, and senior officials, which include the standard disclaimer, *see* https://www.sec.gov/news/speeches-statements, including speeches related to the regulation of digital asset offerings, Ex. E. This standard disclaimer is similar to disclaimers provided by staff and officials at numerous other federal government agencies, including the Commodity Futures Trading Commission, the Federal Trade Commission, the Federal Reserve, and the PCAOB. Ex. F.

[3] Defendants claim that the SEC "has argued in this litigation that Mr. Hinman's speech did not provide any meaningful guidance to the marketplace." D.E. 363 at 14–15. Defendants do not, and indeed cannot, cite to anything to support that statement. To the contrary, Director Hinman testified that the Speech provided "timely guidance" to the marketplace on digital asset transactions. Ex. B at Tr. 80–82.

[4] While the final version of Director Hinman's remarks reflected in Entry 11 is not publicly available, Director Hinman was required to provide the standard disclaimer as part of those remarks. A recording of Chair Clayton's November 27, 2018 interview—draft talking points for which are reflected in Entries 12 to 14—includes the standard disclaimer. *See* https://www.blockchainbeach.com/sec-chairman-jay-clayton-speaks-on-icos-and-bitcoin-etf/.

B. Staff Across the Agency Engaged in Substantive Deliberations About the Content of the Speech, Which Were an Essential Link in the Agency's Deliberations about the Regulation of Digital Asset Offerings.

The dozens of drafts of the Speech exchanged among SEC staff show that the Speech related to SEC policy and particularly to what guidance SEC staff believed could be communicated to market participants about "whether transactions in a particular digital asset involve the sale of a security." Ex. A at 4. In early May 2018, David Fredrickson, then-Corp Fin's Chief Counsel, began drafting what ultimately became the Speech. (Draft 1.)[5] For the next month, Mr. Fredrickson, along with Valerie Szczepanik (Assistant Director in Enforcement's Cyber Unit until June 9, 2018, and then Senior Advisor for Digital Assets and Innovation in Corp Fin), Michael Seaman (then-Director Hinman's counsel), and Director Hinman worked to draft the Speech, exchanging at least 23 drafts between May 3 and June 4. (Drafts 1–23; Hardy Decl. ¶ 3.)

On June 4, Director Hinman circulated a draft of the Speech to officials outside his division— including counsel for the then-Chair, as well as the directors of other divisions and offices, requesting comments. (Draft 24; Hardy Decl. ¶¶ 4, 8–10.) On June 5, this email was forwarded to the Chair—*see* Entry 9. (Draft 28.) In the ensuing days, officials across the SEC provided substantive feedback and comments on the draft: the Division of Trading & Markets ("TM") on June 6; the Division of Investment Management ("IM") on June 7; and the Office of the General Counsel ("OGC") on June 8. (Drafts 29, 33, 35; Hardy Decl. ¶ 5.) Director Hinman, Mr. Fredrickson, and Mr. Seaman worked to revise the Speech to respond to these comments. This revision process led to eight additional drafts between June 7 and June 11. (Drafts 31, 36, 37, 39, 40, 42–44; Hardy Decl. ¶ 6.) On June 11, Director Hinman circulated a revised draft to many of the same officials who had received Entry 9. (Draft 45; Hardy Decl. ¶ 7.) On June 12, officials from

[5] References to "Draft __" correspond to entries in Attachment 1 to the brief, which summarizes the full set of relevant emails and drafts included on the SEC's privilege logs. References to "Hardy Decl." are to the accompanying Declaration of Melinda Hardy, dated February 17, 2022. Ex. G.

TM, IM, and OGC provided a second set of substantive comments on the draft (Drafts 49, 52, 58.) From June 11 until Director Hinman delivered the Speech on June 14, he and Corp Fin staff exchanged another 12 drafts. (Drafts 47, 50, 53–54, 56–57, 59–64) *In total, Director Hinman sent comments on, at most, ten of the 52 "unique" drafts (i.e., excluding forwards) of the Speech.* The SEC is respectfully submitting the following ten documents reflected in Attachment 1 for *in camera* review:

- Document A: On May 21, Mr. Fredrickson sent what he described as a "first, rough draft" of the Speech to Mr. Seaman. This document shows that Mr. Fredrickson, the Chief Counsel for Corp Fin, wrote the earliest drafts of the Speech. It also demonstrates the significant changes to the Speech from this early draft to the final version delivered by Director Hinman on June 14.

- Document B: Mr. Fredrickson sent a revised draft to Ms. Szczepanik, copying Mr. Seaman on May 24. On May 25, Ms. Szczepanik responded with her comments, including a suggestion to add more information on [redacted] This document demonstrates that the initial drafts of the Speech were the result of collaboration among Corp Fin staff, which included but was not limited to Director Hinman.

- Document C: On May 30, Director Hinman circulated his edits to Mr. Fredrickson, Ms. Szczepanik, and Mr. Seaman, and noted: "I need to get this back to you guys to see if you agree with the additions and where I took this." Director Hinman's inquiry as to his staff's views demonstrates that the Speech's contents were intended to reflect the views of Corp Fin's staff.

- Document D: On June 6, Natasha Greiner, then-Assistant Chief Counsel in TM, provided comments on behalf of her division. TM's comments were extensive and substantive. They included a suggestion [redacted] as well as the addition of a [redacted] TM also made lengthy comments on [redacted] This document shows deliberations by TM staff on these important questions.

- Document E: On June 7, Jennifer McHugh, then-Senior Special Counsel in IM, provided comments on behalf of her division. In her cover email, Ms. McHugh referenced a call the previous day with Mr. Fredrickson to discuss the draft and noted that, [redacted] These comments show that staff in other divisions were closely reviewing and deliberating the issues to be communicated through the Speech.

- Document F: On June 8, Laura Jarsulic, then-Associate General Counsel, provided OGC's comments on the June 4 draft. Ms. Jarsulic's cover email referenced a prior meeting between OGC and Corp Fin staff regarding the Speech. OGC provided significant comments on the draft, including a comment that [redacted] and proposed edits to the relevant language. OGC also suggested deleting [redacted]

[redacted] OGC also provided comments on the language relating to [redacted] These comments demonstrate that OGC staff were deliberating these issues internally and with Corp Fin staff.

- Document G: On June 8, Mr. Fredrickson sent a revised draft to Director Hinman, Ms. Szczepanik, and Mr. Seaman, and noted: "This reflects my attempts to deal with GC, TM, and IM's drafts." This draft reflects Mr. Fredrickson's substantial revisions in response to comments from across the agency, as well as additional comments for discussion among the Corp Fin staff.

- Document H: On June 11, Director Hinman sent a revised draft to Ms. Szczepanik, Mr. Seaman, and Mr. Fredrickson. As with Document G, this document exemplifies the iterative process by which Director Hinman and other Corp Fin staff deliberated on these issues.

- Document I: On June 12, Mr. Seaman circulated a revised draft to Director Hinman, Mr. Fredrickson, and Ms. Szczepanik, and noted that the draft reflected "comments from Sean [Memon, Chair Clayton's then-Deputy Chief of Staff], TM, IM and general CF [Corp Fin] clean-up." The draft reflected significant revisions to the June 11 draft made in response to comments from across the agency, including the Chair's Office.

- Document J: On June 12, Ms. Jarsulic provided OGC's comments on the June 11 draft. Ms. Jarsulic's cover email noted: "[T]he big issues are [redacted] The comments included significant revisions to [redacted]

These documents show that, as part of the process of preparing the Speech, SEC staff engaged in substantive deliberations about the SEC's regulation of digital assets including Ether. The extensive participation by many SEC staffers is not consistent with ust lending a helping hand to Director Hinman in making a speech to express his personal views. *See* Hardy Decl. ¶¶ 8–10. The SEC respectfully submits that these discussions show that the Court erred in concluding that the Speech was "merely peripheral to actual policy formation." Order at 14 (internal quotation marks omitted). To the contrary, the discussions surrounding the Speech formed an essential link in the SEC's deliberative process about regulating offerings of Ether and other digital assets, as well as what could be communicated to the public on those topics at that time. The communications here are analogous to the messaging records that the Second Circuit found to be protected in *NRDC v. EPA*, 19 F.4th 177, 189 (2d Cir. 2021) (internal quotation marks omitted):

> [A]gency deliberations over how to communicate and promote existing policies to people outside the agency is not solely a descriptive

> exercise. Rather, such communications can be delicate and audience-sensitive and require the agency to exercise . . . policy-oriented judgment to effectively pursue its policymaking agenda.

Moreover, while it is true that *the SEC* has not expressed a formal agency position on whether offers and sales of Ether constitute offers and sales of securities (Order at 14), the withheld documents reflect deliberations about what to communicate to market participants about *Corp Fin's approach* to the regulation of offers and sales of digital assets including Ether. Indeed, the deliberations here are like deliberations in Additional Document 3, which the Court held to be protected by the DPP because they "plainly reflect SEC employees' predecisional thoughts and analyses . . . including deliberations on whether the asset at issue is subject to the federal securities laws—a quintessential agency decision." Order at 17 (rejecting Defendants' argument that the DPP could not apply "because no-action letters are issued by Corporation Finance, not the Commission itself, so there is no agency decision or decisionmaking process to support the assertion of privilege").

Finally, piercing the DPP is unwarranted here for the reasons the Court outlined in the Order, namely because "the need to promote candor to improve agency decisionmaking is critical" given "the importance in having the SEC 'get it right' on the highly consequential decisions of how (or whether) to regulate digital assets." *Id.* at 22. The many drafts and comments the SEC is withholding reflect that the SEC staff was trying to "get it right" on what kind of guidance from Corp Fin could then be released to market participants, while preserving the agency's ability to regulate digital assets under the securities laws—an important and evolving issue for many of the SEC's divisions and offices. On the other hand, the documents are not relevant to the "fair notice" defense (Order at 18) or to the Individual Defendants' scienter because only the final Speech—and not the dozens of drafts that include preliminary thoughts, suggestions, and discussion points by staff, often provided under time pressure without the opportunity to be fully vetted—could have provided notice to Defendants or impacted their state of mind.

Respectfully submitted,

/s Ladan F. Stewart

Ladan F. Stewart

cc: Counsel for All Defendants (*via* ECF)

ATTACHMENT 1

SUMMARY CHART OF ENTRIES ON SEC PRIVILEGE LOGS RELATING TO HINMAN SPEECH

Draft[i]	Document Submitted *In Camera*	Date	Draft/Comments By[ii]	Description
1		5/3/2018	Fredrickson	Email from Fredrickson to Hinman, Seaman, cc Ingram, Starr, attaching thoughts on issues to be addressed in Speech.
2	**A**	**5/21/2018**	**Fredrickson**	**Email from Fredrickson to Seaman, attaching "first, rough draft" of Speech.**
3		5/22/2018	Hinman	Email from Hinman to Fredrickson, Seaman, attaching comments on Fredrickson's May 21 draft.
4		5/24/2018	Fredrickson	Email from Fredrickson to Szczepanik, cc Seaman, attaching draft Speech.
5	**B**	**5/25/2018**	**Szczepanik**	**Email from Szczepanik to Fredrickson, cc Seaman, attaching comments on Fredrickson's May 24 draft.**
6		5/25/2018	Fredrickson	Email from Fredrickson to Seaman, cc Szczepanik, attaching draft Speech.
7		5/29/2018	Seaman	Email from Seaman to Fredrickson, attaching comments on Fredrickson's May 25 draft.
8		5/29/2018	Fredrickson	Email from Fredrickson to Hinman, cc Szczepanik, Seaman, attaching draft of Speech.

9		5/29/2018	Szczepanik	Email from Szczepanik to Fredrickson, Hinman, cc Seaman, attaching comments on Fredrickson's May 29 draft.
10	**C**	**5/30/2018**	**Hinman**	**Email from Hinman to Fredrickson, Szczepanik, Seaman, attaching comments on Fredrickson's May 29 draft.**
11		5/31/2018	Fredrickson	Email from Fredrickson to Szczepanik, Seaman, attaching comments on top of Hinman's May 30 comments.
12		5/31/2018	Szczepanik	Email from Szczepanik to Fredrickson, Seaman, attaching comments on top of Fredrickson's May 31 comments.
13		5/31/2018	Seaman	Email from Seaman to Ingram, Starr, cc Hinman, attaching draft Speech.
14		5/31/2018	Hinman	Email from Hinman to Fredrickson, cc Seaman, Ingram, Starr, attaching additional comments on top of Szczepanik's May 31 comments.
15		6/1/2018	Hinman	Email from Hinman to Seaman, attaching additional comments on top of Hinman's May 31 comments.
16		6/1/2018	Seaman	Email from Seaman to Hinman, Fredrickson, Szczepanik, attaching new draft of Speech and redline.
17		6/1/2018	Hinman	Email from Hinman to Seaman, Fredrickson, Szczepanik, attaching comments on Seaman's June 1 draft.
18		6/3/2018	Szczepanik	Email from Szczepanik to Hinman, Seaman, Fredrickson, attaching comments on top of Hinman's June 1 comments.
19		6/4/2018	Fredrickson	Email from Fredrickson to Szczepanik, Hinman, Seaman, attaching comments on top of Szczepanik's June 3 comments.

20		6/4/2018	Seaman	Email from Seaman to Hinman, Fredrickson, Szczepanik, attaching new draft of Speech and redline.
21		6/4/2018	Seaman	Email from Seaman to Fredrickson, attaching draft Speech and distribution list for other divisions/offices.
22		6/4/2018	Fredrickson	Email from Fredrickson to Seaman, attaching comments on Seaman's June 4 draft and on distribution list for other divisions/offices.
23		6/4/2018	Seaman	Email from Seaman to Hinman, cc Fredrickson, attaching draft Speech along with distribution list for other divisions/offices.
24		6/4/2018	Hinman	Email from Hinman to: Moskowitz, Memon, Fox (Office of the Chair); Avakian, Peikin, Karp (Enforcement); Stebbins, Jarsulic, Morris (OGC); Blass, McHugh, Bartels (IM); Redfearn, Goldsholle, Seidel (TM), attaching draft Speech and requesting comments.
25*		6/4/2018		Email from Seaman to Corp Fin staff (Parratt, Ingram, Starr, Henseler, Long, Hardiman), cc Hinman, attaching June 4 draft circulated to other divisions/offices by Hinman.
26*		6/4/2018		Email from Fredrickson to Ingram, forwarding Hinman's June 4 email to divisions/offices.
27*		6/5/2018		Email from Seaman to Corp Fin staff (Davis, Garrison), forwarding Hinman's June 4 email to divisions/offices.
28*	**Entry 9**	**6/5/2018**		**Email from Memon (Office of Chair) to Chair Clayton, cc Moskowitz (Office of Chair), forwarding Hinman's June 4 email to divisions/offices.**
29	**D**	**6/6/2018**	**Greiner**	**Email from Greiner (TM) to Fredrickson, Szczepanik, Seaman, cc Redfearn (TM Director) and TM staff (Seidel, Goldsholle,**

				Maitra, Bergoffen, Orr), attaching TM's comments on June 4 draft.
30*		6/7/2018		Email from Seaman to Hinman, forwarding TM's comments on June 4 draft.
31		6/7/2018	Fredrickson	Email from Fredrickson to Szczepanik, Seaman, attaching comments in response to TM's June 7 comments.
32		6/7/2018	McHugh	Email from McHugh to Fredrickson, cc Szczepanik, Seaman, McGinnis (IM), Bartels (IM), attaching IM's comments on June 4 draft.
33	**E**	**6/7/2018**	**McHugh**	**Email from McHugh to Fredrickson, cc Szczepanik, Seaman, McGinnis (IM), Bartels (IM), attaching amended set of IM's comments on June 4 draft.**
34*		6/8/2018		Email from Seaman to Hinman, forwarding IM's comments on June 4 draft.
35	**F**	**6/8/2018**	**Jarsulic**	**Email from Jarsulic (OGC) to Seaman, Lisitza, Cappoli (OGC), cc Hinman, Fredrickson, Szczepanik, attaching OGC's comments on June 4 draft.**
36	**G**	**6/8/2018**	**Fredrickson**	**Email from Fredrickson to Hinman, Szczepanik, Seaman, attaching revised draft incorporating comments from OGC, TM, and IM.**
37	**H**	**6/11/2018**	**Hinman**	**Email from Hinman to Szczepanik, Seaman, Fredrickson, attaching comments on Fredrickson's June 8 draft.**
38*		6/11/2018		Email from Seaman to Hinman, Fredrickson, Szczepanik, attaching Hinman's June 11 comments.

39		6/11/2018	Fredrickson	Email from Fredrickson to Szczepanik, Seaman, attaching comments on top of Hinman's June 11 comments.
40		6/11/2018	Hinman	Email from Hinman to Fredrickson, Seaman, attaching additional comments on top of Fredrickson's June 11 comments.
41*		6/11/2018		Email from Fredrickson to Seaman, attaching redline of Hinman's two sets of June 11 comments.
42		6/11/2018	Szczepanik	Email from Szczepanik to Seaman, attaching comments on top of Hinman's second set of June 11 comments.
43		6/11/2018	Seaman	Email from Seaman to Hinman, Fredrickson, Szczepanik, attaching new draft of Speech and redline.
44		6/11/2018	Seaman	Email from Seaman to Hinman, Fredrickson, Szczepanik, attaching a second new draft of Speech and redline.
45		6/11/2018	Hinman	Email from Hinman to: Moskowitz, Memon, Fox (Office of the Chair); Avakian, Peikin, Karp (Enforcement); Stebbins, Jarsulic, Lisitza, Morris (OGC); Blass, McHugh, Bartels (IM); Redfearn, Goldsholle, Seidel, Greiner (TM), attaching draft Speech and requesting comments.
46*		6/11/2018		Email from Fredrickson to Ingram, forwarding Hinman's June 11 email to divisions/offices.
47		6/11/2018	Fredrickson	Email from Fredrickson to Seaman, attaching comments on June 11 draft.
48*		6/12/2018		Email from Seaman to Corp Fin staff (Parratt, Davis, Brightwell, Garrison), attaching June 11 draft circulated to other divisions/offices by Hinman.

49		6/12/2018	Redfearn	Email from Redfearn (TM Director) to Hinman, Seaman, cc TM staff (Goldsholle, Seidel, Bergoffen), attaching TM's comments on June 11 draft.
50		6/12/2018	Fredrickson	Email from Fredrickson to Seaman, attaching additional comments on top of Fredrickson's June 11 comments.
51*		6/12/2018		Email from Seaman to Fredrickson, Szczepanik, forwarding TM's June 12 comments.
52		6/12/2018	McHugh	Email from McHugh (IM) to Seaman, cc Fredrickson and IM staff (Bartels, Hunter-Ceci, Haghshenas, Harke, McGinnis), attaching IM's comments on June 11 draft.
53		6/12/2018	Hinman	Email from Hinman to Seaman, attaching revised draft addressing comments by TM and IM.
54		6/12/2018	Seaman	Email from Seaman to Fredrickson, attaching revised draft and redline.
55*		6/12/2018		Email from Seaman to Fredrickson, resending Seaman's June 12 revised draft and redline.
56		6/12/2018	Fredrickson	Email from Fredrickson to Seaman, attaching comments on Seaman's June 12 draft.
57	**I**	**6/12/2018**	**Seaman**	**Email from Seaman to Hinman, Fredrickson, Szczepanik, attaching revised draft and redline.**
58	**J**	**6/12/2018**	**Jarsulic**	**Email from Szczepanik to Seaman, Fredrickson, Hinman, forwarding June 12, 2018 email from Jarsulic (OGC) to Szczepanik, attaching OGC's comments on June 11 draft.**
59		6/13/2018	Fredrickson	Email from Fredrickson to Seaman, attaching revised draft.

60		6/13/2018	Seaman	Email from Seaman to Fredrickson, attaching revised draft and redline.
61		6/13/2018	Fredrickson	Email from Fredrickson to Seaman, attaching revised draft.
62		6/13/2018	Seaman	Email from Seaman to Hinman, Fredrickson, Szczepanik, attaching revised draft.
63		6/13/2018	Fredrickson	Email from Fredrickson to Seaman, Hinman, Szczepanik, attaching revised draft.
64		6/13/2018	Fredrickson	Email from Fredrickson to Seaman, attaching revised draft.

[i] Four of the 68 relevant entries on the SEC's privilege logs were duplicative. Attachment 1 includes the 64 non-duplicative documents reflected on the SEC's privilege logs.

An asterisk (*) signifies Drafts that are not unique, but rather are forwards or re-attachments of other, unique drafts. For this reason, the 12 entries where Drafts are marked with an asterisk do not have an entry in the "Drafts/Comments By" column. In total, there are 52 unique drafts reflected in Attachment 1.

[ii] The titles in May/June 2018 of certain of the individuals listed in Attachment 1 are as follows:

1. Bill Hinman: Director, Corp Fin
2. David Fredrickson: Chief Counsel, Corp Fin
3. Valerie Szczepanik: Assistant Director in Enforcement's Cyber Unit until June 9, 2018, and then Senior Advisor for Digital Assets and Innovation and Associate Director in Corp Fin
4. Michael Seaman: Counsel to Director Hinman, Corp Fin
5. Amy Starr: Chief, Office of Capital Market Trends, Corp Fin
6. Jonathan Ingram: Deputy Chief Counsel, Corp Fin
7. Laura Jarsulic: Associate General Counsel, OGC
8. Brett Redfearn: Director, TM
9. Natasha Greiner: Assistant Chief Counsel, TM
10. Jennifer McHugh: Senior Special Counsel, IM

EXHIBIT A

Speech

Digital Asset Transactions: When Howey Met Gary (Plastic)

William Hinman
Director, Division of Corporation Finance

San Francisco, CA

June 14, 2018

Remarks at the Yahoo Finance All Markets Summit: Crypto

Thank you Andy. I am pleased to be here today.[1] This event provides a great opportunity to address a topic that is the subject of considerable debate in the press and in the crypto-community – whether a digital asset offered as a security can, over time, become something other than a security.[2]

To start, we should frame the question differently and focus not on the digital asset itself, but on the circumstances surrounding the digital asset and the manner in which it is sold. To that end, a better line of inquiry is: “Can a digital asset that was originally offered in a securities offering ever be later sold in a manner that does not constitute an offering of a security?” In cases where the digital asset represents a set of rights that gives the holder a financial interest in an enterprise, the answer is likely “no.” In these cases, calling the transaction an initial coin offering, or “ICO,” or a sale of a “token,” will not take it out of the purview of the U.S. securities laws.

But what about cases where there is no longer any central enterprise being invested in or where the digital asset is sold only to be used to purchase a good or service available through the network on which it was created? I believe in these cases the answer is a qualified “yes.” I would like to share my thinking with you today about the circumstances under which that could occur.

Before I turn to the securities law analysis, let me share what I believe may be most exciting about distributed ledger technology – that is, the potential to share information, transfer value, and record transactions in a decentralized digital environment. Potential applications include supply chain management, intellectual property rights licensing, stock ownership transfers and countless others. There is real value in creating applications that can be accessed and executed electronically with a public, immutable record and without the need for a trusted third party to verify transactions. Some people believe that this technology will transform e-commerce as we know it. There is excitement and a great deal of speculative interest around this new technology. Unfortunately, there also are cases of fraud. In many regards, it is still “early days.”

But I am not here to discuss the promise of technology – there are many in attendance and speaking here today that can do a much better job of that. I would like to focus on the application of the federal securities laws to digital asset transactions – that is how tokens and coins are being issued, distributed and sold. While perhaps a bit dryer than the promise of the blockchain, this topic is critical to the broader acceptance and use of these novel instruments.

I will begin by describing what I often see. Promoters,[3] in order to raise money to develop networks on which digital assets will operate, often sell the tokens or coins rather than sell shares, issue notes or obtain bank financing. But, in many cases, the economic substance is the same as a conventional securities offering. Funds are raised with the expectation that the promoters will build their system and investors can earn a return on the instrument – usually by selling their tokens in the secondary market once the promoters create something of value with the proceeds and the value of the digital enterprise increases.

When we see that kind of economic transaction, it is easy to apply the Supreme Court's "investment contract" test first announced in *SEC v. Howey*.[4] That test requires an investment of money in a common enterprise with an expectation of profit derived from the efforts of others. And it is important to reflect on the facts of *Howey*. A hotel operator sold interests in a citrus grove to its guests and claimed it was selling real estate, not securities. While the transaction was recorded as a real estate sale, it also included a service contract to cultivate and harvest the oranges. The purchasers could have arranged to service the grove themselves but, in fact, most were passive, relying on the efforts of Howey-in-the-Hills Service, Inc. for a return. In articulating the test for an investment contract, the Supreme Court stressed: "Form [is] disregarded for substance and the emphasis [is] placed upon economic reality."[5] So the purported real estate purchase was found to be an investment contract – an investment in orange groves was in these circumstances an investment in a security.

Just as in the *Howey* case, tokens and coins are often touted as assets that have a use in their own right, coupled with a promise that the assets will be cultivated in a way that will cause them to grow in value, to be sold later at a profit. And, as in *Howey* – where interests in the groves were sold to hotel guests, not farmers – tokens and coins typically are sold to a wide audience rather than to persons who are likely to use them on the network.

In the ICOs I have seen, overwhelmingly, promoters tout their ability to create an innovative application of blockchain technology. Like in *Howey*, the investors are passive. Marketing efforts are rarely narrowly targeted to token users. And typically at the outset, the business model and very viability of the application is still uncertain. The purchaser usually has no choice but to rely on the efforts of the promoter to build the network and make the enterprise a success. At that stage, the purchase of a token looks a lot like a bet on the success of the enterprise and not the purchase of something used to exchange for goods or services on the network.

As an aside, you might ask, given that these token sales often look like securities offerings, why are the promoters choosing to package the investment as a coin or token offering? This is an especially good question if the network on which the token or coin will function is not yet operational. I think there can be a number of reasons. For a while, some believed such labeling might, by itself, remove the transaction from the securities laws. I think people now realize labeling an investment opportunity as a coin or token does not achieve that result. Second, this labeling might have been used to bring some marketing "sizzle" to the enterprise. That might still work to some extent, but the track record of ICOs is still being sorted out and some of that sizzle may now be more of a potential warning flare for investors.

Some may be attracted to a blockchain-mediated crowdfunding process. Digital assets can represent an efficient way to reach a global audience where initial purchasers have a stake in the success of the network and become part of a network where their participation adds value beyond their investment contributions. The digital assets are then exchanged – for some, to help find the market price for the new application; for others, to speculate on the venture. As I will discuss, whether a transaction in a coin or token on the secondary market amounts to an offer or sale of a security requires a careful and fact-sensitive legal analysis.

I believe some industry participants are beginning to realize that, in some circumstances, it might be easier to start a blockchain-based enterprise in a more conventional way. In other words, conduct the initial funding through a registered or exempt equity or debt offering and, once the network is up and running, distribute or offer blockchain-based tokens or coins to participants who need the functionality the network and the digital assets offer. This allows the tokens or coins to be structured and offered in a way where it is evident that purchasers are not making an investment in the development of the enterprise.

Returning to the ICOs I am seeing, strictly speaking, the token – or coin or whatever the digital information packet is called – all by itself is not a security, just as the orange groves in *Howey* were not. Central to determining whether a security is being sold is how it is being sold and the reasonable expectations of purchasers. When someone buys a housing unit to live in, it is probably not a security.[6] But under certain circumstances, the same asset can be offered and sold in a way that causes investors to have a reasonable expectation of profits based on the efforts of others. For example, if the housing unit is offered with a management contract or other services, it can be a security.[7] Similarly, when a CD, exempt from being treated as a security under Section 3 of the Securities Act, is sold as a part of a program organized by a broker who offers retail investors promises of liquidity and the potential to profit from changes in interest rates, the *Gary Plastic* case teaches us that the instrument can be part of an investment contract that is a security.[8]

The same reasoning applies to digital assets. The digital asset itself is simply code. But the way it is sold – as part of an investment; to non-users; by promoters to develop the enterprise – can be, and, in that context, most often is, a security – because it evidences an investment contract. And regulating these transactions as securities transactions makes sense. The impetus of the Securities Act is to remove the information asymmetry between promoters and investors. In a public distribution, the Securities Act prescribes the information investors need to make an informed investment decision, and the promoter is liable for material misstatements in the offering materials. These are important safeguards, and they are appropriate for most ICOs. The disclosures required under the federal securities laws nicely complement the *Howey* investment contract element about the efforts of others. As an investor, the success of the enterprise – and the ability to realize a profit on the investment – turns on the efforts of the third party. So learning material information about the third party – its background, financing, plans, financial stake and so forth – is a prerequisite to making an informed investment decision. Without a regulatory framework that promotes disclosure of what the third party alone knows of these topics and the risks associated with the venture, investors will be uninformed and are at risk.

But this also points the way to when a digital asset transaction may no longer represent a security offering. If the network on which the token or coin is to function is sufficiently decentralized – where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts – the assets may not represent an investment contract. Moreover, when the efforts of the third party are no longer a key factor for determining the enterprise's success, material information asymmetries recede. As a network becomes truly decentralized, the ability to identify an issuer or promoter to make the requisite disclosures becomes difficult, and less meaningful.

And so, when I look at Bitcoin today, I do not see a central third party whose efforts are a key determining factor in the enterprise. The network on which Bitcoin functions is operational and appears to have been decentralized for some time, perhaps from inception. Applying the disclosure regime of the federal securities laws to the offer and resale of Bitcoin would seem to add little value.[9] And putting aside the fundraising that accompanied the creation of Ether, based on my understanding of the present state of Ether, the Ethereum network and its decentralized structure, current offers and sales of Ether are not securities transactions. And, as with Bitcoin, applying the disclosure regime of the federal securities laws to current transactions in Ether would seem to add little value. Over time, there may be other sufficiently decentralized networks and systems where regulating the tokens or coins that function on them as securities may not be required. And of course there will continue to be systems that rely on central actors whose efforts are a key to the success of the enterprise. In those cases, application of the securities laws protects the investors who purchase the tokens or coins.

I would like to emphasize that the analysis of whether something is a security is not static and does not strictly inhere to the instrument.[10] Even digital assets with utility that function solely as a means of exchange in a decentralized network could be packaged and sold as an investment strategy that can be a security. If a promoter were to place Bitcoin in a fund or trust and sell interests, it would create a new security. Similarly, investment contracts can be made out of virtually any asset (including virtual assets), provided the investor is reasonably expecting profits from the promoter's efforts.

Let me emphasize an earlier point: simply labeling a digital asset a "utility token" does not turn the asset into something that is not a security.[11] I recognize that the Supreme Court has acknowledged that if someone is purchasing an asset for consumption only, it is likely not a security.[12] But, the economic substance of the transaction always determines the legal analysis, not the labels.[13] The oranges in *Howey* had utility. Or in my favorite example, the Commission warned in the late 1960s about investment contracts sold in the form of whisky warehouse receipts.[14] Promoters sold the receipts to U.S. investors to finance the aging and blending processes of Scotch whisky. The whisky was real – and, for some, had exquisite utility. But Howey was not selling oranges and the warehouse receipts promoters were not selling whisky for consumption. They were selling investments, and the purchasers were expecting a return from the promoters' efforts.

Promoters and other market participants need to understand whether transactions in a particular digital asset involve the sale of a security. We are happy to help promoters and their counsel work through these issues. We stand prepared to provide more formal interpretive or no-action guidance about the proper characterization of a digital asset in a proposed use.[15] In addition, we recognize that there are numerous implications under the federal securities laws of a particular asset being considered a security. For example, our Divisions of Trading and Markets and Investment Management are focused on such issues as broker-dealer, exchange and fund registration, as well as matters of market manipulation, custody and valuation. We understand that market participants are working to make their services compliant with the existing regulatory framework, and we are happy to continue our engagement in this process.

What are some of the factors to consider in assessing whether a digital asset is offered as an investment contract and is thus a security? Primarily, consider whether a third party – be it a person, entity or coordinated group of actors – drives the expectation of a return. That question will always depend on the particular facts and circumstances, and this list is illustrative, not exhaustive:

1. Is there a person or group that has sponsored or promoted the creation and sale of the digital asset, the efforts of whom play a significant role in the development and maintenance of the asset and its potential increase in value?
2. Has this person or group retained a stake or other interest in the digital asset such that it would be motivated to expend efforts to cause an increase in value in the digital asset? Would purchasers reasonably believe such efforts will be undertaken and may result in a return on their investment in the digital asset?
3. Has the promoter raised an amount of funds in excess of what may be needed to establish a functional network, and, if so, has it indicated how those funds may be used to support the value of the tokens or to increase the value of the enterprise? Does the promoter continue to expend funds from proceeds or operations to enhance the functionality and/or value of the system within which the tokens operate?
4. Are purchasers "investing," that is seeking a return? In that regard, is the instrument marketed and sold to the general public instead of to potential users of the network for a price that reasonably correlates with the market value of the good or service in the network?
5. Does application of the Securities Act protections make sense? Is there a person or entity others are relying on that plays a key role in the profit-making of the enterprise such that disclosure of their activities and plans would be important to investors? Do informational asymmetries exist between the promoters and potential purchasers/investors in the digital asset?
6. Do persons or entities other than the promoter exercise governance rights or meaningful influence?

While these factors are important in analyzing the role of any third party, there are contractual or technical ways to structure digital assets so they function more like a consumer item and less like a security. Again, we would look to the economic substance of the transaction, but promoters and their counsels should consider these, and other, possible features. This list is not intended to be exhaustive and by no means do I believe each and every one of these factors needs to be present to establish a case that a token is not being offered as a security. This list is meant to prompt thinking by promoters and their counsel, and start the dialogue with the staff – it is not meant to be a list of all necessary factors in a legal analysis.

1. Is token creation commensurate with meeting the needs of users or, rather, with feeding speculation?
2. Are independent actors setting the price or is the promoter supporting the secondary market for the asset or otherwise influencing trading?
3. Is it clear that the primary motivation for purchasing the digital asset is for personal use or consumption, as compared to investment? Have purchasers made representations as to their consumptive, as opposed to their investment, intent? Are the tokens available in increments that correlate with a consumptive versus investment intent?
4. Are the tokens distributed in ways to meet users' needs? For example, can the tokens be held or transferred only in amounts that correspond to a purchaser's expected use? Are there built-in incentives that compel using the tokens promptly on the network, such as having the tokens degrade in value over time, or can the tokens be held for extended periods for investment?
5. Is the asset marketed and distributed to potential users or the general public?
6. Are the assets dispersed across a diverse user base or concentrated in the hands of a few that can exert influence over the application?
7. Is the application fully functioning or in early stages of development?

These are exciting legal times and I am pleased to be part of a process that can help promoters of this new technology and their counsel navigate and comply with the federal securities laws.

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[1] The Securities and Exchange Commission disclaims responsibility for any private publication or statement of any SEC employee or Commissioner. This speech expresses the author's views and does not necessarily reflect those of the Commission, the Commissioners or other members of the staff.

[2] Section 2(a)(1) of the Securities Act of 1933 (Securities Act) [15 U.S.C. § 77b(a)(1)] and Section 3(a)(10) of the Securities Exchange Act of 1934 (Exchange Act) [15 U.S.C. § 78c(a)(10)] define "security." These definitions contain "slightly different formulations" of the term "security," but the U.S. Supreme Court has "treated [them] as essentially identical in meaning." *SEC v. Edwards*, 540 U.S. 389, 393 (2004).

[3] I am using the term "promoters" in a broad, generic sense. The important factor in the legal analysis is that there is a person or coordinated group (including "any unincorporated organization" see 5 U.S.C. § 77n(a)(4)) that is working actively to develop or guide the development of the infrastructure of the network. This person or group could be founders, sponsors, developers or "promoters" in the traditional sense. The presence of promoters in this context is important to distinguish from the circumstance where multiple, independent actors work on the network but no individual actor's or coordinated group of actors' efforts are essential efforts that affect the failure or success of the enterprise.

[4] *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). Depending on the features of any given instrument and the surrounding facts, it may also need to be evaluated as a possible security under the general definition of security – see footnote 2 – and the case law interpreting it.

[5] *Id*. at 298.

[6] *United Housing Found., Inc. v. Forman*, 421 U.S. 837 (1975).

[7] *Guidelines as to the Applicability of the Federal Securities Laws to Offers and Sales of Condominiums or Units in a Real Estate Development*, SEC Rel. No. 33-5347 (Jan. 4, 1973).

[8] *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230 (2d Cir. 1985).

[9] Secondary trading in digital assets by regulated entities may otherwise implicate the federal securities laws, as well as the Commodity Exchange Act. In addition, as SEC Chairman Jay Clayton has stated, regulated financial entities that allow for payment in cryptocurrencies, allow customers to purchase cryptocurrencies on margin or otherwise use cryptocurrencies to facilitate securities transactions should exercise caution, including ensuring that their cryptocurrency activities are not undermining their anti-money laundering and know-your-customer obligations. *Statement on Cryptocurrencies and Initial Coin Offerings* (Dec. 11, 2017). In addition, other laws and regulations, such as IRS regulations and state money servicing laws, may be implicated.

[10] The Supreme Court's investment contract test "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Howey*, 328 U.S. at 299.

[11] "[T]he name given to an instrument is not dispositive." *Forman*, 421 U.S. at 850.

[12] *Forman*, 421 U.S. at 853.

[13] *See* footnotes 10 and 11.

[14] SEC Rel. No. 33-5018 (Nov. 4, 1969); *Investment in Interests in Whisky*, SEC Rel. No. 33-5451 (Jan 7, 1974).

[15] For example, some have raised questions about the offering structure commonly referred to as a Simple Agreement for Future Tokens, or "SAFT." Because the legal analysis must follow the economic realities of the particular facts of an offering, it may not be fruitful to debate a hypothetical structure in the abstract and nothing in these remarks is meant to opine on the legality or appropriateness of a SAFT. From the discussion in this speech, however, it is clear I believe a token once offered in a security offering can, depending on the circumstances, later be offered in a non-securities transaction. I expect that some, perhaps many, may not. I encourage anyone that has questions on a particular SAFT structure to consult with knowledgeable securities counsel or the staff.

EXHIBIT B

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

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SECURITIES AND EXCHANGE	)
COMMISSION,	)
Plaintiff,	)Case No.
vs.	)20 CV 10832 (AT)
RIPPLE LABS, INC.; BRADLEY	)
GARLINGHOUSE, and CHRISTIAN A.	)
LARSEN,	)
Defendants.	)
------------------------------	)

DEPOSITION OF WILLIAM HAROLD HINMAN, JR.

WASHINGTON, D.C.

JULY 27, 2021

REPORTED BY: Tina Alfaro, RPR, CRR, RMR

DIGITAL EVIDENCE GROUP

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Q. As you review that do you see anything on that document that's inaccurate or untruthful?

A. I don't think so, no.

Q. And any material omissions about your professional background from that document?

MR. TENREIRO: Objection to form. Just give him a second, please, just to look at it again. Thank you.

(Witness reviewing document.)

A. This looks accurate to me.

Q. I'd like to direct your attention now to the second page, the first full paragraph, second complete sentence. "He also provided," could you just read that into the record.

A. "He also provided critical and timely guidance to market participants on emerging issues ranging from innovation such as direct listings and digital assets and novel offerings such as direct listings and special purpose acquisition offerings to questions arising from the impact of COVID-19, the effects of Brexit, the replacement of LIBOR, and the disclosure of risk related to foreign issuers and emerging markets."

Q. And, again, that's an accurate statement?

A. Yeah. Yeah, I think that's right.

Q. I'd like to direct your attention to the term "digital assets" in that sentence. What was the critical and timely guidance you provided to market participants with respect to digital assets?

A. I think the division while I was there provided guidance in a number of arenas, meetings with market participants, speeches, testimony in front of Congress about the application of how the division viewed the application of the federal securities laws to digital assets.

Q. We'll come to the meetings later. Did you consider your June 14th, 2018 speech an instance in which you provided timely guidance to market participants with respect to digital assets?

A. I think it was a time when we provided guidance to the marketplace, yes.

Q. And in what respects was your June 14, 2018 speech critical and timely guidance?

MR. TENREIRO: I'm going to object to the form. You know, this is -- you can answer, but you're looking at Simpson's Website and you're assuming something that's not in evidence that they're referring to that speech. But go ahead.

MR. FIGEL: Let's make sure the record's clear. You just testified, if I understood your testimony, that you considered your June 14th, 2018 speech an example of timely and critical guidance on digital asset transactions, correct?

A. Yes.

Q. Now I'm asking you what about that speech in your opinion made it critical and timely guidance?

MR. TENREIRO: Don't disclose, you know, deliberations with the staff of the SEC or facts that you might have learned from your discussions with the staff of the SEC or commissioners.

A. Right. Well, for that -- for that particular speech I think it was a continuation of some themes that had been articulated in the Dow case, in my congressional testimony. I'd have to go back and look at times I spoke publicly whether some of these things had been said before or not. That speech in part because I think it was covered by Yahoo News got a fair amount of publicity and got more coverage than some of the earlier discussions.

Q. What in your mind was significant about that speech?

MR. TENREIRO: Again, same instruction not to disclose. If you can -- if you can answer that question without revealing what's in your mind because of discussions that you had with SEC staff or commissioners.

A. I think that speech, you know, provided a framework for the marketplace to think about digital asset offerings generally. I tried to provide things that would make an offering more likely to be viewed as a security or less likely, to provide contrast, and to give folks a sense of the kind of thing that we did not think the securities laws applied to. We spoke about -- a little bit about Bitcoin and more about Ether as currently being offered, but trying to make clear that depending on how it was being offered that could still be a securities offering. But trying to provide examples.

(Hinman Exhibit 8 was marked
for identification.)

BY MR. FIGEL:

Q. Needless to say, we'll come back to the speech. I'm going to shift gears for a moment. I'm now going to show you a document that I will ask to be marked as Exhibit 8, and for the hotseat it's in the outline as UU. I'm sorry. UUU.

Are you familiar with Exhibit 8?

A. Yes.

Q. And what is Exhibit 8, Director Hinman?

A. I think this was a blog posting that was done by Andreessen Horowitz with respect to a cryptofund they were just closing on.

Q. As relates to you, do you see anything in this document that is inaccurate or untruthful?

MS. KELLY: Take a moment to read.

A. Yes -- no, I don't see anything that's inaccurate. Sorry.

A. I don't think so.

Q. Why did you give the speech, Mr. Hinman?

MR. TENREIRO: Without disclosing -- you know, so let's talk about the final decision only and let's keep it high level, please, without disclosing the reasons you might have discussed with staff of the SEC or commissioners.

A. Okay. I was asked to attend the summit and to speak at the summit, and we agreed -- or I agreed to do that. You know, why I think I gave it? Because this is an area where people were interested in knowing how the division was looking at these issues.

Q. And did you have an understanding as to why people were interested in how the division was looking at these issues?

MR. TENREIRO: Do not discuss -- or disclose understandings you might have derived in the deliberations or conversations with staff or commissioners.

A. Based on my own meetings up to the date of this speech with outside parties it seemed like this was an area they, again, were interested in knowing more about how the division itself felt about this area.

Q. And in your own mind did you think that delivering this speech would answer any open issues with respect to the application of the federal securities laws to digital asset transactions?

MR. TENREIRO: So, again, even in his own mind, if it's in his mind because it came from conversations and discussions with staff, please don't answer. Please try to uncouple what you learned from, you know, your deliberations with the staff to answer his question.

A. Okay. I'm sorry. Would you mind asking me the question again?

Q. In your own mind did you think delivering this speech would answer any open issues with respect to the application of the federal securities laws to digital asset transactions?

A. I think it would inform the marketplace of how corporation -- the division of corporation finance and I felt about these topics, but there's a whole host of things covered here.

Q. Did you think this -- withdrawn.

Did you believe this speech provided clarity to the market with respect to the application of the federal securities laws to digitalize the transactions?

MR. TENREIRO: So same instruction on deliberative process and also object to form.

A. I think it provided clarity as to how I was looking at these issues.

Q. And did you have an -- withdrawn.

Did you believe that was new information to the marketplace?

MR. TENREIRO: Same instruction.

A. I think how I felt about things or the framework I had in my mind was, you know, not -- wasn't something I had published in a speech earlier.

Q. And what about -- what are the things or the framework that you had in your mind that you communicated in the speech that you had not published or stated earlier?

A. Well, as I've mentioned before, a lot of things that are in the speech have been covered in earlier topics, the application of the Howey case in general, our concern about information asymmetries of people who were doing unregistered offerings of tokens. What's more new here is a framework that was meant to help people analyze, okay, this is what I'm doing, am I offering a security and do the securities laws apply, or at least how is corp fin, the director looking at that issue.

Q. And did you view that as guidance that you were offering to the marketplace that had not been made available in the past?

A. I think the framework was -- you know, in terms of articulating specific factors was probably the -- although we had referred to those things in talking to market participants, I'm not sure we had ever given a speech with the framework laid out the way it is here.

Q. All right. Just a ministerial point. So we have the written speech. We've entered into a attachment to the e-mail?

A. No.

Q. Are you familiar with the Blockchain Association?

A. Not very.

Q. According to their Website they claim that they're one of the "Leading advocacy groups in the digital asset space whose goal is to improve the public policy environment so that blockchain networks will thrive in the United States."

Does that refresh your recollection at all as to what the Blockchain Association is?

A. It sounds like a trade association.

Q. And they refer to themselves as the unified voice of the blockchain in cryptocurrency industry?

A. Okay.

Q. Does it refresh your recollection?

A. Just -- just that someone active in the space. I don't really know them very well.

Q. And if you see the attachment, they sent a document that bears the caption the "Hinman token standard, a reasonable framework for determining when tokens are and are not securities." Do you agree that your June 14th, 2018 speech announced a Hinman token standard?

A. I guess people have called it that. I didn't intend it for to be called the Hinman standard.

Q. Putting aside the label, did you understand that people would view your speech as having announced a framework by which the division of corporate finance would determine when tokens are and are not securities?

A. The speech and other guidance was intended to share more generally the framework that the division was using in thinking about these assets.

Q. Did you disagree with the substance of what is reflected in the attachment, which is your speech announced a new framework for determining when tokens are and are not securities?

MR. TENREIRO: Object to form.

A. Do I disagree that it announced a new framework? I think I would quibble with that a little bit. I think that's a framework many folks were using at the time.

Q. After your speech did third parties come to the division of corporate finance and argue that a digital transaction was not a security based on the factors outlined in your speech?

A. They would cite the factors and other factors.

Q. Did you accept that the factors set out in your speech was the criteria by which the division of corporate finance would evaluate whether a digital asset transaction was a security?

A. Generally.

Q. And what do you mean by generally?

A. There are other factors that may be relevant that are not in the framework, things that are more derived from the Gary Plastic case, for instance.

Q. Well, the factors that you outlined in your speech that the Blockchain Association viewed as the Hinman token standard was a new framework that the division of corporate finance announced through you and your speech, correct?

MR. TENREIRO: Objection to form. He already answered no to that question.

A. I think, again, it was the first time that particular framework was published. So you could call it a new publication, but I think the framework itself, the principles underlying the framework have been well known for a long time.

Q. And following the speech the division of corporate finance applied the framework that you announced on June 14th in connection with their evaluation of whether digital asset transactions were securities, correct?

A. Generally, but not always.

(Hinman Exhibit 35 and Exhibit 36 were marked for identification.)

BY MR. FIGEL:

Q. So I'm now showing you what is in the outline as PPP and which I will ask the court reporter to mark as Exhibit 35. In light of the concern about the time I'm going to also show you

EXHIBIT C

Statement by the Divisions of Corporation Finance and Enforcement on the Report of Investigation on The DAO

Divisions of Corporation Finance and Enforcement

July 25, 2017

Emerging Technologies and the Federal Securities Laws

Distributed ledger and other emerging technologies have the potential to influence and improve the capital markets and the financial services industry. Interest in and funding for these technologies appears to be growing at a rapid pace. We welcome and encourage the appropriate use of technology to facilitate capital formation and provide investors with new investment opportunities. We are particularly hopeful that innovation in this area will facilitate fair and efficient capital raisings for small businesses. We are also mindful of our obligation to protect investors and recognize that new technologies can offer opportunities for misconduct and abuse.

A fundamental tenet of our regulatory framework is that an offer or sale of securities in the United States must comply with the federal securities laws. This approach has been critical to maintaining market integrity and fostering investor protection for over 80 years, including through various changes in technology. In this regard, the issue of whether a particular investment opportunity involves the offer or sale of a security — regardless of the terminology or technology used in the transaction — depends on the facts and circumstances, including the economic realities and structure of the enterprise.

Report of Investigation — DAO Tokens are Securities

Today, the Commission issued a Report of Investigation ("Report") relating to an offering by The DAO — a decentralized autonomous organization that used distributed ledger or blockchain technology to operate as a "virtual" entity. The DAO sold tokens representing interests in its enterprise to investors in exchange for payment with virtual currency. Investors could hold these tokens as an investment with certain voting and ownership rights or could sell them on web-based secondary market platforms. Based on the facts and circumstances of this offering, the Commission, as explained in the Report, determined that the DAO tokens are securities.

Sponsors involved in an exchange of something of value for an interest in a digital or other novel form for storing value should carefully consider whether they are creating an investment arrangement that constitutes a security. The definition of a security under the federal securities laws is broad, covering traditional notions of a security, such as a stock or bond, as well as novel products or instruments where value may be represented and transferred in digital form. A hallmark of a security is an investment of money or value in a business or operation where the investor has a reasonable expectation of profits based on the efforts of others.

A market participant engaged in offering an investment opportunity that constitutes a security must either register the offer and sale of the security with the Commission or structure it so that it qualifies for an exemption from registration. Market participants in this area must also consider other aspects of the securities laws, such as whether a platform facilitating transactions in its securities is operating as an exchange, whether the entity offering and selling the security could be an investment company, and whether anyone providing advice about an investment in the security could be an investment adviser. Structuring an offering so that it involves digital instruments of value or operates using a distributed ledger or blockchain does not remove that activity from the requirements of the federal securities laws.

Consultation with Securities Counsel and the Staff

Although some of the detailed aspects of the federal securities laws and regulations embody more traditional forms of offerings or corporate organizations, these laws have a principles-based framework that can readily adapt to new types of technologies for creating and distributing securities. We encourage market participants who are employing new technologies to form investment vehicles or distribute investment opportunities to consult with securities counsel to aid in their analysis of these issues and to contact our staff, as needed, for assistance in analyzing the application of the federal securities laws.

In particular, staff providing assistance on these matters can be reached at FinTech@sec.gov.

Investors Should Be Mindful of Risks Associated with New Technologies, Including Risks of Fraud

Finally, we recognize that new technologies also present new opportunities for bad actors to engage in fraudulent schemes, including old schemes under new names and using new terminology. We urge the investing public to be mindful of traditional “red flags” when making any investment decision, including: deals that sound too good to be true; promises of high returns with little or no risk; high-pressure sales tactics; and working with unregistered or unlicensed sellers. In that regard, the SEC’s website for individual investors, Investor.gov, has a number of relevant resources — including an Investor Bulletin that the SEC’s Office of Investor Education and Advocacy issued today regarding Initial Coin Offerings.

EXHIBIT D

Statement

Statement on “Framework for ‘Investment Contract’ Analysis of Digital Assets”

Bill Hinman, Director of Division of Corporation Finance
Valerie Szczepanik, Senior Advisor for Digital Assets and Innovation

April 3, 2019

Blockchain and distributed ledger technology can catalyze a wide range of innovation. We have seen these technologies used to create financial instruments, sometimes in the form of tokens or coins that can provide investment opportunities like those offered through more traditional forms of securities. Depending on the nature of the digital asset, including what rights it purports to convey and how it is offered and sold, it may fall within the definition of a security under the U.S. federal securities laws.

As part of a continuing effort to assist those seeking to comply with the U.S. federal securities laws, FinHub is publishing a framework for analyzing whether a digital asset is offered and sold as an investment contract, and, therefore, is a security. The framework is not intended to be an exhaustive overview of the law, but rather, an analytical tool to help market participants assess whether the federal securities laws apply to the offer, sale, or resale of a particular digital asset. Also, the Division of Corporation Finance is issuing a response to a no-action request, indicating that the Division will not recommend enforcement action to the Commission if the digital asset described in the request is offered or sold without registration under the U.S. federal securities laws.

As financial technologies, methods of capital formation, and market structures continue to evolve, market participants should be aware that they may be conducting activities that fall within our jurisdiction. For example, market participants may engage in activities that require registration of transactions and persons or entities involved in those transactions. Even if no registration is required, activities involving digital assets that are securities may still be subject to the Commission's regulation and oversight. More specifically, the information contained in this framework may apply to entities conducting the following activities related to digital assets:

- offering, selling, or distributing
- marketing or promoting
- buying, selling, or trading
- facilitating exchanges
- holding or storing
- offering financial services such as management or advice
- other professional services

This framework represents Staff views and is not a rule, regulation, or statement of the Commission. The Commission has neither approved nor disapproved its content. This framework, like other Staff guidance, is not binding on the Divisions or the Commission. It does not constitute legal advice, for which you should consult with your own attorney. It does not modify or replace any existing applicable laws, regulations, or rules. Market participants are encouraged to review all the materials published on FinHub.

The Staff recognizes that determining whether a new type of financial instrument, including a digital asset, is a security can require a careful analysis of the nature of the instrument and how it is offered and sold. If after applying the framework, market participants have questions regarding whether a particular digital asset is a security, they are encouraged to reach out to the Staff through FinHub’s webform.

Related Materials

- Framework for “Investment Contract” Analysis of Digital Assets
- No-Action Letter

Framework for “Investment Contract” Analysis of Digital Assets

[1]

I. Introduction

If you are considering an Initial Coin Offering, sometimes referred to as an "ICO," or otherwise engaging in the offer, sale, or distribution of a digital asset,[2] you need to consider whether the U.S. federal securities laws apply. A threshold issue is whether the digital asset is a "security" under those laws.[3] The term "security" includes an "investment contract," as well as other instruments such as stocks, bonds, and transferable shares. A digital asset should be analyzed to determine whether it has the characteristics of any product that meets the definition of "security" under the federal securities laws. In this guidance, we provide a framework for analyzing whether a digital asset has the characteristics of one particular type of security – an "investment contract."[4] Both the Commission and the federal courts frequently use the "investment contract" analysis to determine whether unique or novel instruments or arrangements, such as digital assets, are securities subject to the federal securities laws.

The U.S. Supreme Court's *Howey* case and subsequent case law have found that an "investment contract" exists when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others.[5] The so-called "*Howey* test" applies to any contract, scheme, or transaction, regardless of whether it has any of the characteristics of typical securities.[6] The focus of the *Howey* analysis is not only on the form and terms of the instrument itself (in this case, the digital asset) but also on the circumstances surrounding the digital asset and the manner in which it is offered, sold, or resold (which includes secondary market sales). Therefore, issuers and other persons and entities engaged in the marketing, offer, sale, resale, or distribution of any digital asset will need to analyze the relevant transactions to determine if the federal securities laws apply.

The federal securities laws require all offers and sales of securities, including those involving a digital asset, to either be registered under its provisions or to qualify for an exemption from registration. The registration provisions require persons to disclose certain information to investors, and that information must be complete and not materially misleading. This requirement for disclosure furthers the federal securities laws' goal of providing investors with the information necessary to make informed investment decisions. Among the information that must be disclosed is information relating to the essential managerial efforts that affect the success of the enterprise.[7] This is true in the case of a corporation, for example, but also may be true for other types of enterprises regardless of their organizational structure or form.[8] Absent the disclosures required by law about those efforts and the progress and prospects of the enterprise, significant informational asymmetries may exist between the management and promoters of the enterprise on the one hand, and investors and prospective investors on the other hand. The reduction of these information asymmetries through required disclosures protects investors and is one of the primary purposes of the federal securities laws.

II. Application of *Howey* to Digital Assets

In this guidance, we provide a framework for analyzing whether a digital asset is an investment contract and whether offers and sales of a digital asset are securities transactions. As noted above, under the *Howey* test, an "investment contract" exists when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others. Whether a particular digital asset at the time of its offer or sale satisfies the *Howey* test depends on the specific facts and circumstances. We address each of the elements of the *Howey* test below.

A. The Investment of Money

The first prong of the *Howey* test is typically satisfied in an offer and sale of a digital asset because the digital asset is purchased or otherwise acquired in exchange for value, whether in the form of real (or fiat) currency, another digital asset, or other type of consideration.[9]

B. Common Enterprise

Courts generally have analyzed a "common enterprise" as a distinct element of an investment contract.[10] In evaluating digital assets, we have found that a "common enterprise" typically exists.[11]

C. Reasonable Expectation of Profits Derived from Efforts of Others

Usually, the main issue in analyzing a digital asset under the *Howey* test is whether a purchaser has a reasonable expectation of profits (or other financial returns) derived from the efforts of others. A purchaser may expect to realize a return through participating in distributions or through other methods of realizing appreciation on the asset, such as selling at a gain in a secondary market. When a promoter, sponsor, or other third party (or affiliated group of third parties) (each, an "Active Participant" or "AP") provides essential managerial efforts that affect the success of the enterprise, and investors reasonably expect to derive profit from those efforts, then this prong of the test is met. Relevant to this inquiry is the "economic reality"[12] of the transaction and "what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect."[13] The inquiry, therefore, is an objective one, focused on the transaction itself and the manner in which the digital asset is offered and sold.

The following characteristics are especially relevant in an analysis of whether the third prong of the *Howey* test is satisfied.

1. Reliance on the Efforts of Others

The inquiry into whether a purchaser is relying on the efforts of others focuses on two key issues:

- Does the purchaser reasonably expect to rely on the efforts of an AP?
- Are those efforts "the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise,"[14] as opposed to efforts that are more ministerial in nature?

Although no one of the following characteristics is necessarily determinative, the stronger their presence, the more likely it is that a purchaser of a digital asset is relying on the "efforts of others":

- An AP is responsible for the development, improvement (or enhancement), operation, or promotion of the network,[15] particularly if purchasers of the digital asset expect an AP to be performing or overseeing tasks that are necessary for the network or digital asset to achieve or retain its intended purpose or functionality.[16]
    - Where the network or the digital asset is still in development and the network or digital asset is not fully functional at the time of the offer or sale, purchasers would reasonably expect an AP to further develop the functionality of the network or digital asset (directly or indirectly). This particularly would be the case where an AP promises further developmental efforts in order for the digital asset to attain or grow in value.

- There are essential tasks or responsibilities performed and expected to be performed by an AP, rather than an unaffiliated, dispersed community of network users (commonly known as a "decentralized" network).
- An AP creates or supports a market for,[17] or the price of, the digital asset. This can include, for example, an AP that: (1) controls the creation and issuance of the digital asset; or (2) takes other actions to support a market price of the digital asset, such as by limiting supply or ensuring scarcity, through, for example, buybacks, "burning," or other activities.
- An AP has a lead or central role in the direction of the ongoing development of the network or the digital asset. In particular, an AP plays a lead or central role in deciding governance issues, code updates, or how third parties participate in the validation of transactions that occur with respect to the digital asset.
- An AP has a continuing managerial role in making decisions about or exercising judgment concerning the network or the characteristics or rights the digital asset represents including, for example:
    - Determining whether and how to compensate persons providing services to the network or to the entity or entities charged with oversight of the network.
    - Determining whether and where the digital asset will trade. For example, purchasers may reasonably rely on an AP for liquidity, such as where the AP has arranged, or promised to arrange for, the trading of the digital asset on a secondary market or platform.
    - Determining who will receive additional digital assets and under what conditions.
    - Making or contributing to managerial level business decisions, such as how to deploy funds raised from sales of the digital asset.
    - Playing a leading role in the validation or confirmation of transactions on the network, or in some other way having responsibility for the ongoing security of the network.
    - Making other managerial judgements or decisions that will directly or indirectly impact the success of the network or the value of the digital asset generally.
- Purchasers would reasonably expect the AP to undertake efforts to promote its own interests and enhance the value of the network or digital asset, such as where:
    - The AP has the ability to realize capital appreciation from the value of the digital asset. This can be demonstrated, for example, if the AP retains a stake or interest in the digital asset. In these instances, purchasers would reasonably expect the AP to undertake efforts to promote its own interests and enhance the value of the network or digital asset.
    - The AP distributes the digital asset as compensation to management or the AP's compensation is tied to the price of the digital asset in the secondary market. To the extent these facts are present, the compensated individuals can be expected to take steps to build the value of the digital asset.
    - The AP owns or controls ownership of intellectual property rights of the network or digital asset, directly or indirectly.
    - The AP monetizes the value of the digital asset, especially where the digital asset has limited functionality.

In evaluating whether a digital asset previously sold as a security should be reevaluated at the time of later offers or sales, there would be additional considerations as they relate to the "efforts of others," including but not limited to:

- Whether or not the efforts of an AP, including any successor AP, continue to be important to the value of an investment in the digital asset.
- Whether the network on which the digital asset is to function operates in such a manner that purchasers would no longer reasonably expect an AP to carry out essential managerial or entrepreneurial efforts.
- Whether the efforts of an AP are no longer affecting the enterprise's success.

2. Reasonable Expectation of Profits

An evaluation of the digital asset should also consider whether there is a reasonable expectation of profits. Profits can be, among other things, capital appreciation resulting from the development of the initial investment or business enterprise or a participation in earnings resulting from the use of purchasers' funds.[18] Price appreciation resulting solely from external market forces (such as general inflationary trends or the economy) impacting the supply and demand for an underlying asset generally is not considered "profit" under the *Howey* test.

The more the following characteristics are present, the more likely it is that there is a reasonable expectation of profit:

- The digital asset gives the holder rights to share in the enterprise's income or profits or to realize gain from capital appreciation of the digital asset.
    - The opportunity may result from appreciation in the value of the digital asset that comes, at least in part, from the operation, promotion, improvement, or other positive developments in the network, particularly if there is a secondary trading market that enables digital asset holders to resell their digital assets and realize gains.
    - This also can be the case where the digital asset gives the holder rights to dividends or distributions.
- The digital asset is transferable or traded on or through a secondary market or platform, or is expected to be in the future.[19]
- Purchasers reasonably would expect that an AP's efforts will result in capital appreciation of the digital asset and therefore be able to earn a return on their purchase.
- The digital asset is offered broadly to potential purchasers as compared to being targeted to expected users of the goods or services or those who have a need for the functionality of the network.
    - The digital asset is offered and purchased in quantities indicative of investment intent instead of quantities indicative of a user of the network. For example, it is offered and purchased in quantities significantly greater than any likely user would reasonably need, or so small as to make actual use of the asset in the network impractical.
- There is little apparent correlation between the purchase/offering price of the digital asset and the market price of the particular goods or services that can be acquired in exchange for the digital asset.
- There is little apparent correlation between quantities the digital asset typically trades in (or the amounts that purchasers typically purchase) and the amount of the underlying goods or services a typical consumer would purchase for use or consumption.
- The AP has raised an amount of funds in excess of what may be needed to establish a functional network or digital asset.
- The AP is able to benefit from its efforts as a result of holding the same class of digital assets as those being distributed to the public.
- The AP continues to expend funds from proceeds or operations to enhance the functionality or value of the network or digital asset.
- The digital asset is marketed, directly or indirectly, using any of the following:
    - The expertise of an AP or its ability to build or grow the value of the network or digital asset.
    - The digital asset is marketed in terms that indicate it is an investment or that the solicited holders are investors.
    - The intended use of the proceeds from the sale of the digital asset is to develop the network or digital asset.

  - The future (and not present) functionality of the network or digital asset, and the prospect that an AP will deliver that functionality.
  - The promise (implied or explicit) to build a business or operation as opposed to delivering currently available goods or services for use on an existing network.
  - The ready transferability of the digital asset is a key selling feature.
  - The potential profitability of the operations of the network, or the potential appreciation in the value of the digital asset, is emphasized in marketing or other promotional materials.
  - The availability of a market for the trading of the digital asset, particularly where the AP implicitly or explicitly promises to create or otherwise support a trading market for the digital asset.

In evaluating whether a digital asset previously sold as a security should be reevaluated at the time of later offers or sales, there would be additional considerations as they relate to the "reasonable expectation of profits," including but not limited to:

- Purchasers of the digital asset no longer reasonably expect that continued development efforts of an AP will be a key factor for determining the value of the digital asset.
- The value of the digital asset has shown a direct and stable correlation to the value of the good or service for which it may be exchanged or redeemed.
- The trading volume for the digital asset corresponds to the level of demand for the good or service for which it may be exchanged or redeemed.
- Whether holders are then able to use the digital asset for its intended functionality, such as to acquire goods and services on or through the network or platform.
- Whether any economic benefit that may be derived from appreciation in the value of the digital asset is incidental to obtaining the right to use it for its intended functionality.
- No AP has access to material, non-public information or could otherwise be deemed to hold material inside information about the digital asset.

3. Other Relevant Considerations

When assessing whether there is a reasonable expectation of profit derived from the efforts of others, federal courts look to the economic reality of the transaction.[20] In doing so, the courts also have considered whether the instrument is offered and sold for use or consumption by purchasers.[21]

Although no one of the following characteristics of use or consumption is necessarily determinative, the stronger their presence, the less likely the *Howey* test is met:

- The distributed ledger network and digital asset are fully developed and operational.
- Holders of the digital asset are immediately able to use it for its intended functionality on the network, particularly where there are built-in incentives to encourage such use.
- The digital assets' creation and structure is designed and implemented to meet the needs of its users, rather than to feed speculation as to its value or development of its network. For example, the digital asset can only be used on the network and generally can be held or transferred only in amounts that correspond to a purchaser's expected use.
- Prospects for appreciation in the value of the digital asset are limited. For example, the design of the digital asset provides that its value will remain constant or even degrade over time, and, therefore, a reasonable purchaser would not be expected to hold the digital asset for extended periods as an investment.
- With respect to a digital asset referred to as a virtual currency, it can immediately be used to make payments in a wide variety of contexts, or acts as a substitute for real (or fiat) currency.

    - This means that it is possible to pay for goods or services with the digital asset without first having to convert it to another digital asset or real currency.
    - If it is characterized as a virtual currency, the digital asset actually operates as a store of value that can be saved, retrieved, and exchanged for something of value at a later time.
- With respect to a digital asset that represents rights to a good or service, it currently can be redeemed within a developed network or platform to acquire or otherwise use those goods or services. Relevant factors may include:
    - There is a correlation between the purchase price of the digital asset and a market price of the particular good or service for which it may be redeemed or exchanged.
    - The digital asset is available in increments that correlate with a consumptive intent versus an investment or speculative purpose.
    - An intent to consume the digital asset may also be more evident if the good or service underlying the digital asset can only be acquired, or more efficiently acquired, through the use of the digital asset on the network.
- Any economic benefit that may be derived from appreciation in the value of the digital asset is incidental to obtaining the right to use it for its intended functionality.
- The digital asset is marketed in a manner that emphasizes the functionality of the digital asset, and not the potential for the increase in market value of the digital asset.
- Potential purchasers have the ability to use the network and use (or have used) the digital asset for its intended functionality.
- Restrictions on the transferability of the digital asset are consistent with the asset's use and not facilitating a speculative market.
- If the AP facilitates the creation of a secondary market, transfers of the digital asset may only be made by and among users of the platform.

Digital assets with these types of use or consumption characteristics are less likely to be investment contracts. For example, take the case of an online retailer with a fully-developed operating business. The retailer creates a digital asset to be used by consumers to purchase products only on the retailer's network, offers the digital asset for sale in exchange for real currency, and the digital asset is redeemable for products commensurately priced in that real currency. The retailer continues to market its products to its existing customer base, advertises its digital asset payment method as part of those efforts, and may "reward" customers with digital assets based on product purchases. Upon receipt of the digital asset, consumers immediately are able to purchase products on the network using the digital asset. The digital assets are not transferable; rather, consumers can only use them to purchase products from the retailer or sell them back to the retailer at a discount to the original purchase price. Under these facts, the digital asset would not be an investment contract.

Even in cases where a digital asset can be used to purchase goods or services on a network, where that network's or digital asset's functionality is being developed or improved, there may be securities transactions if, among other factors, the following is present: the digital asset is offered or sold to purchasers at a discount to the value of the goods or services; the digital asset is offered or sold to purchasers in quantities that exceed reasonable use; and/or there are limited or no restrictions on reselling those digital assets, particularly where an AP is continuing in its efforts to increase the value of the digital assets or has facilitated a secondary market.

III. Conclusion

The discussion above identifies some of the factors market participants should consider in assessing whether a digital asset is offered or sold as an investment contract and, therefore, is a security. It also identifies some of the factors to be considered in determining whether and when a digital asset may no longer be a security. These factors are not intended to be exhaustive in evaluating whether a digital asset is an investment contract or any other type of security, and no single factor is determinative; rather, we are providing them to assist those engaging in the offer, sale, or distribution of a digital asset, and their counsel, as they consider these issues. We encourage market participants to seek the advice of securities counsel and engage with the Staff through www.sec.gov/finhub.

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[1] This framework represents the views of the Strategic Hub for Innovation and Financial Technology ("FinHub," the "Staff," or "we") of the Securities and Exchange Commission (the "Commission"). It is not a rule, regulation, or statement of the Commission, and the Commission has neither approved nor disapproved its content. Further, this framework does not replace or supersede existing case law, legal requirements, or statements or guidance from the Commission or Staff. Rather, the framework provides additional guidance in the areas that the Commission or Staff has previously addressed. *See, e.g., Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO* (Exchange Act Rel. No. 81207) (July 25, 2017) ("*The DAO Report*"); William Hinman, *Digital Asset Transactions: When Howey Met Gary (Plastic)*, Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018), available at https://www.sec.gov/news/speech/speech-hinman-061418.

[2] The term "digital asset," as used in this framework, refers to an asset that is issued and transferred using distributed ledger or blockchain technology, including, but not limited to, so-called "virtual currencies," "coins," and "tokens."

[3] The term "security" is defined in Section 2(a)(1) of the Securities Act of 1933 (the "Securities Act"), Section 3(a)(10) of the Securities Exchange Act of 1934, Section 2(a)(36) of the Investment Company Act of 1940, and Section 202(a)(18) of the Investment Advisers Act of 1940.

[4] This framework is intended to be instructive and is based on the Staff's experiences to date and relevant law and legal precedent. It is not an exhaustive treatment of the legal and regulatory issues relevant to conducting an analysis of whether a product is a security, including an investment contract analysis with respect to digital assets generally. We expect that analysis concerning digital assets as securities may evolve over time as the digital asset market matures. Also, no one factor is necessarily dispositive as to whether or not an investment contract exists.

[5] *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) ("*Howey*"). *See also United Housing Found., Inc. v. Forman*, 421 U.S. 837 (1975) ("*Forman*"); *Tcherepnin v. Knight*, 389 U.S. 332 (1967) ("*Tcherepnin*"); *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344 (1943) ("*Joiner*").

[6] Whether a contract, scheme, or transaction is an investment contract is a matter of federal, not state, law and does not turn on whether there is a formal contract between parties. Rather, under the *Howey* test, "form [is] disregarded for substance and the emphasis [is] on economic reality." *Howey*, 328 U.S. at 298. The Supreme Court has further explained that that the term security "embodies a flexible rather than a static principle" in order to meet the "variable schemes devised by those who seek the use of the money of others on the promise of profits." *Id.* at 299.

[7] Issuers of digital assets, like all issuers, must provide full and fair disclosure of material information consistent with the requirements of the federal securities laws. Issuers of digital assets should be guided by the regulatory framework and concepts of materiality. What is material depends upon the nature and structure of the issuer's particular network and circumstances. *See TSC Industries v. Northway*, 426 U.S. 438, 449 (1976) (a fact is material "if there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision or if it "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available" to the shareholder).

[8] *See The DAO Report*.

[9] The lack of monetary consideration for digital assets, such as those distributed via a so-called "bounty program" does not mean that the investment of money prong is not satisfied. As the Commission explained in *The DAO Report*, "[i]n determining whether an investment contract exists, the investment of 'money' need not take the form of cash" and "in spite of *Howey's* reference to an 'investment of money,' it is well established that cash is not the only form of contribution or investment that will create an investment contract." *The DAO Report* at 11 (citation omitted). *See In re Tomahawk Exploration LLC*, Securities Act Rel. 10530 (Aug. 14, 2018) (issuance of tokens under a so-called "bounty program" constituted an offer and sale of securities because the issuer provided tokens to investors in exchange for services designed to advance the issuer's economic interests and foster a trading market for its securities). Further, the lack of monetary consideration for digital assets, such as those distributed via a so-called "air drop," does not mean that the investment of money prong is not satisfied; therefore, an airdrop may constitute a sale or distribution of securities. In a so-called "airdrop," a digital asset is distributed to holders of another digital asset, typically to promote its circulation.

[10] In order to satisfy the "common enterprise" aspect of the *Howey* test, federal courts require that there be either "horizontal commonality" or "vertical commonality." *See Revak v. SEC Realty Corp*., 18 F.3d. 81, 87-88 (2d Cir. 1994) (discussing horizontal commonality as "the tying of each individual investor's fortunes to the fortunes of the other investors by the pooling of assets, usually combined with the pro-rata distribution of profits" and two variants of vertical commonality, which focus "on the relationship between the promoter and the body of investors"). The Commission, on the other hand, does not require vertical or horizontal commonality *per se*, nor does it view a "common enterprise" as a distinct element of the term "investment contract." *In re Barkate*, 57 S.E.C. 488, 496 n.13 (Apr. 8, 2004); *see also* the Commission's Supplemental Brief at 14 in *SEC v. Edwards*, 540 U.S. 389 (2004) (on remand to the 11th Circuit).

[11] Based on our experiences to date, investments in digital assets have constituted investments in a common enterprise because the fortunes of digital asset purchasers have been linked to each other or to the success of the promoter's efforts. *See SEC v. Int'l Loan Network, Inc.*, 968 F.2d 1304, 1307 (D.C. Cir. 1992).

[12] *Howey*, 328 U.S. at 298. *See also Tcherepnin*, 389 U.S. at 336 ("in searching for the meaning and scope of the word 'security' in the [Acts], form should be disregarded for substance and the emphasis should be on economic reality.")

[13] *Joiner*, 320 U.S. at 352-53.

[14] *SEC v. Glenn W. Turner Enter., Inc.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821, 94 S. Ct. 117, 38 L. Ed. 2d 53 (1973) ("*Turner*").

[15] In this guidance, we are using the term "network" broadly to encompass the various elements that comprise a digital asset's network, enterprise, platform, or application.

[16] We recognize that holders of digital assets may put forth some effort in the operations of the network, but those efforts do not negate the fact that the holders of digital assets are relying on the efforts of the AP. That a scheme assigns "nominal or limited responsibilities to the [investor] does not negate the existence of an investment contract." *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 483 n.15 (5th Cir. 1974) (citation and quotation marks omitted). If the AP provides efforts that are "the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise," and the AP is not merely performing ministerial or routine tasks, then there likely is an investment contract. *See Turner*, 474 U.S. at 482; *see also The DAO Report* (although DAO token holders had certain voting rights, they nonetheless reasonably relied on the managerial efforts of others). Managerial and entrepreneurial efforts typically are characterized as involving expertise and decision-making that impacts the success of the business or enterprise through the application of skill and judgment.

[17] *See, e.g., Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce Fenner & Smith*, 756 F.2d 230 (2d Cir. 1985).

[18] *See Forman*, 421 U.S. at 852.

[19] Situations where the digital asset is exchangeable or redeemable solely for goods or services within the network or on a platform, and may not otherwise be transferred or sold, may more likely be a payment for a good or service in which the purchaser is motivated to use or consume the digital asset. *See* discussion of "Other Relevant Considerations."

[20] As noted above, under *Howey*, courts conduct an objective inquiry focused on the transaction itself and the manner in which it is offered.

[21] *See Forman*, 421 U.S. at 852-53 (where a purchaser is not "'attracted solely by the prospects of a return' on his investment . . . [but] is motivated by a desire to use or consume the item purchased . . . the securities laws do not apply.").

Modified: April 3, 2019

EXHIBIT E

Statement on Digital Asset Securities Issuance and Trading

Division of Corporation Finance, Division of Investment Management, and Division of Trading and Markets

Nov. 16, 2018

In recent years, we have seen significant advances in technologies – including blockchain and other distributed ledger technologies – that impact our securities markets. This statement[1] highlights several recent Commission enforcement actions involving the intersection of long-standing applications of our federal securities laws and new technologies.

The Commission's Divisions of Corporation Finance, Investment Management, and Trading and Markets (the "Divisions") encourage technological innovations that benefit investors and our capital markets, and we have been consulting with market participants regarding issues presented by new technologies.[2] We wish to emphasize, however, that market participants must still adhere to our well-established and well-functioning federal securities law framework when dealing with technological innovations, regardless of whether the securities are issued in certificated form or using new technologies, such as blockchain.

The Commission's recent enforcement actions involving AirFox, Paragon, Crypto Asset Management, TokenLot, and EtherDelta's founder,[3] discussed further below, illustrate the importance of complying with these requirements. Broadly speaking, the issues raised in these actions fall into three categories: (1) initial offers and sales of digital asset securities (including those issued in initial coin offerings ("ICOs")); (2) investment vehicles investing in digital asset securities and those who advise others about investing in these securities; and (3) secondary market trading of digital asset securities. Below, we provide the Divisions' views on these issues.

Offers and Sales of Digital Asset Securities

The Commission has brought a number of actions involving offerings of digital asset securities. To date, these actions have principally focused on two important questions. First, when is a digital asset a "security" for purposes of the federal securities laws?[4] Second, if a digital asset is a security, what Commission registration requirements apply?[5] The importance of these and related issues is illustrated by several recent Commission enforcement actions involving digital asset securities. In particular, the remedial measures in two of these matters demonstrate a way to address ongoing violations by issuers that have conducted illegal unregistered offerings of digital asset securities.

Today, the Commission issued settled orders against AirFox and Paragon in connection with their unregistered offerings of tokens. Pursuant to these orders, AirFox and Paragon will pay penalties and also have undertaken to register the tokens as securities under Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act") and to file periodic reports with the Commission. They have also agreed to compensate investors who purchased tokens in the illegal offerings if an investor elects to make a claim. The registration undertakings are designed to ensure that investors receive the type of information they would have received had these issuers complied with the registration provisions of the Securities Act of 1933 ("Securities Act") prior to the offer and sale of tokens in their respective ICOs. With the benefit of the ongoing disclosure provided by registration under the Exchange Act, investors who purchased the tokens from the issuers in the ICOs should be able to make a more informed decision as to whether to seek reimbursement or continue to hold their tokens.[6]

These two matters demonstrate that there is a path to compliance with the federal securities laws going forward, even where issuers have conducted an illegal unregistered offering of digital asset securities.

Investment Vehicles Investing in Digital Asset Securities

The Investment Company Act of 1940 ("Investment Company Act") establishes a registration and regulatory framework for pooled vehicles that invest in securities. This framework applies to a pooled investment vehicle, and its service providers, even when the securities in which it invests are digital asset securities.[7]

On Sept. 11, 2018, the Commission issued the Crypto Asset Management Order, finding that the manager of a hedge fund formed for the purpose of investing in digital assets had improperly failed to register the fund as an investment company. The order found that the manager engaged in an unlawful, unregistered, non-exempt, public offering of the fund. By investing more than 40 percent of the fund's assets in digital asset securities and engaging in a public offering of interests in the fund, the manager caused the fund to operate unlawfully as an unregistered investment company. The order also found that the fund's manager was an investment adviser, and that the manager had violated the antifraud provisions of the Investment Advisers Act of 1940 ("Advisers Act") by making misleading statements to investors in the fund.

Investment vehicles that hold digital asset securities and those who advise others about investing in digital asset securities, including managers of investment vehicles, must be mindful of registration, regulatory and fiduciary obligations under the Investment Company Act and the Advisers Act.[8]

Trading of Digital Asset Securities

Commission actions[9]and staff statements[10]involving secondary market trading of digital asset securities have generally focused on what activities require registration as a national securities exchange or registration as a broker or dealer, as those terms are defined under the federal securities laws.

Exchange Registration

Advancements in blockchain and distributed ledger technology have introduced innovative methods for facilitating electronic trading in digital asset securities. Platforms colloquially referred to as "decentralized" trading platforms, for example, combine traditional technology (such as web-based systems that accept and display orders and servers that store orders) with new technology (such as smart contracts run on a blockchain that contain coded protocols to execute the terms of the contract). These technologies provide the means for investors and market participants to find counterparties, discover prices, and trade a variety of digital asset securities.

A platform that offers trading in digital asset securities and operates as an "exchange" (as defined by the federal securities laws) must register with the Commission as a national securities exchange or be exempt from registration. The Commission's recent enforcement action against the founder of EtherDelta, a platform facilitating trading digital assets securities, underscores the Division of Trading and Markets' ongoing concerns about the failure of platforms that facilitate trading in digital asset securities to register with the Commission absent an exemption from registration.[11]

According to the Commission's order, EtherDelta—which was not registered with the Commission in any capacity—provided a marketplace for bringing together buyers and sellers for digital asset securities through the combined use of an order book, a website that displayed orders, and a smart contract run on the Ethereum blockchain. EtherDelta's smart contract was coded to, among other things, validate order messages, confirm the terms and conditions of orders, execute paired orders, and direct the distributed ledger to be updated to reflect a trade.[12] The Commission found that EtherDelta's activities clearly fell within the definition of an exchange and that EtherDelta's founder caused the platform's failure either to register as a national securities exchange or operate pursuant to an exemption from registration as an exchange.[13]

Any entity[14]that provides a marketplace for bringing together buyers and sellers of securities, regardless of the applied technology, must determine whether its activities meet the definition of an exchange under the federal securities laws. Exchange Act Rule 3b-16 provides a functional test to assess whether an entity meets the definition of an exchange under Section 3(a)(1) of the Exchange Act. An entity that meets the definition of an exchange must register with the Commission as a national securities exchange or be exempt from registration, such as by operating as an alternative trading system ("ATS") in compliance with Regulation ATS.

Notwithstanding how an entity may characterize itself or the particular activities or technology used to bring together buyers and sellers, a functional approach (taking into account the relevant facts and circumstances) will be applied when assessing whether a system constitutes an exchange.[15] The activity that actually occurs between the buyers and sellers—and not the kind of technology or the terminology used by the entity operating or promoting the system—determines whether the system operates as a marketplace and meets the criteria of an exchange under Rule 3b-16(a). For instance, the term "order" for purposes of Rule 3b-16 is intended to be broadly construed, and the actual activities among buyers and sellers on the system—not the labels assigned to indications of trading interest—will be considered for purposes of the exchange analysis.[16]

The exchange analysis includes an assessment of the totality of activities and technology used to bring together orders of multiple buyers and sellers for securities using "established non-discretionary methods"under which such orders interact.[17] A system "brings together orders of buyer and sellers" if, for example, it displays, or otherwise represents, trading interest entered on a system to users or if the system receives users' orders centrally for future processing and execution.[18]

A system uses established non-discretionary methods if it provides a trading facility or sets rules. For example, an entity that provides an algorithm, run on a computer program or on a smart contract using blockchain technology, as a means to bring together or execute orders could be providing a trading facility. As another example, an entity that sets execution priorities, standardizes material terms for digital asset securities traded on the system, or requires orders to conform with predetermined protocols of a smart contract, could be setting rules. Additionally, if one entity arranges for other entities, either directly or indirectly, to provide the various functions of a trading system that together meet the definition of an exchange, the entity arranging the collective efforts could be considered to have established an exchange.

Entities using blockchain or distributed ledger technology for trading digital assets should carefully review their activities on an ongoing basis to determine whether the digital assets they are trading are securities and whether their activities or services cause them to satisfy the definition of an exchange. An entity engaging in these types of activities should also consider other aspects of the federal securities laws (and other relevant legal and regulatory issues) beyond exchange registration requirements.

Broker-Dealer Registration

An entity that facilitates the issuance of digital asset securities in ICOs and secondary trading in digital asset securities may also be acting as a "broker" or "dealer" that is required to register with the Commission and become a member of a self-regulatory organization, typically FINRA. Among other things, SEC-registered broker-dealers are subject to legal and regulatory requirements that govern their conduct in the marketplace and that provide important safeguards for investors.

Section 15(a) of the Exchange Act provides that, absent an exception or exemption, it is unlawful for any broker or dealer to induce or attempt to induce the purchase or sale, of any security unless such broker or dealer is registered in accordance with Section 15(b) of the Exchange Act. Section 3(a)(4) of the Exchange Act generally defines a "broker" to mean any person engaged in the business of effecting transactions in securities for the account of others. Section 3(a)(5) of the Exchange Act generally defines a "dealer" to mean any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise. As with the "exchange" determination, a functional approach (taking into account the relevant facts and circumstances) is applied to assess whether an entity meets the definition of a broker or dealer, regardless of how an entity may characterize either itself or the particular activities or technology used to provide the services.[19]

The Commission's recent TokenLot Order illustrates the application of the broker-dealer registration requirements to entities trading or facilitating transactions in digital asset securities, even if they do not meet the definition of an exchange. According to the order, TokenLot was a self-described "ICO superstore" where investors could purchase digital assets, including digital asset securities, during or after an ICO, including in private sales and pre-sales. The parties' brokerage activities included marketing and facilitating the sale of digital assets, accepting investors' orders and funds for payment, and enabling the disbursement of proceeds to the issuers. They also received compensation based on a percentage of the proceeds raised in the ICOs, subject to a guaranteed minimum commission. TokenLot also acted as a dealer by regularly purchasing and then reselling digital tokens for accounts in TokenLot's name that were controlled by its operators.

Conclusion

The Divisions encourage and support innovation and the application of beneficial technologies in our securities markets. However, the Divisions recommend that those employing new technologies consult with legal counsel concerning the application of the federal securities laws and contact Commission staff, as necessary, for assistance. For further information, and to contact Commission staff for assistance, please visit the Commission's new FinHub page.

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[1] This statement represents the views of the Divisions of Corporation Finance, Investment Management, and Trading and Markets. It is not a rule, regulation, or statement of the Securities and Exchange Commission ("Commission"). The Commission has neither approved nor disapproved its content.

[2] The Chairman of the Commission and the Director of the Division of Corporation Finance have also provided public statements on this subject. See, e.g., Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017), available at https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11; Digital Asset Transactions: When Howey Met Gary (Plastic) (June 14, 2018), available at https://www.sec.gov/news/speech/speech-hinman-061418.

[3] See CarrierEQ, Inc., Rel. No. 33-10575 (Nov. 16, 2018); Paragon Coin, Inc., Rel. No. 33-10574 (Nov. 16, 2018); Zachary Coburn, Rel. No. 34-84553 (Nov. 8, 2018) (settled order) ("Coburn Order"); Crypto Asset Management, LP and Timothy Enneking, Rel. No. 33-10544 (Sept. 11, 2018) (settled order) ("Crypto Asset Management Order"); and Tokenlot LLC, Lenny Kugel, and Eli L. Lewitt, Rel. No. 33-10543 (Sept. 11, 2018) (settled order) ("TokenLot Order").

[4] On July 27, 2017, the Commission issued a report, which concluded that particular digital assets were securities and explained that issuers of digital asset securities must register offers and sales of such securities unless a valid exemption applies. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017) ("DAO Report"), available at https://www.sec.gov/litigation/investreport/34-81207.pdf. On Dec. 11, 2017, the Commission issued a settled order against an issuer named Munchee, Inc., making clear that a token may be a security even if it has some purported utility. Munchee, Inc., Securities Act Rel. No. 10445 (Dec. 11, 2017) (settled order) ("Munchee Order"). Together, the DAO Report and the Munchee Order emphasize that digital assets offered and sold as investment contracts (regardless of the terminology or technology used in the transaction) are securities.

[5] Of course, if a security is being offered or sold, the anti-fraud protections of the U.S. securities laws apply. The Commission has filed a number of enforcement actions involving digital assets, including those alleging fraudulent ICOs. See https://www.sec.gov/spotlight/cybersecurity-enforcement-actions(listing digital asset-related enforcement actions).

[6] As discussed herein, activities relating to the offer and sale of digital asset securities can also raise other legal and regulatory issues and considerations under the federal securities laws, including, for example, broker and dealer registration considerations.

[7] For a discussion of some questions that are relevant to registered investment companies that invest in certain digital assets, see Staff Letter to ICI and SIFMA AMG: Engaging on Fund Innovation and Crypto-related Holdings, available at https://www.sec.gov/investment/fund-innovation-cryptocurrency-related-holdings.

[8] In addition, pooled investment vehicles not only invest in securities but also are themselves issuers of securities. Although not addressed here, the requirements of the federal securities laws relating to an investment vehicle's offer and sale of securities apply to the same extent when those securities use new technologies, such as blockchain, as when they do not.

[9] See, e.g. Coburn Order and TokenLot Order.

[10] See Divisions of Enforcement and Trading and Markets, Statement on Potentially Unlawful Online Platforms for Trading Digital Assets (March 7, 2018), available at https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading.

[11] See id.

[12] Coburn Order at 6-7.

[13] As stated in the Coburn Order, the Commission's findings were made pursuant to the respondent's offer of settlement and are not binding on any other person or entity.

[14] The relevant legal and regulatory requirements discussed in this statement apply to natural persons or entities. However, for ease of reference, this statement generally refers only to entities.

[15] In its Regulation ATS adopting release, the Commission discussed what constitutes an exchange and provided examples illustrating various applications of Rule 3b-16. See Regulation of Exchanges and Alternative Trading Systems, Exchange Act Rel. No. 40760 (Dec. 8, 1998), 63 FR 70844 (Dec. 22, 1998), available at https://www.gpo.gov/fdsys/pkg/FR-1998-12-22/pdf/98-33299.pdf.

[16] See generally id. at 70844.

[17] See id. at 70852.

[18] See id. at 70852.

[19] There are other potential legal and regulatory issues and considerations under the federal securities laws for entities engaging in digital asset securities activities, including clearing agency and transfer agent registration considerations, among other things.

Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities

Division of Trading and Markets, U.S. Securities and Exchange Commission
Office of General Counsel, Financial Industry Regulatory Authority

July 8, 2019

Market participants have raised questions concerning the application of the federal securities laws and the rules of the Financial Industry Regulatory Authority ("FINRA") to the potential intermediation—including custody—of digital asset securities[1] and transactions. In this statement, the staffs of the Division of Trading and Markets (the "Division") and FINRA (collectively, the "Staffs")—drawing upon key principles from their historic approach to broker-dealer regulation and investor protection—have articulated various considerations relevant to many of these questions, particularly under the SEC's Customer Protection Rule applicable to SEC-registered broker-dealers.[2]

As a threshold matter, it should be recognized by market participants that the application of the federal securities laws, FINRA rules and other bodies of laws to digital assets, digital asset securities and related innovative technologies raise novel and complex regulatory and compliance questions and challenges. For example, and as discussed in more detail below, the ability of a broker-dealer to comply with aspects of the Customer Protection Rule is greatly facilitated by established laws and practices regarding the loss or theft of a security, that may not be available or effective in the case of certain digital assets.

The Staffs are aware of, and encourage and support, efforts to address these issues such that compliance with the Customer Protection Rule and other federal securities laws and FINRA rules is reasonably practicable. In recent months, the Staffs have been engaged with industry participants regarding how industry participants believe a particular custody solution for digital asset securities would meet the possession or control standards prescribed in the SEC's Customer Protection Rule. The Staffs have found these discussions to be very informative and appreciate market participants' ongoing engagement on these issues. The Staffs encourage and support innovation and look forward to continuing our dialogue as market participants work toward developing methodologies for establishing possession or control over customers' digital asset securities. Contact information for Commission and FINRA staffs is provided at the end of this statement.

Importance of the Customer Protection Rule

Entities seeking to participate in the marketplace for digital asset securities must comply with the relevant securities laws.[3] An entity that buys, sells, or otherwise transacts or is involved in effecting transactions in digital asset securities for customers or its own account is subject to the federal securities laws, and may be required to register with the Commission as a broker-dealer and become a member of and comply with the rules of a self-regulatory organization ("SRO"), which in most cases is FINRA. Importantly, if the entity is a broker-dealer, it must comply with broker-dealer financial responsibility rules,[4] including, as applicable, custodial requirements under Rule 15c3-3 under the Securities Exchange Act of 1934 (the "Exchange Act"), which is known as the Customer Protection Rule.

The purpose of the Customer Protection Rule is to safeguard customer securities and funds held by a broker-dealer, to prevent investor loss or harm in the event of a broker-dealer's failure, and to enhance the Commission's ability to monitor and prevent unsound business practices. Put simply, the Customer Protection Rule requires broker-dealers to safeguard customer assets and to keep customer assets separate from the firm's assets, thus increasing the likelihood that customers' securities and cash can be returned to them in the event of the broker-dealer's failure. The requirements of the Customer Protection Rule have produced a nearly fifty year track record[5] of recovery for investors when their broker-dealers have failed. This record of protecting customer assets held in custody by broker-dealers stands in contrast to recent reports of cybertheft,[6] and underscores the need to ensure broker-dealers' robust protection of customer assets, including digital asset securities.

Various unregistered entities that intend to engage in broker-dealer activities involving digital asset securities are seeking to register with the Commission and have submitted New Membership Applications ("NMAs") to FINRA. Additionally, various entities that are already registered broker-dealers and FINRA members are seeking to expand their businesses to include digital asset securities services and activities. Under FINRA rules, a firm is prohibited from materially changing its business operations (e.g., engaging in material digital asset securities activities for the first time) without FINRA's prior approval of a Continuing Membership Application ("CMA").[7]

The NMAs and CMAs currently before FINRA are diverse: Some of the NMAs and CMAs cover proposed business models that would not involve the broker-dealer engaging in custody of digital asset securities. On the other hand, some NMAs and CMAs include the custodying of digital asset securities, and therefore implicate the Customer Protection Rule, among other requirements.

Some of these entities have met with the Staffs to discuss how they propose to custody digital asset securities in order to comply with the broker-dealer financial responsibility rules. These discussions have been informative. The specific circumstances where a broker-dealer could custody digital asset securities in a manner that the Staffs believe would comply with the Customer Protection Rule remain under discussion, and the Staffs stand ready to continue to engage with entities pursuing this line of business.

Noncustodial Broker-Dealer Models for Digital Asset Securities

As noted, some entities contemplate engaging in broker-dealer activities involving digital asset securities that would not involve the broker-dealer engaging in custody functions. Generally speaking, noncustodial activities involving digital asset securities do not raise the same level of concern among the Staffs, provided that the relevant securities laws, SRO rules, and other legal and regulatory requirements are followed.[8] The following are examples of some of the business activities of this type that have been presented or described to the Staffs.

- One example is where the broker-dealer sends the trade-matching details (e.g., identity of the parties, price, and quantity) to the buyer and issuer of a digital asset security—similar to a traditional private placement—and the issuer settles the transaction bilaterally between the buyer and issuer, away from the broker-dealer. In this case, the broker-dealer instructs the customer to pay the issuer directly and instructs the issuer to issue the digital asset security to the customer directly (e.g., the customer's "digital wallet").

- A second example is where a broker-dealer facilitates "over-the counter" secondary market transactions in digital asset securities without taking custody of or exercising control over the digital asset securities. In this example, the buyer and seller complete the transaction directly and, therefore, the securities do not pass through the broker-dealer facilitating the transaction.

- Another example is where a secondary market transaction involves a broker-dealer introducing a buyer to a seller of digital asset securities through a trading platform where the trade is settled directly between the buyer and seller. For instance, a broker-dealer that operates an alternative trading system ("ATS") could match buyers and sellers of digital asset securities and the trades would either be settled directly between the buyer and seller, or the buyer and seller would give instructions to their respective custodians to settle the transactions.[9] In either case, the ATS would not guarantee or otherwise have responsibility for settling the trades and would not at any time exercise any level of control over the digital asset securities being sold or the cash being used to make the purchase (e.g., the ATS would not place a temporary hold on the seller's wallet or on the buyer's cash to ensure the transaction is completed).

Considerations for Broker-Dealer Custody of Digital Asset Securities

Whether a security is paper or digital, the same fundamental elements of the broker-dealer financial responsibility rules apply. The Staffs acknowledge that market participants wishing to custody digital asset securities may find it challenging to comply with the broker-dealer financial responsibility rules without putting in place significant technological enhancements and solutions unique to digital asset securities. As the market, infrastructure, and law applicable to digital asset securities continue to develop, the Staffs will continue their constructive engagement with market participants and to gather additional information so that they may better respond to developments in the market[10] while advancing the missions of our respective organizations: for the SEC, to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation; and for FINRA, to provide investor protection and promote market integrity.

The Customer Protection Rule

Overview

A broker-dealer seeking to custody digital asset securities must comply with the Customer Protection Rule. As noted, the rule is designed principally to protect customers of a registered broker-dealer from losses and delays in accessing their securities and cash that can occur if the firm fails. The rule requires the broker-dealer to safeguard customer securities and cash entrusted to the firm, as discussed below. If the broker-dealer fails, customer securities and cash should be readily available to be returned to customers.[11] In the event the broker-dealer were to be liquidated under SIPA, the SIPA trustee would be expected to step into the shoes of the broker-dealer and expected to be able to transfer, sell, or otherwise dispose of assets in accordance with SIPA.[12]

Among its core protections for customers, Rule 15c3-3 requires a broker-dealer to physically hold customers' fully paid and excess margin securities or maintain them free of lien at a good control location.[13] Generally, a broker-dealer may custody customer securities with a third-party custodian (e.g., the Depository Trust Company or a clearing bank),[14] and uncertificated securities, such as mutual funds, may be held at the issuer or at the issuer's transfer agent.[15] In either case, there is a third party that controls the transfer of the securities. This traditional securities infrastructure (including, for example, related laws of property and security) also has processes to reverse or cancel mistaken or unauthorized transactions.

Considerations for Digital Asset Securities

There are many significant differences in the mechanics and risks associated with custodying traditional securities and digital asset securities. For instance, the manner in which digital asset securities are issued, held, and transferred may create greater risk that a broker-dealer maintaining custody of them could be victimized by fraud or theft, could lose a "private key" necessary to transfer a client's digital asset securities, or could transfer a client's digital asset securities to an unknown or unintended address without meaningful recourse to invalidate fraudulent transactions, recover or replace lost property, or correct errors. Consequently, a broker-dealer must consider how it can, in conformance with Rule 15c3-3, hold in possession or control digital asset securities.

In particular, a broker-dealer may face challenges in determining that it, or its third-party custodian, maintains custody of digital asset securities.[16] If, for example, the broker-dealer holds a private key, it may be able to transfer such securities reflected on the blockchain or distributed ledger. However, the fact that a broker-dealer (or its third party custodian) maintains the private key may not be sufficient evidence by itself that the broker-dealer has exclusive control of the digital asset security (e.g., it may not be able to demonstrate that no other party has a copy of the private key and could transfer the digital asset security without the broker-dealer's consent).[17] In addition, the fact that the broker-dealer (or custodian) holds the private key may not be sufficient to allow it to reverse or cancel mistaken or unauthorized transactions. These risks could cause securities customers to suffer losses, with corresponding liabilities for the broker-dealer, imperiling the firm, its customers, and other creditors.

The Books and Records and Financial Reporting Rules

Overview

The broker-dealer recordkeeping and reporting rules[18] require a broker-dealer, among other things, to make and keep current ledgers reflecting all assets and liabilities,[19] as well as a securities record reflecting each security carried by the broker-dealer for its customers and all differences determined by the count of customer securities in the broker-dealer's possession or control compared to the result of the count with the broker-dealer's existing books and records.[20] The financial responsibility rules also require that broker-dealers routinely prepare financial statements,[21] including various supporting schedules particular to broker-dealers, such as Computation of Net Capital under Rule 15c3-1 and Information Relating to the Possession or Control Requirements under Rule 15c3-3 under the Exchange Act.[22]

The books, records, and financial reporting requirements are designed to ensure that a broker-dealer makes and maintains certain business records to assist the firm in accounting for its activities. These rules also assist securities regulators in examining for compliance with the federal securities laws and as such are an integral part of the financial responsibility program for broker-dealers.

Considerations for Digital Asset Securities

The nature of distributed ledger technology, as well as the characteristics associated with digital asset securities, may make it difficult for a broker-dealer to evidence the existence of digital asset securities for the purposes of the broker-dealer's regulatory books, records, and financial statements, including supporting schedules. The broker-dealer's difficulties in evidencing the existence of these digital asset securities may in turn create challenges for the broker-dealer's independent auditor seeking to obtain sufficient appropriate audit evidence when testing management's assertions in the financial statements during the annual broker-dealer audit.[23] We understand that some firms are considering the use of distributed ledger technology with features designed to enable firms to meet recordkeeping obligations and facilitate prompt verification of digital asset security positions (e.g., regulatory nodes or permissioned distributed ledger technologies). Broker-dealers should consider how the nature of the technology may impact their ability to comply with the broker-dealer recordkeeping and reporting rules.

Securities Investor Protection Act of 1970

Overview

Generally, a broker-dealer that fails and is unable to return the customer property that it holds would be liquidated in accordance with SIPA. Under SIPA, securities customers have a first priority claim to cash and securities held by the firm for securities customers. Customers also are eligible for up to $500,000 in protection (of which up to $250,000 can be used for cash claims) if the broker-dealer is missing customer assets. These SIPA protections apply to a "security" as defined in SIPA and cash deposited with the broker-dealer for the purpose of purchasing securities.[24] They do not apply to other types of assets, including, importantly, assets that are securities under the federal securities laws but are excluded from the definition of "security" under SIPA.[25]

Considerations for Digital Asset Securities

In the case of a digital asset security that does not meet the definition of "security" under SIPA, and in the event of the failure of a carrying broker-dealer, SIPA protection likely would not apply and holders of those digital asset securities would have only unsecured general creditor claims against the broker-dealer's estate.[26] Further, uncertainty regarding when and whether a broker-dealer holds a digital asset security in its possession or control creates greater risk for customers that their securities will not be able to be returned in the event of a broker-dealer failure.[27] The Staffs believe that such potential outcomes are likely to be inconsistent with the expectations of persons who would use a broker-dealer to custody their digital asset securities.

Control Location Applications

As a related matter, the Staffs have received inquiries from broker-dealers, including ATSs, wishing to utilize an issuer or transfer agent as a proposed "control location" for purposes of the possession or control requirements under the Customer Protection Rule. As described to the Staffs, this would involve uncertificated securities where the issuer or a transfer agent maintains a traditional single master security holder list, but also publishes as a courtesy the ownership record using distributed ledger technology. While the issuer or transfer agent may publish the distributed ledger, in these examples, the broker-dealers have asserted that the distributed ledger is not the authoritative record of share ownership. To the extent a broker-dealer contemplates an arrangement of this type, the Division will consider whether the issuer or the transfer agent can be considered a satisfactory control location pursuant to an application under paragraph (c)(7) of Rule 15c3-3.[28]

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As noted, the Staffs encourage and support innovation in the securities markets and look forward to continuing to engage with investors and industry participants as the marketplace for digital asset securities develops. To contact Commission staff for assistance, please visit the Commission's FinHub webpage or contact Thomas K. McGowan, Associate Director, at (202) 551-5521 or Raymond Lombardo, Assistant Director, at (202) 551-5755. To contact FINRA staff for assistance, please visit FINRA's FinTech webpage or contact Kosha Dalal, Associate General Counsel, at (202) 728-6903.

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[1] For the purposes of this statement, the term "digital asset" refers to an asset that is issued and transferred using distributed ledger or blockchain technology, including, but not limited to, so-called "virtual currencies," "coins," and "tokens." A digital asset may or may not meet the definition of a "security" under the federal securities laws. For the purposes of this statement, a digital asset that is a security is referred to as a "digital asset security."

[2] This statement represents staff views of the Division of Trading and Markets and FINRA. This statement is not a rule, regulation, guidance, or statement of the U.S. Securities and Exchange Commission ("SEC" or "Commission") or FINRA, and the Commission and FINRA's Board have neither approved nor disapproved its content. This statement does not alter or amend applicable law and has no legal force or effect.

[3] For purposes of this statement, the Staffs use the term "entities" to refer to both firms and individuals.

[4] The financial responsibility rules include Rule 15c3-1 (the net capital rule), Rule 15c3-3 (the customer protection rule), Rule 17a-3 (the record making rule), Rule 17a-4 (the record retention rule), Rule 17a-5 (the financial reporting rule), and Rule 17a-13 (the quarterly securities count rule) under the Securities Exchange Act of 1934 ("Exchange Act"). This statement does not address all federal securities laws that may be implicated by a broker-dealer seeking to maintain custody of digital asset securities. Further, this statement does not address other securities laws or rules that may apply to digital asset securities.

[5] Rule 15c3-3 was adopted by the Commission in 1972. See Broker-Dealers; Maintenance of Certain Basic Reserves, Exchange Act Release No. 9856 (Nov. 10, 1972), 37 Fed. Reg. 25224 (Nov. 29, 1972).

[6] For example, one blockchain forensic analysis firm estimated that approximately $1.7 billion worth of bitcoin and other digital assets had been stolen in 2018, of which approximately $950 million resulted from cyberattacks on bitcoin trading platforms. The estimate of total losses in 2018 is 3.6 times higher than the estimate of such losses in 2017. See CipherTrace, Cryptocurrency Anti-Money Laundering Report, 2018 Q4, at 3 (Jan. 2019) (available at: https://ciphertrace.com/crypto-aml-report-2018q4/).

[7] Firms can discuss with FINRA whether a contemplated change in business operations such as engaging in digital asset securities activities may require the filing of a CMA through the materiality consultation process.

[8] These business models and transactions must comply with other provisions of the securities laws or regulations. The Staffs offer no views about whether such business models would be in compliance with other securities laws or regulations.

[9] Entities that perform functions to facilitate the clearance and settlement of transactions in digital asset securities may be required to register as a clearing agency under Section 17A of the Exchange Act. See 15 U.S.C. 78q-1.

[10] See, e.g., Statement on Digital Asset Securities Issuance and Trading, Division of Corporation Finance, Division of Investment Management, and Division of Trading and Markets, Commission (Nov. 16, 2018) (available at: https://www.sec.gov/news/public-statement/digital-asset-securites-issuuance-and-trading); see also e.g., Engaging on Non-DVP Custodial Practices and Digital Assets, letter issued by staff, Division of Investment Management, Commission, dated Mar. 12, 2019 (available at: https://www.sec.gov/investment/engaging-non-dvp-custodial-practices-and-digital-assets).

[11] See Financial Responsibility Rules for Broker-Dealers, Exchange Act Release No. 70072 (July 30, 2013), 78 Fed. Reg. 51824, 51826 (Aug. 21, 2013). In addition, if the broker-dealer is liquidated in a formal proceeding under the Securities Investor Protection Act of 1970 ("SIPA"), the securities and cash held by the broker-dealer for its customers would be isolated and readily identifiable as "customer property" and, consequently, available to be distributed to customers ahead of other creditors. Id.

[12] See 15 U.S.C. 78fff-1 (setting forth the powers and duties of a SIPA trustee).

[13] See paragraphs (b) and (c) of Rule 15c3-3. An entity's designation as a good control location is based, in part, on its ability to maintain exclusive control over customer securities. See, e.g., paragraph (c)(5) of Rule 15c3-3 (deeming a "bank" as defined in Section 3(a)(6) of the Exchange Act to be a good control location so long as, among other things, the bank has acknowledged that customer securities "are not subject to any right, charge, security interest, lien or claim of any kind in favor of a bank or any person claiming through the bank" and the securities are in the custody or control of the bank).

[14] See paragraphs (c)(1) and (c)(5) of Rule 15c3-3.

[15] The Commission often receives applications under paragraph (c)(7) of Rule 15c3-3 to designate an issuer or the transfer agent of various types of uncertificated securities as a control location. The Division has delegated authority to "find and designate as control locations for purposes of Rule 15c3-3(c)(7) [under the Exchange Act] certain broker-dealer accounts which are adequate for the protection of customer securities." See 17 CFR 200.30-3(a)(10)(i). The Commission has stated that mutual funds in particular may be held at the issuer or the issuer's transfer agent. See, e.g., Broker-Dealer Reports, Exchange Act Release No. 70073 (July 30, 2013), 78 Fed. Reg. 51910, 51951 (Aug. 21, 2013) (stating that "[g]enerally, mutual funds issue securities only in book-entry form. This means that the ownership of securities is not reflected on a certificate that can be transferred but rather through a journal entry on the books of the issuer maintained by the issuer's transfer agent. A broker-dealer that holds mutual funds for customers generally holds them in the broker-dealer's name on the books of the mutual fund"). See also Form Custody for Broker-Dealers, 17 CFR 249.639 (providing broker-dealers with a field to indicate that they custody mutual fund securities with a transfer agent). The Division has also previously issued no-action letters regarding the maintenance of certain other uncertificated securities at the transfer agent. See, e.g., letter to Fantex Brokerage Services, LLC from Mark M. Attar, Senior Special Counsel, Division of Trading and Markets, Commission, dated Dec. 19, 2014 (providing that the staff would not recommend enforcement action if a broker-dealer treats a transfer agent for uncertificated securities as a good control location, under certain circumstances). These prior no-action letters do not address whether blockchain or distributed ledger technology, in connection with the maintenance of the single master security holder list, establishes control of uncertificated securities by the issuer (or transfer agent).

[16] See, e.g., paragraph (d) of Rule 15c3-3 (requiring that, not later than the next business day, a broker-dealer, as of the close of the preceding business day, shall determine the quantity of fully paid securities and excess margin securities in its possession or control and the quantity of such securities not in its possession or control).

[17] Cf. supra note 13.

[18] See generally Rules 17a-3, 17a-4, and 17a-5.

[19] See paragraph (a)(2) of Rule 17a-3.

[20] See paragraph (a)(5) of Rule 17a-3.

[21] See generally Rule 17a-5.

[22] See paragraph (d)(2)(ii) of Rule 17a-5.

[23] See generally PCAOB Auditing Standard 1105, Audit Evidence (describing sufficient appropriate audit evidence and stating that audit evidence consists of information that supports and corroborates management's assertions regarding the financial statements and information that contradicts such assertions).

[24] The SIPA definition of "security" is different than the federal securities laws definitions. See 15 U.S.C. 78lll(14) (excluding from the SIPA definition of "security" an investment contract or interest that is not the subject of a registration statement with the Commission pursuant to the provisions of the Securities Act of 1933). This means there may be digital assets that are: (1) securities under the federal securities laws and SIPA, and thus are protected by SIPA; (2) securities under the federal securities laws, but not under SIPA, and thus not protected by SIPA; or (3) not securities under the federal securities laws and therefore not protected by SIPA.

[25] If a broker-dealer holds securities that are not protected by SIPA, the broker-dealer must nevertheless comply with the physical possession or control requirements under Rule 15c3-3 with respect to those securities.

[26] Generally, in a SIPA liquidation, assets not included in customer property (other than customer name securities) are liquidated and paid out to general creditors on a pro rata basis. See 15 U.S.C. 78fff-2(c); 15 U.S.C. 78fff(b).

[27] See supra note 16.

[28] See paragraph (c)(7) of Rule 15c3-3.

Statement

Staff Statement on WY Division of Banking's "NAL on Custody of Digital Assets and Qualified Custodian Status"

Division of Investment Management Staff in Consultation with FinHub Staff

Nov. 9, 2020

The Staff of the Division of Investment Management (the "Staff"), in consultation with the FinHub Staff, issue this statement[1] following the publication of a recent letter by the Wyoming Division of Banking that included the Wyoming Division of Banking's views relating to the definition of "bank" and "qualified custodian" under the Investment Advisers Act of 1940 (the "Advisers Act") and rule 206(4)-2 thereunder (the "Custody Rule").[2]

The Wyoming Division of Banking letter seeks to address questions regarding custody of digital assets under federal law and state law by stating that a Wyoming-chartered public trust company is permitted to provide custodial services for digital and traditional assets under Wyoming law.[3] For example, the letter states that the entity may serve as a "qualified custodian" under the Custody Rule based on the definition of "bank" under the Advisers Act. The letter further states that the Wyoming Division of Banking would not recommend an investigation or enforcement action to the Securities and Exchange Commission (the "Commission"). In this regard, the letter seeks to provide interpretive guidance on a critical component of the Custody Rule, the definition of a "qualified custodian."

The Wyoming Division of Banking letter recognizes that it is addressing issues of both federal and state law and expressly states that the letter "should not be construed to represent the views of the SEC or any other regulatory agency." The Staff is issuing this statement to encourage interested parties to engage with the Staff directly on the application of the Custody Rule to digital assets, including with respect to the definition of "qualified custodian" under the rule.[4]

SEC-registered investment advisers have important regulatory obligations under the Custody Rule, and they are expected to exercise care with respect to client assets with which they are entrusted. Determining who qualifies as a qualified custodian is a complicated, and facts and circumstances based, analysis given the critical role qualified custodians play within this framework by safeguarding the client assets entrusted to investment advisers.[5] The Commission has limited the types of financial institutions that may act as qualified custodians to those institutions that possess key characteristics, including being subject to extensive regulation and oversight, that help to ensure that client assets are adequately safeguarded.[6]

The Staff has engaged extensively with investment advisers, custodians and other market participants who are interested in the application of the Custody Rule to digital assets.[7] Our engagement has also centered on soliciting feedback on issues related to the development of staff recommendations to amend the Custody Rule. If you would like to let the Staff know your views regarding these issues, we are providing an email box as a convenient method for you to communicate with us; we continue to communicate through the following address: IMOCC@sec.gov and insert "Custody Rule and Digital Assets" in the subject line.

In particular, we have been interested in the following on the topic of qualified custodians:

- Do state chartered trust companies possess characteristics similar to those of the types of financial institutions the Commission identified as qualified custodians? If yes, to what extent?
- In what ways are custodial services that are provided by state chartered trust companies equivalent to those provided by banks, broker-dealers, and futures commission merchants? In what ways do they differ? Would there be any gaps in – or enhancements to – protection of advisory client assets as a result of a state chartered trust company serving as qualified custodian of digital assets or other types of client assets?
- How do advisers assess whether an entity offering custodial services satisfies the definition of qualified custodian in the Custody Rule? What qualities does an adviser seek when entrusting a client's assets to a particular custodian? Do the qualities vary by asset class? That is, are there qualities that would be important for safeguarding digital assets that might not be important for safeguarding other types of assets? If so, what qualities and why? Should the rule prescribe different qualities based on asset class, or should the rule take a more principles-based approach and allow advisers to exercise care in selecting a custodian?
- Are there entities that currently satisfy the definition of qualified custodian under the Custody Rule that should not be included within that definition because they do not meet the policy goals of the rule? If so, which ones and why? Conversely, are there entities that currently do *not* satisfy the definition of qualified custodian but should? If so, which ones and why?

Submissions in response to this request will be made publicly available, and persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. Please submit only information that you wish to make publicly available.

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[2] Investment Advisers Act of 1940, Pub. L. No. 76-768, 54 Stat. 847 (codified as amended at 15 U.S.C. 80b-1 – 88b-21 (2012); 17 CFR 275.206(4)-2. As relevant here, "qualified custodian" is defined in the custody rule as "a bank as defined in section 202(a)(2) of the Advisers Act or a savings association as defined in section 3(b)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(b)(1)) that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act (12 U.S.C. 1811)," and "bank" is defined in section 202(a)(2) to include "…(C) any other banking institution, savings association, as defined in section 1462(4) of title 12, or trust company, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and which is supervised and examined by State or Federal authority having supervision over banks or savings associations, and which is not operated for the purpose of evading the provisions of this subchapter …".

[3] Wyoming Division of Banking, "No-Action Letter on Custody of Digital Assets and Qualified Custodian Status" (Oct. 23, 2020), available at http://wyomingbankingdivision.wyo.gov/home/pressreleases/twooceanno-actionletterdigitalassetcustodyqualifiedcustodianstatus.

[4] The Commission and the Staff, in considering the requirements of the Custody Rule and any enforcement actions thereunder, are not bound by statements or views expressed by state regulators. This includes statements or interpretations regarding custody of digital assets as well as more traditional securities and whether any entity is a "qualified custodian."

[5] With respect to one aspect of this analysis – whether any entity's business consists of exercising fiduciary powers similar to those permitted to national banks as required by the definition of "bank"– the Staff expects that it would consult with the staff of the Office of the Comptroller of the Currency.

[6] *See* Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2876 (May 20, 2009) [74 FR 25354 (May 27, 2009)], available at https://www.sec.gov/rules/proposed/2009/ia-2876.pdf, at note 4 (discussing the key characteristics of financial institutions that may act as qualified custodians).

[7] Written feedback we have received in response to the Staff's letter on Engaging on Non-DVP Custodial Practices and Digital Assets is available at https://www.sec.gov/investment/engaging-non-dvp-custodial-practices-and-digital-assets. The IM Staff Letter on Engaging on Non-DVP Custodial Practices and Digital Assets (Mar. 12, 2019) is available at https://www.sec.gov/investment/non-dvp-and-custody-digital-assets-031219-206. Comments are made publicly available to further a dialogue on these issues as the Staff prepares recommendations for amendments to the Custody Rule for Commission consideration. *See, also*, Securities and Exchange Commission Regulatory Flexibility Agenda, available at https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202004&RIN=3235-AM32.

Related Materials

- Comments Received

Statement

SEC FinHub Staff Statement on OCC Interpretation

SEC FinHub Staff

Sept. 21, 2020

The Securities and Exchange Commission Strategic Hub for Innovation and Financial Technology Staff (FinHub Staff) issues this statement[1] on an interpretation published by the Office of the Comptroller of the Currency (OCC Interpretation)[2] addressing the authority of national banks and federal savings associations to hold stablecoin reserves. The OCC has limited its Interpretation to holding reserves of a stablecoin associated with hosted wallets that is backed by a single fiat currency and redeemable by the holder of the stablecoin on a 1:1 basis for the underlying fiat currency upon submission of a redemption request to the issuer.

Whether a particular digital asset, including one labeled a stablecoin, is a security under the federal securities laws is inherently a facts and circumstances determination. This determination requires a careful analysis of the nature of the instrument, including the rights it purports to convey, and how it is offered and sold.[3]

We believe that market participants may structure and sell a digital asset in such a way that it does not constitute a security and implicate the registration, reporting, and other requirements of the federal securities laws. However, the label or terminology used to describe a digital asset or a person engaging in or providing financial activities or services involving a digital asset, may not necessarily align with how that asset, activity, or service is defined under the laws and rules administered by the SEC. We encourage parties seeking to structure and sell a digital asset, or to engage in related activities, to contact the FinHub Staff through www.sec.gov/finhub with any questions they may have to help ensure that such digital assets are structured, marketed, and operated in compliance with the federal securities laws. The Staff stands ready to engage with market participants to assist them and to consider providing, if appropriate, a "no-action" position regarding whether activities with respect to a specific digital asset may invoke the application of the federal securities laws.

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[1] This statement represents Staff views and is not a rule, regulation, or statement of the Commission. The SEC has neither approved nor disapproved its content. SEC Staff statements, like all SEC Staff guidance, have no legal force or effect: they do not alter or amend applicable law, and they create no new or additional obligations for any person.

[2] See OCC Interpretation (Sept. 21, 2020).

[3] See SEC v. W.J. Howey Co., 328 U.S. 293 (1946); Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce Fenner & Smith, 756 F.2d 230 (2d Cir. 1985). Market participants are encouraged to review the materials relating to digital assets published on www.sec.gov/finhub. For example, the FinHub Staff has published a framework to assist market participants in determining whether a particular digital asset is an investment contract and therefore a security. See Framework for “Investment Contract” Analysis of Digital Assets (Apr. 3, 2019).

EXHIBIT F

Public Statements & Remarks

Remarks of Commissioner Dawn D. Stump: We Can Do Hard Things

As Prepared for Delivery at the Chamber of Digital Commerce

January 13, 2022

I want to thank the Chamber of Digital Commerce for inviting me to speak today. Before beginning, I want to provide the standard disclaimer that the views I express today are my own and not necessarily those of the Commission I am proud to serve upon.

Do any of you have a theme song? I have several that describe various milestones in my life, and as I reflect on my time at the CFTC, I'm leaning towards *I Can Do Hard Things* by Jennifer Nettles. [1] As the song goes, "Sometimes I don't like it, but that don't mean I don't love it." I do love my job—not in spite of, but because of, the challenging matters that we tackle (often in the face of difficult circumstances well beyond our comfort zones).

That's where I would like to start—getting out of our comfort zones and doing hard things. This is front of mind for me in light of the incredible innovations we are seeing these days in terms of the structure, products, and services being offered in financial markets. Many—but by no means all—of these innovations arise from developments in financial technology such as the growth of digital assets and decentralized finance (or DeFi).

As financial markets evolve and adapt to new demands, market regulators must not stifle beneficial innovations by clinging rigidly to regulatory approaches of the past that may no longer be fit for purpose. But by the same token, infrastructure providers who offer the market access to new, innovative services must not dismiss the fact that they may be required to seek and comply with regulatory oversight in order to assure market integrity and customer protection. It's time to thoughtfully consider the *hard things* we all must do to get comfortable with current realities.

So there, I have acknowledged the obvious, but why is this so hard? Achieving the benefits of innovation in the context of market regulation is tougher than it sounds because we are not starting with a clean slate. Take, for example, the U.S. derivatives markets regulated by the Commodity Futures Trading Commission. These markets have, for some time, been characterized by futures and swaps contracts with varying degrees of execution and clearing occurring on centralized venues through intermediaries responsible for brokering and guaranteeing such transactions predominantly for institutional clients. Recently, though, the pace of technological development and increasing retail interest in these markets is driving new business models that rely less on the traditional centralization of institutional participation via intermediaries, and rather propose to fulfil these functions in a more decentralized way.

These new market innovations are increasingly presenting novel issues that require comprehensive thinking by those of us at the CFTC who regulate the derivatives markets. I believe that our current approach of relying primarily on enforcement actions to impose penalties on those with novel products and markets for their failure to register with the agency is simply an insufficient response. I agree that many of the entities in question should be registered with the CFTC for oversight purposes, as we are tasked by Congress to regulate the infrastructure that permits access to swaps and futures—and many of these entities are, in fact, performing that function. However, we must acknowledge that the infrastructure we oversee is rapidly changing—and our current regulatory regime was not designed to fit the types of services that are evolving to meet the market's demands.

So, what's a regulator to do—continue to take enforcement actions against companies that develop products and business models that are outside-the-box, all the while knowing that our existing rules governing the registration and regulation of the traditional market infrastructure are ill-suited to the very thing that has driven their development (*i.e.* an expansion in the types of participants seeking access to these products and markets, and their preference for less intermediation)? Certainly, that is the easiest answer: "It's not our job to tell you how to meet our rules, just figure it out." Wait, what? How do we expect these companies to conform to a system that does not recognize their value add, the demands of their customers, or even perhaps the future of these markets? What is the goal—to shut down these services, or to encourage those who deliver these services to do so under proper oversight?

I certainly hope it's the latter. After all, it is innovation that provides solutions to meet new market demands. Congress has established a principles-based regime with flexibility to permit adaptation to innovation in the derivatives markets. And welcoming innovation in those markets historically has been at the heart of what we do at the CFTC.

I believe it is thus incumbent upon the CFTC to bridge the gap between its enforcement and oversight functions by setting more clearly defined regulatory expectations for new, innovative applications in the derivatives market infrastructure. That is a much taller task as compared to simply enforcing rules on the books beyond their original context. It's a tough job—but it is our job—and I am confident in our ability to do *hard things*. We cannot be mere bystanders to the fundamental market changes taking place before our eyes, nor should we abdicate the responsibility Congress has given us to "*promote* responsible innovation and fair competition."[2]

Adaptation by market regulators, however, should not be viewed by participants as a means to escape regulation. Quite the contrary, our adaptation to innovation is necessitated by the responsible oversight we owe the marketplace. As these matters continue to land on the CFTC's enforcement docket, it is urgent that we provide direction to those who seek to comply with the law. And then, armed with more clearly defined expectations, the CFTC can better identify those truly bad actors who seek evasion of the rules—and who deserve the full force of robust enforcement action.

In an attempt to start a helpful conversation, I have below identified a non-exhaustive list of areas in which our current rulebook governing infrastructure may require adapting to account for various new innovations taking shape in response to current market demands:

Trading Platforms (Designated Contract Markets and Swap Execution Facilities): In its recent enforcement action against Polymarket,[3] the CFTC found that an online trading platform offering event-based binary options failed to register as a designated contract market (DCM) or swap execution facility (SEF). To operate its markets, Polymarket deploys smart contracts, which are hosted on a blockchain. This was a matter of first impression for the CFTC with respect to a blockchain-based trading platform. Yet, despite this fundamental difference from the traditional DCM/SEF infrastructure for which the CFTC's rules were written, the CFTC has not given any public consideration to how such a platform seeking to register as a DCM or SEF would be expected to operate under its existing rules.

The term "DeFi" is often used to describe some of the protocols relevant in this framework, and some argue DeFi can exist without regulatory oversight—a topic I will leave for another day. But in a broader sense, I believe that DeFi is spurring innovative functionalities by market infrastructure providers that may improve efficiencies for those seeking the benefit of centralized liquidity (a feature of more traditional and regulated derivatives markets). The really *hard thing* that requires our attention is this: How do we achieve our regulatory objectives in a manner that still enables infrastructure providers, and their customers, to benefit from these innovations?

Clearinghouses (Derivatives Clearing Organizations): Beyond trading, difficult questions persist relative to central clearing, which is a key tenet of addressing counterparty credit risks in derivatives markets. Our clearing rules are designed around a structure where intermediaries stand between clients and clearinghouses as guarantors, and where clients (often institutional) use leverage to increase their exposure. But we are lately seeing many new retail-focused derivatives clearing organizations (DCOs) that do not use an intermediary model.

To date, we have accommodated this model by imposing conditions such as requiring products to be fully collateralized. But as we begin to see requests from DCOs to offer leveraged clearing to retail market participants, we would be well-served to clearly define regulatory expectations before enforcing the application of ill-suited rules. And we must do so in a transparent way in order to fairly encourage competition. We are well aware that there is a need for such engagement to maintain the safety and soundness of DCOs while at the same time encouraging retail access to the clearing infrastructure. It's a difficult task, but *we can do hard things*.

Brokers and Counterparties (Futures Commission Merchants): In its recent enforcement action against Kraken,[4] the CFTC found that an online exchange enabling customers to engage in "retail commodity transactions" in digital assets such as Bitcoin operated as an unregistered futures commission merchant (FCM) with respect to those transactions. This finding begs the question: If Kraken had sought to register as an FCM, how would it have been expected to operate? The CFTC has never comprehensively addressed how retail commodity transactions are to be regulated, and many of the CFTC's rules for traditional FCMs do not fit Kraken's role as an exchange.[5] As a result, we are now obligated, in my view, to explain the regulatory parameters such transactions and such non-traditional FCMs are expected to meet—yet, another *hard thing* the CFTC must tackle.

In conclusion, the key takeaway is that we are at a crossroads that requires everyone to roll up their sleeves and *do hard things*. Derivatives infrastructure providers must recognize that while their business models may be novel, they do not operate outside of the regulatory oversight required by U.S. law under the Commodity Exchange Act. And for its part, the CFTC must urgently consider fine-tuning its rulebook (often a hard and tedious task), because responding to technological developments and ongoing market dynamics primarily through enforcement is neither good for the marketplace nor sustainable for the agency. We all benefit from clearly defined regulatory expectations that promote compliance and strong enforcement focused on those who blatantly disregard such expectations to the detriment of your markets.

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[1] Jennifer Nettles, "I Can Do Hard Things," I Can Do Hard Things EP (Big Machine Records, LLC 2019).

[2] Section 3(b) of the Commodity Exchange Act, 7 U.S.C. § 5(b) (emphasis added).

[3] *In re Blockratize, Inc. d/b/a Polymarket,* CFTC Docket No. 22-09 (January 3, 2022).

[4] *In re Payward Ventures, Inc. (d/b/a Kraken)*, CFTC Docket No. 21-20 (September 28, 2021).

[5] *See* Concurring Statement of Commissioner Dawn D. Stump Regarding Enforcement Action Against Payward Ventures, Inc. (d/b/a Kraken) (September 28, 2021), available at https://www.cftc.gov/PressRoom/SpeechesTestimony/stumpstatement092821b (https://www.cftc.gov/PressRoom/SpeechesTestimony/stumpstatement092821b). *See also* Concurring Statement by Commissioner Dawn D. Stump Regarding Tether and Bitfinex Settlement (October 15, 2021), available at https://www.cftc.gov/PressRoom/SpeechesTestimony/stumpstatement101521 (https://www.cftc.gov/PressRoom/SpeechesTestimony/stumpstatement101521).

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UNITED STATES OF AMERICA
Federal Trade Commission
WASHINGTON, D.C. 20580

Office of Commissioner
Rebecca Kelly Slaughter

NTIA Listening Session on Privacy, Equity, and Civil Rights

Keynote Address of Commissioner Rebecca Kelly Slaughter[1]
As Prepared for Delivery

December 14, 2021

Good afternoon, everyone! I'm Commissioner Rebecca Kelly Slaughter from the Federal Trade Commission. It's my pleasure to be able to address you all at the start of the NTIA's listening sessions on privacy and civil rights. I'd like to thank Assistant Attorney General Kristin Clarke for her remarks; the country is so fortunate to have her leading on civil rights and economic justice issues at the Department of Justice.

Thanks as well to everyone at the NTIA that put this event together. Addressing the systemic harms of the data economy, especially those related to civil rights, is going to require coordination across agencies and sustained public participation. I'm excited to hear from the scholars and advocates speaking over the next few days. Your work is integral to advancing policymakers' understanding of these issues and your persistent advocacy helps ensure that we take bold action on advancing the cause of fairness, civil rights, and justice in every corner of our economy.

I am particularly excited that the organizers of this listening session have recognized from the outset that unfair or invasive data practices—like digital redlining, over-surveillance, and other harms to historically marginalized groups—extend beyond a limited understanding of "privacy" violations. These harms, which I think of as data abuses, often stem from the indiscriminate collection of personal data in order to fuel pervasive commercial surveillance in our economy. The framing of these listening sessions has it right. And I think is reflective of an evolution in how the government is approaching data and technology issues across agencies. I can't emphasize enough how glad I am to see us all talking about these issues this way.

The Department of Commerce and the White House have recently announced some artificial intelligence initiatives in an effort to guide the safe use of these tools in the economy. We're seeing the application of this technology in healthcare, criminal justice, employment, credit, and housing—all sectors where historically marginalized communities have been shut out of full and equal access to opportunities and services. Some of the application of these technologies holds promise; it can help distribute opportunities more broadly, resources more efficiently, and benefits more effectively. But technological tools are not necessarily free of the

[1] The views expressed in these remarks are my own and do not necessarily reflect the views of the Federal Trade Commission or any other commissioner.

weaknesses that plague their human designers, and they can be used to perpetuate and exacerbate discrimination and injustice.

Agencies across the government need to take action to address these issues within their spheres of competence. I'd like to unpack some of my thinking about the harms of algorithmic decision-making and artificial intelligence that exist at the intersection of privacy and civil rights, talk about the tools and legal authorities we have at the Federal Trade Commission to address these harms, and how FTC rulemaking play a role.[2]

I've been thinking about algorithmic harms in a few different ways. Poorly designed algorithms facilitate discriminatory harms through faulty inputs, faulty conclusions, and a failure to audit or test those algorithms for discriminatory outputs. But not all harms stem from design; algorithms can also facilitate proxy discrimination, enable surveillance capitalism, and inhibit competition in markets. Failure to closely scrutinize the impact of data-driven decision-making tools can drive discriminatory outcomes.

Figuring out how to map the FTC's authority onto these new technologies in order to effectively and proactively address these harms is a challenge. But, fortunately, we have at our disposal our general authority under the FTC Act; sector-specific rules and statutes, such as the Fair Credit Reporting Act and the Equal Credit Opportunity Act; and our section 18 rulemaking authority.

Most of the enforcement activity conducted by the FTC is brought under the general authority provided to the Commission by section 5 of the FTC Act, which prohibits unfair or deceptive acts or practices. The Act is more than a century old, and since its passage, the agency has been able to apply the statute's general language to meet new enforcement challenges. That same approach urgently needs to be applied to the harms generated by the data-driven economy.

We have our section 5 deception authority which can be used in connection with algorithmic harms where the marketers of certain products or services represent that they can use marching learning technology in unsubstantiated ways. I believe the FTC has an opportunity here to call out algorithmic snake-oil, especially in areas like facial or affect recognition where it's likely these products just cannot deliver on their promises and create huge society-wide harm when their hype is taken at face value.

We can also use our unfairness authority to target algorithmic injustice. The unfairness prong of the FTC Act prohibits conduct that causes or is likely to cause substantial injury to consumers, where that injury is not reasonably avoidable by consumers and not outweighed by countervailing benefits to consumers or to competition. I believe discriminatory harms fall neatly within our unfairness authority. Surreptitious location tracking could give rise to this kind of claim. Or we could use unfairness where an algorithm is used to exclude a consumer from a benefit or an opportunity based on her actual or perceived status in a protected class. Our unfairness authority goes beyond traditional civil rights claims as well. It gives us the opportunity to examine practices like facial recognition and other kinds of increasingly unavoidable biometric data collection which may lead to discriminatory outcomes.

[2] *See* Rebecca Kelly Slaughter, Algorithms and Economic Justice, 23 YALE J. L. & TECH. 1, 11-14 (2021).

I also believe we should also look towards more creative enforcement of our FCRA and ECOA authority. For example, ECOA prohibits credit discrimination on the basis of race, color, religion, national origin, sex, marital status, age, or because you get public assistance. Everyone who participates in the decision to grant credit or in setting the terms of that credit, including real estate brokers who arrange financing, must comply with the ECOA. If lenders are using proxies to determine groups of consumers to target for high interest credit and such proxies overlap with protected classes, the FTC should investigate and, if appropriate, pursue ECOA violations.

A bolder approach that I would like to see the FTC take is to incentivize creditors to make use of the ECOA exception that permits the collection of demographic information to test their algorithmic outcomes. ECOA permits and the FTC should encourage non-mortgage creditors to collect demographic data on most borrowers and use it to reduce disparities and train AI and other algorithmic systems to reduce disparities. Vanishingly few creditors take advantage of this exception, thinking it's just much easier to never ask about race or gender. But this kind of self-testing has to be part of any effort at ensuring that algorithms do not create discriminatory outcomes.

Finally, I believe it is past time for the FTC to begin a section 18 rulemaking process on data abuses; among other benefits, this process can have a clarifying effect for the Congressional debate. Participating in the rulemaking process means businesses, advocates, consumers, workers, researchers, and other interested parties will all have the opportunity to make their opinions known, out in the open, and with specificity in the public record. An open record can provide substantiation of the types of consumer protection and competition harms people are experiencing in digital markets, and it can illuminate how we can act decisively to stamp out these abuses.

If and when the FTC opens that rulemaking record, I hope we'll see the kind of broad participation from the experts we're about to hear from at the NTIA about how we can best address these harms. The era of deploy and hope for the best, or "move fast and break things," has to be over. We're living with the consequences of an unregulated tech sector. I hope the next generation of technology is deployed with a critical eye toward its potential harmful effects so we can all reap the benefits of advanced algorithmic decision-making together.

Thank you all for you time.

Speech

PDF

February 10, 2020

Empowering Community Banks

Governor Michelle W. Bowman

At the Conference for Community Bankers sponsored by The American Bankers Association, Orlando, Florida

Share

Thank you to the American Bankers Association for inviting me to address this year's Conference for Community Bankers. I am delighted to be here with you again. Let me begin by stating that the views I express today are my own, and not necessarily those of the Federal Reserve.

As community bankers, you have worked hard to develop a deep understanding of your local economies, while also keeping perspective on the broader economic picture. There is little I could tell you about your local communities that you do not already know, but I thought I might say a few words on the national economic outlook before turning to my main topic for today.

My colleagues and I on the Federal Open Market Committee had our most recent meeting about two weeks ago, when we decided to keep our target range for the federal funds rate unchanged at 1-1/2 to 1-3/4 percent. This policy setting should help support the economic expansion, which is now in its 11th year. My outlook for the U.S. economy is for continued growth at a moderate pace, with the unemployment rate—which is the lowest it has been in 50 years—remaining low. I also see inflation gradually rising to the Committee's 2 percent objective. So on the whole, the national economic backdrop looks very favorable, which should be broadly supportive of your local economies. And of course, by ensuring that consumers and businesses in your communities have access to financial services, you are key contributors to the health of our national economy.

Let me now turn to my main topic for today, the interaction between innovation and regulation for community banks. As the Federal Reserve Board's first designated governor with experience in community banking, I am committed to maintaining a strong and thriving community bank sector. Small banks are the lifeblood of their communities—and they ensure that consumers and businesses have access to financial services. This capacity to address local needs is fundamental to a strong and stable financial system. To community bankers, customers are much more than their credit score or their annual income, and small businesses are far more than their most recent revenues. By extending credit and offering specialized products and services that meet the needs of their borrowers, these banks empower communities to thrive.

We live in an exciting time, when the face of banking is changing faster and perhaps more fundamentally than it ever has. The first digital banks appeared on the scene about 25 years ago. Since then, financial technology has evolved rapidly. Technology puts more information in the hands of both the customer and the bank. As financial institutions succeed in digitizing more of their offerings, customers are able to monitor cash flows, make direct payments, understand changes in their credit scores, track spending, and budget more easily. Technologies like predictive analytics, when supported with appropriate consumer protections, can improve bank services and performance by enabling continuous tailoring of the customer experience. It also helps banks identify products that are best suited for their customers and their business model and strategy. For those account holders who are willing, an analysis of spending habits may indicate that they could benefit from services they hadn't yet considered.

But successful innovation is not just about adopting the latest technologies. Successful innovation has always required strategic vision and creativity. Community banks thrive when they find creative ways to serve their communities, using everything they know to build relationships, offer solutions, and make lending decisions. We need only look to the performance of community banks during the financial crisis to see how well they leverage this local knowledge and their relationships to make lending decisions.

After the onset of the crisis, community banks' superior loan quality resulted in lower aggregate delinquency and charge-off rates compared to the largest banks. This superior performance was widespread—community banks in the vast majority of states outperformed the largest banks in this way.[1]

Even today, community banks continue to perform with distinction. In the third quarter of 2019, community banks' pre-tax return on average assets was 1.5 percent, marking the highest pre-tax return on assets ratio reported by community banks since 2006. Asset quality also remains strong for community banks and is better than for larger banks. The community bank net charge-off rate for total loans and leases was less than 0.2 percent at the end of the third quarter 2019. Let me state that again—the net charge-off rate was less than 0.2 percent, less than half of the industry average. Community bank capital levels remain at continued high and increasing levels. Community banks reported a total risk-based capital ratio of nearly 16 percent, as compared to the industry average of less than 15 percent. This type of performance positions the community banking sector for continued success this year and well into the future, helping ensure the preservation of the community bank model for future generations of Americans.

Community banks understand their borrowers and their specific needs. While technology continues to evolve and change the way we live and bank for the better, it still cannot by itself fulfill that unique and vital role.

Today, there are more than 4,800 community banks in the United States.[2] Nearly 80 percent of these have assets totaling less than $500 million, with roughly 40 full- and part-time employees, on average. The vast majority of these community banks are financially strong, and are the backbone of the towns and cities they serve, providing loans to individuals and businesses in the local area. But as customers' needs and goals evolve, community banks will need to evolve to meet them.

The successful integration of financial technology into the community bank business model is proving to be enormously valuable to enable community banks to enhance the services they've already proven they can deliver effectively. Access to technology and services to meet customer needs is critical to ensuring community banks remain vibrant.

For the remainder of my remarks, I will focus on my vision for creating pathways to responsible community bank innovation. In particular, I will discuss the promise and the challenges that smaller banks face in identifying, integrating, and deploying transformative new technologies, and I will offer some ideas for how the Federal Reserve can help community banks find and manage their relationships with service providers.

Clearing a Path for Innovation

Community banks have always been innovators, but rapid technology adoption is challenging for banks of all sizes. In most cases, realizing the potential that technology offers requires community banks to obtain services from other companies or products from core service providers, which I will refer to collectively as third-party providers. As I noted earlier, banks with less than $500 million in assets employ roughly 40 people on average—nowhere near the number required to exhaustively develop, test, and manage every element of novel technologies. In my discussions with bankers, they note that the process of selecting, initially vetting, and continuing to evaluate third-party service providers is onerous and presents obstacles to successful innovation.

I agree that the cost of complying with some of our regulations and expectations for third-party relationships can pose an outsized and undue burden on smaller banks. These compliance costs are in some instances disproportionate to bank size, complexity, risk, and capacity and can be the same for a bank with $10 million in assets and a bank with $10 billion in assets. Further, expectations of due diligence when applied to a potential fintech partner may require more financial history or information than that partner can provide.

Due diligence for new third-party relationships, even those that are not start-ups, can require a community bank to collect and analyze a significant amount of complex information. Also, the annual monitoring that is required adds an additional significant and ongoing burden. The process for managing the annual collection and review of the financials, audit results, and other operational compliance materials for multiple vendors can take weeks of time for several employees. Bank employees must review thousands of pages of documentation, and the workload per vendor can be the same for all banks, regardless of their asset size and number of employees. And as someone who has been involved in this compliance work, I know that it's not as if other responsibilities can wait—community bank employees often wear several hats. Community banks must weigh the benefit of any third-party relationship against the additional work required to evaluate the third party. And even when new product offerings emerge from service providers that already serve the bank, contract terms can be complicated to adjust, adding to the costs of obtaining technologies, which may ultimately be prohibitive. Flexible core systems are important for this reason. Collaboration between a bank and its core system provider is critical to ensure that technology solutions can be integrated quickly and cost effectively within the core system.

Creating the Right Regulatory Environment

Responsible innovation, especially for smaller institutions, requires two key aspects: a clear idea of how the technology serves a bank's strategic objectives and a regulatory environment that supports innovation. I will touch today on the important interplay between these factors, and in particular, the role that regulators can play in creating a regulatory environment that is conducive to innovation, preserves the safety and soundness of the financial system, and protects consumers. As regulators, we need to ensure that banks uphold sound risk-management practices. Yet we also have information that can help community banks meet those standards. We should closely examine opportunities to share that knowledge, subject to appropriate safeguards, in order to support innovation.

Responsible innovation begins with a bank's strategy. Banks need to identify their goals and then look to identify the kinds of products and services that can help them move forward to implement that strategy. In the past, I have spoken about the importance of considering the impact of new technologies and finding ways to leverage them, if a bank feels that it fits into its business model and strategy. For community banks, a decision to embrace a new technology or innovation is almost always synonymous with third-party engagement.

Regulators and supervisors can contribute to an environment where banks are empowered to achieve these strategic objectives, simplifying and clarifying the process of third-party selection, due diligence, and monitoring.

A bank may decide that its business model should evolve, and that offering a new product or partnering with a fintech company will help it position itself for future growth. This decision is an essential one, but what comes next? This is a new world for most community banks, and supervisors and regulators can lend their expertise to those banks seeking to navigate the unfamiliar landscape.

To that end, the Federal Reserve recently launched a web page on innovation and announced several upcoming Reserve Bank events. The innovation page on our website (www.federalreserve.gov/innovate) is intended to be a one-stop shop for supervisory information, publications, research, and international work that is related to technology innovation. Most importantly, the web page also facilitates interaction with Federal Reserve System specialists, to enable bankers and tech industry participants to submit questions about all aspects of technology in the financial services industry, or to request an in-person meeting. Essentially, to open a dialogue.

We have also launched a series of Innovation Office Hours events hosted by Reserve Banks. These events incorporate panel discussions and face-to-face meetings for bankers with regulators and supervisors, which are intended to be a resource for both state member banks and fintech companies seeking partnerships with or offering services to banks. During these meetings, banks that attend the office hours will have an opportunity to share specific projects or proposed partnerships and learn about how regulators approach and consider risk management in those contexts. Regulators can also share their observations about effective implementation and risk-management practices across the sector. Equally important, the events provide regulators an opportunity to hear directly from banks and fintech companies about challenges to innovation. The office hours events will also include a panel discussion on innovation topics that will help to provide additional insights into new financial technologies. Our first office hours event will be held at the Federal Reserve Bank of Atlanta later this month. Additional events are planned later in the spring and throughout the rest of the year. These are an important opportunity for us to learn, and I look forward to hearing your feedback on these events.

I'd like to turn next to another step in this process—the selection of a third-party provider. This step can be challenging given a lack of information about potential partners when many firms, and their product offerings, are new. Notably, in the 2019 National Survey of Community Banks, community bankers voiced a desire for more transparency into third-party service providers, to inform decisions about whether to enter into contracts with these providers and the type of contract that may be appropriate.[3]

In this regard, I believe the Federal Reserve should consider several possible steps. First, we should explore the possibility of publishing the list of service providers subject to supervision by the agencies. This could provide a starting point for community banks by sharing information about the types of companies providing services to a large number of financial institutions.

Second, I believe we should increase transparency around our own practices. Through the banking agencies' service provider program, we regularly conduct examinations for and produce independent evaluations of certain providers of critical services. These exams are focused on risk management, audit, and internal controls. The Fed and other agencies have the statutory authority to oversee third-party providers that serve the banks they supervise. Providers that represent a significant level of risk to their clients are part of an interagency supervisory program. The agencies make the outcomes of those exams available to banks that are clients of a supervised service provider.

I believe we can take a step further with increasing transparency on our supervisory program by making information that may be useful about our supervision of key service providers available to banks. This could take a number of forms, such as being more transparent about who and what we evaluate. Of course, moving forward in these areas requires careful consideration and interagency collaboration, and I have asked our staff to work with other agencies to develop and propose workable options for giving banks the benefit of the knowledge that supervisors have about their potential providers in an appropriate manner.

Once banks seeking to innovate have navigated the selection process and identified a partner, they now face a complicated due-diligence process. I believe that regulators and supervisors have a role in easing the burden of that process for community banks in several respects.

First, we could help by implementing clear third-party guidance that is consistent across all regulatory agencies. The Federal Reserve is in the process of working with the other banking agencies to update our third-party guidance. I believe that the banking agencies should all have consistent expectations for third-party relationships, and that the Federal Reserve should, as a starting point, move toward adopting the Office of the Comptroller of the Currency's (OCC) guidance. It is incredibly inefficient to have banks and their potential fintech partners and other vendors try to navigate unnecessary differences and inconsistencies in guidance across agencies.

Second, this guidance should allow banks to conduct shared due diligence on potential partners. If several banks use the same third-party service provider and are open to collaborating, they should be allowed to pool resources instead of duplicating one another's work.

Third, the guidance should explain what due diligence looks like for a potential fintech partner, because the standards applied to other third parties may not be universally applicable. For example, many fintech companies lack the kind of long financial history associated with more traditional bank vendors. Perhaps a fintech company has been around for only a few years. On its own, the fact that a bank cannot evaluate more than five years of the company's financials should not necessarily stop this company from being considered as a partner. Every bank has different objectives, and potential partnerships are not one-size-fits-all. Regulators should especially support partnerships that combine the strengths of community banks and fintech companies, which have a track record of success. The guidance should reflect some supervisory flexibility, and not impede prudent, strategic partnerships between community banks and potential partners.

Fourth, in order to give community banks a better picture of what success in due diligence looks like, and where it begins and ends, I also believe that we should release more information on its necessary elements. This change would provide clarity and assist community banks in completing their work. In particular, I believe that regulators can provide more clarity on the types of questions that should be asked of a prospective third-party provider and our view of a satisfactory answer. Such a handbook would not only have the benefit of increasing transparency for community banks but could also be beneficial for fintech companies that hope to become third-party providers.

Finally, I know from experience that once due diligence has concluded, the evaluation of third-party relationships is not over. As I noted earlier, monitoring can take weeks of work every year for community bank employees. To be sure, this work is an important part of risk management. But I believe regulators and supervisors have a role to play in ensuring that the burden is tailored to bank size, risk, complexity, and capacity. Knowing the burden that third-party monitoring can present to employees of the smallest banks, I have encouraged Federal Reserve staff to consider options for further tailoring our expectations for community banks with assets under $1 billion in this area. We should be mindful that when we apply the same expectations to banks with starkly different asset sizes, we are creating the same workload for a bank with about 30 employees as for a bank with roughly 180 employees, even though their resources and risk profiles are quite different.

Closing Remarks

To conclude, I believe that we can create a regulatory environment in which community banks are empowered to innovate, in which supervisors leverage their own knowledge to help banks understand what to look for in a service provider. It's a regulatory environment in which guidance is clear and supervisors are appropriately flexible, and due diligence and third-party evaluations are appropriately scaled.

Every bank must decide for itself whether and how to adapt their business models to new technologies, but supervisors and regulators can facilitate innovation at a few key milestones on that path forward. First, supervisors and regulators can serve as a resource for banks navigating the financial technology landscape for the first time, and make subject-matter experts accessible. Second, we can make the process of selecting a partner appropriate for a bank's business strategy a more informed one, by being more transparent about our own supervisory program for certain service providers. Third, we can facilitate vetting of potential partners by allowing shared due diligence, providing in our guidance specific expectations for partnerships with fintech companies, and publishing a handbook of sound practices in due diligence. Finally, we can reduce burden on banks as they continue to evaluate risk at third-party providers, by rightsizing our expectations and sharing more information about our supervisory program. Capacity, in addition to complexity and size, should be considered as we continue to tailor supervisory expectations.

As we work toward the environment I described, communication between regulators, supervisors, banks, and fintech partners must be frequent, and confusion about compliance requirements must not be an impediment to banks who wish to partner with third parties. I believe the steps I have laid out today are a promising beginning to making this regulatory environment a reality.

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1. See Jeffrey W. Gunther and Kelly Klemme, *Financial Stability: Traditional Banks Pave the Way* (PDF) (Dallas: Federal Reserve Bank of Dallas, 2012). Return to text

2. See Federal Deposit Insurance Corporation, *FDIC Quarterly Banking Profile* (PDF) 13, no. 4 (Third Quarter 2019). Return to text

3. See https://www.communitybanking.org/~/media/files/publication/cb21publication_2019.pdf . Return to text

Last Update: February 10, 2020

Remarks of Mark W. Olson at the AICPA National Conference on Current SEC and PCAOB Developments

Mark W. Olson
Chairman
Public Company Accounting Oversight Board

December 11, 2006

INTRODUCTION

I appreciate the opportunity to be here today to offer you a sense of some current priorities and recent developments of the Public Company Accounting Oversight Board (or PCAOB), and how they may intersect with U.S. competitiveness, an issue, which for good reason, is currently at the top of many agendas.

I would like to share my views on the PCAOB application of a supervisory model in overseeing auditors. The six months that I have logged with the PCAOB, added to my years in banking supervision, have only strengthened my belief that the Board's mandate to oversee the auditors of public companies continues to be best accomplished through robust supervision that is premised on a communicative relationship. In addition to a close dialogue with the firms that the PCAOB supervises, our overall mandate is best achieved through communication with external stakeholders. This philosophy has assisted the work of the Board immensely.

Before I go further, I must note that the views I express today are my own, and not necessarily those of other Board members or staff of the PCAOB.

News & Events Headlines

Events

- **Forum on Auditing in the Small Business Environment**

News

- Board to Consider Proposing a Revised Auditing Standard on Internal Control over Financial Reporting
- Board Approves 2007 Budget
- Board to Hold Forum in Chicago on Auditing in the Small Business Environment

What's New

- View a list of web site updates or join the mailing list.

News & Event Archives

Webcasts

- Listen to web casts of past Board, Standing Advisory Group, and roundtable meetings.

PCAOB CURRENT PRIORITIES

To begin our discussion this morning, I would like to mention where I see the PCAOB organizationally and then share with you some of our priorities.

Where the PCAOB is organizationally

Now in its fourth year of operation, the PCAOB has established a strong foundation for its oversight of public company auditors. Importantly, the Board continues to assess its oversight program, as we learn from our inspections program and the open and frank dialogue that we have with the audit firms. Based on what we learn, the Board is prepared to make appropriate adjustments to assure that it achieves the objectives of the Sarbanes-Oxley Act in the most effective and efficient manner possible. A supervisory model must remain flexible to keep pace with a dynamic industry.

From an organizational perspective, we must continue with our work to move the PCAOB from its start up phase into its steady state.

Standard Setting

Standard setting is one of the key roles of the PCAOB, and Tom Ray, the PCAOB's Chief Auditor and Director of Professional Standards, will speak later at this conference on the PCAOB's current standard setting priorities. My focus will be on highlighting how the PCAOB receives input regarding our rulemaking process. This is particularly important as we are at a critical stage in the PCAOB's rulemaking initiative for its auditing standard for internal control.

The Board seeks out input regarding its standards and rules from the many entities that have a stake in the changes that they may bring - including investors, accountants, executives and others through its Standing Advisory Group (or the SAG); comments received from the public; from domestic and international regulators; and from the many small business forums that we conduct across the United States. One important feature of this process is that the outreach takes place both prior to and after the effective date of a standard or rule.

Revising Auditing Standard No. 2 (AS2)

With regard to AS2, the PCAOB announced on December 5th that it will consider at a public meeting on December 19th proposing for public comment a new auditing standard to supersede the Board's existing auditing standard on internal control over financial reporting, and other related proposals. The proposals are the result of the PCAOB's two-year assessment of the standard's implementation for audits of issuers of all sizes. The PCAOB has focused on exploring ways to improve its audit requirements and accounting firms' implementation of them, while preserving the intended benefits. The proposal will be designed to focus auditors on areas that pose higher risk of fraud or material error in order to achieve cost-savings and the objectives of Section 404.

The PCAOB is working closely with the SEC to ensure that our goals are carefully aligned. Tom Ray is going to provide an overview of some key features you can expect to see reflected in the Board's proposal. However, it also is important for you to know that the PCAOB has remained committed to the four goals it announced in May:

- **First**, the PCAOB plans to propose changes to make the standard simpler to read, easier to understand and more clearly scalable to companies of any size. At the same time, by emphasizing core principles, the new proposal is expected to focus auditors on the areas of greatest importance.
- **Second**, the PCAOB is critically evaluating every area of the audit of internal controls to determine whether the existing standard encourages auditors to perform procedures that are not necessary to achieve the intended benefits of the audit.
- **Third**, the PCAOB plans to propose changes that would make explicit in the standard the PCAOB's past guidance on how to make internal control audits as efficient as possible.
- **Fourth**, the proposal should emphasize the importance of a company's control environment, and how it can impact the risk of financial reporting fraud or other material failure, in order to focus auditors on what really matters, which is identifying material weaknesses in a company's system of internal control before those weaknesses result in material misstatements in the company's published financial statements.

The SEC simultaneously is in the process of developing risk-based management guidance for implementing Section 404 that its Commission will consider on December 13th. It is important that these two initiatives are closely coordinated and that they are available for public consideration concurrently - the PCAOB has made coordination with the SEC a priority.

Beyond AS2

Based on our press coverage, one might be led to believe that the PCAOB's sole focus is AS2. The hard working professionals in the PCAOB's Office of the Chief Auditor certainly would disagree. While the PCAOB does not view the proliferation of standards as a performance measure, we do take our standard setting role very seriously. In addition to the tremendous focus rightly being given to AS2 at present, there are several other standard setting priorities on the PCAOB's agenda. I'd like to take a moment to highlight three of those other initiatives:

> **(i)** We are working closely with FASB to ensure that their accounting standards and our audit standards are closely aligned. An example of this work is our focus on changes to auditing literature that may be needed in order to conform with FASB's 2005 Statement of Financial Standards No. 154 (Accounting Change and Error Corrections) and their move to incorporate the "GAAP hierarchy" directly into their new accounting standard. Although this is largely a "housekeeping" matter, we do believe it is important for us to facilitate the FASB's projects in these areas and to bring the Board's standards in line with them.
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> **(ii)** Engagement quality review – The Sarbanes-Oxley Act requires the Board to include in the auditing standards it adopts a requirement that each registered public accounting firm provide a concurring or second partner review of each audit report. We refer to this as the engagement quality review. Over the past year, the PCAOB has taken time to more fully evaluate what we are learning in the inspections process about engagement quality reviews that are being conducted under the Board's interim concurring partner standard, and have made substantial progress on this project.
>
> **(iii)** Risk assessment – Other standard setters recently made some improvements to certain "core" auditing standards we refer to as the "risk assessment" standards. Our staff is in the process of analyzing the work of those other standards setters for the purpose of making recommendations to our Board as to how we should amend certain of the Board's interim standards.
>
> This is a large project that affects several of the Board's interim auditing standards. We have made progress in analyzing the issues, and are in the preliminary stages of our project. We plan to make substantial progress on this project over the next 12 months.

AUDITOR OVERSIGHT — THE PCAOB'S SUPERVISORY APPROACH

As some of you know first hand, the core of the PCAOB's supervisory model is its inspections program. PCAOB inspections are designed to identify auditing problems at an early stage and focus firms on correcting them. PCAOB inspections begin by looking at the professional environment in which audits are performed and focus on the influences – both good and bad – on a firm's audit practice. These influences include a firm's culture and the relationships between the firm's audit practice and its other practices, as well as between engagement personnel in field or affiliate offices and a firm's national office.

PCAOB inspections are also risk-based, in that they focus on the aspects of audits that present the greatest risk of undetected material misstatements of financial statements. When inspectors find an audit that is not satisfactory, they discuss with the firm precisely what the deficiency is. Often this dialogue leads to immediate corrective action. I place a great deal of emphasis on making this supervisory dialogue – and therefore the PCAOB supervisory model – be as valuable as possible.

Since I joined the PCAOB in July, I have made it a priority to visit each of our field offices and talk with the inspection teams. As with any supervisory model, the field inspectors are our eyes and ears, and are thus the front line in our ongoing supervisory dialogue with registered firms. That dialogue takes place in a structured way through the inspection process and the inspection report process.

Let me talk briefly about a few of the areas on which our inspections focus. Those of you who are most familiar with our inspection process, or who have read our public descriptions of inspections procedures at large firms, will recognize that this list is only a subset of what we look at.

For one thing, of course, we are always looking to see whether audit teams are being sufficiently objective. We look at whether auditors are treating their role as that of merely trying to gather enough evidence to support the issuer's position, or whether they are rigorously evaluating both corroborative and contradictory evidence.

We look at whether strains on individual partner capacity may contribute to issues with audit quality, and whether a firm's compensation practices provide incentives likely to promote audit quality and technical competence.

With respect to consideration of fraud, we look to see whether audit teams are mechanically complying with the requirements of AU 316, which sets out the auditor's responsibility with regard to fraud, rather than with its substance and intent by applying appropriate professional skepticism.

- For example, we check to see whether auditors appear to be appropriately modifying the nature, timing, and extent of audit procedures directly in response to an identified fraud risk, and whether auditors are varying their audit procedures to bring an element of unpredictability to the audit process.
- In addition, we look at whether firms' information technology resources are being used to their fullest extent to aid in the efficient and effective identification of certain potential indicators of fraud.

We look at how the concurring partner review process is implemented. This includes an assessment of the quality of the execution of the concurring partner reviews, and whether the level of concurring partner involvement appears to correspond with the firm's assessment of the audit risk. We also are attentive to whether the concurring review is a genuinely independent and objective assessment of the significant auditing, accounting, and financial reporting matters.

We look at these and other issues, and seek to engage with a firm in a constructive manner rather than an adversarial one. While still evolving, I believe the PCAOB's supervisory model is working. Our approach avoids attempting to manage the firm's quality control systems through overly prescriptive remedies, and the process is based on the assumption that each firm knows best how to manage its operations and to define the specific methods by which it can address a particular quality control criticism. This approach also allows each firm to craft effective remedies based on its particular organizational structure and operations.

I believe this model provides the best framework to encourage firms to take action to improve audit quality, and I am encouraged by what I understand about the level of cooperation generally from most firms.

It is encouraging to note the substantial and meaningful changes that some firms have made to enhance audit quality, including improvements relating to internal inspection, partner evaluation, promotion and compensation, and the supervision of foreign affiliates. The Board described many of these changes in a release issued this past March, and I think any reader of that release would have to be encouraged that the PCAOB's supervisory approach is helping to focus firms on meaningful improvement.

Additionally, the PCAOB's investigations and enforcement program is an important component of our auditor oversight; it provides a necessary tool for addressing the more serious violations of professional standards and other applicable law that we encounter in our auditor oversight activities. While I am mindful that remediation efforts are our preferred tool in addressing most deficient auditing practices, I believe that our enforcement efforts are vital for assuring that public confidence is not undermined by firms or individual audit professionals whose conduct does not reflect the profession's high standards of quality, independence, and competence.

A View on Competition and the Direction of Audit Firms

The audit profession continues to evolve. Over the last few years, we have seen audit firms realign their business models to focus on quality audit services and services that are consistent with maintaining appropriate levels of independence. (Non-audit services have not gone away, but to be consistent with independence rules, some firms are structuring their practices to market prohibited non-audit services to non-audit clients.) We are seeing enhanced independence and a renewed focus on audit services, which is working to enhance the overall quality of audits. More immediately this has also resulted in a "repricing" of the audit that will take some time for the issuer community to absorb.

Since the early 1990s and well before the events of 2001 and 2002, audit firms have undergone a series of mergers which has resulted in a concentration in the number of large firms. Those mergers and the demise of Arthur Andersen in 2002 have resulted in four remaining largest audit firms that currently audit almost 99% of the market capitalization of companies listed in the United States. These mergers coincided with the global expansion of many Fortune 500 firms, which demanded that their audit firms have a global footprint. This increased the size of the large firms' clients, and the magnitude and complexity of their international operations. As a consequence, large firms now require large, global networks and significant investments in technology, personnel and other support functions. There is no easy solution to the current high level of concentration, and it is a global issue. Because of the demands of their business, certain large, multinational issuers realistically are limited in their choice of auditor, and we have been told that the preferences of some underwriters also put pressure on issuers when selecting their auditors.

However, I am encouraged by the growth in size and skill taking place in firms following the Big 4. This will allow the market – in particular for small, medium, and even some larger issuers - to have additional choices, which I believe is important for the resiliency of the audit profession.

THE INTERNATIONAL OUTLOOK

There are two topics on the international outlook that I would like to raise with you today. First, is the importance of the PCAOB's international coordination in carrying out our mandate, and second, the topical issue of capital markets and foreign investment.

International Coordination

Due to the global footprint of large audit firms and the number of non-U.S. firms registered with the PCAOB, we view it as a priority to enhance our coordination with counterparts internationally.

With regard to the PCAOB's counterparts, countries have taken a variety of approaches in implementing their auditor oversight models, due in part to differences in legal and cultural foundations. This demands that the PCAOB take a flexible approach in carrying out its mandate. For the PCAOB, regulatory coordination is imperative: more than 700 of the firms registered with the PCAOB are in countries outside the United States, although they may be affiliated with large, U.S. based audit firms. Audit oversight bodies must continue to work together to minimize the burdens of duplicative or contradictory regulation at the same time that each organization fulfills its statutory obligations to investors and the public.

Fortunately, the PCAOB rules enable the PCAOB to rely on the work of the home-country regulator, and we are exploring the degrees of reliance that could be implemented. We continue to be keenly aware of the potential for duplicative regulatory costs and the sensitivity to having PCAOB personnel inspect the files of non-U.S. firms.

The PCAOB's degree of reliance on home-country inspections is directly based on the independence and rigor of the home-country system of oversight and agreement between the PCAOB and the home-country regulator on the inspection work program for individual firms. The more independent and rigorous the home-country system, the more the PCAOB can rely on its counterpart to conduct an inspection of a PCAOB-registered firm.

Let me use this as a segue to the important subject of how we, as overseers of the audit profession, see our work intersecting with the vitality and integrity of capital markets.

Global Capital Markets

Today, financial markets are more global than ever, and financial systems are increasingly more sophisticated and accessible. Cross border transactions have been greatly facilitated in recent years due to the removal of a number of barriers and technological advancements. This has, in turn, facilitated greater access by investors and companies to cross border markets, thus enhancing their ability to achieve greater overall returns while controlling risks through diversification of their portfolios. This increase in global mobility of funds means that we all have a stake in promoting vibrant, transparent markets. Supervisors and regulators must keep pace.

To this end, a healthy degree of competition among our markets should be embraced. Companies today are presented with more options when they are determining where to raise capital. Regulatory regimes, litigation systems, as well as local political and cultural influences, are often factored into this decision. Competition can force efficiencies, yet we should be wary of competition that is based on cost alone. Having the right balance of oversight and regulation promotes innovation and protects the long-term reliability, stability and depth of capital markets, so they can continue to attract investors and issuers worldwide. The health and competitiveness of U.S. capital markets have increasingly been a focus of attention among policy makers, business leaders, and the investor community. As one example, in late November, the interim report of the Capital Markets Committee reiterated the important fact that U.S. capital markets play a critical role in the global economy, and analyzed the U.S. market's competitiveness from both a macro and micro economic perspective.

While policy makers in the United States continue to place a high value on the growth and overall health of our capital markets, growth in other markets should also be viewed as a positive development, and one that certainly predates Sarbanes-Oxley. To be sure, many financial markets outside of the United States have risen to become global players, due to a number of factors, including, as I mentioned a moment ago, the ease of information exchange and the reduction of certain barriers to cross-border transactions.

What role does regulation play in this context? I firmly believe that regulation, if balanced, attracts capital and builds confidence in markets. In fact, from the U.S. perspective, we have seen that listings on the U.S. markets have continued to command a valuation premium. Although some evidence seems to indicate that the cross-listing premium for foreign companies listing in the United States has declined post-Sarbanes-Oxley, there remains a substantial premium for cross-listing in the United States.

I remain optimistic. Importantly, in the two years since companies have been reporting and obtaining audits on their internal control, the amount of capital raised by non-U.S. companies on U.S. exchanges has grown, not shrunk as it did in the years directly after the scandals. Moreover, the United States continues to be a leader in financial innovation.

CONCLUSION

The PCAOB oversees the auditors of public companies, in order to protect the interests of the investing public in the preparation of informative, accurate and independent audit reports on public company financial statements. Simply put, the PCAOB's job is to improve the quality and reliability of public company audits, so that investors can have more confidence in audited financial statements. High quality financial disclosure by public companies is a cornerstone of capital markets in the United States and is necessary for the continued growth and competitiveness of the U.S. economy. Both the PCAOB and the audit firms themselves have direct roles in this important area.

To be effective, a supervisory model is premised on a relationship between the supervised and the supervisor, which, while always at a healthy arms-length, revolves around a constructive approach to a shared objective – the objective in this case being a culture of integrity, rigor, skill and good sense in public company auditing in order to maintain investor confidence. I believe that the firms and the PCAOB can be commended for having established strong roots in a very brief time frame.

Going back to a hot topic, next week, the PCAOB will hold its public meeting to consider changes to the auditing standard on internal control over financial reporting to provide for more efficient, risk-based, scalable implementation. It is important that you carefully consider this proposal and provide the PCAOB thoughtful feedback through the comment process.

Thank you in advance for that input, and thank you again for inviting me to speak with you today.

EXHIBIT G

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,	:	
Plaintiff,	:	**20 Civ. 10832 (AT) (SN)**
- against -	:	**ECF Case**
RIPPLE LABS, INC., BRADLEY GARLINGHOUSE, and CHRISTIAN A. LARSEN,	:	
Defendants.	:	

DECLARATION OF MELINDA HARDY

I, Melinda Hardy, pursuant to 28 U.S.C. § 1746, declare as follows:

1. I am an Assistant General Counsel in the Office of the General Counsel of the Securities and Exchange Commission ("Commission" or "SEC"). I coordinate the assertion of governmental privileges, including the deliberative process privilege, by the Office of the General Counsel; I issue decisions on administrative appeals of decisions to withhold documents requested under the Freedom of Information Act ("FOIA"), including decisions to withhold under the deliberative process privilege; and I provide advice to staff throughout the Commission on issues relating to privileges and the FOIA. I have been employed by the Commission in this capacity since December 1998.

2. I have reviewed the documents on the SEC's privilege logs that were the subject of Defendants' motion to compel and that were described as emails attaching drafts of a June 14, 2018 speech ("Speech") by Bill Hinman, who was at that time the director of the SEC's Division of Corporation Finance ("Corp Fin"). Those documents contain early drafts of the Speech and comments and edits on the Speech from staff in Corp Fin as well as comments

and edits from staff in other SEC divisions and offices, including the Office of the Chairman, Division of Trading and Markets ("TM"), Division of Investment Management ("IM"), and Office of the General Counsel ("OGC").

3. The emails show that David Fredrickson, the Chief Counsel for Corp Fin, circulated a document titled, [redacted] on May 3, 2018 to Mr. Hinman and others in Corp Fin. The document appears to be a rough list of cases and legal principles relevant to [redacted]. About two weeks later, on May 21, 2018, Mr. Fredrickson sent a "first, rough draft" to Michael Seaman, Mr. Hinman's counsel. Between May 21, 2018 and June 4, 2018, Mr. Fredrickson, Mr. Seaman, Mr. Hinman, and Valerie Szczepanik (Assistant Director in Enforcement's Cyber Unit until June 9, 2018 and then Senior Advisor for Digital Assets and Innovation and an Associate Director in Corp Fin) all provided substantive comments and edits. Several of the emails, including ones regarding substantive changes, did not include Mr. Hinman. Nothing in the emails suggests that any of the staff working on the Speech viewed the Speech as something separate or distinct from their duties as SEC employees. In addition, Mr. Hinman's comments in emails and on drafts of the Speech suggest that he was preparing the Speech to reflect the views and practices of Corp Fin; in one email in which he circulated some edits, he said, "I need to get this back to you guys to see if you agree with the additions and where I took this."

4. On June 4, 2018, Mr. Hinman circulated a draft to staff in the SEC's Office of the Chairman, TM, IM, Enforcement, and OGC. In the hours leading up to the circulation of the Speech, the emails indicate that Mr. Fredrickson, Ms. Szczepanik, and Mr. Seaman were making changes to the Speech and addressing decisions that needed to be made, and the

privilege log does not contain any emails from Mr. Hinman commenting on these issues in those final hours. At 10:50 am on June 4, Mr. Seaman sent Mr. Hinman a clean version of the Speech and a suggested distribution list. At 11:10 am on June 4, Mr. Hinman sent the Speech to the people Mr. Seaman recommended (with the exception of one person who had recently announced his retirement).

5. Emails on the privilege log show that staff from TM, IM, and OGC all provided substantive edits and comments on the Speech. These comments raised a variety of issues, including [redacted]

6. Staff in TM, IM, and OGC provided their comments to Corp Fin staff, and Corp Fin staff worked with Mr. Hinman to incorporate those comments. The drafts show that Corp Fin staff carefully considered the comments and incorporated many of them into a new draft.

7. On June 11, 2018, Mr. Hinman sent a new draft to the people on the June 4, 2018 distribution list as well as to some additional people who had been included in emails providing the first round of comments. Staff in TM, IM, and OGC continued to provide substantive edits that staff in Corp Fin continued to consider and incorporate.

8. The documents on the privilege log do not reveal what considerations went into the decision to share drafts of the Speech with many staff throughout the SEC, but the sharing as well as the comments provided indicate that staff in Corp Fin, TM, IM, and OGC recognized

that the Speech was providing guidance that would indicate to the public how staff throughout the SEC would handle issues relating to digital assets. Indeed, the Speech recognizes that it could have an impact on parts of the SEC other than Corp Fin:

> [W]e recognize that there are numerous implications under the federal securities laws of a particular asset being considered a security. For example, our Divisions of Trading and Markets and Investment Management are focused on such issues as broker-dealer, exchange and fund registration, as well as matters of market manipulation, custody and valuation.

Speech at 4.

9. Corp Fin, TM, IM, and Enforcement all have discrete responsibilities, but the guidance one division provides can have a significant impact on others. The descriptions of the divisions in the Code of Federal Regulations provide evidence of the overlapping responsibilities of the divisions.

a. The description of Corp Fin lists many matters for which Corp Fin is responsible but states that Corp Fin is not responsible for those matters to the extent they "pertain[] to investment companies registered under the Investment Company Act of 1940." 17 C.F.R. § 200.18.

b. IM is responsible for "[a]ll matters arising under the Securities Act of 1933 . . . arising from or pertaining to material filed pursuant to the requirements of that Act by investment companies registered under the Investment Company Act of 1940." 17 C.F.R. § 200.20b(b).

c. TM has responsibility for the "[a]dministration of all matters arising under the Securities Exchange Act of 1934" except for several matters for which Corp Fin has responsibility. 17 C.F.R. § 200.19a.

d. Enforcement is responsible for "supervising and conducting all enforcement activities under the acts administered by the Commission," so it brings actions based on the conduct that other divisions are overseeing. 17 C.F.R. § 200.19b.

e. OGC has responsibilities that relate to the work of all of the divisions and offices in the SEC, and its duties include "the review and clearance of the form and content of . . . prepared speeches and addresses by members of the staff relating to the Commission or to the statutes and rules administered by the Commission. The General Counsel also is responsible for coordinating and reviewing the interpretive positions of the various divisions and offices." 17 C.F.R. § 200.21.

10. By sharing the Speech with TM, IM, OGC, Enforcement, and the Chairman's Office, Corp Fin staff, including Mr. Hinman, were able to receive input that helped ensure the Speech would not interfere with or contradict positions or actions of other Commission staff.

I declare under penalty of perjury that the foregoing is true and correct. Executed on February 17, 2022 in Arlington, Virginia.

Melinda Hardy