

SEC Issues Statement and Request for Comment Regarding Broker-Dealer Custody of Digital Asset Securities

December 28, 2020

On December 23, 2020, the Securities and Exchange Commission (“SEC”) published a statement and request for comment (“Statement”) regarding the custody of assets that are issued and/or transferred using distributed ledger or blockchain technology and that meet the definition of a “security” under the federal securities laws (“digital asset securities”) by broker-dealers that limit their business to digital asset securities.

The Statement sets forth the SEC’s position that for five years, such a special purpose broker-dealer will not be subject to an enforcement action on the basis that the broker-dealer deems itself to have obtained and maintained physical possession or control of customer fully paid and excess margin digital asset securities, if the broker-dealer meets certain conditions. The conditions are designed to mitigate the potential for the loss or theft of digital asset securities that may cause the broker-dealer and its customers to incur financial losses.

The Statement also requests comment on certain industry practices with respect to digital asset securities in order to gain insight into the evolving standards and best practices for custody of such securities. The SEC intends to use the responses it receives to inform future SEC action with respect to digital asset securities.

The Statement becomes effective 60 days after publication in the Federal Register.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

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Background

Rule 15c3-3 under the Securities Exchange Act of 1934 (“Rule 15c3-3”) requires a broker-dealer to obtain promptly and thereafter maintain the physical possession or control of all fully paid and excess margin securities it carries for the accounts of customers. A broker-dealer that maintains custody of a fully paid or excess margin digital asset security for a customer must comply with these requirements.

Questions have arisen regarding the application of Rule 15c3-3 to digital asset securities. Specifically, it may not be possible for a broker-dealer to control digital asset securities in the same manner it controls traditional securities, which has traditionally been done through the broker-dealer’s accounts at securities depositories or custodian banks. Additionally, risks exist for digital asset securities that are not present for traditional securities. This is because digital asset securities may not be subject to the same established clearance and settlement process, which contain certain checks and controls that can be used to verify both proprietary and customer holdings of traditional securities by broker-dealers and transfers of such securities. Consequently, the SEC has not, to date, permitted broker-dealers to custody digital assets for their customers.

The Statement is intended to provide time-limited relief for special purpose broker-dealers, allowing such broker-dealers to deem themselves to have obtained and maintained physical possession or control of customer fully paid and excess margin digital asset securities where certain conditions are met. It also follows previous guidance and relief for broker-dealers that engage in a digital assets business without maintaining custody of customer digital asset securities, which previously raised questions and issues relating to the application of Rule 15c3-3 to

digital asset securities¹ and provided relief in certain circumstances where an alternative trading system (“ATS”) is deemed not to have custody.²

Conditions for Special Purpose Broker-Dealers

A special purpose broker-dealer that deems itself to have obtained and maintained physical possession or control of customer fully paid and excess margin digital asset securities will not be subject to an enforcement action if the following conditions are met:

- The broker-dealer has access to the digital asset securities and the capability to transfer them on the associated distributed ledger technology;
- The broker-dealer limits its business to dealing in, effecting transactions in, maintaining custody of, and/or operating an ATS for digital asset securities;
 - However, the broker-dealer may hold proprietary positions in traditional securities solely to (1) meet its minimum net capital requirements under Rule 15c3-1 or (2) hedge the risks of its proprietary positions in traditional securities and digital asset securities.
- Before effecting transactions in and maintaining custody of a digital asset security, the broker-dealer establishes, maintains, and enforces reasonably designed written policies and procedures to conduct and document analyses of whether (1) the digital asset is a security offered and sold pursuant to an effective registration statement or an available exemption from registration and (2) the

¹ See *Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities*, dated July 8, 2019, available at <https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custodydigital-asset-securities> (“Joint Statement”).

² See Letter to Ms. Kris Dailey, *Financial Industry Regulatory Authority, ATS Role in the Settlement of Digital Asset Security Trades*, dated September 25, 2020, available at <https://www.sec.gov/divisions/marketreg/mr-noaction/2020/finra-ats-role-insettlement-of-digital-asset-security-trades-09252020.pdf> (“ATS NAL”).

broker-dealer meets its requirements to comply with the federal securities laws with respect to effecting transactions in the digital asset security;

- The broker-dealer establishes, maintains, and enforces reasonably designed written policies and procedures to conduct and document an assessment of the characteristics of a digital asset security’s distributed ledger technology and associated network prior to undertaking to maintain custody of the digital asset security and at reasonable intervals thereafter;
- The broker-dealer does not intend to maintain custody of a digital asset security if it is aware of (1) any material security or operational problems or weaknesses with the distributed ledger technology and associated network used to access and transfer the digital asset security or (2) other material risks posed to its business by the digital asset security;
- The broker-dealer establishes, maintains, and enforces reasonably designed written policies, procedures, and controls that are consistent with industry best practices to (1) demonstrate it has exclusive control over the digital asset securities it holds in custody and (2) protect against the theft, loss, and unauthorized and accidental use of the private keys necessary to access and transfer the digital asset securities;
- The broker-dealer establishes, maintains, and enforces reasonably designed written policies, procedures, and arrangements to

(1) specifically identify, in advance, the steps it will take in the wake of certain events that could affect its custody of the digital asset securities,³ (2) allow for it to comply with a court-ordered freeze or seizure, and (3) allow for the transfer of the digital asset securities to another special purpose broker-dealer, trustee, receiver, liquidator, or person performing a similar function, or to another appropriate person, in the event the broker-dealer self-liquidates or is subject to an insolvency proceeding;

- The broker-dealer provides written disclosures to prospective customers; and
 - The written disclosures must disclose (1) that the firm is deeming itself to be in possession or control of digital asset securities held for the customer for purposes of Rule 15c3-3(b)(1) based on its compliance with the Statement and (2) the risks of investing in or holding digital asset securities.⁴
 - The broker-dealer must retain such written disclosures in accordance with broker-dealer record retention rules.
- The broker-dealer enters into a written agreement with each customer that sets forth the terms and conditions with respect to receiving, purchasing, holding, safekeeping, selling, transferring, exchanging, custodizing, liquidating, and otherwise transacting in

³ Events that could affect the broker-dealer’s custody of digital asset securities include, without limitation, blockchain malfunctions, 51% attacks, hard forks, or airdrops.

⁴ The broker-dealer’s written disclosures about the risks of investing in or holding digital asset securities must include, at a minimum: (1) prominent disclosure that digital asset securities may not be “securities” as defined in the Securities Investor Protection Act (“SIPA”)—and in particular, digital asset securities that are “investment contracts” under the *Howey* test but are not registered with the SEC are excluded from SIPA’s definition of

“securities”—and thus the protections afforded to securities customers under SIPA may not apply; (2) description of the risks of fraud, manipulation, theft, and loss associated with digital asset securities; (3) description of the risks relating to valuation, price volatility, and liquidity associated with digital asset securities; and (4) description, at a high level that would not compromise any security protocols, of the processes, software and hardware systems, and any other formats or systems utilized by the broker-dealer to create, store, or use the broker-dealer’s private keys and protect them from loss, theft, or unauthorized or accidental use.

digital asset securities on behalf of the customer.

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This SEC position will expire five years after the Statement's publication date. The SEC noted that this period is designed to provide market participants with an opportunity to develop practices and processes that will enhance their ability to demonstrate possession or control over digital asset securities and the SEC with experience in overseeing broker-dealer custody of digital asset securities. The SEC also stated that it will continue to evaluate its position during the five year period on an ongoing basis.

Key Takeaways

- *The Statement clarifies the role that special purpose broker-dealers can play in the digital asset security space.* Due to the novel and rapidly evolving nature of digital asset securities, many questions have arisen with respect to the role of broker-dealers in transacting in digital asset securities, as well as the application of broker-dealer requirements to such securities. The Statement is an important first step in providing further clarity to the role that broker-dealers can play in the digital asset security market and protection of customer digital asset securities.
- *The SEC's position appears to prevent a broker-dealer from transacting in non-security digital assets.* The second condition for qualifying for relief requires that a broker-dealer limit its business to dealing in, effecting transactions in, maintaining custody of, and/or operating an ATS for digital asset securities. The SEC has not extended the relief to, or provided further guidance regarding, how broker-dealers—even those that limit their activities to digital assets—should treat non-security digital assets. This condition thus significantly limits the usefulness of the SEC's position because digital asset securities are often sold for other digital assets, such as Ether or Bitcoin. It also may create challenges to the extent that the security status of certain digital assets remains unclear.
- *The SEC's position does not extend to traditional broker-dealers.* The SEC's position does not apply more broadly to traditional broker-dealers. The reason for this position likely is to address potential SIPA-related concerns, such as a shortfall in digital asset securities due to loss or theft or SIPA definitional issues creating a customer property estate shortfall for other customers.
- *The Statement seems focused on self-custody of digital asset securities by a broker-dealer.* The Statement does not appear to address custody of digital asset securities by a bank or transfer agent for the broker-dealer similar to custody arrangements for traditional securities, which broker-dealers have been exploring for digital asset securities.
- *The Statement does not extend to other requirements under Rule 15c3-3.* The Statement is limited to the possession or control requirements set forth in Rule 15c3-3(b). Special purpose broker-dealers will continue to be subject to the other provisions of Rule 15c3-3 (such as reserve account requirements for customer cash), as well as the federal securities laws applicable to traditional broker-dealers.
- *The Statement appears to establish an alternative path to a situation where the broker-dealer does not have custody of the digital asset securities.* The Joint Statement and ATS NAL allow for broker-dealers to engage in a digital asset business in situations where the customers themselves are responsible for custody of their digital assets and settlement of transactions, e.g., through a custodian bank acting for the customer instead of the broker-dealer. The Statement seems to provide broker-dealers with a second alternative for broker dealers to engage in a digital asset business.

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