

July 18, 2019

# SEC and FINRA Issue Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities

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## Identifies Compliance Challenges for Broker-Dealers Seeking to Custody Digital Asset Securities and Welcomes Ongoing Engagement With Industry on Proposed Methods to Comply

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### SUMMARY

On July 8, 2019, the Staffs of the SEC's Division of Trading and Markets and FINRA's Office of General Counsel issued a joint statement on the application of securities laws to digital asset securities. The Statement focuses in particular on questions that arise when a broker-dealer holds a digital asset security in its possession or control and must comply with the custodial requirements of Exchange Act Rule 15c3-3, known as the Customer Protection Rule. The Customer Protection Rule requires a broker-dealer to hold its customers' assets separately from its own assets, and to have physical possession of customers' fully paid and excess margin securities—including digital asset securities—or maintain them, free of liens, at a good control location. The Staffs note that it may be challenging for market participants wishing to custody digital asset securities to comply with the broker-dealer financial responsibility rules, including the Customer Protection Rule, without putting in place significant technological enhancements and solutions unique to digital asset securities. However, the Staffs stated that they "encourage and support" innovation in this area, and "stand ready to continue to engage with entities pursuing this line of business."

### BACKGROUND

The Staffs issued the Statement<sup>1</sup> following months of engagement with industry participants about whether any of various proposed custodial arrangements would meet the possession or control standards

prescribed in the Customer Protection Rule.<sup>2</sup> Both registered and unregistered entities have submitted New Membership Applications and Continuing Membership Applications, respectively, to FINRA seeking approval to engage in broker-dealer activities involving digital asset securities. Some applicants have proposed to engage in broker-dealer activities that do not involve taking custody of digital asset securities, which may provide an easier path to regulatory approval compared to custodial activities because, as noted in the Statement, “noncustodial activities involving digital asset securities do not raise the same level of concern among the Staffs.”<sup>3</sup> The Statement describes several types of broker-dealer activities that involve digital asset securities but do not implicate custody considerations because they are execution-only arrangements where the parties settle away from the broker-dealer.

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## **BROKER-DEALER CUSTODY OF DIGITAL ASSET SECURITIES**

Broker-dealers that do seek to custody digital asset securities must comply with the Customer Protection Rule. As noted above, the Customer Protection Rule requires a broker-dealer physically to hold customers’ fully paid and excess margin securities or maintain them, free of liens, at a good control location. The rule (as interpreted by the staff of the SEC’s Division of Trading and Markets) generally is satisfied if certificated securities are held at a third-party custodian (for example, the Depository Trust Company or a clearing bank), or if uncertificated securities are held at the issuer or at the issuer’s transfer agent. In either case, a third party controls the transfer of the securities and processes are available to reverse or cancel mistaken or unauthorized transactions. The goal of the “control” provision of the Customer Protection Rule is to ensure that, if a broker-dealer fails and becomes subject to liquidation under the Securities Investor Protection Act (SIPA), its customers’ assets will be readily available and capable of being returned to customers because there is a third party that controls the transfer of the securities. In this regard, the Staffs also noted that the “traditional” securities infrastructure (presumably a reference to the rules of exchanges and self-regulatory organizations and internal broker-dealer compliance policies) includes mechanisms by which erroneous or unauthorized transfers of securities can be reversed.

Broker-dealer activities involving custody of digital asset securities raise unique investor protection concerns among the Staffs because there “are many significant differences in the mechanics and risks associated with custodizing traditional securities and digital asset securities” and established laws and practices regarding fraud or theft “may not be available or effective in the case of certain digital assets.”<sup>4</sup> The Staffs note that “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.”<sup>5</sup> Moreover, even in the absence of fraud or error, the Statement notes that a broker-dealer may not have *exclusive* control over a security, even if it properly maintains the private key relating to a digital asset security, because it is

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possible that another party may have a copy of the private key and could transfer the digital asset security without the broker-dealer's consent. The Statement goes on to suggest that compliance with the Customer Protection Rule with respect to custody of a digital asset security will require a broker-dealer to demonstrate that it has overcome each of these issues.

In addition to the Customer Protection Rule, the Statement discusses briefly the application of other broker-dealer financial protection rules to digital asset securities, including the books and records and financial reporting requirements under Exchange Act Rules 17a-3, 17a-4 and 17a-5 and considerations for digital asset securities under SIPA. From the Staffs' perspective, 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."<sup>6</sup>

With respect to SIPA, the Staffs note that "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."<sup>7</sup> The Statement further indicates that if a broker-dealer provides custody for digital assets that are *not* securities (as defined in SIPA), the claims of customers that hold those digital assets would be limited to general creditor claims (in other words, rather than a right to the return of the asset itself).<sup>8</sup>

The Statement is a welcome sign of constructive interest by the Staffs, and a step toward resolution of uncertainties concerning the application of federal securities laws—the Customer Protection Rule in particular—to the potential intermediation of digital asset securities and transactions, which could pave the way for increased participation in the marketplace for digital asset securities by traditional investors.

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ENDNOTES

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- 1 See 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), *available at*: <https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities> (the Statement).
- 2 *Id.*
- 3 *Id.*
- 4 *Id.*
- 5 *Id.*
- 6 *Id.*
- 7 *Id.*
- 8 Whether this proves to be true in any given case may ultimately depend at least in part on how such assets are deemed to be held by the custodian under applicable state law. See 15 U.S.C. § 78III(4).

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