

SEC Issues No Enforcement Statement and Requests for Comment Regarding the Custody of Digital Asset Securities by Special Purpose Broker-Dealers

On December 23, 2020, the Securities and Exchange Commission (the “Commission”) issued a statement and request for comment regarding the custody of digital asset securities by certain special purpose broker-dealers with respect to the application of Securities Exchange Act Rule 15c3-3 to such securities. The statement sets forth the Commission’s position that, for a period of five years from the publication date in the Federal Register, a broker-dealer operating under in a certain manner set forth in the statement will not be subject to a Commission 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 for the purposes of paragraph (b)(1) of Rule 15c3-3 (the “Statement”).ⁱ

The circumstances set forth in the Statement include, among other things, that the broker-dealer limits its business to digital asset securities, establishes and implements policies and procedures reasonably designed to mitigate the risks associated with conducting a business in digital asset securities, and provides customers with certain disclosures regarding the risks of engaging in transactions involving digital asset securities. In addition, the Commission is requesting comment to enable the Commission to gain additional insight into the evolving standards and best practices with respect to custody of digital asset securities with a view to inform any potential future Commission actions in this arena.

The Commission’s actions represent a step forward in the evolution of the regulatory framework for digital assets that meet the definition of a security under the federal securities law.ⁱⁱ (“Digital Asset Securities”)ⁱⁱⁱ The application of Rule 15c3-3 under the Securities Exchange Act of 1934 (the “Rule”) impeded broker-dealers from trading Digital Asset Securities in the same manner as traditional securities because Digital Asset Securities would generally not be subject to the same established clearance and settlement processes familiar to traditional securities market participants. The Rule requires a broker-dealer that maintains custody of a fully paid or excess margin digital asset security for a customer to hold it in a manner that complies with the Rule, including that the security must be in the exclusive physical possession or control of the broker-dealer. The Statement is based in part on the Commission’s view that “a digital asset security that is not in the exclusive physical possession or control of the broker-dealer because, for example, an unauthorized person knows or has access to the associated private key (and therefore has the ability to transfer it without the authorization of the broker-dealer) would not be held in a

manner that complies with the possession or control requirement of Rule 15c3-3 and thus would be vulnerable to the risks the rule seeks to mitigate.”^{iv}

The Statement provides a means for broker-dealers to hold Digital Asset Securities in a manner that complies with the Rule. However, in order to comply a broker-dealer must limit its business to Digital Asset Securities (i.e., a “special purpose broker dealer”); thus, broker-dealers that deal in securities that are not Digital Asset Securities (with limited exceptions) may not rely upon this relief. In addition, the broker-dealer must have policies and procedures to, among other things, assess a given digital asset security’s distributed ledger technology and protect the private keys necessary to transfer the digital asset security. The Commission’s no enforcement position is limited to compliance with the Rule and predicated on the broker-dealer meeting certain minimum steps in order to obtain and maintain physical possession or control of customer fully paid and excess margin Digital Asset Securities. These steps are summarized in the chart below:

Specific Requirements for Compliance with the Statement

Requirement	Description
<i>Eligibility</i>	Broker-dealer must be registered under the Securities Exchange Act of 1934 and subject to the full application of Rule 15c3-3; not rely on an exemption from such rule.
<i>Access and the capability to transfer on the associated distributed ledger technology</i>	The broker-dealer has access to the Digital Asset Securities and the capability to transfer them on the associated distributed ledger technology
<i>Limited business</i>	The broker-dealer limits its business to dealing in, effecting transactions in, maintaining custody of, and/or operating an alternative trading system for Digital Asset Securities; provided a broker-dealer may hold proprietary positions in traditional securities solely for the purposes of meeting the firm’s minimum net capital requirements under Rule 15c3-1, or hedging the risks of its proprietary positions in traditional securities and Digital Asset Securities

<p><i>Policies and Procedures for:</i> <i>-analysis of status as security;</i> <i>-assessment of registration status or availability of an exemption;</i></p>	<p>The broker-dealer establishes, maintains, and enforces reasonably designed written policies and procedures to conduct and document an analysis of whether a particular digital asset is a security offered and sold pursuant to an effective registration statement or an available exemption from registration, and whether the broker-dealer meets its requirements to comply with the federal securities laws with respect to effecting transactions in the digital asset security, before undertaking to effect transactions in and maintain custody of the digital asset security;</p>
<p><i>Policies and Procedures for:</i> <i>-assessment of distributed ledger technology and associated network</i></p>	<p>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;</p>
<p><i>Assess whether there are any material security or operational problems or weaknesses with distributed ledger technology and associated network or other material risks</i></p>	<p>The broker-dealer does not undertake to maintain custody of a digital asset security if the firm is aware of 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 is aware of other material risks posed to the broker-dealer's business by the digital asset security</p>
<p><i>Policies and Procedures that are consistent with industry best practices to demonstrate exclusive control and protect against theft, loss and unauthorized and accidental use of the private keys necessary to access and transfer the Digital Asset Securities held in custody</i></p>	<p>The broker-dealer establishes, maintains, and enforces reasonably designed written policies, procedures, and controls that are consistent with industry best practices to demonstrate the broker-dealer has exclusive control over the digital asset securities it holds in custody and to 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 holds in custody;</p>

<p><i>Policies and Procedures that identify steps that the broker-dealer will take</i></p> <ul style="list-style-type: none"> - in the event of the occurrence of certain events adverse to the firm's custody of the Digital Asset Securities; - to comply with a court ordered freeze or seizure of the digital asset securities; -allow for the transfer of the digital asset securities in the event that the broker-dealer can no longer continue as a going concern. 	<p>The broker-dealer establishes, maintains, and enforces reasonably designed written policies, procedures, and arrangements to: (i) specifically identify, in advance, the steps it will take in the wake of certain events that could affect the firm's custody of the digital asset securities, including, without limitation, blockchain malfunctions, 51% attacks, hard forks, or airdrops; (ii) allow for the broker-dealer to comply with a court-ordered freeze or seizure; and (iii) allow for the transfer of the digital asset securities held by the broker-dealer to another special purpose broker-dealer, a trustee, receiver, liquidator, or person performing a similar function, or to another appropriate person, in the event the broker-dealer can no longer continue as a going concern and self-liquidates or is subject to a formal bankruptcy, receivership, liquidation, or similar proceeding;</p>
<p><i>Disclosures to customers</i></p>	<p>The broker-dealer provides written disclosures to prospective customers: (i) that the firm is deeming itself to be in possession or control of digital asset securities held for the customer for the purposes of paragraph (b)(1) of Rule 15c3-3 based on its compliance with this Commission position; and (ii) about the risks of investing in or holding digital asset securities that, at a minimum: (a) prominently disclose that digital asset securities may not be "securities" as defined in the Securities Investor Protection Act of 1970 ("SIPA")—and in particular, digital asset securities that are "investment contracts" under the Howey test but are not registered with the Commission are excluded from SIPA's definition of "securities"—and thus the protections afforded to securities customers under SIPA may not apply; (b) describe the risks of fraud, manipulation, theft, and loss associated with digital asset securities; (c) describe the risks relating to valuation, price volatility, and liquidity associated with digital asset securities; and (d) describe, at a high level that would not compromise any security protocols, the processes, software and hardware systems, and any other formats or systems utilized by the broker-dealer to create,</p>

	store, or use the broker-dealer’s private keys and protect them from loss, theft, or unauthorized or accidental use
<i>Written Agreement</i>	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, custodying, liquidating and otherwise transacting in digital asset securities on behalf of the customer

The Statement is limited to the application of Rule 15c3-3(b)(1) and does not in any way lessen the other regulatory requirements applicable to broker-dealers.

In addition to issuing the Statement, the Commission is seeking comment on the following questions below:

1. What are industry best practices with respect to protecting against theft, loss, and unauthorized or accidental use of private keys necessary for accessing and transferring digital asset securities? What are industry best practices for generating, safekeeping, and using private keys? Please identify the sources of such best practices.
2. What are industry best practices to address events that could affect a broker-dealer’s custody of digital asset securities such as a hard fork, airdrop, or 51% attack? Please identify the sources of such best practices.
3. What are the processes, software and hardware systems, or other formats or systems that are currently available to broker-dealers to create, store, or use private keys and protect them from loss, theft, or unauthorized or accidental use?
4. What are accepted practices (or model language) with respect to disclosing the risks of digital asset securities and the use of private keys? Have these practices or the model language been utilized with customers?
5. Should the Commission expand this position in the future to include other businesses such as traditional securities and/or non-security digital assets? Should this position be expanded to include the use of non-security digital assets as a means of payment for digital asset securities, such as by incorporating a de minimis threshold for non-security digital assets?
6. What differences are there in the clearance and settlement of traditional securities and digital assets that could lead to higher or lower clearance and settlement risks for digital assets as compared to traditional securities?

7. What specific benefits and/or risks are implicated in a broker-dealer operating a digital asset alternative trading system that the Commission should consider for any future measures it may take?

The Commission statement and request for comment are published on the Commission's website at <https://www.sec.gov/news/press-release/2020-340> and will become effective 60 days after publication in the Federal Register.

The Statement and the steps required for compliance may pose significant operational and technological challenges for many broker-dealers that seek to rely on the Statement to hold Digital Asset Securities. While not addressed in the Statement, the changes that broker-dealers are required to undertake in order to comply with the Statement may constitute a material change requiring approval by FINRA pursuant to FINRA Rule 1017 and may implicate other areas of broker-dealer regulation and compliance, such as capital, clearance and settlement. FisherBroyles attorneys are knowledgeable on broker-dealer regulation and compliance and digital assets and are able to advise and assist you with complying with the Statement and navigating the regulatory landscape. Please contact any of the following or your regular contact at FisherBroyles for assistance: Robert A. Boresta at robert.boresta@fisherbroyles.com, Julian Hammar at julian.hammar@fisherbroyles.com, Michael Pierson at michael.pierson@fisherbroyles.com, and Seth Travis at seth.travis@fisherbroyles.com.

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ⁱ Exchange Act Release No. 90788 (Dec. 23, 2020).

ⁱⁱ The term "digital asset" refers to an asset that is issued and/or transferred using distributed ledger or blockchain technology ("distributed ledger technology"), including, but not limited to, so-called "virtual currencies," "coins," and "tokens."

ⁱⁱⁱ A digital asset may or may not meet the definition of a "security" under the federal securities laws. See, e.g., Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81207 (July 25, 2017).

^{iv} See the Statement, Section III.