CLIENT ALERT

SEC and FINRA Staffs Issue Statement on Custody of Digital Asset Securities; FINRA Encourages Firms to Notify FINRA if Engaging in Digital Asset Activities

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As cryptocurrencies and related instruments viewed as securities by the SEC ("digital asset securities") have developed, the issue of how they can be held in a manner consistent with various custody requirements, including broker-dealer custody requirements, has arisen frequently. The SEC and FINRA staffs recently issued a joint statement on the potential challenges faced by broker-dealers that participate in the marketplace for digital asset securities to comply with financial responsibility rules.[1] The staffs note a number of related issues and that they have engaged with industry participants to discuss these issues. The Joint Statement also describes several ways in which broker-dealers may participate in the digital asset securities marketplace without having custody of customer digital asset securities.[2]

[1] *Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities*, SEC, July 8, 2019, available here (the "Joint Statement").

[2] For firms engaging or seeking to engage in material digital asset securities activity, the Joint Statement notes that FINRA rules prohibit firms from materially changing their business operations without FINRA's prior approval of a Continuing Membership Application ("CMA"). The Joint Statement indicates that FINRA likely would consider engaging in material digital asset securities activity for the first time as a material change in business that would require FINRA approval of a CMA; however, firms may use FINRA's materiality consultation process to discuss whether a specific contemplated change would require a CMA.

Customer Protection Rule

Broker-dealers engaging in a digital asset securities business must comply with the Customer Protection Rule, 15c3-3 of the Securities Exchange Act of 1934. Under the Customer Protection Rule, a broker-dealer must maintain fully paid or excess margin securities of customers in its physical possession or control. The Joint Statement notes that holding a private key may not evidence such control since the broker-dealer may not be able to establish definitively that a copy of the private key is not also held by another party. The SEC and FINRA staffs also note that the structure of the immutable ledger may not allow for transactions to be cancelled or reversed if they are mistaken or unauthorized.

Financial Reporting Rules

The Joint Statement also discusses potential challenges for broker-dealers that hold digital asset securities in complying with books and records and financial reporting requirements.[3] Since digital asset securities are held on an encrypted ledger, broker-dealers may not be able to provide sufficient evidence of the existence of digital asset securities for the purposes of maintaining required books and records. Similarly, the difficulties surrounding proof of ownership may interfere with a broker-dealer's ability to obtain required audited financial statements.

Securities Investor Protection Act

The Joint Statement also notes that the protections of the Securities Investor Protection Act ("SIPA") may not extend to digital asset securities, which might be inconsistent with the expectations customers have of the broker-dealers that hold their digital asset securities. SIPA provides protections to customers of failed broker-dealers that cannot return assets to their customers by providing a first-priority claim for missing customer assets. However, it is unclear whether digital asset securities are included in the definition of "securities" under SIPA, which differs from the definition in the federal securities laws. If a digital asset security does not meet the definition of a security under SIPA, then SIPA protection likely would not apply and holders of those digital asset securities would have only unsecured general creditor claims against the failed broker-dealer's estate.

[3] SEC Rules 17a-3, 17a-4, and 17a-5.

Non-Custodial Models

The challenges for broker-dealers in complying with the financial responsibility rules are premised on the broker-dealer having custody of the digital asset securities. Therefore, broker-dealer business models that do not entail custody of digital asset securities may not raise the same level of concern. The SEC and FINRA staffs provide three examples of such models. One approach is similar to a traditional private placement in which a broker-dealer facilitates a transaction between an investor and an issuer by sending the trade-matching details to the parties, and the issuer settles the transaction bilaterally between the buyer and the issuer, away from the broker-dealer. Another is an over-the-counter secondary market transaction in which a broker-dealer arranges an over-the-counter transaction and the parties complete the transaction directly without the securities passing through the broker-dealer. In a third approach, a broker-dealer operates a registered alternative trading system ("ATS") that matches buyers and sellers and the parties settle their transactions directly or give instructions to their respective custodians to settle the transactions. 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.

FINRA Firm Notification for Activities in Digital Assets

Subsequent to the Joint Statement, FINRA issued a Notice that extended its guidance from last year encouraging firms to notify FINRA if they engage in activities related to digital assets.[4] The Notice encourages firms to continue to keep FINRA informed of activities related to digital assets, including digital assets that are not securities, until July 31, 2020.

[4] *Regulatory Notice 19-24*, FINRA, July 18, 2019, available here (the "Notice").

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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