July 25, 2019

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

Summary

On July 8, the Division of Trading and Markets for the Securities and Exchange Commission (SEC) and the Office of General Counsel for the Financial Industry Regulatory Authority (FINRA) issued a joint statement (the "Statement") setting forth the concerns that appear to be delaying their approval of broker-dealers facilitating digital asset security transactions for their customers. The joint statement highlighted the importance of Section 15(c)(3) of the Securities Exchange Act of 1934 and Rule15c3-3 thereunder (the "Customer Protection Rule").[1]

The Statement noted that a broker-dealer holding cryptosecurities for customers would have to comply with the Customer Protection Rule by separating such assets from the firm's own. In addition, to demonstrate satisfactory control over an asset for purposes of the Customer Protection Rule, a broker-dealer or its agent must be able to demonstrate that it maintains "exclusive control" over the asset. The Statement raised concerns over the potential ability of a broker-dealer or its agent to demonstrate the requisite exclusive control over a private key (i.e., the security code) to a digital wallet holding a cryptosecurity, even where it or its agent held the private key. Specifically, the Statement expressed concern that: 1) a broker-dealer "may not be able to demonstrate that no other party has a copy of the private key and could transfer the digital asset without the broker-dealer's consent;" and 2) even with a private key, a broker-dealer might not be able to reverse or cancel a mistaken or unauthorized transaction.

The Statement also expressed concern regarding the ability of a broker-dealer holding cryptosecurities to prepare accurate financial records, as required by law.[2] This concern was based on the fact that it may be "difficult for broker-dealers to evidence the existence" of digital asset securities, which could impede their ability to produce accurate financial records, as well as the capability of independent third-party accountants to test representations made by a broker-dealer's management in financial statements.

The SEC noted that the definition of a "security" under the law governing insurance protection for customer assets—the Securities Investor Protection Act—might not apply to cryptosecurities. This is because the law does not cover investment contracts or interests that are not the subject of a registration statement.[3]

[1] 17 CFR § 240.15c3-3.

[2] *See* 17 CFR § 240.17a-4;17 CFR § 240.17a-5.

[3] *See* 15 U.S.C. § 78lll.

For more information, please contact the following attorneys or any members of Katten's **Financial Services** practice. Katten represents Eris Clearing and Eris Exchange and assisted Eris Clearing in obtaining its DCO Order from the CFTC.

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Lastly, the Statement noted that many of its concerns regarding the application of the Customer Protection Rule may not apply where a broker-dealer solely engages in "non-custodial activities" for digital asset securities such as facilitating the bilateral settlement of a transaction directly between a buyer and an issuer without interposing itself, or where a broker-dealer facilitates a peer-to-peer over-the-counter transaction between a buyer and seller with no digital security passing through the broker-dealer.

The Statement concluded by suggesting that depending on the type of securities, third-party custodians or an issuer's transfer agent may serve as good "control locations" because these methods could protect clients from broker-dealer misappropriation and failure and allow the ability to reverse or cancel mistaken or unauthorized transactions.

A copy of the statement is available here.

Commentary

While it was important for staff of the SEC and FINRA to publicly identify issues that have been delaying qualification of broker-dealers to handle digital asset securities, the regulators did not provide any guidance as to what measures might be taken to satisfy their concerns.

The Commodity Futures Trading Commission (CFTC) recently approved the application of Eris Clearing LLC ("Eris Clearing") to serve as a derivatives clearing organization (DCO), allowing it to clear fully collateralized virtual currency futures contracts potentially deliverable into spot cryptocurrencies. In 2011, the CFTC approved Eris Exchange LLC ("Eris Exchange"), Eris Clearing's indirect parent company, as a designated contract market. Branded together as "ErisX," Eris Clearing anticipates offering the clearing of digital asset futures contracts traded on Eris Exchange beginning later in 2019.

In approving Eris Clearing's order, the CFTC provided a path forward for CFTC registrants wanting to handle cryptocurrencies processed in connection with exchange-traded derivatives contracts and to comply with its equivalent of the Customer Protection Rule.[4] Based on this approval, it would appear that the CFTC has reasonable confidence that private keys can be protected through robust policies, procedures and practices that guard against both external and internal fraud, and that at least certain cryptoassets can be seen and verified on their host blockchains.

Moving forward, the SEC and FINRA should review the standards being applied by the CFTC in approving DCOs to see what measures could be exported to make the regulators more comfortable with SEC registrants handling cryptosecurities.

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[4] *See* 7 U.S.C. § 6d.