

Joint SEC/FINRA Staff Statement Offers Guidance Relating to Broker-Dealer Custody of Digital Asset Securities

WRITTEN BY

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On July 8, 2019, the staffs of the Division of Trading and Markets, U.S. Securities and Exchange Commission (“SEC”) and the Office of General Counsel, Financial Industry Regulatory Authority (“FINRA”) released a joint statement^[1] (the “Joint Statement”) providing guidance with respect to applicable regulations relating to broker-dealer custody of digital asset securities. More specifically, the Joint Statement focuses on three major areas: (1) the SEC Customer Protection Rule; (2) the SEC Books and Records and Financial Reporting Rules; and (3) the Securities Investor Protection Act of 1970.

1. The SEC Customer Protection Rule

Rule 15c3-3 under the Securities Exchange Act of 1934 (the “Exchange Act”), known as the Customer Protection Rule, requires an entity registered broker-dealer to safeguard customer securities and funds it holds to prevent investor loss or harm in the event the broker-dealer is unable to safeguard those funds for any reason.^[2] One of the key provisions requires a broker-dealer to physically hold customers’ fully paid and excess margin securities at a good control location, such as a bank. The Customer Protection Rule, along with other similar regulations aimed to address the broker-dealer relationship, is based on a more traditional securities infrastructure where transactions may be more easily reversed or cancelled.

The Joint Statement notes that digital asset securities pose new and singular custody challenges with respect to the broker-dealer relationship. For example, the Joint Statement provides 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.” For instance, unlike in a traditional broker-dealer relationship where there is systematic process to reverse or cancel mistaken or unauthorized transactions, the process to reverse or cancel digital asset securities may not be as practicable because the broker-dealer holds the private keys. The Joint Statement explains that “[t]hese risks could cause securities customers to suffer losses with corresponding liability for the broker-dealer, imperiling the firm, its customers, and other creditors.” Ultimately, the Joint Statement recognizes that the custody and control of digital asset securities present distinct regulatory challenges that broker-dealers must understand.

2. The SEC Books and Records and Financial Reporting Rules

Section 17(a)(1) of the Exchange Act requires registered broker-dealers to make, keep, furnish and disseminate records and reports prescribed by the SEC, including financial reporting. The Joint Statement explains that distributed ledger technologies offer novel challenges with respect to this requirement. More specifically, the Joint Statement provides that the “broker-dealer’s difficulties in evidencing the existence of these digital asset securities may in turn create challenges for the broker-dealer’s independent auditor seeking to obtain sufficient appropriate audit evidence when testing management’s assertions in the financial statements during the annual broker-dealer audit.” No specific guidance was offered on this issue, but rather the Joint Statement put broker-dealers on notice about this potential challenge.

3. Securities Investor Protection Act of 1970

A broker-dealer who is unable to return customer property is subject to liquidation under the Securities Investor Protection Act of 1970^[3] (“SIPA”). Under SIPA, securities customers have a first priority claim to cash and securities held by the broker-dealer firm. The Joint Statement specifically notes that the SIPA protections only apply to securities and cash deposited to a broker-dealer account intended to purchase securities. The Joint Statement cautions that digital asset securities may not meet the definition of “security” under SIPA.^[4] In effect, this issue creates “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.”

Conclusion

The Joint Statement demonstrates that the SEC and FINRA are actively grappling with some of the most complex issues relating to digital asset securities. As the blockchain industry continues to evolve and expand, regulatory agencies will need to keep pace to ensure that customers involved with digital assets securities are protected from fraudulent conduct.

^[1] Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities Public Statement can be found [here](#).

^[2] See 17 CFR § 240.15c3-3.

^[3] See 15 U.S.C. § 78fff.

^[4] See 15 U.S.C. § 78lll(14).

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