

## **SEC: Special Purpose Broker-Dealers May Custody Digital Assets**

Effective April 27, 2021, the SEC issued a statement on the Custody of Digital Asset Securities by Special Purpose Broker-Dealers and outlined the steps broker-dealers of digital asset securities must take to comply with a safe harbor available for the next five years.<sup>1</sup> Per the Statement, a broker-dealer operating under certain circumstances will not be subject to a Commission enforcement action for violation of SEC Rule 15c3-3(b)(1).

### **Background**

A major question facing brokers and dealers seeking to conduct transactions of digital asset securities is how to comply with customer protection rules provided under the Securities Exchange Act of 1934 (the “Exchange Act”). The Customer Protection Rule, SEC Rule 15c3-3(b)(1), generally requires a broker-dealer to maintain the *physical possession or control* of all fully paid securities and excess margin securities carried or received by the broker-dealer for the account of customers. The language prompts the question of how a broker-dealer of digital securities, which have no physical component, can demonstrate possession and control of such assets received and held in custody for customers.

### **Special Purpose Broker-Dealer Exemption**

The Statement issued by the SEC acknowledges the difficulty in proving a broker-dealer exercises “control” over digital securities compared to traditional securities and provides a time-limited exemption for special purpose broker dealers who meet certain requirements. Previously, the SEC provided guidance permitting broker-dealers to transact in digital asset securities but only when providing noncustodial services. As a result of this new exemption, for five years following the publication of the Statement, a broker-dealer will not be subject to an enforcement action for violation of the Customer Protection Rule if the broker dealer:

1. has access to the digital asset securities and the capability to transfer them on the associated distributed ledger technology;
2. limits its business to dealing in, effecting transactions in, maintaining custody of, and/or operating an alternative trading system for digital asset securities;
3. establishes, maintains, and enforces reasonably designed written policies and procedures covering a range of issues, including the following:
  - a. **Determine Whether a Digital Asset is a Security** – a broker must conduct and document an analysis of whether a digital asset is a security offered and sold pursuant to an effective registration statement or an available exemption from

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<sup>1</sup>*Custody of Digital Asset Securities by Special Purpose Broker-Dealers*, SEC Release No. 34-90788 at 4 (Dec. 23, 2020) (SEC Release No. 34-90788). The Statement will become effective 60 days after publication in the Federal Register. As of the date of this Client Alert, the Statement has not been published.

registration, and whether the broker-dealer has fulfilled its requirements to comply with the federal securities laws with respect to effecting transactions in that digital asset security before undertaking to effect transactions in and maintain custody of such asset. Such policies and procedures should provide a reasonable level of assurance that any digital assets transacted in or held in custody by the broker-dealer are in fact digital asset securities.

- b. **Conduct Network Due Diligence** - a broker-dealer must 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.
  - c. **Demonstrate Exclusive Control and Possession** - a broker-dealer must implement policies for safekeeping and demonstrating the broker-dealer has exclusive possession or control over digital asset securities that are consistent with industry best practices 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.
  - d. **Develop Specific Event Responses.** A broker-dealer must develop procedures to address specific events, including: (1) specifically identify, in advance, the steps it intends to take in the wake of certain events that could affect the firm's custody of the digital asset securities, including blockchain malfunctions, 51% attacks, hard forks, or airdrops; (2) allow the broker-dealer to comply with a court-ordered freeze or seizure; and (3) allow the transfer of the digital asset securities held by the broker-dealer to another special purpose broker-dealer, a trustee, receiver, liquidator, a person performing a similar function, or 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.
4. does not 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;
  5. 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
6. **Provide written disclosures to prospective customers about the risks of investing in or holding digital asset securities.**
    - Anchorage Comments: BDs should provide

1. Written disclosures that it is deemed to be in possession or control of Digital Asset Securities held for the customer for purposes of SEC Rule 15c3-3(b)(1) based on its compliance with the Statement;
  2. written disclosures about the risks of investing in or holding digital securities that: a. prominently disclose that digital securities may not be “securities” as defined in SIPA — and in particular, Digital Asset Securities that are “investment contracts” under the Howey test but are not registered with the SEC 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; 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 used to create, store, or use the private keys and protect them from loss, theft, or unauthorized or accidental use; e. a set of risks relevant to any specific digital asset; and f. any additional risks that arise over time related to the industry at large or the protocol at issue; and
  3. any unique risks specific to the applicable protocol or smart contract.
7. 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; and
  8. 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, custodizing, liquidating, and otherwise transacting in digital asset securities on behalf of the customer.

## **Takeaways**

The Statement creates a safe harbor for a “special purpose broker-dealer” provided the business exclusively to deals in, effects transactions in, maintains custody of and/or operates an alternative trading system for digital asset securities. As such, existing broker-dealers cannot add digital asset activities to an broker-dealer license and must apply for a new license for an entity that will only conduct digital asset activities.

The Commission requested comments on specific topics relevant to digital asset securities and blockchain technology. In response, various industry participants provided feedback with respect to protection against theft and loss of digital asset securities, and events that could affect a broker-dealer’s custody of digital asset securities.

Overall, the Statement received a lukewarm welcome with many industry participants commenting on the need for additional clarity regarding certain requirements and the rejecting the idea that a single purpose broker is needed to ensure customer protection in digital securities brokerage transactions.

Comments have also challenged the necessity and practicality of certain procedures and disclosures, questioning:

- whether it is practical to require BDs to determine whether a digital asset is a security, because (1) all digital asset securities are “intended” securities issued by issuers pursuant to federal securities laws; (2) no clear guidance exists on how to make such determination;<sup>2</sup>
- whether BDs may rely on network due diligence provided by third-parties or must conduct its own due diligence;
- whether the requirement that BDs demonstrate industry best practices implemented to protect against loss or theft of digital assets or private keys can be met; and
- whether digital asset securities require additional disclosures because they are in fact riskier than traditional securities.

The special purpose BD exemption is a significant step towards creating a regulatory environment for digital asset securities that acknowledges the innovative features of blockchain technology as applied to private securities while purporting to safeguard consumers from the unique risks that do not exist with respect to traditional securities. In doing so, the SEC’s five-year incubator period requires broker-dealers to silo traditional securities brokerage activities from digital asset securities activities, which will undoubtedly prevent smaller firms from participating in both types of transactions. Moreover, many questions remain as to the best practices for protecting against theft, loss and fraud with respect to private keys held by special purpose broker dealers. The Statement includes a request for comment on these and other issues.

*The attorneys at Bull Blockchain Law are closely tracking developments with respect to special purpose broker-dealers and the comments submitted by industry participants. If you have any questions about becoming a special purpose broker-dealer, contact Tyler Harttraft, Esq. at [tyler@bullblockchainlaw.com](mailto:tyler@bullblockchainlaw.com).*

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<sup>2</sup> Chamber of Digital Commerce

## DRAFT NOTES

### Industry Comments

#### i. Anchorage Comments:

1. Since digital assets have no physical makeup by nature, the idea of “maintaining physical possession of or control over” digital asset securities presents a number of challenges. Put differently, and to borrow the Commission’s language, “the traditional securities infrastructure contains checks and controls that can be used to verify proprietary and customer holdings of traditional securities by broker-dealers.” an effective proxy exists, and that it should be required of any custody provider in digital assets: the ability to prove exclusive control over private keys and existence of assets on-chain. The broker dealer-dealer should be able to prove that that thing exists, and that it is under the exclusive control of said broker-dealer. One important distinction to note is the fact that private keys, like any piece of software, are copied easily. They can exist in a number of different locations and instances. This means that it’s possible, even likely for multiple copies of a given private key to exist and that proving control over one key doesn’t necessarily prove exclusive control—that the key only exists within a given entity’s custody. To meet the requirements under the Customer Protection rule, a broker dealer must be capable of proving exclusive control over private key material. It is possible to achieve proof of exclusive control through a combination of software, hardware, and operational processes. That said, not all custody models are structured in such a way that this is possible. More specifically, custody providers that base their security model on the maintenance of many copies of private key material may struggle to prove that all instances of a private key exist within their control. Not only does this throw compliance with the Customer Protection Rule into doubt, but it also greatly increases consumer risk. By relying on redundant copies of private key material in the name of security, such entities actually increase risk by making their own surface of attack larger, and drastically increasing the type and number of potential chances for loss through theft or internal collusion.

2. Suggests Hardware Security used by federal government.

#### ii. Anchorage Comments:

1. Technical Analysis: Anchorage recommends BDs be required to conduct a rigid technical analysis of each digital asset security it supports. Such analysis should achieve three primary goals:

- a. To determine whether the development of a given asset and its associated blockchain meet a level of safety and soundness consistent with a secure software development lifecycle,
  - b. To identify and report defects to a given asset's code base or other known vulnerabilities related to the asset or its blockchain network, and
  - c. To devise an overall assessment of the unique features and capabilities of a given asset and its underlying blockchain.
  - d. E.g. For ERC-20, necessary to expand technical
  - e. analysis to also include the source code of the smart contract used to create, issue, and otherwise manage that asset.
2. Blockchain Governance Analysis:
- a. The risk assessment should be crafted to the type of network: permissioned networks, unpermissioned networks, and token-based digital asset networks.

## **2. Chamber of Digital Commerce Comments**

- It is not practical to require BDs to determine whether a digital asset is a security, because (1) all digital asset securities are “intended” securities issued by issuers pursuant to federal securities laws, and (2) the guidance issued to date provides no reasonable basis for to determine whether digital assets that are not intended to be securities are in fact securities.
- In connection with the requirement to conduct network due diligence, (1) a Broker should not be required to conduct due diligence on the technology used by its custodians, and (2) the Commission should make clear that special purpose broker-dealers are permitted to rely on a reasonably determined third party assessment of that technology.
- In connection with the requirement to demonstrate industry best practices implemented to protect theft or loss of digital assets or private keys, the Chamber has questioned whether such best practices exist. Instead, the Commission should require Brokers to adopt processes and procedures reasonably designed to demonstrate its exclusive control and possession over digital assets.
- In connection with the requirement to develop procedures for specific responses, the Chamber argues digital asset security creation utilizes technology that is fully capable of allowing an issuer to freeze, revoke, and reassign any digital asset security issued in a way that makes theft or loss of keys or anything sent to the wrong address as easily correctable as with traditionally represented securities. This technology also allows for corrections, compliance with court-ordered freezes, or transfer of wallets on a broker-dealer insolvency.
- The requirement to disclose risks of investing in digital asset securities to customers also drew scrutiny:

- *We question the idea that such a disclosure must include language "explaining that digital asset securities may not be "securities" as defined in SIPA." This would imply that the intended digital asset securities that special purpose broker-dealers will trade and/or custody for their customers (upon which they must undertake specific analyses to classify as "digital asset securities") may, at some point in the future, not be deemed securities after all. This is inconsistent with the Statement's primary premise: that special purpose broker-dealers may ONLY engage in digital asset securities business, further demonstrating that the temporary safe harbor requires revision.*
- The Chamber disagrees with requiring a broker-dealer to provide the proposed written disclosures since the requirement reinforces the false narrative that digital asset securities are in fact riskier.
- In connection with the requirement to enter a written agreement To the extent that the Commission is not imposing additional obligations on a brokerdealer custodial digital asset securities compared to a broker-dealer custodial traditional securities, and that the term "written agreement" contemplates the language typically included in a broker-dealer's Terms of Service, the Chamber is generally supportive of this requirement.

### **3. Anchorage Comments**

- In the immediate term, we believe clearance and settlement by SPBDs should take the following form. Upon receipt of an order match with an exchange, broker, OTC desk or other counterparty, the SPBD should confirm the match with the counterparty and receive confirmation and approval from the Transfer Agent. Next, the SPBD should transfer the applicable consideration (either digital asset securities or USD) to the counterparty, and instruct the counterparty to transfer the corresponding consideration either into an account with the SPBD for the benefit of its customers, or directly into the appropriate customer account. The Transfer Agent should then record the transaction, which is reflected on the applicable blockchain, and the SPBD should report trade execution and settlement to its customers.

See:

[https://www.goodwinlaw.com/publications/2020/12/12\\_24\\_sec-to-permit-custody-of-digital-asset#1](https://www.goodwinlaw.com/publications/2020/12/12_24_sec-to-permit-custody-of-digital-asset#1)

<https://www.wilmerhale.com/en/insights/client-alerts/20210202-the-sec-issues-statement-and-requests-comment-regarding-the-custody-of-digital-asset-securities-by-special-purpose-broker-dealers>