SEC No-Action Letter Facilitates Secondary Market Trading of Digital Asset Securities

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Digital Asset Securities

The term "digital asset" refers to an asset that is issued and/or transferred using distributed ledger or blockchain technology, including, but not limited to, so called "virtual currencies," "coins," and "tokens." A digital asset may or may not be considered a "security" under the federal securities laws. The No-Action Letter refers to a digital asset that is a security as a "digital asset security."

In a game-changing development for the future viability of digital asset securities trading, staff of the Division of Trading and Markets of the SEC issued a **No-Action Letter** to FINRA on September 25, 2020 clarifying a structure under which registered broker-dealers could operate alternative trading systems ("**ATSs**") that allow for real-time trading of blockchain-based securities, without running afoul of the custody requirements of Rule 15c3-3 (the "**Customer Protection Rule**"). The structure was originally proposed to the SEC staff in a request for no-action relief from Davis Polk & Wardwell partners Annette Nazareth and Zachary Zweihorn on behalf of several clients, but the staff ultimately decided to issue the relief more broadly as industry-wide no-action guidance to FINRA.

Background on the Customer Protection Rule

As described in our July 12, 2019 **memorandum**, the Customer Protection Rule has been a key hurdle to the development of legal trading platforms for digital asset securities, as it requires a broker-dealer to obtain and maintain physical possession or control of all fully paid and excess margin securities carried by a broker-dealer for the account of customers. Unlike traditional securities, ownership of digital asset securities is typically recorded on a distributed ledger, or blockchain, rather than through stock certificates or book-entry records maintained by an issuer's transfer agent or a central securities depository, such as the Depository Trust Company. In July 2019, the SEC and FINRA issued a **joint statement** (the "**Joint Staff Statement**") highlighting many of the operational and regulatory concerns arising from broker-dealers proposing to hold custody of digital asset securities on behalf of customers,[1] and generally suggested that broker-dealers could not adequately maintain physical possession or control of such securities in compliance with the Customer Protection Rule. As a result, it has been unclear until now how broker-dealers that propose to facilitate secondary market trading of digital asset securities could do so in a manner compliant with the Customer Protection Rule.

[1] Among the concerns was the fact that digital assets may be difficult to recover in situations where a (i) broker-dealer is victimized by fraud or theft, (ii) private keys for digital asset wallets are lost, or (iii) digital assets are sent to an incorrect address. Additionally, even if a broker-dealer can prove that it holds a private key that may not be sufficient to evidence possession or control, as this does not prove that no third party also has the private key.

The "Four-Step Process"

Step 1: The buyer and seller send their respective orders to the ATS

Step 2: The ATS matches the orders

Step 3: The ATS notifies the buyer and seller of the matched trade

Step 4: The buyer and seller settle the transaction bilaterally, either directly with each other or by instructing their respective custodians to settle the transaction on their behalf

While the Joint Staff Statement indicated that broker-dealers, including ATSs, could be involved in executing trades, it required that those trades be settled bilaterally between the parties or based on the parties' specific instructions to their custodians—without any involvement of the broker-dealer. By essentially imposing a private placement settlement process on a real-time ATS trading market, this sequence, referred to as the "**Four-Step Process**," was cumbersome and introduced operational risk. A trade could be matched in the ATS, but settlement was at risk of either party failing to send the necessary settlement instruction—a real risk in a fast-moving market where adverse price movements could create negative incentives for a party to honor a trade. Real-time trading of the type that typically occurs on securities exchanges or ATSs was incompatible with the Four Step Process.

Overview of the No-Action Relief

The Davis Polk proposal, as reflected in the No-Action Letter to FINRA, sought to satisfy the SEC staff's position that custody and settlement of digital asset securities could only occur outside of a broker-dealer, but under a three-step structure that would allow the settlement instructions to be passed to a custodian at the time of execution, thereby reducing settlement risk and delay. Specifically, under the "**Three-Step Process**," the customer would:

- establish a separate cash and digital asset security custody account with an appropriately regulated non-broker-dealer custodian (such as a bank or trust company);
- provide the custodian with a standing instruction to settle any trades on the customer's behalf that the broker-dealer reported to the custodian as having being executed; and
- request that the broker-dealer simultaneously report matched trades both to the customer as well as the customer's custodian.

The "Three-Step Process"

Step 1: The buyer and seller send their respective orders to the ATS, notify their respective custodians of their respective orders submitted to the ATS, and instruct their respective custodians to settle transactions in accordance with the terms of their orders if the ATS notifies the custodians of a match on the ATS

Step 2: The ATS matches the orders

Step 3: The ATS notifies the buyer and seller and their respective custodians of the matched trade and the custodians carry out the conditional instructions

Although the broker-dealer would not, in fact, maintain possession or custody of the customer's digital asset securities (which are held by the customer's separate custodian), the broker-dealer would indirectly cause the movement of the securities by reporting to the custodian that a trade occurred. We understand that the SEC staff generally believes that a broker-dealer that has the ability to cause the movement of a customer's securities held by a third party could be deemed to hold "custody" within the meaning of the Customer Protection Rule, which the Joint Staff Statement indicated was not currently permissible for digital asset securities.

Without directly speaking to the applicability of the Customer Protection Rule, the No-Action Letter clarifies that the SEC staff would not object to a broker-dealer implementing the Three-Step Process so long as the following conditions are met:

- the broker-dealer maintains a minimum of $250,000 in net capital;
- the agreements between the broker-dealer and its customers clearly state that the broker-dealer does not guarantee or otherwise have responsibility for settling the trades;

- the broker-dealer has established and maintains reasonably designed procedures to assess whether a digital asset security was offered and sold initially pursuant to an effective registration statement or an available exemption from registration, and whether any secondary transactions of the digital asset security on or through the ATS are made pursuant to an effective registration statement or an available exemption from registration; and
- the transactions in digital asset securities otherwise comply with the federal securities laws.

Next Steps

The No-Action Letter, which comes on the heels of an interpretive letter from the Office of the Comptroller of the Currency confirming that national banks may hold "crypto assets" for customers (see our recent **memorandum**), may allow legal, regulated and fully functional trading platforms for digital asset securities to finally come to market. To be sure, there remain a number of other potential legal and regulatory hurdles—such as whether the particular digital asset security traded on the platform was issued and can being traded in compliance with the registration requirements of the Securities Act of 1933 and state blue sky laws (or available exemptions).

Further, the No-Action Letter is not a complete solution for normalizing the secondary market trading of digital asset securities, as it relies on complicated work flow not necessary for any other type of security. At the moment, this appears necessary as the Joint Staff Statement would continue to prohibit broker-dealers from themselves custodying digital asset securities for their customers, either directly or through a third-party "good control location." But until the broader seemingly intractable Customer Protection Rule obstacles are solved, the No-Action Letter provides at least an interim regulatory workaround to allow legitimate digital asset security trading to occur on regulated platforms.

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