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SEC Issues No-Action Letter Facilitating the Secondary Trading of Digital Assets

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On Sept. 25, 2020, the Securities and Exchange Commission (SEC) issued a No-Action Letter[1] to the Financial Industry Regulatory Authority (FINRA), in response to a previously issued Joint Statement[2] (Joint Statement) by the SEC and FINRA. This No-Action Letter detailed how broker-dealers could operate alternative trading systems (ATS) that trade digital assets without garnering enforcement action from the SEC for not meeting the custody requirements required under Rule 15c3-3 (Customer Protection Rule).[3] In the No-Action Letter, the SEC stated that it would not recommend enforcement under Section 15(c)(3) of the Securities Exchange Act of 1934, as amended (Exchange Act), as long as the broker-dealer: (1) maintained a minimum of $250,000 in net capital; (2) unambiguously stated in all agreements that the broker-dealer operator did not have responsibility for settling trades; (3) established and maintained reasonably designed procedures to assess whether digital assets were being properly offered under applicable securities registration rules or exemptions; and (4) guaranteed that the offer or sale of digital assets complied with the Securities Act of 1933 (Compliance Requirements).[4]

The primary focus of the Customer Protection Rule is to "ensure uniform net capital standards, or liquidity standards,"[5] for brokers and dealers registered with the SEC under Section 15(b) of the Exchange Act.[6] The Customer Protection Rule, by requiring that broker-dealers have physical possession and/or control of all fully paid and excess margin securities carried by the broker-dealer account, has historically created complications for broker-dealers attempting to trade cryptocurrency or other digital assets. The main hurdle of such requirement is that cryptocurrencies and other types of digital assets are recorded via blockchains and other ledgers, while shares of stock are recorded through stock certificates. The digital asset being recorded via a blockchain or ledger instead of on a stock certificate in possession of the broker-dealer, means the broker-dealer never has physical possession of the digital asset, and thereby does not meet the custody requirement of the Customer Protection Rule.

Historical Background

Prior to the issuance of this No-Action Letter, broker-dealers complied with the Customer Protection Rule by following a non-custodial four-step ATS model. In response to the complications imposed by the four-step model, several broker-dealers seeking to operate an ATS asserted that this four-step model increased settlement risks.[7] Such settlement risks arose from the fact that a trade could be matched in the ATS, but either party could fail to send the necessary settlement instructions and prolong the time between the ATS match and settlement. Extending the period between the ATS match and settlement, in a market where the valuations of digital assets changes instantly, provided little incentive for parties to honor trades. This was especially true in cases where the transaction, as a result of an extended waiting period between being matched in the ATS and settled, became less profitable.

Current ATS Framework

In response to broker-dealer concerns with the four-step model, the SEC implemented the following three-step ATS framework in compliance with the Customer Protection Rule, so long as the Compliance Requirements are met:

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 when the ATS notifies the custodians of a match on the ATS;

Step 2. The ATS matches the orders; and

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.

The above three-step framework differs from the original four-step method in that the four-step method requires the "buyer and seller to settle their transaction bilaterally, either directly with each other or by instructing their respective custodians to settle the transaction on their behalf."[8] In cutting out that step, the three-step framework reduces the time between match in the ATS and settlement, thereby reducing settlement risks.

Looking Forward

The No-Action Letter, issued days after the Office of the Comptroller of the Currency confirmed that national banks could hold stablecoin reserves,[9] demonstrates that regulatory agencies are reevaluating their previously held distrust of digital currency and assets. Furthermore, it shows that they may be preparing for digital assets to one day be sold on mainstream stock exchanges such as the New York Stock Exchange or NASDAQ. It also demonstrates that broker-dealers may further play a role in implementing regulations regarding the secondary market trading of digital asset securities.

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1 *See* ATS Role in the Settlement of Digital Asset Security Trades No-Action Letter, dated Sept. 25, 2020.

2 *See* Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities, dated July 8, 2019.

3 *See* 17 C.F.R 240.15c3-3(b)(a) “A broker or dealer shall promptly obtain and shall thereafter maintain the physical possession or control of all fully-paid securities and excess margin securities carried by a broker or dealer for the account of customers.”

4 *See Supra*, note 1.

5 *Appendix 11 Key. SEC Financial Responsibility Rules*: “To comply with SEC's net capital rule, broker-dealers must perform two computations: one computation determines the broker-dealer's net capital (liquid capital), and another computation determines the broker-dealer's appropriate minimum net capital requirement (base capital requirement).”

6 *See* 15 U.S. Code § 78, the Securities Exchange Act of 1934.

7 *See* Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities, dated July 8, 2019: “There are many significant differences in the mechanics and risks associated with custodying traditional securities and digital asset securities. For instance, 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. Consequently, a broker-dealer must consider how it can, in conformance with Rule 15c3-3, hold in possession or control digital asset securities.”

8 *Supra*, note 1.

9 *See* OCC Chief Counsel’s Interpretation on National Bank and Federal Savings Association Authority to Hold Stablecoin Reserves, dated Sept. 21, 2020: “Companies that issue stablecoins often desire to place the funds backing the stablecoin, or reserve funds, with a U.S. bank . . . Several of these issuers promote these reserves—and the fact that they are held by banks—to support the trustworthiness of their stablecoin…we conclude that a national bank may hold such stablecoin “reserves” as a service to bank customers.”

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