



May 20, 2021

Vanessa Countryman  
Secretary, Securities and Exchange Commission  
100 F Street NE  
Washington, DC 20549-1090

**RE: File No. S7-25-20: SEC Statement And Request For Comment on Custody of Digital Asset Securities by Special Purpose Broker-Dealers**

Dear Ms. Countryman,

On December 23, 2020, the Securities and Exchange Commission (“SEC” or “Commission”) issued a statement describing certain conditions under which a broker-dealer could comply with the requirements of Rule 15c3-3 under the Securities Exchange Act of 1934 (hereinafter the “Customer Protection Rule” or “Rule 15c3-3”) with respect to digital asset securities (hereinafter the “Statement” or the “Custody of Digital Asset Securities by Special Purpose Broker-Dealers”).<sup>1</sup> The Commission further requested comments on best practices with respect to custody of digital asset securities to consider in connection with any future rule-making or Commission action in this area.

The Securities Industry and Financial Markets Association appreciates the opportunity to provide comments on this statement.<sup>2</sup> Like many other industry participants and regulators alike, SIFMA recognizes the potential transformative effect of blockchain technology in the securities industry and welcomes the Commission’s efforts to provide needed clarity on the ability of broker-dealers to custody digital asset securities in compliance with the Customer Protection Rule.

In particular, SIFMA acknowledges and appreciates the Commission’s concerns about the unique attributes of digital asset securities and desire to protect investors while allowing broker-dealers to engage in customary broker-dealer activities with respect to digital asset securities. However, a unique, or different, risk profile does not necessarily mean risks are *greater* with respect to digital asset securities compared to traditionally represented securities. Additionally, SIFMA believes the Statement’s restriction of only allowing broker-dealers who exclusively engage in activities related to digital asset securities to

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<sup>1</sup> See Custody of Digital Asset Securities by Special Purpose Broker-Dealers, Exchange Act Release No. 90788 (proposed Dec. 23, 2020).

<sup>2</sup> SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry’s nearly 1 million employees, we advocate for legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA).

provide custody of such securities will not best serve the interests of investors in every case, as explained below.

As such, SIFMA urges the Commission to take into consideration the following:

- The Definition of Digital Asset Security
- The Effectiveness of Special Purpose Broker-Dealers
- Proposed Control Frameworks and Industry Best Practices
- Clearance and Settlement Considerations
- Investor Protections

SIFMA looks forward to continuing a productive dialogue on these issues.

#### **I. The Definition of Digital Asset Security**

The Statement defines a “digital asset” as “an asset that is issued and/or transferred using distributed ledger or blockchain technology (‘distributed ledger technology’), including, but not limited to, so-called ‘virtual currencies,’ ‘coins,’ and ‘tokens.’”<sup>3</sup> A “digital asset security” is further defined as any digital asset that meets the definition of “security” under the federal securities laws. Digital asset securities are, therefore, a subset of a broader category of digital assets. We understand the need for the SEC to distinguish between digital asset securities and digital assets that are not securities. However, the SEC’s guidance and any future rulemaking should take a technology neutral approach and avoid framing rulemaking in such a way that restricts a broker-dealer’s ability to conduct business by virtue of the technology it wishes to implement.

In particular, SIFMA believes this categorization of “digital asset security” is overbroad for purposes of the Statement and captures digitally represented securities (or digitally represented interests in securities) that do not necessarily involve the risks described in the Statement. There are various types of securities and ways of digitally representing and transferring such securities that could meet the Statement’s definition of a “digital asset security,” while possessing different characteristics and risk profiles. For instance, a bearer security in a public network may have significant differences that inform the associated operational and regulatory risks when compared to a non-bearer security in a permissioned network. There may also be significant differences even within these broad categories depending on how a particular digital asset or network is configured. These differences mean that the Commission’s concerns identified in the Statement may not be applicable for all digital asset securities, making it difficult to provide generalized answers to some of the questions raised in the Statement.

For this reason, the Commission should continue to take a technology-neutral regulation approach to regulation that focuses on the relevant risks, and not the specific technology used to record or transfer securities. This approach should allow broker-dealers to develop policies, procedures, and best practices that may be customized to different types of digital asset securities and/or related technologies and provide flexibility for broker-dealers to address issues unique to different forms of digital asset securities and digital asset securities offerings.

Some of the concerns raised in the Statement are related to the technology used by the issuer, while others may relate to the type of digital asset security itself. For example, as defined in the Statement, each of the following could be interpreted as a digital asset security: (i) an unregistered

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<sup>3</sup> The Statement at 2.

investment contract issued on a public blockchain network, such as that described in the DAO Report;<sup>4</sup> (ii) a registered equity security issued natively on a public blockchain network;<sup>5</sup> (iii) registered equity securities reflected on the books and records of an issuer's transfer agent for which a "courtesy copy" of the transfer agent share register exists on a public blockchain;<sup>6</sup> or (iv) a digital representation on a permissioned blockchain of a security entitlement to registered equity security held in an account at the Depository Trust Company.<sup>7</sup> Although each such example could be interpreted as a digital asset security, there are significant operational differences and corresponding risks that broker-dealers would need to take into consideration when developing best practices to support each of these digital asset securities.

Accordingly, SIFMA believes that the SEC should take a principle-based approach to regulating activities related to digital asset securities in order to allow a broker-dealer the flexibility to develop best practices and comply with its existing regulatory obligations, rather than focusing on the underlying technology (i.e., distributed ledger technology), as it and other regulators have done in the past.<sup>8</sup> For example, the Commodity Futures Trading Commission ("CFTC") implemented a principle-based approach when revising the recordkeeping requirements under the Commodity Exchange Act rather than proscribing specific technology requirements in a manner that allows "recordkeepers to leverage advances in information technology as a means to reduce costs associated with the retention and production of paper and electronic records and to decrease the risks of cybersecurity threats, while maintaining necessary safeguards to ensure the integrity, availability, and accessibility of records required to be kept pursuant to the Commodity Exchange Act."<sup>9</sup> Any future rulemaking by the Commission should not be based on a general distinction between digital asset securities and "traditional" securities, but rather should be technology neutral, should be principle-based, and should allow firms the ability to evaluate what digital asset securities they will support, taking into consideration the relevant operational risks and regulatory requirements related to the technology underlying the digital asset security and unique configuration and facts related to a particular digital asset security.

## **II. The Effectiveness of Special Purpose Broker-Dealers**

To comply with the Statement, a broker-dealer that would custody digital asset securities must "limit its business exclusively to . . . digital asset securities" in order to "isolate risk."<sup>10</sup> Given the varying risks of different types of digital asset securities customers may be interested in, SIFMA believes that broker-dealers can develop appropriate operational procedures to establish that digital asset securities are sufficiently within a broker-dealer's control and do not pose extraordinary risks that require the establishment of a special purpose broker-dealer ("SPBD") for custody of digital asset securities.

Both traditional securities and digital asset securities will be in place for the foreseeable future. Attempting to isolate risk via the establishment of an SPBD may not support the long-term objectives of building the industry capability and insights required to manage a mainstream offering that includes both

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<sup>4</sup> Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81207 (July 25, 2017).

<sup>5</sup> See INX Limited Prospectus (Filed September 29, 2020).

<sup>6</sup> See Overstock.com, Inc. Digital Voting Series A-1 Preferred Stock FAQ at <https://www.overstock.com/dividend>

<sup>7</sup> SEC Division of Trading and Markets' No-action letter to Paxos Trust Company LLC (Oct. 28, 2019).

<sup>8</sup> See Release No. 34-44238, Commission Guidance to Broker-Dealers on the Use of Electronic Storage Media under the Electronic Signatures in Global and National Commerce Act of 2000 with Respect to Rule 17a-4(f). ("[T]he Commission encourages the use of technological innovation when both broker-dealers and investors will benefit.").

<sup>9</sup> Federal Register, Volume 82 Issue 12 (Thursday, January 19, 2017) (revising 17 C.F.R. Parts 1 and 23), available at <https://www.cftc.gov/LawRegulation/FederalRegister/proposedrules/2017-01148.html>.

<sup>10</sup> The Statement at 3 and 8.

methods of recording securities – it merely continues the bifurcation seen in the marketplace today between regulated broker-dealers and digital asset service providers.

The establishment of an SPBD goes further, resulting in a trifurcated market between digital and traditional securities (and further, non-security digital assets). This trifurcation creates obstacles for broker-dealers and customers alike:

*Cost.* The need to create an SPBD for digital asset securities activity, as opposed to leveraging an existing broker-dealer with a new digital asset security business line will be a significant cost burden for the broker-dealers, which is then passed on as an additional cost to end customers. Forming an SPBD, whether as a new entrant or as a stand-alone business of an existing broker-dealer, will involve significant costs in connection with navigating regulatory approvals, building new operational infrastructure and other start-up costs. For existing broker-dealers, certain costs may be duplicated across businesses. Furthermore, the ambiguity of what will occur after the 5-year safe harbor provided by the Statement makes it difficult to assess the value of these expenditures without a long-term view of the viability to the proposed business model.

In particular, establishing a new SPBD requires a significant financial outlay in order to comply with regulatory minimum net capital requirements.<sup>11</sup> This creates a significant cost burden hindering the expansion and development of a digital asset securities market, as broker-dealers may be reluctant to enter the space when faced with substantial regulatory capital costs in order to carry out an initial venture or pilot program, that may be coupled with low initial volumes. This also potentially limits competition among broker-dealers by favoring certain business models that are not subject to the same requirements as “traditional” securities broker-dealers, further limiting development of the digital asset securities market.

*Existing policies and procedures.* A new and separate SPBD would not benefit from the established controls and risk management protocols already in place, tested, and relied on at existing broker-dealers. Established broker-dealers already have in place policies and procedures that could be generally applicable or easy to tweak to be applicable to digital asset securities. These established policies and procedures, could address concerns identified in the Statement.

*Customer inconvenience.* An SPBD forces customers that wish to deal in digital and non-digital securities to open accounts with different broker-dealers. This will disadvantage investors who prefer the convenience of dealing with a single broker-dealer and may result in added costs and fees. Furthermore, the Statement may create an artificial distinction that presents challenges for both issuers and investors, as both issuers and investors may not clearly distinguish digital asset securities from traditional securities. As mentioned earlier, certain activities with respect to digital asset securities that meet the definition of securities may be inseparable from traditional securities, such as Overstock.com, Inc.’s digital dividend issued to holders of traditional shares, and digital securities entitlements to traditional securities held at DTC.<sup>12</sup>

*Concentration of risk.* At least in the near term, an SPBD’s capital risk exposure would likely be concentrated in a narrow category of securities issued by “early adopter” companies that may be closely

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<sup>11</sup> See SEC Rule 15c3-1. In addition, the Basel Committee on Banking Supervision intends to finalize ongoing initiatives relating to the prudential treatment of banks’ crypto-assets exposures within the next year, which will impact certain broker-dealers’ considerations for capitalizing an SPBD. See Basel Committee Work Programme and Strategic Priorities for 2021-22, available at: [https://www.bis.org/bcbs/bcbs\\_work.pdf](https://www.bis.org/bcbs/bcbs_work.pdf).

<sup>12</sup> See *Part I, above*.

correlated with each other. Broker-dealers able to custody both traditional securities and digital assets securities would have more flexibility to appropriately manage risk.

*Clearance and settlement challenges.* Limiting an SPBD's business to dealing only in digital asset securities may prevent broker-dealers from utilizing the benefits of distributed ledger technology on the payment side of a trade. Moreover, fragmentation in clearance and settlement processes may occur, for example, in a situation where traditional securities are settling at T+2, whereas an SPBD may settle faster for potentially the same or similar securities, by using distributed ledger technology to process or represent such securities.<sup>13</sup>

The operational fragmentation that would result from requiring an SPBD to custody digital asset securities runs counter to the goals adopted by regulators after the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Simplification of entity structures for risk management purposes has been seen by policy makers and regulations as supportive of financial stability and better management of systemic risk.<sup>14</sup> The SEC should re-consider whether this additional organizational complexity of requiring existing broker-dealers to create a separate SPBD is necessary to achieve its investor protection goals, particularly for what is likely to represent a small portion of a broker-dealer's business, at least in the near term.

### **Traditional Broker-Dealers Can Provide Adequate Protections For Digital Asset Securities**

SIFMA agrees with the Commission that a broker-dealer should take into consideration differences between certain digital asset securities and traditional securities when developing internal operations and compliance procedures. However, SIFMA believes that traditional broker-dealers can provide adequate protections for digital asset securities, making a special purpose broker-dealer unnecessary. This may especially be the case in light of the risk profiles of the types of digital asset securities established broker-dealers are mostly likely to interact with. As explained below, certain types of digital asset securities may not pose additional material concerns compared to existing securities. SIFMA is prepared to work with the Commission to alleviate concerns regarding the custody of particular types of digital asset securities.

#### *Established Risk Management And Control Frameworks*

Established broker-dealers have a range of risk management and control frameworks in place across their existing business lines (vendor risk, tech risk, compliance, ops risk, etc.). Restricting digital asset activities to special purpose broker-dealers, many of which may be newly formed, could actually increase risk in this market by making it harder to take advantage of these existing controls and long-established business management experience.

In many cases, the necessary policies, procedures, and controls required for digital asset securities fit within broker-dealers' existing security frameworks. For example, broker-dealers have existing IT and data security controls, including role-based access permissioning, etc. Many safeguards applicable to digital asset securities would be a subset of these existing controls and not necessarily a stand-alone control framework. Existing broker-dealers also have developed experience monitoring

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<sup>13</sup> While the U.S. securities settlement cycle is currently T+2, this is an evolving standard and SIFMA, the Investment Company Institute (ICI), and The Depository Trust & Clearing Corporation (DTCC) are currently collaborating on efforts to accelerate it from T+2 to T+1; <https://www.sifma.org/explore-issues/shortening-settlement-cycle/>

<sup>14</sup> See FED. DEPOSIT INS. CORP. & BD. OF GOVERNORS OF THE FED. RESERVE SYS., FINAL GUIDANCE FOR 2019 §165(d) ANNUAL RESOLUTION PLAN SUBMISSIONS BY DOMESTIC COVERED COMPANIES THAT SUBMITTED RESOLUTION PLANS IN JULY 2017, 84 FR 1438 (Feb. 4, 2019) (outlining considerations for legal entity rationalization).

market risk, credit risk, and third-party risk management, which certain new SPBDs may not benefit from. For example, existing broker-dealers can leverage controls such as standing settlement instruction verification, transaction monitoring and surveillance, payment monitoring and threshold-controls, and call-back authentication for instructions.

Existing risk management procedures can also address seemingly unique challenges posed by digital assets securities. Concerns around private keys and the security of assets, auditability, and traceability can be mitigated through the right technology controls by a broker-dealer, or by delegated responsibilities to a clearing house or specialized custodian (as is currently done for most traditional securities), without requiring every broker-dealer that could have control over a customer's digital asset securities to custody such securities directly themselves. Such controls could include solutions such as the use of permissioned blockchains and other cybersecurity protections. For a further discussion, see Section III, Proposed Control Frameworks And Industry Best Practices.

#### *Traditional Remedies*

The fact that a security may be represented as a digital asset does not preclude the availability of traditional remedies, such as replacing lost or stolen securities. A security does not become a bearer instrument merely because it is reflected using distributed ledger technology, depending on the configuration of the network or applicable digital asset smart contract. The ability to replace lost or stolen securities is a question of how certain roles and functions are performed with respect to a particular digital asset security, rather than the technology supporting a digital asset itself.

#### *A Special Purpose Broker-Dealer Is Not The Only Way To Meet The Commission's Concerns*

The Statement discusses the concern that digital assets are uniquely at risk of loss or theft, which could cause the broker-dealer to fail, thus impacting traditional customers and other creditors. However, an SPBD is not necessary to limit insolvency risk. Any incremental risks associated with digital asset securities could potentially be addressed via enhanced procedures in a broker-dealer's compliance program, rather than technology-specific regulation such as the establishment of SPBDs. Broker-dealers that custody digital assets may also consider exploring the availability of insurance policies to mitigate the risk of theft or loss, based on the level of risk associated with their activities.

#### **Special Purpose Broker-Dealers Will Limit The Broker-Dealer's Ability to Serve Customers**

Limiting a broker-dealer's business activities to only digital asset securities will likewise limit the broker-dealer's ability to serve customers. Most customers prefer to do all of their business in one place. A continuous service model will ensure that the investor benefits a single experience and the associated advantages.

#### *Operational Complexity and Customer Convenience*

For existing broker-dealers, forming an SPBD would require operational expenditures in order to integrate systems and present a seamless customer experience across broker-dealer affiliates through online portals and applications in order to access investment advice, research, account statements, and similar services. Depending on the level of integration necessary, these costs could likely be passed through to customers. Furthermore, this would create additional operational complexity, as back office activities would need to be managed across multiple entities, requiring additional operational and risk management processes and controls, and could also introduce undue risk to the system.

Custodying digital asset securities in a separate entity than traditional securities would also create disruptions in a broad range of client interactions across the securities lifecycle, as customers could lose

the potential benefits of cross-margining, leverage, and liquidity for their digital asset securities based on their traditional securities holdings that would be separated in a different entity. Although firms may make services available to customers through a single point of entry, an SPBD unnecessarily prevents customers from holding digital asset securities and traditional securities in a single account. As a result, customers may not be able to engage in certain transactions as seamlessly as for traditional securities activities.

### **Special Purpose Broker-Dealers Will be Disruptive to the Introducing Firm and Clearing Firm Relationship.**

Clearing firms will not be able to freely operate as SPBDs and would need to ensure the respective obligations on both sides of a transaction are satisfied by other digital asset custodians (i.e., banks or trust companies that may custody a non-security digital assets used for settlement of one side of the transaction).<sup>15</sup> This seems to be overly exclusionary, perhaps unintentionally, and could disadvantage introducing firms (or their investors that want access) or further fragment the industry.

Many of the advantages to be realized by the use of digital asset securities are related to operational efficiencies in the clearance and settlement of transactions. In order to take full advantage of these efficiencies, transactions would need to clear and settle “on-chain” using digital forms of payment for digital asset securities. Limiting a broker-dealer from effecting transactions in non-security digital assets, such as digital or tokenized cash, renders the broker-dealer unable to take advantage of one of the important benefits of distributed ledger technology on the payment side of the trade. Digital asset clearance and settlement allows firms to leverage benefits inherent to distributed ledger technology and automation in general (for example, in matching of instructions or use of smart-contract capability). These tools can help reduce transaction capture, settlement risks, and payment errors. For further discussion, see Section IV on Clearance and Settlement Risks.

Finally, although broker-dealers have an existing obligation under the securities laws to perform due diligence on the products they offer, the Statement’s requirement that all digital asset securities activities be conducted by broker-dealers who themselves must maintain policies and procedures to determine whether a particular digital asset is a security puts an extra onus on broker-dealers, who would become gatekeepers for the entire digital asset securities industry. As we have mentioned in the context of the definition of a “digital asset security,” this obligation is straightforward where the digital asset security is merely a digital representation of an equity security. For digital asset securities that are investment contracts, however, there is very little legal precedent for determining when a digital asset is an investment contract. The Statement places a burden on SPBDs to find evidence or arguments for why a digital asset is or is not a security where there is unlikely to be a definitive answer, as the SEC has acknowledged by not itself providing unequivocal guidance as to how determine when a digital asset is a security. By shifting this responsibility to the broker-dealer, it may create a scenario where different SPBDs or other market participants reach a different conclusion as to the security status of a particular instrument, which may cause overall disruption in the market for that security, among other unintended regulatory consequences for issuers and investors.

### **III. Proposed Control Frameworks And Industry Best Practices**

The Statement provides a helpful discussion of various controls that a broker-dealer could establish to mitigate potential risks involved with the custody of digital asset securities. For instance, the Statement requires broker-dealers to “establish, maintain, and enforce reasonably designed written

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<sup>15</sup> Most transactions are comprised of security and cash payment legs, and it is rare that a security would be traded directly for another security. As drafted however, the Statement prohibits custody of non-security digital assets which stymies the ability of a broker to clear and settle transactions in digital asset securities. See Part IV, below.

policies, procedures, and controls 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.”<sup>16</sup>

This is a welcome development, as the Statement provides a starting point for broker-dealers to consider requirements needed to mitigate the risks associated with digital asset securities that other regulations do not expressly proscribe. In fact, SIFMA suggests the adoption of minimum practices or principles that every broker-dealer involved with digital asset securities should meet.

### **Current Industry Best Practices**

Since no broker-dealers are currently approved to provide custody of digital asset securities in compliance with the Customer Protection Rule, identifying best practices may require looking to other digital asset market participants. The Commission, and broker-dealers that intend to custody digital asset securities, may look to industry practices established by other regulated financial institutions and technology providers that currently provide custody services for digital assets (including non-security digital assets) in formulating minimum practices for broker-dealers – though we note that best practices with respect to securities may evolve differently than best practices for non-security digital assets. For example, unlike many non-security digital assets, digital asset securities may be structured in such a way that they are not bearer instruments, and therefore the risks related to the safekeeping of private keys may be reduced in comparison to those for bearer digital assets on public networks.

For example, SIFMA directs the Commission to the white paper on digital asset custody published by KPMG, *Cracking Crypto Custody* (2020),<sup>17</sup> that recommends four key actions for digital asset custodians: (1) next-gen security and resilience ensuring the finality of public blockchain transactions and implantation of cybersecurity controls such as NIST 800-53 and NIST 800-57; (2) comprehensive compliance concerning financial services regulations; (3) third-party trust – for instance, through System and Organization Controls (SOC) examinations; and (4) value-added custody by keeping pace with rapid technical changes and building out core capabilities. While these resources are a useful starting point, they do not necessarily take into account best practices specific to digital asset securities. Given that broker-dealers are only now able to provide custody of digital asset securities in light of the Statement, we believe best practices will continue to develop as both the market and technology evolve. Accordingly, SIFMA intends to further investigate this issue, and will share its findings with the Commission in a supplemental response.<sup>18</sup>

Finally, SIFMA directs the Commission to the recently issued report by the National Institute of Standard and Technology, *Blockchain Networks: Token Design and Management Overview* for a discussion of the technological variables that may be implemented with respect to a particular digital asset, including wallet and private key management techniques (including key generation and recovery) and transaction validation procedures, among other things. The technologies surrounding digital assets are continuously evolving, and it is crucial that broker-dealers and regulators stay on top of these changes to ensure secure custody for investors.

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<sup>16</sup> *Id.* at 11.

<sup>17</sup> *Cracking Crypto Custody*, KPMG (2020) available at <https://advisory.kpmg.us/content/dam/advisory/en/pdfs/2020/kpmg-cracking-crypto-currency.pdf>.

<sup>18</sup> SIFMA is also aware of other market participants that provide custody of digital assets and related services that may be able to inform the Commission (and broker-dealers) as to best practices for providing custody of digital asset securities, such as national banks, state-chartered banks and trust companies, and specialized technology companies that provide key management solutions that are implemented by custodians.



## **Control Under the Customer Protection Rule**

Although the Statement does not expressly address whether a broker-dealer may comply with the Customer Protection Rule by relying on a good control location under paragraph (c) of Rule 15c3-3 for digital asset securities, it is possible that concerns regarding investor protection may be addressed by a broker-dealer relying on an experienced digital asset custodian, such as a bank, that follows industry best practices and otherwise meets the requirements of Rule 15c3-3(c).<sup>19</sup> SIFMA would appreciate the Commission's guidance on whether reliance on a good control location may be available for digital asset securities, under what circumstances, and whether a separate SPBD would still be required if a broker-dealer otherwise complies with Rule 15c3-3 vis-à-vis their digital asset securities business operations.

## **IV. Clearance and Settlement Considerations**

### **Risks Associated With Digital Asset Securities Are Not Necessarily Greater Than Those Resulting From Traditional Securities**

The Statement suggests that the nature of risks associated with the custody of certain digital asset securities may be different to those from custodying traditional securities. For instance, the Commission states that “[d]igital assets that are issued or transferred using distributed ledger technology may not be subject to the same established clearance and settlement process familiar to traditional securities market participants.”<sup>20</sup> However, SIFMA disagrees with the characterization that these risks are necessarily greater than those resulting from traditional securities.

By and large, the risks that could arise from custodying digital asset securities could be in broad terms the same as those for traditional securities. In both cases custodians would need to mitigate the risk of loss, hacks or theft to those assets. However, firms can mitigate these risks by adequate security controls and additional operational and technology risk mitigants, which are technology appropriate. And as previously discussed, digital asset securities may be designed to allow issuers to replace, reissue, revert, or reassign digital asset securities to mitigate the risks of erroneous transactions, theft or lost keys – much like traditional securities.

### **Non-Security Digital Assets**

The Statement recognizes that the prohibition on engaging in activities with respect to non-security digital assets may present challenges, as it requests feedback on whether the Commission's position should be expanded to provide for use of non-security digital assets as a means of payment for digital asset securities.

Certain benefits to using distributed ledger technology relate to efficiencies in the clearance and settlement process. However, to take full advantage of some of these efficiencies, it would need to be possible to process both legs of the transaction on the same rails. By restricting the ability of broker-dealers to engage only in activities related to digital asset securities, the Statement may limit the potential

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<sup>19</sup> See Rule 15c3-3(c)(5). Note that a few entities that provide digital asset custodial services have been approved by the Office of the Comptroller of the Currency as federally chartered national trust banks. See *OCC Conditionally Approves Conversion of Anchorage Digital Bank*, Office of the Comptroller of the Currency (Jan. 13, 2021) available at <https://www.occ.gov/news-issuances/news-releases/2021/nr-occ-2021-6.html>; see also *OCC Conditionally Approves Conversion of Protego Trust Bank*, Office of the Comptroller of the Currency (Feb. 5, 2021) available at <https://www.occ.treas.gov/news-issuances/news-releases/2021/nr-occ-2021-19.html>; see also *OCC Conditionally Approves Chartering of Paxos National Trust*, Office of the Comptroller of the Currency (Apr. 23, 2021), available at <https://occ.gov/news-issuances/news-releases/2021/nr-occ-2021-49.html>.

<sup>20</sup> The Statement at 6.

benefits to broker-dealers and investors offered by distributed ledger technology to conduct close to real time on-chain atomic payments. In any event, the inability of a special-purpose broker dealer to use non-security digital assets (i.e., a blockchain-enabled payment leg for settlement) may in effect limit the DvP benefits from atomic settlement on-chain.

SIFMA supports the Commission's suggestion in Question 5 of the Statement of providing for a de minimis threshold during the limited phase of the Statement for certain non-security digital assets, such as a stablecoin, digital representation of commercial bank money, or a central bank digital currency, to facilitate the payment for and clearance and settlement of digital asset securities transactions. However, that de minimis exemption would need to allow for DvP settlement to occur in the regular conduct of business. Enabling the use of non-security digital assets that represent forms of tokenized cash as a means of DvP or exchange of cash on ledger against digital asset securities on-chain or atomically to effect settlement, may provide an opportunity to more robustly observe the range of benefits provided by distributed ledger technology. SIFMA goes further to suggest that those cash equivalent non-security digital assets should be allowed for settlement purposes without a de minimis threshold.

As addressed previously herein, if a broker-dealer is permitted to accept non-security digital assets as a means of payment for digital asset securities, it will be helpful for the SEC to provide clear standards as to whether a digital asset is a security or not. Enabling the use of other non-security and non-cash like digital assets would also place a burden on broker-dealers to find evidence or arguments for why a digital asset is or is not a security where there is unlikely to be a definitive answer, as the SEC has acknowledged by not itself providing unequivocal guidance as to how to determine when a digital asset is a security.

We note that there are currently non-custodial broker-dealers that allow for payment in non-security digital assets in order to facilitate digital securities transactions.

## **V. Investor Protection**

The Statement highlights a number of risks that may accompany the custody of digital asset securities. The Commission should take care to distinguish between factors that may contribute to the risk of loss or theft of digital asset security, and factors that may contribute to the operational performance of a particular digital asset network, and potentially the value of a particular digital asset. For instance, certain factors discussed in the Statement, such as performance/transaction speed, scalability, resilience, complexity, and visibility, are related to the operational performance of a digital asset network. While these factors may impact the value of a digital asset security, they may not impact the risk of loss or theft of private keys. Material facts about a digital asset security would need to be disclosed by the issuer and broker-dealer – but this relates to the *value* of a digital asset security, and not the risk that the possession or control of private keys would be lost by a broker-dealer.

Relatedly, even digital asset securities that rely on public blockchains may be configured in such a manner to enhance investor protections. For example, digital assets securities may be issued on “sidechains” that contain minimal information on the public blockchain, and reference external data in a centralized database.

In addition – although we reiterate that the focus should remain on risks, not specific technologies – some of these risks can be further managed with tools that have been developed to monitor network

health, including the probability of a 51% attack.<sup>21</sup> As suggested in the Statement, processes, policies, and adequate disclaimers can also be established to mitigate these risks.

### **Bearer Instrument**

As previously stated, a security does not become a bearer instrument merely because it is reflected using distributed ledger technology. The Commission can set standards ensuring that investors are protected from issues such as lost keys, including the following non-exhaustive suggestions:

- (1) Technological and operational key management controls and security;
- (2) Processes and parties who can be leveraged to restore / return assets to parties who may have lost private keys. For instance, parties can utilize central governance structures, redundancies, or back-up keys within their network or platform to do so; and
- (3) Duplicated, off-chain ownership records.

In the event of a broker-dealer insolvency, digital asset securities may be clearly identified and corralled by a trustee or regulator and potentially transferred to another solvent broker-dealer.

### **VI. Further Guidance Needed**

Although the staff of FINRA and the SEC have questioned the ability of broker-dealers to comply with recordkeeping and reporting rules, such as those under 17 CFR §§ 240.17a-3, 17a-4, and 17a-5 requiring broker-dealers to maintain up-to-date records reflecting assets, liabilities, and securities counts,<sup>22</sup> the Statement does not discuss how to comply with such requirements with respect to digital asset securities, and further guidance from the SEC would be helpful for broker-dealers seeking to provide custody of digital asset securities. SIFMA maintains that many securities rules are interconnected to one another wherein lack of clarity on one rule may nevertheless impact the efficacy of the clarity provided to another rule.

\* \* \*

SIFMA appreciates the Commission's interest in the continued development of the market for digital asset securities and opportunity to engage with the Commission on the best practices and other issues raised in Statement. We welcome the opportunity to discuss this with you further at a time of convenience for you and your staff. Please do not hesitate to reach out to us or our counsel with any questions or to schedule a meeting with our members. We would also like to acknowledge the work of Lilya Tessler, Partner at Sidley Austin LLP and her colleagues in developing this letter on behalf of SIFMA.

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<sup>21</sup> For instance, BitGo, KPMG, and Coin Metrics released a service that provides clients the ability to monitor and manage public blockchain network risks. See *KPMG LLP, BitGo, Inc. and Coin Metrics, Inc. launch combined offering including the debut of Coin Metrics' FARUM™ for public blockchain networks*, Cision PR Newswire (Feb. 18, 2021), available at <https://www.prnewswire.com/news-releases/kpmg-llp-bitgo-inc-and-coin-metrics-inc-launch-combined-offering-including-the-debut-of-coin-metrics-farum-for-public-blockchain-networks-301231178.html>

<sup>22</sup> See *Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities*, Securities and Exchange Commission and Financial Industry Regulatory Authority (July 8, 2019) available at [https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities#\\_ftn18](https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities#_ftn18).

Sincerely,

A handwritten signature in blue ink that reads "Charles De Simone".

Charles De Simone  
Vice President, Technology and Operations  
[cdesimone@sifma.org](mailto:cdesimone@sifma.org)

Cc:  
Lilya Tessler, Partner  
Sidley Austin LLP  
[ltessler@sidley.com](mailto:ltessler@sidley.com)