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By Electronic Mail (rule-comments@sec.gov)

Vanessa Countryman, Secretary
Office of the Secretary
U. S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

**Re: File No. S7-25-20
Custody of Digital Asset Securities by Special Purpose Broker-Dealers**

Dear Ms. Countryman:

The Securities Investor Protection Corporation (“SIPC”) is pleased to submit this letter in response to the Commission’s Statement and Request for Comment regarding the Custody of Digital Asset Securities by Special Purpose Broker-Dealers (“Statement”).¹ SIPC shares the Commission’s concern expressed in the Statement that the risk to investors who custody their digital asset securities with their broker must be minimized. How customer assets are custodied with their broker is fundamental to the safety of those assets. Customers must have confidence that in the event of a brokerage failure that results in a proceeding under the Securities Investor Protection Act, 15 U.S.C. § 78aaa *et seq.* (“SIPA”), the hard-earned assets that they have entrusted to their broker are not lost.

The Commission notes in its Statement that market participants have questioned whether SEC Rule 15c3-3, 17 C.F.R. § 240.15c3-3, applies in the context of digital asset securities, because the methods of transacting and custodying such assets differ from more traditional securities. SIPC welcomes the Commission’s efforts to consider potential future rulemaking that protects customers while accounting for how digital asset securities are traded and held. Nevertheless, SIPC is concerned that unless and until such rules are adopted and unless any interim measures proposed by the SEC are adequate and are complied with, the risk to customers remains.

¹ *Custody of Digital Asset Securities by Special Purpose Broker-Dealers*, Release No. 34-90788, 86 Fed. Reg. 11627 (Feb. 26, 2021)

The Securities Investor Protection Act and Rule 15c3-3

SEC Rule 15c3-3, commonly known as the Customer Protection Rule, goes hand-in-hand with SIPA. Indeed, the adoption of Rule 15c3-3 grew out of SIPA.

In 1970, against the background of a paperwork crisis and lack of automation, brokerages were unable to maintain control over the possession, custody, location, and delivery of customer assets. As broker-dealers failed and customer losses grew, Congress responded to the crisis by enacting SIPA to “restore investor confidence in the capital markets, and upgrade the financial responsibility requirements for registered brokers and dealers.” *Sec. Inv’r Prot. Corp. v. Barbour*, 421 U.S. 412, 415 (1975). In addition to creating a program for the resolution of a failed firm and the return to customers of their entrusted assets, Congress included in SIPA, as a further customer protection measure, an amendment to Section 15(c)(3) of the Securities Exchange Act of 1934 (“1934 Act”). In relevant part, Section 7(d) of SIPA, 15 U.S.C. § 78ggg(d) (1970), amended Section 15(c)(3) of the 1934 Act, 15 U.S.C. § 78o, to read as follows:

No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security ... in contravention of such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility and related practices of brokers and dealers including, but not limited to, the acceptance of custody and use of customers’ securities, and the carrying and use of customers’ deposits or credit balances. Such rules and regulations shall require the maintenance of reserves with respect to customers’ deposits or credit balances, as determined by such rules and regulations.

See H. R. Rep. No. 91-1613, at 12-14, and 22-23 (1970), *reprinted in* 1970 U.S.C.C.A.N. 5266-5268 and 5276-5277. Under the mandate of Section 15(c)(3) of the 1934 Act, as amended by SIPA, the SEC adopted its Rule 15c3-3 requiring broker-dealers promptly to obtain and maintain physical possession or control of all fully-paid and excess margin securities carried for customers.²

Customer Claims in a SIPA Proceeding

If a SIPC member broker-dealer is placed in liquidation, in order to obtain the release of

² *See also Study of Unsafe and Unsound Practices of Brokers and Dealers: Report and Recommendations of the Securities and Exchange Commission*, H.R. Doc. No. 92-231, at 11-12 (1971)

cash and securities that they have entrusted to the broker, customers of the failed firm must file claims with the SIPA trustee. Valid customer claims are satisfied from two sources. One, customers share, *pro rata*, in the distribution of customer property which, under SIPA, includes all cash and securities received, acquired, or held by the broker for the account of customers. See 15 U.S.C. §§ 78lll(4) and 78fff-2(c)(1)(B). Two, to the extent customer property is insufficient, customer claims are satisfied with advances from SIPC. Each customer is protected by SIPC up to \$500,000 against the loss of cash and securities entrusted to the broker. Of the \$500,000, the limit of protection for cash claims is \$250,000.

By requiring physical possession or control of securities by the broker, SEC Rule 15c3-3 is designed to ensure that, in case of a brokerage failure, the securities owed to customers are available for distribution to customers. In short, together, SIPA and Rule 15c3-3 work to provide “that customer funds and securities not be exposed to risk of loss through broker-dealer insolvency.”³

The amount that SIPC advances in a liquidation proceeding depends upon the amount of missing customer property for which customer claims have been filed and allowed. The larger the amount of missing customer property, the greater the SIPC advance. The SIPC Fund, from which advances for customers are made, is comprised largely of assessments paid to SIPC by its member broker-dealers. The failure of a firm properly to segregate customer property creates a potential financial risk for other firms. If the size of the Fund becomes smaller, members may be assessed at higher rates in order to replenish the Fund. 15 U.S.C. § 78ddd(c).

Significantly, a firm’s failure properly to segregate customer property creates a potential financial risk not only for other broker-dealers, but for the U.S. taxpayer. Should the SIPC Fund be insufficient for its purposes, SIPC may borrow up to \$2.5 billion from the U.S. Treasury through the SEC. 15 U.S.C. § 78ddd(g).

The Collection of Customer Property

Over time, the processes of clearing, settling and custodizing traditional securities have evolved and by now, are well-established. As the Commission notes in its Statement, clearing agencies, depositories, clearing banks, transfer agents, and issuers are in place to confirm that a broker-dealer in fact is holding customer cash and securities, as shown on its books and records. The comparative newness of the digital asset securities market has not allowed for the buildout of a similarly time-honored infrastructure. As a result, the means by which digital asset securities are held present more risk.

If a firm that is engaged in a digital asset security business were to be placed in SIPA

³ Exchange Act Release No. 34-9856, 37 Fed. Reg. 25,224 at 25,225 (1972).

liquidation, it would be critical for the SIPA trustee to be able to gain access to the securities. This would require the trustee to know who at the firm has access to the private keys to customers' digital asset securities, how to gain access to those keys, and to be able to transfer the assets on the associated blockchain. Without access, the SIPA trustee's ability to marshal and return customer property would be limited, and require larger advances from SIPC.⁴

It is noteworthy that access to the property is important not only to the SIPA trustee's ability to administer the liquidation, but could by itself trigger a liquidation if the misappropriation or loss of private keys by a firm prevented its access to customers' digital asset securities, and threatened its ability to satisfy its obligations to customers. A firm's inability to meet its customer obligations as they mature is grounds for commencement of a SIPA liquidation. 15 U.S.C. § 78eee(b)(1).

Physical Possession or Control

In its Statement (IV. Commission Position), the Commission lists nine conditions under which the broker-dealer would deem itself to have obtained and maintained physical possession or control of investors' digital asset securities. If met, the broker-dealer would not be subject to an SEC enforcement action for five years from April 27, 2021. SIPC's comments below relate to some of these conditions.

1. Commission Position, Conditions 6 and 7

Under Condition 6, the broker-dealer must have and enforce written policies, procedures and controls that are consistent with industry best practices and that show the brokerage's exclusive control over the digital asset securities. Under Condition 7, the brokerage must have written policies, procedures and arrangements that demonstrate the steps to be taken to safeguard investor assets in case of a blockchain malfunction or a firm's inability to continue to operate. Both conditions are important to the safety of the assets, on the one hand, in the ordinary course of the brokerage's business, and on the other hand, in the event of a firm failure.

We are concerned, however, that in the aforementioned conditions and in others, the fact that policies and procedures must be "reasonably designed" creates ambiguity on whether the purposes of Rule 15c3-3 are achieved. Although in some instances, policies, procedures and controls must be consistent with industry best practices, there may not yet be "best practices" in place due to the novelty of the industry. Furthermore, the absence of uniform standards or practices makes it difficult for an examiner or an auditor to determine whether adherence to the firm's policies or procedures accomplishes the goals of the Customer Protection Rule.

⁴ Customer claims for securities generally are satisfied in kind. To the extent securities are not in the debtor's possession, the trustee may purchase them for the customer, within limits. If there is no fair and orderly market for the securities, the customer may receive their filing date market value. 15 U.S.C. § 78fff-2(b) and (d).

SIPC also expressed above the need for a SIPA trustee to be able to access and transfer customer assets on the blockchain in case of a firm failure. Since a broker-dealer must develop a plan under Condition 7 for resolution of the firm if it is unable to continue as a going concern, SIPC believes that the Commission should consider adding to Condition 7 a requirement that firms file periodically with, and for review by, their regulatory authority, a copy of the plan and associated policies, procedures, and arrangements, as well as any updates to those documents. This would provide valuable information and a road map to any trustee, liquidator or receiver that takes control of the firm.

2. Commission Position, Condition 8

In a July 8, 2019 Joint Statement, SEC and FINRA Staffs, for purposes of that Statement, viewed a digital asset as one “issued and transferred using distributed ledger or blockchain technology” such as “virtual currencies,’ ‘coins,’ and ‘tokens’.” Unlike digital assets which might or might not be “securities,” digital asset securities were viewed as “securities.”⁵

In the current Statement, the Commission correctly notes that the definition of a “security” under SIPA differs, in some respects, from the definition of a “security” under the 1934 Act. The Commission requires in the Statement, that broker-dealers disclose in writing to prospective customers that digital asset securities may not be protected under SIPA, and in particular, that digital asset securities that are unregistered investment contracts are excluded from SIPA’s definition of securities. 15 U.S.C. § 78III(14). SIPC agrees that this disclosure offers important information to potential investors.

In closing, SIPC appreciates the opportunity to express its views to the Commission. We support the efforts of the Commission to mitigate the risk to customers who invest in digital asset securities and custody those assets with their broker. Whether or not SIPA protection is available to such investors, the same concerns exist.

Very truly yours,


Josephine Wang
President and CEO

cc (by e-mail):

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⁵ <https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities>, n.1.

Vanessa Countryman, Secretary
Office of the Secretary
U. S. Securities and Exchange Commission
May 13, 2021
Page 6

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