GLI GLOBAL LEGAL INSIGHTS

Blockchain & Cryptocurrency Regulation

2021

Third Edition

Contributing Editor: **Josias N. Dewey**

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Global Legal Insights
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GLOBAL LEGAL INSIGHTS – BLOCKCHAIN & CRYPTOCURRENCY REGULATION

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PREFACE

Another year has passed and virtual currency and other blockchain-based digital assets continue to attract the attention of policymakers across the globe. A lack of consistency in how policymakers are addressing concerns raised by the technology is a major challenge for legal professionals who practice in this area. Perhaps equally challenging is keeping up with the nearly infinite number of blockchain use cases. In 2017 and 2018, it was the ICO craze. In 2019, the focus shifted to security tokens. In 2020, decentralized finance (or DeFi) attracted over several billion dollars' worth of investment. So, while ICOs are still being offered and several groups continue to pursue serious security token projects, we should expect DeFi to draw scrutiny from regulators, such as the U.S. Securities and Exchange Commission (SEC). Once again, legal practitioners will be left to counsel clients on novel issues of law raised by the application of laws and regulations enacted long before blockchain technology existed.

Of course, capital raising is only one application of the technology. Bitcoin, which remains the king of all cryptocurrencies, was intended to serve as a form of digital money. Arguably, it is this use case that has seen the most attention from governments around the word. The European Union enacted more stringent anti-money laundering (AML) regulations impacting virtual currency exchanges operating in the EU. U.S. regulators and state government officials continue to enforce money transmitter statutes and BSA regulations applicable to money services businesses. In the U.S., the state of New York, which was once thought to have over-regulated the industry out of doing business in the state, is now attracting applications from blockchain companies to become state-chartered trust companies. The charter may provide relief to virtual currency exchanges and similar businesses seeking to avoid the nearly 50-state patchwork of licensing statutes.

Institutional and large enterprise companies continue to expand into the space. It is no longer just FinTechs and entrepreneurial clients who need counsel on blockchain-related matters. Whether a small start-up or Fortune 100 company, clients need counsel in areas beyond compliance with government regulation. In some cases, intellectual property rights must be secured, or open source licenses considered to the extent a client's product incorporates open source code. Blockchain technology adopted by enterprise clients may involve a consortium of prospective network users, which raises joint development issues and governance questions.

As with the first two editions, our hope is that this publication will provide the reader with an overview of the most important issues across many different use cases and how those issues are impacted by laws and regulations in several dozen jurisdictions around the globe. And while policymakers continue to balance their desire to foster innovation, while protecting the public interest, readers of this publication will understand the current state of affairs, whether in the U.S., the EU, or elsewhere in the world. Readers may even discover themes across this book's chapters that provide clues about what we can expect to be the hot topics of tomorrow and beyond.

Josias N. Dewey
Holland & Knight LLP

FOREWORD

Dear Industry Colleagues,

On behalf of the Enterprise Ethereum Alliance ("EEA"), I would like to thank Global Legal Group ("GLG") for bringing to life an explication of the state of regulation in the blockchain and cryptocurrency sector, with its third edition publication of *Blockchain & Cryptocurrency Regulation*. GLG has assembled a remarkable group of leaders in the legal industry to analyse and explain the environment in front of us, and the EEA members and participants were pleased to contribute to the publication.

We stand at the beginning of an industry, and the depth and breadth of the contributors from leading law firms across the world only serve to highlight the growing interest and fascination with accelerating the adoption of blockchain technology. We thank each of the authors for taking the time to compose their chapters and for the expertise they demonstrate. We hope readers will find this publication useful.

The EEA is the industry's first member-driven global standards organisation whose mission is to develop open, blockchain specifications that drive harmonisation and interoperability for businesses and consumers worldwide. The EEA's world-class Enterprise Ethereum Client Specification, Off-Chain Trusted Compute Specification, and forthcoming testing and certification programs, along with its work with the Token Taxonomy Initiative, will ensure interoperability, multiple vendors of choice, and lower costs for its members – hundreds of the world's largest enterprises and most innovative startups. For additional information about joining the EEA or the Token Taxonomy Initiative, please reach out to membership@entethalliance.org and info@tokentaxonomy.org.

Sincerely,

Aaron Wright

Chairman, EEA Legal Advisory Working Group

GLOSSARY

***Alice* decision**: a 2014 United States Supreme Court decision about patentable subject matter.

Cold storage: refers to the storage of private keys on an un-networked device or on paper in a secure location.

Copyleft licence: the practice of offering people the right to freely distribute copies and modified versions of a work with the stipulation that the same rights be preserved in derivative works down the line.

Cryptocurrencies: a term used interchangeably with virtual currency, and generally intended to include the following virtual currencies (and others similar to these):

- Bitcoin.
- Bitcoin Cash.
- DASH.
- Dogecoin.
- Ether.
- Ethereum Classic.
- Litecoin.
- Monero.
- NEO.
- Ripple's XRP.
- Zcash.

Cryptography: the practice and study of techniques for secure communication in the presence of third parties, generally involving encryption and cyphers.

DAO Report: report issued in July, 2017 by the U.S. Securities and Exchange Commission, considering and ultimately concluding that The DAO (*see below*) was a security.

Decentralised autonomous organisation ("The DAO"): a failed investor-directed venture capital fund with no conventional management structure or board of directors that was launched with a defect in its code that permitted someone to withdraw a substantial amount of the $130,000,000 in Ether it raised.

Decentralised autonomous organisation ("a DAO"): a form of business organisation relying on a smart contract (*see below*) *in lieu* of a conventional management structure or board of directors.

Digital assets: anything that exists in a binary format and comes with the right to use, and more typically consisting of a data structure intended to describe attributes and rights associated with some entitlement.

Digital collectibles: digital assets that are collected by hobbyists and others for entertainment, and which are often not fungible (e.g., CryptoKitties) (*see* **Tokens**, non-fungible).

Digital currency: a type of currency available only in digital form, which can be fiat currency or virtual currency that acts as a substitute for fiat currency.

Digital currency exchange: a business that allows customers to trade cryptocurrencies or digital currencies for other assets, such as conventional fiat money, or one type of cryptocurrency for another type of cryptocurrency.

Digital/electronic wallet: an electronic device or software that allows an individual to securely store private keys and broadcast transactions across a peer-to-peer network, which can be hosted (e.g., Coinbase) or user managed (e.g., MyEtherWallet).

Distributed ledger technology ("DLT"): often used interchangeably with the term *blockchain*, but while all blockchains are a type of DLT, not all DLTs implement a blockchain style of achieving consensus.

Fintech: new technology and innovation that aims to compete with traditional financial methods in the delivery of financial services.

Initial coin offering: a type of crowdfunding using cryptocurrencies in which a quantity of the crowdfunded cryptocurrency is sold to either investors or consumers, or both, in the form of "tokens".

Initial token offering: *see* **Initial coin offering**.

Internet of Things: a system of interrelated computing devices, mechanical and digital machines, objects, animals or people that are provided with unique identifiers and the ability to transfer data over a network without requiring human-to-human or human-to-computer interaction.

Licences, software: the grant of a right to use otherwise copyrighted code, including, among others:

- Apache.
- GPLv3.
- MIT.

Mining, cryptocurrency: the process by which transactions are verified and added to the public ledger known as the blockchain, which is often the means through which new units of a virtual currency are created (e.g., Bitcoin).

Money transmitter (U.S.): a business entity that provides money transfer services or payment instruments.

Permissioned network: a blockchain in which the network owner(s) decides who can join the network and issue credentials necessary to access the network.

Platform or protocol coins: the native virtual currencies transferable on a blockchain network, which exist as a function of the protocol's code base.

Private key: an alphanumeric cryptographic key that is generated in pairs with a corresponding public key. One can verify possession of a private key that corresponds to its public key counterpart without exposing it. It is not possible, however, to derive the private key from the public key.

Private key storage:

- *Deep cold storage*: a type of cold storage where not only Bitcoins are stored offline, but also the system that holds the Bitcoins is never online or connected to any kind of network.
- *Hardware wallet*: an electronic device capable of running software necessary to store private keys in a secure, encrypted state and structure transactions capable of being broadcast on one or more blockchain networks. Two popular examples are Ledger and Trezor.

Protocols: specific code bases implementing a particular blockchain network, such as:

- Bitcoin.
- R3's Corda.
- Ethereum.
- Hyperledger Fabric.
- Litecoin.

Public network: blockchain that anyone can join by installing client software on a computer with an internet connection. Best known public networks are Bitcoin and Ethereum.

Qualified custodian: a regulated custodian who provides clients with segregated accounts and often places coins or tokens in cold storage (*see above*).

Robo-advice/digital advice: a class of financial adviser that provides financial advice or investment management online, with moderate to minimal human intervention.

Sandbox (regulatory): a programme implemented by a regulatory agency that permits innovative start-ups to engage in certain activities that might otherwise require licensing with one or more governmental agencies.

Security token: a token intended to confer rights typically associated with a security (e.g., stock or bond), and hence, are generally treated as such by regulators.

Smart contract: a piece of code that is written for execution within a blockchain runtime environment. Such programmes are often written to automate certain actions on the network, such as the transfer of virtual currency if certain conditions in the code are met.

Tokens: a data structure capable of being fungible (ERC-20) or non-fungible (ERC-721) that is capable of being controlled by a person to the exclusion of others, which is typically transferable from one person to another on a blockchain network.

Utility token: a token intended to entitle the holder to consume some good or service offered through a decentralised application ("dApp").

Vending machine (Bitcoin): an internet machine that allows a person to exchange Bitcoins and cash. Some Bitcoin ATMs offer bi-directional functionality, enabling both the purchase of Bitcoin as well as the redemption of Bitcoin for cash.

Untying the Gordian Knot – Custody of digital assets

Richard B. Levin, David M. Allred & Peter F. Waltz
Polsinelli PC

Like the Gordian Knot solved by Alexander the Great, regulators in the United Stated have attempted to craft a clean solution to the complex problem of the custody of digital assets.[1] Starting with the Great Depression, regulators in the United States have focused on the safety and soundness of locations holdings customer funds or securities. As investors have become increasingly interested in digital assets, U.S. regulators have faced the challenge of attempting to protect customer funds and securities using laws written in the 1930s, 1940s, and 1970s. Unfortunately, these laws were not designed to regulate custody of digital assets.

In this chapter, we provide an overview of digital assets and the technology used to hold digital assets, including Bitcoin, followed by a focus on the current state of the regulation of custody of digital assets by the U.S. Securities and Exchange Commission ("SEC"), the U.S. Office of the Comptroller of the Currency ("OCC"), and the New York Department of Financial Services ("NYDFS").

Background

Blockchain technology is a database structure that can only be updated by appending a new set (or block) of valid transactions to the log of previous transactions.[2] As noted by Goldman Sachs in a note to clients:

> In its most basic form, the *blockchain records ownership of bitcoin and transactions involving the crypto currency across a wide network of computers, as opposed to a centralized ledger*. Transactions are signed off by the parties involved using the software, checked by the network or the "crowd," then added to the blockchain – a long string of code that records all activity. Encryption in the software ensures these "blocks" cannot be tampered with or altered. And the decentralized nature means the "crowd" police the whole system. *The software cuts out the need for a "trusted middleman" to sit in between parties in a transaction, such as a bank or clearinghouse*. This makes transactions quicker, cheaper, and easier when compared to the current systems banks use.[3]

Many firms in the financial services industry believe blockchain technology can be adapted for use in traditional financial services transactions in a way that "*has the potential to redefine transactions and the back office of a multitude of different industries*. From banking and payments to ... trade settlement ... a distributed shared ledger has the potential to make interactions quicker, less-expensive and safer".[4]

Digital currencies

Digital currencies are monetary units of exchange stored or represented in a digital or other electronic format that operate like currency in some environments, but that do not have

legal tender status in any jurisdiction.[5] The term digital currency refers to electronic money that operates like a currency in some environments, but does not have all the attributes of "real" (i.e., fiat) currency issued by a governmental agency.[6] Digital currencies can be created by an individual, corporation, or organisation, or can arise from use and acceptance by people as currency.[7] Traditional currencies are generally either backed by the faith and credit of the national governments that recognise the currency (the fiat system) or by real assets or hard commodities, such as gold, silver, or minerals (the commodity system).

Blockchain and the SEC

The focus of the financial services industry on blockchain technologies has attracted the attention of the SEC, which has published several pieces of guidance on blockchain technology and has hosted events such as a FinTech Forum that included a panel discussion on blockchain technologies.[8] The SEC has noted:

> [T]he blockchain ... is being tested in a variety of settings, to determine whether it has utility in the securities industry. What utility, if any, would a distributed public ledger system have for transfer agents, and how would it be used. What regulatory actions, if any, would facilitate that utility? *How would transfer agents ensure their use of or interaction with such a system would comply and be consistent with federal securities laws and regulations, including the transfer agent rule?*[9]

Advocates of blockchain technology believe it could substantially improve the trading, clearance and settlement of securities.[10] SEC Commissioner Kara Stein noted "one could imagine a world in which securities lending, repo, and margin financing are all traceable through blockchain's transparent and open approach to tracking transactions".[11]

Digital assets

The SEC has defined digital assets as "an asset that is issued and transferred using distributed ledger or blockchain technology".[12] Digital assets include, but are not limited to, virtual currencies, coins, and tokens.[13] A digital asset may in certain instances be deemed a security under the federal securities laws. While not defined in the securities laws, the SEC often refers to digital assets that are securities as "digital asset securities".[14]

Wallets and keys

Digital assets are stored by associating them with addresses called "wallets" which can be stored on web servers, local hardware like personal computers, jump drives and mobile devices, or on paper print-outs.[15] A digital asset wallet takes the form of a cryptographic public key, which is a string of numbers and letters.[16] Each public key has a matching "private key", known only to the user.[17] Control of the private keys is what assures one of control of the digital assets at any address, so collections of private keys must be protected by passwords or other means of securing them.[18] The question of the custody of digital assets that are securities presents substantial problems for firms registered with the SEC as an investment adviser or a broker-dealer.

Digital asset securities

The definitions of "security" under the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act") are virtually identical and each is broad enough to include the various types of instruments that are used in commercial marketplaces that one might suspect to fall within the ordinary concepts of a security.[19] This includes common instruments like stocks, bonds, and notes, as well as the various collective investment pools and common enterprises devised by persons seeking to generate profits from the efforts and investments of others (i.e., investment contracts

and instruments commonly known as securities).[20] The definitions of security under the Securities Act, the Exchange Act, the Investment Advisers Act of 1940 (the "Advisers Act"), and the Investment Company Act of 1940, do not include currencies. However, the SEC has argued that investments in digital asset-related schemes are investment contracts – a contract, transaction, or scheme involving (i) an investment of money, (ii) in a common enterprise, (iii) with the expectation that profits will be derived from the efforts of the promoter or a third party.[21]

Assuming you agree with the Chairman of the SEC that nearly all digital assets that have been issued to date are securities,[22] the custody of such securities by investment advisers and broker-dealers registered with the SEC will require the application of existing securities laws that address custody and protection of customer funds and securities.

Investment advisers

The Advisers Act defines an "investment adviser" as any person who, for compensation, engages in the business of providing advice to others or issuing reports or analyses regarding securities.[23] A person must satisfy all three elements to fall within the definition of "investment adviser".

The Custody Rule

A registered adviser with custody of client funds or securities ("client assets") is required by Rule 206(4)-2 of the Advisers Act (the "Custody Rule") to establish a set of controls to safeguard those assets.[24] Custody means "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them".[25] An adviser is deemed to have custody if an affiliate has custody of its client funds or securities in connection with advisory services it provides to clients. Custody includes:

- *physical possession of client funds or securities*;
- any arrangement under which an adviser is permitted or authorised to withdraw client funds or securities (such as check-writing authority or the ability to deduct fees from client assets); and
- *any capacity that gives an adviser or its supervised person legal ownership of or access to client funds or securities*.[26]

An investment adviser is deemed to have custody if it or a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them.[27]

Qualified custodians

An adviser with custody must maintain client funds and securities with a qualified custodian either under the client's name or under the adviser's name as agent or trustee for its client.[28] A qualified custodian is a federally insured bank or savings association, a registered broker-dealer, a registered futures commission merchant (with respect to client funds and security futures), or a foreign financial institution that customarily holds financial assets for its customers.[29] A "bank" is defined as:

- a *banking institution* organised under the laws of the United States or a federal savings association;
- a member bank of the Federal Reserve System; or
- any other banking institution, savings association, or *trust company, whether incorporated or not, doing business under the laws of any state or of the United States*, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and which is supervised and examined by state or federal authority having supervision over banks or savings associations.[30]

The qualified custodian must send an account statement at least quarterly to each client, and client funds and securities must be verified at least annually by an independent public accountant.[31]

Client assets that are not cash or securities need not be maintained with a qualified custodian. Two types of securities are not required to be maintained with a qualified custodian: (i) shares of mutual funds held with the fund's transfer agent; and (ii) privately offered securities (i.e., uncertificated securities acquired in a private placement that are recorded in the name of the client only on the books of the issuer or its transfer agent and transferrable only with the consent of the issuer).[32]

Since most digital asset securities are uncertificated securities, and assuming they were sold in a private placement under a safe harbour from registration under the Securities Act, such as Regulation D, such digital assets should not be subject to the Custody Rule. However, many digital asset securities, including the majority of those issued in the initial coin offering boom of 2016–2018, likely were not sold in compliance with federal securities laws. Any digital assets securities that are registered with the SEC and that are held by a registered investment adviser on behalf of a client are subject to the Custody Rule.

SEC Guidance on custody of digital assets by investment advisers

The SEC has deemed client digital assets that are not securities to be client funds. On March 12, 2019, the staff of the SEC Division of Investment Management (the "Division") published a letter seeking input from investment advisers, other market participants, and the public regarding the application of the Custody Rule to digital assets.[33] That letter was a response to issues raised by investment advisers and other market participants following the publication of SEC Guidance on the issue in 2017.[34] In the letter, the SEC staff noted digital assets are subject to the Custody Rule if they are either "funds" or "securities" and if the registered investment adviser has any authority to obtain possession of them.

On January 18, 2018, the Director of the Division sent a letter to the Investment Company Institute and the Securities Industry Financial Markets Association, captioned "Engaging on Fund Innovation and Cryptocurrency-related Holdings".[35] In the letter, the SEC staff noted:

> *We appreciate that proponents of cryptocurrencies and related products have identified a range of potential benefits*. ... [T]he innovative nature of cryptocurrencies and related products, as well as their expected use and utility in our financial markets, means that they are, in many ways, unlike the types of investments that registered funds currently hold in substantial amounts.[36]

In the letter, the Division requested information on several investor protection issues before sponsors begin offering these funds to retail investors, including the custody of digital assets that are securities.[37] The Division noted the Advisers Act requires the use of safeguards to ensure that registered funds maintain safe custody of their holdings custodian.

Broker-dealers

Like registered investment advisers, broker-dealers must comply with rules that are designed to protect customer funds and securities, including Rule 15c3-3 of the Exchange Act (the "Customer Protection Rule"). The Customer Protection Rule is meant to prevent investor loss or harm in the event of a broker-dealer's failure and to enhance the SEC's ability to monitor and prevent unsound business practices. The rule requires a broker-dealer to physically hold customers' fully paid and excess margin securities or maintain them

free of lien at a *good control location*.[38] Generally, a broker-dealer may custody customer securities with a third-party custodian (e.g., the Depository Trust Company or a clearing bank),[39] and uncertificated securities may be held at the issuer or at the issuer's transfer agent.[40] The question of how a broker-dealer may custody digital assets that are securities has plagued FinTech firms and broker-dealers since 2009.

In July 2019, the SEC staff and the staff of the Financial Industry Regulatory Authority ("FINRA") published a statement to broker-dealers that plan to facilitate transactions in digital assets that are securities, including the custody of such securities.[41] The SEC and FINRA staff addressed how broker-dealers can comply with aspects of the Customer Protection Rule.

Non-custodial broker-dealer models for digital asset securities

The Joint Statement notes that some entities have contemplated engaging in broker-dealer activities involving digital asset securities that would not involve the broker-dealer engaging in custody functions. The SEC and FINRA staff identified the following examples of business activities presented by FinTech companies:

- A broker-dealer sends the trade-matching details to the buyer and issuer of a digital asset security (similar to a traditional private placement), and the issuer settles the transaction bilaterally with the buyer away from the broker-dealer. The broker-dealer instructs the customer to pay the issuer directly and instructs the issuer to issue the digital asset security to the customer's digital wallet.
- A broker-dealer facilitates a secondary market transaction in digital asset securities and does not take custody or control over the digital asset securities. The buyer and seller complete the transaction directly. The digital asset securities do not pass through the broker-dealer facilitating the transaction.
- A secondary market transaction involves a broker-dealer introducing a buyer to a seller of digital asset securities through a broker-dealer that operates an alternative trading system ("ATS").[42] The ATS brings together the buyer and the seller of digital asset securities. The trades are settled directly between the buyer and seller, or the buyer and seller would give instructions to their respective custodians to settle the transactions. The ATS will not guarantee or have responsibility for settlement of the trades and will not at any time exercise any level of control over the digital asset securities being sold or the cash being used to make the purchase. The ATS will not place a temporary hold on the seller's wallet or on the buyer's cash to ensure the transaction is completed.

These are only some of the examples presented to the SEC and FINRA staff.[43]

Custody of digital asset securities

The SEC and FINRA staff acknowledged in the Joint Statement that market participants wishing to custody digital asset securities might find it challenging to comply with the Customer Protection Rule without putting in place significant unique technological solutions. However, the SEC and FINRA staff reiterated their desire to engage with FinTech firms so that they may better respond to developments in the market[44] while advancing the missions of the respective organisations: for the SEC, to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation; and for FINRA, to provide investor protection and promote market integrity.[45]

The Customer Protection Rule and digital asset securities

In the Joint Statement, the SEC and FINRA staff noted a broker-dealer seeking to custody digital asset securities must comply with the Customer Protection Rule. Rule 15c3-3

requires a broker-dealer to physically hold customers' fully paid and excess margin securities or maintain them free of lien at a *good control location*.[46] Generally, a broker-dealer may custody customer securities with a third-party custodian (e.g., the Depository Trust Company or a clearing bank),[47] and uncertificated securities at the issuer or at the issuer's transfer agent. In either case, a third party controls the transfer of the securities.

Suitable control location

The Customer Protection Rules require customer funds and securities be held at a custodian that meets the definition of a "bank" under Section 3(a)(6) of the Exchange Act. Section 3(a)(6) of the Exchange Act defines a bank as:

> (A) a banking institution organized under the laws of the United States, (B) a member bank of the Federal Reserve System, (C) *any other banking institution, whether incorporated or not, doing business under the laws of any State* or of the United States, *a substantial portion of the business of which consists* of receiving deposits *or exercising fiduciary powers* similar to those permitted to national banks under the authority of the Comptroller of the Currency ... and *which is supervised and examined by State or Federal authority having supervision over banks ...*

Banks that are regulated by the Federal Reserve meet the definition of a "bank" under Section 3(a)(6) of the Exchange Act.

The SEC has not issued formal guidance on whether a state-chartered trust company is a bank for purposes of Section 3(a)(6) of the Exchange Act or a suitable control location for purposes of the Customer Protection Rule. There is a tenable argument that a state-chartered trust company is a bank for purposes of the Exchange Act because it is doing business under the laws of a state of the United States, so long as a substantial portion of the business of the trust company consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency.

OCC regulation of custody of digital assets

On July 22, 2020, the OCC published an interpretive letter recognising that a national bank may provide custody services for cryptocurrencies, including storage of the cryptographic keys that permit the control and transfer of the customer's cryptocurrency.[48] The letter recognised past OCC interpretive letters that authorise national banks to provide similar services such as escrow encryption keys used in connection with digital certificates, and secure web-based document storage, retrieval and collaboration of documents and files containing personal information or valuable confidential trade or business information.[49] The letter notes providing custody for cryptocurrencies will require a bank to provide custody for cryptographic keys. The OCC stated prior letters establish that national banks have the authority to provide custody for this type of digital asset.[50] The OCC also affirmed the agency's belief in its own expansive power to "authorize national banks to perform, provide or deliver through electronic means and facilities any activities that they are otherwise authorized to perform".[51]

National banks have declined to provide custody services for cryptocurrencies and other digital assets because of the lack of clarity on the permissibility of custody of digital assets. While some state-chartered trust companies have provided these services, the majority of state banks have also declined to do so because of the lack of regulatory clarity. The OCC guidance may expand the number of banks that are willing to provide custodial services for digital assets, which will enable more institutions and individuals to invest in digital assets.

The OCC letter may also enable registered investment advisers, which are required to maintain custody of their assets at banks under the Investment Company Act[52] to hold cryptocurrencies. The OCC letter may also enable registered investment advisers with retail customers, whose assets are commonly held in brokerage accounts, to advise on cryptocurrencies. Finally, the OCC letter may enable broker-dealers to hold cryptocurrencies in customer accounts consistent with the requirements of the Customer Protection Rule.[53]

While there are tenable arguments that banks regulated by the OCC and state-chartered trust companies may hold digital assets for customers, the issue is complicated by the State of New York's regulation of digital assets.

New York regulation of custody of digital assets

On June 24, 2015, NYDFS adopted regulations on virtual currency businesses in New York State.[54] Under the regulations, any person that is a resident of or located in, or has a place of business or is conducting business in, New York, and is engaged in a "virtual currency business activity", is required to obtain a licence from NYDFS. Licensed virtual currency businesses must: (i) have in place certain compliance policies; (ii) meet capital requirements set by NYDFS on a case-by-case basis; (iii) *meet prescribed customer protection and asset custody standards*; (iv) keep certain required books and records subject to NYDFS examinations; (v) have implemented anti-money laundering and cyber security programmes; (vi) have a business continuity and disaster recovery programme in place; and (vii) establish and maintain a customer complaints process.[55]

BitLicense

A three-step analysis helps determine if a business must obtain a BitLicense. First, the entity must offer a product or service that involves a "virtual currency". NYDFS Rule 200.2(p) defines "virtual currency" to include "any type of digital unit that is used as a medium of exchange or a form of digitally stored value".[56] If the business involves a virtual currency, the analysis turns to whether the business is engaged in a "virtual currency business activity". The regulations define the term "virtual currency business activity" as the conduct of one or more of several types of activities involving New York or a New York resident, including, among others:

- *storing, holding, or maintaining custody or control of virtual currency on behalf of others*;
- performing Exchange Services as a customer business;[57] or
- *controlling*, administering, or issuing a virtual currency.[58]

The development and dissemination of software alone does not constitute a virtual currency business activity.[59] However, the act of serving as a custodian of virtual currency in New York or for New York residents brings a party within the scope of the BitLicense, unless they fall within the scope of an exemption from registration.

Exemptions

The BitLicense regulations provide limited exemptions from the licensing requirement for entities chartered under the New York Banking Law and "merchants and consumers using virtual currency solely for the purchase of goods or services or for investment purposes".[60] A firm that is subject to regulation by a functional federal regulator, including the OCC, the SEC, or a futures commission merchant registered with the U.S. Commodity Futures Trading Commission, would be required to obtain a BitLicense if it performs any of the functions discussed above. In addition, because the exemption is only for entities chartered under the New York Banking Law, money transmitters registered with the U.S. Office of Financial

Crimes Enforcement Network, and licensed by NYDFS or other states, are not exempt from the BitLicense licence requirement.[61] Agency principals also do not apply to licensing requirements for the BitLicense as they otherwise might within other regulatory regimes.

Reciprocity

The BitLicense regime does not provide for any reciprocity for persons similarly registered in other states. Accordingly, a custodian that is not chartered under the New York Banking Law will have to obtain a BitLicense to provide custody of digital assets for New York residents.

Limited purpose trust charter

In New York, virtual currency businesses are exempt from the BitLicense requirements if they are chartered under the New York Banking Law as a limited purpose trust company, and are approved by the superintendent to engage in virtual currency business activity.[62] An entity chartered as a New York limited purpose trust company must obtain approval from NYDFS when there is a change in the general character of its business or a change in its corporate structure or control.[63] Under the limited purpose trust charter, an entity must comply with similar regulatory compliance requirements as required by the BitLicense.

Conclusion

The issue of custody of digital assets is a complex problem that has plagued the development of the FinTech industry. Investment advisers and broker-dealers that have custody or control of digital assets securities must attempt to reconcile the Custody Rule and the Customer Protection Rule that were not designed for securities that are digital assets. However, the SEC and FINRA have attempted to fit the proverbial square peg into the round hole by applying the Customer Protection Rule and the Custody Rule to digital assets securities. In both cases, broker-dealers and investment advisers can use entities that meet the definition of a bank under the Advisers Act and the Exchange Act, including state trust companies. While the recent guidance from the OCC states that national banks may hold digital assets, the letter does not address whether such assets are protected by the Federal Deposit Insurance Corporation. Finally, while trust companies in certain states may be authorised to hold digital assets, the New York BitLicense limits the ability of such firms to provide services in all states because the BitLicense regime does not recognise trust companies that are chartered in other states as being exempt from the registration requirement. While blockchain technology holds tremendous promise for the financial services industry, the regulation of custody of digital assets will continue to slow innovation in the industry until such time as regulators completely untie the knot of how to reconcile 21st century technology with laws written in the early 20th century.

* * *

Endnotes

1. In this chapter, we use the term the term "digital asset" which refers to an asset that is issued and/or transferred using distributed ledger or blockchain technology, including virtual currencies, coins, and tokens. A digital asset may meet the definition of a "security" under the federal securities laws. For the purposes of this chapter, a digital asset that is a security is referred to as a "digital asset security".
2. PricewaterhouseCoopers, 2016. *What is the blockchain? Available at*: http://www.pwc.com/us/en/financial-services/publications/qa-what-is-blockchain.html (last visited Sep. 23, 2020).

3. Goldman Sachs, *Emerging Theme Radar: What if I Told You...* (2015), *available at*: https://www.goldmansachs.com/insights/pages/macroeconomic-insights-folder/what-if-i-told-you/report.pdf#:~:text=Emerging%20Theme%20Radar%20What%20if%20I%20Told%20You…,to%20creating%20a%20alternative%20to%20fossil%20fuel%20in (last visited Sep. 23, 2020).
4. *Id.*
5. Financial Crimes Enforcement Network ("FinCEN") (2013). Guidance FIN-2013-G0001: Application of FinCEN's Regulations to Persons Administrating, Exchanging, or Using Virtual Currencies. United States Department of the Treasury, New York, *available at*: https://www.fincen.gov/sites/default/files/shared/FIN-2013-G001.pdf (last visited Sep. 23, 2020).
6. *Id.*
7. Turpin, J., *Bitcoin: the economic case for a global, virtual currency operating in an unexplored legal framework.* Ind. J. Global Legal Stud. 21 (1), 335–368 (2014), *available at*: http://www.repository.law.indiana.edu/ijgls/vol21/iss1/13/ (last visited Sep. 23, 2020).
8. SEC FinTech Forum, *available at*: https://www.sec.gov/spotlight/fintech (last visited Sep. 23, 2020).
9. Securities Exchange Act Release No. 76743 (Dec. 22, 2015), 80 Fed. Reg. 81948 (Dec. 31, 2015) ("Transfer Agent Release"), *available at*: https://www.sec.gov/rules/concept/2015/34-76743.pdf (last visited Sep. 23, 2020).
10. *Id.*
11. Stein, K., 2015. Speech, *Surfing the Wave: Technology, Innovation, and Competition* – Remarks at Harvard Law School's Fidelity Guest Lecture Series, *available at*: https://www.sec.gov/news/speech/stein-2015-remarks-harvard-law-school.html (last visited Sep. 23, 2020).
12. *Statement on Digital Asset Securities Issuance and Trading*, Division of Corporation Finance, Division of Investment Management, and Division of Trading and Markets, SEC (Nov. 16, 2018), ("Statement of Digital Asset Securities") *available at*: https://www.sec.gov/news/public-statement/digital-asset-securites-issuuance-and-trading (last visited Sep. 23, 2020).
13. *Id.*
14. *Id.*
15. Levin, R., O'Brien, A., and Zuberi, M., *Real Regulation of Virtual Currencies*, Handbook of Digital Currency (2015).
16. *Id.*
17. *Id.*
18. *Id.*
19. Levin, R., Waltz, P., and LaCount, H., *Betting Blockchain Will Change Everything – SEC and CFTC Regulation of Blockchain Technology*, Handbook of Blockchain, Digital Finance, and Inclusion, Volume II (2016).
20. *Id.*
21. *Securities Exchange Commission v. W.J. Howey, Co.*, 328 U.S. 293 (1946).
22. SEC Chairman Jay Clayton, Testimony on Virtual Currencies: *The Roles of the SEC and CFTC*, Before the Committee on Banking, Housing, and Urban Affairs, United States Senate (Feb. 6, 2018) (stating "[B]y and large, the structures of ICOs that I have seen involve the offer and sale of securities and directly implicate the securities registration requirements and other investor protection provisions of our federal securities laws."),

available at: https://www.sec.gov/news/testimony/testimony-virtual-currencies-oversight-role-us-securities-and-exchange-commission (last visited Sep. 23, 2020). The Chairman also stated in response to questions from a Senator at the same hearing, "I believe *every* ICO I've seen is a security". *Id.*

23. Section 202(a)(11) of the Advisers Act.
24. Rule 206(4)-2.
25. Rule 206(4)-2(d)(2).
26. Rule 206(4)-2(d)(2); *see also* SEC Division of Investment Management Guidance Update 2017-01, *Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority* (2017) ("2017 Guidance"), *available at*: https://www.sec.gov/investment/im-guidance-2017-01.pdf (last visited Sep. 23, 2020).
27. *Id.*
28. Rule 206(4)-2.
29. Rule 206(4)-2(d)(6).
30. Rule 206(4)-2(d)(6)(i); *see also* 15 U.S.C. § 80b–2. There is a tenable argument that a state-chartered trust company is a bank for purposes of the Custody Rule.
31. Rule 206(4)-2(a)(3).
32. Rule 206(4)-2(b)(2). The staff has issued guidance indicating that it would not "object" if an adviser to a pooled investment vehicle that is subject to an audit in accordance with paragraph (b)(4) of the rule does not maintain private stock certificates with a qualified custodian under certain circumstances that suggest that loss of the certificate will not adversely affect the pooled investment vehicle. *See* IM Guidance Update 2013-04 (Aug. 2013).
33. *Engaging on Non-DVP Custodial Practices and Digital Assets*, SEC Division of Investment Management (Mar. 12, 2019), *available at*: https://www.sec.gov/investment/non-dvp-and-custody-digital-assets-031219-206#_edn1 (last visited Sep. 23, 2020).
34. 2017 Guidance.
35. Staff Letter: *Engaging on Fund Innovation and Cryptocurrency-related Holdings to Paul Schott Stevens, President & CEO, Investment Company Institute and Timothy W. Cameron, Asset Management Group – Head, Securities Industry and Financial Markets Association, from Dalia Blass, Director, Division of Investment Management*, U.S. Securities and Exchange Commission, Jan. 18, 2018, *available at*: https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm (last visited Sep. 23, 2020).
36. *Id.*
37. *See* SEC Staff Letter from *Dalia Blass, Director of SE Division of Investment Management, to Paul Schott Stevens, President & CEO, Inv. Co. Inst., & Timothy W. Cameron, Asset Mgmt. Grp.–Head, SIFMA* (Jan. 18, 2018), *available at*: https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm (last visited Sep. 23, 2020).
38. *See* Rule 15c3-3(b)&(c). Whether an entity is a good control location is based on its ability to maintain exclusive control over customer securities. *See*, *e.g.*, Rule 15c3-3(c)(5) (recognising a "bank" as defined in Section 3(a)(6) of the Exchange Act as a good control location so long as, among other things, the bank has acknowledged that customer securities "are not subject to any right, charge, security interest, lien or claim of any kind in favor of a bank or any person claiming through the bank" and the securities are in the custody or control of the bank).
39. *See* Rule 15c3-3(c)(1)&(5).

40. The SEC often receives applications under Rule 15c3-3(c)(7) to designate an issuer or the transfer agent of various types of uncertificated securities as a control location. The SEC Division of Trading and Markets has delegated authority to "find and designate as control locations for purposes of Rule 15c3-3(c)(7) certain broker-dealer accounts which are adequate for the protection of customer securities". *See* 17 CFR 200.30-3(a)(10)(i). *See also* letter to Fantex Brokerage Services, LLC from Mark M. Attar, Senior Special Counsel, Division of Trading and Markets, SEC (Dec. 19, 2014) (providing that the staff would not recommend enforcement action if a broker-dealer treats a transfer agent for uncertificated securities as a good control location, under certain circumstances). The no-action letters do not address whether the use of blockchain technology, in connection with the maintenance of the single master security holder list, establishes control of uncertificated securities by the issuer (or transfer agent).
41. *Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities*, Division of Trading and Markets, SEC Office of General Counsel and Financial Industry Regulatory Authority (July 8, 2019) (the "Joint Statement"), *available at*: https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities (last visited Sep. 23, 2020). *See also Financial Industry Regulatory Authority – ATS Role in the Settlement of Digital Asset Security Trades*, SEC No-Action Letter (Sep. 25, 2020) (granting no action relief to FINRA for a three-step model for the settlement of transactions in digital asset securities), *available at*: https://www.sec.gov/divisions/marketreg/mr-noaction/2020/finra-ats-role-in-settlement-of-digital-asset-security-trades-09252020.pdf (last visited Sep. 23, 2020).
42. An ATS is a trading system that meets the definition of an "exchange" under federal securities laws that is not required to register as a national securities exchange if the ATS complies with the conditions to the exemption provided under Rule 3a1-1(a)(2) of the Exchange Act. *See* 17 CFR 242.300(a) (defining an alternative trading system) and CFR 242.3a1-1(a)(2) (the exemption from the definition of an exchange for an ATS). An ATS that is required to comply with Regulation ATS must register with the SEC as a broker-dealer. *See* 17 CFR 242.301(b)(1).
43. Joint Guidance.
44. *See*, *e.g.*, Statement on Digital Asset Securities.
45. SEC, *What We Do* (June 10, 2013), *available at*: https://www.sec.gov/Article/whatwedo.html (last visited Sep. 23, 2020) and FINRA, *What We Do*, *available at*: https://www.finra.org/about/what-we-do (last visited Sep. 23, 2020).
46. *See* Rule 15c3-3(b)&(c). An entity's designation as a good control location is based, in part, on its ability to maintain exclusive control over customer securities. *See*, *e.g.*, Rule 15c3-3(c)(5).
47. *See* Rule 15c3-3(c)(1)&(c)(5).
48. Authority of a National Bank to Provide Cryptocurrency Custody Services for Customers, OCC Interpretive Letter #1170 (Jul. 2020) ("OCC letter"), available at: https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2020/int1170.pdf.
49. *Id.* at 6–7.
50. *Id.* at 8.
51. *Id.*
52. *See* Section 17(f)(1) of the Investment Company Act, 15 USC § 80a-17(f)(1), and the rules thereunder. Following the OCC letter, the staff of the SEC Strategic Hub for Innovation and Financial Technology ("FinHub Staff") issued a statement noting

the OCC has issued a limited interpretation regarding holding reserves of a stablecoin associated with hosted wallets that is backed by a single fiat currency and redeemable by the holder of the stablecoin on a 1:1 basis for the underlying fiat currency upon submission of a redemption request to the issuer. The FinHub staff reminded firms that whether a digital asset is a security under the federal securities laws is based on a facts and circumstances analysis. *SEC FinHub Staff Statement on OCC Interpretation* (Sep. 21, 2020), *available at*: https://www.sec.gov/news/public-statement/sec-finhub-statement-occ-interpretation (last visited Sep. 23, 2020).

53. Rule 15c3-3.
54. Louisiana recently joined New York and became the second state to enact a stand-alone virtual currency law. Louisiana's Virtual Currency Business Act became effective August 1, 2020. For a comparison with the New York BitLicense, s*ee* Timothy C. Brown and Caroline L. Cordell, *Louisiana Serves Up New Virtual Currency Business Law Cajun Style*, The National Law Review (July 30, 2020), *available at*: https://www.natlawreview.com/article/louisiana-serves-new-virtual-currency-business-law-cajun-style (last visited Sep. 23, 2020).
55. N.Y. COMP. CODES R. & REGS. tit. 23, pt. 200 Virtual Currencies.
56. N.Y. COMP. CODES R. & REGS. tit. 23, § 200.2(p).
57. "Exchange Service" means "the conversion or exchange of Fiat Currency or other value into Virtual Currency, the conversion or exchange of Virtual Currency into Fiat Currency or other value, or the conversion or exchange of one form of Virtual Currency into another form of Virtual Currency". *Id.* § 200.2(d).
58. *Id.* § 200.2(q).
59. *Id.*
60. N.Y. COMP. CODES R. & REGS. tit. 23, § 200.3(c).
61. *See* BitLicense Frequently Asked Questions, N.Y. State Department of Financial Services, *available at*: https://www.dfs.ny.gov/apps_and_licensing/virtual_currency_businesses/bitlicense_faqs (last visited Sep. 23, 2020).
62. N.Y. COMP. CODES R. & REGS. tit. 23, § 200.3(c).
63. *Organization of a Trust Company for the Limited Purpose of Exercising Fiduciary Powers*, N.Y. State Department of Financial Services, *available at*: https://www.dfs.ny.gov/banking/iaus1a.htm (last visited Sep. 23, 2020).

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