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May 8, 2023

Submitted electronically via rule-comments@sec.gov

Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F St NE
Washington, DC 20549

Re: Safeguarding Advisory Client Assets: File Number S7-04-23

Dear Ms. Countryman,

Anchor Labs, Incorporated–also known as Anchorage Digital–appreciates the opportunity to comment on the U.S. Securities and Exchange Commission's (SEC's) proposed safeguarding rule: File Number S7-04-23.

Anchorage Digital is a global regulated digital asset platform that provides institutions with integrated digital asset financial services and infrastructure solutions. Anchorage Digital offers clients an unparalleled combination of secure custody, regulatory compliance, product breadth, and client service. Our clients are institutions, such as banks, sovereign wealth funds, family offices, and financial technology, private equity, and venture capital firms. We maintain offices throughout the world including in the United States, Portugal, and Singapore.

Of particular relevance to the proposed rule, Anchorage Digital is the parent company of Anchorage Digital Bank N.A. (ADB), the first and only operational U.S. Office of the Comptroller of the Currency (OCC) chartered digital asset bank with explicit authorization to provide digital asset custody services. As a "qualified custodian" (QC) of digital assets, we bring a unique perspective to this conversation. We have a vested interest in making sure the proposed rule not only helps keep clients' assets safe but also is practical and prudent. For these reasons we have elected to provide comments on the proposed rule and thank the SEC Commissioners and their staff for their efforts.

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At Anchorage Digital Bank we provide for the safekeeping of our clients' cryptographic keys that unlock their digital assets. We use air-gapped, hardware security module (HSM) based

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key storage that mitigates the risks of human error and attack vectors by showing proof of existence and maintaining exclusive control over the keys at all times. Transaction endorsements are protected by behavior anomaly detection, based on a collection of meaningful risk indicators and any sensitive operations require approval of a quorum of members within a client group. At Anchorage Digital, we hold the highest industry standard for securing digital assets. We have successfully passed System and Organization Control (SOC) 2 Type 2 audits, we are examined twice a year by our primary federal regulator, the OCC, and we use military-grade encryption.

Further, at no point do clients or any other party–except our bank–have access to the keys we create and protect for clients. We never, under any circumstances, create copies or shards of our clients' cryptographic keys. This **exclusive control of keys** by our bank is critical to reducing risks of theft, misappropriation, or any other unauthorized use of clients' digital assets. It also means that the beneficial ownership of a client's digital assets cannot change, unless our bank participates in such action by effectuating the transaction prior to the change in ownership, meeting the requirements of participation in the change of beneficial ownership mandated in the proposed rule. Further, we can provide evidence of this exclusive control with our logs and audits of such logs.

At ADB, we will never–nor have we ever–moved clients' digital assets unless our clients have explicitly instructed us to do so. Client instructions to move digital assets are validated by ADB, and if all criteria are met, we approve and broadcast the transaction to the blockchain. Also, at no time are client and non-client funds commingled at ADB.

The HSM, exclusive-control architecture we use gives our clients all the benefits of cold storage and hot wallets, without their respective tradeoffs. Like with hot wallets and unlike cold storage, our clients have the ability to quickly access and use their digital assets. However, unlike hot wallets and similar to cold wallets, our clients digital assets are securely stored in segregated on-chain vaults, and clients' assets under our care are never lent out or hypothecated. Further, our clients can rest assured that due to the unique protections of National Bank Act and our designation as a nondepository custodian that maintains all client assets off balance sheet, client assets would never directly or indirectly be subject to claims of creditors of ADB or its affiliates in the event of an insolvency. In other words: assets at ADB are unequivocally "bankruptcy remote."

In order to allow greater access to our qualified custodian services and enhance consumer and investor protections throughout the digital asset industry, we developed a separate custody counterparty offering. Had FTX used a similar structure, FTX's ability to fraudulently move clients' assets from FTX to Alameda Research would have been severely constrained. Beyond that, client assets would never have been subject to being used as company funds for Alameda or FTX because we, as the underlying custodian, would be there to serve as a segregated counterparty. That is because a segregated custody and settlement structure eliminates the need for customers to prefund accounts on exchanges. Instead, digital assets that will be used for trading on the exchange remain in ADB–where the funds are securely earmarked for transactions but maintained in segregated on-chain vaults–until settlement. Through the transparency of the blockchain we can prove the customers have beneficial ownership of the digital assets for the trade and place an API hold on the vault. Functionally, this means customers' digital assets remain within the qualified custody of our bank until settlement, and then the new assets are placed back into our customers' secure and segregated vaults. This segregation and settlement process greatly minimizes third-party risks and would have greatly mitigated the opportunity for a bad actor like FTX to misappropriate customers' assets, had a similar segregated settlement structure and separation of functions been used.

While we are a digital asset native company, ADB must and does follow the traditional banking requirements contained within the Bank Secrecy Act. We are proud to work with law enforcement and our regulators to help stop illicit finance. Though specific information is confidential, we have and continue to prevent digital assets from getting into the hands of sanctioned entities or persons. In fact, because of the inherent transparency of the blockchain, we can track flows of assets once they leave our custody and help fight illicit finance.

At Anchorage Digital, we know the mission of the SEC is to "protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation." Though we are not tasked by the American people with this noble mission, we are pleased that we can help our industry provide better investor protections and enhanced digital asset markets by providing safe qualified custody services.

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This comment letter is organized into six categories: (1) types of assets within scope, (2) possession and control requirements, (3) federal vs. state QCs, (4) assurances in the written contract, (5) bankruptcy remoteness, and (6) miscellaneous.

Types of Assets Within Scope

The proposed rule expands the scope of the existing custody rule to require Registered Investment Advisors (RIAs) to use a QC to maintain not just client "funds" and "securities," as is currently required, but all "assets." "Assets" in the proposed rule include "funds, securities, or other positions held in a clients account," which includes digital assets such as crypto.

We generally agree that digital assets managed by a RIA should be maintained by a QC. However, it is important to remember that not all digital assets are the same. Already, there

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is a great diversity of digital assets that exist today; that diversity is only going to become more complex in the coming years. Taking an overly scrupulous view of which digital assets must be maintained by a QC may have unintended consequences such as stifling innovation and capital formation without a commensurate safeguarding benefit. At the same time, excluding certain digital assets from the proposed rule without good reason may run counter to the SEC's mission of investor protection. Therefore, we encourage the SEC to prudently consider important distinctions that may preclude certain digital assets from needing to be held by a QC. While this may be counter to our short-term bottom line we think it is better for the industry overall and will provide greater integrity to the ecosystem.

Anchorage Digital encourages the SEC to consider expanding the exemption in the proposed rule provided for privately offered securities and physical assets to also include digital assets that cannot yet be maintained with a QC. Generally these are newly issued tokens that are typically bought and held by sophisticated investors that are apprised of the risks associated with investments in early-stage tokens which includes the lack of custodians available to support such assets. Without this exemption, many digital asset projects would effectively fail instantly, thereby harming innovation (and potentially even capital formation), without a concomitant safeguarding benefit. We see this regulatory fragility of fledgling digital assets firsthand in our vetting process at Anchorage Digital. We thoroughly and arduously evaluate whether or not to support custody of each new digital asset we consider, and then build the requisite infrastructure for it. Our chief concern here is that the "limbo" period for new digital assets should not, as an unintended externality of this rule, stifle innovation nor tilt the scales in favor of larger, more established, digital assets. For these specific assets, we believe it is not necessary for a RIA to use a QC, especially when sophisticated investors are apprised of and accept the risks inherent with digital asset investments in the absence of a QC.

Possession and Control Requirements

Anchorage Digital agrees with the "possession or control" requirements in the proposed rule. We believe it is an important consumer and investor protection to require that the QC "participate" in the change of beneficial ownership of a digital asset. Specifically, participation means that the QC "...would effectuate the transaction involved in the change in beneficial ownership, and the qualified custodian's involvement is a condition precedent to the change in beneficial ownership." This definition ensures there is an appropriate check on RIAs by the QC; moreover, we believe that requiring QCs to deliver accounting statements to the RIA's clients adds an additional level of transparency that will enable the RIA's client to check if the RIA is managing the client's assets appropriately.

As stated above, at ADB, the beneficial ownership of clients' assets cannot change unless ADB participates in this change. ADB has exclusive control of all clients' cryptographic keys–throughout their entire lifecycle—including those that are associated with RIAs. This is because the keys are created and permanently stored within our HSMs, which only the bank can access, and they are never shared with our clients or third parties.

Our model doesn't require key sharing or manual human operations, both of which expose the client to the risk of losing their digital assets. A potential issue with multi-party computation (MPC) custodian architecture, of which a characteristic is anonymity of signing, is that the system itself cannot prove which key shares were used to execute a transaction. Like a key used to open a locked front door, the lock will open with the key inserted, but there's no ability to audit or prove the person turning the key should be allowed to enter or who actually entered the home. Anchorage Digital's unification of policy and signing means the same system which constructs and signs transactions can provide the audit logs approval. We can also easily prove to external auditors and clients that we have control of keys of digital assets at any time through on-demand challenge response authentication.

We specifically elected not to implement a key sharding model whereby keys are shared with clients and third parties, due to increased risk of keys being lost or acquired by unauthorized parties. Furthermore, we chose not to use a key sharding model, because that protocol would potentially obviate the requirement that the QC "participate" in the beneficial ownership change of digital assets. Sometimes under key sharding arrangements, only the client of the QC and a non-QC third-party collectively have possession or control of the key, and it is not necessary for the QC to participate in the change of beneficial ownership.

Additionally, in order for beneficial ownership to change at ADB, a "quorum" needs to be reached by client authorized users with cryptographic signatures. As part of this quorum requirement, ADB also authenticates the client authorized cryptographic signatures via biometric, IP geolocation, and device identity checks, among other measures. Only once this information is verified ADB will effectuate the transaction and broadcast the transaction to the blockchain.

Federal vs. State QCs

In order for there to be greater adoption of digital assets, we believe that there should be more–not less–adequately-regulated banks in the digital asset ecosystem. The proposed rule does not change which entities may be a QC. Federal or state chartered banks, certain trust companies, registered broker-dealers, registered futures commission merchants, or certain foreign financial institutions may all be QCs. At Anchorage Digital, we are supportive of all these entities having the opportunity to be a QC. To create parity (part of the intent of the proposed rule itself), we believe that the requirements of each of these institution types should be substantially similar. We also urge the SEC to approve broker-dealers to custody digital assets pursuant to SEC Rule 15c3-3 to provide for SEC-regulated entities to be QCs in addition to banks.

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As it was before, under the proposed rule, RIAs must perform their own analysis to determine if a prospective custodian is in fact a QC. This diligence process may be particularly burdensome for RIAs evaluating state trusts and foreign financial institutions. To illustrate, not only does a RIA have to examine the prospective custodian, but they must assess associated state or foreign banking, contract, and property laws to see if they conflict with requirements in the proposed rule (e.g., bankruptcy remoteness). These conflicts could potentially make it impossible for custodians from certain jurisdictions to be QCs. RIAs must also keep in mind that state and foreign laws are not static and will have to continuously monitor pertinent laws to ensure these state and foreign-based custodians are QC compliant. With US national banks, the RIA does not have to worry about state or foreign laws potentially making a custodian ineligible to be a QC. However, as we detail later in the bankruptcy remoteness section of this letter, US national banks subject to SEC's Staff Accounting Bulletin Number 121 (SAB 121) also may not be QCs or may be subject to knock-on capital restraints that limit their ability to custody digital assets.

Assurances in the Written Contract

Anchorage Digital supports the SEC's proposal to require a written contract between RIAs and QCs. In fact, this is the current practice of ADB today. In terms of the specific assurances in the written contract between the two parties, we would like to highlight an area that creates disparate treatment of digital asset custodians relative to traditional asset custodians: *indemnification*. About this the SEC says, on pages 285-286:

> "The proposed rule would require the adviser to obtain reasonable assurances from the qualified custodian that the qualified custodian will indemnify the client (and will have insurance arrangements in place that will adequately protect the client) against the risk of loss in the event of the qualified custodian's own negligence, recklessness, or willful misconduct. Our staff has observed that custodians often include indemnification clauses in their custodial agreements with customers. Staff has also observed that the contractual limitations on custodial liability vary widely in the marketplace, in some instances reducing a qualified custodian's liability to such an extent as to not provide an appropriate level of investor protection. By requiring advisers to obtain reasonable assurances from the qualified custodian that the qualified custodian will indemnify the client against the risk of loss in the event of the qualified custodian's own negligence, recklessness, or willful misconduct, the proposed rule seeks to create a minimum floor of custodial protection for investors in the event of custodial misconduct (i.e., simple negligence). For those investors whose qualified custodians indemnify the client against the risk of loss in the event of the qualified custodian's gross negligence, the proposed requirement that an adviser obtain reasonable assurances from the qualified custodian that the qualified custodian will indemnify the client against the risk of loss in the event of the qualified custodian's own negligence, recklessness, or willful misconduct would likely operate

as a substantial expansion in the protections provided by qualified custodians to advisory clients by preventing these custodians from disclaiming liability for misconduct that does not rise to the level of gross negligence."[1]

With respect to negligence standards and associated indemnification insurance requirements for QCs, we believe there should be parity between requirements for QCs that custody digital assets and those that custody traditional assets. In traditional finance, there is currently a gross negligence (or lower) standard; this proposed rule would therefore make digital asset custodians go above and beyond standards required of their peers in traditional finance. The current industry standard used in digital asset custody contracts is gross negligence. Some companies, including ADB, indemnify clients from this risk with insurance. We strongly believe that the imposition of a negligence standard, rather than a gross negligence standard, will have a disparate impact on smaller custodians and start-up custodians that are a necessary part of the industry, because they help to move innovation forward and provide important custody services with respect to digital assets.

To establish parity between digital and traditional asset custodians, we recommend that the SEC remove the requirement that digital asset QCs indemnify clients against simple negligence committed by the QC, and instead adopt the current industry standard of gross negligence.

Bankruptcy Remoteness

Anchorage Digital generally supports the bankruptcy remote requirements in the proposed rule. It requires banks to "hold client assets in an account that is designed to protect such assets from creditors of the bank…in the event of the insolvency or failure of the bank …(i.e., an account in which client assets are easily identifiable and clearly segregated from the bank's assets) in order to qualify as a qualified custodian."[2] Specifically, the proposed rule states: "The account terms should identify clearly that the account is distinguishable from a general deposit account and clarify the nature of the relationship between the account holder and the qualified custodian as a relationship account that protects the client assets from creditors of the bank or savings association in the event of the insolvency or failure of the bank or savings association."[3]

Though Anchorage Digital generally supports the bankruptcy remote requirements in the proposed rule, we want to highlight the material consequences of these requirements. Despite the best efforts of a custodian, for those subject to certain state or foreign laws, RIAs may find that the custodian cannot be sufficiently bankruptcy remote–due to failures to

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[1] See SEC Proposed Rule: Safeguarding Advisory Client Assets at pg. 285-286, https://www.sec.gov/rules/proposed/2023/ia-6240.pdf
[2] Ibid, page 44
[3] Ibid, page 46

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properly segregate client assets from the bank's general assets to qualify for QC status. For example, even when state trusts have placed clients assets in "special accounts," "custody accounts," or categorized these clients assets as "special deposits," due to the varying and subjective nature of state laws, some courts have ruled that customers assets held in these special accounts are still subject to the creditors claims. Concerningly, those custodians therefore may not adequately protect clients' assets from being included in the bankruptcy estate should the entity become insolvent or fail. In theory, U.S. national banks do not have these problems because of the clarity provided by federal statute on these matters.

Due to SAB 121 requiring digital assets be included on the balance sheet of certain SEC reporting banks–which is not required of traditional assets held in custody by banks–these same banks may not meet the bankruptcy remote requirements in the SEC's proposed rule. That is because in bankruptcy, counsel for creditors may argue that digital assets held on the balance sheet of a failed bank should be property included in the bankruptcy estate of the failed bank and subject to creditors claims. While it may be ultimately decided that those assets of the client on the balance sheet of a SAB 121 compliant bank are not part of a bankruptcy estate, it could take *years* before clients get their digital assets back.

Lastly, it is already well established that SAB 121-compliant banks cannot scale the digital asset custody offerings due to knock-on capital costs associated with putting custodied digital assets on their balance sheets.[4] This is because these banks have to hold 500 bps in tier 1 capital for any digital assets they hold on their balance sheets, despite their estimated returns for custodying digital assets amounting between 5-50 bps. This makes it unprofitable for banks subject to SAB 121 to custody digital assets. It has also taken away the ability of many American investors to access QC-level digital asset custody services, either directly through these large banks or indirectly through sub-custody arrangements provided by banks like ours.

Anchorage Digital is not subject to SAB 121 and meets the bankruptcy-remote requirements in the proposed rule. In the short-term, these regulations actually may drive digital asset custody business to ADB. Meanwhile, the long-term effects of SAB 121 and lack of clarity related to bankruptcy remoteness of certain types of entities that do not have a federal charter like our bank, is immensely concerning for the industry as a whole.

For these reasons, we encourage federal policymakers to make more pathways available for custodians to get federal approval to custody digital assets. Because SAB 121 limits the ability of certain well-regulated US banks to scale their digital asset custody services, we request that the SEC revoke and replace this staff bulletin with a more workable alternative that better accomplishes the bankruptcy protections that were undoubtedly its original intent.

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[4] https://www.ledgerinsights.com/sec-digital-asset-custody-state-street-bny-mellon-insane/

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Miscellaneous

Question 71 from the proposed rule asks,

> "Do commenters agree that there are circumstances when qualified custodians' services require them to commingle advisory client assets and assets of non-advisory customers? For example, when a qualified custodian uses sweep accounts, escrow accounts, and loan servicing accounts? In these circumstances, should the rule require additional protections? Which protections and why and would they differ depending on the type of commingled account?

It is worth noting that sweep fees from client accounts do not in fact violate a prohibition on the commingling of client and non-client funds if permitted by the contracts between the QC and the client. Once the fees are lawfully swept, they are the property of the QC, and thus no commingling of client and non-client funds would have occurred.

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Anchorage Digital believes that the safeguarding of digital assets by RIAs for their clients with clear-cut qualified custodians is of critical importance. As such, we thank the SEC for this opportunity to comment on its proposed safeguarding rule. If SEC officials would like to ask Anchorage Digital any follow-up questions, please do not hesitate to contact us.

Sincerely,

DocuSigned by:
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Nathan McCauley
Co-Founder and CEO
Anchor Labs Inc.

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