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February 18, 2021

File No. S7-25-20

Security Exchange Commission
100 F Street N.E.
Washington, DC 20549-1090

Re: Release No. 34-90788; File No. S7-25-20
Custody of Digital Asset Securities by Special Purpose Broker-Dealers

To the Commission:

The Security and Exchange Commission has identified a series of risks associated with the custody of digital asset securities by Special Purpose Broker-Dealers including the risk of loss or theft of digital assets held in custody by the Broker-Dealer. In response to the Commission's general request for comment, Evertas is pleased to submit suggestions regarding the Commission's proposed Release No. 34-90788, *Custody of Digital Assets Securities by Special Purpose Broker-Dealers*.

Since 2017, Evertas has been at the forefront of developing the risk management and insurance infrastructure for digital assets and blockchain infrastructure including digital asset securities – applying world leading expertise in assessing the theft/loss risk for holders of digital assets. This includes custodians maintaining physical possession or control of fully paid and excess margin digital asset securities. We strongly agree with the Commission that "the loss or theft of digital asset securities may cause the firm and its digital asset customers to incur substantial financial losses [which], in turn, could cause the firm to fail, imperiling its traditional securities customers as well as the broker-dealer's counterparties and other market participants."[1]

Response to Commission Request for Comments

1. **What are industry best practices with respect to protecting against theft, loss, and unauthorized or accidental use of private keys necessary for accessing and transferring digital asset securities? What are industry best practices for generating, safekeeping, and using private keys? Please identify the sources of such best practices.**

[1] *17 CFR Part 240 [Release No. 34-90788; File No. S7-25-20] Custody of Digital Asset Securities by Special Purpose Broker-Dealers,* Securities and Exchange Commission (Dec. 23, 2020), at 8, https://www.sec.gov/rules/policy/2020/34-90788.pdf

Evertas believes that any specific technology-based answers to the above question is likely going to be at best out of date within the next six months and at worst obsolete. Developments within this industry are occurring rapidly, with significant changes coming to the market on a quarterly and even monthly basis. Accordingly, the best answer to this question involves (1) the development and incorporation of a **framework and process for risk mitigation** combined with (2) **third-party evaluations** conducted using assessors (i.e., insurance companies) with "skin the game" to properly assess risk.

Framework and process for risk mitigation

Evertas has developed a comprehensive underwriting framework to assess the risk of cryptoasset custody. This framework covers sixteen categories with over 1,000 points of analysis to support a comprehensive underwriting determination. Evertas's framework is updated regularly to not only incorporate changes to custody practices and procedures, but to also incorporate knowledge gained through current, real-world risks including attacks (both successful and unsuccessful) against custodians and exchanges. These regular updates are required to keep abreast of technology changes and to identify new threat vectors.

In our view, any "snapshot" approach taken by regulators will always be out-of-date and, in some cases, be significantly so.

Third-party evaluations

The federal government and the SEC have for decades encouraged companies providing critical infrastructure to purchase insurance; this is especially the case for rapidly changing technology risks. For example, as early as 2003, Paul B. Kurtz, Special Assistant to the President and Senior Director for Critical Infrastructure Protection, stated with respect to internet risk that "The Insurance industry has a pivotal role in play, particularly by developing cyber-insurance policies."[2] Similarly, former DHS Secretary Michael Chertoff stated on April 29, 2005 that "Sometimes we can … be a little bit more vigorous in using market-based incentives, working with the insurance industry, for example…"[3]. In June 2011, the Department of Commerce Internet Policy Task Force came to the same conclusion finding that insurance is a potentially "effective, market-driven way of increasing cybersecurity." [4]

In October 2011, the SEC joined Commerce and DHS in highlighting to its industry participants the value of insurance and the positive impact insurance had on the operations, security, and

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[2] *Cyber-Insurance Metrics and Impact on Cyber-Security*, White House (Aug. 19, 2010), at 1, https://obamawhitehouse.archives.gov/files/documents/cyber/ISA%20-%20Cyber-Insurance%20Metrics%20and%20Impact%20on%20Cyber-Security.pdf

[3] *Ibid.*

[4] *Cybersecurity, Innovation and the Internet Economy,* Department of Commerce Internet Policy Task Force (June 2011), *at 23*-24, http://www.nist.gov/itl/upload/Cybersecurity_Green-Paper_FinalVersion.pdf

liability exposure for companies as summarized below in DHS's November 2012 "Cybersecurity Insurance Workshop Readout Report"[5]:

> Participants noted that the SEC's guidance from October 2011 – which effectively requires publicly- traded companies to disclose not only their material cybersecurity risks and cyber incidents but also their insurance policies to address them – has had some impact on corporate boards of directors.

Furthermore, on February 26, 2018, the SEC updated its 2011 advice and re-affirmed at several points the use of insurance as part of a cyber security risk mitigation and management program[6] including such financial incentives as a failure to maintain and update proper security could result in increased insurance premiums[7] thereby helping to disclose the extent of any risk exposure[8] and costs associated with proper management of the risk[9].

Evertas believes this to be a wise course of action by the SEC and very much worth repeating with respect to the issue of risk management and risk mitigation of the custody of digital assets by special purpose broker-dealers. The reasoning is the same as it was for cyber risk and cyber insurance – namely, that insurance carriers can play a critical dual role: (1) as a **third-party independent assessor of risk** (with the prospect of potential payment of losses) to evaluate the other risk mitigation steps taken by the broker-dealer (including those listed in the Statement) and (2) in the event of a loss, provide a **source of third-party financial support** for both the broker-dealer as well as its customers.

Evertas believes that a regulatory approach prescribing "best practices" at the level of implementation will stifle innovation and likely increase risk for the entities operating in this space as well as their customers. Regulations that solely prescribe "best practices" can quickly become upper bounds for the requirements of systems and risk controls. The likely outcome of such regulated "best practices" will be a static approach that is not suited for success.

Instead, Evertas submits that a focus on dynamic solutions such as insurance will enable the expertise of the broader market to be leveraged where insurance companies are able to act and react more quickly and often more effectively than regulatory bodies due to the economic incentives for insurers to appropriately manage risk. Insurance solutions focused on cryptoasset related risks are an effective tool to mitigate the risks identified by the Commission.

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[5] *Cybersecurity Insurance Workshop Readout Report*, Department of Homeland Security (November 2012), at 20, https://www.cisa.gov/sites/default/files/publications/November%202012%20Cybersecurity%20Insurance%20Workshop.pdf

[6] *17 CFR Parts 229 and 249 [Release Nos. 33-10459; 34-82746] Commission Statement and Guidance on Public Company Cybersecurity Disclosures*, Securities and Exchange Commission (February 26, 2018), https://www.sec.gov/rules/interp/2018/33-10459.pdf

[7] *Ibid* at page 4, 17

[8] *Ibid* at page 14

[9] *Ibid* at page 15

Accordingly, Evertas recommends adding an eighth step in *Section III Discussion* portion of the Release related to insurance as an additional risk mitigation measure. Proposed text for this additional step is provided below:

> *An eighth step the broker-dealer could take is to investigate and purchase, if advisable, specific insurance against loss suffered by its customers arising out of the loss or theft of digital asset securities of its customers held in custody by the broker-dealer, (i.e., cryptoasset theft insurance). This step potentially provides two major benefits for the broker-dealer and its customers. First, it provides an independent third-party assessment by a risk bearing entity who evaluates the strengths and weaknesses of the broker-dealer's processes and security measures over its custody as well as the disclosures and other risk mitigating actions discussed in earlier steps of this statement. Second, in the event of a financial loss covered by the insurance, it provides a source of third-party financial support for both the broker-dealer and its customers. The limits of this coverage should be appropriate to the risk based on the amount of assets under custody; however, in many cases, distinctions between digital assets held in "cold storage" versus "hot storage" carry different levels of risk so a broker-dealer might reasonably need to purchase 100% coverage for digital assets held in "hot storage" and a potentially smaller percentage of coverage for digital assets held in "cold storage".*

Proposed Further Remedies to SEC Concerns and the Insurance Market

While cryptoasset theft insurance is the most obvious type of insurance broker-dealers who maintain custody of digital assets should purchase due to the reasons set forth above, there is wisdom in the SEC also recommending that broker-dealers evaluate their Directors and Officers insurance as well as their Professional Liability insurance policies and Fidelity Bonds. Ideally a full insurance coverage review would be undertaken.

We thank the SEC for their attention to this important new market, its thoughtful regulations, and consideration of our comments.

Respectfully,

Raymond Zenkich
President
Evertas Inc.