Digital Asset Regulation Poses Challenges For Insurers

By Jennifer Odrobina and David Buishas (December 16, 2019, 5:42 PM EST)

Bitcoin was born out of the 2008 recession — a complex financial crisis resulting in a bailout of companies deemed too big to fail.[1] The primary goal of Bitcoin was to create a new digital financial system that removed reliance on centralized banks, yet still ensured the safety of consumers’ finances and personal data.[2]

Public blockchain, the underlying technology upon which bitcoin was built, is a decentralized peer-to-peer network that is powered by its users and free from central authority.[3] Blockchain removes the need for a middleman because the technology itself verifies and records each transaction on an open ledger.[4]

The open ledger is permanent and immutable (at least, in theory), meaning the recorded transactions are trustworthy and easily verifiable.[5] By recording transactions on an open public ledger rather than within a single institution, public blockchain lacks centralized points of vulnerability that hackers can exploit (i.e., data breach).[6] It also prevents centralized entities from aggregating and selling consumers’ personal data.

Though bitcoin was the first cryptocurrency to gain widespread traction, many other digital assets have followed in its path and proliferated in recent years.[7] According to CoinSchedule, issuers of cryptocurrencies raised approximately $31 billion through initial coin offerings in the last three years alone.[8] In 2018, the total market capitalization for all cryptocurrencies reached over $800 billion.[9]

ICOs are used to launch new cryptocurrencies and develop networks on which the digital assets will operate.[10] The ICO promoters sell tokens as a form of fundraising, rather than selling shares or obtaining financing from banks.[11] To attract investors, ICOs are typically promoted online through the release of a whitepaper describing the project and terms of the ICO.[12] Investors often purchase tokens hoping to earn a profit, usually by selling their tokens in the secondary market once a digital enterprise is built and the value of the project increases.[13]

Evolution of Digital Asset Regulation

Regulators have been slow to catch up with this rapidly evolving space, in part because cryptocurrencies are novel and present challenging questions of how to categorize these
ill-defined assets. Although bitcoin and other cryptocurrencies can be used to purchase goods and services, the U.S. Department of the Treasury has concluded that cryptocurrencies are not actually currencies because they are not legal tender.[14]

The U.S. Commodity Futures Trading Commission, which oversees futures, options and derivative contracts, has accepted regulatory jurisdiction over virtual currency transactions as commodities.[15] The CFTC’s jurisdiction is implicated whenever a virtual currency is used in a derivative contract, or where there is fraud or manipulation involving a traded virtual currency.[16]

The U.S. Securities and Exchange Commission’s scope of regulatory authority for virtual assets is less clear because cryptocurrencies do not neatly fit within existing U.S. securities laws. In SEC v. W.J. Howey & Co., the U.S. Supreme Court established the test for determining when an investment contract constitutes a security.[17]

According to the court, “an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person (1) invests his money (2) in a common enterprise and (3) is led to expect profits (4) solely from the efforts of the promoter or a third party.”[18]

Existing cryptocurrencies like bitcoin are unlikely to meet the Howey test. Indeed, SEC Chairman Jay Clayton recently acknowledged that bitcoin does not meet the formal definition of a security.[19] Conversely, a newly launched ICO may qualify as a security under certain circumstances, which would subject its promoters to the rigorous disclosure and registration requirements of U.S. securities laws.[20] Understanding what those circumstances are, however, is often a fact-intensive inquiry.

Seeking to clarify its position on regulation of ICOs, the SEC recently issued a public statement regarding digital assets.[21] Therein, the SEC emphasized that cryptomarket participants must adhere to the “well-established federal securities law framework when dealing with technological innovations, regardless of whether the securities are issued in certificated form or using new technologies, such as blockchain.”[22]

Clayton echoed this position, stating, “[E]very ICO I’ve seen is a security.”[23] More recently, the SEC published a framework for applying U.S. federal securities laws to digital assets, which identifies the factors market participants should consider in assessing whether a digital asset is offered or sold as an investment contract and, therefore, is a security.[24]

In an effort to regulate initial public offerings of cryptocurrency tokens, the SEC has been aggressively pursuing enforcement actions against companies for engaging in, facilitating and/or promoting the unregistered offering and sale of securities.[25] The SEC keeps a list of all ICO-related enforcement actions on its website.[26]

This list, which includes numerous enforcement actions in 2019, does not encompass nonpublic investigations by governmental agencies or the hundreds of private lawsuits brought by purchasers of digital assets alleging violations of U.S. securities laws, fraud and breach of contract.[27] Notably, recent private litigation has targeted both the companies that create and promote ICOs, as well as the directors and officers of these organizations.

In response to this growing ICO-litigation trend, U.S. courts have struggled with providing clear guidance on whether ICOs actually involve an offer/sale of securities, in part because that determination is so fact-intensive.[28] On Feb. 14, however, the U.S. District Court for the Southern District of California issued an important decision in SEC v. Blockvest, holding that the promotion of a particular ICO token was a securities offering and satisfied the Howey test.[29]
This decision is notable because it marks the first time a U.S. court has determined as a matter of law that the promotion of a particular ICO violated securities laws. The holding, however, should not be viewed as a blanket rule extending the application of U.S. securities laws to all ICOs, as each ICO presents a unique factual scenario.

One reason U.S. courts and regulators have been somewhat constrained in their ability to provide clear guidance on the scope of cryptocurrency regulation is that the regulatory framework is arguably outdated for this new asset class. However, the legislative scheme may soon be changing.

The United States House Committee on Financial Services recently hosted a crypto roundtable with over 45 representatives from major Wall Street firms to discuss improving regulatory uncertainty of cryptocurrencies.[30] On April 9, Reps. Warren Davidson, R-Ohio, and Darren Soto, D-Fla., introduced the bipartisan Token Taxonomy Act, H.R. 2144, in an attempt to modernize the treatment of cryptocurrencies under U.S. securities laws.[31]

The Token Taxonomy Act aims to amend the Securities Act of 1933 and Securities Exchange Act of 1934 to exclude digital tokens from the definition of security.[32] It also seeks to clarify that securities laws would not apply to a cryptocurrency once it has become a fully functioning network.[33] While the Token Taxonomy Act aims to promote innovation of blockchain economies by clarifying the regulatory landscape, it is still too early to tell whether the bill will gain traction in Congress.[34]

Due to regulatory uncertainty in this rapidly evolving space, it is common for businesses engaged in ICOs to go to market without necessarily complying with state and federal securities laws.[35] With the recent precipitous drop in the value of cryptocurrencies, the number of ICO-related securities class actions is climbing and will likely continue to grow. Until legislative guidance arrives on treatment of virtual currencies, businesses engaged in blockchain technology or virtual currency development can expect this litigation trend to continue.

**Impact on Insurance Market**

The insurance industry is grappling with difficult decisions on how to interpret and apply traditional insurance products to the recent string of ICO-related enforcement actions and litigation. Indeed, many of the current ICO-related claims arose prior to the development of a dedicated cryptocurrency insurance market. As a result of these developments, entities and individuals targeted by ICO-related litigation have sought coverage under traditional errors-and-omissions and directors-and-officers liability policies.

A threshold issue for analyzing traditional insurance coverage for ICO claims is whether the insurer ever intended to cover such risks. Policy insuring agreements and exclusions should be examined carefully to determine their applicability depending on the particularity of the ICO-related claim.

For instance, a professional liability E&O policy generally provides coverage to entities and individuals who are accused of committing wrongful acts while rendering or failing to render professional services. E&O insurance could potentially become relevant if an SEC subpoena, enforcement action or ICO-lawsuit targets the advisers, lawyers, promoters or broker-dealers that helped facilitate the ICO.

The SEC has specifically warned in a newsletter that its enforcement actions could extend to market professionals assisting companies in planning and executing ICOs.[36] Therefore, evaluating whether an E&O policy is triggered will generally require an analysis of whether the promoter, broker-dealer or other individual is accused of committing wrongful acts in rendering or failing to render professional services.
ICO litigation may also impact traditional D&O liability policies. A private company’s (as opposed to public company) D&O policy generally provides coverage for claims involving violations of securities laws. However, private company D&O policies also often contain exclusions that bar coverage for publicly traded securities.

D&O policies also may exclude coverage for claims involving professional services. Therefore, when considering whether a particular D&O policy might respond to an ICO claim, it is important to evaluate whether the ICO constitutes a public offering of securities or involves professional services.

A solution for insurance companies that do not want to cover such risks could be to include a cryptocurrency exclusion by endorsement or on the base form of the policy. A solution for insureds who may wish to cover potential cryptocurrency exposure is to work closely with their insurance broker to ensure their exposure — whether E&O, D&O or another — is appropriately tailored to fit within the policy’s insurance grants and not precluded by any exclusions.

Conclusion

Blockchain technology presents a paradigm shift in virtually every industry, including financial services, health care, social media and insurance. It allows consumers to securely transmit information and assets (cryptocurrencies/tokens) without relying on central intermediaries to process their transactions.

The rise of cryptocurrencies, driven largely by speculators and the ICO phenomenon, has resulted in a multibillion-dollar increase in market cap valuation over recent years. U.S. regulators have been slow to adapt, but are beginning to aggressively patrol this evolving space. Additionally, ICO and cryptocurrency-related securities class action lawsuits are on the rise.

For insurers, marketing to crypto-related businesses presents opportunities for substantial growth. Managing risks arising from ICOs and other digital asset transactions, however, will require clearer direction from U.S. regulators, legislators and courts.

Jennifer L. Odrobina is a vice president at Sompo International Holdings Ltd.

David J. Buishas is a partner at BatesCarey LLP.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.


[3] Id.

17, 2019).

[5] Id.

[6] Id.


[8] Id.


[12] Id.

[13] Id.


[16] Id.


[18] Id.


[21] Id.

[22] Id.


[27] Id.


[32] Id.

[33] Id.

[34] Id.
