Reuters Legal News

Will SEC regulation and FTX suits cause more insurers to consider cryptoassets?

By Michael L. Zigelman, Esq., and Andrew Ioannou, Kaufman Dolowich

JULY 25, 2023

In the fall of 2008, as the nation grappled with the consequences of what was generally considered the most severe financial crisis since the Great Depression, many questioned whether the traditional financial system best served their needs. With the extraordinary aftermath of the crisis, the seeds of the digital asset market were initially planted, when a person, or persons, using the pseudonym "Satoshi Nakamoto" published a Bitcoin whitepaper.

This whitepaper introduced the idea of a "peer-to-peer" electronic cash payment system that would remove third-party intermediaries present in traditional monetary transactions, which the paper described as the cause of high levels of fraud and high transactional costs.

Cryptocurrencies remain unregulated by any central authority, which means that there are no standard guidelines for insurers to follow when looking to insuring them.

Since that whitepaper, the digital asset market has proliferated, and its growth skyrocketed during the pandemic. Today, there are more than 10,000 tokens — or digital assets — and hundreds of digital asset platforms on which customers can buy and sell these tokens. According to a Sept. 16, 2022, release put out by The White House, "White House Releases First-Ever Comprehensive Framework for Responsible Development of Digital Assets," it is estimated one in five adult Americans has purchased digital assets.

Legacy financial institutions like Visa, Mastercard and JP Morgan have also acknowledged the benefits of new technologies like blockchain, and Facebook announced a proposal for a new digital currency that would replace *all* currency as a global medium of exchange. Most recently, BlackRock, the world's biggest asset manager, filed for a bitcoin exchange-traded fund (ETF), and a few days later Fidelity did the same.

However, due to the recent collapse of crypto exchange FTX Trading Ltd. ("FTX"), the limited market regulation overseeing cryptocurrency and the volatile prices of digital assets, the insurance market, which has, to date, been reluctant to underwrite broad protection policies for crypto companies and assets, was even more risk-adverse. *See* "Insuring Crypto: The Birth of Digital Asset Insurance" 75 U. Ill. J.L. Tech. & Pol'y 92,94 (2021).

It is also not surprising that difficulties obtaining adequate coverage for these assets have been exacerbated by the recent implosion and insolvency of the once valued $32-billion crypto exchange FTX. In fact, a mere 2-3% of global cryptoassets are believed to be insured, according to a release put out by Evertas, a crypto insurance company, "Cryptoasset insurer Evertas gains new policy writing capacity in Canada," June 22, 2022.

A heightened focus on crypto lenders and intermediaries

Crypto exchanges, lending platforms and token issuers quickly became top priorities for the Securities and Exchange Commission, with a flurry of enforcement activity following the collapse of FTX. For some, FTX's collapse serves as the perfect opportunity to reiterate the need for comprehensive U.S. regulation of crypto markets and potentially create a workable framework to distinguish cryptoassets that are securities from those that are not — while also addressing concerns that cryptoassets are not subject to regulation because they are new financial instruments that do not fit conventional statutory definitions.

SEC Chair Gary Gensler has stated that most of the nearly 10,000 digital asset tokens in the market are likely offered as securities. Without anyone prejudging any particular entity, Gensler stated in a Sept. 8, 2022, speech before the whole agency that if there are digital asset issuers and intermediaries illegally operating outside of the federal securities laws, they would undermine the general principle of transparency as well as the SEC's ability to protect vulnerable investors in a market that is susceptible to volatility and fraud.

FTX collapse

The FTX collapse, in November 2022, stemmed from a liquidity shortfall that occurred when clients attempted to withdraw funds from the platform. This shortfall led to the discovery that $10 billion of customer funds had allegedly been improperly transferred from FTX to another company. The SEC promptly brought charges against four of the top FTX executives and its sister crypto hedge fund, Alameda Research LLC ("Alameda") executives. *See* "SEC Enforcement Mid-Year Review" by Gray, Elizabeth P., "The Harvard Law School Forum on Corporate Governance," June 14, 2023.

It is alleged that FTX executives deceived their equity investors by touting the platform as a safe cryptoasset trading platform, while simultaneously diverting FTX customer funds to Alameda for the hedge fund's own trading purposes, as well as paying Alameda's lenders and bankrolling FTX CEO Sam Bankman-Fried's political and personal investments and to manipulate the price of FTT (an FTX-issued "exchange token" that the SEC alleges was a security).

It is incumbent upon insurers to carefully consider how they will address coverage for cryptocurrency, balancing the reasonable expectations of insureds with prudent underwriting and claim handling practices.

The Commission has alleged that this conduct constitutes securities fraud under both Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act (and Rule 10(b)(5) thereunder). However, the Commission's civil action against Bankman-Fried has been stayed pending resolution of a parallel criminal case against the founder by the U.S. Attorney's Office for the Southern District of New York. Bankman-Fried has pleaded not guilty to all his charges, including looting FTX funds, and is free on $250 million bond, currently living in Palo Alto, California.

Despite FTX's alleged misconduct, these recent events offer an opportunity to make a meaningful inquiry — can innovative blockchain technology exist side-by-side and be compatible with the existing federal securities law framework? If a token is deemed a security, then its offering must comply with securities law requirements, including cybersecurity requirements, and requirements for policies that prevent fraud and market manipulation. Additionally, having the backing of a well-established insurance carrier would be a strong signal that blockchain technology is a viable player in the market.

Although the SEC has attempted to provide clarity through numerous enforcement actions and lawsuits, determining whether a cryptocurrency is a security and how to apply the Howey Test — a method to determine whether a financial instrument qualifies as a security — remains a developing area in federal securities regulation. For insurers, if such cryptocurrency is considered a "security" then, depending on the type of insurance policy, coverage may or may not be implicated, as "Securities Claims" and "Security" are terms of art found in various D&O/Management reimbursement-type policies. Moreover, carriers may start to add cryptoasset-specific exclusions to clarify that they only cover traditional "securities" claims.

In *S.E.C v. W. J. Howey Co*. (1946), the Supreme Court held that an investment contract exists when there is "an investment of money in a common enterprise with profits to come solely from the efforts of others." Here, while much remains to be seen as the SEC attempts to bring cryptoassets within its purview, a principle of administrative law in the U.S. known as the 'major questions doctrine' could challenge the SEC's use of the Howey Test to determine if an asset is a security under federal law. This doctrine argues that if an agency seeks to regulate a matter, especially if it involves national, economic, or political importance, it must first obtain explicit approval from Congress.

In *West Virginia v. Environmental Protection Agency* (2022), the Supreme Court struck down the EPA's 2015 Clean Power Plan, holding that the agency lacked the authority to adopt the plan based on the major questions doctrine. The majority opinion cited a line which extends far beyond environmental regulation, stating that where there is reason to doubt that Congress authorized a particular agency action, "both separation of powers principles and a practical understanding of legislative intent [require] clear congressional authorization for the power it claims."

Here, the major questions doctrine could operate to challenge the SEC's reach and authority in regulating digital assets that operate on decentralized blockchains. However, it is unlikely to be tested until the SEC's lawsuits against cryptoasset giants like Coinbase and Binance reach the appellate courts. In June, the SEC filed complaints, alleging that Coinbase and Binance trading platforms were operating as unregistered brokers, unregistered exchanges, and unregistered clearing agencies. The SEC has also accused Binance of deceiving customers and of funneling their money into other firms controlled by executives, drawing comparisons to FTX.

In an April 19, 2023, Wells Submission made to the SEC, Coinbase stated that an enforcement action against the crypto exchange would pose "major programmatic risks" to the SEC that would "fail on the merits," and that it does not "list, clear, or effect trading in securities," while Binance has stated it plans to vigorously defend the charges. More recently, a U.S. District Judge Analisa Torres of the U.S. District Court of the Southern District of New York sided with crypto firm Ripple Labs highlighting that the regulator might be facing an uphill battle, *SEC v. Ripple Labs, Inc*., July 13, 2023.

While the SEC engages in numerous enforcement actions and lawsuits, insurance companies are no doubt watching the space closely. Cryptocurrencies, however, remain unregulated by any central authority, which means that there are no standard guidelines for insurers to follow when looking to insuring them. The aim of the proposed regulation is to meet the challenge of implementing appropriate consumer safeguards while preserving innovation, growth and competition in the industry.

The question for insurers today is no longer whether there should be coverage for cryptocurrency, given the market entrants already in the field. Rather, the question is what forms such coverage will or should take. If digital currency exchanges are ultimately regulated, insurance can play a key role in ensuring there is the capacity to provide redress and compensation in the event that private keys, for example, are lost due to negligence of the custody provider.

Notwithstanding, it is incumbent upon insurers to carefully consider how they will address coverage for cryptocurrency, balancing the reasonable expectations of insureds with prudent underwriting and claim handling practices. Indeed, insurers currently considering underwriting digital asset policies are balancing the desire to move quickly to establish themselves as industry leaders, with the need to remain vigilant in taking into consideration the unknown risks of the new industry.

Very few insurance policies currently cover crypto, and while some crypto exchanges and crypto custodians may offer insurance for their services, supplemental insurance on top of what these entities provide may be necessary to adequately protect from all crypto-related risks.

As the cryptocurrency world continues to evolve and change at breakneck speed, insurers considering entering the crypto-market must remain focused on following these various governmental developments which, at conclusion, should provide much clearer guidance on the regulation of cryptocurrency as a security.

Michael L. Zigelman is a regular contributing columnist on corporate and professional liability insurance for Reuters Legal News and Westlaw Today.

About the authors

Michael L. Zigelman is co-managing partner of the New York City office of **Kaufman Dolowich** and chair of its general liability coverage practice group. He concentrates his practice on all aspects of insurance coverage — including directors and officers liability, professional liability, ERISA/fiduciary-related claims, commercial general liability (CGL), admiralty and maritime, toxic/mass tort and environmental coverage. He can be reached at mzigelman@kdvlaw.com. **Andrew Ioannou** (not pictured) is a summer law clerk with the firm. Prior to joining the firm, he served as a Judicial Intern to the Honorable Andrea Masley, in the New York State Supreme Court, Commercial Division.

This article was first published on Reuters Legal News and Westlaw Today on July 25, 2023.