Current Developments in the Federal Regulation of Cryptocurrencies and Tokens

Can a cryptocurrency, over time, become something other than a security? That was a question raised in a recent speech by Bill Hinman, director of the Securities and Exchange Commission’s (SEC) Division of Corporation Finance. Talking about the regulation of cryptocurrencies and tokens, Hinman asked whether “a digital asset that was originally offered in a securities offering [can] later [be] sold in a manner that does not constitute an offering of a security?” The answer goes toward determining whether, and to what extent, securities laws and regulations apply to transactions involving cryptocurrencies and tokens.

Evolving Regulations, Increasing Risk

Hinman initially repeated the SEC’s position that if a buyer expects to earn a return on a digital asset through the efforts of a promoter, that investment is likely a security subject to SEC regulation. In the SEC’s view, calling the transaction an “initial coin offering (ICO)” or the “sale of a token,” does not change this result.

Hinman stressed that, in this regard, there are two important criteria in determining whether a cryptocurrency is a security: a customer’s expectations and the role of third parties in creating value in the digital asset. “Primarily, consider whether a third party — be it a person, entity, or coordinated group of actors — drives the expectation of a return,” he said. If it does, then the digital asset is likely a security. By contrast, if the consumer is purchasing the asset for consumption, it is likely not a security.

Hinman then discussed a digital asset, like a cryptocurrency such as Bitcoin or Ethereum, where (1) there is no longer a central enterprise being invested in, or (2) the digital asset is sold only to be used to purchase a good or service available through the network on which it was created. Additional criteria may include whether the digital asset is issued to meet the needs of users — as opposed to fueling speculation — and whether independent actors set its price. In certain circumstances, Hinman said, the sale of Bitcoin or Ethereum to a consumer may not be the sale of a security subject to SEC regulation. He noted that the
application of the securities laws to that transaction would seem to add little value.

Interestingly, at about the same time as Hinman’s speech, the Commodity Futures Trading Commission was in federal court in Boston arguing that virtual currencies fall within the definition of goods and articles subject to CFTC regulation.

The regulatory landscape surrounding cryptocurrency and token issuance is in flux, with little doubt that it is moving toward a more highly regulated process. Like with any evolving law or regulation, there will be an accompanying increase in risk to companies contemplating an offering as they navigate the issuance process. The increased exposure will undoubtedly be borne both by companies and their directors and officers.

Mitigating The Exposure

Risk transfer solutions, including insurance, can serve an important function for companies contemplating issuing cryptocurrency or tokens. For example, most companies look to obtain directors and officers (D&O) liability insurance before going through any public or private offering. The same should be true for any cryptocurrency or token offering. D&O insurance can protect both the company and its directors and officers, and insures defense costs and indemnity payments (such as settlements or judgments) associated with litigation and regulatory investigations and proceedings. Some forms of D&O insurance protect the company’s balance sheet while others serve as personal asset protection for its directors and officers. How expansive the coverage is depends on how the policy is negotiated and how the D&O program is structured.

Because of the evolving regulatory landscape, companies issuing cryptocurrency or going through an ICO or token offering have become prime targets for private litigation and regulatory investigations and proceedings. D&O insurance is available for private and public companies in this space, with the breadth of coverage varying from policy to policy. Regardless of whether your company is private or public, you should work with your insurance advisor to consider the following issues when purchasing D&O insurance:

1. Based on your specific potential risk exposures, what are the appropriate limits of liability to put in place?
2. Which insurers will make the best partners, and what is their claims-paying reputation?
3. Are you purchasing sufficient Side-A D&O insurance limits? Side-A coverage applies solely to the directors and officers, not the company, and is something that many qualified board members will require.
4. What are your specific risk exposures (for example, regulatory investigations or civil litigation) and how can your D&O policy best insure the defense costs and indemnity payments associated with those exposures?
5. How will your D&O insurance respond in connection with a regulatory investigation?
6. What exclusions are in the policy, such as a regulatory exclusion or a securities offering exclusion? What do they mean for coverage?
7. How narrowly tailored are the exclusions in your policy?
8. How much will D&O insurance cost?

Purchasers and sellers of digital assets such as cryptocurrency and tokens ought to stay attuned to developments in this rapidly changing area of the law and should carefully consider how they impact their plans and regulatory exposure. They should also consider the importance of purchasing D&O insurance to protect their balance sheets and personal assets, especially in light of the increased risks associated with unsettled regulation.

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