



KAUFMAN BERGEEST & RYAN LLP

Crypto, Claims and D&O

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Agenda

- The Crypto Industry and Ecosystem
- The Regulatory Landscape
- Are Crypto Investments Securities?
- Class Actions
- SEC Enforcement Actions
- D&O Insurance

The Digital Asset Industry (as of April 2023)

- total global market cap of all cryptocurrencies was \$1.17 trillion
- nearly 9,000 cryptocurrencies
 - top 20 make up about 90% of market
- 10 most popular cryptocurrencies by market cap
 - Bitcoin (BTC), Ether (ETH), Tether (stablecoin), Binance (BNB), USDCoin (stablecoin known best as USDC), Ripple (XRP), Cardano (ADA), Dogecoin (DOGE), Polygon (MATIC), Solana (SOL)
- between 2012 and April 2023, Bitcoin gained 127,310% (from \$22 to \$28,030)
- Bitcoin's market cap exceeded \$542 billion
- the daily trading volume of all cryptocurrencies globally was \$50.9 billion
- approximately 16% of Americans (or 53 million people) use cryptocurrency

The Ecosystem

- **Blockchain**

- A type of distributed ledger technology (DLT)
 - a database spread across networks of computers or nodes where each network or node has a copy of the ledger and transactions are validated through a consensus mechanism
- Public blockchains
 - “permissionless” (open)
 - often used for exchanging and mining cryptocurrency (Bitcoin and Ethereum)
- Private blockchains
 - “permissioned” (closed)
 - typically used by a specific organization or group of organizations for enterprise applications and supply chain management

The Ecosystem

- 2 most common blockchain-based digital investments: **Coins** and **Tokens**
- **Coins**
 - digital ***currencies*** created on their own blockchain network
 - mined through proof of work or forged through proof of stake
 - traded on crypto exchanges; used for speculative trading and investment
- **Tokens**
 - digital ***assets*** issued by projects built on existing blockchain network (usually Ethereum)
 - block-chain based projects (decentralized apps or “Dapps”) include crypto exchanges, crypto lending platforms, cloud storage, etc.
 - sold (ICO) or distributed for free (air drop) by developers
 - traded on crypto exchanges

The Ecosystem

- Some common tokens
 - **Access or Utility tokens** – provide access to a product or service on the platform; designed to incentive use of a platform or some feature of the platform
 - **Loyalty tokens** – provide discounts on services or digital goods available on the platform
 - **Governance tokens** – provide the right to participate in voting on the future development of the project
 - **Asset-backed tokens** – provide rights to a real asset, such as land or real estate; backed by the underlying asset
 - **Security tokens** – digital equity in a project sold through a Security Token Offering
 - **NFTs (non-fungible tokens)** – provide rights to non-fungible, one-of-a-kind objects, including works of art
 - **Stablecoins** – a token pegged to another asset, such as the U.S. dollar; designed to be stable; used to buy other cryptocurrencies
- token purchasers look to profit from the success of the project or an increase in value of the underlying asset

The Ecosystem

- **Consensus Mechanisms**

- no central authority to validate transactions in a decentralized network, such as a blockchain
- a way for computers or nodes in a network to reach a common understanding about which transactions are valid and should be added to the blockchain
- Proof of Work (PoW)
 - the original consensus mechanism used in Bitcoin and used in several other cryptocurrencies
 - involves **miners** competing to solve a complex mathematical problem, with the first miner to solve the problem rewarded with newly minted coins and right to add a new block to the blockchain
- Proof of Stake (PoS)
 - **stakers** selected to validate transactions and create new blocks on the blockchain based on the amount of cryptocurrency they "stake" or lock up as collateral
 - rewarded with additional cryptocurrency and the right to add a new block

The Ecosystem

- **Passive Income**

- **Staking**

- becoming a staker requires technical expertise and a significant amount of crypto to stake
 - individuals can delegate their stake to a third-party staker, who will perform the necessary validation on their behalf and share a portion of the rewards received for validating with the individual

- **Crypto Lending**

- a way to earn interest in crypto holdings by lending them to other users or institutions who need to borrow them for a variety of reasons, such as margin trading, short selling, or other types of financial transactions
 - need to use a cryptocurrency lending platform, which acts as a marketplace and matches lenders with borrowers and facilitates the lending process
 - interest rates earned by lending cryptocurrency can vary depending on the lending platform, the cryptocurrency loaned and current market conditions

The Regulatory Landscape

- SEC: “Everything other than Bitcoin” is a security and subject to SEC regulation
- CFTC: “Bitcoin, ether, litecoin, and tether tokens, along with other digital assets,” are commodities, like corn, wheat, gold or silver and subject to CFTC regulation
- *In re Voyager Dig. Holdings, Inc.*, 649 B.R. 111, 119 (Bankr. S.D.N.Y. Mar. 11, 2023)
 - “[R]egulators themselves cannot seem to agree as to whether cryptocurrencies are commodities that may be subject to regulation by the CFTC, or whether they are securities . . . subject to securities laws, or neither, or even on what criteria should be applied in making the decision. This uncertainty has persisted despite the fact that the cryptocurrency exchanges have been around for a number of years.”
- Congress so far unable to pass comprehensive crypto legislation
 - In April 2023, Rep. Patrick McHenry (R–N.C.) said that Congress will consider a bill this summer that will address both securities and commodities issues
- Some states also considering legislation
 - in May 2023, NYAG bill, called the Crypto Regulation, Protection, Transparency and Oversight, or CRPTO, Act, that would strengthen the NY DFS’s regulatory authority over digital assets.
- in the meantime, SEC and CFTC (and state regulators) “regulate through litigation”

Are Crypto Investments Securities?

- Securities Act of 1933:
 - “security” means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, **investment contract**, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing
- *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293 (1946)
 - investors purchased land and trees in an orange grove in Florida from Howey and entered into a service contract with Howey whereby Howey cultivated, harvested and marketed the oranges and split the proceeds with the investors
 - “investment contract” – (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profit, (4) to be derived from the efforts of others

Filing Trends – Class Actions

- in 2022, class actions related to crypto more than doubled to a record 23
 - weakened crypto market
 - start of 2022, crypto prices at an all-time high
 - by end of 2022, many cryptocurrencies and crypto companies, including FTX, had collapsed
 - increased regulatory scrutiny, especially by the SEC
- “Crypto is the new frontier in securities fraud litigation”
- in 2023, 7 class actions through 4/20/23
- defendants: token issuers, lenders, exchanges, miners
 - public and private companies

Filing Trends – Class Actions

- public companies
 - plaintiffs: shareholders, token purchasers
 - damages under §10(b) of the Exchange Act for paying inflated prices for company stock
 - rescission / disgorgement under §12(a)(1) of the Securities Act for sale of unregistered securities, *e.g.*, tokens
- private companies
 - plaintiffs: token purchasers, digital asset lenders, NFT purchasers, etc.
 - rescission / disgorgement under §12(a)(1) of the Securities Act for sale of unregistered securities
 - state law violations for deceptive practices, unregistered securities, etc.

Filing Trends – SEC Enforcement Actions

- in May 2022, SEC announced the Crypto Assets and Cyber Unit would double in size to 50 dedicated positions
- in 2022, SEC brought 30 enforcement actions against digital-asset market participants, up 50% from 2021
- in 2023, 11 enforcement actions through 3/8/23
- SEC focusing on lending, crypto exchanges and stablecoins
- most frequent allegations are
 - **fraud** (§10(b) of Exchange Act)
 - **unregistered securities offerings** (§12(a)(1) of Securities Act)
 - **failure to register as a broker or exchange** (§15 of Securities Act)

Claims Against Public Companies

- Ryvyl Inc. (shareholder class action)
 - crypto company focused on developing, marketing and selling blockchain-based payment solutions
 - plaintiffs – shareholders who bought Ryvyl stock in its initial public offering and later in the aftermarket
 - defendants – Ryvyl and its Ds and Os (and its underwriters)
 - allegation: at the time of the offering and during the class period, defendants failed to disclose material weaknesses in internal controls in violation of federal securities laws

Claims Against Public Companies

- Ryvyl Inc. (shareholder class action)
 - following restatement, shareholders filed class action alleging violations of §10(b) of Exchange Act and §11 of Securities Act
 - **Securities Claim**
 - **Claim** brought by security holder of the **Insured Organization**
 - defense and indemnity for Ds and Os under Side B and for Ryvyl under Side C
 - not a claim unique to crypto, but an example of a D&O exposure for crypto companies, nonetheless

Claims Against Public Companies

- Coinbase, Inc. (*Wells* Notice from the SEC)
 - largest digital asset trading platform in the United States
 - first, Coinbase is acting as an unregistered securities exchange in violation of the Exchange Act
 - second, Coinbase is acting as an unregistered broker in violation of the Exchange Act
 - third, Coinbase's staking services constitute an unregistered securities offering in violation of the Securities Act

Claims Against Public Companies

- Coinbase, Inc. (*Wells* Notice from the SEC)
 - putting aside whether coverage is available for Coinbase's response to the *Wells* Notice, would coverage be available for an enforcement proceeding by the SEC against Coinbase and its Ds and Os?
 - **Claim** includes regulatory proceeding against (i) **Insured Person** or (ii) **Insured Organization**, provided proceeding is made and maintained against an **Insured Person**
 - Coverage (at least for defense) for **Insured Person** for SEC enforcement proceeding under Side B for **Claims**

Claims Against Public Companies

- Coinbase, Inc. (*Wells* Notice from the SEC)
 - Side C coverage limited to **Securities Claims**:
 - a **Claim**
 - ~~(i) brought by a security holder of the Insured Organization~~
 - (ii) based upon or arising out of the sale or offer to sell securities issued by the **Organization** or
 - (iii) based upon or arising out of the violation of any securities law involving the sale or offer to sell securities issued by the **Organization**

Claims Against Public Companies

- Coinbase, Inc. (*Wells* Notice from the SEC)
 - Is Coinbase's staking program a "security"?
 - Is it "issued by the **Organization**"?
 - SEC: staking program = investments contract: (i) investment (crypto) (ii) in a common enterprise (stake pool) (iii) with expectation of profit (more crypto) (iv) derived from efforts of others (Coinbase)
 - Coinbase: staking not a security but a service offered for a fee
 - 4 corners rule – allegations control; security for purposes of coverage and defense?
 - BUT, is it "issued by the **Organization**"?

Claims Against Public Companies

- Eqonex Limited (shareholder and token class action)
 - digital assets financial services company that operated a crypto exchange EQONEX
 - in October 2020, went public *via* SPAC and traded on Nasdaq
 - in April 2021, launched utility token EQO to incentive use of EQONEX by providing benefits such as reduced trading fees and that could be used for passive income through staking
 - EQO traded on EQONEX and value of EQO was dependent on success of EQONEX as a crypto exchange

Claims Against Public Companies

- Egonex Limited (shareholder and token class action)
 - plaintiffs: Egonex shareholders and purchasers of EQO tokens
 - defendants: Egonex and its Ds and Os
 - allegations: defendants falsely represented that they were devoting resources to grow EQONEX and that a merger with Binance (world's largest crypto exchange) was possible
 - merger never happened and Egonex exited exchange business citing intense competition and low margins due to decreased trading volumes
 - Egonex stock price drops and EQO tokens worthless

Claims Against Public Companies

- Egonex Limited (shareholder and token class action)
 - §10(b) of the Exchange Act with respect to the common stock for misrepresentations regarding growing EQONEX and a possible merger with Binance
 - §12(a)(1) of the Securities Act with respect to the EQO tokens for the sale of unregistered securities
 - token is a security (investment contract) because it is an investment (dollars for tokens) in a common enterprise (EQONEX crypto exchange) with expectation of profit (increased value of EQO) through efforts of others (Egonex's maintenance and growth of EQONEX crypto exchange)

Claims Against Public Companies

- Eqonex Limited (shareholder and token class action)
 - coverage available for Ds and Os under Side B for **Claims**
 - coverage available for Eqonex under Side C for §10(b) stock claim
 - coverage available for Eqonex under Side C for EQO token claim?
 - are EQO tokens “securities”?
 - if a security, “issued by the **Organization**”?
 - allocation?

Claims Against Private Companies

- Gemini Trust Company, LLC (class action by crypto lenders)
 - crypto asset exchange that offered lending program “Gemini Earn”
 - Gemini matched crypto lenders with crypto borrower Genesis Global Capital
 - Genesis paid interest on the crypto it borrowed, and Gemini split the interest payments between itself and the crypto lenders
 - Genesis filed for bankruptcy, failed to return the crypto it borrowed, and lenders lost all the crypto they loaned

Claims Against Private Companies

- Gemini Trust Company, LLC (class action by crypto lenders)
 - Gemini Earn lending accounts were securities (investment contracts)
 - Plaintiffs invested (purchased crypto to lend) in a common enterprise (the lending program) with expectation of profit (interest on the loans) through efforts of others (Gemini and its partners)
 - violation of §10(b) of Exchange Act for misrepresentations about risks involved with Gemini Earn program
 - violation of §12(a)(1) of the Securities Act for the sale of unregistered securities

Claims Against Private Companies

- Thor Technologies, Inc. (SEC enforcement action over ICO)
 - Thor sold "Thor Tokens" to the public for stated purpose of developing a software platform for "gig economy" companies and workers
 - Thor used the funds to develop the platform but also (i) to repay a loan from one of its officers, (ii) to invest in a crypto asset fund owned and controlled by Thor officers (losing most of the investment), and (iii) to pay the salary of two individuals that worked for the fund
 - Thor was unsuccessful in building its platform and shut down, rendering the tokens worthless
 - violations of Section 5 of the Securities Act for sale of unregistered securities (investment contracts)
 - injunction from further coin offerings, disgorgement of ill-gotten gains and civil monetary penalties

D&O Coverage for Non-Crypto Private Company

- Sides A, B and C: **Loss** for a **Claim** against an **Insured**
- lawsuits by token purchasers or digital asset lenders and the SEC are **Claims**
- broad securities exclusion – no coverage for **Claims**
 - based upon or arising out of the public sale of securities issued by the Organization
 - brought by security holders of the Organization
- are tokens or lending programs securities?
 - 4-corners rule supports treating them as securities?
- are they “issued by the **Organization**” or securities “of the **Organization**”?

D&O Coverage for Crypto Private Company

- Sides A, B and C: **Loss** for a **Claim** against an **Insured**
- narrower securities exclusion – no coverage for **Claims**
 - based upon or arising out of the sale of public equity securities or **Coin Offerings** by the **Company** or
 - based upon or arising out of the violation of any law relating to public equity securities
- **Coin Offering**: sale of tokens by the **Company** to the public
- excludes coverage for **Claims** related to raising funds (IPO or ICO) but maintains coverage for other “securities” Claims (digital asset lenders, staking program participants)
 - Thor (SEC lawsuit for ICO) not covered? Gemini (class action by crypto lenders) covered?

D&O Coverage – Loss and Retention

- **Loss**
 - does not include fines, penalties and relief deemed uninsurable under applicable law (disgorgement and rescission)
 - many class actions (especially against private companies) seek rescission for the sale of unregistered securities
 - SEC actions seek fines or penalties and/or disgorgement
 - defense-costs only scenario?
- “security” issue relevant not only to entity coverage, but also to applicable retention
 - lower **Claim** retention or higher **Securities Claim** retention?

Summary

- crypto industry large, growing and constantly evolving
- no clear regulator – SEC and CFTC both claim jurisdiction
- class actions and claims by regulators increasing in frequency
- potential coverage issues under non-crypto D&O policies
 - are claims **Securities Claims** (public company D&O)?
 - are claims excluded by securities exclusion (private company D&O)?
 - what retention applies?
- multiple markets in U.S., London and Bermuda
- regulatory clarity and better understanding of industry could lead to more markets

Thank you for your time!

Questions?