SOCIUS

A Cryptocurrency Primer: Definitions, Risks and Insurance

In recent years, cryptocurrency has attracted the attention of both financial institutions and individual investors. However, the market is volatile, and because it is a relatively new asset, regulations are still in development. As a result, there are risks as well as insurance challenges to consider.

Defining Cryptocurrency

Cryptocurrency includes several types of digital currencies. According to Investopedia, cryptocurrencies are not typically issued by a central authority. Additionally, they are secured by cryptography, which is defined as the art of writing or solving code. Many cryptocurrencies use blockchain technology and decentralized networks.

A blockchain is an immutable (unchangeable) ledger that is shared on a computer network. According to IBM, all network participants have access to the ledger, but once a transaction is recorded on the blockchain, no participant can change it. Decentralization is a big part of the cryptocurrency movement. According to Coinbase, the term decentralized finance, or DeFi, is used to refer to various financial services on public blockchains, especially Ethereum. These services allow people to earn interest, borrow, lend, trade and conduct many other activities traditionally supported by banks. Cointelegraph explains that Web 3.0 is the next state of the internet's evolution, and decentralization is the key distinction between Web 3.0 and earlier stages of the internet. Web 3.0 apps, called decentralized apps or DApps, use blockchains or networks of peer-to-peer nodes.

There are many distinct types of cryptocurrency. The term "altcoin" is typically used for any coin other than Bitcoin. In addition to coins, there are also tokens. Investopedia says that tokens are often used to raise funds for crowd sales, and they are created through an initial coin offering (ICO), which is essentially the cryptocurrency version of an initial public offering (IPO).

Coins and tokens are fungible, meaning that they are not unique, so one can be exchanged for another. Non-fungible tokens, or NFTs, are stored on a blockchain, but these assets are indeed unique. According to CoinDesk, NFTs give gamers and collectors the opportunity to become the immutable owners of in-game assets. NFTs also give artists a way to program in royalties so they receive a percentage of the profits each time a piece of art is sold to a new owner.

The Current State of the Cryptocurrency Market

According to Fortune, the crypto market cap hit $3 trillion in November 2021. However, a crypto crash has since brought this value down significantly. The global cryptocurrency market cap is $1.14 trillion as of August 16, according to CoinMarketCap.

According to Barron's, this has not deterred venture capitalist investors. As of July 14, the 2022 year-to-date venture capital investment in crypto and blockchain industries reached $17.9 billion.

© Socius Insurance 2021. All Rights Reserved.
License# 0D6077

Cryptocurrency Regulations

Because cryptocurrencies are not typically issued by a central authority, they have been fairly unregulated. However, as interest and investments have grown, so too have efforts at regulation.

According to CNBC, Securities and Exchange Commissioner Hester Peirce has said there isa lot of fraud in the crypto space, and the U.S. has dropped the ball on regulatory action. Therefore more regulations may be coming. In March 2022, President Biden issued an executive order calling for responsible development of digital assets, and in July, the U.S. Department of the Treasury released a fact sheet on a framework for international engagement on digital assets.

Risks and Insurance Challenges

According to a Cornerstone Research report on securities class action filings, there were 11 core federal filings involving cryptocurrency in 2021, and halfway through 2022, there have already been 10. These filings include suits against cryptocurrency exchanges as well as coin issuers.

Property Casualty 360 says that some companies are adding or considering having crypto on their balance sheets. Storage becomes a critical issue. Cryptocurrency can be stored in different ways, including in cold wallets that are not connected to the internet and on cloud-based exchanges, which are generally considered less secure. Inadequate storage methods could leave crypto assts vulnerable to loss or theft, resulting in claims of negligence and breach of fiduciary duties, and insurance underwriters may ask about crypto and storage methods.

How does insurance respond to these exposures? Reed Smith says that because cryptocurrency is still in its infancy, many insurance policy forms do not address it directly. However, some coverage may be found in different policies, including D&O, cyber, E&O, crime and property, depending on the policy terms and the nature of the claim.

According to Bloomberg Law, some insurers are taking steps to exclude crypto-related risks from coverage due to the risks and regulatory uncertainty. As a result, crypto coverage may be harder to find, more restrictive and more expensive.

Looking for crypto coverage for your clients? Contact Socius for assistance.

We can provide advice, access to new markets and underwriting advocacy for you and your clients. Below is a list the different types of crypto accounts for which we can help secure coverage:

- Blockchain/cryptocurrency creation or development
- Cryptocurrency or token exchanges
- Cryptocurrency storage (hot or cold)
- Professional service providers (e.g. tax and compliance professionals)
- Non-profit advocacy, professional, or trade organization
- ICO (either native or third-party consulting/advisory)
- Decentralized Finance (DeFi)
- Metaverse developers or investment
- NFT creation, distribution, or marketplaces
- DAO
- Specialized hardware and structural service providers (e.g. energy, cooling, contract manufacture, etc.)

Brendan Barber
Vice President - Financial Institutions Director
email: bbarber@sociusinsurance.com
mobile: (925) 262-3357

© Socius Insurance 2021. All Rights Reserved.
License# 0D6077