Review: Blockchain & Smart Contracts 101

A blockchain is:
● An immutable, append-only database
● Cryptographically secured
● Distributed + decentralized

Smart contracts:
● Self-enforcing terms and conditions
● Automatically execute administrative actions
Update: Insurer Uses of Blockchain Technology

- USAA: payments, decentralizing back office operations
- John Hancock: KYC, legal & back office operations
- Allianz: cat swaps, international payments
- B3i: consortium founded by Aegon, Allianz, Munich Re, Swiss Re and Zurich

Insurers do not legally own the securities they report on Schedule D
Instead, insurers own IOUs called “security entitlements”
Benefits of finding a cost-effective way to fix this:
- Protect insurance consumers by ensuring insurers actually have the money to pay claims when due
- Make ownership of securities clear and identifiable
- Eliminate counterparty risk to brokers (T+3 settlement risk & prime brokerage/rehypothecation)
- Reduce insurers’ operational reliance on intermediaries

Fixing a Low-Probability but High Severity Risk: Custody

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Delaware Blockchain Initiative

Delaware will soon begin to store “foundational” documents of finance on a blockchain.

- “Smart Records” – in production at Delaware Public Archives
- “Smart UCC Filings” – stay tuned
- Incorporation Documents – expected later in 2017
  - One problem this change addresses is lack of beneficial owner tracking in securities markets

Update: A Key Ally Emerges—Judge Laster

“I want you, the institutional stockholders of America, to take back the voting and stockholding infrastructure of the U.S. securities markets.”

“The current system works poorly and harms stockholders.”

“But the current plumbers—financial intermediaries—do not have an incentive to fix it. They are making healthy profits in a non-competitive market. They might play around the edges, but real change will have to come from the outside. The good news is that you have a plunger that you can use to clean up the plumbing. That plunger is distributed ledger technologies, the technology that drives bitcoin…

“The plumbing needs to be fixed. A plunger exists. The takeover doesn’t have to be hostile. It can be friendly. But it needs to be done.’’

Problem: Lack of Beneficial-Owner Tracking in Securities

In other words, how can regulators measure insurer solvency when securities—especially U.S. Treasuries—may be over-issued?

Pre-1978 UCC Amendment

- Issuer
- Investor (as individual or via pension fund, mutual fund, insurance company)

Pre-1994 UCC Amendment

- Issuer
- Cede & Co.
- Custodian
- Sub-custodian
- Investor (as individual or via pension fund, mutual fund, insurance company)

Post-1994 UCC Amendment

Needlessly introduces:
- Counterparty Risk
- Operational Risk

Pro Rata Claim on Global Security
Pro Rata Claim on Omnibus Account

UCC Article 8 (Securities): What Happened?

<table>
<thead>
<tr>
<th>Who Holds Title?</th>
<th>Pre-1978</th>
<th>1978 Amendment</th>
<th>1994 Amendment</th>
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<tbody>
<tr>
<td>Owner</td>
<td>Owner</td>
<td>Central Securities Depository (Cede &amp; Co.)</td>
<td></td>
</tr>
<tr>
<td>Owner Owns</td>
<td>Property Right</td>
<td>Property Right</td>
<td>Contractual Right (IOU)</td>
</tr>
<tr>
<td>Legal Status</td>
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<tr>
<td>Evidence</td>
<td>Paper Certificate</td>
<td>Book Entry on Issuer’s Records</td>
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<td>Legal Form</td>
<td>Security</td>
<td>Security</td>
<td>“Security Entitlement”</td>
</tr>
<tr>
<td>Direct vs. Indirect</td>
<td>Direct</td>
<td>Direct</td>
<td>Indirect Pro Rata Share of the Security Entitlement Issued by Your Securities Intermediary, Which Holds an Indirect Pro Rata Share of the Security Entitlement Issued by Its Securities Intermediary, Which Holds a Pro Rata Share of the Global Security Held at the CSD (Cede &amp; Co.)</td>
</tr>
</tbody>
</table>

Sources:
- “Policy Perspectives on Revised UCC Article 8,” James S. Rogers, Boston College Law School Faculty Papers, 1996.
How Might Insurers Reduce Custody Risk?

Failure along the chain of custody is a **low-probability but high-severity risk.**

- Blockchains enable direct ownership/self-custody in a cost-effective, transparent way
  - Syndicated loans, private equity: blockchains are going into production stage
  - Bonds: stay tuned!
  - Delaware Blockchain Initiative highly significant
  - Timing: 5-10+ years to full implementation, but enabling legislative/regulatory changes underway now

- Interim options to reduce insurers’ custody risk:
  - DTC: each insurer has a direct account
  - Custodians: restrict holding insurer assets in omnibus accounts
  - Broker/dealers: use segregated accounts
  - Examination by Insurance Departments of entire chain of securities custody, esp. DTC & omnibus accounts

Blockchains for Insurance Departments?

Public records maintained by state Insurance Departments may lend themselves to blockchains:

- Customer complaint filings and status
- Agent licensing, continuing education status
- Insurance company licensing filings
- New product filings & approval
- Rate filings & approval

Source: Iowa Insurance Division, www.iid.state.ia.us

**How Can We Help You?**

- Consumer Information - file a complaint, find an agent/company
- Insurance Agents - online licensing, continuing education, applications
- Insurance Companies - those licensed to sell products in Iowa
- Securities & Regulated Industries - broker-dealers, securities agents, investment adviser firms and representatives, pre-need funeral plans
- State Partnership Exchange Plans Management - company information regarding Qualified Health Plan criteria and other information for companies about the exchange in development
- Information for Consumers about Health Care Coverage and the Exchange - information about health care coverage, the health insurance exchange, its function, and how it can be accessed.

Source: Iowa Insurance Division, www.iid.state.ia.us