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*Re: Law Commission's Digital Assets Consultation Paper dated (July 28, 2022)*

## **Response to the Law Commission Digital Assets Consultation Paper**

The Crypto Council for Innovation ("CCI") submits this letter in response to the Law Commission's Digital Assets Consultation Paper dated 28 July 2022 ("**Consultation Paper**"). CCI welcomes the opportunity to share its expertise and views on this important issue of how English law on personal property does and should apply to cryptoassets.

CCI appreciates the opportunity to share its information, expertise, and views on these vital issues with the United Kingdom Law Commission. cryptoassets represent one of the most significant innovations in finance—and beyond—in many years, with the potential to alter ownership structures, commercial applications, cross-border payments, transaction processing and settlement, access to capital, investment opportunities, and much more. These developments contribute to equitable growth and financial inclusion, as well as investor and consumer choice and security.

### **About CCI**

CCI is an alliance of crypto industry leaders with a mission to communicate the benefits of crypto and demonstrate its transformational promise. CCI members include some of the leading global companies and investors operating in the crypto industry, including Andreessen Horowitz, Block (formerly Square), Coinbase, Electric Capital, Fidelity Digital Assets, Gemini, Paradigm, and Ribbit Capital. CCI members span the crypto ecosystem and share the goal of encouraging the responsible global regulation of crypto to unlock economic potential, improve lives, foster financial inclusion, protect national security, and disrupt illicit activity. CCI and its members stand ready and willing to work with the Law Commission members to accomplish these goals.

## **Introductory remarks**

Crypto assets and the underlying distributed ledger technology ("**DLT**") represent some of the most significant innovations in many years, with the potential to alter ownership structures, commercial applications, cross-border payments, transaction processing and settlement, and access to capital and investment opportunities. Additionally, Web 3.0 is the next evolutionary stage in internet development that offers redistributive and novel models for contributors and, consequently, novel and exciting applications for users. Web 3.0's new internet ecosystem is powered by blockchain and digital assets, and the development of a flourishing Web 3.0 relies upon not only a foundation of optimistic innovators but also on laws, regulations, and policies that guide policymakers, investors, businesses to facilitate long term value. Accordingly, we support the Law Commission's efforts to ensure that English law is capable of accommodating cryptoassets in a way that grants cryptoassets consistent legal recognition and protection and which allows the possibilities of this type of technology to flourish.

We recognise the significant amount of thought that has gone into the Consultation Paper and the Law Commission's proposed approach to the creation of a new category of personal property. However, we do have concerns with the proposed approach of defining cryptoassets (or "crypto-tokens" to use the terminology of the Consultation Paper) as a type of "data object" as discussed in our response to the Consultation Paper below. In our response, we identify key questions to which English law ought to provide clear answers in order to achieve the Law Commission's stated aim of creating legal certainty and so enabling cryptoassets to flourish. Focusing on practical considerations relevant to cryptoassets, we propose how English law might answer these questions, including through targeted statutory amendments.

## **Response to select issues**

Instead of expressing views regarding every question raised, we have structured our response around the following key issues, which are of practical importance for providing legal certainty and enabling markets in cryptoassets to flourish.

### **1. Approach**

First, we recognise that there is a broad spectrum of cryptoassets that have emerged to date, and we expect this trend to continue as the technology matures. Accordingly, there is currently no universally accepted way of categorising cryptoassets, but we find it useful for the purpose of this letter to divide cryptoassets broadly into four main classes.

The first is cryptoassets which have an existence solely on the ledger in which they are recorded and are not backed with outside collateral. These are referred to as cryptocurrencies; Bitcoin is probably the best-known example. The second is cryptoassets which are intended to embody a stable money value and are backed by some money claim. This may be either a claim on an underlying pool of monetary assets, or a promise by an issuer (such as a bank) to pay that value. The third is cryptoassets which confer economic rights in an asset. These may be either claims to a share of the value of a single underlying asset or claims to a specific asset (such as NFTs). Fourth, cryptoassets may confer rights to participate in the operation of an activity (such as a DAO).

In many of these cases, DLT has been deliberately chosen in order to facilitate transfers and settlement of transactions in the relevant cryptoassets in a robust manner on the distributed ledger. The use of DLT as the basis for such assets necessarily implies an intention that the asset is capable of being robustly and frequently transferred<sup>1</sup>.

This is important because legal policy with regard to property transactions has for many years been bifurcated according to whether transactions are "commercial" or not. The basic distinction is that for commercial transactions, protection of the market takes precedence over protection of individual rights. In particular, the ordinary principle that the buyer should be required to investigate the title of the seller before transacting, and that if he does not do so he does so at his own risk, is generally displaced in favour of an approach that transactions should be upheld unless they can be shown to have been executed dishonestly. In this regard, there is a direct line of legal development connecting the bills of exchange cases decided by Lord Mansfield in the 18<sup>th</sup> century, the Factors Act 1887 and the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (the "SFRs").

We believe that cryptoassets should be approached as falling within this "commercial" framework from an English law perspective. In particular, we believe that protections such as those provided to transactions in financial assets under the SFRs should by default be provided to transactions in cryptoassets. In considering the applicability of rules such as those protecting netting to contracts in cryptoassets, we believe that the default approach should be that such rules should apply, and that it is for those who argue otherwise to make their case.

## **2. Practical importance of clarifying the status of cryptoassets as personal property under English law**

We agree that it is important to understand not only whether cryptoassets are personal property under English law but also what type of personal property they are and in particular how they can therefore be transferred.

This is critical for commercial usability. Put at its simplest, if the wrong mechanism is used to transfer an asset (for example, an attempt to assign an instrument which can only be validly transferred by physical delivery), the transfer will (usually) simply fail and be legally invalid. Thus, uncertainty as to characterisation leads directly to uncertainty as to legal validity of transfer. This type of uncertainty would render this class of assets unusable for Web 3.0 participants and uninvestable for many investors.

We also note that the issue of legal certainty is necessary for the development of broad markets in these assets. We are aware that some of the submissions that you have received (particularly from the legal profession) have argued that the significant legal uncertainties which surround these assets at the moment are best left to be unraveled through litigation in due course. We would therefore like to emphasise that those market participants who are required, either by regulation or by their status, to take a prudent approach to investment, will generally be unwilling to acquire assets unless they can obtain a relatively high degree of legal comfort that they are acquiring good, unchallengeable and transferrable title to those assets. Crypto assets are also considered a critical building block for Web 3.0, and

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<sup>1</sup> Whilst consensus mechanisms mean that transfers on DLT can be slow in practice, it remains the case that the intent behind the creation of cryptoassets on DLT systems is typically to facilitate their transfer in a robust and commercially reliable manner.

there is a risk that their utility could be seriously undermined if there remains a lack of certainty that cryptoassets attract property rights or how title to cryptoassets can be properly transferred by settlement of a transaction on the blockchain. We are, therefore, of the view that the work which the Law Commission is doing is invaluable in this regard and should lead to facilitating primary legislation.

### **3. Unintended consequences of defining "data objects" as a third category of property**

With respect to the Law Commission's proposed definition of "data object" as a new category of personal property, we consider that it is generally unhelpful to think of data as a "thing" attracting personal property rights. Existing data protection legislation protects personal data differently from property law, and it is unclear how the two would interact. We foresee that this could also create difficult interactions with potential future expansion of data-related law and regulation, for example, in the context of open banking (or open finance) and plans for a digital ID. Leaving aside the specific statutory contexts of intellectual property and protection of personal data, it seems clear that someone can communicate data to a third party, but the idea that they can sell data as property to a third party (i.e. thereby transferring proprietary rights to that data) is an odd one from an English law perspective.

This approach of defining a third category of property by reference to data also seems to lead to a disproportionate focus on the technical make-up of the cryptoasset, giving rise to some counterintuitive conclusions, for example, in connection with how cryptoassets are transferred. In particular, the idea that cryptoassets recorded in token-based blockchain systems such as Bitcoin are destroyed and created upon transfer from one person to another is at odds with how these transactions are understood by market participants. This is demonstrably not the case with respect to specific types of cryptoassets, such as many NFTs. It would also have undesirable implications and create uncertainty with respect to the taking of security and tracing property. We therefore favour a legal treatment where the cryptoasset persists throughout a transfer process, as opposed to a technology-driven view in which a token-based cryptoasset is conceptualised as being destroyed and re-created upon transfer.

The primary reason for this is that this is, in fact, how market participants think of transactions in cryptoassets today. It is clear that this is not a decisive consideration, but we say that the law should, as far as possible, seek to support rather than supplant the beliefs and intentions of the parties as to the nature of the transaction which they have engaged in. This would also avoid the undesirable consequence that the legal analysis of transfer of cryptoassets is dependent on the technical details of how the relevant software on the relevant DLT system operates to "transfer" cryptoassets (where there are currently different processes employed on different DLT systems, for different types of cryptoassets).

### **4. Proposed analysis of cryptoassets as property comprising a right to have the ledger updated**

We therefore put forward an alternative analysis of cryptoassets as property. In our view, where a person owns a cryptoasset, the thing which constitutes property is the *right to have the ledger updated* (and not the data which forms the ledger) in accordance with the relevant protocols of the distributed ledger, where the exercise of this right may have the effect of

conveying the "right to update" to another person, who in turn acquires such right.<sup>2</sup> Under this understanding of cryptoassets as property consisting of a right to have the ledger updated, actual transfer of the cryptoasset would require two things: (i) a contract for sale of the cryptoasset; and (ii) a conveyance (i.e. updating of the ledger) giving effect to the obligation created by the contract.

We consider that this characterisation of cryptoassets as property is consistent with an intuitive understanding of ownership of cryptoassets whereby (to take a simple example) if the owner of a cryptoasset broadcasts a sale of the cryptoasset on a DLT network that is validated according to the relevant consensus mechanism, this should result in updating of the ledger in line with the DLT network's protocols. Or in other words, the owner of a cryptoasset has the right to have the ledger updated to reflect the sale or other transfer of such cryptoasset, as requested by them in accordance with the DLT network's protocols. However, if someone broadcasts a transaction purporting to be for the sale of a cryptoasset that is not associated with their private keys on the DLT network, this should fail as they do not have the right to have the ledger so updated in this scenario.

This characterisation of cryptoassets as property draws on the existing English law principles of conveyancing for transfer of property. In particular, it should be possible to have a right which the law treats as a piece of property, and which is transferrable by conveyance in the ordinary way. Indeed, whilst cryptoassets do not fit neatly into existing categories of property under English law of (i) choses in action, which are transferred by assignment, (ii) rights in physical things, which are transferred by delivery, and (iii) rights in other sorts of statutory property (shares in companies, intellectual property etc.) which are transferred by statutory mechanisms, this existing categorisation is not exhaustive.

English law comprises a number of transferrable pure rights. Historically such rights were characterised as having the legal nature of the asset to which they are related – thus, a right over real estate (such as a right of presentment) was characterised as a real estate asset, and was transferable by conveyance. This approach cannot be applied here, since the property is the right to amend the ledger, and the legal nature of the ledger is not clear. However, the principle – that a right to procure a particular outcome is a property asset capable of transfer – does not seem to be in doubt.

In our view, the best approach would be to amend the Law of Property Act 1925 to expressly provide that a right to have a digital ledger amended should be regarded as a property right, and that the making of any such amendment should have the effect of transferring ownership of that right to the person who, as a result of the transfer, acquires the right to instruct the amendment. We agree that it should be explicitly specified that such

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<sup>2</sup> Ownership of a cryptoasset may also give the holder other linked rights, for example, the right to participate in the operation of an activity such as a DAO or contractual rights to commercially exploit intellectual property associated with an NFT. Exercise of such linked rights would not typically result in those rights being conveyed to another person. This is analogous to a shareholder having voting rights that it may exercise without impacting its ownership of the share. It may also be possible to agree to transfer those linked rights to another person (e.g. under a smart contract), which again could be seen as analogous to a shareholder appointing a proxy to exercise voting rights associated with their shares.

However, for the purpose of achieving clarity on the status of cryptoassets as property, we are seeking to isolate the essential characteristic or attribute of *every* cryptoasset that constitutes "property" without impacting the flexibility of market participants to develop cryptoassets which may also give the holder a wide range of other linked rights.

a right is neither real estate, goods, services nor a chose in action, but a new category of property.

We consider this approach of making a targeted statutory amendment would provide legal certainty for market participants both as to the legal status of digital assets as property under English law and also with respect to how they can be validly transferred under English law – i.e. by conveyance effected by updating of the ledger in accordance with the protocols of the relevant DLT system.

Our proposed approach to defining cryptoassets as property does give rise to some questions, including whether a distinction should be drawn with uses of DLT for pure accounting or record keeping purposes (i.e. where there is no intention of the parties using the DLT to create cryptoassets attracting property rights). In our view, the key distinction that can be drawn between cryptoassets and other uses of DLT is that in a 'pure' accounting context, the right to have the ledger updated is not transferable (or transferred in practice). This is to some extent similar to the Law Commission's proposed requirement that cryptoassets must be "rivalrous" to qualify as property. We discuss this further in section 6 below, in the context of custody arrangements for cryptoassets (where custodians may record beneficial entitlement to cryptoassets on their own systems, which may run on DLT or another technology).

Of course, it is possible for a person to transfer a cryptoasset to another without intending to transfer full beneficial ownership, for example, to hold as a trustee or mortgagee. However, all of those situations can be, and are addressed by, existing law.

## **5. Comparison with US approach to defining cryptoassets as property under Article 12 UCC**

We think it is helpful to consider how the American Law Institute has addressed these issues in the United States of America. In particular, they have approached the question of clarifying the status of cryptoassets as property through proposed amendments to the Uniform Commercial Code ("UCC") rather than relying purely on incremental developments via case law. In addition, they do not seek to define cryptoassets as property based on a data-driven or technology-driven analysis. Rather, the proposed new Article 12 UCC defines "controllable electronic records" as a new type of property, namely a record stored in an electronic medium that can be subjected to control. The concept of control set out in Article 12 UCC requires that the person with "control" has (i) the power to enjoy substantially all the benefit; (ii) the exclusive power to prevent others from enjoying substantially all the benefit; and (iii) the exclusive power to transfer or cause another person to obtain control, of the controllable electronic record.<sup>3</sup>

The approach to defining cryptoassets as controllable electronic records under the UCC framework does differ in some details from our proposed analysis of cryptoassets under English law. In particular, the references in points (i) and (ii) above to the "benefit" of a controllable electronic record could be taken to imply that the cryptoasset affords some rights or benefits to holders over and above the ability to sell the cryptoasset in return for

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<sup>3</sup> This is also similar to the proposed definition of a "digital asset" set out in the UNIDROIT consultation on draft principles on digital assets and private law published in January 2023 and available at <https://www.unidroit.org/work-in-progress/digital-assets-and-private-law/digital-assets-and-private-law-public-consultation/>.

consideration. We do not think it is necessary for this to be an inherent part of an English law definition of a cryptoasset and if element of the definition is stripped away, in our view, point (iii) then substantively amounts to a right to have the ledger updated, as described in section 3 above.

We note that this approach to defining cryptoassets as controllable electronic records under Article 12 UCC does rely and build upon other elements of the UCC framework, which differ from the English law position, particularly in relation to the way in which rules on transfers of ownership and security interests are codified under the UCC. Article 12 UCC expressly addresses how transfers of property rights in cryptoassets (or controllable electronic records) can be achieved and provides that a "qualifying purchaser" of a controllable electronic record benefits from a "take-free" protection (similar to existing Article 8 UCC) whereby the qualifying purchaser acquires an ownership interest in the controllable electronic record free from competing property claims. Broadly speaking, this gives controllable electronic records the characteristic of negotiability, which is, in our view, appropriate (as discussed further in section 5 below).

These UCC amendments also provide a statutory mechanism for how security interests attach to controllable electronic records, how they can be perfected and rules of priority. However, these are based on existing UCC rules on security interests, which differ from the position under English law. We do not think it appropriate to follow the UCC approach in this respect but rather approach the questions of how to take security over cryptoassets under English law based on the existing concepts and principles of English law (including the ability to separate legal and beneficial title and grant charges over property), as discussed further in section 7 below.

However, as a general matter, we do think it important that English law provides clear answers to the questions addressed by these UCC amendments, including whether cryptoassets are property, how they can be transferred (including whether they have a characteristic of "negotiability") and how security can be taken over them. In our view, these are important building blocks for good commercial law, which is capable of supporting the development of broad markets in cryptoassets. We have discussed the first of these questions in section 3 above and turn to consider the others below.

In addition, we do think that our proposed approach to defining cryptoassets as property is broadly compatible with the US approach under Article 12 UCC (and the proposed UNIDROIT definition of a digital asset), such that the differences in approaches ought not give rise to vastly different characterisation of cryptoassets, and in particular how they are transferred, which will be of practical importance in cross-border contexts.

## **6. Providing certainty for transfers of cryptoassets**

As noted above, it is important to understand how to validly transfer a cryptoasset under English law. We propose a targeted amendment to the Law of Property Act 1925 to clarify that this can be done by conveyance of the right to have the ledger updated, effected by updating of the ledger.

This leaves a set of issues relating to settlement finality and whether the principle of *nemo dat quod non habet* should apply to wrongful transfers of cryptoassets. In our view, it should not.

The key here is that physical money has the highest form of settlement finality protection possible because that is inherent in its ability to perform its task as a payment medium. For anything else to perform that function reliably, it must have equivalent protection. This was the rationale for the introduction of the concept of "negotiability" for bills of exchange when they started being passed from hand to hand as a means of payment. The law recognised that they should be treated in this regard in the same way as cash, giving rise to the doctrine of negotiability. For digital coins to perform the function of money, they need to be treated as such. For other types of cryptoassets, putting these on a similar footing as bearer bills, bonds and promissory notes also seems appropriate, particularly since the validity of the register is integral to the DLT model (and is broadly consistent with the approach taken under the UCC as described above, which is helpful in an international or cross-border context).

Of course, it should also be noted that this does not mean that there are no circumstances under which transfers of cryptoassets may be challenged or economically reversed. In particular, there would still be an English law right for transactions to be "reversed", for example, in cases of fraud or duress (which, in the context of cryptoasset transactions recorded on an immutable distributed ledger, we consider should be understood and interpreted as a right for the injured party to be made whole<sup>4</sup>).

Turning to consider how best to achieve this outcome in practice, we propose using Chalmers' approach to negotiability under the Bills of Exchange Act 1882 as a starting point. The issue here is that Chalmers' drafting did not create a new legal principle, but merely codified the existing law. The essence of the English Law position on bills of exchange had been for many centuries that the protection of good faith transactions "trumped" the "buyer beware" principle, and the principle of negotiability simply gave legal form to this policy.

The basis of this statutory codification of the principle of negotiability is that where a person receives an instrument before it is overdue, without notice of any default in respect of it, and has otherwise obtained it in good faith, for value, and without notice of any pre-existing claims to it (broadly the definition set out in s. 29 of the Bills of Exchange Act 1882), that person should be and have all the rights of an owner in respect of that instrument. In this context, that means that they will take title to the cryptoasset clear of any defect in the title of his transferor. Therefore, the holder in due course of a cryptoasset (i.e. the person with the right to have the register updated) is to be assumed to be the owner, and third parties acting bona fide may treat with him as owner.

We do not advocate the wholesale importation of the law of negotiable instruments as it currently stands into the law of cryptoassets – it is no longer the case that commercial men (or even lawyers) are readily familiar with this body of law, and it would be a significant onerous task for them to become so. However, the concepts which lie behind the law of negotiable instruments match closely the structural elements which a law of cryptoassets should achieve, and this body of law provides some useful conceptual scaffolding which could be relatively easily adapted to the position in respect of cryptoassets.

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<sup>4</sup> We would propose that this is expressly clarified, so as to guard against risks of judicial or other remedies having the effect of introducing forks in ledgers to "reverse" a transaction, which we consider would cast doubt on the immutable nature of the digital ledger technology and undermine confidence in DLT structures.



## 7. Use of intermediaries to hold cryptoassets and separation of legal and beneficial title

In practice, large investors and active participants in Web 3.0 may want to use service providers to hold – and administer – cryptoassets for them, for many of the same reasons as they may choose to hold traditional securities via custodians. This gives rise to a set of questions about the basis on which a custodian or other intermediary may hold cryptoassets for a beneficiary and indeed whether it is possible to hold cryptoassets on trust or otherwise separate legal and beneficial title. Again, from a practical and commercial perspective, it is important that there is legal certainty about the basis on which custodians hold cryptoassets for their clients.

Custody arrangements for securities today are largely characterised at English law as being based on a trust analysis. Many of the difficulties which have arisen for custodians regarding the legal analysis of cryptoassets would be resolved by a clear statutory provision to the effect that such assets are in fact a separate class of property. This would make clear that the conventional market analysis can be applied to this new class of assets.

We note, however, that there are significant overlaps between the legal and the regulatory spheres in this area. In particular, the provision of custody services in respect of financial assets is itself a regulated activity. Regulators will have to decide where to place the regulatory perimeter in this regard – in particular, whether the provision of wallet services is a form of regulated custody or not.

Possibly more importantly, it should be up to regulators to determine what arrangements should be made in respect of cryptoassets held in custody.<sup>5</sup> It may be appropriate for regulatory requirements to be introduced requiring custodians and other entities holding cryptoassets for customers to do so in a bankruptcy-remote manner, which can be achieved in practice under English law in the same way as for other types of custody assets. We understand that protection of customer assets (including cryptoassets) is an important issue for policy makers and regulators particularly in light of the recent collapse of FTX. However, these regulatory policy questions go beyond the scope of the English property law issues under consideration in the Law Commission's consultation, so we do not address them further here.<sup>6</sup>

For the purpose of the Law Commission consultation, the question is therefore as to whether, if regulators were to decide that such assets should be held on a segregated basis, this would require any change in the law relating to property. In our view, it would not. Although current client money and client asset provisions have some statutory backing in the Financial Services and Markets Act 2000, it is not in doubt that the effect of these provisions can be entirely replicated in a properly drafted client money trust deed. We are therefore of the view that the imposition of statutory requirements on providers of

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<sup>5</sup> We note that HM Treasury published a consultation on a future regulatory framework for cryptoassets, including regulation of custody services, on 1 February 2023. This indicates that once cryptoasset custody is brought within the regulatory perimeter, the FCA would be responsible for developing detailed rules of the cryptoasset custody regulatory framework.

<sup>6</sup> Similarly, we note that other initiatives seeking to clarify the status of cryptoassets as property as a matter of private law, such as under Article 12 UCC in the US, or under the UNIDROIT consultation, do not seek to address questions such as whether cryptoasset custodians should be obliged to hold cryptoassets in a particular bankruptcy-remote manner, recognising that this is a question that should be left to financial services policy makers and regulators.

administration and safeguarding services in respect of cryptoassets is neither necessary nor desirable.

The importance of such arrangements is, of course, to ensure that the assets concerned are safeguarded in the insolvency of the service provider, and are returned as rapidly as possible to the true owners of those assets in such an insolvency. As noted above, we regard the first of these as being capable of being achieved through the law in its current state. As regards the second, however, the issue is primarily an issue of insolvency law. In this regard, it may be necessary to make some amendment to UK insolvency law to ensure that such claims are not only legally valid but also speedily resolved. In this regard, we agree that the mechanism developed in the post-Lehman review through the Investment Bank Special Administration Regulations 2011 should be applied to wallet providers<sup>7</sup>. We understand that the effect of these regulations is that any shortfall in the pool of available assets is shared *pari passu* amongst all holders. However, we believe that the nature of this market is such that a rapid distribution of the majority of assets is preferable to an extended period of paralysis in which all such claims remain in suspense.

From a technical perspective, such a custody service offering will typically involve the intermediary custodising or storing private keys associated with the public address(es) where the client's cryptoassets are recorded, giving it the power or right to update the ledger, in accordance with the client's instructions. However, from a legal perspective this is very similar to the way in which traditional securities custodians typically hold securities for their clients. In particular, for securities recorded in book entry form in a central securities depository, the legal title holder is the entity recorded on the register, typically holding the securities on trust for a client. In intermediated securities structures, there are typically several custodians each holding their interest in the security on trust for a client, up to the ultimate beneficial owner<sup>8</sup>.

We do not consider that the creation of an intermediated holding structure is of concern in the context of cryptoassets. This is a structure with which market participants are familiar today. In our view, it is helpful that intermediaries can hold cryptoassets for investors in a legally similar manner to the way they custody traditional securities, particularly if custodians seek to offer services with respect to both traditional securities and cryptoassets.

Where custodians use DLT (or indeed a different record keeping system) to record clients' entitlements to assets this gives rise to the question of whether the custodian's right to update their own ledger or record itself amounts to a cryptoasset on our proposed definition. We consider that it should not do so on the basis that in this example, the custodian retains the right to update its own ledger or records throughout. Therefore, there is no transfer or conveyance of the right to update the ledger or register. In this case, it is not the structure of the DLT system which determines that there is the transfer of assets, but the separate terms agreed by the custodian with its clients. The cryptoassets that exist independently of the custodian's right to update its ledger or record are however transferred by the exercise of that right (and exercise of an underlying right the custodian has to have an underlying

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<sup>7</sup> In this regard, we note that this would not have the effect of imposing day-to-day reporting or other regulatory obligations on wallet providers.

<sup>8</sup> For example, see the Law Commission's scoping paper on Intermediated Securities, available at <https://www.lawcom.gov.uk/project/intermediated-securities/>.

ledger updated on which cryptoassets or a right to cryptoassets are recorded); whereas the right itself remains static and held by the custodian.

## **8. Taking security over cryptoassets**

Traditional English law title-based security mechanisms based on title divide into three:-

- (i) Title Transfer - where the grantor has nothing more than a contractual right to the return of equivalent assets;
- (ii) Mortgage - where the grantor transfers ownership of an asset but retains a property interest in that asset; and
- (iii) Charge - where the grantor retains ownership of the asset, but the beneficiary can compel him to sell the charged asset and apply the proceeds in discharge of the secured obligation.

Title transfer is legally possible whenever an asset can be validly transferred. However, title transfer provides almost no protection to the collateral giver. We note that regulated firms are therefore restricted in their ability to provide service on this basis to certain types of client (notably private clients). However, this is a regulatory and not a legal policy point.

We believe that it should be possible to create the same sorts of security over cryptoassets as over any other kind of property.

The primary obstacle to the grant of security over any type of asset is the necessity to be able to identify the legal claims to the asset concerned. Thus, in general, security over personal property assets is generally granted using possessory rather than title-based security. Possessory security (pledge and lien) are based on the idea of assets being physically segregated, and their possession being transferred to the security taker. Such segregation and transfer can be effected either by a physical transfer of assets, or by a custodian (such as a warehouse operator) confirming that they hold for the transferee rather than the transferor ("attornment").

In the context of securities, security interests are usually based on the segregation of assets held by custodians, with the segregation being effected within the books of the custodian. Such segregation constitutes a separate, identifiable pool of assets, and that pool, once created, can be either charged or transferred. Thus, all three forms of title-based security can be created. It should be noted that in the context of securities market transactions it is common to refer to securities being "pledged" This is a historic legacy from the days when debt securities took the form of negotiable paper, and security over them was created by a physical pledge.

We are therefore of the view that the optimal legal structure for the creation of security interests under English law would have the effect that the segregation of cryptoassets within the books of a custodian or wallet provider would create an asset capable of being mortgaged or charged.

A further issue in this regard is that UK law invalidates charges and mortgages created by UK firms unless they are registered under the UK Companies Act 2006. For financial transactions this requirement is disapplied by the Financial Collateral Arrangements (No.2) Regulations 2003 (2003/3226). Regulation 4 of these regulations also disapplies s.53(1)(c)

and s.136 of the Law of Property Act 1925 as well as s.4 of the Statute of Frauds Act 1677. We believe that this treatment should be extended to transactions in cryptoassets where the purpose of the security arrangement is to secure the financial obligations of the grantor of the security. For the reasons given above, we believe that these regulations should be applied to cryptoassets generally. This could be accomplished with some minor amendments to the Regulations.

We are aware that this proposal raises the issue as to whether such registration is necessary for some other policy reason. In general, the arguments for registration are based on the idea of "false wealth". However, we perceive this as a confusion based on a misunderstanding of the intended effect of the false wealth doctrine. In *Re Vandervell*<sup>9</sup> Lord Upjohn said that the "false wealth" principle should be applied in pursuance of the objectives of the Statute of Frauds, and that the aim of that statute was to "prevent hidden transactions in fraud of those truly entitled". A transaction which is recorded on a publicly accessible register is not a "hidden" transaction. It is as easy or as hard to discover as a lien created by a physical transfer of a document of title – indeed, since it leaves a permanent record, where a physical transfer does not, it is less objectionable on this basis.

## 9. Enforcing title to a cryptoasset

The question of how to enforce title to a cryptoasset is an important practical and legal question for parties holding and dealing in cryptoassets. There are two aspects to this. One is as to how a proprietary remedy in respect of a cryptoasset might be granted. The other is as to how damages for interference with control of a cryptoasset might be quantified and awarded.

As we set out above, in our view the legal essence of a cryptoasset is the power to have the ledger updated (as described further in section 4 above). The enforcement of property rights over a power can be effected by the appointment of a receiver over the power – see *Tassaruf v Merrill Lynch* [2011] UKPC 17. There may well be a case for legislative confirmation of the court's right to make an *in personam* order over the holder of a right instructing him to exercise that right in a particular way, but it may be that the Tassaruf power is sufficient. However, this is only of relevance before the power to amend has been exercised. The important question is as to what the position should be after the power is exercised.

This, however, leads to the question of the available remedy where a proprietary remedy is not available. In general, there are two potentially applicable approaches to this issue. One is that the person whose rights over the cryptoasset have been interfered with should be compensated on the basis of the loss which he has actually suffered (the "compensatory measure"). The other is that, where a person has been deprived of a thing, they should be entitled to the value of that thing at the time of the interference (the "conversion measure"). The primary difference between the two is that in the former case issues such as culpability and contributory negligence will be considered, and the amount the claimant is awarded may differ significantly from the value of the asset of which he has been deprived. In the latter case, he is entitled to his asset or its value without discount or assessment.

The conversion measure is the remedy usually applied in the context of interference with proprietary rights. Thus, for example, if I own a promissory note to the value of £100, and it is misappropriated, my claim is for £100. In our view, the conversion measure should be

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<sup>9</sup> [1967] 2 A.C. 291

applied in respect of cryptoassets. We perceive these assets as being most closely akin to negotiable instruments such as bonds and promissory notes, and we believe that this is the approach which corresponds most closely with the way in which market participants currently think about assets of this kind.

There is also a practical aspect to this approach. The application of the conversion measure provides a simple analysis of any situation where an asset is misappropriated – the person entitled to the asset is entitled either to the return of the asset or to the payment of its value. By contrast, where the compensatory measure is applied, the person entitled to the asset must show that he has suffered loss by reason of the deprivation, must show that he was not contributorily negligent in respect of the deprivation, and is subject to valuation risk as regards changes in the value of the asset.

This approach would require amendment of the Torts (Interference with Goods) Act 1977 – inter alia to specify that cryptoassets should be treated as "goods" for this purpose<sup>10</sup>.

Finally, it should be noted that interference with ownership rights in respect of cryptoassets may take one of two forms. Typically, such interference would be effected by amending a register to transfer assets away from the owner to a third party. This sort of activity fits neatly into the "conversion" analysis described above.

There is an alternative form of interference whose effect is to obstruct the owner's access to an asset. This typically arises in "ransomware" and "hi-jacking" attacks, where cryptoassets have not been stolen or otherwise transferred but the owner is unable to access and use them. A fundamental distinction should be made here between these two types of interference (i.e. someone who obstructs access and uses property on the one hand, and someone who merely obstructs access but does not use the property on the other). In legal analytical terms this latter type of interference is a form of detinue – what is obstructed is not the property, but the owner's right to it. In our view, in the field of cryptoassets (at least) this should be treated as a form of conversion and the usual principles of English law ought to determine who is liable for such interference.

## 10. Set-Off

It is a general principle of English law that whereas money claims may be set off at common law, proprietary claims may not. Where parties are in a pre-existing contractual relationship set-off between them is usually addressed by contractual provisions which permit such set-off. However, we believe that as regards the sub-set of cryptoassets that are created to perform the function of monetary instruments (such as stablecoins), it should be made clear that such claims may be set off against each other in the same way that money claims may be set off.

Implementation of this measure would require at least an amendment of CPR 16.6 to expand the meaning of the term "money" as used therein. However, it would be better to apply the simple provision of reg. 12 of the Financial Collateral (No 2) Regulations 2003 to provide that contractual netting provisions are generally effective.

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<sup>10</sup> And this purpose only – we agree that the extension of the Sale of Goods Act 1979 to digital assets would be undesirable.

## **Conclusion**

In conclusion, we consider that the status of cryptoassets as property under English law (comprising a right to have the ledger updated, as outlined in this letter) should be clarified via facilitating primary legislation. In our view, providing legal certainty in this way will be critical for commercial usability of cryptoassets and is a necessary prior condition for the development of broad markets in cryptoassets. CCI appreciates the opportunity to provide these comments and appreciates your consideration of our feedback. We would be pleased to further engage on the comments contained in this letter issues relating to the legal characterisation of cryptoassets generally.

Sincerely,

/s/ Linda Jeng

Linda Jeng  
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