Law Commission Consultation on Digital Assets

International Securities Lending Association (ISLA)

islaemea.org

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Dear Sir / Madam

Please see below our response to the Law Commission's Digital Assets Consultation Paper dated 28 July 2022 (the "**Consultation Paper**").

1. **BACKGROUND**

1.1 The International Securities Lending Association ("**ISLA**") represents the common interests of securities lending and financing market participants across Europe, Middle East, and Africa, with a geographically diverse membership of over 190 firms, which includes institutional investors, asset managers, custodial banks, prime brokers, and service providers. For further information please visit the following site https://www.islaemea.org/about-isla/.

1.2 ISLA has published various standard form documents for use in the securities lending market. Under those documents, legal and beneficial title to the loaned securities is transferred from the lender to the borrower against the provision by the borrower of collateral. ISLA has published two principal types of documentation: the first (most recently represented by the 2010 Global Master Securities Lending Agreement, the "**Title Transfer GMSLA**") represents a title transfer arrangement, whereby legal and beneficial title to the collateral is transferred standard from the borrower to the lender; the second, represented by the 2018 Global Master Securities Lending Agreement

(Security Interest Over Collateral) (the "**Pledge GMSLA**"), represents an arrangement whereby the borrower creates a security interest over the collateral in favour of the lender.

1.3 We welcome the opportunity to provide a response to the Consultation Paper, which we consider represents a significant step in identifying and resolving some of the legal uncertainties facing the industry in relation to digital assets. We support the Law Commission's efforts in this regard.

2. RESPONSE

2.1 ISLA's members have requested that we provide a response to the Consultation Paper. Since ISLA's primary focus is on the securities lending and associated financing markets, our members' interests in the Consultation Paper are to those aspects which are relevant for those markets. We are conscious that there are various aspects of the Consultation Paper which are not directly relevant to those markets, and we therefore do not express any views on those aspects of the Consultation Paper.

2.2 Our response in this letter therefore focuses on:

(a) matters relating to the intermediated securities market, including the way in which securities may be tokenised or issued in digital asset form;

(b) matters relating to securities lending, including questions relating to financial collateral; and

(c) the extent to which current market practice in the securities lending industry may be relevant to broader questions relating to financing using cryptocurrencies or other digital assets (either as the finance currency or as the collateral).

2.3 We therefore do not respond individually to each question in the Consultation Paper, but set out our response by reference to the key issues which are of most relevance as described above.

2.4 Executive summary

(a) ISLA is supportive of the Law Commission's efforts to enhance the extent of legal certainty relating to proprietary interests in digital assets.

(b) ISLA recognises the significant benefits of the FCARs insofar as they relate to traditional financial collateral. We consider that those benefits should extend to digital assets (to the extent that they do not already do so). ISLA therefore supports the Law Commission's proposal to implement law reform to establish a legal framework that better facilitates the entering into, operation, rapid priority enforcement and/or resolution of crypto-token collateral arrangements. Whether to do so by extending the FCARs or by adopting a separate, similar collateral regime in relation to digital assets will require additional, detailed analysis.

(c) While we support the Law Commission's efforts to improve legal certainty, we consider that the proposals in the Consultation Paper could, without further consideration, inadvertently create further uncertainty. We also consider that, in implementing law reform in this area, it will be necessary to ensure that the proposals are workable from a practical perspective, and take into consideration the way in which market participants assess the robustness of, enter into and manage financial transactions. We identify in this response some areas of uncertainty which we consider arise from the proposals in the Consultation Paper, together with some practical considerations which we consider require further attention.

2.5 **Third category of personal property**

(a) This response primarily relates to Consultation Question 3 and, insofar as it relates to existing independently of the legal system, Consultation Question 6.

(b) ISLA supports the Law Commission's efforts to enhance the extent of legal certainty relating to proprietary interests in digital assets. In this regard, ISLA is supportive of any method by which this is achieved, whether it is a distinct third category or an extension or clarification of existing categories.

(c) We note that one of the main proposals in the Consultation Paper is that for a "thing" to fall within the third category of personal property, the thing in question must exist independently of the legal system. We understand that the primary purpose of this test is that property which already constitutes a *chose in possession* or a *chose in action* should not fall within the third category of

personal property, presumably on the basis that the existing laws of England and Wales already adequately address issues relating to those types of property.

(d) We consider that an approach which defines the third category of personal property by reference to the digital asset being independent of the legal system (and therefore, for example, not constituting a chose in action) is unlikely, in practice, to significantly improve the amount of legal certainty. While it will remove the residual risk that a digital asset is not considered to be property at all, market participants will be unable to determine whether a digital asset falls within the third category of data objects without undertaking an analysis as to whether the digital asset constitutes a *chose in possession* or a *chose in action*. Given the context of the Consultation Paper, the range of views in the market and the difficulties already faced by the courts as to whether digital assets constitute *choses in action*, the ongoing uncertainty will not be immaterial. In other words, the "permeability" of what constitutes a *chose in action*, as identified in paragraph 5.35 of the Consultation Paper, will continue to exist but, instead of being limited to the question of whether a digital asset constitutes property, it will apply in the context of identifying which category of property it falls within and therefore which personal property regime applies to it.

(e) In addition to the remaining legal uncertainty, it may, as a practical matter, be difficult or impossible for market participants or their legal counsel to satisfy themselves that a digital asset satisfies a requirement that the digital asset does not fall within one of the existing categories of personal property. Market participants may not have access to sufficient information to determine whether a digital asset represents a *chose in action*. Requiring market participants to establish that the digital asset does not constitute a *chose in action* may also introduce the practical impossibility, as noted by the Law Commission in paragraph 11.97 of the Consultation paper (in the context of "control") of having to prove a negative.

(f) These issues potentially apply to all types of digital asset, but may be particularly pronounced in the context of a crypto-token which is issued by a person who holds an underlying linked asset (such as a security) and declares that the token represents an interest in that linked asset. Absent legislative or regulatory reform requiring this information to be made available, market participants may

not have sufficient information to determine whether the token is simply being used for record-keeping, whether it represents a claim against the issuer, or whether it represents a claim in respect of the linked asset.

(g) The consequence of this potential uncertainty is also more pronounced to the extent that a separate personal property regime applies to the third category. For example, if a financial collateral regime applies to data objects, and that regime is different to the regime applicable to other types of financial collateral, market participants will need sufficient certainty as to which type of property is represented by a particular digital asset to be able to identify which financial collateral regime applies to it.

(h) We would therefore encourage that, to the extent that the proposal will continue to be that the third category of data objects is restricted to things which exist independently of the legal system, there should be a mechanism by which market participants are able to clearly distinguish between data objects and other types of personal property.

(i) Further consideration should also be given to the approach to 'composite' digital assets, i.e. those that encapsulate a digital asset AND an existing category of property e.g. a digital bond, whether this is achieved through common law constitution, contractual mechanisms or otherwise. We understand that the effect of the Law Commission's proposal is that the digital asset in this scenario would not constitute a data object, since it does not exist independently of the legal system (the digital asset being also a chose in action in this example). However, it is likely to be difficult, in practice, to distinguish between a 'composite' digital bond (which, on this basis, would not be subject to the data object regime) and a token which represents an interest in a linked underlying bond (which would be subject to the data object regime). To have different regimes applicable to each scenario would be unworkable in practice. It will also be unthinkable that the composite 'thing' need to meet formal legal requirements for both first or second category of property AND a third category of property.

2.6 **Distinction between the data object and an interest in the data object**

(a) We note that, in paragraph 10.68 of the Consultation Paper, the Law Commission draws a distinction between a crypto-token (and, we assume, any other type of digital asset) being held directly (in self-custody) by a user, and one which is held via a service provider such as an exchange or custodian. In that paragraph, the Law Commission states that the depositor's relationship with the service provider would properly be characterised as a thing in action and would therefore fall outside of the third category of personal property (we comment on this further below).

(b) The distinction drawn by the Law Commission is similar to the distinction that applies in the context of intermediated securities (although we note that there may be factual differences between how indirect holdings operate in the securities and digital assets markets). In the context of intermediated securities, the nature of a holder's interest in securities, as represented by its relationship with the relevant intermediary, has developed over several decades. This will not be the case for the nascent market in indirect holdings in digital assets.

(c) Whether the Law Commission's observation, that the nature of the depositor's relationship with a custodian (or other intermediary) of a digital asset is a chose in action, produces the correct outcome is, we believe, something that would benefit from similar analysis and consideration to the questions currently being considered regarding the nature of property rights in the digital asset itself. Any such analysis would, of course, be directly related to the question raised by the Law Commission as to whether there should be an implied trust relationship between customer and custodian.

(d) It will also be necessary to consider carefully whether there are any unintended consequences of applying the third category of personal property to the data object, while applying the existing category of chose in action to an indirect holding in that data object. Such distinctions already exist in relation to intermediated securities (for example, a bearer security constitutes a chose in possession, while the indirect holding in that security constitutes a chose in action). However, there may be unintended consequences as a result of applying a different legal regime to the different categories of property.

(e) For example, consider a tokenised security which is held through an intermediary, such as a custodian[1], where the token represents an ownership interest in the underlying linked security and pursuant to which a transfer of the token constitutes a transfer of the linked security. To the extent that the linked security constitutes financial collateral, a transfer of the token by way of collateral may by subject to the financial collateral regime applicable to data objects, while a transfer of the interest in that token represented by the relationship between the holder and the custodian may be subject to the existing financial collateral arrangement regime (noting the Law Commission's comment at footnote 1671 of the Consultation Paper that entitlements held under indirect and intermediated holdings can benefit from the FCARs).

(f) Similarly, consider a transfer by way of collateral by Person A of its interest in a crypto-token to Person B, where Person A's interest, prior to the transfer, is held through a custodian but Person B's interest, following the transfer, is held directly. It seems an unusual, and potentially unworkable, proposition that the nature of the property changes (in this example, from a *chose in action* to a data object) as a result of the transfer. This may give rise to a variety of unintended uncertainties, including as to whether it remains appropriate to describe the resulting property as fungible with the original property.

(g) We therefore consider that, if there is to be law reform (as proposed by the Consultation Paper) identifying and clarifying the nature of a direct holder's personal property rights in a digital asset, that law reform should also identify and clarify the nature of the indirect holder's personal property rights (either as a data object itself or, based on the Law Commission's comment in paragraph 10.68 of the Consultation Paper, as a thing in action), and how transfers in, or collateral arrangements represented by, those rights is affected by the data object regime. We are conscious that imposing an implied trust may be one method of achieving this, although we express no view as to whether this is the correct (or only) approach.

[1] For these purposes, we have assumed that the custodian/depositor relationship is not purely contractual.

2.7 **Linked data objects**

(a) This response primarily relates to Consultation Question 27.

(b) As the use of distributed ledger technology in the capital markets develops, it is expected that interests in securities may be tokenised, in particular as a means to facilitate settlement, and ISLA is aware of initiatives already underway to achieve this result. It is also likely that, in the future, the traditional and digital markets converge such that traditional securities intermediaries look to use crypto-tokens to work alongside, or to supplement, their existing holding patterns.

(c) We agree with the Law Commission's proposal that market participants should have the flexibility to develop their own legal mechanisms to establish a link between a crypto-token and something else.

(d) We also agree with the general concept that a crypto-token might constitute a separate item of property to the thing to which it is linked or with which it is associated. For example, a crypto-token may be a mere record on a register, documenting ownership of a linked asset. We also note that this may not always be the case, and crypto-tokens might operate as a representation of the token-holder's interest in the underlying linked asset.

(e) It will be important for market participants to have certainty as to the nature of the asset(s) which they hold.

(f) For example, if a person issues a crypto-token and declares that the token represents an interest in an underlying linked asset (such as a debt or equity security) which is held by the issuer of the token, market participants will need to know whether:

(i) the crypto-token is a data object attracting property rights, and the holder of the token has a proprietary interest in the token and the linked asset; or

(ii) the crypto-token is a data object attracting property rights, and the holder of the token has a proprietary interest in the token only; or

(iii) the crypto-token is not a data object attracting property rights, and the holder of the token has a proprietary interest in the linked asset only.

(g) By having separate personal property regimes apply to a crypto-token and to the asset to which it is linked, there is the potential for further uncertainty, particularly where the crypto-token purports to constitute an interest in the linked asset rather than simply operating as a record or register. In such an arrangement, by effecting a transfer of such a crypto-token, the parties are effecting a transfer of the proprietary interest in the asset to which it is linked.

(h) Holders of the crypto-token may therefore need to investigate not just how to effect a transfer of the crypto-token (together with associated questions regarding, for example, how to perfect a security interest), but may also need to investigate how to effect transfers of the underlying linked securities (or whether a transfer of the crypto-token is itself sufficient to give effect to that transfer). Such an outcome, of needing to investigate two or more interests in property, would give rise to several issues (including the potential for different legal regimes to apply to the same transfer), and may introduce a risk equivalent to "upper-tier attachment" in the intermediated securities market (a risk which, absent specific high risk factors such as an intermediary being located in a high-risk jurisdiction, is generally not prevalent). For the same reasons as given above in the context of 'composite' digital assets, such an approach would be unworkable in practice.

(i) We agree with the Law Commission's statement in paragraph 14.64 of the Consultation Paper that, in an issuance of new debt securities, it may be possible to ensure that all parties are aware of and agree to the terms of the linkage. However, we anticipate that, as well as being used in respect of new issuances, crypto-tokens may be used to tokenise existing issuances of securities, most likely by granting the holder of the token a beneficial interest in the underlying linked security.

(j) We also recognise that some of these issues may be addressed by issuers of crypto-tokens ensuring that the effect of the linkage between the token and the linked asset is robust, and by disclosing the effect (and potential consequences) of such linkage to token-holders and potential token-holders.

(k) However, if the Law Commission's proposal is to allow market participants the flexibility to develop their own legal mechanisms to establish a link between a crypto-token and an asset to which it is linked, we would recommend that clear guidance is given as to how market participants should be able to identify the proprietary effect (if any), on the underlying asset, of a transfer of the crypto-token. Alternatively, such a flexible legal regime could provide that, if the linkage between the crypto-token and the linked asset is to afford the holder of the crypto-token a proprietary interest in the linked asset, a transfer of the crypto-token would be recognised as an effective transfer of the proprietary interest in the underlying asset, without further action or perfection requirements. We are aware that such a regime would require careful consideration from a policy perspective as to which linkages to permit and which continue to require perfection or transfer requirements applicable to the underlying linked asset (to avoid, for example, the ability to circumvent requirements relating to the registration of property transfers by the use of tokens). Another alternative would be to adopt the "strictest of" approach, requiring satisfaction of the strictest of the regimes, although again this may be difficult for market participants to adopt in practice without clear guidance.

(l) We would also encourage exploring whether the strength of the link can be improved (to avoid, for example, the risk of "upper-tier attachment") by analogy with the intermediated securities market.

2.8 **Ability for market participants to be able to determine additional matters raised by the Consultation Paper**

(a) This response primarily relates to:

(i) Questions 4 and 6, in relation to the ability to determine rivalrousness; and

(ii) insofar as it relates to existing independently of the legal system, Consultation Questions 3 and 6.

(b) We have indicated elsewhere in this response, in the context of specific proposals in the Consultation Paper and specific use cases, where there may be difficulties in determining, at a practical level, whether those proposals apply to a particular digital asset. For example, we describe above some difficulties

associated with determining whether a data object exists independently of the legal system.

(c) In this section of our response, we identify further potential practical difficulties which are of generic application.

(d) For a market in data objects to be sustainable and have a prospect of significant growth, it will be necessary for market participants to be able to determine with sufficient certainty whether the various criteria are satisfied for the relevant asset to constitute a data object. In practice, many market participants will be relying on legal opinions in connection with these matters. For those market participants who are subject to prudential requirements relating to the maintenance of regulatory capital, they will likely be reliant upon reasoned legal memoranda of law covering issues such as whether they have legally enforceable netting or collateral arrangements. The analysis in these memoranda of law may depend upon whether the arrangement constitutes a financial collateral arrangement.

(e) Legal opinions are, by their nature, only able to express opinions relating to matters of law. They will typically make assumptions regarding, and not express any opinion on, matters of fact. As such, market participants relying on those legal opinions will need to satisfy themselves, by other methods, as to whether any factual requirements have been satisfied.

(f) A number of aspects of the Consultation Paper suggest that there will be factual elements which determine whether an asset falls within the third category of data objects, or whether and when a party acquires an interest in that data object. For example, in paragraph 2.67 you note that you consider rivalrousness to be necessary for a digital asset to attract property rights. In Chapter 10 of the Consultation Paper, you consider how rivalrousness might be satisfied in respect of crypto-tokens by reference to the nature of the operation of the technical systems in which the crypto-tokens operate.

(g) While we do not disagree with the criterion of rivalrousness, we would suggest that such a criterion should be applied without imposing a significant (and potentially impossible) burden on market participants to determine whether the criterion is satisfied. If phrased in absolute terms, it may require market participants to undertake an exhaustive technological study of the technical system in which the crypto-token operates to definitively determine that one person's use of the digital asset is at the exclusion of every other person's ability to use that digital asset. In some ecosystems, we expect that it may either be impossible, or prohibitively expensive, to make this determination. Again, this may suffer from the difficulty of inherently being a proof of a negative statement. Instead, we would suggest that a more nuanced test might be considered, for example whether it would be reasonable for a person to believe that the system is designed in a manner to preclude one person from using another person's asset.

2.9 **Collateral**

(a) This response relates primarily to Consultation Questions 35, 38 and 39.

(b) We agree that there is sufficient certainty that, provided that a data object is recognised as property, collateral arrangements, both in the form of title transfer and non-possessory security interests, can be effected under English law. We note that title transfer and non-possessory security interests are the types of collateral arrangement which are currently used in the securities lending and associated financing markets.

(c) We also agree that crypto-tokens, of themselves and to the extent that they are considered as a distinct asset class either from any asset to which they might be linked or from any asset which they may represent, are unlikely to constitute financial collateral for the purpose of the FCARs or the FCD.

(d) We are supportive of efforts to ensure legal certainty in relation to collateral arrangements involving data objects. We therefore support the Law Commission's suggestion of establishing a legal framework that facilitates the entering into, operation, rapid priority enforcement and / or resolution of crypto-token collateral arrangements.

(e) We believe that the primary impact of such a framework, from a domestic English law perspective[2], will be in the context of security collateral arrangements over crypto-tokens. This is because law reform would not be necessary, from a purely domestic legal perspective, to ensure robust and effective title transfer collateral arrangements.

(f) In the context of security interest collateral arrangements, the primary impact of the FCARs from a domestic English law perspective has been to disapply perfection requirements, to remove or limit the scope of English insolvency law which might delay or otherwise interfere with the ability of a secured creditor to enforce security, and to provide for the ability of the secured creditor to use the collateral.

(g) As noted above, securities lending arrangements typically involve an outright transfer of title, both in relation to the loaned assets and the collateral. However, the Pledge GMSLA involves collateral being provided by way of security. One of the main reasons that the Pledge GMSLA was developed was to enable parties to mitigate the risks that would otherwise arise in the context of a title transfer arrangement, in particular the credit risk taken by the collateral provider (that is, the borrower) on the collateral taker (the lender) in respect of excess collateral.

(h) The FCARs have therefore facilitated market participants being able to put in place robust collateral arrangements which balance, on the one hand, the ability of the collateral taker to enforce the security in timely fashion with, on the other hand, protections for the collateral provider against the credit risk of the collateral taker.

(i) We consider that these benefits of a financial collateral regime would apply equally to collateral in the form of crypto-tokens. In the absence of an equivalent regime applicable to crypto-tokens, it is likely that market participants seeking to collateralise their exposures would be encouraged to use title transfer collateral arrangements, which as noted above do not suffer from some of the limitations under domestic English law as those applicable to security interests. This unintended consequence may be unwelcome, as it limits the ability of the parties

[2] That is, aside from any conflicts of law questions, which we note are outside the scope of the Consultation Paper.

to effectively mitigate the credit risk of both the collateral provider and the collateral taker.

(j) In relation to the question as to how to achieve this outcome, we note the following:

(i) In relation to the Law Commission's conclusion in paragraph 18.69 of the Consultation Paper that it is possible to argue that tokenised securities fall within the existing financial collateral regime, while we agree that there may be circumstances in which this is the case, it will be highly fact dependent. As noted elsewhere in this response, uncertainty may arise if the crypto-token is a separate asset to, and falls within a different personal property regime from, the asset to which it is linked, which may raise questions as to whether the token (as distinct from the linked security) constitutes a right, privilege or benefit "attached to or arising from" the linked asset, particularly if that linkage occurs after issuance rather than being an integral part of the security itself.

(ii) While we recognise the difficulties that have existed in relation to the FCARs, we do not believe that these difficulties should be reason for having a separate regime applicable to data objects. Having a separate, more favourable, regime for data objects could potentially have a distortive effect over which types of asset are used as financial collateral, as it may encourage the use of data objects over traditional asset classes. We agree with the principle behind your suggestion in paragraph 18.94 of the Consultation Paper that it may be appropriate to minimise the risk of collateral regime arbitrage.

(iii) Collateral arrangements in the securities lending and financing markets typically provide for broad categories of eligible collateral, with the collateral provider being entitled to choose which collateral to provide from a pre-defined list of eligible collateral. The collateral that is provided can therefore, at any given time, comprise a combination of different assets. The list of eligible assets is determined bilaterally by reference to a number of factors, including any applicable regulatory regime. Which assets are provided from time to time from that list of eligible collateral is then determined by the collateral provider (or an agent on its behalf) by

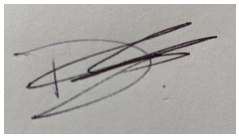
reference to a combination of other factors, including liquidity in the relevant asset. As a result, if a separate collateral regime were to apply to data objects, it would be difficult in practice, and potentially unworkable, to have data objects fall within the same list of eligible collateral as traditional collateral. Market participants may be forced to either isolate the different types of collateral and provide them separately, or to apply the "strictest of" approach to determining which requirements apply to the different types of collateral (which itself raises its own difficulties).

(iv) We note that the FCARs will, other than in limited circumstances (in relation to collateral arrangements governed by English or Welsh law between two English or Welsh participants in relation to collateral located in England and Wales), unlikely be determined in isolation by reference to English law. Therefore, to the extent that the FCARs are amended to accommodate data objects (or to otherwise deal with some of the difficulties experienced in relation to existing types of financial collateral), any differences with the FCD may have limited utility other than in those limited circumstances. For example, an English lender who lends securities to a German borrower and accepts a combination of traditional assets and digital assets as collateral will need to establish whether the arrangement, as a whole, satisfies all relevant legal regimes. To the extent that the revised English financial collateral regime is not consistent with the FCD (and with the German application of the FCD), in practice it may be difficult for the English lender to accept the digital asset collateral under the same collateral arrangement as the traditional assets.

(v) For the sake of completeness, we also refer you to our comment above regarding the potential uncertainty that would arise if a (directly-held) data object were subject to one financial collateral regime and an (indirectly-held) interest in that data object were subject to a different financial collateral regime.

We are at your disposal to discuss any of the above points.

Yours sincerely,



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