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125 YEARS

CUSTODY OF CRYPTOASSETS: MOVING TOWARDS INDUSTRY BEST PRACTICE

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EXECUTIVE SUMMARY

The provision of custody services for cryptoassets has recently been under heightened scrutiny, particularly following high-profile insolvencies of certain crypto service providers. These insolvency proceedings have demonstrated that determining what type of claim clients of custodian wallet providers have in respect of their cryptoassets is crucial.

In the absence of a clear regulatory framework for custodial wallet services, the product offering of custodian wallet providers varies significantly with the effect that, in practice, services provided under the label of *crypto custody services*, may not involve true "custody" by custodian wallet providers and instead fall under an alternative legal regime, which has important consequences for a customer's claim to the "custodied" assets, including on insolvency. In many circumstances this is not the result of obscure practices by the custodian wallet provider but the effect of uncertainty as to the precise legal position. This contributes to the hesitancy amongst established institutions to develop offerings in this space and presents a significant obstacle to market growth.

With this paper, we aim to improve clarity for market participants on best practice, as well as draw attention to areas of legal and regulatory uncertainty where it would be helpful for legislators and regulators to take action that enhances certainty.

The focus of this paper is custody offerings for cryptoassets where the custodian wallet provider is safeguarding and administering the cryptoasset on behalf of the client with the objective that the client retains a proprietary interest in the cryptoasset such that it does not form part of the estate of the custodian in the custodian's insolvency. The client would therefore expect to have a proprietary claim to the cryptoasset safeguarded and administered by the custodian wallet provider. This paper does not consider in detail cryptoassets which qualify as existing types of regulated investments that are subject to existing custody regimes. It also does not cover self-custody wallet services that enable a user to hold the cryptographic keys necessary to control their own cryptoassets.

HOW CAN CRYPTOASSETS BE HELD IN CUSTODY? WHAT LEGAL FRAMEWORKS EXIST?

There is well-established law and market practice that has developed around the provision of custody services for securities and other traditional assets. For example:

- Some jurisdictions use trust structures where assets can be held on behalf of beneficial owners without being included in the custodian's estate. A trust may be created by statute, or contractually agreed by the parties.
- Where jurisdictions do not have a concept of trust or similar division of ownership (where one person holds the asset, but ownership is recognised to sit with the client or other beneficiary), a combination of statutory and contractual arrangements will usually lead to a similar outcome. Applicable law recognises that assets 'held' by the custodian are assets that do not beneficially belong to them (and are not available to creditors of the custodian, whether before or after insolvency) but to the custodian's client(s).

We consider whether and how these existing frameworks or any cryptoasset-specific regimes apply to the safeguarding of cryptoassets in several key jurisdictions. Significantly, there are legal frameworks in many jurisdictions that allow custodian wallet providers to effectively safeguard cryptoassets on behalf of clients, provided that certain structuring or legal requirements are met. Common themes exist across many of the jurisdictions that we have analysed, including, for example, requirements for segregation. However, the lack of consistent regulatory frameworks for cryptoasset custody globally represents a challenge for custodian wallet providers interested in offering services internationally. The complex and diverging regulatory landscape makes the delivery of effective custody arrangements for cryptoassets practically difficult.

International overview

Broadly, the analysis of how existing custody concepts and rules can apply to cryptoassets differs depending on whether jurisdictions are common law jurisdictions (where case law created by judges forms part of the law, and where trusts are generally recognised), or civil law jurisdictions (where codified statutes prevail, and where trusts are often not recognised or are only available in certain specific circumstances). Cryptoassets should be capable of being held on trust in most common law jurisdictions, including Australia, Jersey, Singapore and the UK, as outlined in detail below. The effect of this is that custodian wallet providers using this structure can hold cryptoassets in a recognised way that offers clients protection in the event of an insolvency of the custodian wallet provider. In all of these jurisdictions, custodian wallet providers would need to fulfil certain obligations and/or fiduciary duties – for example, acting honestly – although the extent and detail of such obligations varies between jurisdictions. Another common feature is the emphasis on segregation of custodial assets from the custodian wallet provider's own assets, ensuring that the cryptoassets are more easily identifiable as belonging to separate beneficiaries. This helps to ensure protection in any insolvency claims on the custodian wallet provider's estate.

Despite these commonalities, there are notable differences in the extent and maturity of the specific regulatory and legal frameworks that apply to the custody of cryptoassets within these jurisdictions. While Australia, Singapore and the UK are at different stages of exploring proposals to introduce specific new supervisory frameworks that will govern the provision of custodial wallet services and introduce new licensing requirements, Jersey has chosen (at least for the time being) to regulate services relating to cryptoassets that include custody generally within its existing financial services framework. Singapore has enacted an amendment to its payments services legislation that will bring custodial services for digital payment tokens within the scope of regulation, which will become effective from a date to be notified, and is currently consulting on the subsidiary legislation that will operationalise the amendments to its payment services regime.

However, even in the absence of specific supervisory frameworks for the provision of custodial wallet services, there may be registration and/or licensing requirements in different jurisdictions that will need to be carefully considered. In the UK, certain trusts must register beneficial owners, and custodian wallet providers are subject to existing anti-money laundering (AML) requirements. In Jersey and Singapore, there are registration and licence requirements, respectively, for trust businesses, in addition to the requirement in Jersey for custodian wallet providers to register as Virtual Asset Service Providers for AML compliance.

While the US is broadly a common law jurisdiction that does recognise trusts, it has a complex legal landscape, with state and federal laws impacting custodial relationships, and requirements will vary based on individual circumstances. There is no comprehensive regulatory framework covering cryptoassets in the US, with regulators, including notably the Securities and Exchange Commission (SEC), seeming to prefer a regulation-by-enforcement approach, which has led to significant uncertainty for many crypto service providers. In the institutional market, the Uniform Commercial Code will often govern the relationship between a custodian wallet provider and its clients.

Generally, the legal structures and regulatory frameworks governing the custody of cryptoassets in civil law jurisdictions are more varied and differ between those where new crypto-specific supervisory frameworks are already in place, including Japan and parts of the UAE, and those where a supervisory framework for the provision of custodial wallet services remains to be, or is in the process of being, updated. Significant differences therefore arise in terms of legal structures and licensing requirements.

Germany's framework is based on the existing German Civil Code and new provisions proposed for the German Banking Act. In the UAE, regulation is developing at a different pace across the jurisdiction – with certain UAE-wide federal level regimes being supplemented by specific regulatory frameworks for cryptoasset custody in certain emirates, such as the VARA Rulebook in the emirate of Dubai. These sit alongside separate regimes introduced in the UAE's financial free zones – the Abu Dhabi Global Market and the Dubai International Financial Centre. Japan has also introduced cryptoasset-specific regulation under the Payment Services Act and the Trust Business Act, which allow custodian wallet providers, trust companies and trust banks to accept cryptoassets as custody assets or trust assets. Conversely, the Netherlands does not regulate custody services relating to cryptoassets other than through AML laws, and such services are instead governed by Dutch contract law. Applicable frameworks in certain civil law jurisdictions, including Germany, Japan and the UAE, may require custodian wallet providers to fulfil certain specific obligations and duties, including in relation to the segregation of assets. While segregation is not legally required in the Netherlands, the Dutch Central Bank requires custodian wallet providers incorporated in the Netherlands to ensure segregation in the context of AML regulations.

The position will change for European Union (EU) member states under the EU's new Markets in Crypto-assets Regulation (MiCA), which introduces a comprehensive regulatory framework for cryptoassets and the licensing of cryptoasset service providers, including custodian wallet providers. MiCA will enter into force on 29 June 2023, with provisions relevant to custodian wallet providers applying from 30 December 2024. See the spotlight on MiCA on page 24 for further detail.

Can cryptoassets be held in a "bankruptcy remote" manner?

Client assets held by a custodian are "bankruptcy" or "insolvency remote" where they will continue to be treated as assets of the client, and not as assets of the custodian, upon the custodian's entry into insolvency proceedings. This does not necessarily mean that a client will receive the full amount of their assets if the custodian is insolvent; there may be costs associated with enforcement, for example, or a shortfall owing to theft, fraud, or any number of other reasons. However, where assets are bankruptcy remote,

they will not be available to meet demands from the custodian's general creditors, and the assets or any value realised from them will be reserved for the client (or clients) for whom the custodian holds the assets.

The basic question is whether the custody arrangement has been structured, and is operated, so that the client's assets can be recovered from the custodian before or after the custodian's insolvency (subject to agreed terms and the rights of any insolvency official). Crucially, many jurisdictions have frameworks that in practice facilitate custodian wallet providers holding cryptoassets in a bankruptcy remote manner where relevant requirements are met. However, the challenge for custodian wallet providers is in obtaining an appropriate level of comfort that these regimes can extend to cryptoassets and that they will not be subject to contrary interpretation by the courts in all relevant locations. For potential clients, the challenge remains understanding exactly what the service on offer is, i.e. whether it is a true "custody" arrangement or not, whether the requisite conditions to achieve adequate separation of the cryptoassets being custodied and the estate of the custodian wallet provider have been met, and accordingly how the custodied cryptoassets would be treated in insolvency proceedings of the custodian wallet provider in the relevant jurisdiction(s).

International overview

In jurisdictions that recognise trusts as a legal structure through which cryptoassets are held in custody, bankruptcy remoteness is generally achieved by following the particular requirements for creating a valid trust. These requirements are broadly similar across Australia, Jersey, Singapore and the UK, and cover certainty of object, certainty of subject matter and certainty of intention. Elsewhere, and particularly in civil law jurisdictions, whether and how cryptoassets can be held in a bankruptcy remote manner will vary depending on the legal and regulatory framework. For example, in the US, the specific treatment of cryptoassets in custody arrangements in the context of bankruptcy has not been extensively tested, even though bankruptcy law, trust law and bailment law may govern bankruptcy remoteness in different contexts. In Japan, despite having a comprehensive regulatory regime for custodial wallet services, there is no clear view as to the legal nature of custody services for cryptoassets. However, it is interesting to note that, in practice, the Japanese regulatory regime seems to have been sufficiently robust to allow cryptoassets held by FTX Japan (a subsidiary of FTX US) to be treated as out of scope of the US Chapter 11 proceedings and returned to clients. In Germany, the classification and legal nature of the cryptoasset plays a crucial role in determining the regulatory protections and treatment, and will need to be determined on a case-by-case basis. A recent proposal to amend the German Banking Act clarifies the legal position in the sense that "crypto values" (which are, by and large, cryptoassets as defined in the German Banking Act) held in custody for a client as part of custodial wallet services shall be deemed to belong to the client (the proposed law also covers omnibus custody arrangements and custody of private cryptographic keys). In an insolvency of the custodian wallet provider, such client has a right of segregation. The presumption of ownership would, however, not apply if the client has given their consent to dispose of the cryptoasset for the account of the custodian wallet provider or third parties. In the Netherlands, there is no legal framework through which a custodian wallet provider can hold cryptoassets in a bankruptcy remote way. However, custodian wallet providers may choose to establish a 'bankruptcy-remote' foundation to better protect client assets, in line with the structures commonly used in the Dutch financial services industry.

Although MiCA aims to bring some consistency to the regulatory treatment of cryptoassets and crypto service providers across the EU, the difficulty is that the question of bankruptcy remoteness and segregation in many EU jurisdictions depends on a combination of national civil, property and insolvency law. This presents a challenge in many member states where cryptoassets remain to be characterised, with treatment around them to be confirmed.

Jurisdiction	Legal system	Are cryptoassets capable of being held in a bankruptcy remote manner?	Is there a specific regulatory framework for cryptoasset custody?
Australia	Common law	✓	In progress
Germany	Civil law	✓[1]	In progress at an EU level through MiCA
Japan	Civil law	✓	✓
Jersey	Common law	✓	X
The Netherlands	Civil law	✓	In progress at an EU level through MiCA
Singapore	Common law	✓	In progress
UAE	Civil law	✓[2]	✓[2]
UK	Common law	✓	In progress
US	Common law	✓	X

1 Based on the proposed amendments to the German Banking Act (*Kreditwesengesetz*).
2 In certain emirates only.

Segregation

This paper also explores the importance and methods of segregating custody assets from those of the custodian and other custodial client assets with the aim of safeguarding client assets and establishing clear ownership rights.

The level of protection provided by segregation hinges on the contractual terms governing the client's relationship with the custodian as well as the applicable legal framework and any regulatory requirements. Custodians are typically required to maintain in their own books separate records and accounts for each client's custodied assets; however, omnibus accounts may be opened in the books of sub-custodians where the custodian holds assets belonging to clients with a sub-custodian.

Applying traditional segregation principles to the custody of cryptoassets may present its own unique challenges, particularly in jurisdictions where trusts are a recognised mechanism through which assets can be custodied. Although holding any assets on trust in common law jurisdictions provides clear protection of the assets against claims from creditors of the custodian, there can be difficulties with establishing that a trust exists. For example, this may be the case if, based on the contractual documentation and actions of the parties, there is an argument that it is not clear whether there was an intention to hold cryptoassets on trust, or it is unclear which cryptoassets are held for which client. It is possible that the client may agree in the terms that, although the arrangement is called 'custody', the cryptoassets are to be transferred to the custodian wallet provider subject to a contractual obligation to redeliver the same cryptoassets, or cryptoassets of the same type, to the client in future. In this case, the custodian has no obligation to hold the client's cryptoassets for the benefit of the client (or to hold the client's cryptoassets separately from its own cryptoassets, or to refrain from making use of such cryptoassets) and it is difficult to see how such cryptoassets could be regarded as held on trust by the purported custodian. This point is also acknowledged in the **UNIDROIT Principles on Digital Assets and Private Law** which were **adopted in May 2023** as non-binding guidance for national regulators and legislators, which state that "An agreement … is not a custody agreement if it is clear from the agreement that, if the service provider enters into an insolvency-related proceeding, the digital asset would be part of the service provider's assets available for distribution to its creditors."

Clear contractual terms and reliable mechanisms are essential for identifying and segregating cryptoassets belonging to different clients, and will be essential to achieving the desired degree of protection.

Policy considerations

Well-considered and internationally consistent regulation for the custody of cryptoassets is crucial to allow the market to continue to develop responsibly and to avoid any further high-profile insolvencies, the cost of which is ultimately borne by investors. In the absence of such an internationally consistent approach, what is the best approach to regulate the risks and challenges outlined in this paper? We have set out our recommendations for the ideal legal and regulatory framework for custody of cryptoassets below, and we note that certainty regarding how cryptoassets can be held in custody so that they are not available to the custodian wallet provider's creditors on insolvency is paramount. It is also important to be clear what a custodian wallet provider is authorised to do, or not do, with the assets it holds for clients. The extent to

which the custodian wallet provider accepts liability for loss is also important, but in principle, if the services to be provided by a custodian wallet provider are clear, the corresponding level of liability could be determined by commercial agreement and market forces. Any regulatory framework should strive to afford client protections commensurate with the commercial realities of a high-volume low-margin business.

How this is achieved in practice will vary between jurisdictions depending on the existing legal and regulatory framework. While many jurisdictions are considering and/or developing new bespoke frameworks which address custody of cryptoassets and which clearly offer market participants visibility and certainty, in some jurisdictions it may be sufficient to have something much simpler which expands existing requirements for financial instruments; for example, introducing a requirement to hold cryptoassets on a segregated basis. The International Swaps and Derivatives Association (ISDA) agreed **in a recent paper** that clarity around the rules governing the ownership of cryptoassets following insolvency of an intermediary (including custodian wallet providers) is paramount and will help to ensure that clients are given equivalent rights and protections to what they would expect for traditional assets or financial products. The global nature of cryptoassets presents additional jurisdictional challenges for custody arrangements, and conflict of laws challenges will need to be addressed separately.

Helpfully, on 23 May 2023, the International Organization of Securities Commissions (IOSCO), issued for consultation **detailed recommendations** on the regulation of cryptoassets to jurisdictions across the globe. The consultation includes a chapter with recommendations on custody of client monies and assets, that includes requirements for cryptoasset service providers (CASPs) to: ensure that client assets are adequately protected at all times, including when placed with a third party chosen by the CASP; to place client assets in trust, or to otherwise segregate them from the CASP's proprietary assets; to make certain disclosures about the custodial wallet services; and to have in place appropriate systems and procedures, including for reconciliations. The proposals go some way to addressing some of the current challenges for the cryptoasset custody market. In addition, the recently-adopted **UNIDROIT Principles on Digital Assets and Private Law** specify basic duties for custodians of cryptoassets (termed digital assets in the Principles) which include (unless the parties otherwise agree), duties to "keep a record of the digital assets it maintains for each client" and to "separate the digital assets maintained for clients from the digital assets maintained for its own account". These principles are not binding, but are intended to guide national regulators and legislators and so may contribute to the development of more consistent rules internationally

Our recommendations

The ideal regulatory framework for custodial wallet services would have the following features:

- A clear and specific definition of what constitutes custodial wallet services, and the underlying legal basis for these, is imperative. This should clarify the different types of possible service provision, from true custody to other offerings that involve title transfer arrangements.
- Prudential requirements, including mandatory regulatory capital and allocation of ring-fenced wind-down funds, could practically support favourable outcomes for clients of custodial wallet services.

- Mandatory arrangements to support the argument that cryptoassets are not available to creditors of the custodian wallet provider (whether before or after insolvency, and whether the arrangement is a trust structure or equivalent) - for example, a requirement for separate identification of assets of each client in the books of the custodian wallet provider, and, where assets are held with/recorded in a third party system, a minimum requirement for separate identification of the custodian wallet provider's own assets from any client assets.
- Secondary objective of providing clarity to market participants by ensuring consistency with and not unnecessarily disrupting existing regimes for securities custody.
- Clarity on the meaning of the term "custodian" – there should be a minimum level of activities or services the custodian wallet provider has to offer to be allowed to use this designation, as well as registration or licensing requirements and adherence with the relevant rules.
- Clarity as to segregation (in the books of the custodian and any delegate) best practice, in a way, to the extent possible, that achieves ring-fencing on insolvency. Ideally, this would also minimise the risk of any client assets being mistakenly regarded as assets belonging to the custodian wallet provider and/or other clients as a practical matter.
- Recommended disclosure around business operations and how client assets are held and recorded by the custodian wallet provider, including any use of omnibus wallet structures and title transfer arrangements. Transparency is key to allowing clients to make informed choices, particularly if the business model of the custodian wallet provider could ever involve the rehypothecation of client assets or similar arrangements that would impact the insolvency analysis.
- International cooperation and consistency, with the aim of having a broadly accepted market standard for what good custodial wallet services look like and how they are treated, as can be seen in the custody market for traditional financial instruments today.

Practical considerations

While clear regulatory requirements and guidelines will go a long way to providing clarity for the developing industry, the fundamental questions for any analysis of custody services are what has the custodian wallet provider agreed to do and what has it actually done in practice. Custodian wallet providers should carefully consider the legal, regulatory and operational considerations for developing and offering custodial wallet services to ensure they have properly understood their product offering and its likely legal characterisation.

For any potential client of custodial wallet services, it will be crucial to carefully review the terms of the service which it will receive, regardless of the name of such service. Detailed due diligence will help legal teams and decision-makers carry out an informed assessment of the risk that cryptoassets will not be treated in a bankruptcy remote way on the insolvency of the custodian wallet provider, among other considerations. It is important that ongoing due diligence is undertaken in relation to the custodian wallet provider's operations; for example, to confirm that there is no commingling of accounts, and that robust security mechanisms, such as multi-signature wallets, are followed. This should help minimise potential losses resulting from acts or omissions of the custodian wallet provider.

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What do we mean by "custody" for cryptoassets?

The current market for institutional custody of cryptoassets accommodates a range of "custody" solutions which, in practice, are provided using different business models and operational arrangements, such that the practical outcome for clients and their claim or relationship to the custodied assets varies significantly.

Under existing principles in civil and common law jurisdictions, there are a number of generally accepted legal regimes which determine the basis on which assets are held by someone other than the original owner:

- **Deposit**, where ownership of the asset transferred is given to the transferee, and the transferee's only obligation is to give an equivalent asset back;
- **Hire**, where the asset is delivered to the receiver on the basis that the receiver may use it, but the same asset must be returned;
- **Custody** (including bailment), where the object handed over may not be used and must be kept in safe custody and the same asset (or, if treated as fungible, an asset of the same type) returned; and
- **Pledge**, where the asset is handed over on terms that it must be kept safe, but that it need not be returned until a particular condition has been satisfied (usually the repayment of a loan made by the transferee).

Frequently, services described as "custody" lack the central tenets of true custody and have outcomes which are more akin to a deposit or a hire arrangement. For example, the custodian wallet provider may be receiving assets as principal and lending them out to third parties through title transfer arrangements. In many cases, this distinction could mean that assets are not truly safeguarded for the client and have the effect that, on insolvency of the custodian wallet provider, the client is left only with an unsecured claim against the custodian wallet provider.

Such market practices can make it difficult for market participants and potential clients to know what any particular service provider means when they offer a custody wallet service. This uncertainty, at least in part, may be attributed to the fact that acting as a custodian wallet provider is currently unregulated in many jurisdictions and that the role of a custodian wallet provider is still being developed.

To illustrate the fundamental issues, it is helpful to consider the position in respect of traditional (non-digital) assets. In the financial services markets, there are broadly two types of claim that a client may have against their financial services provider in respect of property: a debt claim and a claim for redelivery of the asset (sometimes referred to as a proprietary claim).

- **Debt claim** A debt claim arises in circumstances where the client has deposited fiat money with their bank. Essentially, the bank receives funds and recognises that they are repayable to the client either on demand or at a later date, with or without interest. Typically, arrangements in fiat money are such that, as soon as the money moves from one holder to the other, ownership passes so that the new holder is, in the first instance, recognised as the owner of such money absent any intervening action being taken to avoid this. In this example, the cash deposited by the client becomes part of the bank's estate. As such, it is available to the bank's creditors on the bank's insolvency and the client's claim in the context of the bank's insolvency would be as an unsecured creditor. In practice, in many jurisdictions, there may be consumer deposit protection schemes that would protect, enhance or insure the client's claim. However, this does not change the nature of their underlying unsecured claim. Conventionally, any payment of money to a bank has this effect of creating a deposit, since the legal nature of cash is such that its physical transfer results in a transfer of legal ownership (sometimes referred to as "supernegotiability").

- **Claim for redelivery (or proprietary claim)** Where a specific asset or object is being held for the benefit of another person, such property typically does not automatically belong to the holder. As such, the resulting obligation is not a general debt claim. In the financial markets, the main example of this obligation arises when a custodian safeguards and administers financial instruments, such as shares or bonds, for a client. The nature of the claim that the client has in respect of the asset will depend on the applicable contractual arrangements and the legal framework. In certain jurisdictions, including under English law, the client may have a proprietary claim to the financial instruments because the custodian is holding the assets on trust. In other jurisdictions, contractual and statutory provisions may achieve a similar outcome, i.e., that ownership of the asset does not move to the custodian. The client remains the owner of the assets and the assets are safeguarded and administered for them by the custodian. In this scenario, on insolvency of the custodian, the client's claim is a stronger claim than an unsecured debt claim and it should be enforceable against third parties, including creditors of the custodian. This is sometimes referred to as "insolvency remoteness". While the asset is subject to a higher degree of protection on the custodian's insolvency, the client is still entrusting the asset to the custodian. As such, they are still exposed to the custodian and its practical operational arrangements. It may be possible in certain jurisdictions for the client and the custodian to agree a different arrangement; for example, the client may agree that the property title in the asset is transferred to the custodian, allowing it to use the asset as if it were theirs with an obligation to return a similar asset in due course. However, this would impact the insolvency analysis.

While certain cryptoassets are sometimes referred to as cryptocurrencies or virtual currencies, generally speaking the "supernegotiability" aspect of money does not apply to virtual currencies. This distinction is not always appreciated and, as such, there may be custodian wallet providers who take the view that cryptoassets held by them are held as "deposits", granting the client a debt claim and enabling the provider to use the assets with only an obligation to repay the client in due course. However, the regulatory frameworks that have been proposed in respect of cryptoassets in many jurisdictions, including the EU and in the UK, generally do not take this approach and treat cryptoassets more like financial instruments than fiat money.

Safeguarding and administering

The focus of this paper is on custodial wallet services where the custodian wallet provider is safeguarding and administering the cryptoasset on behalf of the client, and the client should therefore have a proprietary claim to the cryptoasset.

In the UK, the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, Article 40, describes the activity of safeguarding and administering investments as requiring both the elements of safeguarding and administering to be present for a person to be found to be carrying on the relevant regulated activity, and proceeds to clarify that:

> "For the purposes of this article … it is immaterial that title to the assets safeguarded and administered is held in uncertificated form."

Similar rules apply internationally. In the context of cryptoassets, the question of when a person such as a custodian wallet provider *holds* a cryptoasset has not been universally settled and legal certainty will only be achieved in individual jurisdictions through case law or specific legislation. However, in the UK, the Law Commission considers the concept of "control" as the best one to capture the notion of "holding" or "having" in the context of data objects. In its 2022 consultation paper, the Law Commission proposed that "*the person in control of a data object at a particular moment in time*" should be *"the person who is able sufficiently*

> *(1) to exclude others from the data object;*
>
> *(2) to put the data object to the uses of which it is capable (including, if applicable, to effect a passing of, or transfer of, that control to another person, or a divestiture of control); and*
>
> *(3) to identify themselves as the person with the abilities specified in (1) to (2) above".*

This idea of "control" is aligned with the recently adopted **UNIDROIT Principles on Digital Assets and Private Law** that propose a similar approach for holding digital assets. However, an approach based on control is not without difficulties, since in structures where keys are sharded and there are a number of persons, some or all of whom are required to initiate transfers or other relevant actions, the identification of who has control for the purpose of the above proposals may be debateable.

The UK Financial Conduct Authority's perimeter guidance manual describes administration as follows:

> "Administration covers services provided to the owner or manager of the property, such as settlement of sale transactions relating to an investment, dealing with income arising from the investment and carrying out corporate actions such as voting."

In the context of cryptoassets, this guidance does not apply directly. However, arguably, an analogy would be that, to the extent applicable, the custodian wallet provider would be regarded as carrying on administration services where it recognises any direct benefits to the client resulting from holding the cryptoassets. These may include any airdrops resulting from holding the cryptoassets, as well as deciding on any forking proposals, voting on smart contracts or staking protocols and similar matters that result from holding the cryptoassets.

What type of cryptoassets are in scope for this paper?

This paper's focus is on cryptoassets which would qualify as property under the relevant legal system and which to cover, the relevant financial services regulatory framework needs to be adapted, i.e., they do not qualify as other existing types of regulated investments such as equity instruments, debt instruments, derivative contracts or units in collective investment undertakings. This may mean that a specific regulatory framework is in the process of development but not yet in force or that a framework has recently been implemented. In some jurisdictions, regulators have yet to develop proposals. The common characteristic of the cryptoassets in scope of this paper is that there is no central issuer or, to the extent that there is one, the assets do not create or otherwise represent an obligation by the issuer.

Consideration of custody of digital assets that qualify as regulated investments, such as shares, bonds or other assets in respect of which a given regulatory framework already imposes custody obligations, is beyond the scope of this paper.

Spotlight on staking

"Staking" allows the holders of certain cryptoassets to receive rewards from locking up their holdings to help validate new transactions on the underlying DLT network.

Staking is only relevant for cryptoassets on networks that use a proof-of-stake consensus mechanism, like Ethereum, where transactions are validated by certain holders of staked cryptoassets. The stake acts factually as a form of collateral guaranteeing the adequate performance of a validator and may be lost if the validator does not perform as required. This contrasts with energy-intensive proof-of-work networks, such as the Bitcoin blockchain, where new blocks are added by "miners" competing to solve cryptographic problems. In those networks, the first to solve a problem is able to add a block or verified transaction to the blockchain and will also receive some of the relevant cryptoasset as a reward. It is important to note that the terms of staking activity are unlikely to be set out in a stand-alone contract but are typically coded into the relevant proof-of-stake consensus mechanism. As such, any legal consequences from a staking arrangement must be considered in light of the specific consensus mechanism and relevant interactions between the parties.

Staking offers holders of cryptoassets, including institutional investors, the means to receive rewards by making their stake available to active validators to use. The higher the amount of cryptoassets locked up by a would-be validator, the higher the chance of being chosen as the validator for the next block and the higher the ultimate reward is likely to be.

Custodian wallet providers will often facilitate staking to some extent as part of the range of services they offer, typically by holders making an election via their digital wallet. Market practice is still developing and, depending on the contractual terms and the way that staking has been undertaken, as well as the relevant jurisdiction(s), there may be quite different outcomes in terms of how staked cryptoassets would be treated in the event of insolvency of the would-be validator or custodian wallet provider.

Staking is effected in different ways for different cryptoassets, as well as depending on the relevant custodian wallet provider's terms. At one end of the scale, some cryptoassets can be staked but remain in a customer's wallet with a "flag" on the asset that marks them as available for staking for a particular validator. At the other end of the scale, some staking schemes require cryptoassets to be transferred to alternative validator addresses. Certain custodian wallet providers may distinguish between custodial staking and non-custodial staking. The former includes arrangements where if the cryptoasset leaves the wallet there must be at least a "replacement" arrangement which allows the custodian wallet provider to retain control of equivalent tokens. The specific legal and regulatory categorisation of these arrangements requires further consideration, on the basis that while there are similarities to title transfer arrangements, arguably the custodian wallet provider is at all times "in control" of the relevant asset. Other forms of staking arrangements may involve the pooling of assets and/or the management of the assets without the day-to-day involvement of the client, for these arrangements it is crucial to consider whether requirements around collective investment, including rules implementing AIFMD or other applicable funds legislation, apply. Where this is the case the ability of a custodian wallet provider to offer staking may be significantly curtailed in certain jurisdictions.

Whatever the arrangement, the service provision will require very careful analysis on both sides to help ensure that the expected custody outcome is achieved and, in the case of the custodian wallet provider, to limit any unanticipated liability. Some questions it would be worth asking include:

- How does the staking operate? Does it involve the cryptoassets leaving the wallet or blockchain address?
- Could the arrangements as a whole qualify as a collective investment scheme or alternative investment fund or equivalents under relevant regulatory regimes?
- If cryptoassets are transferred, where do they go and what is the mechanism for their return? Is it possible to argue that "the same" cryptoasset is returned notwithstanding any technical additions to the tokens as a result of the transfers? What happens if something goes wrong, e.g., a technical error or fraud?
- What is the duration of lock-up and in what (if any) circumstances can this be changed?
- Does the custodian have any discretion to exercise instructions?
- How is the staking reward calculated, or is the payment a flat reward rate unrelated to the staking?
- Are any additional fees charged by the custodian wallet provider for the service and how are these calculated and paid?

How do new crypto regulatory initiatives address custody?

Increasingly, new regulatory regimes are being developed that specifically address the provision of custody services for cryptoassets. Specific frameworks have been introduced or are in the process of development in jurisdictions including the EU, Japan, UAE, UK and USA, among other jurisdictions. The status and extent of these regimes vary; please see the executive summary above and the relevant jurisdiction sections below for more detail. Generally, these proposals do not seek to strengthen the ring-fencing of client assets from the custodian's own assets but copy certain existing regulatory requirements for regulated custodians (and fund depositaries). In some jurisdictions, like the UK, there are proposals to impose mandatory levels of liability on custodian wallet providers for loss of custody assets. This will, of course, not assist if the custodian wallet provider is insolvent, since a claim for loss will be an unsecured claim ranking alongside other unsecured creditors of the custodian wallet provider.

Any regulatory framework should strive to afford client protections commensurate with the commercial realities of a high-volume low-margin business. It may be questioned whether mandatory liability is reasonable, rather than leaving liability to be determined by generally accepted market standards, and, ultimately, contractual agreement. There will be a cost to custody clients for increased liability, as custodians will inevitably need to increase fees accordingly, which may be commercially unsustainable.

By way of comparison, the EU's Markets in Financial Instruments Directive (MiFID) does not impose a specific level of liability on custodians of securities, although custodians are required to take appropriate steps in choosing delegates and in ongoing monitoring of such delegates (*culpa in eligendo*). As a result, regardless of the level of liability accepted by the custodian, there are potential issues for the custodian if it becomes aware that using a particular delegate increases the risk of loss of client assets but does not take appropriate steps, such as seeking further assurance from (or replacing) the delegate, and is therefore regarded as having breached relevant regulatory obligations. MiFID also does not exclude any contractual or statutory liability.

A fundamental point for consideration by the crypto industry is what is it that custodian wallet providers do, and what are clients willing to pay for this.

The core custody service is the holding of cryptoassets and acting only as the client instructs or agrees. Custody is not a service which is subject to the same risks as, for example, investment management or prime brokerage. The client may specify how the cryptoassets are to be held, or this may be implicit from the nature of the cryptoassets (e.g., certain types may only be held on the blockchain to which they are native), or this may be left to the decision of the custodian wallet provider, relying on its expertise.

A custody service is not the provision of a guarantee of the value of the assets, or that there will be no loss of the assets (that is not attributable to the custodian), or that the assets will be available to the client in all circumstances. The purpose of a custody service is not to put the client in a better position than if it held the assets directly (where it would still be exposed to the risk of holding the assets, and the risks of the system in which such asset exists). There is the perennial argument that a custodian

should take full responsibility for any delegate or system through which it holds assets, not least because this is the custodian's choice and the client has no direct claims against such delegate or system, but a contrary argument is that the client will (in most cases) know, and the custodian wallet provider will disclose, that cryptoassets must inevitably be held through such delegate or system and the custodian may have little choice or control regarding the relevant delegate or system. Moreover, in the context of decentralised systems, there is no entity over which the custodian wallet provider could have control or against which it could make a claim[3]. The custodian wallet provider should, of course. agree to perform its functions properly and to take liability for its own actions or omissions that breach the agreed level of service.

Inevitably, much depends on how the custodian wallet provider actually carries out its functions. The terms of a custody agreement and regulatory requirements can set out what the custodian wallet provider has agreed to do, and what it should do, but if the custodian wallet provider fails to do so, whether due to its fault or not, the client will be left to make a claim, the success of which will vary depending on whether it has proprietary claims to assets (under a trust or equivalent arrangement), and whether there is any available investor protection scheme.

Other solutions might be possible to increase the ability to recover cryptoassets held in custody. For example:

- custody clients could be given first priority over the custodian wallet provider's own assets in the event of insolvency if the custodian wallet provider, for any reason, does not hold sufficient cryptoassets for clients. This would be a significant variation of insolvency law (in most jurisdictions) and would raise significant questions about potential lack of clarity as to the extent of the custodian's own assets, and issues such as conflict with rights of holders of security interests and the claims of creditors in the event of the custodian wallet provider's insolvency;

- custodian wallet providers could be required to maintain compulsory insurance to cover any loss of cryptoassets for any reason. Such insurance may be difficult or even impossible to obtain, the coverage limits will invariably only cover a fraction of the assets held under custody and, even if available, the cost could be high, which would inevitably increase custody fees or risk causing this business to be commercially non-viable;

- custodian wallet providers could be required to guarantee, or obtain a third-party guarantee of, redelivery of client cryptoassets in all cases. In the event of the loss of any cryptoassets, the client would have a contractual claim under the guarantee instead of a proprietary claim to cryptoassets. The giving of such a guarantee by the custodian wallet provider would have capital implications for the custodian wallet provider, and, as an unsecured contractual claim, it would not assist in the recovery or redelivery of the relevant cryptoassets in the event of the custodian wallet provider's insolvency, as such claim would simply constitute an unsecured claim for the losses suffered, ranking alongside other unsecured creditors of the guarantee

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3 This reflects the generally assumed position of most industry participants but there is currently a case in the English courts (the *Tulip Trading case*) in which an owner of Bitcoin claims the control of relevant blockchains are not decentralised and that certain software developers can and should introduce code to restore his control to stolen assets. If the claims succeed, it would, among many other consequences, give rise to questions as to what claims custodians were required to pursue on behalf of clients.

provider. Whether given by the custodian wallet provider or a third party, this would increase the cost of the custody services and custody fees;

- custodian wallet providers could be required to accept liability for any loss of cryptoassets in any circumstances. This may well be characterised as a guarantee, with the same implications discussed above, and, again, would increase the expense of the custody services and custody fees but would not assist in the event of the custodian wallet provider's insolvency.

This leads back to the question of the events for which custodian wallet providers should take liability, and whether new legislation should impose liability on a custodian wallet provider rather than leaving it to the agreement of the custodian and client, and the related question of whether the approach should be different for different types of clients (for example, requiring additional protections for retail clients).

In principle, it is difficult to justify the custody of cryptoassets being subject to legal and regulatory requirements which are significantly different from those for the custody of securities. To create different requirements risks the potential for market disruption and market arbitrage, particularly in situations where the characterisation of an asset as a cryptoasset, as distinct from a security, is difficult. Custodian wallet providers may in some cases, depending on the particular arrangements and commercial pressures, choose to accept increased liability for the services they provide in relation to cryptoassets, but the fact that cryptoassets can be more volatile and riskier than certain other assets is not an argument for passing such risks to custodians.

It is also crucial that regulators consider and address the different types of risks that custodian wallet providers face and do not regulate the particular technology. For example, regulators may conflate cybersecurity and operational risks with the risk arising from inadequate segregation of custody assets from the assets of the custodian. While both can lead to the loss of the assets, e.g., if the custodian wallet provider gets hacked or if the custodian wallet provider becomes insolvent, different types of rules are required to solve for these separate problems.

Inadequate segregation may result in the exposure of clients to the credit risk of the custodian wallet provider. Although requiring the custodian wallet provider to comply with enhanced prudential requirements, or to hold capital against the relevant cryptoassets, may increase the likelihood of clients recovering for loss resulting from failure to segregate client assets (or for other reasons, such as cybersecurity failures or fraud), holding additional capital should not be a replacement for appropriate controls and due diligence to minimise the risk of loss arising.

As has been seen with the Basel Committee on Banking Supervision (BCBS)'s **prudential standard on banks' cryptoasset exposures**, there has been a tendency among some regulators to believe that holding a particular asset on DLT is riskier than holding the same asset using traditional means or a different technology type. This is problematic as regulation should be technology-neutral, with the same products regulated in the same way regardless of the technology used. Whether assets are held via DLT or not should not matter, provided that, ultimately, bankruptcy remoteness can be achieved in the same way.

JURISDICTION ANALYSIS

We now consider in more detail how cryptoassets can be held in custody and whether bankruptcy remoteness can be achieved for nine key jurisdictions. Given the inherent international nature of cryptoassets, one of the key challenges of making an assessment in relation to particular cryptoassets is the determination of the relevant governing law(s). A detailed analysis of conflict of law issues in relation to cryptoassets is beyond the scope of this paper, but it is worth noting that the **UNIDROIT Principles on Digital Assets and Private Law** include an approach for this issue, suggesting that the law which governs proprietary issues in respect of digital assets should be "the domestic law of the State expressly specified in the digital asset, and those Principles (if any) expressly specified in the digital asset; or, failing that … the domestic law of the State expressly specified in the system on which the digital asset is recorded, and those Principles (if any) expressly specified in the system on which the digital asset is recorded", failing which further options apply).

UK

How can cryptoassets be held in custody?

Under English law, an express or implied trust is the most used legal structure under which a custodian wallet provider can hold cryptoassets such that the cryptoassets are not the custodian wallet provider's property and are not recorded on its balance sheet as its own assets. Bailment (where possession is transferred but not ownership) is not an option for assets which are not physical, and agency is not a relationship of holding assets. Recent English case law states that cryptoassets are a form of property, and the courts have recognised that, as a matter of principle, cryptoassets can be held on trust.

A trustee under English law is subject to the core obligation to act honestly. Certain additional obligations are implied by common law or imposed by statute, but can be varied, limited or excluded by contract. The extent of the custody services will depend on the terms of the agreement between custodian and client. The custodian's core function of holding assets is characterised as holding as trustee, but additional trustee obligations of a custodian (apart from the irreducible core of a trustee's duties) are typically limited by the agreement terms. This trust analysis is the same whether the assets held by the custodian are cryptoassets or dematerialised securities.

Acting as a trustee is not of itself a regulated activity, but certain other requirements apply. In particular, under the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017: (i) certain types of express trust must register information relating to beneficial owners (subject to certain exceptions, although it is not clear any exception is available for custodian wallet providers); (ii) a custodian wallet provider in the UK is subject to due diligence requirements for AML purposes; and (iii) a custodian wallet provider holding cryptoassets in the UK is subject to registration and disclosure requirements.

In contrast, a UK custodian of securities performs a regulated activity and is required to be authorised and regulated in the UK under the FSMA regime, as well as being subject to UK AML legislation. The changes proposed to introduce a UK regulatory framework for cryptoassets would result in a more level playing field.

UK – new regulation for crypto custody

In February 2022, HM Treasury proposed a **comprehensive new UK regulatory** regime for firms engaging in certain cryptoasset activities. This latest consultation builds on previous discussion papers and consultations, including the prior proposal to introduce a specific regime for the regulation of fiat-backed stablecoins which are used for payments (or "Digital Settlement Assets"). These will be introduced pursuant to the Financial Services and Markets Bill (FSMB), which introduces new powers for HM Treasury to bring cryptoassets within the scope of the UK financial services regulatory perimeter.

Scope

The proposed definition of cryptoasset has been drafted broadly so as to capture all current types of cryptoasset, similar to the definition of "cryptoasset" in MiCA for the EU and the Financial Action Task Force's definition of "virtual asset". The consultation is not clear on the final scope of cryptoassets to be regulated but provides an indicative list of cryptoassets that would be in scope. Notably, this covers (among others): Exchange Tokens (e.g., BTC or ETH); Utility Tokens (cryptoassets which provide digital access to a specific service or application) and certain Non-Fungible Tokens; Stablecoins; Governance Tokens; and Fan Tokens.

HM Treasury intends to create various new regulated activities relating to cryptoassets, including the custody and administration of cryptoassets on behalf of third parties. Similar to MiCA, the UK has proposed to create an adapted version of the MiFID II regime for financial instruments. The UK will adapt existing frameworks for traditional finance custodians under the Regulated Activities Order, making suitable modifications to accommodate unique cryptoasset features, or putting in place new provisions where appropriate (e.g., specific controls and safeguards for the safekeeping of private keys).

As currently proposed, this activity would be broader than the closest equivalent regulated activity as it would capture firms that only safeguard (but not administer) assets, as well as extend the custody scope to not just the assets but the means of access to the cryptoasset (e.g., a wallet or cryptographic private key).

Controversially, the proposal also includes a statement that "Liability standards for custodians are also under consideration by the authorities. The government is exploring taking a proportionate approach which may not impose full, uncapped liability on the custodian in the event of a malfunction or hack that was not within the custodian's control." The imposition of a level of liability would be wholly new for custodians.

Timeline / next steps

This latest consultation is "Phase 2" of the UK's phased approach to cryptoasset regulation – with Phase 1 being the implementation of the Digital Settlement Assets regime. Once the FSMB gains Royal Assent (expected in Q2 2023) HM Treasury will be able to make secondary legislation covering the detail of the regime taking into account industry feedback received. The Financial Conduct Authority will then need to consult and make the wide range of relevant rules to bring the regulatory regime into operation.

Can cryptoassets be held in a bankruptcy remote manner?

Under English law, the question in the context of a custodial relationship is whether the assets are held under a valid express or implied trust. If held on trust, there are rules to enable recovery of trust assets if the trustee has wrongfully disposed of the assets (although recovery will not be possible in all cases), and the trustee will be liable for breach of trust (although this may not assist on insolvency).

For a valid trust to exist, there must be certainty: (i) as to which assets are held on trust; (ii) that the arrangement was intended to be set up as a trust or that the contractual arrangements governing the arrangement are reflective of the irreducible core of a trustee's duty; and (iii) as to the person for whom the assets are held.

In relation to dematerialised securities held by a custodian in pooled client[4] accounts with a sub-custodian, certainty of the assets held on trust is unlikely to be an issue, provided that it is clear that all the assets in the pooled custody account are held on trust, it is clear what amount of such assets is held for each custody client, and the assets are (or are treated by the clients as) fungible. Arguably, the same should be true for custody of cryptoassets.

However, as recognised by ISDA in its recent paper on **Navigating Bankruptcy in Digital Asset Markets**, in contrast to the position for traditional securities, for cryptoassets there may be a distinction between the wallet under the control of a custodian wallet provider and their respective books and records. In that context, it is factually possible for the custodian wallet provider (or their sub-custodian) to:

- maintain cryptoassets in the same wallet as the custodian's assets and only "segregate" at the level of the books and records;
- maintain client cryptoassets in a wallet that is segregated from the custodian's wallet but not identify particular client entitlements; and
- at all times operate individual client wallets that reflect the books and records held for each client.

For cryptoassets held in custody, certainty of the assets held on trust is arguably clearest where the cryptoassets held for each client are recorded at one address on a blockchain or DLT system which records only the cryptoassets held for that client, or there is some other mechanism (including a custodian wallet provider's off-chain general ledger system) for identifying not simply the quantity of, but which specific, cryptoassets are held for each client.

In relation to cryptoassets held by a custodian wallet provider for a number of different clients in a single address on a blockchain or DLT system, or in a single client account with a sub-custodian, the same reasoning should apply.

4 From a trust law perspective, there is no reason why the trustee's own assets cannot be held in the same pooled account, provided the trustee is a beneficiary under the same trust, but this is not usual in a custody context (and case law has shown that the separation of client assets and custodian's own assets is viewed as supporting a trust argument, therefore the absence of separation between client assets and custodian's own assets may be viewed as evidence that no trust was intended) , and regulatory requirements (see CASS and MiFID) do not permit a regulated custodian to hold its own assets and client assets in the same account with a delegate.

Certainty of intention to create a trust is clearest where the terms documenting the arrangement expressly state that the arrangement is a trust. However, this is not essential, and an implied trust can still be established contractually, because English courts will consider all the facts to decide whether there is certainty of intention. In case law considering custody arrangements, it has been concluded that references in the agreement to assets belonging to the client and a prohibition on pooling client assets with the custodian wallet provider's own assets are clear evidence that the custodian wallet provider intended to hold assets on trust.

Certainty as to the beneficial owner for whom assets are held will depend on the books and records of the custodian wallet provider.

It is therefore important not only that the custody terms are clear as to what is intended, but also that the custodian wallet provider complies with the agreed terms (in particular, by maintaining accurate books and records and by not dealing with the assets in a manner that is inconsistent with the agreed terms).

Australia

How can cryptoassets be held in custody?

Australian law recognises that a trust structure can be used as a vehicle for custodians (as 'trustee') to have legal title over the assets subject to a trust, without bringing the asset held in trust within scope of the insolvency estate, similar to the position under English law. This is on the basis that the beneficiary of the asset held in trust has an equitable title to the asset.

In March 2022, the Australian Government's Treasury released a **consultation paper**, in which it was proposed that cryptoasset secondary service providers (which covers crypto exchanges, brokers and dealers and other crypto service providers) who maintain custody (either themselves or via third parties) of cryptoassets on behalf of consumers should be required to (i) hold assets on trust for the consumers; and (ii) ensure that consumers' assets are appropriately segregated. Although the regulatory framework continues to be subject to ongoing development, this proposal suggests that trusts are the preferred structure for custodian wallet providers to hold cryptoassets.

Can cryptoassets be held in a bankruptcy remote manner?

Under Australian law, the same principles apply in relation to the creation of a valid trust as under English law, that is, there ought to be (i) certainty of object, (ii) certainty of subject matter, and (iii) certainty of intention. However, given the lack of domestic case law with respect to cryptoassets, the position of the Australian courts on the application of these principles remains unclear.

In relation to the first limb, certainty of object is given so long as there is a readily identifiable beneficiary who stands to benefit from the thing to be held on trust. In relation to cryptocurrency this will ordinarily be the bearer of the uniquely identifiable key, which should not be contentious.

In relation to the second limb, certainty of subject matter can be satisfied by identifying the form of property that is to be held on trust. Crucially, the thing to be held on trust must satisfy the definition of 'property' to be capable, in principle, of forming the subject of a trust. Currently, it is still unclear whether the Australian courts would feel

inclined to characterise cryptocurrencies as property for the purposes of trust law. Absent relevant jurisprudence, guidance may be taken from indicative precedents, in particular (i) case law from other common law jurisdictions, (ii) rulings from the Australian Tax Office (ATO), and (iii) limited Australian jurisprudence.

Recent case law in New Zealand, Singapore and England, including as identified above, indicates that cryptocurrency may constitute some form of property, without conclusively defining its precise nature. Australian authorities may be inclined to be guided by other common law jurisdictions in their assessment of whether cryptocurrencies may constitute property.

Further, the treatment of cryptocurrency on the part of the ATO could be a helpful indicator of the position in Australia. Prior to 2017, the ATO treated cryptocurrencies as commodities, thus property. The ATO suggested that Bitcoin was not real property nor a chose in action but some form of intangible property. With some countries, such as the Central African Republic and El Salvador, adopting Bitcoin as legal tender, the ATO reconsidered its position and, with effect from 1 July 2017, has regarded Bitcoin – and other cryptocurrencies that present similar characteristics – as currency for tax purposes. Regardless of whichever position is adopted, either leads to the conclusion that cryptocurrencies may be held on trust.

Guidance may also be taken from the Supreme Court of Victoria's judgment in *Chen v Blockchain Global Ltd*, where the court issued a preservation order under r37.01(1) of the Supreme Court (General Civil Procedure) Rules 2015 (Vic) (Rules). Attiwill J issued an order to preserve the property – namely Bitcoins – until the issues in dispute were settled. By virtue of this order, it is arguable that the Court has implied its acceptance that Bitcoin constituted property, without debating its precise legal nature.

Viewed holistically, it appears that there is a high likelihood for Australian courts to treat cryptocurrency as some form of intangible property, which – as a matter of principle – is capable of being held on trust.

Finally, in relation to the third limb of conditions for the valid creation of a trust, there ought to be certainty of intention. In *Quoine Pte Ltd v B2C2 Ltd*, the Singaporean Court of Appeal struggled to identify this requisite intention to create an express trust, as a result of which the trust failed. The court considered the existence of separate accounts to which the cryptoassets could be credited as well as the relevant terms and conditions between client and exchange as indicative of the requisite intention, but not sufficient on their own. The circumstances of the individual case would need to be considered. Similar to other common law courts, the Australian courts will also consider the facts of each case holistically. The terms and conditions, the handling of assets by the custodian and other factors are likely to play a role in ascertaining this intention. At the same time, the question as to how precisely certainty of intention could be established in the context of cryptocurrencies remains unresolved; it ties in with the issue as to whether cryptocurrency held by a custodian wallet provider can be bankruptcy remote. In fact, the more clearly the custodian treats the assets as being held on trust, the clearer the intention to create a trust, and the higher the likelihood of establishing bankruptcy remoteness.

Ultimately, in the absence of legislation expressly stating that cryptoassets held by a custodian wallet provider are held (or to be held) on trust, the position in Australia will be subject to the jurisprudence being developed by domestic courts.

Spotlight on MiCA – the new EU regulation impacting crypto custody

The EU's new Markets in Crypto-assets Regulation (MiCA) will radically change the regulatory environment for cryptoassets, establishing a broad regulatory framework for cryptoassets in the EU which introduces licensing of cryptoasset service providers and issuers. Over two years after it was first proposed, it is currently going through the final stages of the legislative process and certain provisions will apply from 2024.

Scope

MiCA applies with respect to "cryptoassets", which are defined very broadly as "a digital representation of a value or a right that uses cryptography for security and is in the form of a coin or a token or any other digital medium which may be transferred and stored electronically, using distributed ledger technology or similar technology", with certain specific carve-outs, including for security tokens, which would qualify as financial instruments for the purposes of MiFID II. This means that firms engaging in cryptoasset activities will still need to consider whether they will fall under the MiCA definition of "cryptoassets" or whether they are subject to another regulation.

MiCA creates a broad regulatory framework for cryptoassets in the EU which, among other things, introduces licensing requirements for cryptoasset service providers and issuers of stablecoins. Similar to the UK proposals, MiCA will create an adapted version of the MiFID II regime for financial instruments. One of the new regulated activities is the custody and administration of cryptoassets on behalf of third parties. This is broader than the MiFID II equivalent as it also extends to "controlling" on behalf of third parties and covers both the cryptoassets and the "means of access to such cryptoassets, where applicable in the form of private cryptographic keys".

As currently proposed, this activity would be broader than the closest equivalent regulated activity as it would capture firms that only safeguard (but not administer) assets, as well as extending the custody scope to not just the assets but the means of access to the cryptoasset (e.g., a wallet or cryptographic private key).

Extensive provisions apply to custodian wallet providers, including requirements as to segregation and record-keeping. For example, MiCA includes a specific requirement that client assets should be legally segregated from the cryptoasset service provider's estate in accordance with applicable law to ensure that there is no recourse for creditors of the service provider, in particular on insolvency. This means that, once MiCA is effective, how segregation measures are applied will likely continue to differ between member states. It also remains unclear if a custodian wallet provider is required to maintain segregation of client cryptoassets throughout the custody chain, for example where sub-custodians are used.

Challenges for MiCA

While the new regime aims to bring some consistency across the EU, the difficulty under MiCA, as opposed to MiFID and other EU laws, is that segregation depends on national civil, property and insolvency law. This presents a challenge in many member states where cryptoassets remain to be characterised. The terminology of financial regulatory, civil, property and insolvency law regimes is often not aligned, presenting a further challenge.

Timeline / next steps
MiCA was published in the Official Journal on 9 June 2023 and will enter into force on 29 June 2023. Its provisions in relation to stablecoins will apply from 30 June 2024, while the remaining provisions on issuers of other cryptoassets and cryptoasset service providers including custodian wallet providers will apply from 30 December 2024.

Germany

How can cryptoassets be held in custody?

The German Civil Code (*Bürgerliches Gesetzbuch* (BGB)) stipulates the duties and obligations, including any potential liability, for custody services (*Verwahrung*) generally. The provisions assume that the relevant asset to be held in safe custody will be returned at the end of the custody relationship. If assets are deposited in such a way that ownership is to be transferred to a custodian and the custodian is obliged to return items of the same kind, quality and quantity, then the provisions on loan of goods (*Sachdarlehen*) would apply instead.

To consider whether the German custody services rules apply to any particular custodial wallet service, the characterisation of the relevant cryptoasset(s) must be determined. Such cryptoassets would need to qualify as “objects” (*Sachen*) rather than as mere contractual rights, as contractual rights cannot be held in safe custody under the BGB. If someone is entrusted with holding any contractual rights, the legal analysis would depend on the terms and circumstances. In that case, the relationship may instead be qualified as an agency or another relevant service. The BGB upholds the freedom to contract and enables parties to agree what duties and obligations they owe each other, subject to certain mandatory requirements such as when standard business terms are used or if any terms would be against moral standards (*bonos mores*).

If the relevant cryptoassets qualify as securities, then additional requirements would need to be observed, such as licence requirements and specific requirements for how these securities must be held and segregated, including under the German Safe Custody Act (*Depotgesetz* (DepotG)). A detailed study of these requirements is outside the scope of this paper. Even outside of the securities framework, certain cryptoassets may qualify as financial instruments under German law and the service of holding such cryptoassets in safe custody is a licensable financial service (crypto safe custody business, *Kryptoverwahrgeschäft*) and similar rules would apply where the assets are held in Germany.

With regard to MICA entering into force, the German Ministry of Justice is proposing to introduce a new section 26b into the German Banking Act (*Kreditwesengesetz* (KWG)) dealing with asset segregation. Under the proposed new section, an institution conducting crypto custody business must ensure that the cryptoassets and private cryptographic keys are kept separately from the cryptoassets and private cryptographic keys of the institution. If cryptoassets of several clients are held in custody in a bundle (joint custody), it must be ensured that the share of individual clients in the total assets held in joint custody can be allocated at any time. The proposed addition will also require an institution to ensure that the cryptoassets and private cryptographic keys held in custody cannot be transferred for the institution’s own account or for the account of another person without the client’s express consent.

Additional regulatory requirements published by the German Federal Financial Supervisory Authority (BaFin) must also be observed. There is limited guidance by BaFin on the safe custody aspects and the main focus is on IT security and business continuity.

For further detail on MiCA, see the spotlight on page 24.

Can cryptoassets be held in a bankruptcy remote manner?

In principle, the BGB and the Germany custody services rules may apply to certain cryptoassets and provide some certainty around the position of what happens on the insolvency of a custodian wallet provider. However, this will depend on the relevant cryptoasset, and need to be determined on a case-by-case basis.

The starting point for any legal analysis in respect of cryptoassets is the qualification of the relevant cryptoasset under the definitions of the applicable regime. It must be determined whether any existing financial regulatory provisions apply, based on the definitions of “security” or “financial instrument” under MiFID and also whether it is covered by the definition of “crypto-asset” under MiCA or “crypto asset” under German law. The definitions are not yet aligned, and applying the right definitions is key to determining the applicable regime. Cryptoassets which qualify as financial instruments under MiFID are excluded from MiCA.

The legal nature of the cryptoasset (as “object”, “security” or “contractual claim”) under the applicable civil and insolvency law regime must also be determined, as this is key when determining the transferability requirements, establishment of collateral or treatment in insolvency. The definitions and terminology used in the financial regulatory laws and the civil and insolvency law regimes are not aligned and must be determined independently. However, in light of the requirements under MiCA and its timeline for entering into force, the German Ministry of Justice has proposed a new section 46i KWG, which stipulates a segregation right in insolvency proceedings for cryptoassets as defined under the KWG. Pursuant to the proposed law, a cryptoasset held in custody for a client as part of custodial wallet services is deemed to belong to the client. However, this would not apply if the client has given their consent to the disposal of the cryptoasset for the account of the institution or third parties. The new section clarifies that this rule also applies *mutatis mutandis* to the share of cryptoassets in joint custody to which the customer is entitled and to private cryptographic keys held in isolation. If, in insolvency proceedings over the assets of the institution, the client demands segregation and if the segregation is not to be effected by transferring the cryptoasset to another institution which also offers the custodial wallet services, the client shall bear the costs of the segregation.

Japan

How can cryptoassets be held in custody?

In Japan, custody services in respect of traditional securities such as shares and bonds are generally provided in such a way that only the possession is transferred to the custodian wallet provider while the title to such securities remains with their holders. The terms of such custody services are distinct from those of "trust services" which can also be provided under the Japanese regulatory framework. The key difference between the arrangements is that trust services involve title transfer of assets from the original holder of the assets to the trustee, with the transferred assets being legally recognised as segregated from the other assets of the trustee, and the holder of the beneficial interest in the trust ultimately benefitting from the assets.

With respect to cryptoassets, it is unclear if custodial wallet services would be characterised as custody services or trust services, mainly due to the uncertainty under Japanese law as to who holds the title to the cryptoassets and if such title may be transferred to the custodian wallet provider upon the establishment of the custody relationship.

However, despite the uncertainty as to the legal nature of the relationship between the custodian wallet provider and the holder of the cryptoassets, "cryptoasset custody services" have been regulated under the Payment Services Act of Japan (the JPSA) since 2020. These are defined as the management of cryptoassets on behalf of another person.

Under the JPSA, custodian wallet providers must manage clients' money separately from their own money in such a way that clients' money is entrusted to a legally segregated trust established by a regulated trust company and must undergo periodic audits with regard to such management status. They must also manage clients' cryptoassets separately from their own cryptoassets in such a way that private keys of at least 95% of such clients' cryptoassets are kept in 'cold' wallets which comprise offline storage, which must also undergo periodic audits. Custodian wallet providers can keep the private keys of no more than 5% of the value of the aggregate amount of any client's cryptoassets in 'hot' wallets which are online, only if they hold cryptoassets of the same type and quantity separately and keep them segregated from other cryptoassets they hold.

In addition, the JPSA provides certain protections to the clients of custodian wallet providers including, among other things, in the case of the insolvency of the custodian, a priority claim for clients over the segregated or pre-protected assets of the custodian wallet provider.

In addition to the regulation of custodial wallet services under the JPSA, trust companies have been permitted to accept cryptoassets as trust assets under the Trust Business Act since 2020. For the purpose of facilitating investments in cryptoassets by institutional investors, the Japanese government has recently amended the relevant ordinance to also permit trust banks to accept cryptoassets as trust assets from a regulatory perspective.

When trust companies or trust banks conduct cryptoasset trust business, while these activities are generally regarded as trust rather than as custody services, they are required to meet requirements similar to those of custodians under the JPSA in relation to the segregation of cryptoassets and limitations in terms of private key storage, in addition to the general requirements applicable to trust companies or trust banks in conducting trust business under the Trust Business Act and/or the Act on Engagement in Trust Business Activities by Financial Institutions.

Can cryptoassets be held in a bankruptcy remote manner?

Although the above-mentioned regulatory framework does not provide any clear view of the legal nature of cryptoasset custody services under Japanese law, in the case of FTX US's Chapter 11 proceedings, it is reported that the assets (money and cryptoassets) of clients of FTX Japan (a subsidiary of FTX US) were treated as assets out of scope of Chapter 11. We assume that such treatment was made based on the opinion of legal counsel to FTX US, taking the Japanese regulatory framework into account. While the exact reasons for the opinion and treatment are unknown, FTX Japan is now in the process of returning the assets to its clients. This case illustrates that, in the US, the segregation of cryptoassets as contemplated under the Japanese regulatory framework is recognised such that the segregated cryptoassets should not be treated as constituting the assets of the custodian wallet provider. There is no assurance, however, that the same treatment would be applied in other jurisdictions in a similar situation.

Jersey

How can cryptoassets be held in custody?

The position under Jersey law is similar to that under English law, in that an express or implied trust is the only legal structure under which a custodian wallet provider can hold cryptoassets, such that the cryptoassets are not the custodian wallet provider's property and not recorded on its balance sheet.

Jersey trust law draws heavily on English trust law and, although Jersey has its own trust legislation and court system, the regimes are similar with a broadly equivalent application of fiduciary rules and obligations. Jersey trust law is designed to allow flexibility as between settlors and trustees; for example, the default requirement for a trustee to preserve and enhance the value of trust property can be ousted; powers and duties can be reserved to a settlor or granted to non-trustee parties instead.

From a regulatory standpoint, Jersey has (for the most part) decided not to introduce specific laws and regulations to cater for cryptoassets and instead has chosen to regulate this new asset class within its existing financial services legal and regulatory framework.

"Custody" is not a (conduct) regulated activity *per se* under Jersey's principal financial services law, except when acting as a custodian in relation to collective investment funds. However, acting as a trustee of an express trust "by way of business" (i.e., being remunerated) is a regulated activity and requires a "trust company business" (TCB) licence from the Jersey Financial Services Commission (JFSC). However, this category of regulated business has traditionally been used for trust companies providing registered office, directors and administrative services to corporate structures domiciled in Jersey and is not a natural fit for the custody of cryptoassets. Service providers who, for the main part, fall under other regulatory regimes and offer custodian services as an

incidental part of their services will likely benefit from an exemption from the requirement to hold a TCB licence.

To evidence an "express trust", a custodian wallet provider seeking a TCB licence from the JFSC will need to make clear in its terms and conditions that it is holding client assets on trust and that its custody function constitutes an express trust (with all the features required for an express trust being present). In an implied trust arrangement, where the provision of trust services is not the dominant feature of the relationship or the applicable licensing regime, a custodian wallet provider could act without fulfilling the requirements of an express trust (and therefore not be required to hold a TCB licence).

Separately, Jersey has recently introduced the Financial Action Task Force's Virtual Asset Service Provider (VASP) Guidelines into its domestic AML legislation to ensure its continued compliance with international standards. Acting as a custodian wallet provider falls within one of the limbs of the VASP definition – "*carrying on the business of…safekeeping or administration of virtual assets or instruments…… for or on behalf of another natural or legal person*". Accordingly, a Jersey custodian wallet provider needs to register as a VASP with the JFSC. Such registration will not give the custodian wallet provider a "regulated" status but will make it subject to Jersey AML requirements. In this context, the JFSC will expect to see custodian wallet providers using some form of chain analytics to verify sources of funds. In addition, because crypto is deemed by the JFSC to be a sensitive / high-risk activity, any application for VASP registration will be scrutinised carefully.

Can cryptoassets be held in a bankruptcy remote manner?

The position under Jersey law in relation to what bankruptcy remoteness means is similar to that under English law. If a custodian arrangement is used (i.e., the assets are held on trust), then the assets will typically fall outside the pot of assets that can be used to satisfy the insolvent company's creditors. This is subject to the proviso that the assets cannot have been transferred into a trust in a reactionary manoeuvre to defeat creditors. Therefore, a custodian wallet provider arrangement should ideally be built into the structure from the outset.

Trust law in Jersey borrows much from English law and therefore the considerations set out above, such as regards certainty, will apply. There is a dearth of authority in Jersey on custodian arrangements, particularly in the crypto context. In a pure trusts context, the Jersey courts have held that, when a trust becomes insolvent, the trustees' duties will shift from the beneficiaries to the trust's creditors, who will rank pari passu. However, the idea of a custodian arrangement is, of course that the entities housing the assets which are held on trust should not themselves become insolvent.

The Netherlands

How can cryptoassets be held in custody?

The Dutch Civil Code (*Burgerlijk Wetboek* (DCC)) includes a regime for the provision of custody services (*bewaarneming*) in relation to tangible goods (*zaken*), which requires that the relevant goods be kept in safe custody and returned at the end of the custody relationship. There are also other regimes in the DCC which determine the basis on which assets are held by someone other than the original owner, including provisions on hire (*huur*), which also broadly apply to tangible goods only, with some limited exceptions that generally would not apply to the custody of cryptoassets.

In respect of custody of non-tangible assets, including securities or (other) property rights, there is no general principle that the assets held or controlled by a custodian are assets which do not belong to the custodian (and are not available to its creditors, either before or after insolvency) but to the custodian's client(s), and the nature of the claim that the client has in respect of the asset will depend on the applicable contractual arrangements and the legal framework. In the case of a custodian wallet provider holding the cryptographic keys necessary to control certain cryptoassets, any proprietary claim on such cryptoassets by a client cannot, in principle, be based merely on contractual terms.

In the Netherlands, well-established law and market practice has developed around the provision of custody services for securities. There is a legal framework, embedded in the Securities Giro Act (*Wet giraal effectenverkeer*), pursuant to which a custodian can hold securities such that the securities are not the custodian's property and are not recorded on its balance sheet. This means that clients have a proprietary claim to the securities. However, the Securities Giro Act framework is only relevant for the safeguarding of certain types of securities within the scope of MiFID, including transferable securities that are administered on securities accounts in the Netherlands and that can be traded by book-entry delivery. The framework is not applicable to cryptoasset service providers (including custodian wallet providers).

Another way of providing custody services for securities that also complies with the MiFID requirement to safeguard client financial instruments consists of using a bankruptcy-remote legal entity (usually a foundation (*stichting*)) that serves as a custody special purpose vehicle. Even though clients do not have a proprietary claim on the investment firm or the foundation in relation to their financial instruments in such structure, they have a claim for redelivery of assets. In this structure, the custody vehicle is the legal owner of the assets and protection of the client assets is achieved by making the custody vehicle 'bankruptcy remote', including by limiting its commercial objects and imposing other requirements on the custody vehicle and its management. The restrictions for such custody vehicles are set out in Dutch law for investment firms that hold client assets. Again, these restrictions do not apply to cryptoasset service providers. Cryptoasset service providers may, if their contract with clients is governed by Dutch law, choose to establish a similar 'bankruptcy-remote' foundation to better protect client assets.

Custody services in relation to cryptoassets are not currently regulated in the Netherlands, other than through Dutch AML laws that have implemented the relevant provisions of the EU Anti-Money Laundering Directive. The Dutch AML laws provide that custodian wallet providers must be registered with the Dutch Central Bank if they provide their services to Dutch residents, that persons who hold a management function in such entities or are the beneficial owners of such entities, are fit and proper persons, and that such entities must follow certain organisational requirements. For these purposes, a 'custodian wallet provider' is defined as an entity that provides services to safeguard private cryptographic keys on behalf of its clients, to hold, store and transfer virtual currencies. These AML laws do not regulate the actual custodial structure and how this can serve to protect clients.

In practice, the Dutch Central Bank requires custodian wallet providers incorporated in the Netherlands to segregate clients' cryptoassets by using a bankruptcy-remote legal entity (such as a foundation), similar to the requirement applicable to investment firms described above. If contracts with Dutch clients are not governed by Dutch law, then foreign law asset protection measures, including trust arrangements, may be recognised in the Netherlands as a matter of private international law.

As with Germany, the introduction of MiCA across the EU will significantly impact the regulatory environment for the provision of cryptoasset custodial services in the Netherlands. See the spotlight on MiCA on page 24 for further detail.

Can cryptoassets be held in a bankruptcy remote manner?

In the Netherlands there are no existing legal frameworks pursuant to which a custodian wallet provider can hold cryptoassets in a bankruptcy-remote way, such that the cryptoassets are not the custodian wallet provider's property and are not recorded on its balance sheet.

However, a bankruptcy remote custody vehicle may be used by a custodian wallet provider. As described above, the 'bankruptcy remoteness' of such a vehicle is achieved by limiting the commercial objects of the custody vehicle and imposing other requirements on the vehicle and its management. An insolvency of such a vehicle can lead to similar outcomes, as where a common law custodian trustee is subject to insolvency proceedings, in the sense that the assets included in both types of bankruptcy estates are primarily meant for fulfilling the claims of the cryptoasset clients. In this respect it is also relevant to note that the bankruptcy-remote custody vehicle would, in principle, not have any creditors other than the cryptoasset clients. Having certainty as to which assets are held in custody and as to the persons for whom the assets are held, including by maintaining accurate books and records, is also relevant where the cryptoassets are held in a bankruptcy-remote custody vehicle, even if it is only to minimise potential losses.

Singapore

How can cryptoassets be held in custody?

Under Singaporean law, a trust is also the legal structure under which a custodian wallet provider can hold cryptoassets such that the cryptoassets are not the custodian wallet provider's property and are not recorded on its balance sheet, similar to the position under English law.

Custodial services in relation to cryptoassets are not currently regulated in Singapore. However, custodial services for digital payment tokens will be added to the list of payment services that are licensed and regulated under the Payment Services Act 2019 (PS Act) once the Payment Services (Amendment) Act 2021 (Amendment Act) comes into force. The Amendment Act has been enacted but will only be effective from a future date to be notified in the Gazette.

Custodial services that will be regulated pursuant to the Amendment Act comprise: (a) any service of safeguarding a digital payment token, where the service provider has control over the digital payment token; (b) any service of carrying out an instruction for a customer relating to a digital payment token, where the service provider has control over the token; (c) any service of safeguarding a digital payment token instrument, where the service provider has control over one or more digital payment tokens associated with the digital payment token instrument; and (d) any service of carrying out an instruction for a customer relating to one or more digital payment tokens associated with a digital payment token instrument, where the service provider has control over the digital payment token instrument. A "digital payment token instrument" means any password, code, cipher, cryptogram, private cryptographic key or other instrument that enables a person: (i) to control access to one or more digital payment tokens; or (ii) to execute a transaction involving one or more digital payment tokens.

Entities carrying on a business of providing digital payment token custodial services will be required to be licensed under the PS Act once the Amendment Act comes into force, and, among other conduct of business requirements, would be subject to AML requirements.

Under the Trust Companies Act 2005, a person carrying on trust business in or from Singapore must hold a trust business licence unless an exemption applies. This would include a bare trustee (i.e., a trustee who has a nominal interest in the subject matter of a trust).

The Monetary Authority of Singapore (MAS) issued a **consultation paper** on certain proposed consumer protection regulatory measures for digital payment token services in October 2022. MAS proposed that digital payment token service providers should ensure that customers' assets are segregated from the digital payment token service provider's own assets, and held for the benefit of the customer (for instance, in a trust account or arrangement). MAS also sought views on whether having an independent custodian would be appropriate in the context of the digital payment token sector, and whether there are other more effective measures to address concerns, including in relation to customers' assets in the event of a service provider's insolvency.

To implement the proposals, MAS will first issue Guidelines taking into account industry responses to the consultation paper, which set out their expectations for digital payment token service providers. Details on the specific regulatory requirements and subsidiary legislation will be separately published for consultation in due course.

Can cryptoassets be held in a bankruptcy remote manner?

The position in Singapore is similar to that under English law as described above.

United Arab Emirates (UAE)

How can cryptoassets be held in custody?

The UAE is another civil law system where the law does not recognise trusts, and there is no system of binding legal precedent "onshore" in the UAE. However, there are several relevant regulatory frameworks in individual emirates and the UAE's financial free zones, which introduce licensing and outline other requirements that are likely to apply to custodian wallet providers.

In the emirate of Dubai, the newly established Virtual Assets Regulatory Authority (VARA) recently published a rulebook on custody services (VARA Rulebook) as part of its Virtual Assets and Related Activities Regulations 2023. The VARA Rulebook determines that the relationship between a custodian of cryptoassets (or virtual assets) and a client is a contractual arrangement under which a client lawfully in control of, or entitled to control, a cryptoasset, transfers control (and not legal title) of the cryptoasset to the custodian wallet provider solely for the purpose of receiving custody services. The VARA Rulebook then sets out several requirements governing this relationship. Crucially, it stipulates that cryptoassets held by a cryptoasset service provider providing Custody Services (as defined below) are not depository liabilities or assets of the custodian wallet provider provided that the applicable requirements are adhered to, which includes a prohibition on rehypothecation of custodied assets, even with client consent.

Similar rules apply in the UAE's financial free zones – the Abu Dhabi Global Market (ADGM) and the Dubai International Financial Centre (DIFC). The ADGM Financial Services and Markets Regulations 2015 (as recently amended in contemplation of Virtual Assets) have a regulated activity of "providing custody" in respect of cryptoassets (again termed virtual assets) that includes the provision of a custodian wallet and/or safeguarding and administering cryptoassets on behalf of clients by way of business, including holding private cryptographic keys on behalf of clients in order to hold, store and transfer cryptoassets. The DIFC has also recently amended its regulations to permit a similar regulated activity of "providing custody" in respect of "Crypto Tokens", although it further restricts the cryptoassets in respect of which activities can be conducted to a specific list of "recognised" tokens (including Bitcoin, Ethereum and Litecoin) – this being similar to, but more restrictive than, the ADGM's requirement that activities be conducted in relation to "accepted" virtual assets.

Can cryptoassets be held in a bankruptcy remote manner?

The position on insolvency of a custodian holding client assets in the UAE is unclear as, for the most part, the onshore legal system does not recognise trusts in this context.

As outlined above there are regulatory frameworks in individual emirates including Dubai's VARA Rulebook, which introduce licensing and outline other requirements that are likely to apply to custodian wallet providers. These include requirements for the segregation of custodied assets. However, any provisions in the VARA Rulebook which seek to identify the custodied assets as separate from assets of the custodian would not override UAE Federal bankruptcy laws as applicable in the emirate of Dubai.

The VARA Rulebook also provides that custodian wallet providers must segregate the cryptoassets of each client in separate wallets (so that each wallet contains cryptoassets of one client) and maintain control of custodied cryptoassets at all times. Additionally, the custodian wallet provider must be established as a separate legal entity from any other member of their group providing other cryptoasset-related services, and have adequate policies and procedures in place to ensure operational and physical segregation between those staff providing custody services and any other parts of the business. The scope of "Custody Services" as defined in the VARA Rulebook is narrower than its equivalent under English law. The ADGM rules similarly mandate segregation of custodied assets.

There are separate regimes in ADGM and the DIFC that are likely to be helpful.

There is an exception to UAE Federal bankruptcy laws for the ADGM and DIFC. Both are financial free zones with separate regimes for commercial and regulatory laws that recognise the application of trusts and equivalent principles to English law more broadly, subject to relevant formalities being followed. Whilst the ADGM and DIFC often apply more restrictive rules – for example, only permitting VASPs to deal in specific types of approved virtual assets – these regimes offer greater clarity in this area for market participants and have their own separate court system, which would govern assets (digital and otherwise) custodied in the financial free zones. While these rules mandate segregation of assets, they remain untested in a contested insolvency context.

United States (US)

How can cryptoassets be held in custody?

Under US law, the relationship between a custodian wallet provider and its client is governed, in the first instance, by state law. It may be further impacted by applicable federal and state legal and regulatory requirements which apply to custodian wallet providers that are regulated and supervised institutions; for example, trust companies, banks, investment advisers and broker-dealers.

A custodial relationship can take many different forms, and the facts and circumstances will affect the legal analysis. While the documentation is critical, it is not always determinative. In the institutional market, the form the relationship often takes is that between an entitlement holder and securities intermediary governed by Uniform Commercial Code (UCC) Article 8, as enacted in the relevant state whose law governs the relationship. A custodial relationship may fall within UCC Article 8 if the asset being

maintained is a "financial asset", which includes both securities and any property that is held by a securities intermediary for another person in a "securities account"[5] if the securities intermediary has expressly agreed with the other person that the property is to be treated as a financial asset under UCC Article 8. A typical custodial agreement for cryptoassets seeking to qualify for this treatment will therefore contain an express opt-in clause to UCC Article 8.

If the custodial relationship is subject to UCC Article 8, then the custodian wallet provider, as securities intermediary, will be subject to certain duties, including a duty to maintain a sufficient quantity of custodial assets to satisfy the client's securities entitlements, a duty to comply with the client's instructions and a prohibition on granting security interests in the client's assets without consent, and the custodian wallet provider must exercise due care in accordance with reasonable standards, unless the parties otherwise agree. UCC Article 8 specifically provides that financial assets held by a securities intermediary are not property of the securities intermediary, and that each entitlement holder's property interest is a *pro rata* property interest in all interests of the securities intermediary in the specific type of financial asset that is being held for the entitlement holder by the securities intermediary.

Other forms that a custodial relationship can take under state law include a bailment or trust. A written agreement is not necessarily required for a bailment or trust relationship to form under state law, and a court may conclude from the circumstances that such a relationship was created. In practice, custodial agreements are typically in place for custodial wallet services, particularly in the institutional context, and a bailment or trust relationship is unlikely to be established in the absence of specific provisions that would support a determination that such relationship existed between the custodian wallet provider and its client. If the custodian wallet provider is recognised as the bailee or trustee of the client, then the custodian wallet provider would owe certain duties to the client as bailor or trust beneficiary. Such duties include, if the custodian wallet provider is recognised as a bailee, a duty to exercise ordinary care in keeping and safeguarding property of the bailor or, if instead the custodian wallet provider is recognised as the client's trustee, then the duties of loyalty and prudence, among others.

Alternatively, there may be other legal forms of relationship between the custodian wallet provider and its client. For example, there may only be a contractual relationship in which the custodian wallet provider has no special duties, the relationship is one between debtor and creditor, and the client may have only an unsecured monetary claim (not a claim to actual custodial assets) on the custodian wallet provider's insolvency.

Finally, any body of federal or state regulation that applies to one or both parties to the custodial relationship may impose additional requirements. As regulatory obligations applicable to the parties may vary widely depending on individual circumstances, we do not discuss all potentially applicable regulatory requirements here.

5 An account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset.

SEC proposal for new Safeguarding Rule

In February 2023, the SEC proposed amendments to the so-called "Custody Rule" under the Investment Advisers Act of 1940 that would expand the scope of the rule and impose extensive new requirements for registered investment advisers who custody assets on behalf of their clients.

Scope

The Custody Rule currently applies in the context of a registered investment advisor's custody of "funds and securities." The proposed amendments would expand the scope of the Custody Rule to cover all client "assets," including cryptoassets. The proposed amendments to the rule would require that an investment adviser maintain client assets with a qualified custodian that has "possession or control" of those assets and would define that term to mean holding assets such that the qualified custodian is required to participate in any change in beneficial ownership of those assets, that the qualified custodian's participation would effectuate the transaction involved in the change in beneficial ownership, and that the qualified custodian's involvement is a condition precedent to the change in beneficial ownership. The proposed amendments would also require advisors with custody of client assets to segregate such assets. In particular, the proposal would require that client assets: (i) be titled or registered in the client's name or otherwise held for the benefit of that client; (ii) not be commingled with the adviser's assets or the advisor's related persons' assets; and (iii) not be subject to any right, charge, security interest, lien, or claim of any kind in favour of the adviser, its related persons or creditors, except to the extent agreed to or authorised in writing by the client. The amended rule would also require investment advisers to enter into a written agreement with a qualified custodian, which marks a change to current market practice as investment advisers are not always party to custody agreements between the custodian and the advisory client.

Other new requirements under the proposal include that a qualifying bank or foreign financial institution must hold custodial client assets in an account that is designed to protect such assets from creditors of the bank in the event of the insolvency or failure of the bank/foreign financial institution. The proposed amendments to the Custody Rule would also impose certain new client indemnification requirements, in relation to losses of client assets resulting from the custodian wallet provider's negligence, recklessness or wilful misconduct.

Impact on custodian wallet providers

If adopted as proposed, the amendment would impact current custodial market practices for cryptoassets. For example, the requirement for client assets to be maintained with a qualified custodian that has possession or control of the assets means that advisers with custody of client assets could not "prefund" trades on cryptocurrency trading platforms that are not qualified custodians (i.e., they could not transfer the assets to the exchange prior to the execution of the trade).

The introduction of these changes would potentially result in significant legal fees and compliance costs for custodian wallet providers. Compliance may also present practical challenges, in the short term at least. For example, there are currently very few providers of cryptoasset insurance and it is likely to be difficult to find comprehensive, cost-effective policies that would meet the requisite criteria. It is likely that these increased costs will be passed on to clients. This may be commercially unsustainable and ultimately may lead to a reduction in the number of firms offering custodial wallet services in the US.

Can cryptoassets be held in a bankruptcy remote manner?

Under U.S. bankruptcy law, the commencement of a bankruptcy case creates an estate, commonly referred to as a "bankruptcy estate". Upon the filing of a case, all of the debtor's legal and equitable interests in property, wherever located and by whomever held, become property of the estate. Property of the estate is then available to satisfy the claims of creditors in accordance with the priority scheme set out in the U.S. Bankruptcy Code. For custodian wallet providers that are regulated institutions, such as trust companies, banks, and broker-dealers, special insolvency or resolution regimes may apply under different bodies of state and federal law and regulation which could potentially result in varying treatment of custodially held digital assets. Because of the diversity of such regimes, this section focuses on federal bankruptcy law.

Whether a debtor has an interest in property that becomes property of the estate is a question of applicable non-bankruptcy law, typically state law. In particular, property that is held by a debtor on trust for another, or that is held by a debtor as bailee, generally is not considered property of the debtor's estate. In the case of trust property, that is because the Bankruptcy Code expressly provides that property in which the debtor holds only bare legal title but no equitable interest becomes property of the estate only to the extent of the legal interest, but not to the extent of any equitable interest. Likewise, in the case of property held by a debtor as bailee, the property subject to the bailment never becomes property of the debtor as a matter of applicable non-bankruptcy law. In considering whether property held by a debtor is the subject of a bailment (and therefore does not become property of the estate), courts focus on whether the debtor holding the property is obligated by the contract to return the identical property to its owner, or simply property of "like kind". If an Article 8 "opt-in" has occurred, the cryptoassets in question may not be property of the estate and/or subject to the claims of creditors. However, this proposition has not yet been tested in the context of a custodian wallet provider.

In the crypto context, the terms of service offered by a crypto service provider – such as an exchange on which cryptoassets may be purchased and sold – commonly include language suggesting that the service provider is acting as a custodian or "fiduciary" under applicable law. Such terms may even state that title to the assets will remain with the user and not be transferred to the custodian wallet provider. However, such language by itself does not conclusively establish that any cryptoassets are held on trust for the user, nor does it clearly create a bailment. Other characteristics that may impact the analysis include (a) where cryptoassets held by a third party are not individually segregated into unique blockchain addresses for each user, but instead are held in shared blockchain addresses (i.e., omnibus wallets) over which the custodian wallet provider maintains the private keys, (b) where cryptoassets are commingled with assets belonging to other clients or the custodian wallet provider itself, or (c) where cryptoassets are held by a third party who reserves the right to use the cryptoassets, such as lending them to another third party, staking them for additional yield, or otherwise exercising rights of "rehypothecation". All of these treatments are not consistent with a typical trust or bailment relationship and, should a bankruptcy case be filed by the third party / alleged "custodian", may result in converting what the client thought of as being their cryptoassets into an unsecured claim against the custodian wallet provider's bankruptcy estate.

The establishment of a true and valid trust vehicle or a bailment that is properly operated at formation (at least from a documentary perspective) will help ensure that custodial assets remain property of the client and do not become property of the custodian wallet provider's bankruptcy estate. This requires a careful reading of the applicable agreement - in a number of recent cryptocurrency bankruptcy filings, a careful reading of the applicable documents would have demonstrated that there was no trust or bailment relationship created or that the creation of such a relationship could be disputed. It next requires that the custodian wallet provider abides by the terms of the applicable trust or bailment agreement with respect to the property – thus a good and reputable custodian wallet provider is needed. Where a custodian wallet provider breaches the agreement, the custodian wallet provider will likely be liable, although this outcome will not necessarily result in a return of client assets.

FOCUS ON SEGREGATION

Meaning

It is important to clarify what is meant by the term 'segregation' in relation to custody assets. Generally, segregation may refer to the separation of one client's assets from the assets of the custodian, and from the assets of all other clients of the same custodian, or may refer to just the separation of one client's assets from the assets of the custodian. When referring to assets recorded in accounts, these types of segregation can be achieved by separate accounts.

Often, custodians hold traditional assets on behalf of their clients with sub-custodians that are members of, or otherwise have access to, centralised financial asset depositories. For example, custody assets that are dematerialised securities may be held by a custodian with a sub-custodian which, in turn, has a custodial account with a central securities depositary. In such securities custodial chains, in the books of the primary custodian with whom the custodial client has a contractual relationship the securities of the custodial client are typically segregated from the securities of any other person by the maintenance of a separate account recording those securities. In the books of the primary custodian's sub-custodian, the securities of the custodial client are typically held in an omnibus client account in which the assets of a number of the primary custodian's clients are commingled[6], therefore the client assets are segregated from the securities of the primary custodian, the sub-custodian, and other clients of the sub-custodian, but not from securities of other clients of the primary custodian. Similar arrangements apply where the sub-custodian holds the assets through its own delegate. It is usual (and regulatory requirements normally require) that the primary custodian maintains a minimum level of segregation: in its own books, by maintaining a separate account for each client; and, in the books of any sub-custodian, by requiring the sub-custodian to record the assets of the primary custodian's clients in an account for the primary custodian which is separate from the account in which the primary custodian's own assets are recorded. It would be highly unusual (and generally impractical) for a primary custodian to be required (by regulation or contractual terms) to ensure an individual client's assets are held in a separate account throughout the entire custody chain (although separate client accounts might be feasible at initial levels).

Given that a custody client's relationship is with its custodian, and it is the custodian from whom it will seek to recover its assets, it is essential that the custodian maintains a clear and accurate record of what it holds for each client and that each client's assets are actually held by the custodian (i.e. are in the custodian's possession and control). Typically, a regulated custodian is required to maintain separate records of custody assets held for each client in its own books, and, when holding client assets with a sub-custodian (or a central securities depository in which it or its sub-custodian is a participant), is required to maintain with that entity omnibus accounts recording custody assets held for the custodian's clients which are separate from accounts recording the custodian's own assets. The EU's Central Securities Depositories Regulation (CSDR) does not require CSD participants who are custodians to maintain individual CSD

6 In a sub-custodial relationship, the primary custodian becomes the client of its sub-custodian, and the sub-custodian establishes one or more accounts in the name of the primary custodian. A sub-custodian may, at the request of the primary custodian, establish an account in its books for the primary custodian but designated with the name of an individual client of the primary custodian, but in such case the sub-custodian does not become the primary custodian for such custodial client.

accounts for each client, but does require the custodian to offer clients the option of their assets being held in an individual client account or omnibus client account in the CSD, together with disclosure of the costs of each option, so that clients may make a choice, balancing potential risk against the cost.

What might segregation of cryptoassets by custodian wallet providers look like in practice?
Segregation of assets can be achieved through the use of multiple wallets. This is technology dependent but separate on-chain wallets may be set up for different clients. While it may go beyond what is prescribed by law or regulation, a simple and elegant solution for the segregation of client assets of each client from the assets of any other person is holding each client's cryptoassets in separate unique blockchain addresses. However, multiple addresses of the same cryptoasset may not be easily configured and managed for all custody technology solutions. For example, utilising HD wallets is a practical way to create multiple wallets from a singular master 'seed phrase' and enables manageable segregated storage of client and proprietary assets. Whereas, managing multiple addresses of the same asset is often impractical on hardware wallets and lightweight (hot) wallets (if possible at all). Moreover, the custodial fees charged by custodians for holding each client's cryptoassets at a separate unique address may be cost-prohibitive for some customers.

Examples of segregation requirements

The question of what is workable in practice must also be considered. In the context of the EU Alternative Investment Fund Managers Directive (AIFMD) and Undertakings for Collective Investment in Transferable Securities Directive (UCITS), the original Level 2 Regulations required that a fund depositary should not only maintain separate records for each fund in its own books but should also require a delegate to maintain separate accounts in which only the assets of the depositary's AIF clients and (separately) UCITS clients would be held. Even under the original proposals, neither AIFMD or UCITS sought to impose an extreme approach of requiring separate accounts for each fund to be maintained with each sub-custodian and throughout the custody chain. Given the widespread usage of omnibus client accounts, the Level 2 Regulations were subsequently amended to state that the assets of both AIF clients and UCITS clients could be held by the depositary in an omnibus client account with its delegate.

Under the MiFID regime, there is no requirement that client assets must be held by a custodian on trust (or other local law equivalent), but minimum account segregation requirements are imposed, namely the requirement for the custodian to maintain its own records and accounts which enable the custodian at any time to distinguish the assets held for a particular client from assets held for other clients (or the custodian's own assets), and also to take the necessary steps to ensure that client securities held by a delegate of the custodian are identifiable separately from the securities belonging to the delegate or the custodian. It is interesting to note that, in relation to client assets held with delegates, the required segregation may be achieved by separate accounts maintained by the delegate, or by "other equivalent measures that achieve the same level of protection". It is not wholly clear what "other equivalent measures" might be, but this indicates that a technology solution that provides separate identification of client assets other than by maintaining separate accounts would be acceptable.

Technical considerations for crypto omnibus accounts

Segregation of a specified client's cryptoassets within a commingled blockchain address is theoretically achievable for unspent transaction output (UTXO)-based protocols. In these scenarios segregation could be facilitated through the identification of specific UTXOs and maintenance of a record of ownership. However, this requires extensive monitoring and only works if the exact same amount is used for any future transactions.

Commingling of cryptoassets on account-based protocols is likely to be impractical as these protocols do not support identification of specific asset holdings beyond maintaining a private external record (ledger) of allocated ownership. It is therefore easier and more transparent to keep cryptoassets in segregated wallets (own assets vs client assets and even between client assets).

Select blockchains facilitate practical segregation of cryptoassets within an individual address by operating a 'Tag' feature. This 'Tag' is used to denote specific sub-allocations of cryptoassets within a singular blockchain address and can used by senders to communicate with the receiving party to distinguish ownership of assets received to a single address.

Regardless of the specific blockchain protocol, if cryptoassets are commingled on a single blockchain address, then appropriate care must be given to ensure that transaction fees are accurately deducted exclusively from the transacting client's balance. This could become particularly impractical when a client wishes to withdraw their entire position, as exact fees are not known at the time of transaction initiation, and it must be ensured that any fees are not deducted from the remaining commingled balance.

Certain blockchains may permit one or more distinct cryptoasset(s) (or tokens) to be held within a single address, for example ERC-20 tokens on the Ethereum blockchain. These tokens may be either fungible or non-fungible. Special consideration is required when processing outbound transfers from a blockchain address that contains multiple tokens within a single address. Transfer of these tokens will require transaction (gas) fees payable by the mainnet cryptoasset. Therefore, regard must be given to maintenance of a record of ownership over all relevant assets in any such arrangement. For example, a custodial wallet provider may hold its own ETH which funds client transactions of ERC-20 tokens where the client does not hold ETH.

What does segregation achieve?

Segregation is an important mechanism, even though the degree to which segregation of clients' assets would provide protection for such client assets largely depends on the contractual terms and conditions governing the purported custodial relationship and the relevant legal and regulatory framework in the jurisdiction from which the custody services are provided. For example, the maintenance of separate client accounts by a custodian in its books and with its sub-custodian may be regarded as evidence that the assets recorded in such accounts are held on trust (and therefore not available to creditors of the custodian) as outlined above, or may be regarded as conclusively showing the property rights of the client which must be satisfied in priority to all claims of other creditors of the custodian.

If account segregation does not provide the necessary level of assurance of protection for client assets, other steps may be necessary. For example, under the MiFID regime, if, as a result of applicable law in an EU jurisdiction "including in particular the law relating to property or insolvency", firms cannot comply with the segregation requirements (i.e. the requirements for separate client accounts in the custodian's books, and omnibus client accounts with sub-custodians) in order "to safeguard clients' rights to satisfy the requirements" to make "adequate arrangements to safeguard the ownership rights of clients, especially in the event of the investment firm's insolvency", the relevant jurisdiction must "put in place arrangements to ensure that clients' assets are safeguarded to meet" the relevant objectives. Under AIFMD, a depositary must notify the fund's manager if the depositary becomes aware that account segregation of assets (as required by AIFMD, separate client accounts in the depositary's books and omnibus client accounts with delegates) is not sufficient to ensure protection of the fund assets on the insolvency of a delegate of the depositary. Under UCITS, EU member states must ensure that, on the insolvency of an EU depositary or any of its delegates, the fund assets are unavailable to creditors of the depositary or any delegate. Another approach may be seen under the Electronic Money Regulations (EMRs) and Payment Services Regulations (PSRs) in the UK, although the relevant requirements relate to the holding of safeguarded money. Under the EMRs/PSRs requirements, it is interesting to note how the protection of such money is achieved, since, rather than requiring that the money is held on trust, the legislation (to date at least) has been determined to impose a statutory priority, so that safeguarded money must be paid out in priority to all other claims against the entity safeguarding the funds, notably from the relevant safeguarded account and also from the entity's own funds.

As may be seen, the effect of segregation may vary. Considering the EU and UK:

- where MiFID applies, segregation (in the books of the custodian and its delegates) should achieve protection against the custodian's insolvency (and an EU member state will be in breach of its obligations under MiFID if this is not the case).

- where AIFMD applies, segregation by use of omnibus client accounts at the level of the delegate may not achieve protection against the delegate's insolvency, but if this is the case, the depositary must notify the fund manager.

- where UCITS applies, as a separate requirement, EU member states must ensure that, on the insolvency of an EU depositary or any of its delegates, the fund assets are unavailable to creditors of the depositary or any delegate.

- where the EMRs/PSRs apply in the UK, safeguarded monies may be recovered under the statutory priority, even if there has been no segregation.

How can segregation be applied to cryptoassets?

There may be challenges applying the same laws and principles to custody of cryptoassets.

As indicated above, although the holding of assets (whether dematerialised securities or cryptoassets) on trust under English law provides clear protection of the assets against claims from creditors of the custodian, there can be difficulties with establishing that a trust exists. This may be the case if, on the facts, based on the contractual documentation and actions of the parties, there is an argument that it is not clear that there was an intention to hold cryptoassets on trust, or it is unclear which cryptoassets are held for which client. In principle, an entity providing custody wallet services under English law should normally be regarded as holding cryptoassets for the client as trustee, but much will depend on what the relevant agreed terms actually say. It is possible that the client may agree that, although the arrangement is called 'custody', the cryptoassets will be transferred to the custodian wallet provider subject to a contractual obligation to redeliver to the client in future, such that the custodian has no obligations to hold the client's cryptoassets for the benefit of the client (or to hold the client's cryptoassets separately from its own cryptoassets, or to refrain from making use of such cryptoassets), in which case it is hard to see how such cryptoassets could be regarded as held on trust by the purported custodian. It is therefore extremely important that a potential custody client reviews carefully the terms of the service which it will receive, regardless of the name of such service.

There is also the question of how segregation of cryptoassets may be achieved. In principle, there seems to be no reason why a custodian wallet provider cannot maintain a clear record of the amount of cryptoassets held for each client. This would provide segregation in the books of the custodian wallet provider. However, in order to have certainty as to which are the cryptoassets held by the custodian wallet provider for its clients, it is also necessary to be able to identify the cryptoassets which are the ones recorded in the custodian wallet provider's books as client assets. This would be simple if, for example, the custodian wallet provider only holds one type of cryptoasset at one blockchain address, and holds those cryptoassets only for one client, or each cryptoasset has a unique identifier which can be recorded against the name of the relevant client in the custodian wallet provider's books. The position is more complicated where cryptoassets are (or are treated as) fungible, and a number of different types of cryptoassets are held for a number of different clients. If the custodian wallet provider holds cryptoassets at one blockchain address controlled by one private key held by the custodian wallet provider, from an English law perspective the custodian wallet provider can hold all such cryptoassets on trust for a number of clients, provided it is clear what proportion of the holding (i.e., what amount of cryptoassets) is held for each custody client.

It should be recognised that multiple (different) cryptoassets may be held at one blockchain address. Unless the cryptoassets are also securities subject to regulatory requirements, there is, in principle, no reason why the custodian wallet provider cannot hold its own cryptoassets at the same blockchain address subject to the same trust (provided it is clear that, under such arrangement, the custodian wallet provider would act as trustee for all trust beneficiaries, including itself in the capacity of a beneficiary), but this is unlikely to be effective if the trust arrangement is not created expressly (since

the commingling of own assets and client assets may be regarded as showing lack of intention to create a trust), and would not be feasible if the custodian wallet provider was not a beneficiary under the trust, because there would then be no certainty as to which assets were held on trust and which were not.

If cryptoassets become subject to rules requiring that a custodian wallet provider holding cryptoassets with a third party must require segregation between its own cryptoassets and client cryptoassets, there is then the question of whether separate accounts are required in the books of the third party, or whether some other mechanism is possible. In principle, provided it is possible to separately identify client assets so that it is clear that they are client assets, there seems to be no reason why such identification should have to be made by using separate accounts if some other means is possible, such as appropriate flagging or earmarking in the main record.

One practical consequence of assets being held in an omnibus account is that it does not allow the client to independently verify the assets as being held as agreed. A client would then rely on obtaining that assurance from the custodian wallet provider, or a third party appointed by the custodian wallet provider, assessing this situation at any particular point in time. Holding a client's assets separately (in on-chain segregated accounts) allows a client to verify that the assets are available to them at any time. A comparison of the other consequences and relative benefits of omnibus client accounts and individual custody accounts is beyond the scope of this paper.

Possible approaches for segregation of cryptoassets will need to be considered carefully to ensure that they achieve the required result of identifying client assets separately from other assets, but equally they must be achievable in practice as it would be pointless to impose requirements with which it is impossible to comply.

Even where specific rules on segregation are introduced with the intention to harmonise requirements, for example as has been seen under MiCA (see the spotlight on MiCA on page 24), ultimately the effect of segregation depends on a combination of national civil, property and insolvency law. In respect of MiCA, this presents a challenge in many EU member states where cryptoassets remain to be characterised, with treatment around them still to be confirmed. This means that, in practice, the method of segregation under MiCA will likely differ from one member state to another.

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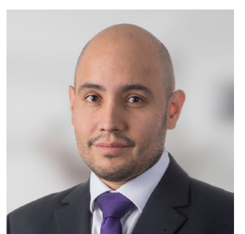

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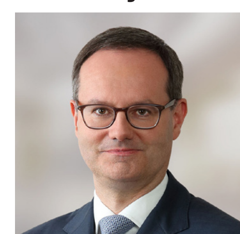

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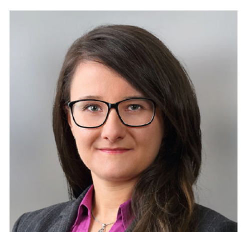

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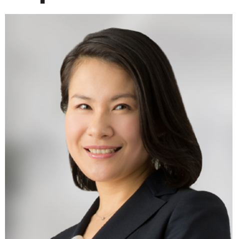

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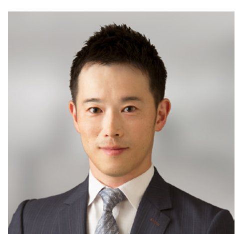

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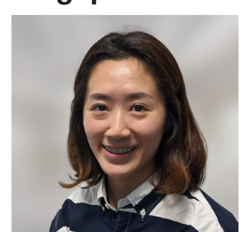

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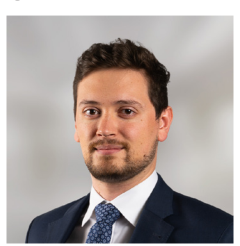

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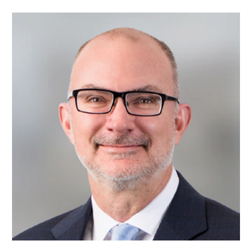

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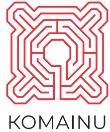

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