

By Email

4 November 2022

Response to the Law Commission Digital Assets Consultation Paper dated 28 July 2022 (the “CP”)

The International Swaps and Derivatives Association, Inc. (“**ISDA**”) welcomes the opportunity to respond to the CP, which represents a significant contribution to the digital asset markets. We agreed with much of the analysis in the CP and commend the tremendous effort that has clearly gone into producing it.

We strongly support the Law Commission’s stated objective of creating a facilitative and legally certain environment in which digital assets can flourish. Legal certainty is integral to safe and efficient derivatives markets. The CP, in and of itself, is already serving to promote legal certainty under English law, and we expect the effect will be crystalised once the final report is published. We welcome the Law Commission’s further efforts to enhance legal certainty under English law, in areas where uncertainties (or perceptions of uncertainty) linger. We also look forward to the Law Commission’s forthcoming consultation on the rules relating to conflicts of laws as they apply to emerging technologies, a topic of particular relevance in cross-border derivatives activities.

Before addressing some of the specific questions posed in the CP, we have sought to provide some context to our views. We would welcome further discussion on any of these matters.

1 Context to our response

1.1 Digital asset derivatives

In response to rapidly developing markets in digital assets and derivative products, ISDA published a Whitepaper on Contractual Standards for Digital Asset Derivatives in December 2021 (the “**Digital Assets Whitepaper**”).¹ Among other things, the Digital Assets Whitepaper set out a roadmap for developing contractual standards to support the evolving digital asset derivatives markets. Contractual standards are expected to promote the growth of safe, efficient and liquid markets in digital asset derivatives and have been widely welcomed across the industry.

Pursuant to the Digital Assets Whitepaper, ISDA will soon publish an initial set of product templates and definitions tailored for non-deliverable options and forwards in respect of bitcoin and ether. In due course, ISDA intends to develop further contractual mechanics and products to cater for a wider range of digital assets and transactions, including physically settled transactions. Many of the issues explored in the CP are more relevant in the context of physically settled transactions since, unlike cash-settled transactions, these involve transfers of the underlying assets from one party to the other.

1.2 Smart derivative contracts

¹ Available at <https://www.isda.org/a/QVtgE/Contractual-Standards-for-Digital-Asset-Derivatives.pdf>

ISDA (in collaboration with various partners) has published a series of whitepapers in relation to smart derivatives contracts, as outlined below, with a view to identifying some of the key legal issues presented by the deployment of distributed ledger technologies and smart contracts in derivatives markets. We have also published various legal guidelines aimed at promoting the development of smart derivatives contracts.² We would be very happy to discuss any of these topics further with you.

- **The Future of Derivatives Processing and Market Infrastructure** (September 2016).³ This whitepaper summarises the need to develop new and efficient processes for the global derivatives market and highlights the importance of distributed ledger technology and smart contracts.
- **Smart Contracts and Distributed Ledger – A Legal Perspective** (August 2017).⁴ This whitepaper sets out a framework for smart contracts in the context of ISDA's documents. It describes what smart contracts are and gives a preliminary and high-level description of the application of smart contracts within the ISDA documentation framework.
- **Smart Derivatives Contracts: From Concept to Construction** (October 2018).⁵ This whitepaper proposes a practical framework for the construction of smart derivatives contracts.
- **Private International Law Aspects of Smart Derivatives Contracts Utilizing DLT** (January 2020).⁶ This whitepaper considers the conflict of law aspects of derivatives contracts involving DLT including those governed by the laws of England and Wales.⁷

1.3 Voluntary Carbon Credit derivatives

Voluntary Carbon Credit (“VCC”) markets are supporting the transition to a low carbon economy by channelling financing into projects aimed at reducing carbon emissions or removing carbon from the atmosphere. The development of the VCC derivatives market will help promote liquidity and transparency in the primary VCC markets.

In December 2021, ISDA published a Whitepaper on the Legal Implications of Voluntary Carbon Credits (the “VCC Whitepaper”).⁸ Among other things, the VCC Whitepaper

² <https://www.isda.org/2019/10/16/isda-smart-contracts/>

³ Available at <https://www.isda.org/a/UEKDE/infrastructure-white-paper.pdf>

⁴ Available at <https://www.isda.org/a/6EKDE/smart-contracts-and-distributed-ledger-a-legal-perspective.pdf>

⁵ Available at: <https://www.isda.org/a/CHvEE/Smart-Derivatives-Contracts-From-Concept-to-Construction-Oct-2018.pdf>

⁶ Available at <https://www.isda.org/a/4RJTE/Private-International-Law-Aspects-of-Smart-Derivatives-Contracts-Utilizing-DLT.pdf>

⁷ It also considers these issues from a Singapore law perspective. ISDA has also published papers that consider these issues from French, Irish, Japanese and New York law perspectives - see <https://www.isda.org/2020/10/21/private-international-law-aspects-of-derivatives-contracts-involving-dlt/> for more information

⁸ Available at <https://www.isda.org/a/38ngE/Legal-Implications-of-Voluntary-Carbon-Credits.pdf>

set out a roadmap for the development of contractual standards for VCC derivatives. As for digital asset derivatives, contractual standards are expected to promote safety, efficiency and liquidity in the market. Pursuant to the VCC Whitepaper, ISDA will shortly publish a set of product templates and definitions tailored for physically settled spot, forward and option transactions in respect of VCCs.

The VCC Whitepaper also called for measures to resolve residual legal uncertainties in respect of the legal status of VCCs.

2 Response to select issues

Rather than responding exhaustively to every question raised, we have identified below the key issues that are of particular importance to the derivatives markets.

2.1 Third category of property *(relevant to Questions 1 – 6 and 13 – 15)*

We agree that digital assets do not fall neatly within the two categories of personal property that have traditionally been recognised by the law of England and Wales (i.e. things in possession and things in action in a strict sense). As such, we acknowledge the benefits associated with the Law Commission’s proposal for the law of England and Wales to recognise a third category of personal property.

ISDA understands that, as noted in the CP, there are authoritative legal statements⁹ under English law to the effect that there exists a third category of property (either as a standalone category or as a subset of “things in action”, in a broad sense as a residual category of property). ISDA also understands that the crypto-tokens that currently underlie many of the transactions in the derivatives markets (such as BTC and ETH) fall within the scope of such authoritative statements as objects of property, falling within that third category. To the extent that the Law Commission considers that there remain perceived residual uncertainties on these issues, ISDA is supportive of any measures that address that perception in an effective and efficient manner. One means of achieving such an outcome in the timeframes that will meet market expectations may be by extending existing legal statements to address any residual legal uncertainties.

ISDA would also observe that perceived uncertainties in relation to the precise boundaries of the third category of property are not currently a significant barrier to development of safe, efficient derivatives markets in cryptoassets. Attempts to define the proposed third category (particularly where introduced by statute) may give rise to difficult boundary issues and risk undermining legal certainty, as explained in the following paragraphs. In our view, such issues are for that reason better left to incremental development under the common law, although this should of course be balanced with the need to ensure consistency with other jurisdictions and legal systems that are also considering law reform measures intended to achieve greater legal certainty on similar issues relating to digital assets.

For example, as highlighted in paragraphs 10.100 – 10.114 of the CP, whether the criterion of “rivalrousness” is met is not a binary matter, and may change from time to time. This could therefore, on a strict application of the proposed criteria, mean that a data object that initially meets the test for rivalrousness and therefore can be the object

⁹ Including the UKJT Legal Statement on cryptoassets and smart contracts, which has been endorsed in several court judgments in England and Wales. The CP also constitutes an authoritative legal statement to this effect in its own right.

of property rights, ceases to do so in due course and, accordingly, ceases to be capable of being recognised as property. Whether the criterion of rivalrousness is met is complex and highly fact-specific (including, for example, an assessment as to the degree of centralisation of the system). Users of the system may not be aware or have at their disposal the means of assessing certain factors, such as centralisation, that influence a data object's rivalrousness, or otherwise. That leads to the unsatisfactory outcome that a data object could cease to be capable of being the object of property rights owing to circumstances unknown (and potentially unknowable) to users of the system. Such an outcome could significantly undermine market confidence. While, in principle, this is also a potential concern if it is left to the courts to apply and interpret the boundaries of property through common law principles, the issue becomes more acute if the boundaries are enshrined in statute, given the inherent rigidity of the latter.

Seeking to define criteria in statute also risks setting boundaries that are too inflexible to accommodate future evolution in the context of assets that are subject to rapid technological development. In contrast to common law development, a statutory approach runs the risk of enshrining in legislation a particular stage of evolution of a rapidly evolving technology. This could, depending on how the technology develops, inhibit the further development of derivatives markets in such asset classes as they evolve, particularly when it comes to physically-settled transactions.

Furthermore, the proposed “data objects” category does not purport to function as a residual category, and appears to exclude certain assets which are or, in our view, should be categorised as property under English law but which may not be things in action nor things in possession. That then naturally raises the question of a fourth category of property being recognised under English law (as discussed in further detail below). Those other assets include regulated emissions allowances and, we would contend, certain VCCs. EU Allowances under the EU Emissions Trading Scheme (“EUAs”) have already been recognised by the common law as a form of intangible property, as you point out in the CP.¹⁰ We acknowledge that there remains a degree of perceived or residual uncertainty over the characterisation of VCCs. However, as we argue in the VCC Whitepaper, in our view they are capable of being recognised as a form of property.

As discussed in further detail in the VCC Whitepaper, VCCs can be seen as representing exclusive access to a finite resource – namely, an independently verified certification that the holder either directly or indirectly has reduced or removed from the atmosphere one metric ton of carbon dioxide equivalent, in accordance with relevant carbon standards and registry rules. They therefore constitute an intangible asset that is distinct from any underlying register in which entitlements to such VCCs are recorded. This view is consistent with the perceived market value of VCCs, which is associated with the holder's ability to claim some level of responsibility (through the retirement or cancellation of the credit) for a finite quantity of carbon dioxide equivalent reduction or removal arising from a finite set of certified projects.

¹⁰

Armstrong v Winnington [2012] EWHC 10, [2013] Ch 156

As is acknowledged in the CP, much like cryptoassets, VCCs are capable of meeting the *Ainsworth*¹¹ criteria and achieving the quality of “rivalrousness” through a complex myriad of factors, not limited to the characteristics of the register recording entitlements to such VCCs alone. These include (i) the limited supply of carbon in the atmosphere; (ii) the limited number of carbon standards issuing VCCs; (iii) the limited number of carbon reduction or removal projects capable of meeting the relevant carbon standard rules; (iv) the limited number of entities capable of verifying compliance with the relevant carbon standard rules; and (v) the multilateral contractual arrangements governing the relevant registers, including the frameworks for issuance, transfer and cancellation of VCCs (albeit that the registers are centrally administered). Excessive focus on the characteristics of the register relating to the VCCs in connection with any analysis relating to their “rivalrousness” in our view conflates the distinction between the register and the VCC itself (not being reduced or reducible to the data recorded in the register or the ability to control that data) and gives insufficient weight to the other circumstances giving rise to, and pursuant to which the market attributes value to, VCCs.

Yet, VCCs do not meet all of the Law Commission’s proposed criteria for “data objects”. While they are *evidenced* by data, they are not “composed of data”; as outlined above, the asset is the exclusive access to an independently verified certification that the holder either directly or indirectly has reduced or removed from the atmosphere one metric ton of carbon dioxide equivalent, rather than data as such. Likewise, the VCCs would not exist in the absence of contractual frameworks, and thus it is difficult to argue that they exist independently of the legal system. EUAs also do not meet these criteria, despite having been recognised by the courts as a form of intangible property.

As the CP recognises, not all intangible assets recognised as property under English law will be capable of constituting “data objects”, as defined by reference to the proposed criteria.¹² However, defining the third category of property as “data objects” raises (without necessarily addressing) questions as to whether EUAs and VCCs constitute property at all, and if so, whether a fourth category of property exists under English law. This could create significant uncertainty and undermine confidence in these markets. It would also run counter to the Law Commission’s objective of developing a strong conceptual foundation that allows the law of England and Wales to remain able to deal with other novel objects of property in the future.¹³

We note that some concerns have been raised in the market that introducing a new category of “data objects” may cast doubt as to whether a particular asset is appropriately categorised as a thing in action or a data object. In principle, we expect this not to be an issue in relation to arrangements involving the linking of a thing in action to data that does not itself qualify as a data object (as, unless the proposed legislation was particularly poorly drafted, there would be nothing to pull the asset into the “data objects” category). However, there are complexities to be considered where a thing in action is linked to an asset that is itself a data object (or otherwise an object

¹¹ I.e. the requirements that a thing must be definable, identifiable by third parties, capable in its nature of assumption by third parties and have some degree of permanence or stability, as set out by Lord Wilberforce in his judgment in *National Provincial Bank v Ainsworth*.

¹² See 9.21 CP. Note: this also suggests that EUAs are more appropriately regarded as a form of statutory property analogous to certain types of intellectual property rights. However, such intellectual property rights are recognised as property *by virtue of* statute, which is not the case in respect of EUAs.

¹³ 4.97 CP

of property). English law has historically proven highly agile in accommodating the expectations of the market in dealing with novel arrangements that cross established boundaries. For example, documentary intangibles, such as bearer bonds, are a hybrid of a thing in possession (a paper instrument) and a thing in action (such as a debt claim), deemed in law to be linked together and capable of being transferred by way of negotiation through delivery of the paper instrument. A specific body of law has been developed by the English courts which treats the composite of the thing in action and the thing in possession in which it is embodied, as a combined object of property, subject to specific rules applicable to documentary intangibles. We note that in some cases, structures linking things in action to data objects may fall within the scope of the Law Commission's proposed Electronic Trade Bill, which may enable them to acquire the same status as a documentary intangible. In other cases, we expect it will fall to the common law to interpret whether particular linking arrangements achieve similar outcomes and precisely what rules apply to the composite asset (for example, for the purposes of taking security or proprietary interests). We expect this will need to be determined by reference to the facts and circumstances, including the legal structuring techniques used.

In summary, to the extent there is considered to be uncertainty as to whether a third category of property exists, we are supportive of any measures (statutory or otherwise) that address that uncertainty. We would however note that this increased certainty for data objects should not operate to introduce greater uncertainty for other intangibles by implication or otherwise. Notably, in many instances the market in VCCs (and EUAs) already operates on the basis that VCCs amount to a form of intangible property as a matter of English law. As set out in the VCC Whitepaper, that is consistent with the characteristics of VCCs and legal framework in which they operate.

2.2 Transfers (*relevant to Questions 16 – 26*)

There are two issues we wish to raise in the context of transfers, as set out below.

2.2.1 Conditions for transfer of legal title of crypto-tokens

We refer to the conclusion in the CP that a transfer operation that effects a state change is a necessary (but not sufficient) condition for the transfer of (superior) legal title to a crypto-token.¹⁴ We do not disagree with this in principle. However, it would be helpful to clarify that legal title can also be transferred off-chain, albeit that it will be defeated by a subsequent (and conflicting) on-chain transfer. We consider it important to enable legal title to transfer off-chain, in order to provide sufficient flexibility for the market to flourish.

In our view, the concept of “control” could be a useful legal tool for effecting off-chain transfers. We acknowledge there are challenges with defining the boundaries of control, including in the context of multiple parties sharing control (whether acting in concert or in competition), legal control and constructive control. To address these issues, we support the proposal for a panel of industry, legal and technical experts to provide non-binding guidance on the complex and evolving issues relating to control.¹⁵

¹⁴ 13.21 and 13.22 CP

¹⁵ As set out in Question 19

2.2.2 Innocent acquirer rule in the context of crypto-tokens

We agree that there is a need for innocent acquirers trading crypto-tokens to be able to take good title, free of defects in the title of the transferor and equities. As pointed out in the CP, the market already functions on the basis that this is the case.¹⁶ Given this fact, we do think there is a case to be made, at least in relation to some categories of crypto-tokens, that there already exists a mercantile practice of treating such crypto-tokens as negotiable instruments, which may allow them to be recognised as negotiable under the common law with limited development of the common law. In this respect, the CP may have underplayed the strength of existing market practices.

We would be supportive of non-legislative measures that provide certainty that that is the case or, alternatively, a statutory intervention that achieves the same result. However, we expect there may be challenges in formulating appropriate boundaries for any statutory solution.

2.3 Custody (*relevant to question 32*)

We agree with the conclusion in paragraph 17.40 of the CP that there are strong arguments for asserting that dealings in book entry and tokenised equitable entitlements to crypto-tokens fall outside the scope of section 53(1)(c) LPA 1925. To the extent that there is considered to be residual uncertainty, we would be supportive of authoritative legal guidance or statutory clarification to resolve such uncertainty, provided that this does not undermine confidence in existing arrangements in either the crypto-token or intermediated securities markets. In this regard, we support the conclusion in paragraph 17.49 that any proposals would need to be wide enough to apply to both.

2.4 Collateral (*relevant to questions 37 – 39, and 16 – 19 on control*)

We agree that there is sufficient certainty that both title-transfer arrangements and security interests in the form of mortgages or charges can be effected in respect of crypto-tokens under English law. We also agree that it is unlikely that crypto-tokens themselves (ignoring any linked choses in action) will qualify as financial collateral under the FCARs¹⁷ or the FCD¹⁸. On that basis, and as explained in the CP, while English law already provides a range of tools to support collateral arrangements in respect of crypto-tokens, there are certain collateral structures and arrangements (including arrangements used widely in the DeFi markets) that may not be supported by English law (depending upon the precise nature of the arrangements and whether such arrangements involve the creation of security by legal persons).

ISDA is supportive of extending the flexibility of English law, in order to accommodate a wider range of collateral arrangements, where that is appropriate from a policy perspective.

In particular, we are in favour of enabling control-based security interests (akin to pledges) in respect of crypto-tokens, as this is likely to improve liquidity and efficiency in crypto markets. In the context of derivatives markets, any policy reasons in favour of

¹⁶ 13.54 CP

¹⁷ The Financial Collateral arrangements (No 2) Regulations 2003

¹⁸ The EU Financial Collateral Directive, Directive 2002/47/EC

maintaining a registration requirement for UK corporate security providers are limited, given that most collateral arrangements fall under the FCARs and, as such, are not subject to registration. Furthermore, developing the law in this way would merely be confirmatory of the basis on which the market is already operating in many instances in relation to crypto-tokens, where many security arrangements are entered into on the basis of a factual state of control without any registration being performed. To displace that market practice would require a very clear rationale.

Considering the policy considerations discussed in the CP, we would encourage policymakers to undertake a detailed review of the crypto ecosystem in order to determine whether, and to what extent, an extension of the FCARs, or the creation of a new bespoke collateral regime for crypto-tokens (which could be tailored to address the specific policy considerations applicable for the asset class) is appropriate. Any such measures require careful consideration in order to avoid unintended consequences and unnecessary complexity. There will also be implications of creating misalignment between the FCARs and FCD, which need to be taken into account (acknowledging that there already is a degree of misalignment and that this is not an issue that is unique to digital assets).¹⁹

In order to promote legal certainty, we would strongly encourage measures to clarify the existing boundaries and requirements of the FCARs in the context of emerging technologies, including certain linked crypto-tokens. For example, there remains uncertainty around how the term “account” should be construed in the context of transaction-based distributed ledger arrangements; where the boundaries of “financial instruments” lie; and to what extent the terms “money” and “pecuniary claims” capture tokenised forms of cash and claims denominated in tokenised forms of cash, respectively. Likewise, it would be helpful to have further clarity around how smart contract code can be used to meet a possession or control requirement.

We would welcome further discussion on any of these matters.

Yours sincerely,



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¹⁹ We also note that in order for crypto-tokens to be used as part of collateral arrangements relating to derivatives, they will need to be included in the list of eligible collateral under the uncleared margin requirements (and equivalents in other jurisdictions). Such requirements should therefore be considered alongside any extension to the FCARs or any alternative bespoke regime.