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Client Asset Protection for Crypto

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It was on the **11**th day of the **11**th month in 20**22** that FTX formally applied for Chapter-**11** bankruptcy in the USA[1]. Founded in 2019, FTX was a leading crypto-exchange in its heyday before it filed for bankruptcy in 2022. The systemic flaws unearthed in FTX´s operations questioned the quality of processes it had set in place. Those who had lost dearly were retail investors. In the weeks that followed, one question kept resonating. Could this scale of damage have been mitigated? In a statement issued by the European Securities & Markets Authority (ESMA)[2] during the weeks that followed, they indicated that it could.

> **"The lack of safeguards** in place at many entities active in crypto markets **such as client asset segregation** was one among many factors that prompted ESMA and the other ESAs to issue warnings to investors – in 2018, and again this year – about the severe risks involved in holding crypto-assets."

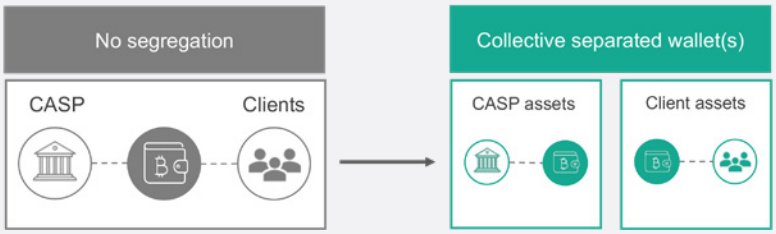
The collapse of FTX has since made retail investors aware of dubious market practices and risks involved in dealing with unregulated financial institutions. For example, it was only when FTX halted withdrawals that retail investors understood that their assets were not safeguarded to begin with. As a result, they now seek out investor protection measures. Amongst other things, this has resulted in an increased **demand for segregation** of client crypto-assets from the custodian's holdings to mitigate potential insolvency risks. This heightened awareness translates to requiring crypto-asset service providers (CASPs) to do their homework on the fine print of their business models.

Pre-emptively, the European Commission had proposed strong investor protection measures in the Markets in Crypto-Asset Regulation (MiCAR). MiCAR has a suite of regulatory requirements. Here we focus on the requirement strengthening Client Asset Protection (CAP) while also adding operational complexities on CASPs' businesses. Take for example Article 67 (7) of MiCAR which states:

> "Crypto-asset service providers that are authorized for the custody and administration of crypto-assets on behalf of third parties shall segregate holdings of crypto-assets on behalf of their clients from their own holdings and ensure that the means of access to crypto-assets of their clients are clearly identified as such. They shall ensure that, on the DLT, their clients' crypto-assets are held on separate addresses from those on which their own crypto-assets are held."

[1] https://www.cnbc.com/2022/11/11/sam-bankman-frieds-cryptocurrency-exchange-ftx-files-for-bankruptcy.html
[2] https://www.esma.europa.eu/sites/default/files/library/public_statement_to_econ_sk.pdf

For you as a CASP, this article requires that - as a basis - your own funds are segregated from those of your clients:

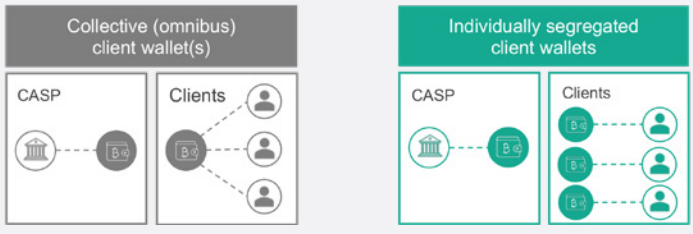


For example, if your client deposits €1.000 worth of BTC with your custodial service and you have €500 worth of BTC from your proprietary trading desk, instead of having €1.500 in one account, the assets are split into separate wallets.

Another key legal consideration which comes into play here, further complicating the matter is that your client's crypto-assets must be **assignable** (in German legal parlance "zurechenbar"). In the event of the insolvency of a CASP, the ownership rights of clients must be safeguarded. The aspect of assignability is covered under MiCAR Article 67 (2)

> "Crypto-asset service providers that are authorized for the custody and administration of crypto-assets on behalf of third parties shall **keep a register of positions,** opened in the name of each client, corresponding to each client's rights to the crypto-assets."

CASPs have two options to evaluate while fulfilling this regulatory requirement. The two options are graphically represented below. The first option, on the left-hand side, is to provide collective "omnibus" wallets complimented with internal bookkeeping systems, which could also be an off-chain register, to allocate assets to various clients. The second option, on the right-hand side, is to provide (individually) segregated wallets for each client's asset.



The legal complexities of Client Asset Protection do not end with a CASP offering these solutions. Granted, besides meeting critical regulatory requirements, it is seen as a comparative advantage when you can offer your client a custody solution that is fully transparent and flexible. For instance, it might make sense to offer more than one segregation model and reflect the choice in your fee schedule. However, the solutions must be legally compliant, and insolvency

protected, i.e., in case of a default the insolvency administrator should not have access to the client funds. Again, with the implementation of those models the CASP would simply answer the increased demand for safeguarded solutions, both from retail but also from institutional investors.

The draft bill for the Future Financing Act (Zukunftsfinanzierungsgesetz) already provides, prior to the general implementation of the provisions of MiCAR into German law, that crypto custodians must ensure that client's crypto-assets and private cryptographic keys are kept separate from the crypto-assets and private cryptographic keys of the institution. In the case of joint custody, it is correspondingly stipulated that it must be ensured that it is possible to determine at any time the shares of the total stock held in joint custody to which the individual customers are entitled.

Existing legal frameworks could pose challenges to CASPs

Now it's getting complex and to just point out the tip of the iceberg, crypto-assets and other tokens are not considered to be objects ("Sachen") according to German insolvency and property law. It is therefore impossible to establish legal property ("Sacheigentum") of them. Thus, clients' crypto-assets actually remain subject to the crypto custodian's insolvency estate.

The legislator therefore provides in the draft bill on the Future Financing Act (Zukunftsfinanzierungsgesetz) that the crypto-asset held in custody for a customer as part of a crypto custody transaction shall be deemed to belong to the customer. This does not apply if the customer has given consent to disposals of the value for the account of the CASP or third parties.

What could CASPs do?

To strike a balance by being compliant with existing and forthcoming regulations while also providing value to your clients and making your service model even more attractive, CASPs need to establish a custody solution which ensures:

- The segregation of own assets and customer assets
- The segregation of customer assets from the assets of other customers
- The portability of customer assets from own custodian to another in the event of custodian's default

As long as the Future Financing Act in its current draft has not become law, a solution could be that you, the CASP, establishes a "real" trust ("Treuhand") for client's crypto-assets.

Despite the current lack of regulations on preventing insolvency risks associated with holding client crypto-assets, crypto custodians should immediately act and put in place custody models that in case of their insolvency best protect the crypto-assets of their clients. Implementing such a solution would not only ensure that you meet the requirements of MiCAR, but it would also contribute towards the fostering of a trustworthy crypto-ecosystem.

How can we help?

x-markets consulting brings over two decades of focused experience mainly in the banking and capital markets space including leading clearing houses and (international) central securities depositories. Having developed and implemented complex asset segregation models for our clients, we are your partner through the entire lifecycle of your CAP implementation: Starting with the initial solution design and specification phase, followed by customized process design and documentation, we also support and manage all relevant testing stages ensuring highest software quality. Consulting on all aspects necessary to achieve your internal operational readiness as well as the onboarding readiness of your clients, a smooth roll-out and regulatory compliance is ensured.

FIN LAW regularly assists crypto custodians with BaFin license applications and the preparation of documentation necessary for the operation of the business. Accordingly, FIN LAW can advise and support you in setting up the documents relevant for the CAP, such as the custody conditions or compliance manuals. This can ensure that you meet the current and upcoming requirements for crypto custody.

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About FIN LAW

FIN LAW is a fintech law firm with specialization in banking and capital markets regulatory law. The law firm's main focus of practice lies on the implementation of business models on basis of or with reference to innovative technologies such as the blockchain technology or crypto-assets. FIN LAW offers the legal planning of fintech business models, the preparation of BaFin licensing applications as well as legal representation in BaFin licensing proceedings.

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About x-markets

x-markets is a boutique consulting firm focusing on working together with clients in the banking and capital markets space and solving their strategic and operational challenges.

Our expertise is built on our diverse international team who are experienced in the topics we consult for. Our experience spans across all relevant areas of the financial industry. From trading, clearing, and settlement, to compliance regulation and information security.

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