The City of London Law Society

4 College Hill
London EC4R 2RB
Tel +44 (0)20 7329 2173
Fax +44 (0)20 7329 2190
DX 98936 – Cheapside 2
mail@citysolicitors.org.uk
www.citysolicitors.org.uk

DIGITAL ASSETS:

THE LIMITS OF THE CONCEPT OF "POSSESSION"

A. Introduction

1. The City of London Law Society ("CLLS") represents approximately 17,000 City solicitors through individual and corporate membership including some of the largest international law firms in the world. It specialist Committees comprise leading solicitors in their respective fields. These solicitors and their law firms operating in the City of London act for UK and international businesses, financial institutions and regulatory and governmental bodies in relation to major transactions and disputes, both domestic and international. The Financial Law Committee of the CLLS (with members also drawn from the Regulatory Law Committee) has formed a working group (the ***Working Group***) to consider and respond to the Law Commission's *"Digital assets: Call for Evidence"* (the ***CE***) and Consultation Paper on *"Digital assets: electronic trade documents"* (the ***CP***). The CE and CP together form the Law Commission's current project on digital assets, including cryptoassets. We refer to the CE and CP collectively, therefore, as the ***Digital Assets Papers***.

2. For the reasons we explore in greater detail in our response below, the Working Group considers that caution should be exercised in relation to any proposal for legislative reform to extend the application of the "possession" concept – at least to areas beyond those industry sectors where, arguably, it may serve an appropriate and helpful purpose in supporting the safe, efficient and effective holding and transfer of value or rights constituted or evidenced exclusively in digital form.

3. Members of the Working Group have considerable experience, garnered over many years and in different market sectors, of dealing with and resolving most of the legal and practical issues identified and discussed in the Digital Assets Papers. That experience in fact also extends to a number of those matters on which the Law Commission is not currently seeking views from consultees, including regulatory, tax, data protection and settlement finality issues (see the CE, para. 1.19).

4. The Working Group believes that while it is certainly correct that new technologies and types of asset can create novel legal issues (for example, in the area of conflict of laws where under certain models of DLT the primary record of entitlement to a cryptoasset may be held, maintained or located in numerous different jurisdictions at the same time), many of the

legal issues associated with digital assets have been encountered and resolved by practitioners, policy-makers and law-makers in analogous contexts and markets. It will, in many areas, prove fruitful and enhance legal certainty to draw parallels with the corresponding solutions that have been adopted in those other contexts and markets. This is likely to be especially the case where these are solutions mirrored in other legal systems and, therefore, the approach may be more readily accepted internationally.

5. We are, therefore, concerned to ensure that the Law Commission's thinking in this area should be informed by our experiences in assisting the development (on a case-by-case basis) of legal and statutory solutions to the problems of "digitalisation"[1] examined in the Digital Assets Papers. We believe that those experiences show that it is unlikely to prove helpful, and may indeed undermine the certainty of English law, to seek to make all types of digital asset amenable to possession.

B. Policy and other considerations

6. Before extending the concept of possession, and its related legal principles, to digital assets, we consider it important to determine the principal policy reasons behind the concept and those principles. Specifically, it seems self-evident to us that the rules on the negotiability of documentary intangibles (such as bills of exchange and promissory notes), as well as their amenability to the pledge device and perfection of third party interests without the requirement for registration on a public charges register, are inextricably tied to the physical manifestation of a document as the holder's "root of title" to the rights constituted by the document.

7. Possession of a document, title to the value and rights constituted by which is reducible to possession, is itself the best available evidence of the title of the holder to that value and those rights[2]. A documentary intangible is both a document of title and an instrument of transfer[3], so that delivery of possession of the document itself (whether with or without endorsement) immediately, irrevocably and unconditionally transfers the value and rights constituted by the document to the transferee.

[1] We use the term ***digitalisation*** in this paper to refer to any legal and operational process under which value or rights that are reducible to possession or transfer of a physical document are replicated by a legal and operational process that converts such value or rights into a digital or other intangible representation stored and transferred by means of a register, ledger, account or other electronic technology.

[2] This, of course, finds expression in the French civil law presumptive rule, in relation to (tangible) movable assets, that *"En fait de meubles, la possession vaut titre"*. A person lawfully in possession of a tangible asset is usually presumed to be its owner.

[3] In this way, for a documentary intangible, there is unity between the right to dispose of the thing (as an incident of ownership acquired through possession) and the power to dispose of the thing (as an incident of the document being itself the instrument of transfer). In contrast, for shares, securities and other registered intangible assets, title to the asset is distinct from the means used to effect a transfer of title to the asset. Title to a registered intangible asset is constituted or evidenced by entry of the holder on the relevant register, but that title is only capable of being transferred by delivery up of a relevant certificate and a "proper instrument of transfer" (or equivalent process) by or on behalf of the person named on the register (as transferor). We consider that this bifurcation between the source of title (i.e. the register) and the mechanism for transfer of that title, as applicable to registered intangible assets, is a key distinctive feature of such assets in comparison to tangible or other assets that are "possessable". It is the person entered on the register of a registered intangible asset that alone has the right (as against the issuer of the share etc.) to control and enjoy the rights constituted by the asset to the exclusion of others, and the right to dispose of it. This is so even though it may have given the power to a third party to dispose of its title to the asset by depositing any relevant share or other certificate and completed proper instrument of transfer. Any such disposal by the third party will be effected in the name (and in right) of the person entered on the register – it will not be effected in the name (or in right of) the person who possesses and, therefore controls, the means of transfer over those rights.

8. In relation to such a document, it is a perfectly sensible policy position to conclude that no further formal act should be required to perfect the intended title of the transferee to the instrument (and the value or rights constituted by it). As the instrument itself is the root of title to such value or rights, any absence of possession of the instrument should in itself put third parties on notice as to any claimed rights of a person to the instrument (but who is not in possession of it). Thus, a creditor dealing with a debtor who claims to own a particular documentary intangible can properly ask to have sight of the asset to confirm the debtor's ownership of it, and if that is not forthcoming the creditor is put on enquiry for a proper explanation as to the reason for the debtor's lack of possession of the claimed asset. The risk of "false wealth", and related fraud or other operational risk concerns, is materially reduced for a third party dealing with a person who holds (or claims to hold) a documentary intangible[4].

9. In contrast, where value or rights are represented in digital form, solutions adopted under the law relating to negotiable instruments (or other documentary intangibles) may not be appropriate because the policy basis for those solutions may be absent. This may be so even though the digital asset, in economic or legal substance, replicates (or seeks to replicate) the value or rights that may be constituted or evidenced by its physical (tangible) equivalent.

10. Specifically, certain legal and operational models for digital assets may accord to the ledger or account (to which the assets are recorded) a status equal or similar to the primary record of entitlement to an asset constituted by entry on a register[5]. In addition, the process for transfer of title to digital assets under such models may be closely aligned to the process for transfer of title to shares or other registered securities[6]. In such cases, we consider it likely

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[4] On this point, we would agree and adopt the observations of the Law Commission in the CP that, *"The tangible quality of an asset can make it easy to observe who has control of, or who is using that asset at any particular time…"* (at para. 5.39) and that, *"The role that tangibility is really playing … is that it allows legal rights to be allocated based on an observable state of facts"* (at para. 5.41).

[5] Legal title to corporate shares and other registered securities is constituted or evidenced by entry of the holder on the register itself: *Société Générale -v- Walker (1886) 11 AC 20 at 28*; and *J Sainsbury Plc -v- O'Connor (Inspector of Taxes) [1991] 1 WLR 963 at 977*. The register is a public instrument of which third parties can make enquiry to verify the title of the holder and place trust as to the integrity of the holder's title recorded on it. For such registered intangible assets, the instrument that constitutes or evidences title (the register) is different from the instruments that must be used to transfer that title (i.e. a certificate and proper instrument of transfer, where the shares or other securities are held in certificated form; or a "properly authenticated dematerialised instruction" attributable to the relevant "system-member", where the shares or other securities are held in uncertificated form in the CREST relevant system under the Uncertificated Securities Regulations 2001 (the ***USRs***)). Similarly, for cryptoassets stored on DLT or similar electronic technology, the relevant ledger or account may perform equivalent or similar functions to that of a register. For example, as the Law Commission notes, *"As each addition to the ledger requires the collective consensus of the other participating nodes, it is very difficult (if not practically impossible) to tamper with the ledger's contents. <u>Additionally, this immutable quality means that individual users can trust the ledger's veracity and transact with one another in confidence</u>"* (see para. 2.52). Equally, as is noted in the UK Jurisdiction Taskforce's *"Legal Statement on cryptoassets and smart contracts"* (the ***UKJT Legal Statement***), under DLT it is the distributed ledger that represents the "public data parameter" of the asset, while the private key is the "private data parameter" of the asset: see paras. 28 and 29 of the UKJT Paper. The functions of a distributed ledger to keep a reliable history of transactions and ownership, and so prevent double-spending, correspond to the like functions performed by a register in relation to shares, securities and other registered intangible assets. Equally, the function of the cryptographic private key to enable or facilitate transfers or other dealings in the cryptoasset corresponds to the instruments of transfers that are used for registered shares, securities or other registered intangible assets.

[6] In the view of the Working Group, for such assets, the process of transfer (being essentially one of novation) can rationally be analysed as being the same or similar as between shares, securities and other registered intangible assets as for cryptoassets (at least where the cryptoasset is held and transferred under rules and protocols of a DLT or similar system that accord status to the ledger as the primary record of a holder's entitlement to the asset). We consider the process of transfer for assets so stored on such DLT or similar technology, as described in paras. 42 to 48 of the UKJT Legal Statement and paras. 2.29 to 2.41 of the CE, to be most closely analogous with the similar novation process that occurs in relation to the transfer of shares or other registered securities: see *Goode & Gullifer on Legal Problems of Credit and Security (6th edition) at paragraph 3.10, footnote 68*. Under such transfers effected by novation, in contrast to transfers by assignment, a "new" asset and new relationships are created upon transfer – in much the same way as the process for this class of cryptoasset: see the CE, paras. 2.39 and 2.40; and the UKJT Legal Statement, para. 45. However, we think this is a more accurate and helpful comparator than that made by the UKJT or the Law Commission in relation to debits/credits to bank accounts because, as for shares or other registered securities, the process for the transfer of cryptoassets requires the existence and use of an "instrument of

to be inappropriate, and generative of legal uncertainty and inconsistency, to seek to impose a legislative or other legal solution that makes (or purports to make) such assets "amenable to possession". This is because the policy rationale at the basis of core legal rules associated with a person's possession of a tangible asset would not apply, and the extension of the applicability of the concept of possession itself to the asset will produce unhelpful and unclear policy results.

11. For example, if a cryptoasset is recorded on a ledger or account which performs functions equivalent to or similar to a register[7], then to legislate that the transfer of "control" over that asset effects delivery of "possession" of the asset is likely, in our view, to produce incorrect or irrational policy results.

12. The concept of "control" is an elusive one, although we recognise both that the challenges to defining the concept may not be insurmountable and that there is increasing support among academics and market commentators for a doctrine of control in place of an extension of the concept of possession. The UKJT Legal Statement[8] suggests that exclusive control of a cryptoasset (by analogy with possession of a tangible asset) arises in a person who has acquired knowledge and control of the private key linked to the asset by some lawful means. Such control may in fact be exercisable by a person who is not identified (or identifiable) by the ledger as the holder of the cryptoasset at the relevant time[9]. For such

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transfer" – for assets recorded on DLT or similar electronic technology, that instrument of transfer is the private key. This analogy with transfers effected across a register of shares, securities or other registered intangible assets also responds appropriately, in our view, to concerns that the novation analysis for the transfer of digital assets may, in fact, be unhelpful. In this context, we are aware that concerns have been expressed by some stakeholders that this type of analysis may not reflect the expectation of market participants as to the transfer of their digital assets, and may give rise to unintended practical consequences for the taking of security or priority disputes in the event of the wrongful acquisition of such digital assets. However, the financial markets (supported by English company law and personal property law) have never found these issues to be material with regard to the "transfer" of, taking security over or priority disputes relating to, shares or other registered securities. Market participants still properly view a transfer of such assets as a "transfer"; a mortgage or charge remains a well-accepted means of creating a security interest of such assets; and there is a clear, well-founded body of law that governs any priority or other title dispute as between competing claims to such assets – and in all cases, this is so notwithstanding the proper legal analysis for the transfer of such assets being founded on novation reasoning.

[7] For example, the system rules under which a ledger or account is operated may provide or otherwise recognise that the person with title to the relevant cryptoasset, as the person who has the ultimate right to control and enjoy that asset to the exclusion of others and the right to dispose of it, is the person who is entered on the ledger or account at the relevant time. In this context, we note the discussion on the ownership and transfer of cryptoassets assets recorded on DLT at paras. 43 to 46 of the UKJT Legal Statement. While it is suggested there that *"the starting point"* is that a person who has acquired knowledge and control of a private key by lawful means would *"generally"* be treated as the owner of the associated cryptoasset, the discussion goes on to recognise that until a transfer (as evidenced by the transferor's authentication and broadcast to the system for validation) is actually recorded on the ledger, there remains the risk that the transferor will make a second transfer (i.e. double-spend the cryptoasset) and that will be accepted on the ledger *"in priority to the first"*. Accordingly, while it may be correct to say that (depending on the rules and protocols governing the operation of a ledger) a ledger should not be regarded as a *"definitive"* record of title, it may nevertheless represent the primary record (or best available evidence) of title and, as a result, perform "title" functions equivalent to a register. On this point, which may not be widely appreciated, it is worth emphasising that under English company law, a relevant register of shares or other securities is <u>not</u> given definitive value as to matters of title: it is given evidential value only – but this does not, and should not, adversely affect the status of the register of members or other company law register as a "register". Generally, under English company law, a register is *"prima facie evidence"* of any matter which under statute is directed or authorised to be inserted in it: see, for example, section 127 of the Companies Act 2006 and regulations 24(1) of the USRs. Indeed, this is the basis of the court's power of rectification over a register. In our view, analogous reasoning can equally be applied to those matters that, under the rules or protocols governing a ledger's operation, are directed or authorised to be inserted in it where (as a practical matter) the ledger remains the "best available evidence" of a person's title to a cryptoasset recorded in its name or attributable to its address identifier.

[8] See UKJT Legal Statement, paras. 28 and 43.

[9] On this point, see for example the discussion at paras. 44 to 46 of the UKJT Legal Statement. Such a person may include a third party who has knowledge or custody of the private key. There is some discussion of this issue at paras. 5.94, 5.128 and 6.70 of the CP, but while the Law Commission suggests that, in such cases, *"we still think it would be possible to identify which party was the party intended to have "possession" being the person… named on the system"*, this may not provide the level of legal certainty that would be required by the financial markets dealing with proprietary and other issues relevant to financial instruments recorded on DLT or a similar electronic technology. For example, systemically important financial market infrastructures, including CCPs and CSDs (that require finality and

an asset, the relevant rules or protocols may make the ledger or account the root or source of the holder's title to the asset – and *__not__* the private key which must be used to transfer that title. In such a case, transfer of control over the cryptoasset may be effected to vest equitable title in the asset (e.g. by way of security) in another person. As the key is a *private* function, this would be a private operation that would (and should) not be capable of third party verification by a person dealing with the holder of the asset (as disclosed by the ledger). The ledger or account, as part of the *public* parameter of the asset, would continue to show the holder of the asset as its owner.

13. In this context, one possible solution to mitigate the risk of "false wealth" or fraud or other operational risk considerations is that the interest of the collateral-taker should be entered on a public charges register enquirable by third parties dealing with the person recorded as holder on the ledger or account. However, if the relevant cryptoasset is treated as being amenable to possession (and the control function as described transfers that possession), then the legal result would be that the operation has effected a "pledge" over the asset and, as such, no public registration of the security interest on a charges register needs to be made. Where the relevant digital asset is held and transferred by entries on a ledger that, under the rules or protocols of the DLT or other technological system, is accorded a contractual or other legal status equivalent to a register (as the primary record of entitlement to the digital assets), this automatic and self-executing result (avoiding the need for registration of the security interest) is unlikely to produce the correct policy result in the interests of the safe and efficient operation of the financial markets.[10]

14. We also believe that, if the legal and operational arrangements governing the holding and transfer of value or rights recorded on a ledger or account are more analogous to their

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integrity of title to cryptoassets transferred to or by them or between their participants), would expect the legal framework supporting such transfers to *"provide a high degree of certainty"*: see Principle 1 (*Legal basis)*, Key Consideration 1 of the CPMI-IOSCO Principles for financial market infrastructures (April 2012). Even if the Law Commission's proposed definition of "control" in its draft Bill (see paras. 5.91 to 5.94 of the CP) is capable of providing a high level of assurance, so that, for cryptoassets held under system rules providing for the primacy of the ledger as a record of title, it is the person recorded as the holder on the ledger who has "possession", legal uncertainty and inconsistencies would still be created. For example, under the Law Commission's legislative proposal, such a transfer of possession to a collateral-taker (by way of security) would amount to a "pledge" perfected by possession (and, therefore, no relevant registration of the collateral arrangement would be required on a charges register). In contrast, unless the arrangement is within scope of a "security financial collateral arrangement" for the purposes of the Financial Collateral Arrangements (No. 2) Regulations 2003 (the ***FCARs***), any corresponding security interest created over a cryptoasset (characterised as a registered intangible asset that is not amenable to possession) would be a mortgage or charge and, as such, require registration (in a charges register) in order to perfect the security interest against competing or adverse third party claims. If the rule-based and functional operation of a cryptoasset (and the ledger recording it) is equivalent to that applicable to a registered security (and the related securities register), there seems no logical or policy reason to make this distinction under the relevant rules for perfection of the security interest. For completeness, we would note however that it is not the case that every person who transacts in digital assets will hold via a wallet or using a custodian arrangement. The market for custody of digital assets is at an early stage and is not harmonised. From an investor perspective, the owner of a digital asset held by a custodian will potentially receive various service offerings depending on its relationship with, and specific terms of, the relevant custodian, which in turn will mean different types of rights and levels of protection needing to be factored into any assessment of "control" on a case-by-case basis. It should be possible under English law to recognise the fact that certain types of digital asset may be held materially differently to securities.

[10] We recognise, of course, that for certain types of asset operating in certain markets a separate policy decision may be made, for example in the interests of the efficient operation of a financial market or where such public registration would require a fundamental change to accepted practices (and/or the imposition of increased costs) in a particular market (e.g. the trade finance market), to disapply a requirement for public registration on a charges register that might otherwise apply to a security or other arrangement over the asset: see, for example, the treatment of financial collateral (in the form of securities, cash or credit claims) provided by a collateral-provider to a collateral-taker under the FCARs. However, we consider that any such policy decision should be made with reference to the specific considerations relevant to the particular market and the requirements of its participants. It would not be sensible, in our view, to remove normal standards for the transparency of dealings with an asset (e.g. to minimise the risk of fraud) by means of a broad, generic and "one size fits all" extension of the applicability of the concept of possession, and its attendant legal consequences, to all types of digital asset in all circumstances.

characterisation as registered intangible assets (rather than "possessable" assets), it would create legal uncertainty to *impose* legal rules developed for negotiable instruments (or other documentary intangibles) to determine priority or other proprietary issues affecting title to the asset. For such assets, we see no reason to import a requirement, as a condition to establish title to the asset, that there must be an action manifesting an intention to possess the asset (*animus possidendi*[11]) – as such a requirement might suggest an action that is required beyond the simple entry of the holder on the relevant ledger or account (as the primary record of entitlement to the asset). Equally, we consider that the priority or perfection of rights or interests relating to such cryptoassets should be determined by the corresponding rules relating to registered intangible assets[12] – and not to the rules relating to negotiability[13].

15. We also consider that the Digital Assets Papers may underestimate the jurisprudential difficulty, as a matter of English law, of possessing intangible, fungible assets. Many of the intangible assets recorded on DLT or other similar electronic technology will be constituted as identical and interchangeable rights or claims, which are not numbered or otherwise identifiable individually so as to be capable of segregation. As a general principle, it is a pre-condition to the effective possession or bailment of an asset under English law that the asset should be identified, segregated and appropriated by or for the person who claims to possess it[14]. In the absence of such identification, segregation and appropriation, the relevant party may at best have only a personal claim in relation to the asset. This fundamental principle of English law is modified for a pre-paying buyer of part of a bulk of goods under section 20A of the Sale of Goods Act 1979, but with respect to fungible cryptoassets it may in principle (without appropriate associated legislative reform) prove difficult to satisfy the requirements for identification, segregation and appropriation to a holder or transferee in order to establish their "possession" of the relevant cryptoasset as a matter of law[15].

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[11] On the requirement for an intention to possess as a criterion to establish title founded on possession of an asset: see the CP at paras. 5.40 and 5.121 to 5.128.

[12] See, for example, *Société Générale -v- Walker (1886) 11 AC 20, Ireland -v- Hart [1902] 1 Ch. 52* and *Dodds -v- Hill (1865) 2 H&M 424*.

[13] We would emphasise, on this point, that there is no reason to conclude that the finality and integrity of the title of a transferee to a cryptoasset treated as analogous to a registered security, and therefore governed by the priority and perfection rules applicable to registered securities, would be "lesser" than the corresponding title that the transferee might acquire if the asset were treated as amenable to possession (and, therefore, transferable subject to the rules of negotiability). In connection with the dematerialisation of the UK's money markets (see Section C of this paper), CRESTCo Limited (the former name of EUI) and the Bank of England consulted leading counsel, Richard Sykes QC, on this point of equivalence of finality and integrity of title in respect of money market instruments to be converted into uncertificated form under the USRs and held in the CREST relevant system. Counsel concluded that the scheme for the transfer of such instruments, as registered "eligible debt securities" with the protections afforded to transferees under regulation 35 of the USRs, would provide at least equivalent integrity and finality of title for a transferee as would be acquired by a transferee of a corresponding negotiable instrument held outside the CREST relevant system: see *"The Future of Money Market Instruments: A Consultation – Appendix II" (November 1999), https://studylib.net/doc/8778983/the-future-of-money-market-instruments*.

[14] See *Goode and McKendrick on Commercial Law at paras. 2.45, 2.59, 2.87 – 2.91 and 10.10*. See also *Re Goldcorp Exchange Ltd. [1995] 1 AC 74*, *Re Stapylton Fletcher Ltd. [1994] 1 WLR 1181* and *Re London Wine (Shippers) Ltd [1986] PCC 121.*

[15] Under English law, the issue of appropriation as relating to the creation of a trust over intangible, fungible assets has now largely been resolved as a practical matter by the decision of the Court of Appeal in *Hunter -v- Moss [1994[1 WLR 452*. As under current English law an intangible asset is not considered to be possessable, the English courts have not been required to date to develop similar jurisprudential reasoning to support the transfer, possession or bailment of an intangible, fungible asset that *ex hypothesi* is incapable of identification and segregation from another interchangeable asset.

C. *Existing market solutions: the risk of "overreach" under the Law Commission's proposals*

16. In Section B above, we have highlighted at the level of principle some fundamental concerns that the Working Group would have with any legislative proposal to extend wholesale the application of the concept of possession to digital assets governed by legal and operational arrangements that make them more akin to registered intangible assets.

17. A real-life example of how such a proposal could cause considerable uncertainty and disruption arises in the current operation of the UK's money markets. Prior to 2003, instruments such as bankers' acceptances, certificates of deposit, commercial paper and other short-term debt instruments were held and settled (as negotiable instruments) in physical form[16]. However, as a result of amendments made to the USRs in 2003[17], it became possible to issue, hold and transfer such instruments (in uncertificated form) in and through the CREST relevant system under the USRs.

18. In developing the statutory, contractual and operational model for the digitalisation of the money markets, Euroclear UK & Ireland Limited (***EUI***), as operator of the CREST relevant system, the Bank of England (as the relevant supervisory authority) and HM Treasury consciously and specifically avoided any solution based upon an extension of the concept of possession to MMIs when held in uncertificated form in CREST. Any such extension was felt to be artificial and unhelpful, potentially incorporating legal concepts developed with reference to tangible assets (MMIs as negotiable instruments) into a statutory, contractual and operational framework developed with reference to shares and other registered securities.

19. In particular, none of EUI, the Bank of England or HM Treasury considered it fundamentally problematic or complex for the transfer of title to an MMI (when held in uncertificated form in the CREST relevant system) that the MMI was not (and should not be) amenable to possession[18]. Under the USRs, the new concept of an "eligible debt security" was established

[16] Between 1 October 1990 and the dematerialisation of the UK's money markets in 2003, trades in money market instruments (***MMIs***) were settled through the Central Moneymarkets Office (the ***CMO***) operated by the Bank of England (and, subsequently, CRESTCo Limited – the former name of EUI). While this system supported the electronic transfer of title to MMIs, the instruments themselves remained in physical form and were held on a non-fungible basis in the vaults of the Bank of England. The legal arrangements underpinning the holding and transfer of title to MMIs during this period relied on the bailment of the instruments to the Bank of England and the Bank's corresponding attornment of the instrument to the CMO member in whose electronic account (maintained as part of the service) the instrument was credited at any time. The operation of the CMO is an early example in the UK financial markets of how an entry on an electronic account can be "tethered" to a physical asset held outside of the securities settlement system itself. This was a product of the supporting contractual and custody arrangements, under which the bailee (the Bank of England) agreed to hold identifiable, segregated money market instruments for the benefit of (and so as to attorn to) the account-holder to whose account the digital representation of the relevant MMIs were credited at any particular time. The example of the CMO also, in our view, underscores the legal risk in seeking to impose a uniform statutory solution, whether based on "possession" or otherwise, for the transfer of "tokenised" assets (see paras. 2.53 to 2.57 of the CE). Participants of a systemically important financial market infrastructure or other system, in which tokenised or equivalent assets are recorded and transferable, are highly likely in practice to have put in place a clear, well-founded and enforceable legal basis (whether by contract and/or statute) to support the finality and integrity of transfer of title to those asserts through the system. The legal solutions adopted are likely to be highly responsive to the operational model adopted by the system and the relevant requirements of its stakeholders (including participants, the provider(s) of the settlement asset and relevant supervisory authorities). Such solutions may rely on bailment, trust or other legal constructs. It would be essential to ensure that any legislative reform in this area does not undermine the enforceability of, or public confidence in, such arrangements by creating legal uncertainty through an inappropriate extension of an inconsistent statutory solution to bring such arrangements within scope of the proposed reform.

[17] The relevant amendments were made under the Uncertificated Securities (Amendment) (Eligible Debt Securities) Regulations 2003.

[18] In this respect, we would strongly disagree with the statement in the CE (at para. 2.33) that, *"Part of the complexity in relation to the transfers of digital assets arises because digital assets are intangible and so are not currently possessable under law"*. We do not consider, on the basis of the operation of the UK's money markets through the CREST relevant system, that the failure of English law to apply the concept of possession to digital assets in itself creates complex or insoluble issues. The statutory framework established under the USRs

to cover and replicate (as a matter of statutory interpretation and practical application) the complete range of instruments that are issued, traded, held and settled in the UK's money markets. These instruments are held and transferred under a statutory scheme for the maintenance of "Operator registers of eligible debit securities" on and subject to the provisions of the USRs. This framework allows for, and supports, a robust, clear and enforceable basis for the transfer of digitalised MMIs and related provisions to govern perfection, priority and other proprietary issues affecting such instruments (as eligible debit securities)[19].

20. We would also briefly mention the statutory solution that was adopted to allow for the "electronic presentment" of cheques, other bills of exchange, promissory notes and other instruments through the Image Clearing System (the ***ICS***) (now operated by Pay.UK Limited) – which was launched on 30 October 2017. Section 13 of the Small Business, Enterprise and Employment Act 2015 inserted a new Part 4A into the Bills of Exchange Act 1882. New sections 89A to 89F of the 1882 Act modify the old statutory and common law rules that required the physical presentment of an instrument to the drawee for payment. An image of such instruments can now, on the basis of these provisions, be transmitted to the drawee bank or other payment service provider through the ICS and be an effective presentment of that instrument for payment under English law.

21. In a similar way to the approach taken for the dematerialisation of the UK's money markets, considerable care was taken by the operator of the ICS, in collaboration with HM Treasury, to develop a legislative solution for the partial digitalisation of instruments to respond to the particular needs of the markets for payments services to be served by the ICS[20]. In this case, it was concluded that it would not be appropriate or helpful to seek to digitalise cheques or other payment instruments – which are still issued and held in physical form – but a key part for the process of exercising the rights of a holder (i.e. to present an instrument as a condition to receive payment on it) was, in effect, "digitalised". The importance of this project, in the context of the Digital Assets Papers, is that it is another

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for digitalised MMIs (that include some of the instruments, e.g. banker's acceptances as bills of exchange that are, or may become, the subject of the Law Commission legislative proposals for possession under the CP: see paras. 3.79 and 3.85) has supported the safe, efficient and effective holding and transfer of title to such assets since 2003. It would be highly disruptive to the MMIs market, that statutory framework and the operation of the CREST relevant system if such instruments were now to be brought into scope of the Law Commission's legislative proposals for electronic trade and related documents. At a minimum, therefore, we consider it would be essential for any instrument constituted (under its terms of issue) as an eligible debt security, to be held and transferred in the CREST relevant system on and subject to the USRs, to be excluded from scope.

[19] These include solutions for functions that operate in a similar way to the off-chain "Layer 2" applications that, as explained in para. 2.35 of the CE, may cause specific problems for the proposal to extend the concept of possession to all types of digital asset. This is because "possession", as a construct of common law, is likely to be less flexible than those concepts developed in equity to deal with issues arising in relation to intangible assets.

[20] In the course of developing the new legislative framework for electronic presentment of cheques and other eligible instruments, the ICS Operator and HM Treasury identified a number of provisions of the Bills of Exchange Act 1882 which were drafted on the basis that the relevant bill of exchange or promissory note would be held in tangible form. We consider that there may be a number of additional sections of the 1882 Act that would need to be modified under the statutory proposals put forward by the Law Commission in its CP, if it were proposed to apply them to relevant bills of exchange or promissory notes issued and held in digital form. Some of these changes would be required because the relevant section of the 1882 Act contemplates a physical location for an act relevant to the instrument to take place (see e.g. the concept of the "proper place" in ss. 45(3) and (4)) or for the continuing tangible nature of the instrument on which an act may be required to be effected (e.g. the requirement that any act of cancellation of a bill of exchange or promissory note must be *"apparent thereon"*: see s. 63).

example of a bespoke statutory solution[21] developed and adopted by a particular market that is responsive to the requirements of that market. It suggests that a "one size fits all" legislative proposal to extend the applicability of the concept of possession to all instruments (that are negotiable or transferable as documentary intangibles in the certificated environment) should be developed with considerable caution and with care to avoid disrupting established market practice for existing financial instruments.

22. However, it is fair to say that we recognise that there may be limitations to the introduction of closed statutory or contractual systems, such as those we outline above in this Section C, which effectively require market participants to "opt-in" for them to apply. There may be a number of digital asset types that relate to tangible real-world assets accepted as negotiable and widely tradeable by a range of market participants (including consumers). In these circumstances, it is likely that English courts will still need to resolve issues in relation to digital assets where parties have not consciously opted-in or opted-out of an applicable regime. In such cases, it would still be necessary to rely upon an apposite and well-founded underlying analysis of property rights, including how they relate to the relevant digital asset outside of such a closed system's specific arrangements.

23. We also recognise that, in those cases where the digital asset is not itself a chose in action (but is properly viewed as some form of "third category" property right[22]) and/or is not recorded on a ledger that performs functions equivalent to a register of shares, securities or other registered intangible assets, there may be no perfect analogy between securities and the relevant digital asset. In developing policy in this space, it will be necessary to consider the nuances between different types of digital assets.

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[21] Aside from the statutory solutions outlined in this paper, and in addition to the non-statutory solutions identified and discussed in the CP at paras. 2.36 to 2.43, modern day custody arrangements in relation to intermediated securities generally (as a matter of English law and regulation) rely upon the custodian's status as a trustee (and not as a bailee) of the underlying securities or cash deposits (or right or interest in or in relation to the underlying securities or cash deposits) held by or on behalf of the custodian for the benefit of its clients (as account-holders). We consider that the wide recognition and acceptance of such trust structures, as relating to intangible rights recorded in securities and cash accounts maintained by custodians and other intermediaries, further potentially undermine the view that the legal risk issues created by the digitalisation of assets requires as a solution the extension of the applicability of the concept of possession (and its related legal constructs, such as bailment, pledge or conversion) to such assets: see paras. 2.59 to 2.81 of the CE. We believe, for example, that custodians and other intermediaries (or other financial market participants as collateral-takers of intermediated securities) do not in practice consider that any material legal, operational or other risks arise by reason of the fact that the proper characterisation of any security interest over intermediated securities is that of a charge or mortgage – rather than a pledge. Indeed, we consider material legal uncertainty and inconsistency would be introduced into English law (whether as the law governing a securities account, the law of the financial collateral arrangement over securities credited to such an account or the law of the place where the securities account is maintained) if law reform were to re-characterise intermediated securities (contrary to the accepted market view and supporting contractual/regulatory frameworks) as being amenable to possession (and bailment or pledge arrangements and conversion claims). We would, separately (and as the City of London Law Society has indicated in its response document to the Law Commission's call for evidence relating to its scoping paper on intermediated securities published on 11 November 2020) strongly support specific and targeted reforms on certain aspects of the law relating to the holding and transfer of title to intermediated securities. However, we do not consider that the clarity, certainty and enforceability of the law relating to such assets (whether held on DLT or a similar electronic technology) would be enhanced by extending the concept of possession to them when held in digital form. We make these observations not to suggest, of course, that the trust device (which is a specific construct of English common law) should itself be used to provide any form of general solution to the issues identified in the Digital Assets Papers. They merely illustrate that, in practice, other market solutions (outside the extension of the concept of possession) have been developed in response to the digitalisation of assets in certain markets. Any proposed legislative solution in this area should, as far as possible, reflect the inherently international nature of digital assets and accordingly adopt a clear, well-founded and comprehensible legal framework that is likely to be widely acceptable for use in cross-border business – but do so without undermining existing market solutions for digitalisation that remain efficient and effective for participants in those markets.

[22] We use the term "third category" property right to refer to a digital asset that, upon a proper analysis of its inherent features, does not display the indicia of either a chose in possession or a chose in action.

24. The appropriate classification and legal analysis is likely, therefore, to differ for any digital asset depending on its purpose and audience. This may allow for a distinct approach to be taken in relation to specific markets, including for trade finance as is proposed in the CP, acknowledging that in this case possession and the ability to pledge trade instruments may well be considered as crucial to the smooth continuation of existing market practice (subject to our observations in footnote 10 above).

The Working Group which prepared this paper consists of:

Financial Law Committee

Dorothy Livingston, Herbert Smith Freehills LLP (Chairman Committee and Working Group)

Mark Evans, Travers Smith LLP

Laura Nixon, Clifford Chance LLP

Sarah Smith, Dechert LLP

John Sayers, Simmons & Simmons LLP

Richard Hay, Linklaters LLP

Regulatory Law Committee

Karen Anderson, Herbert Smith Freehills LLP (Committee Chair)

Mark Kalderon, Freshfields LLP