



Response to Law Commission: Consultation on Digital Assets

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1. Introduction and Background

- 1.1. The role of the Financial Markets Law Committee (the “**FMLC**” or the “**Committee**”) is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.
- 1.2. Following its Call for Evidence on Digital Assets¹, the Law Commission has published its Digital Assets: Consultation Paper (the “**Consultation Paper**”) setting out its recommendations for the development of English private property law in relation to digital assets and seeking views on its proposals.²
- 1.3. In July 2021, the FMLC responded to the Law Commission’s initial Call for Evidence, putting forward its views on how the law could be reformed to improve legal certainty in this area for the wholesale financial markets (the “**FMLC Paper**”).³
- 1.4. This paper builds on the FMLC Paper, responding to questions posed by the Consultation Paper. The Committee has chosen to focus on the questions which are most relevant to the wholesale financial markets and therefore does not seek to address all the questions posed by the Law Commission.⁴

2. Third Category of Personal Property and Crypto-Tokens

- 2.1. **Consultation Question 1:** *We provisionally propose that the law of England and Wales should recognise a third category of personal property. Do you agree? [Paragraph 4.101 of the Consultation Paper]*

Yes, we agree. See paragraph 3 of the FMLC Paper for further comment on the development of a third category of personal property.

- 2.2. **Consultation Question 2:** *We provisionally propose that, to fall within our proposed third category of personal property, the thing in question must be composed of data represented in an electronic medium, including in the form of computer code, electronic, digital or analogue signals. Do you agree? [Paragraph 5.21 of the Consultation Paper]*

Yes, we agree.

¹ Law Commission, Digital Assets Call for Evidence (30 April 2021), available at: <https://www.lawcom.gov.uk/project/digital-assets/#digital-assets-call-for-evidence>

² Law Commission, Digital Assets: Consultation Paper (July 2022), available at: <https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2022/07/Digital-Assets-Consultation-Paper-Law-Commission-1.pdf>

³ FMLC, Response: Law Commission Call for Evidence on Digital Assets (July 2021), available at: <http://fmlc.org/response-to-law-commission-call-for-evidence-on-digital-assets/>

⁴ Accordingly this paper is organised by topic and does not address the questions in chronological order in all places.

- 2.3. Consultation Question 3:** *We provisionally propose that, to fall within our proposed third category of personal property, the thing in question must exist independently of persons and independently of the legal system. Do you agree? [Paragraph 5.41 of the Consultation Paper]*

Yes, we agree.

- 2.4. Consultation Question 4:** *We provisionally propose that, to fall within our proposed third category of personal property, the thing in question must be rivalrous. Do you agree? [Paragraph 5.73 of the Consultation Paper]*

Yes, we agree.

- 2.5. Consultation Question 5:** *We provisionally propose that a data object, in general, must be capable of being divested on transfer. Do you agree? Please give examples, if any, of when this will not be the case.*

We provisionally propose that divestibility should be regarded as an indicator, or general characteristic of data objects, rather than as a gateway criterion. Do you agree? [Paragraph 5.105 of the Consultation Paper]

The Committee agrees with the idea that the data object must be capable of being divested on transfer. We think this is consistent with the concept of the data object being rivalrous. We cannot think of any examples of tokens that do not operate in this way although we note there is debate as to whether upon transfer a crypto-token is actually transferred or whether the crypto-token held by the transferor is extinguished and a new crypto-token created to be held by the transferee. Please see paragraph 3.4 of this paper for further comment on this.

We agree with including this concept as an indicator rather than as one of the gateway criteria; such inclusion allows for greater flexibility and we believe that the rivalrous requirement will in many cases mirror whether or not the data object can be divested.

- 2.6. Consultation Question 6:** *We provisionally propose that: (1) the law of England and Wales should explicitly recognise a distinct third category of personal property; and (2) a thing should be recognised as falling within our proposed third category of personal property if: (a) it is composed of data represented in an electronic medium, including in the form of computer code, electronic, digital or analogue signals; (b) it exists independently of persons and exists independently of the legal system; and (c) it is rivalrous. Do you consider that the most authentic and appropriate way of implementing these proposals would be through common law development or statutory reform? [Paragraph 5.142 of the Consultation Paper]*

The Committee recognises that both options, either common law development or statutory reform, have their benefits and their drawbacks. Ultimately we appreciate that the decision will require policy makers to determine what their policy priorities are in order to decide on the appropriate approach. On balance, in our view we consider common law development the most appropriate way to implement the Law Commission's proposals on a third category of personal property.

As noted in the Consultation Paper at paragraphs 4.39 to 4.47, the English courts have begun to recognise crypto-assets as property for the purposes of English law, and have at the same time noted that such assets do not neatly fall into the

two existing categories. The courts have also begun to recognise things as property despite recognising that they do not in fact fall into the two existing categories, for example emission allowances.⁵ A key advantage of the common law is its flexibility, and it is the Committee's view that English courts have the tools (including the Law Commission's recommendations in its Consultation Paper) to recognise a third category of personal property which is able to adapt to the constantly evolving technologies associated with crypto-assets.

In addition to the flexibility afforded by the common law, development by common law would be more consistent with the existing articulation of property and would allow the third category to benefit from the significant body of common law that already considers how the existing types of property can be transferred, held and used as collateral.

The FMLC is aware of the disadvantages of waiting for common law development (and the corresponding advantages of statutory reform) particularly the need for appropriate cases to be heard by sufficiently senior courts, such cases being limited to the facts at hand and the need for willing parties and sufficient funding. The Committee also recognises that until sufficient precedent has been established, a level of uncertainty may remain which in itself can impact the types and quantity of cases that will reach the court. However, on balance, the flexibility of common law and consistency with the existing approach to property, outweighs these possible disadvantages in our view. The Committee would also argue the procedure for bringing test cases could be used to mitigate some of these issues, as this can be done fairly quickly and does not require very lengthy and costly litigation (as evidenced by the precedent set in the business interruption cases brought as a result of the disruption caused by COVID-19).

Although statutory reform may provide some certainty and comfort to the market in the short term, inevitably the statute risks being so narrow as to become out of date soon after it is drafted (particularly given the nature of this constantly evolving area) or so wide as to be reliant on further interpretation by the court to provide certainty as to its application and operation. While others may argue that statutory reform is usually faster than the common law, given the Government's recent decision to tackle retained EU law and the likely full parliamentary timetable up until the new general election, statute on this matter is unlikely to be in force for a number of years in any case.

2.7. Consultation Question 15: *We provisionally conclude that crypto-tokens satisfy our proposed criteria of data objects and therefore that they fall within our proposed third category of personal property. Do you agree? [Paragraph 11.139 of the Consultation Paper]*

Broadly, we agree. However, the pace of change in this area means that we cannot rule out the possibility of crypto-tokens being created in the future that do not neatly fit within the definition. This follows our support for common law development of the third category of personal property to ensure flexibility in light of this constantly evolving area.

2.8. Consultation Question 27: *Are there any other types of link between a crypto-token and a thing external to a crypto-token system that you commonly encounter or use in practice?*

⁵ See *Armstrong DLW GmbH v Winnington Networks Ltd* [2012] EWHC 10 paragraphs 58 – 61.

We provisionally conclude that market participants should have the flexibility to develop their own legal mechanisms to establish a link between a crypto-token and something else — normally a thing external to the crypto-token system. As such, we provisionally conclude that no law reform is necessary or desirable further to clarify or specify the method of constituting a link between a crypto-token and a linked thing or the legal effects of such a link at this time. Do you agree? [Paragraph 14.114 of the Consultation Paper]

The Committee has not encountered any other types of link that are not already outlined in the Consultation Paper.

We agree that market participants should have flexibility in establishing a link between a crypto-token and something else and that no law reform is required.

3. The Concepts of Control and Possession

3.1. Consultation Question 16: *We provisionally propose that the concept of control is more appropriate for data objects than the concept of possession. Do you agree? [Paragraph 11.11 of the Consultation Paper]*

As a foundation for considering the acquisition of property rights, transfers, custody arrangements, etc., but without being determinative of legal title, we agree that 'control' is a more applicable concept than 'possession' (which can include 'occupancy' of a chose and may also imply legal rights). Control of a data object including the private key to such data object giving the ability to act upon that data object (e.g. to buy, sell or otherwise exchange it; or to use the private key for access to the ledger) is more operative than 'possession' which is a bundled concept and 'occupancy' of a data object is difficult to establish.

3.2. Consultation Question 17: *We provisionally propose that, broadly speaking, the person in control of a data object at a particular moment in time should be taken to 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 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) and (2) above. Do you agree? [Paragraph 11.112 of the Consultation Paper]*

While we agree with the criteria set out in (1) and (2) above, in our view these should be reversed in terms of order. The initial question should be whether or not a person is able to put the data object to the uses it is capable of, and then whether they are able to exclude others from doing the same. As a starting point "to exclude others from the data object" could be read more broadly as blocking others from having any access to the data object (whether they are able to make use of it or not). We do not agree with (3) as the ability to identify oneself as having the abilities set out in (1) and (2) is not a necessarily a relevant characteristic of having control. As with the traditional forms of property, a person may have control and/or possession of the property without necessarily being aware they have acquired it.

3.3. Consultation Question 18: *We provisionally conclude that the concept of control as it applies to data objects should be developed through the common law, rather than being codified in statute. Do you agree? [Paragraph 11.128 of the Consultation Paper]*

The Committee agrees that common law development where robust elements of existing law are adapted and applied to fact patterns involving data objects is a

better approach than codification. This would better align with the development of the concept of possession in relation to choses in possession.

- 3.4. Consultation Question 20:** *We provisionally conclude that a transfer operation that effects a state change within a crypto-token system will typically involve the replacing, modifying, destroying, cancelling or eliminating of a pre-transfer crypto-token and the resulting and corresponding causal creation of a new, modified or causally-related crypto-token. Do you agree? [Paragraph 12.61 of the Consultation Paper]*

The FMLC has previously expressed its disagreement with this characterisation, please see our comments in paragraph 7 of the FMLC Paper. While we agree that this may describe the technological sequence of events that may be involved in a transfer, we do not think this best describes what is happening from a legal perspective and may not reflect what market participants see as happening (in relation to certain implementations, there may be more support for the view of continuity between the data object in the hands of both transferor and transferee). We also consider that it should be possible for transfers to occur off-chain (see our response to Question 24 at paragraph 4.4 of this paper) and therefore think the focus on this type of analysis is problematic when taking into account the range of transfers which may be undertaken. While this may be an appropriate characterisation in some instances, it will depend on the facts.

4. Factual and Legal Transfers

- 4.1. Consultation Question 21:** *We provisionally conclude that the rules of derivative transfer of title apply to crypto-tokens, notwithstanding that a transfer of a crypto-token by a transfer operation that effects a state change involves the creation of a new, causally-related thing. Do you agree? [Paragraph 13.90 of the Consultation Paper]*

We generally agree, although we would note that the rules on derivative transfers of title are not a unitary body of law that either applies or does not apply, but rather constitute a complex set of rules that have largely been developed by the courts in response to particular circumstances through the evolution of the common law and equity. The application of those rules in the context of crypto-tokens is therefore more nuanced than would appear to be suggested by the statement that they simply apply (as indeed is recognised in Chapter 19 of the Consultation Paper).

For example, if a transfer of a crypto-token by an operation that effects a state change involves the creation of a new, albeit causally-related, asset (see our comments on this at paragraph 3.4 of this paper), then legal title cannot pass from transferor to transferee. This is because legal title cannot survive the destruction of the asset to which it relates. We therefore agree with the Consultation Paper's conclusion in paragraph 19.48 that the process of following at common law is likely to be of little relevance in the event of such a transfer. Furthermore, although we agree it is a question of fact, our understanding is that transfers of crypto-tokens do not generally involve the clean substitution of one crypto-token for another. This means that, although theoretically available, the process of tracing at common law is also unlikely to be available in practice for many crypto-tokens as currently structured (see our comments in paragraph 7.2 of this paper regarding tracing). The rules on derivative transfers of title nevertheless do remain relevant, insofar as they take effect in equity, notably under the rules on equitable tracing. (We would note that this is also the position for most transfers of incorporeal money, notwithstanding that a transfer of incorporeal money operates to extinguish the claim of the transferor against its

bank, and to give rise to a fresh claim in the hands of the transferee against the transferee's bank.) By contrast, if there is a continuous asset in the hands of both transferor and transferee, the rules on derivative transfers of legal title will also be available.

This means the applicability (or otherwise) of particular rules on derivative transfers of title may depend on the technical implementation of a particular crypto-token. For example, there may be cause to distinguish between UTXO-based and account-based crypto-tokens (to the extent these more clearly align with the Commission's favoured destruction and creation analysis), on the one hand, and certain implementations of NFTs, on the other (noting the Committee's comments on the destruction and creation analysis more generally). In many cases, notwithstanding these differences, the common law and equitable rules will provide substantively equivalent outcomes in terms of remedies. Nevertheless, differences in outcome may remain, which the FMLC would not consider to be a satisfactory outcome in line with market expectations. For that reason, particularly if the "destruction-creation" analysis is to persist, the FMLC would view this as further support for the development of an innocent acquisition rule applicable regardless of the particular features of the underlying technology (see our further comments in paragraph 4.2 of this paper).

We would also note that the application of the rules on derivative transfers of title is subject to the question of the negotiable status (or otherwise) of crypto-tokens. We note the view expressed in the Consultation Paper that it "seems clear [...] that a crypto-token is not a negotiable instrument, as that term is currently understood" (at paragraph 13.43). This coincides with the UKJT Statement, which noted that the authors were not aware of any mercantile usage treating crypto-assets as negotiable. The FMLC notes that the evidence required for the establishment of a new category of negotiable instrument is that of its "passing by delivery from hand to hand" (*Bechuanaland Exploration Co v London Trading Bank Ltd* [1898] 2 QB 658), and that it does not matter that a practice is recent provided that there is evidence of it being established (*Edelstein v Schuler & Co* [1902] 2 KB 144). The FMLC would observe that crypto-tokens in many cases pass from transferor to transferee without inquiry of the underlying chain of title, with the market expectation generally being that a good faith transferee does not take the crypto-token subject to prior equities. There is currently no direct authority to the effect that the courts would be ready to apply the rules in relation to the establishment of a mercantile custom in relation to negotiable instruments, which have to date evolved in the context of transfers of tangible instruments (and, therefore, reliant on possessory concepts such as delivery), as applicable to intangible assets that are incapable of being possessed in the traditional sense. To the extent they were, however, and a relevant market practice established, it is important to note that to that extent, the rules on derivative transfers of title would apply only subject to the rules applicable to transfers of negotiable instruments.

4.2. Consultation Question 22: *We provisionally propose that:*

- 4.2.1. (1) *A special defence of good faith purchaser for value without notice (an innocent acquisition rule) should apply to a transfer of a crypto-token by a transfer operation that effects a state change. Do you agree?*

The FMLC agrees that a special defence of good faith purchaser for value without notice (an innocent acquisition rule) should apply to a transfer of crypto-token, even where the transfer operation is considered to effect a causally connected state change. The growing decentralised finance industry is based on the transferring of digital assets for later use and, by applying the special defence of

good faith purchaser for value without notice to crypto-tokens, the law would promote the security of transactions.

Noting the Commission's position at paragraphs 13.37 to 13.50 of the Consultation Paper that the defences of good faith purchaser for value without notice that apply to negotiable instruments and money are unlikely to apply to crypto-tokens because they likely do not constitute money or negotiable instruments, and our agreement in response to Question 25 in paragraph 4.5 of this paper that it is not appropriate to treat crypto-tokens as analogous to "goods" under the Sale of Goods Act 1979 and other related statutes, there are good reasons why a similar defence should be developed by analogy with the existing defences. As the Consultation Paper observes, it is likely that market participants expect that an innocent acquisition rule already applies to the transfer of crypto-tokens. Furthermore, we agree that the implementation of a specific innocent acquisition rule in this context would provide certainty, even if there are arguments that the technical characteristics of a transfer operation that effects a state change might mean that such a defence is not strictly needed.

The FMLC further notes similar recommendations for the introduction of an explicit innocent acquisition rule in the context of crypto-tokens by both the Uniform Law Commission's Uniform Commercial Code and Emerging Technologies Committee, which was adopted among the "Amendments to the Uniform Commercial Code (2022)" that were finalised in July 2022, and the UNIDROIT Digital Assets and Private Law Working Group and considers, that in the absence of international co-ordination, the application of a similar position under English law would reduce the possibility of a conflicts of law issues in this area.

The FMLC also notes the recommendation made by the Law Commission in its Scoping Paper titled "Intermediated securities: who owns your shares?" that the Government should consider undertaking further work to make the position for innocent purchasers certain, clear and fair in relation to intermediated securities. Given intermediated securities and crypto-tokens share similar characteristics, we would recommend that reform in this area is considered for both types of assets to ensure consistent treatment and mitigate any unintended consequences of different treatment.

4.2.2. (2) An innocent acquisition rule should apply to both "fungible" and "nonfungible" technical implementations of crypto-tokens. Do you agree?

The FMLC agrees that the special defence of good faith purchaser for value without notice should in principle apply to transfers of all crypto-tokens.

4.2.3. (3) An innocent acquisition rule cannot and should not apply automatically to things that are linked to that crypto-token. Do you agree? [Paragraph 13.91 of the Consultation Paper]

The FMLC agrees that the innocent acquisition rule cannot and should not apply automatically to things that are linked to that crypto-token. Proceeding from the Commission's observations at paragraph 13.87 of the Consultation Paper that whether any external legal rights of the (former) holder were preserved notwithstanding the transfer to an innocent acquirer would depend on how those rights were structured, the FMLC agrees that an automatic application of the defence to things that are linked to the crypto-token may result in a certain degree of inflexibility for market participants, which in turn could harm legal certainty. As set out in our response to Question 27 in paragraph 2.8 of this

paper, we agree the market participants should be afforded legal flexibility when establishing links between crypto-tokens and things external to the crypto-token.

4.3. Consultation Question 23: *We provisionally propose that an innocent acquisition rule in respect of transfers of crypto-tokens by a transfer operation that effects a state change should be implemented by way of legislation, as opposed to common law development. Do you agree? [Paragraph 13.94 of the Consultation Paper]*

The FMLC agrees that it would better ensure legal certainty to implement an innocent acquisition rule in respect of transfers of crypto-tokens by way of legislation, this being consistent with the Law Commission's recommendations in relation to intermediated securities. However, common law negotiability should not be excluded for crypto-tokens as it would allow for market customs to develop over time thereby providing flexibility for participants in structuring their arrangements, as the technology further develops.

4.4. Consultation Question 24

4.4.1. *We provisionally conclude that the rules of derivative transfer of title apply to crypto-tokens and that it is possible to separate (superior) legal title from the recorded state of the distributed ledger or structured record and/or factual control over a crypto-token. Do you agree?*

With respect to the conclusion on the rules of derivative transfer of title, we refer to our response to Question 21 at paragraph 4.1 of this paper.

With respect to the question of the separation of superior legal title from the recorded state of the distributed ledger and/or factual control over a crypto-token, the Committee agrees and considers that it is a distinguishing feature of crypto-tokens that they are amenable to the recognition of a form of relative legal title based on a factual state of affairs associated with control, as distinct from absolute title (and, to that extent, have a degree of commonality with tangible property, as opposed to things in action, which are not susceptible to relative title by their very nature). By extension, there would appear to us to be no reason that the law should not develop to recognise forms of constructive, in addition to actual, relative legal interests (just as the law currently recognises constructive possession as a legal, proprietary interest).

Furthermore, we consider there to be no compelling reason for the law to curtail the legitimate commercial arrangements of parties seeking to transfer absolute title off-chain through an effective transfer of control. We therefore do not agree with the statement that the transfer operation that effects a state change is a necessary but not sufficient condition for a transfer of the superior legal title (at paragraph 13.18 of the Consultation Paper), and do not see a clear basis for concluding in paragraph 13.142 of the Consultation Paper that "this is already the position at law". If it is possible to separate (superior) legal title from the recorded state of the distributed ledger or structured record, then a transfer operation that effects a state change (which necessitates a change in the distributed ledger or structured record) cannot be necessary for a transfer of title.

4.4.2. *We provisionally conclude that, over time, the common law is capable of developing rules to assist with the legal analysis as to title and/or priority where disputes arise between multiple persons that have factual control of a cryptotoken, and that statutory reform would not be appropriate for this purpose. We consider that those rules will need to be specific to the technical means by which such factual circumstances can arise within crypto-token systems or with respect to crypto-tokens. Do you agree? [Paragraph 13.112 of the Consultation Paper]*

Yes, we agree.

4.5. Consultation Question 25: *We provisionally conclude that it is not appropriate to treat crypto-tokens as analogous to "goods", as currently defined in the Sale of Goods Act 1979 and other related statutes, including the Supply of Goods and Services Act 1982 and the Consumer Rights Act 2015. Do you agree? [Paragraph 13.144 of the Consultation Paper]*

Yes, we agree. The Sale of Goods Act 1979 is clearly intended to deal with tangible movable objects. The implied terms in that Act, other than arguably the term on quiet possession, are not appropriate to crypto-assets. There is no "description" of the goods: crypto-assets could be said to be described by their name, and possibly in the white paper accompanying them, however that white paper will not describe their quality or condition, at most white papers would touch on a token's functionality. Buyers will not make a purpose known to the seller, and therefore it would not be possible to ensure such assets are "fit for purpose" (noting that sellers can generally safely assume that the assets are being bought either for investment or speculative purposes).

4.6. Consultation Question 26: *We provisionally propose that the law should be clarified to confirm that a transfer operation that effects a state change is a necessary (but not sufficient) condition for a legal transfer of a crypto-token. We consider that this state change condition is more appropriate than the potentially wider condition of "a change of control". Do you agree? Do you agree that such a clarification would be best achieved by common law development rather than statutory reform? Accordingly, we provisionally conclude that allowing title to a crypto-token to transfer at the time a contract of sale is formed, but where no corresponding state change has occurred, would be inappropriate. Do you agree? [Paragraph 13.145 of the Consultation Paper]*

4.6.1. (1) *The law should be clarified to confirm that a transfer operation that effects a state change is a necessary (but not sufficient) condition for a legal transfer of a crypto-token, and the state change condition is more appropriate than the potentially wider condition of "a change of control".*

No, we do not agree. In the Committee's view and as per our response to Question 24 in paragraph 4.4 of this paper, it is possible to transfer title of a crypto-token without there being a state change, for example in certain custody arrangements, or the sharing of a private key in certain circumstances. If there has been a state change, then this should lead to the conclusion that there has been a change of title, but the absence of such a state change, for example in the case of off-chain transfers of title, should not automatically lead to the opposite conclusion.

4.6.2. (2) *The clarification regarding the state change condition would be best achieved by common law development rather than statutory reform?*

See our response above regarding our disagreement with the state change condition. However, we generally agree that common law development of legal principles surrounding the title and transfer of crypto-tokens would be best, allowing for flexibility as market practice and technology evolves.

- 4.6.3. (3) *Allowing title to a crypto-token to transfer at the time a contract of sale is formed, but where no corresponding state change has occurred, would be inappropriate.*

We would disagree with this proposal. As noted above, there can be a transfer of title without a state change and the possibility of a transfer of a crypto-token should be allowed off-chain as well as on-chain. The FMLC supports market participants' ability to enter into legitimate commercial arrangements to this effect.

5. Custody

- 5.1. Consultation Question 29:** *We provisionally conclude that it is appropriate to draw a distinction between direct custody services (that is, holding crypto-tokens on behalf of or for the account of other persons and having capacity to exercise or to coordinate or direct the exercise of factual control in terms of both its positive and negative aspects) and custodial or other technology-based services that do not involve a direct custody relationship. Do you agree? [Paragraph 16.41 of the Consultation Paper]*

The Committee agrees that it is appropriate to draw a distinction between what the Consultation Paper refers to as "direct custody services" and other services which do not involve a direct custody relationship. We agree there is a need to distinguish and treat these types of services and relationships differently with respect to the obligations owed to the ultimate owner.

However, the Committee notes that there will be a spectrum of relationships and services, where some may clearly fall on either side of the spectrum (on one side relationships which look like, and are documented, in a similar manner to custodial arrangements for traditional assets and on the other, manufacturers of hardware which are used to "store" digital assets), there may be edge cases where on the face of the service or relationship it is not clear. It is also the Committee's view that multiple services and relationships along that spectrum are a typical part of holding, owning, transferring or otherwise controlling digital assets. As each of these aspects (holding, owning, transferring or otherwise controlling digital assets) is capable of taking multiple physical forms as well as digital-only forms they need to be considered in their appropriate context. Properly drafted contractual relationships between all parties involved will help to avoid ambiguity and confusion between the parties as to their respective responsibilities and obligations, and disputes in relation to the ownership of, particularly of fungible, crypto-tokens.

The Consultation Paper suggests that much of the legal framework could be left to private law and that it would be up to the parties (the custodian or custody service provider and client) to agree the commercial terms under which the crypto-tokens are held (i.e., under outright transfer of title or on trust, for example) as well as any terms that would exclude or limit the custodian's liability for breach, including negligence. Whether such arrangements would provide suitable protection, particularly for consumers given the increasing use of crypto-token as a means of investment for retail clients, is a policy issue which is outside of our remit.

5.2. Consultation Question 30

5.2.1. *We provisionally conclude that, under the law of England and Wales, crypto-token custody arrangements could be characterised and structured as trusts, even where the underlying entitlements are (i) held on a consolidated unallocated basis for the benefit of multiple users, and (ii) potentially even commingled with unallocated entitlements held for the benefit of the custodian itself. Do you agree?*

The Committee agrees that crypto-token custody arrangements could be structured as trusts even in the case of commingled unallocated entitlements held for the benefit of multiple users, and even where commingled with unallocated entitlements held for the benefit of the custodian itself. In such a case, however, the arrangements must also meet the criteria for a trust under English law, i.e., (i) certainty of intention to hold on trust; (ii) certainty as to both the beneficiary and the subject matter of the trust; and (iii) no commingling of assets subject to the trust with assets not subject to the trust.

The characterisation of the trust under which crypto-tokens could be held is, however, in the Committee's view, still open to some debate. As set out in Lord Hope's judgment in *In Lehman Brothers International (Europe) (In Administration) and In the matter of the Insolvency Act 1986*, [2012] UKSC 6., under English law the mere segregation of fungible assets such as money into separate bank accounts is not sufficient to establish a proprietary interest in those funds in anyone other than the account holder and a certainty of intention to create a trust over the balances standing to the credit of the segregated accounts is needed to protect those funds in the event of the firm's insolvency. The court in *Lehman Brothers International* went on to state that segregation alone is not enough to provide that protection - nor is a mere declaration of trust. The court found that both elements must be present to give the degree of protection against the insolvency risk of the person holding client money.

If a third category of personal property is adopted in respect of data objects, including crypto-tokens, then the Committee is of the view that there must be sufficient definition to establish the "three certainties" noted in the Consultation Paper. These are that a trust has been declared, the identification of the beneficiaries that are the objects of the trust and the identification of the crypto-tokens which constitute the subject matter of the trust.⁶ These principles were adopted by section 137B of the Financial Services and Markets Act 2000 ("**FSMA 2000**") when the rule making powers conferred on the Financial Services Authority relating to the handling of client money were being formulated. The nature of the trust may present some difficulties with other types of data object (specifically NFTs) but it is likely that in relation to crypto-tokens these criteria can be satisfied.

5.2.2. *We provisionally conclude that the best way of understanding the interests of beneficiaries under such trusts are as rights of co-ownership in an equitable tenancy in common. Do you agree?*

Yes, we agree that the equitable co-ownership approach is the best way of understanding the interests of beneficiaries. Cases involving crypto-token custody arrangements should be analysed along similar lines to those applied to

⁶ Consultation Paper, Para. 16.56.

fungible intangible assets such as dematerialised shares and securities.⁷ Noting the Law Commission’s comment at paragraph 16.70 of the Consultation Paper that “where there are no express contractual provisions providing for an equitable co-ownership, the analysis [with respect to equitable co-ownership] could be regarded as being somewhat artificial”, we would argue that it would be even more difficult to consider the interests as anything else without express contractual agreement by the owners of the assets to that effect. For example, it would not be appropriate or consistent with the relationship between the owners for them to be treated as joint tenants.

5.2.3. *Do you consider that providers and users of crypto-token custody services would benefit from any statutory intervention or other law reform initiative clarifying the subject matter certainty requirements for creating a valid trust over commingled, unallocated holdings of crypto-tokens? If yes, please explain what clarifications you think would assist. [Paragraph 16.77 of Consultation]*

The Committee supports the Commission's provisional conclusion that no statutory reform is required to clarify the legal position in relation to subject matter certainty requirements for creating a valid trust over commingled, unallocated holdings of crypto-tokens. The Committee considers the courts would refer to existing case law, including that noted in the Consultation Paper in relation to intermediated securities, and apply similar judgements when faced with crypto-tokens.

Furthermore, if it is the intention of the regulatory authorities to include custody and safeguarding of crypto-tokens as a regulated activity⁸ under the FSMA 2000, it is likely that any safeguarding rules would reflect existing legal and regulatory requirements, including segregation of assets belonging to customers from the custodian's own assets, record-keeping, use of third-party providers, annual audit and insurance or guarantee arrangements.⁹

5.3. Consultation Question 31: *We provisionally conclude that a presumption of trust does not currently apply to crypto-token custody facilities and should not be introduced as a new interpretive principle. Do you agree? [Paragraph 16.107 of the Consultation Paper]*

Yes, the Committee agrees with the Law Commission’s conclusion that a new statutory presumption of trust should not be introduced. To institute a statutory presumption of trust could interfere with the valid transfer of data objects¹⁰ and could limit the remedies (personal or proprietary) available to users and custody providers. As the Consultation Paper sets out at paragraph 16.105, the law as it stands is sufficiently flexible that a court may find the existence of a trust where

⁷ See *Pearson, Lomas v Lehman Brothers Finance S.A.* [2010] EWHC 2914 (Ch).

⁸ See Financial Conduct Authority, Policy Statement Guidance on Cryptoassets Feedback and Final Guidance to CP 19.3 (PS 19/22). See also FCA CryptoSprint initiative which includes identified gaps in applying the existing custody framework for cryptoassets, particularly the FCA CASS Sourcebook. CryptoSprint has identified issues relating to the definition of “custody”, the evidence of ownership (specifically in case of a custodian’s insolvency), the bearer nature of private keys and other technological devices and issues relating to cross-border insolvencies involving crypto-assets including crypto-tokens.

⁹ Financial Conduct Authority, Finalised guidance, Coronavirus and safeguarding customers’ funds: additional guidance for payment and e-money firms, 9 July 2020.

¹⁰ See *Wang v Darby* [2021] EWHC 3054 (Comm).

appropriate in the circumstances, and the lack of a new statutory presumption would not prevent this.

Such a statutory presumption would not necessarily achieve the desired result in relation to claims arising from the insolvency of the custodian, as even without a statutory presumption it would be open to users to establish whether the arrangements constituted a Quistclose-type trust or other characterisation (express or resulting trust) and to use tracing to establish ownership or beneficial interest in the crypto-token assets under equitable principles.

5.4. Consultation Question 32

5.4.1. We provisionally propose that clarification of the scope and application of section 53(1)(c) LPA 1925 would be beneficial for custodians and would help facilitate the broader adoption of trust law in structuring custody facilities, in relation to cryptotokens specifically and/or to other asset classes and holding structures, including intermediated investment securities. Do you agree?

Yes, the Committee agrees such clarification should be made. Section 53(1)(c) of the Law of Property Act 1925 ("**LPA 1925**") imposes various limitations on the transfer or disposal of trust-based assets which are subject to it. However, issues remain as to the uncertainty of the application of sections 53(1)(c) and 136 LPA 1925 to intermediated securities (see our further comments below).

Any modification to the scope or application of section 53(1)(c) of the LPA 1925 should reflect industry concerns regarding the potential for fraudulent or criminal (including hacking) misappropriation of crypto-tokens held in custody. The use of DLT records introduces additional issues in relation to book entry and the record-keeping requirements of this section and the impact which these would have on transfers or dispositions of crypto-tokens.

For crypto-tokens, the Committee agrees that this risk can and should be adequately addressed for the different transfer types by the ledgers on which they would be settled (whether decentralised, external or professionally-maintained, centrally controllable) and the associated transaction instructions by which they would be executed or initiated.

5.4.2. If you think that clarification of the scope and application of section 53(1)(c) LPA 1925 would be beneficial, what do you think would be the best way of achieving this? Please indicate which (if any) of the models suggested in the consultation paper would be appropriate, or otherwise outline any further alternatives that you think would be more practically effective and/or workable. [Paragraph 17.58 of the Consultation Paper]

The options presented by the Law Commission are to:

1. Do nothing.
2. Statutory Reform:
 - a. Amend the LPA 1925 to disapply section 53(1)(c) to specified dealings in equitable entitlements and express recognition of various electronic communications satisfying "in writing" and signature formalities (as part of a wider agenda of reform and not specifically to deal with data objects and crypto-tokens).

- b. To expressly extend the LPA 1925 to cover equitable entitlements undertaken through centralised custodial arrangements and centrally controlled ledgers such as DLT records.
3. Clear and authoritative legal guidance (by the courts and/or a panel of industry experts, legal practitioners, academics, and judges,) as to the application of section 53(1)(c) rather than changing the LPA 1925.

Of these options, the Committee agrees with the Law Commission's view that Option 2a is likely the best approach for the reasons set out in paragraph 17.57 of the Consultation Paper. The FMLC has highlighted the uncertain application of this section of the LPA 1925 to transfers of intermediated securities in the past¹¹ and supports a broader reform of this section not limited to crypto-tokens. The Committee would note that any changes to the scope and application of this section should be made consistent with other changes to the law on the electronic execution of documents.¹²

5.5. Consultation Question 33: *We provisionally propose that legislation should provide for a general pro rata shortfall allocation rule in respect of commingled unallocated holdings of cryptotokens or crypto-token entitlements in a custodian insolvency. Do you agree? [Paragraph 17.81 478 of the Consultation Paper]*

No. The Committee considers that given the wider considerations on the impact of insolvency on crypto-tokens held in "custody" a general pro rata shortfall allocation rule would not be helpful unless in the context of comprehensive distribution rules similar to those under the Financial Conduct Authority's CASS Rules.¹³ Such a stand-alone rule could lead to extended litigation and, given the complexity of custody chains in relation to commingled unallocated crypto-tokens, particularly on a cross-border basis, could give rise to conflicts between the governing laws of platforms and exchange and those under which the custody arrangements are held.

5.6. Consultation Question 34

5.6.1. We provisionally conclude that extending bailment to crypto-tokens, or the creation of an analogous concept based on control, is not necessary at this time. Do you agree?

Yes, the Committee does not believe it is necessary or desirable to specifically extend bailment to crypto-tokens. As the FMLC Paper sets out¹⁴, bailment would not generally be a useful concept in the context of digital assets (with the exception of staking) and the concept of bailment would be rendered unnecessary if proof of stake protocols can be effectively managed under contractual or trust frameworks. To the extent such a concept would be useful for digital assets in

¹¹ See paragraph 14.19 of the FMLC Paper.

¹² Law Commission, Electronic execution of documents (Law Com No. 386) See also Financial Markets Law Committee letter to the Law Commission on 14th Programme of Law Reform including section 53(1)(c) of the Law of Property Act, 30 July 2021. (<http://fmlc.org/wp-content/uploads/2021/07/FMLC-response-to-Law-Commission-Consultation-on-14th-programme.pdf>)

¹³ Matteo Solinas, Investors' Rights in (Crypto) Custodial Holdings: *Ruscoe v Cryptopia Ltd* (in Liquidation). (2021) (84)(1) *Modern Law Review* 155 at 165-166.

¹⁴ FMLC Paper, Para 11.

the future, this should be open for development by the courts with the support of market commentary.

- 5.6.2. *If not, please provide specific examples of market structures or platforms that would benefit from being arranged as bailments, that could not be effectively structured using the trust and/or contract frameworks currently available. [Paragraph 17.103 of the Consultation Paper]*

No comment.

6. Security and Collateral

- 6.1. Consultation Question 35:** *We provisionally conclude that crypto-tokens, as objects of personal property rights, can be the subject of title transfer collateral arrangements without the need for specific law reform to provide for this. Do you agree? [Paragraph 18.17 of the Consultation Paper]*

The Committee agrees with the conclusion in the Consultation Paper that crypto-tokens, as objects of personal property rights, can be the subject of title transfer collateral arrangements without the need for specific law reform to provide for this.

We recognise that there may be operational and practical considerations which transacting parties will need to work through as part of a title transfer collateral arrangement to ensure that a transfer of title has indeed taken effect at law and is not at risk of being recharacterised as a security arrangement (for example, if the transferee is required to transfer back the same crypto-token at the end of the arrangement rather than “equivalent” crypto-tokens, this may weaken the argument that the arrangement is one of title transfer). Such operational and practical considerations, however, do not, in our view, merit a need for specific law reform.

As a side note, there may also be reasons why collateral takers will not favour the title transfer mechanism. In particular, banks and other entities may suffer from punitive regulatory capital costs from direct exposures. Similar considerations may apply in relation to a security interest effected by way of mortgage.

- 6.2. Consultation Question 36:** *We provisionally conclude that non-possessory securities can be satisfactorily granted in respect of crypto-tokens without the need for law reform. Do you agree? [Paragraph 18.26 of the Consultation Paper]*

The Committee agrees with the conclusion in the Consultation Paper that non-possessory securities can be satisfactorily granted in respect of crypto-tokens without the need for law reform. However, this is subject to the points raised in our response to Consultation Questions 38 and 39 in paragraph 6.4 of this paper, and in particular:

- We believe registration of a non-possessory security interest may be a barrier to the development of the types of legally enforceable smart contract collateral arrangements that might otherwise be possible. While there may be public policy reasons (as summarised in paragraph 18.39 of the Consultation Paper) in favour of maintaining a registration requirement, there are also market-based reasons for exemptions in certain cases, similar to those that drove the creation of the financial collateral arrangements regime (e.g., improving the efficiency and liquidity of crypto-asset markets) as well as providing a legal foundation to a practice that is already happening (particularly in a DeFi context). We

agree it would be helpful to develop technology-specific means of publicising the interest in lieu of registration (as per the proposal in paragraph 18.100 of the Consultation Paper).

- The methods of enforcement available pursuant to non-possessory security interests may not reflect market practice (particularly in a DeFi context), which underlines the importance of the points raised in our response to Consultation Questions 38 and 39 in paragraph 6.4 of this paper.

6.3. Consultation Question 37: *We provisionally conclude that it is not desirable to make provision for data objects to be the subject of possessory securities such as the pledge, or to develop analogous security arrangements based on a transfer of control. Do you agree? If not, please provide specific examples of market structures or platforms that would benefit from the availability of possessory security arrangements, that could not be effectively structured using the non-possessory security frameworks currently available. [Paragraph 18.44 of the Consultation Paper]*

The FMLC agrees that no statutory provision for this should be made. However, we note that if a concept of “control” is developed through the common law in relation to crypto-tokens in particular (which we think it should be, as per our response to Question 18 in paragraph 3.3 of this paper), we think a consequence of this should be that possessory style security interests in relation to crypto-tokens could be supported by English law. This would be accelerated by market commentary coalescing around a possessory-style concept of control, which we would be in favour of.

In terms of the merits of this:

- In the context of wholesale financial markets, the Committee notes that possessory security interests are not typically used in relation to security arrangements for traditional financial instruments. Although it is not uncommon for a security interest to be described as a lien, there is typically a power of sale included and as a result the security interest would constitute a charge. The main reason for this is likely to be the prevalence of the intermediated securities model and use of other forms of purely intangible financial collateral (such as cash in bank accounts) in wholesale markets structures and financial collateral arrangements.
- That said, we recognise that outside wholesale financial markets there may be different considerations at play, and conceptually we can see that there may be conflicts of laws benefits to recognising such arrangements, as: (i) jurisdictions which do not easily recognise English law trust arrangements may more easily recognise a form of possessory security arrangement; and (ii) established English law private international law principles that are applied to possessory security interests could be adopted.

6.4. Consultation Questions 38 and 39: *We provisionally conclude that the Financial Collateral Arrangements (No 2) Regulations 2003, SI 2003 No 3226 (the “FCARs”) should not be extended to more formally and comprehensively encompass crypto-token collateral arrangements. Do you agree? [Paragraph 18.47 of the Consultation Paper]*

We provisionally conclude that it would be beneficial to implement law reform to establish a legal framework that better facilitates the entering into, operation, rapid, priority enforcement and/or resolution of crypto-token collateral arrangements. Do you agree?

If so, do you have a view on whether it would be more appropriate for any such law reform to aim to create: (i) a unified, comprehensive and undifferentiated regime for financial collateral arrangements involving both traditional types of financial collateral and crypto-tokens; or (ii) a bespoke regime for financial collateral arrangements in respect of crypto-tokens. [Paragraph 18.113 of the Consultation Paper]

Questions 38 and 39 give rise to similar considerations. Accordingly, our response below applies to both.

The Committee agrees that it would enhance legal certainty, and therefore be beneficial, to implement law reform to establish a legal framework that facilitates the entering into, operation, rapid, priority enforcement and/or resolution of crypto-token collateral arrangements. As indicated in our response to Question 36 in paragraph 6.2 of this paper, this would require important policy matters to be determined such as the appropriateness of applying the same similar relief from registration and other formalities, insolvency safe harbours and remedies to crypto-token collateral arrangements as to traditional financial collateral arrangements, and how such regulations may be adapted for crypto-tokens to ensure legal certainty. Leaving these aside, however, there are pros and cons for legal certainty to both proposed models for such reform.

Echoing the 'same risk, same regulatory outcome' principle of financial regulation, a unified regime, which could be an amended FCARs regime (see below), may result in a more coherent and comprehensive framework that builds on existing, recognised principles but risks paying insufficient regard to the specific characteristics of crypto-tokens. The Consultation Paper comprehensively identifies the key areas of potential "bifurcation" between crypto-tokens and traditional assets that should be taken account of in developing the legal framework to accommodate crypto-tokens. However, a bespoke regime risks incoherence, especially as developments in the technologies emerge that may fall between the traditional and bespoke regimes. In this regard, the FMLC observes in relation to the Law Commission's commentary in paragraph 18.84 of the Consultation Paper regarding the possibility that a unified regime could encourage markets to fall back on "traditional" centralised structures, that the concentration of the holding and settlement of securities, in central securities depositories, is a relatively recent development; originally, securities holdings, via bearer instruments, were distributed. There are reasons which drove the shift towards intermediated securities that could drive a similar shift with respect to crypto-tokens in the future. Therefore, there is a risk to legal certainty in making too much of the differences between crypto-tokens and the (now) traditional financial collateral assets classes.

On balance, we consider that the optimal approach to be to expand the reach of the FCARs in a manner that does not unnecessarily restrict future innovation or require parties to make a determination as to whether an asset is a crypto-token, cash, credit claim or financial instrument. Subject to the policy choices mentioned above, this could be achieved, for example, by providing that: (i) crypto-tokens which meet the definition of "financial instruments" can constitute "financial collateral" (i.e., FCAR protections apply to all financial instruments irrespective of the form in which they are evidenced or constituted), (ii) other crypto-tokens, that it would be desirable to include within the FCARs, are an additional category of financial collateral and (iii) that there is an alternative test to "possession or control", or appropriate characterisation/clarification of how possession or control could be applied in the context of crypto-tokens, which is designed not to limit innovation (to be applied, as appropriate, both to crypto-tokens which constitute financial instruments and those falling within the

proposed additional category). If a bespoke regime was adopted then there is a risk of unclear boundaries creating more legal uncertainty than is resolved by the creation of the regime. This assessment is based on the fact that, as the Consultation Paper observes in paragraphs 18.54 to 18.80, the application of the FCARs to crypto-tokens is unclear. In our view, it is likely that certain crypto-tokens are “financial collateral” under the FCARs and there may be ambiguity as to which regime is applicable if a dual regime approach is adopted. This approach would not prevent other helpful clarifications of the FCARs (e.g., in respect of “possession” or “control”). This approach can also be adapted to suit whatever definition of crypto-tokens reflects the policy choices that are made (e.g., as to whether NFTs should qualify as “financial collateral”).

International coordination in this area would also be beneficial. While such coordination has proved elusive in relation to intermediated securities (and Brexit has exacerbated the fragmentation in this area), it is likely that conflicts of laws issues in this area could only properly be resolved by international treaty or, if not achievable, domestic legislation that is consistent with the legal frameworks of other major jurisdictions.

7. Remedies

7.1. Consultation Question 41

7.1.1. We provisionally conclude that tracing (rather than following) provides the correct analysis of the process that should be applied to locate and identify the claimant’s property after transfers of crypto-tokens by a transfer operation that effects a state change, and that the existing rules on tracing (at equity and common law) can be applied to crypto-tokens. Do you agree? [Paragraphs 19.43-19.52 of the Consultation Paper]

Yes, we agree with both these propositions.

7.1.2. Do you consider that the common law on tracing into a mixture requires further development or law reform (whether generally or specifically with respect to crypto-tokens)?

We believe there are good reasons for treating tracing at law and in equity as part of a unified process, as favoured by Lords Steyn and Millett in *Foskett v McKeown* [2001] 1 A.C. 102 at 113 and 128-9 (and the commentary to which they refer). We would welcome any steps the Law Commission could take to cement this view

7.2. Consultation Question 42

We provisionally conclude that the following existing legal frameworks can be applied to data objects, without the need for statutory law reform (although the common law may need to develop on an iterative basis):

(1) breach of contract;

(2) vitiating factors;

(3) following and tracing;

(4) equitable wrongs;

(5) proprietary restitutionary claims at law; and

(6) unjust enrichment.

Do you agree?

[Paragraphs 19.54-19.88 of the Consultation Paper]

Yes, we agree.

7.3. Consultation Question 47

7.3.1. We provisionally conclude that there is an arguable case for law reform to provide courts in England and Wales with the discretion to award a remedy (where traditionally denominated in money) denominated in certain crypto-tokens in appropriate cases. Do you agree? [Paragraphs 19.159-19.168 of the Consultation Paper]

Yes, we believe that most, if not all, market participants, would expect the courts in England and Wales to be able to grant awards denominated in crypto-tokens in appropriate circumstances. We agree with the reasoning on this point propounded by the Law Commission in the Consultation Paper.

7.3.2. If so, what factors should be relevant to the exercise of this discretion?

Our instinct is that any discretion should be broadly drafted (e.g., where it considers it just to do so / where the interests of justice require) so that the Court can make an appropriate decision on the facts before it.

8. Conclusion

8.1. The FMLC welcomes the Law Commission's Digital Assets Project and its willingness to propose law reform to help provide legal certainty. In particular the Committee supports the Commission's conclusions regarding a third category of personal property and have provided our views on how this should best be implemented.

8.2. The Committee does support more flexible approach in relation to the criteria for transfers, believing that the focus on a "state change within a crypto-token system" and the "replacing, modifying, destroying, cancelling or eliminating of a pre-transfer crypto-token and the resulting and corresponding causal creation of a new, modified or causally-related crypto-token" analysis does not reflect all types of possible transfer, all technologies or how transfers are perceived.

8.3. We would flag that some of the areas of reform identified in the Consultation Paper, apply not only to digital assets, but also traditional intermediated securities. The FMLC would urge that both asset classes are considered in relation to any such reforms to ensure legal certainty and to mitigate any unintended consequences.

FMLC Members

Lord Thomas of Cwmgiedd (Chairman)

David Greenwald (Deputy-Chairman)

Andrew Bagley, Goldman Sachs International

Sir William Blair, Queen Mary, University of London

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