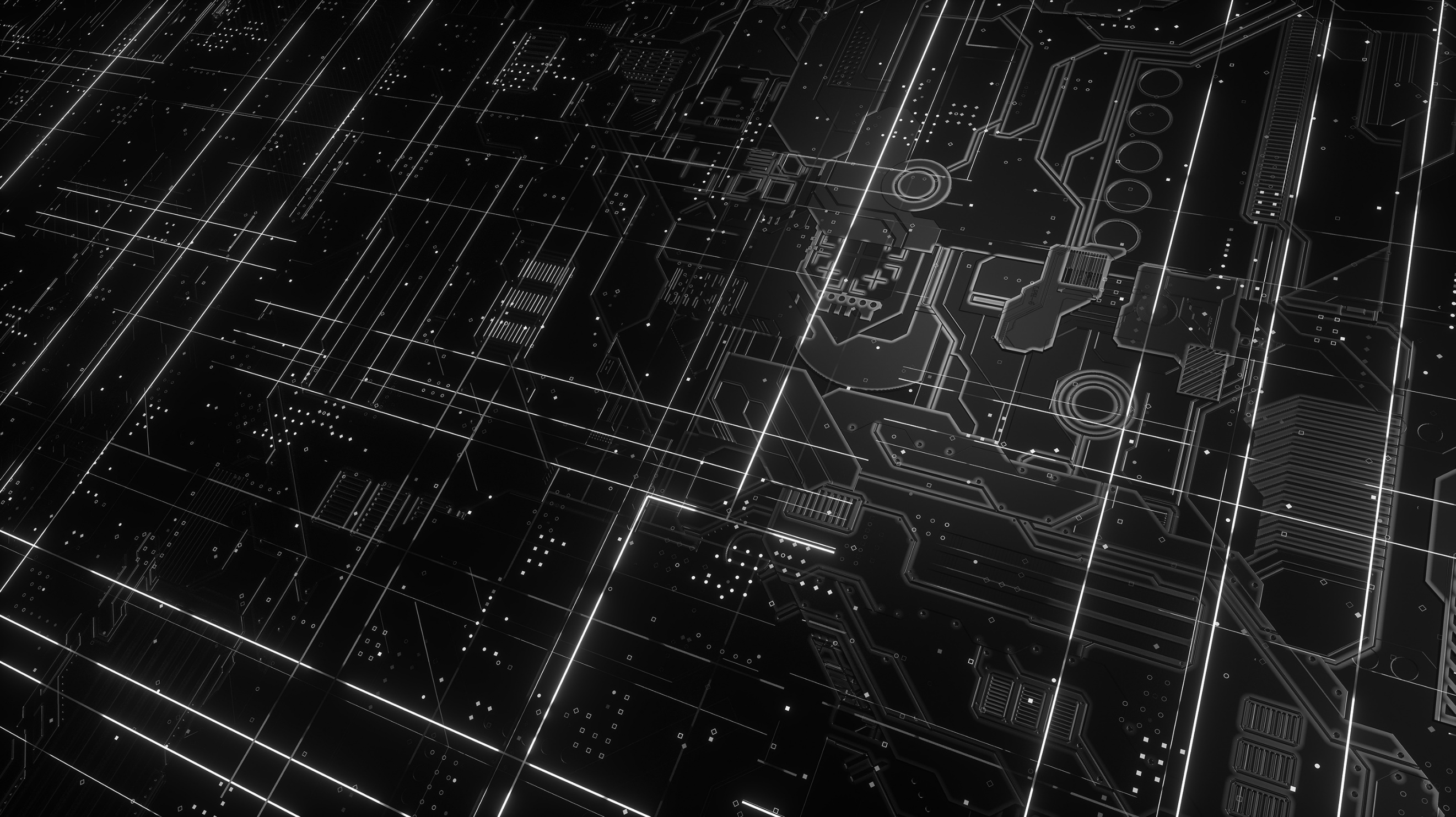
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| Mapping Grey Areas in International Legal Approaches to The Failure of Crypto Firms  Preliminary Findings From Workshop 3  Held on 12 and 13 August 2024  Crowne Plaza Nottingham |
| AHRC Grant Ref: AH/Y006674/1 Nottingham Trent UniversityINSOL InternationalIstanbul Bar Association www.crypto-insolvencies.com |





### Mapping Grey Areas in International Legal Approaches to The Failure of Crypto Firms

## Introduction

Cryptoassets have grown in popularity in recent years, with 2.3 million UK citizens identified as having invested in these assets, with around 6% borrowing money to do so. There has been similar or greater interest in many other countries, including in developing countries, often without awareness of the real risk entailed. Legal issues in this sector are beset with uncertainties, not least as to what will happen in the event of an insolvency. Cryptocurrencies and crypto exchanges, “crypto firms”, operate in a volatile market beset with legal uncertainties, making insolvencies likely, especially where cryptocurrencies have no intrinsic value and where regulatory changes will bring turmoil. In the event of an insolvency, claims by crypto investors are likely to be met with difficulty as proceedings may be opened in another, unfamiliar, jurisdiction. **The legal impacts of insolvencies in the crypto sector are also complex, international in dimension, and under researched.** There is presently no comprehensive analysis of this international dimension and little public awareness.

This project is a first step towards this analysis by identifying the issues that are likely to arise in the event of the failure of a crypto firm, mapping the jurisdictions that are likely to be involved, and identifying possible legal responses. It will do so through the establishment of an international network funded by the Arts and Humanities Research Council and in partnership with INSOL International and the Istanbul Bar Association, bringing together academic and practitioner representation from major crypto-investing countries, with equal representation from developing countries where there are high levels of crypto investment.

There has been excellent discussion in our three workshops, attended by 32 experts, or future experts, from 20 countries. In this report we identify the key points that emerged from the discussions in the final event, held in person at the Crowne Plaza, Nottingham.

# Project Headline Findings

There is much that we don’t know about where crypto insolvencies will take place. This creates uncertainties as to rights that customers will have in the event of an insolvency.

* Strong levels of crypto regulation are emerging e.g. in the EU. Some businesses avoid doing business in well-regulated jurisdictions however. There is significant scope for regulatory arbitrage.
* This can mean that customers slip between the cracks of regulation.
* There can also be a lack of clarity about where crypto firms do business, as well as other factors, which would have implications as to where an insolvency took place.
* In an insolvency the contract that a customer has with a crypto service provider can be important to their claim. However, in many cases contracts were not readily available or contained weak rights for customers.
* There are limitations of a contractual approach. A contract may state that assets are segregated but the firm may not do so in practice. Conversely some firms may segregate even though they don’t advertise this.
* Cryptoassets can offer real benefits for some consumers and regulatory responses should not damage positive aspects or chill innovation.
* Further research is required to establish how these problems can be addressed. Can a global approach be developed so that gaps in regulation by individual countries don’t deny protection to consumers? Can more be done to inform consumers about the risks of crypto firm insolvencies?

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| A group of people posing for a photo  Description automatically generated |
| Day 1 |
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| Day 2 |

## Workshops

The Nottingham event was the third workshop in the project. It was the only in-person event and it was great to see many of those who had participated in the previous online workshops, as well as some new faces. We had delegates who had travelled from India, Turkey and Singapore. We were also pleased to have other participants join us on Microsoft Teams, including Mohd Hwaidi, who had participated in the online workshops previously and had been due to travel to Nottingham but geopolitical tensions prevented this.

The first workshops had been held online on 17 and 18 June 2024. We divided participants into two groups, “East” and “West” according to time zone. We had very interesting discussions during the 6 hours of the East Group and 6 hours of the West Group. We offered previous participants in the online workshops the opportunity to attend via the Teams meeting.

Transcripts of the meetings have been made available to participants via secure Sharepoint site. We have produced key findings documents and made these available on our website [www.crypto-insolvencies.com](http://www.crypto-insolvencies.com).

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| A person in a white suit holding a microphone  Description automatically generated |
| *Marilyne Ordekian, sponsored by the EPSRC to do a project on crypto at UCL shared her preliminary findings*  Marilyne Ordekian explained that her EPRSC funded project has looked at a very wide range of terms of centralised crypto exchanges. She meticulously extracted 50 principles from the EU’s MiCA (Markets in Crypto Assets) and DORA (Digital Operational Resilience Act). These were weighted for comparative seriousness, and used to examine the arrangments for the exchanges set out in various documents including their terms of service. There were many interesting statistics and findings from this that will appear in due course in Marilyne’s thesis and publications. |

Prof Iris Chiu gave an insightful presentation on crypto custodians via Teams, drawing upon MIFID and MiCAR. She highlighted that there were complexities that regulation need to take into account. It was uncertain if MiCAR applied to DeFi. Prof Chiu insightfully noted that aspects of DeFi service providers could be custodial in nature. There was a need to map how services were provided as there were ambiguities in where e.g. liabilities would fall. Preferably regulation would achieve a balance between agent responsibility and the customers’ own responsibilities.

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| A group of people sitting around a table  Description automatically generated |
| The project also featured group discussions on possible further projects. Several fruitful ideas were generated, and these will be developed in due course.  A group of people sitting around a round table  Description automatically generated |

# Worshop 3 Key Findings

The Nottingham event was based around themes of different types of crypto business, namely unbacked crypto and stablecoins; centralised and decentralised exchanges; and crypto custodians. To illustrate the likely difficulties that would be presented in the event of a crypto insolvency the workshop also discussed a fictional example that was based on recent cases.

## Unbacked Crypto Assets

Dr Hakan Sahin discussed unbacked cryptos, which derive their values mainly from the faith and trust of their users. So in that respect it can be said that investment, sentiment or market sentiment plays the difficult role behind unbanked cryptoassets. There is price volatility.

The movement started with the Bitcoin white paper. This contains very complex and technical issues and it addresses a new currency and the unique and the network to deliver payments. It also detailed the complex way transaction will work, as well as the heightened privacy offered to account holders and how the software would prevent double spending.

Unbacked cryptoassets’ terms of use, white papers, or other legal documents generally lack clarity ( of course if there are any!). Out of 26 unbacked cryptos considered in the study (Bitcoin, Ethereum and many memecoins), 17 of them have no terms and conditions and one Pitbull only had a risk disclaimer. Operating in a decentralised manner and given the anti-establishment origin of Bitcoin it would not be expected that detailed legal terms, similar to those of traditional intermediaries, would be provided.

Since unbacked cryptoassets are decentralised and the identities of issuers are often unknown, as well as the lack of asset backing, it can be hard to determine the presence of interests, activities or assets in any jurisdiction. This presents uncertainties regarding future insolvencies, as well as risks and regulatory challenges.

The study had earlier found unbacked cryptoassets to be freely available in the countries where most participants were from. Although some jurisdictions had initially taken restrictive approaches to crypto these had in some instances, such as Nigeria and India, been softened. In contrast, Turkiye has enacted a strict new law.

There was some discussion of whether cryptoassets should be regarded as commodities or securities, although recognised that it is primarily for the market to regulate exchanges at present, subject to money laundering controls.

A participant noted that any investment, such as shares, has the potential to go up or down. It was noted, however, as far as listed companies are concerned, the likes of Apple, there are strong protections for anybody that buys their shares. So the disclosure requirements and audits and listing rules which prevent inside information being exploited so that those in the know can’t gain an advantage in an unfair way, and there's nothing like that with unbacked crypto. There will be many people who invest in unbacked crypto that will know that there are those risks and be prepared to take that. The problem arises when consumers do think this is just like e.g. shares. And that do therefore expect that there are these things like disclosure requirements and listing rules that are there to ensure a fair market and that there just aren't.

## Stablecoins

The issues around stablecoins seem to be different. These cryptoassets normally have an asset backing but some use an algorithmic basis. Compared to other cryptoassests considered in this study stablecoins generally had clear documentation, although not always offering protections to customers that might be expected. They don’t present the same issues of volatility as unbacked crypto. They are used much more in transactions and can be a store of value. They can be very convenient compared to e.g. fiat currency transactions through a bank. As a result there is a danger that stablecoins can displace fiat currencies in some countries. For this reason many jurisdictions are enacting regulations for stablecoins. The UK now has a special administration regime for stablecoins and there is a similar vehicle in the MiCAR.

## Utility Tokens

Utility tokens can be used for many different reasons e.g. voting rights in a DAO, tokens in a game or tokens that can be spent on a website. Those considered in this study had quite poor legal documentation. Often there was no documentation evident for a utility token other than a technical white paper. There was nothing that set out what entitlements (if any) a utility token brought. This is a category of cryptoassets which is poorly developed and understood.

## Centralised Exchanges

Centralised exchanges are the main way in which many will obtain cryptoassets. They are more likely than DEx to hold property on behalf of customers. In the event of the failure of an exchange a customer may have only an unsecured claim or, depending on the terms of the contract with the exchange, they may be able to establish a propriety right. We discussed the 50 centralised exchanges whose terms of service had been examined. Only 32 of the 50 discussed how they would hold assets on behalf of customers. There were also patchy approaches to risk disclosure and wide exclusion clauses and force majeure clauses.

The main focus of the study was in geographical indicators of where a centralised exchange is located, particularly to identify where the centre of main interests, or “COMI”, might be, as an important concept in international insolvencies. 41 out of 50 exchanges stated a governing law, although this would not necessarily correspond with where the COMI was located. Many chose English law but Mohd Hwaidi pointed out that this is the case for around 30% of commercial contracts. Some were simply contracts for different regional areas. There seemed to be a few exchanges that were deliberately avoiding jurisdictions with high levels of regulation.

## DeFi or DEx

These emerged as many users would find peer to peer trading otherwise difficult. There are different types of DEx and some can be decentralised in name only. They would not necessarily have a custodial function although Prof Iris Chiu noted that some DEx do have a custodial character. Issues can also arise in insolvencies if DEx are hacked or if there are liability claims by customers. Terms and conditions of DEx are unlikely to be of assistance in the event of an insolvency. Out of 22 DEx that were examined there were only terms available for 14 DEx. 6 of those discussed the possibility that they might hold customer funds or tokens and all were clear that this was on a non custodial basis. 8 of the 14 made reference to a governing law, although this would not necessarily correlate with the centre of main interests of the DEx.

These could be difficult cases for insolvency practitioners and we discussed that a set of guiding principles could be of benefit. Given issues of pseudonymity it can be difficult to track down individuals. DAOs can also complicate matters. There can also be difficulties in tracing assets. Tools such as freezing orders may help. If the debtor had crypto holdings should these be converted to fiat? These points were not peculiar to DEx.

## DAOs

It was noted that DAOs have attracted attention as a different type of governance model. Although they operated in a decentralised way via smart contracts human input was still required.

There could also be problems in engaging with the “outside world” in holding property and entering into contracts, as well as complying with licensing and registration requirements in some jurisdictions. Many were therefore using different “wrappers” such as the Swiss foundation.

Another reason why a wrapper might be used was to limit personal liability. The Law Commission noted that ambiguity as to how the DAO would be identified in law might lead to it being regarded as e.g. an ordinary partnership, if for profit, or an unincorporated association, if not for profit. This presented risks of personal liability, which could be a particular problem for the person with the deepest pockets as they would be most likely to be sued. In some jurisdictions, however, a lack of intention to form a legally binding arrangement could present problems in characterising a DAO.

There could be problems in engaging token holders to participate in voting. Experience in listed companies already illustrates the difficulties of getting a dispersed range of voters to engage. There could also be problems if a majority of tokens were controlled by a small number of people. Ape Coin had suffered governance issues in this context, due to founders becoming dysfunctional, and had failed.

There were variations in different types of DAO. The [Celo Africa DAO](https://www.celoafricadao.xyz/) was set up to try to support a blockchain project and Web 3 startups and developers in Africa, enabling Africa as a hub of web 3 forefront jurisdictions. We also have [GFY DAO](https://docs.gamefactory.gs/web3-and-game-factory/gfy-dao), which is a for profit DAO and this was created by Game Factory. It was associated with YTÜ Yıldız Teknoparkalso, again for web 3 game startup. There's been a lot of discussion within gaming about how things like artificial intelligence and decentralisation blockchain can further increase the engagement and the enjoyment.

There had been an insolvency of a DAO not long before the workshop. This was Hector DAO which went into receivership in the British Virgin Islands and this was recognised in the US under Chapter 15. It appeared that a treasury of $100 million had been depleted to around $7 million. There were indications of fraudulent mismanagement. It seemed that there had also been a concentration of tokens in the hands of a small number of individuals.

## Crypto Custodians

Most consumers will need to use a crypto custodian. This is reflected in MiCAR and licensing requirements. The matter requires examination as MiCAR only applies within the EU and licensing requirements are national. There had been a study of the terms and conditions of custodians but a problem in selection had been that 45% did not publicly provide anything of this nature. There could be ambiguities in the terms of some custodians and what was said in the contract would not necessarily reflect how custodians operated in practice. Some could outsource custodial functions. Uncertainties as to ownership of assets in custodial arrangements led to uncertainties as to what rights customers would have in the event of an insolvency.

Project Partners

We are grateful to our project partners, INSOL International and Istanbul Bar Association for joining us in this project

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| A group of people sitting at a table  Description automatically generated | INSOL International | LinkedIn |
| Sean Lee (right), see here with Hakan Sahin, represented INSOL International | |
| Two women standing together smiling  Description automatically generated | Istanbul Bar Association |
| Ayça Aktoglu (left), seen here with Pinar Aksoy, represented Istanbul Bar Association | |

#### WorkPLAN

The project has found some interesting findings related to the likely complexity of crypto insolvencies, as well as this being only one ambiguity in how crypto business operate. As an initial scoping exercise the aim of the project was to identify areas of concern that require further investigation.

We will prepare a briefing document for translation in several languages and further dissemination. The project team are working on additional publications and planning how the project’s findings can be further investigated.

#### Network

AHRC Grant Ref: AH/Y006674/1

NTU WT ID: 1766421

Principal investigator: Prof Rebecca Parry rebecca.parry@ntu.ac.uk, Tel: 44(0)115 8486883

Co-investigator: Dr Hakan Sahin hakan.sahin@ntu.ac.uk, Tel: +44(0)1158488037

Co-investigator: Dr Phoebe Gatoto phoebe.gatoto@ntu.ac.uk, Tel: +44(0)115 84 88094;

Co-investigator: Dr Akrum El Menshawy, akrum.elmenshawy@ntu.ac.uk.

All of Nottingham Law School, Chaucer Building, Nottingham Trent University, 50 Shakespeare Street, Nottingham, NG1 4FQ

Project Partners: INSOL International and Istanbul Bar Association

Project website: https://crypto-insolvencies.com/

Thanks to our advisory board: Dr Lorena Carvajal (Pontificia Universidad Católica de Valparaíso), Dr MS Sahoo (former Indian regulator), Prof Umut Turksen (Coventry University), Prof Adrian Walters (Chicago Kent Law School)

Thanks to the Workshop 3 Discussants

Theophilus Aigbogun

Franklina Adanu

Pinar Aksoy

Ayça Aktolga

Shan Ali

Nkem Amadike

Alexander Brauneis

Sanjay Chapagain

Iris Hse Yu Chiu

Nanjwan Yale Damap

Tam Egbe

Serhat Eskiyörük

Risham Garg

Vaidehi Gulati

Mohd Hwaidi

Sean Lee

Xiaocong Liu

Samuel T Matthew

Paula Moffatt

Hamiisi Nsubuga

Ochanya Ochigbo

Marilyne Ordekian

Kerry Purcell

Dominik Skauradszun

Jingchen Zhao

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