THE LAW COMMISSION: CALL FOR EVIDENCE ON DIGITAL ASSETS AND ETDS IN PRIVATE INTERNATIONAL LAW: WHICH COURT, WHICH LAW

CLLS FINANCIAL LAW COMMITTEE RESPONSE

INTRODUCTION

The City of London Law Society ("**CLLS**") represents approximately 15,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multijurisdictional legal issues.

This response to the Law Commission's Call for Evidence on its paper entitled, "Digital assets and ETDs in private international law: which court, which law?" (the "**Call for Evidence**") (this "**Response**") has been prepared by the Financial Law Committee ("**FLC**") of the CLLS, whose members specialise in major financings involving obligors incorporated in multiple jurisdictions, creditors incorporated or doing business in multiple jurisdictions, and assets located, or deemed by principles of private international law to be located, in multiple jurisdictions. Concepts of English law and other laws relating to digital assets and the development of these concepts are increasingly critical to the transactions and advisory matters on which members of the FLC advise. Full details of the members of the FLC appear on the CLLS website. We understand that Linklaters LLP is making its own submission to the Call for Evidence and we wish to note that the Linklaters LLP has not been involved in the preparation of this Response. We note also that Clifford Chance LLP has not been involved in the preparation of this Response.

The FLC continues to appreciate greatly the thorough work and detailed analysis undertaken by the Law Commission with regard to the legal issues that arise in the context of digital assets, including the private international law issues the subject of the Call for Evidence. As the FLC noted in its response dated 4 November 2022 to the Law Commission's Consultation Paper on Digital Assets issued in July 2022 (the "**July 2022 Consultation Paper**"), and as has also been recognised by the UK Jurisdictional Taskforce (the "**UKJT**"), the very nature of most types of digital assets has given rise to, and will continue to give rise to, complex cross-border legal issues, and we fully support the Law Commission's ongoing work in this area.

We set out below the FLC's responses to those questions listed in the Call for Evidence to which we had a substantive response. In doing so, we have sought to retain the terminology used in the Call for Evidence, notably the terms defined in the Glossary to the Call for Evidence. A number of the questions included in the Call for Evidence fall outwith the experience of or specialisms in law practised by the members of the FLC; we have either not responded to these questions or have included only limited responses. Before setting out specific responses to specific questions, we set out below a summary of the points we would like to raise generally with some of the concepts and proposals set out in the Call for Evidence, in particular with regard to financial products which are or may in the future be evidenced by or created on distributed ledgers ("**DLs**") or on exchanges or other systems which utilise distributed ledger technology ("**DLT**").

We appreciate that the Call for Evidence seeks input on a broad range of digital assets and potential issues arising under principles of private international law: it is not focused solely on financial assets or financial products, and it raises questions in the context of both consumers and commercial parties. This Response primarily addresses voluntary commercial dealings; questions arising in the context of consumers and criminal law raise points of policy beyond the remit of the members represented on the FLC, including in the context of the regulation of financial services and financial products in the UK. On the other hand, the development of financial products, the proper functioning of the international capital markets and maintaining the core role in which English law has played in developing and sustaining these products and markets are key areas of interest for the FLC.

SUMMARY

1. English law has developed over the centuries as a dominant legal system in terms of both international trade and international finance; two significant reasons why English law continues to maintain its dominance in these areas are (a) the flexibility of the common law and principles of equity and, thus, their ability to evolve over time, and (b) the relative certainty of the outcome of a dispute arising under English law, because of the relative certainty of the law and the expertise of the judiciary of the English courts. As the Call for Evidence notes, the English courts are very adept and skilled in determining international disputes, but litigation is a competitive arena. We are concerned to ensure that the English legal system maintains its pre-eminence in financial law, and in financial services regulation, by developing in a manner that embraces digital technology, maintaining and enforcing clear principles so that parties have confidence in their dealings and clarity as to the rights and obligations arising from those dealings.

2. In our view, in the context of intangible financial products and financial assets which are or are capable of being transferable, traded or settled across national borders, English law principles of private international law should recognise and give effect to the existing English law principle of party autonomy, or (in the context of clearing, settlement and payment systems) participant autonomy, and not seek to apply concepts such as *lex situs*. We consider that, given that digital assets may be anywhere or nowhere, or in many places at the same time, the application of the existing English law principle of party autonomy or participant autonomy to allow persons dealing with digital assets to choose the law to govern their rights and contractual obligations will provide the most robust, practical and internationally-recognised solution to determining the rights and obligations of those parties. In addition, where there are sound public policy reasons to do so, the principle of party autonomy should also apply to determine and govern the circumstances in which rights, interests and obligations may affect and be binding on third parties, so as to derogate from mandatory laws that might otherwise apply to a participant in a system. It is critical that English principles of private international law in this area are not unnecessarily subsumed in or confused by principles of property law developed over the centuries primarily to deal with tangible property, or with claims or other intangible proprietary rights realisable against a person or persons located in a single sovereign state.

3. English law already recognises principles of participant autonomy in the context of financial market infrastructure and has done so for twenty five years in the form of legislation. Regulation 24 of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (the "**Settlement Finality Regulations**") implemented Article 8 of the (then) EC Settlement Finality Directive. Regulation 24 of the Settlement Finality Regulations provides that, in the event of an insolvency of a participant in an applicable securities settlement, clearing or payment system, the governing law of the system (defined to mean the law "chosen by the participants" in the system) determines any question relating to the rights and obligations arising from, or in connection with, that insolvent participant's participation in the system. The primacy of the system's governing law will give third party effects to the contractual and other provisions of the system's default rules or other arrangements (including

netting, porting and collateral) in priority to the rights, claims and interests of third parties, e.g. the relevant insolvency office-holder or non-participant creditors of the insolvent participant, in relation to the same assets the subject of the rules or other arrangements.

4. The same Directive and the Settlement Finality Regulations implementing it in the UK include further provisions which are intended to ensure the continuing smooth operation of securities settlement, clearing and payment systems notwithstanding the insolvency of a participant, including, for example, giving primacy to the rules of the system over provisions of national insolvency law applicable to an insolvent participant which would otherwise prevent or inhibit agreed trades or other obligations from settling. It seems to us that there is no obvious reason why similar laws applicable to digital assets may not be enacted in the United Kingdom, where required. Financial market counterparties in the UK and the European Union (and in other sophisticated jurisdictions) are already familiar with and accepting of the principles of participant autonomy in the context of dealings with financial assets, including in the context of dealing with associated proprietary rights. Indeed, it would be a retrograde step to move away from this already established, legally robust and commercially accepted means of dealing with cross-border financial products and payments issued, transferred and/or settled through a consensual system, towards a system based on solutions developed for tangible assets which will not result in the necessary certainty or commercial or international acceptance.

5. The FLC is keen to assist the critical work which the Law Commission is undertaking with respect to digital assets so as to encourage the development of an appropriate and internationally recognised new applicable law rule to govern proprietary issues affecting native crypto-tokens, i.e. tokens that are not constitutively linked to another asset, such as a share or other security, and which may be recorded in a permissionless or permissioned DLT-based system. International acceptance and recognition of the applicable law is a fundamental criterion, and for this reason, we consider that the correct approach to the applicable law issues for "linked" assets should be one based upon Principles 4 and 5 of the UNIDROIT Principles on Digital Assets and Private Law (the "**UNIDROIT Principles**"), namely that the "normal" conflict of laws rules determining the applicable law for proprietary issues affecting the underlying linked asset (and not that of the crypto-token) should have primacy and will govern (see paragraph 5.24 of the UNIDROIT Principles). The application of the relevant conflict of law rule for the underlying asset (e.g. the place of the relevant register in the case of a linked share) should not itself be affected by the fact that the underlying share is recorded on a DL or is constitutively linked to a crypto-token recorded in a DLT system. In consequence, no new or different conflict of law rule will need to be developed for linked assets.

6. Where we refer in this Response to the principle of party autonomy, or participant autonomy, allowing the participants in a system to choose a single governing law, we mean that governing law without reference to its conflicts of law, i.e. without admission of concepts such as renvoi, which could muddy the waters by taking one to a different system of law. The necessity of avoiding this outcome is reflected in Principle 5 of the UNIDROIT Principles and in Regulation 19 of The Financial Collateral Arrangements (No.2) Regulations 2003[1] (the "**FCARs**"). Regulation 19 of the FCARs states that any question relating to the matters specified in paragraph (4) of Regulation 19[2] which arises in relation to book entry securities collateral which is provided under a financial collateral arrangement shall be governed by "the domestic law of the country in which the relevant

[1] UKSI 2003 No. 3226.

[2] These matters include the legal nature and proprietary effect of book entry securities collateral and the requirements for rendering a financial collateral arrangement which relates to book entry securities collateral effective against third parties.

account is maintained"; paragraph (3) of Regulation 19 further provides that "domestic law" excludes any rule under which, in deciding the relevant question, reference should be made to the law of another country.

7. Adopting, where possible, the principle of party autonomy or participant autonomy should also facilitate an appropriate and internationally-agreed approach to financial services and markets regulation in a number of different ways. For example, the current BIS[3] -based capital adequacy regime applicable to banks and other financial institutions is based primarily first on the risk-weighting of assets by reference to counterparty risk, modified where appropriate by credit risk mitigation factors such as valid security interests supported by appropriate legal opinions; and secondly on market risks. It is almost certainly the case that the current capital adequacy regime will need to adapt over time to reflect the manner in which financial exposures (bonds, loans, derivatives, shares, etc) are created, evidenced, settled or secured or used as collateral for other exposures, but it is axiomatic that if these exposures are created based on DL technology or the like, the recognition of participant autonomy will greatly facilitate determining the risks that arise, where those risks are likely to fall, and the potential magnitude of those risks; and, therefore, will enable financial services and markets regulation to be appropriately focused (including, for example, requiring any operator or administrator of a DLT-based system to be regulated) and, thus, foster confidence in the system[4]. This is critical in a world in which financial assets now move in an instant across national borders, all the time.

8. We believe it would be helpful for the Law Commission to analyse and determine how, in practice, the conflict of law rule for determination of the applicable law for proprietary issues affecting a share or other registered security, by reference to the location of the relevant register, is to be applied where the register is a DL register. The same practical considerations will arise in relation to any underlying asset that is linked to a token recorded in a DL, where the DLT-based system performs functions in relation to the token (e.g. to support issuance, transfer or payment of the digital asset) and where the relevant conflict of laws rule points to the location of the performance of the relevant act in determining the applicable law for the relevant legal issue to be decided by the court.

9. Unlike tangible assets, an intangible asset has no existence other than by and under the arrangement (typically but not necessarily consensual) under which it arises, is created or is "instantiated" and that allows it to be enjoyed; for example, by its transfer or by the receipt of rights, privileges or benefits attached to or arising from the intangible asset. As a consequence, English law has long recognised that consensual arrangements[5] may give rise to "conditions", "burdens" or "obligations" which are inextricably linked to and form part of the intangible assets and, are, therefore, capable of third party effects and are exercisable *erga omnes*. Those conditions, while rooted in contract or

[3] The Bank for International Settlements, aka in this context, the Basel Committee.

[4] Another example of the key importance of legal certainty in the regulation or supervision of participants in the financial markets can be found in the internationally-recognised standards for financial market infrastructures set out in the CPMI-IOSCO Principles for financial market infrastructures (April 2012) (the "**PFMIs**"). The recognition of a single, clear conflict of laws rule for proprietary issues, based on the applicable law chosen by the participants in a systemically important system (securities settlement system, CCP or payment system) using DLT-based functionality, will enable or facilitate observation of Principle 1: "An FMI should have a well-founded, clear, transparent and enforceable legal basis for each material aspect of its activities in all relevant jurisdictions". Such a clear, certain and pragmatic approach to relevant conflict of laws issues, readily manageable by the participants in the system, will allow for the obtaining of "well-reasoned and independent legal opinions or analyses" on proprietary and collateral-related issues (as contemplated by paragraph 3.1.3 of the PFMIs); as well as the mitigation of the risks arising from the potential conflict of laws across the jurisdictions in which such systemically important systems operate (as contemplated by Principle 1, Key Consideration 5 and paragraphs 3.1.1, 3.14.5 and 3.18.5 of the PFMIs).

[5] These arrangements may include trusts as well as contracts.

another consensual arrangement, may be said to be intrinsic to the arrangement and impressed upon the intangible asset so as to travel with it upon any transfer, and to be binding upon and effective against third parties, including any third party asserting a proprietary interest in the asset. The intangible asset is, therefore, capable of being governed by the same law (in determining its proprietary or third party effects) as the parties decide should govern the consensual terms of the arrangement. This is particularly so in the case for consensus-based DLT-based systems, where the participants in the consensus have agreed to apply a specific law to govern proprietary matters in relation to the digital asset and as impacting upon status changes to the DL; and where the majority of the consensus required to validate a transaction and effect an update to the DL are not located in a single country or territory.

10. In our view, therefore, English law principles of private international law would and should respect party autonomy or participant autonomy in the context of determining the appropriate law to govern the proprietary aspects of a contractual or other consensual arrangement involving the creation, issuance and transfer of rights in and to the digital asset, including the creation, attachment, priority and perfection of security interests over such assets. English law already recognises this approach, both in the common law and, in the context of the clearing and settlement of securities, through specific legislation. Parties dealing with digital assets evidenced by entries on a DL (whether or not maintained by an exchange) may prefer to choose the law that governs the issuance and transfer of digital assets on the DL, as well as the nature of the security interests that may be created over the digital assets and the manner by which the security interests may be enforced and the forum in which disputes should be settled; so their choice of applicable law includes both the law of obligations and the law of property, insofar as that pertains to proprietary rights to the digital assets represented on the DL.

11. Equally, it is not necessarily the case that the law chosen to determine the contractual provisions of a digital asset must be the same governing law as the law that determines whether the asset has been transferred, or whether security has been created over the asset. For example, bonds governed by English law, New York law and the laws of many other jurisdictions are, if issued in the European capital markets, typically held (through an established legal mechanism) in one or both of the two principal European clearing systems, Euroclear and Clearstream. If the bonds are held in the international central securities depositary ("**ICSD**") operated by Euroclear, the terms on which interests in the bonds are transferred by participants in Euroclear are governed by the rules binding on participants in the Euroclear system; these rules are governed by Belgian law, because Euroclear Bank S.A./N.V. is a Belgian company operating the ICSD under Belgian law as the governing law of the system. A similar analysis applies to bonds held in Clearstream Banking S.A., where Luxembourg law applies to the terms on which the bonds held in that system are cleared and settled. The arrangements for clearing and settlement do not, however, prevent or preclude the terms and conditions of the bonds themselves from having a different governing law from the law applicable to the relevant clearing system. The same result is possible, in our view, where digital assets are cleared and settled using DLT-based systems rather than an ICSD using legacy systems, albeit it may be necessary to enact specific legislation in order to ensure the primacy of the clearing and settlement regime over other laws that may be relevant, for example in the context of an insolvency of a participant and the impact upon any rights and obligations arising from or in connection with its participation in the system (see our comments above on the Settlement Finality Regulations). We are concerned that although the Call for Evidence clearly and correctly, in our view, states that the principles used to determine the key "connecting factors" relevant to determining the "right" law or forum for a dispute involving digital assets must be pragmatic, practical and based on sound policy grounds (crucially, respected in other relevant jurisdictions), there is an emphasis on connecting factors based on *situs* which the FLC considers will not foster a workable solution in

the context of financial assets and financial products, held in DLT-based systems and, worse, may undermine the intentions of users, developers and operators of DLT-based financial products.

12. Reliance on principles of *situs* developed for tangible assets will give rise to complications where digital assets are recorded on a DLT-based system such as blockchain, where the system is built on consensus, i.e., the DL can only be updated, rectified, amended or (generally) maintained by a qualified majority of validating node operators ("**VNO**s"). The VNOs operating a particular blockchain are likely to be resident or domiciled in many different jurisdictions, so basing the question of which court should have jurisdiction over a dispute on whichever court has *in personam* jurisdiction over the VNOs is very unlikely to work; likewise, there is likely to be no single law, aside from the governing law of the system chosen by the VNOs and other participants, based on *situs* or otherwise, that can provide a suitable "connecting factor" to determine proprietary issues affecting digital assets recorded in the system. Any attempt by a court to impose upon the consensus majority a solution to a proprietary dispute affecting such a digital asset, e.g., by reference to the location of the transferor at the time of transfer, by issuing an order to rectify the DL under and in accordance with a law different from that chosen by the consensus majority, is likely to be futile.

13. For example, there is clearly commercial appetite to decentralise dealings through (and associated credit and other risks arising from) clearing and settlement systems for securities, whether debt or equity, as assets "constitutively linked" to a crypto-token recorded on a DL and for "native" (or "endogenous") digital assets that are not linked to an underlying "real world" asset. If, however, principles of *situs* are attempted to be applied to, for example, the issuance and then subsequent transfer or settlement of bonds or other digital assets recorded in a DLT-based system, there will be multiple potential governing laws for those digital assets recorded in the same DLT-based system, depending on the *situs* of the issuer of the bond (or, if there is an issuer, other digital asset) and the *situs* of any transferor or subsequent holder of the bond or other digital asset, or the *situs* of the nodes that from part of the DL maintained by the system. This is clearly not a workable or sustainable approach. The same concern would apply to syndicated loans where participations are recorded in the same DLT-based system and, indeed to any intangible financial asset, including an electronic trade document ("**ETD**") that is capable of transfer, assignment, novation or other disposition, whether absolutely or by way of security, on-chain or off-chain.

14. In our response to questions relating to matters of jurisdiction, we are commenting strictly from the point of view of when the English courts should take or refuse jurisdiction, not on the substantive law that should be applied to the particular case.

15. As with previous responses made by the FLC to the Law Commission's work on digital assets, we wish to note, also, that the law applicable to digital assets cannot be viewed without also considering the regulatory environment in which numerous persons operate, including investors in and users of digital assets and those providing finance for the acquisition of, or secured by, digital assets. We appreciate that not all persons who deal with digital assets operate in a regulated environment, but many do (and some may argue, as a policy matter, that more should), and it is critical that the regulatory environment reflects, so far as possible (noting again that principles of private international law are almost invariably engaged when dealing with digital assets), accepted legal characteristics of these types of asset and the rights, obligations and restrictions to which these characteristics give rise. Another aspect of regulation relevant to digital assets is the legal and regulatory regime which many sovereign nations have enacted to protect consumers ordinarily resident in those nations. Legislation protecting consumers differs from jurisdiction to jurisdiction, depending on the policies adopted by the relevant sovereign state, and for that reason, achieving international consensus in the context of digital assets held by consumers is likely to be more difficult than achieving international consensus when dealing with other persons and entities. As

we have noted above, we do not comment on policy matters pertaining to the protection of consumers' rights or related questions as to the extent to which UK financial services regulations should apply to businesses with no nexus to the UK.

RESPONSES

Our responses to the questions raised in the Call for Evidence are set out below.

1. **Question 1, Paragraph 5.11 and Paragraph 13.1 of the Call for Evidence: views and evidence on jurisdiction over consumer contracts.**

    1.1 We have no comment on this question other than to note that if consumers in the UK are permitted to invest in and/or trade digital assets on an exchange or on a native DL, the views we set out below regarding the appropriate law and jurisdiction applicable to such assets should apply also in the context of consumer contracts; and the applicable choice of law may result in a UK regulator determining that a UK-based consumer does not have the necessary knowledge or expertise to invest in or trade in the applicable digital assets (or, at least, not on an exchange or DL which is based outside the UK) and, therefore, that they may not be offered to consumers in the UK. There is a separate question as to how a UK regulator may enforce that restriction against non-UK entities seeking to promote their activities to UK consumers, but that appears to us to be beyond the remit of the Call for Evidence.

    1.2 For avoidance of doubt, any digital asset which may be created in the future that deals with land or title to land in England and Wales, including the taking of security over land or interests in land and whether the interest in land is held by a consumer or any other person, must be subject to English law and the jurisdiction of the English courts. In other words, for land and interests in land, the *lex situs* should continue to determine the applicable law and jurisdiction. This is consistent with the view we express in the Summary above that, where an underlying asset is constitutively linked to a crypto-token, it should be the relevant applicable law for the underlying asset that governs proprietary issues affecting the crypto-asset (in line with Principles 4 and 5 of the UNIDROIT Principles).

2. **Question 2, Paragraph 5.20 and Paragraph 13.2 of the Call for Evidence: views and evidence sought on jurisdiction founded on the basis that a contract was concluded in England and Wales.**

    2.1 We think that a distinction should be made between smart contracts concluded within a participant-based system, and other smart contracts. In the case of the former, participant autonomy should apply; in the case of the latter, particularly for consumer contracts, it seems to us that the relevant connecting factor should be the real-world (consumer) actor, based on his/her/its habitual residence; otherwise, it is difficult to see how statutory protections for consumers will apply.

    2.2 We believe that the question of where a smart contract is made will become prevalent in practice particularly in the context of consumer contracts, where policy reasons in the jurisdiction in which the relevant consumer is habitually resident will be dominant; and in the context of DLT-based systems used in international finance and international trade, where legal certainty as to the applicable law and its effects, including in the context of an insolvency of a participant in the system, is critical.

3. **Question 3: Paragraph 5.56 and Paragraph 13.3 of the Call for Evidence: views and evidence sought on jurisdiction founded on the basis of damage or detriment suffered in England and Wales.**

3.1 The FLC has no particular views or evidence on this question other than to note that where any claim relates to a digital asset held or evidenced in a DLT-based system, the rules and governing law of the system should prevail over and otherwise determine any tortious claims; to do otherwise would be to undermine the safety and soundness of the system and could undermine participant or wider confidence in the integrity of the system's governance and operational arrangements. We agree with the Law Commission's point that the issues raised here are more difficult, not least because the actions giving rise to the damage or detriment suffered frequently involve criminal acts, which give rise to different and difficult policy considerations.

4. Question 4: Paragraph 5.76 and Paragraph 13.4 of the Call for Evidence: views and evidence sought on jurisdiction founded on the basis that an unlawful act was committed in England and Wales.

4.1 The FLC has no particular views or evidence on this question, which we view as a policy matter.

5. Question 5: Paragraph 5.116 and Paragraph 13.4 of the Call for Evidence: views and evidence sought on jurisdiction founded on the basis that the claim relates to objects within England and Wales.

5.1 The FLC has no particular views or evidence on this question other than to note that if where any claim relates to a digital asset held or evidenced in a DLT-based system, the rules and governing law of the system should prevail and otherwise determine the relevant claim; to do otherwise would be to undermine the safety and soundness of the system and could undermine participant or wider confidence in the integrity of the system's governance and operational arrangements.

6. Question 6: Paragraph 5.133 of the Call for Evidence: views and evidence sought on the types of claims and causes of action relied upon in applications to serve proceedings relating to crypto-tokens out of the jurisdiction.

6.1 The FLC has no particular views or evidence on this question other than to note that if where any claim relates to a digital asset held or evidenced in a DLT-based system, the rules and governing of the system should prevail; to do otherwise would be to undermine the safety and soundness of the system and could undermine participant or wider confidence in the integrity of the system's governance and operational arrangements.

6.2 Specifically in the context of crypto-exchanges, the question whether a crypto-exchange should be deemed to hold crypto-tokens, or otherwise be liable, as a constructive trustee appears to us to be a question that should be determined by the rules of the exchange applied in accordance with the relevant principles of the governing law of the system and, specifically, by reference to the person who the operator of the exchange determines, by applying the rules of the exchange in accordance with the governing law of the system, is the true beneficial owner of the assets held in the exchange. It may be that it is necessary to develop the rules of crypto-exchanges so that they capture situations in which there is a dispute as to who the true beneficial owner of the digital assets is, and provide for a means of determining that dispute. We have considerable sympathy for the argument that the operator of a crypto-exchange should not be held to the standards of, and subject to the liabilities of, a

manager/discretionary trustee or other fiduciary under English law simply by reason of its operating the exchange – which is largely a mechanical, administerial function intended to ensure smooth settlement of transfers of instruments traded on or through the exchange. We note, also, that typically under current operating models[6] for financial instruments (as distinct from crypto-tokens), it is not the exchange that holds legal title to assets traded on or through the exchange; legal title tends to be held by a depositary institution or other custodian. It is equally important, however, that systems are developed which protect the assets of beneficial owners of digital assets from criminal or tortious acts or acts otherwise in breach of equitable duties owed to the beneficial owner; these will likely be matters determined, for a particular exchange, by domestic law and regulation in the jurisdiction in or under which that exchange is incorporated or operates the exchange and principles of participant autonomy should then apply.

7. Question 7: Paragraph 7.28 and Paragraph 13.7 of the Call for Evidence: views on applicable law and DeFi.

7.1 We agree that contractual disputes in the context of DeFi are not likely to come before the courts and as a result, they are not likely to be resolved by reference to English law principles of private international law and the question of applicable law.

8. Question 8: Paragraph 7.84 and Paragraph 13.8 of the Call for Evidence - questions on the law applicable to non-consumer contracts; Question 10: Paragraph 8.93 and Paragraph 13.10 of the Call for Evidence – questions concerning the exclusions in Articles 6(4)(d) and (e) of the Rome I Regulation.

8.1 We are setting out our views on these three questions combined because they raise similar points and concerns.

8.2 We do not agree with the conclusion in paragraph 12.35 of the Call for Evidence that "there is a general consensus that property law remains a mandatory form of law from which parties cannot derogate using the principle of party autonomy and freedom of contract", at least insofar as that statement purports to apply to transactions involving financial assets held, cleared and settled via a DLT-based system where the participants in the system have agreed to abide by the rules of that system in accordance with the governing law of that system. The rules and chosen governing law of the system should, in our view, trump the concept of "factual control"; factual control is a concept suited to tangible assets, but is strained beyond any efficacy when attempted to be applied to intangible assets held in a DLT-based system in which the participants, and specifically the VNOs participating in the consensus mechanism, have agreed to apply the chosen governing law to determine proprietary and other issues affecting digital assets held or recorded in the system. In our view, it is not sensible to seek to apply possession-type characteristics to assets that are incapable of being possessed, as that concept is formulated and understood in English law, nor is it necessary to force an unhappy analogy with possession on intangible assets. As we have noted in our

[6] It is possible that, going forward, this position will change as DLT-based systems allow exchanges for linked financial instruments to act additionally as a "digital securities depository". These operating models are likely to be the subject of FMI sandbox arrangements governed by the Financial Services and Markets Act 2023 (Digtial Securities Sandbox) Regulations 2023 and related rules made by the Financial Conduct Authority and the Bank of England.

Summary, the Settlement Finality Regulations demonstrate that the statement in paragraph 12.35 of the Call for Evidence is disproved in the context of securities, settlement, clearing and payment systems; these Regulations derive from an EC Directive and are reflected in the domestic laws of the member states of the European Union as well as in UK law.

8.3 We consider that it is also not necessary to adopt, for the purposes of English law principles of private international law, the "user consent" principles summarised in paragraphs 12.50 to 12.63 of the Call for Evidence (which also considers Principle 5 of the UNIDROIT Principles). The "user consent" principle posits that, as a matter of the law of obligations, a non-user of or a non-participant in a system cannot be bound by an obligation unless it has agreed or consented to be so bound and that, therefore, in the absence of this agreement or consent, the choice of law agreed by the users or participants of the system (including as to the transfer of proprietary rights) cannot bind any such non-user or non-participant and, thus, the choice of law will not be effective *erga omnes*. We do not consider that it is necessary to analyse the participant autonomy principle, as it may apply to digital assets held or recorded in a DLT-based system, in this way. The better analysis is that the law that the participants in the system have agreed shall apply to proprietary disputes will also bind third parties seeking to deal with digital assets held or recorded in that system, even if they have not actively agreed or consented to that law, because that agreement is an inherent and intrinsic part of the digital asset over which that third party seeks to take a proprietary interest. English law has developed the "conditional benefit" principle; this dictates that where a right assigned or transferred to a third party is itself conditional or qualified so that its exercise is subject to a restriction or burden, the assignee or transferee must comply with that restriction or burden: see *Chitty on Contracts*, at paras. 23-082 and 23-083. Thus, we would qualify the observation made in paragraph 12.33 of the Call for Evidence that contractual rights "are only valid and enforceable against a particular person [the contractual counterparty]".

8.4 Accordingly, a third party who seeks to acquire a proprietary interest or right in or to a digital asset held or recorded in a DLT-based system must take that interest or right subject to the intrinsic restrictions or burdens associated with that interest or right, including that it may only exercise its rights, or certain of its rights (notably with respect to transfers of title), with respect to the asset in question subject to the law chosen by the participants in that system (and, in particular, by the VNOs of the DLT-based system). The "right", authority or power of the system itself (or the operator of and participants in the system), as against any third party acquiring the benefit of a digital asset held or recorded in the system, to determine proprietary issues affecting that asset by reference to applicable law is not a contractual construct but is, rather, an intrinsic feature of the digital asset. We do not consider there to be any material policy reason why this approach should not apply to digital assets: it is consistent with established principles of English law that an intangible proprietary right is inevitably subject to a framework within which the right arises, exists or is instantiated and by which it may be transferred or the other rights of ownership otherwise enjoyed, including the ability to grant a security interest over the proprietary right and the rights of the holder of that security interest. To take a more simple example, a beneficial interest in a trust exists upon and subject to the terms of that trust and any third party who seeks to take a proprietary interest in that beneficial interest, e.g. a person taking security over the interest, takes subject to the regime that created that interest.

8.5 By way of further example, let us assume that the owner with legal title to a digital asset held or recorded on a DL, with factual control through possession of the private key, is Party A. Party A effects, or purports to effect, off-chain equitable assignments to the same digital asset to both Party B and Party C and, thus, there is a title dispute between Party B and Party C. If Party A is physically located in country X and a court in country X (applying its domestic law) determines that Party B has priority and title to the digital asset, the court might consider making an order declaring Party B to be the true owner and that the private key should be passed by Party A to Party B. However, the court in country X also knows that the consensus mechanism in the system in which the digital asset in dispute is recorded has agreed to resolve proprietary disputes by reference to the laws of country Y. Under the laws of country Y, Party C rather than Party B has good title to the digital asset.

8.6 If the court in country X were to declare in favour of Party B, it would need to recognise that its order may be futile and in vain, and would not prevent Party C from obtaining an order from a court in country Y declaring that it has title to the asset under country Y's proprietary laws, and notify the system's participants of the correct priority position under which it, and not Party B, has good title to the digital asset. In such a case, Party C could reasonably argue that if the consensus mechanism were to update the ledger in response to a transaction input by Party B (applying the laws of country X), it would be acting contrary to its agreement to operate the consensus mechanism solely in accordance with the laws of country Y – with the resulting adverse reputational and other effects on the integrity and predictability of the system so as to vitiate public confidence in the system. This would be contrary to the economic self-interests of the VNOs and other participants, as the continuing financial value of the digital assets they hold in the system will be directly affected by the wider market confidence in the integrity and predictability of the system's governance and operational arrangements. Further, Party C could reasonably assert that any legal title vested in Party B in execution of the court order made in country X would (under the applicable law governing the system) in fact be impressed with Party C's continuing, subsisting prior equitable interest. Party B could not take the legal title to the digital asset, by the passing of control of the private key to it in compliance with an order of the court of country X, free and clear of Party C's equitable interest. If English law applied, Party B would hold the legal title to the digital asset on trust for Party C. In such a case, Party C could maintain that any action the VNOs might take to execute and complete a transaction input by Party B without the consent of Party C would be a breach of trust and would, therefore, potentially put all VNOs verifying that transaction and effecting a consequential change to the DL at risk of constructive trust accessory liability.

8.7 The result would be that any legal title passed to Party B by order of the court in country X would potentially render the digital asset valueless. It would no longer be capable of an effective transfer through the system in which it exists. In principle, Party B might be able to make onward "off-ledger" transfers of the legal title by passing the private key to a new transferee and so on. However, any such onward transfer is likely to be effected subject to the continuing, subsisting prior equitable interest of Party C from transferee to transferee. One of the key economic features of the digital asset, its transferability through the DLT-based system in which it is recorded, is lost. In practice, this is likely to mean that there will be a fork in the blockchain. The consensus mechanism will only respond to a transaction input by Party C and its successors in title.

8.8 Faced by this practical reality – evidencing that the true "root of title" to a digital asset is the consensus mechanism applicable to the DLT-based system in which the digital asset is held or recorded and not factual control alone – the courts in country X (seeking to avoid making a futile order) are likely to apply the laws of country Y, and not their own domestic law, to make an order instructing Party B to pass control of the digital asset in dispute to Party C. Party C can then input a transaction into the system requiring it to enter on the ledger its system address (under its private key), or that of its nominee, agent or custodian or that of a third party transferee (as Party C's successor in title).

8.9 We noted in paragraph 8.2 above that we do not agree with the statement in paragraph 12.35 of the Call for Evidence, that "property law remains a mandatory form of law from which parties cannot derogate using the principle of party autonomy and freedom of contract". In our view, in the context of a DLT-based system where the participants may be domiciled or resident in many different jurisdictions, but have agreed a consensus mechanism for the operation of the system and transfers of digital assets through the system by way of a status change to the DL, any principle of private international law applicable to this arrangement must recognise that no particular jurisdiction will have coercive authority to enforce its principles of personal property law against the consensus agreed by the participants. To put it another way, the transfer mechanism for digital assets held or recorded on a DLT-based system, and the entities which operate that mechanism through the consensus, are not within the "sphere of sovereignty" of any particular country or territory. Therefore, the "nature of property law" referred to in paragraph 12.34 of the Call for Evidence cannot apply to the digital asset and in our view, and recognising the operation of a DLT-based system independently of any particular legal system, where a person takes or purports to take a proprietary interest in a digital asset held or recorded in a DLT-based system, that person must be taken to have accepted that, to ensure the validity of that transaction as against third parties, it has no choice but to invoke the authority of the consensus operating in the DLT-based system in applying the prescriptive sovereignty of the jurisdiction whose laws have been chosen to determine proprietary issues affecting the digital asset.

8.10 As we indicated in the Summary, where we indicate our support for recognition of the principle of party autonomy, or participant autonomy, to allow the participants in a system to choose a single governing law, we mean that governing law without reference to its conflicts of law, i.e. without admission of concepts such as renvoi, which could undermine the desire to achieve legal certainty by taking one to a different system of law from that intended by the participants in the system and understood by third parties who take subject to the rules and governing law of the system. The necessity of avoiding this outcome is reflected in Principle 5 of the UNIDROIT Principles and in Regulation 19 of the FCARs.

8.11 In the context of financial assets in particular, therefore, we believe that attempts to apply the *lex situs* of a digital asset held or recorded in a DLT-based system will be impractical and ineffective. It is critical to the effectiveness, stability and utility of cross-border international finance transactions that the principles of private international law applied to dealings with digital financial assets should provide legal certainty; absent that, systemic risks are inevitable. This outcome may be achieved if the principle of participant autonomy is applied to systems which operate a consensus mechanism. There is support for this approach in *Dicey & Morris*, Rule 143; this

approach is already recognised in the Settlement Finality Regulations, in the context of clearing, settlement and payment systems, and is at least implicit in the assumptions as to the risks inherent in financial systems and dealings in financial assets made by financial services regulators in multiple jurisdictions. There are strong public policy reasons to support the "participant autonomy" approach and, thus, to support the objectives of the efficacy of court action and public confidence in a safe, efficient and predictable mechanism for the treatment of rights associated with digital assets, including the taking of collateral over digital assets held in a consensus-based system.

8.12 As is implicit in the comments we have made in this Response on the policy benefits of protecting the primacy of the governing law chosen by the participants of a DLT-based system to determine proprietary and non-proprietary claims or other issues, we would also strongly favour a review (and amendment) process to the Rome I Regulation and the Rome II Regulation (as applicable in the UK) so as to ensure that relevant consumer, mandatory and locational rules are subordinated to the governing law of the system, or, as appropriate, the country or territory whose law governs the system, so that participants have certainty as to the law that will govern any claim or other issue arising out of, or in connection with, their participation in the system as affecting relevant digital assets held in the system. For similar reasons, we would also favour consideration as to whether the common law rule in *Ralli Bros. -v- Compania Naviera Sota y Aznar*[7], which as a matter of English private international law may require that a contract is not enforced or is invalid insofar as its performance is unlawful by the law of the country where the obligations arising out of it are to be performed, should be modified in its application to contracts executed on, or to be performed by the functions provided by, an exchange, clearing or settlement system operating with DLT-based functionality. Specifically, it might be clarified that the place of performance of any such contract, for the purpose of the common law rule, should be deemed to be the country or territory whose law governs the system. Any relevant modifications made to the relevant provisions of the Rome I Regulation and the Rome II Regulation and the relevant common law principle for "simple" contracts should be applied equally to the corresponding conflict of laws rules adopted and applied to contracts made on bills of exchange, promissory notes or other negotiable instruments held in a reliable system, including ETDs.

9. Question 9: Paragraph 8.92 and Paragraph 13.9 of the Call for Evidence - questions concerning the applicable law for consumer contracts.

9.1 The FLC has no particular views or evidence on this question other than to note (a) that much will depend on consumer protection legislation, which raise questions of policy beyond the competence of the FLC, and (b) where any claim relates to a digital asset held or evidenced in a DLT-based system, the rules and governing law of the system should prevail for the reasons set out above.

10. Question 11: Paragraph 9.38 and Paragraph 13.11 of the Call for Evidence – views and evidence on localising damage arising in tortious claims relating to crypto-tokens for the purposes of applicable law; and Question 12: Paragraph 9.54 and Paragraph 13.12 of the

[7] [1920] 1 KB 614.

Call for Evidence – views and evidence on the "escape clause" in Article 4(3) of the Rome II Regulation.

10.1 In our view, the key policy objective of obtaining legal certainty with respect to dealings with digital assets, and thus assuring confidence in those dealings, may be achieved in part through the common law (the principle of participant autonomy), and in part by legislation which enables those dealing with digital assets, and in particular participants in a DLT-based system, to choose a law to govern both their contractual rights and their non-contractual rights arising with respect to the system, including enabling contracts to be performed or settled through that system. The chosen law should govern both the relationships between participants in the system and third parties in dealings in digital assets issued, held, recorded or transferred within the system.

10.2 We think a more certain result would be obtained, including in the context of non-contractual claims, if the first option in any waterfall of options provided by English law principles of private international law (and, ideally, in any supranational treaty or convention to which the UK may come to adhere) is the law chosen by the participants in the relevant system which, as we have noted above, we consider would also bind third parties, including in the context of proprietary rights arising with respect to the digital assets held or recorded in the system.

10.3 In those cases where participants in a system have not expressly chosen the applicable law to govern proprietary issues affecting digital assets recorded in the system, we consider that (without affecting the primacy of the chosen law, where specified) the relevant conflict of laws rule will need to provide a "waterfall" of options to determine the applicable law to govern proprietary issues. This could include application of the law of the country or territory in which the operator or administrator (if there is one) of the system has its registered office or "statutory seat" (as provided by Principle 5 of the UNIDROIT Principles); or, failing that, the law of the country or territory in which the owner or controller of the digital assets in dispute is domiciled, has its habitual residence or is located as at the time of the transaction. We would favour priority (where available) for the location of the administrator of the system, especially where it has access to "master node" functionality to update the DL, over the location of the issuer of a digital asset recorded in the system.

10.4 We agree that a "default position" is likely to be needed in the absence of an express choice of law or satisfaction of the other "higher priority" tests in the waterfall, for the location of the controller or transferor of the digital asset the subject of the particular dispute or transaction. This may be of particular relevance for permissionless DLT systems. It would, though, be fundamental to the concept of a waterfall of options that there would be no "escape clause" that would override the participant autonomy rule.

10.5 We note that anonymity, or the inability to identify holders, transferors or transferees of digital assets, has been a problem in the tortious cases thus far considered by the English courts. Any rule of private international law that is based on the location or the transferor or current holder of a digital asset means (particularly for digital assets recorded or held in a permissionless system) that the applicable law may be incapable of being ascertained, which in turn may cast doubt on the question whether the courts of any particular sovereign country could or should accept jurisdiction in the applicable dispute.

11. **Questions 13 to and including Question 19 on electronic bills of lading, electronic bills of exchange/negotiable instruments and the Electronic Trade Documents Act 2023.**

11.1 We note the comments made by members of trade associations during the industry/practitioners roundtable events held by the Law Commission in April 2024, that (a) English law is invariably included as the governing law of bills of lading; (b) section 72 of the Bills of Exchange Act 1882 (the "**1882 Act**") does not apply to bills of lading; (c) local law matters typically arise only in the context of fraud and insolvency, and (d) there was and is a very well understood and consistent approach to trade documents recognised in multiple legal systems around the world, based principally either on the 1882 Act or the French civil law approach. We agree that in the experience of the members of the FLC, UK and European banks use bills of exchange less, these days, than banks in the Middle East and the Far East. Finally, we note the comments made by practitioners at the roundtable events that there is growing use of ETDs and the Electronic Trade Documents Act 2023 has been a catalyst for legislation in other jurisdictions. Our comments on these questions are, therefore, primarily limited to the concerns arising from section 72 of the 1882 Act, in the context of bills of exchange and promissory notes.

11.2 We agree with the comments made by participants at the roundtable events that the policy objectives should be to foster and ensure transparency, cost-efficiency and effective cash management in the context of international trade and, therefore, an approach which provided for a single system of law as data/ETDs move through the inevitable multiple platforms for the submission of ETDs will be a critical objective; the key is developing "reliable systems.

11.3 We do not agree with those who would argue that there should be movement away from reliable systems towards relevant participants; this seems to us to be likely to undermine the need for certainty.

11.4 Where a bill of exchange or promissory note is issued as an ETD, the functions of the relevant reliable system will or may operate on the ETD to perform the acts of issuance, drawing, acceptance, indorsement, presentment and payment (and to make the related contracts on the instrument) that are the subject of the conflict of laws rules of section 72 of the 1882 Act. As the performance of those functions will be governed by the law of the reliable system and section 72 is primarily concerned with legal issues (formal validity of instruments/contracts, contract interpretation and duties), it would be logical and consistent with legal policy for the country whose law governs the system to be identified as the relevant "place" for the purposes of s. 72. This would provide a coherent, certain and readily ascertainable conflict of laws solution for s. 72 in its application to bills of exchange and promissory notes issued, held and negotiated as ETDs in a reliable system; and relevant stakeholders could readily assess and analyse the validity and effectiveness of the reliable system's functions as operating in relation to an ETD, under the applicable law, to support the formal validity of the ETD held and negotiated through the system, as well the other legal matters the subject of section 72.

11.5 It is conceivable that a negotiable instrument, which is not a bill of exchange or promissory note, may be issued, held and transferred as an ETD by means of a reliable system. It seems likely that such an instrument would not fall within the scope of the

conflict of laws rules set out in section 72. In order to provide legal certainty for the corresponding conflict of laws rules that would apply to such an instrument, a suitable statutory provision is likely to be needed to extend like rules to those set out in section 72, as modified above for bills of exchange and promissory notes recorded in a reliable system, to other types of negotiable instrument recorded in the reliable system.

11.6 Separately, as a general observation and although not strictly a private international law issue relevant to bills of exchange, promissory notes and other negotiable instruments recorded in a reliable system, in order to allow for the effective presentment for payment or acceptance of such instruments as ETDs by means of a reliable system, substantive amendments would also need to be made to the rules for due presentment for payment (section 45 of the 1882 Act) and due presentment for acceptance (section 41) to the extent they require presentment "at a reasonable hour on a business day" and/or presentment "at the proper place". Presentment is a process under which the bill of exchange itself is physically delivered to the payer: see *Barclays Bank plc -v- Bank of England*[8]; see also s. 52(4) of the 1882 Act. These substantive provisions would need to be expressed to apply to any instrument constituted as an ETD which requires the instrument to be presented (as a matter of the 1882 Act or common law) with reference to temporal or locational requirements that are inapposite for the DLT-based system or similar operation of a reliable system. As it is likely that a legislative instrument will be required to set out the conflict of laws rules for ETDs that are negotiable instruments (and to make amendments to the provisions of section 72 to govern how the relevant conflict of laws rules are intended to apply to bills of exchange or promissory notes issued as ETDs), it would be reasonable to take the opportunity to make appropriate modifications to the rules for presentment for payment/acceptance (both under the 1882 Act and at common law) to support the presentment for payment/acceptance of ETDs, as negotiable instruments, by means of a reliable system.

11.7 Please note on this point that the statement in paragraph 11.36 of the Call for Evidence that "… the place where a bill is payable, where an act relating to presentment is done, or where the bill is dishonoured do not seem to relate to the location of the bill of exchange itself", is not correct. A bill is payable at the location of the "proper place" where the bill itself must be duly presented for payment in accordance with section 45 of the 1882 Act and it will be dishonoured by non-payment at that place where payment is refused or cannot be obtained in accordance with section 47 of the 1882 Act.

11.8 Consideration should also be given as to whether the safety and integrity of the operation of reliable systems, and public confidence in such systems, might be further enhanced by establishing in legislation conflict of laws rules for ETDs recorded in reliable systems, but which are not within scope of the limited rules set out in section 72 of the 1882 Act, for example, material validity, effect of illegality, mandatory provisions and other matters that are governed by the Rome I Regulation for "simple" contracts, i.e. those that are not made in the form of a negotiable instrument.

16 May 2024

[8] [1985] 1 All ER 385 at 394