

The Jam in the Sandwich – the EIR’s Strengths and Shortcomings in the Crypto-asset Market

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This paper explores the pros and cons of the existing insolvency tools available for addressing a crypto-asset service provider (CASP) insolvency, considers the “sandwich” position of the European Insolvency Regulation Recast (EIR) within a plethora of highly technical EU bank insolvency legislation, and recommends the best approach for the EU to take.

Until recently, the market in crypto-assets has been largely unregulated in the EU. This changed in May 2023 with the introduction of the Markets in Crypto-assets Regulation (MiCAR), which is seeking to “safeguard the ownership rights of clients, especially in the crypto-asset service provider’s insolvency” (Art 70(1)).

Failures such as FTX, Three Arrows Capital, Voyager and BlockFi have exposed the insolvency risk CASPs can pose to consumers. Some consumers have treated these new types of business as if they were traditional banks or financial institutions, presumably unaware of the high levels of financial protection for consumers provided by banks that are not matched in the market in crypto-assets.

As this market becomes gradually more mainstream, it has become clear that one type of CASP that merits particular attention is the crypto custodian. Crypto custodians are significant because they control the crypto-assets of others, often for long periods of time, whereas other CASP often do not control the crypto-assets or do so for a relatively short period of time.

The regulatory oversight resulting from MiCAR is a welcome step in ensuring that crypto custodians act to minimise their insolvency risk and the clients’ risk of a loss of crypto-assets. However, regulation alone cannot prevent insolvency and the critical question for insolvency lawyers remains: *what happens if a crypto custodian becomes insolvent?*

Unsurprisingly, the answer to this question is not straightforward. This depends on the type of services that these CASPs provide – while some of these might appear similar to the services a bank or investment firm might provide (hence the confusion for consumers), many CASPs lines of services are very different from banks, although some *may* fall within the definition of a credit institution or investment firm.

At EU level, the Single Resolution Mechanism Regulation (SRMR), the Bank Recovery and Resolution Directive (BRRD) and the Credit Institutions Winding-up Directive (CIWUD) are comprehensive regulatory regimes designed for financial sector entities in financial distress.

Jammed in amongst this plethora of highly technical legislation, is the European Insolvency Regulation recast (EIR), which applies to insolvencies other than those of credit institutions, investment firms and those named in Art 1(2) EIR and which has demonstrated its effectiveness for almost a quarter of a century.

Yet the insolvency related articles of MiCAR seem to indicate that the SRMR and BRRD may be a more suitable insolvency regime for CASPs, even though tools such as bail in are mostly incompatible in this regard.

The EIR is not perfectly suitable for CASPs' insolvencies. But despite its flaws, the authors argue that the less complex insolvency rules of the EIR will provide a better toolbox for managing the insolvency of CASPs, especially pure crypto custodians.