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

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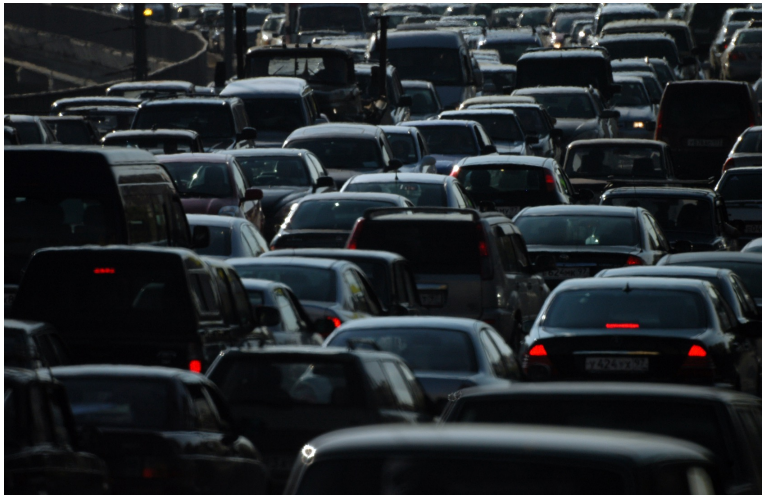
Overview

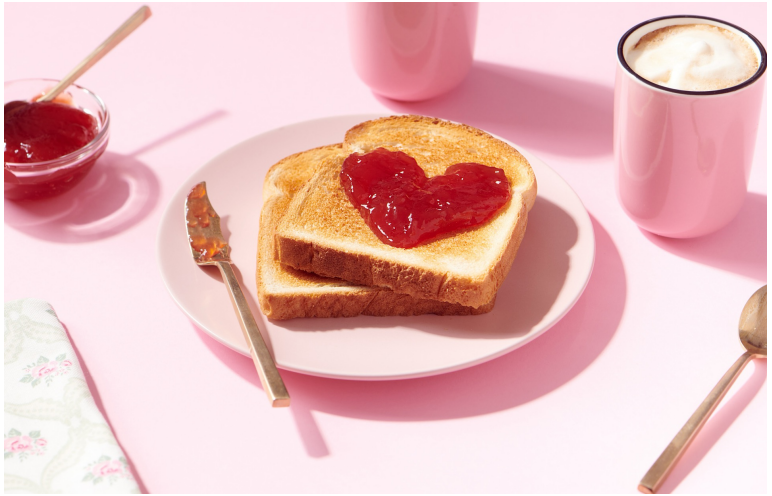
- Why the jam in the sandwich?
- The emergence of new types of debtor in the crypto-market
- The insolvency question: what is the best regime for managing crypto-custodian insolvencies?
- What are the strengths and shortcomings of the EIR in this debate?

Why “the jam in the sandwich”?

A traffic jam



The other (best?) kind of jam



New types of debtor

- We have debtors with new types of business, including
  - Crypto-asset issuers
  - Crypto-asset service providers (CASP)
- We have seen failures…

THREE ARROWS CAPITAL

FTX

BlockFi

VOYAGER

Some burning questions for insolvency lawyers

- What is the best insolvency regime for managing the insolvency of a CASP such as a crypto-custodian?
  - The EU Single Resolution Mechanism (**SRM**) for credit institutions and investment firms?
  - The **EIR**?
  - A **bespoke** (as yet undetermined) mechanism?
- And where does the Markets in Crypto-assets Regulation (**MiCAR**) fit in?

A legislative jam?

2001

- European Insolvency Regulation (2000)
- Credit Institutions Winding Up Directive (2001)
- Plus national insolvency laws

2023

- Credit Institutions Winding up Directive (CIWUD, 2001)
- Bank Recovery and Resolution Directive (BRRD, 2013)
- Single Resolution Mechanism Regulation (SRMR, 2014)
- European Insolvency Regulation (recast) (EIR, 2015)
- Preventive Restructuring Framework Directive (2019)
- Markets in Crypto-assets Regulation (MiCAR, 2023)
- Plus national insolvency laws

Non-insolvency legislation relevant to determining whether an institution is a credit institution or an investment firm

- Capital Requirements Regulation (CRR, 2013)
- Markets in Financial Instruments Directive (MiFID II, 2014)

A technical point and an observation…

The technical point…

- A CASP set up *solely* to offer services as e.g. a crypto-custodian will not be a credit institution and is very unlikely to fall within the definition of an investment firm under CIWUD
- Determining this will require a forensic consideration of the activities it undertakes with reference to CIWUD and MiFID II

The observation…

- In an insolvency, you want to act quickly to preserve assets. Having to undertake a detailed analysis as to whether an entity does or does not fall within the classification as a credit institution or investment firm will not be quick

Some similarities between MiCAR and the SRM

MiCAR

- Some issuers must draw up and maintain a **recovery plan** to protect the reserve of assets (Art 46)
- Some issuers must draw up and maintain a **redemption plan**, *inter alia*, for the "case of insolvency" (Art 47)

- Client assets must be legally and operationally segregated to protect client claims "in the event of insolvency" of the CASP (Art 75(7))
- Issuers must have a reserve of assets legally and operationally segregated (Art 36)

SRM

- BRRD: each institution must draw up a **recovery plan** to cover the case where there is "a significant deterioration of its financial situation" (Art 5) and a **resolution plan** where **conditions for resolution** are met (Art 10)
- SRMR: the Single Resolution Board must draw up **resolution** plans for significant financial institutions, those supervised directly by the ECB, and cross-border banking groups (Art 7(2))
- Art 44(2)(d) BRRD and Art 27(3)(c) SRMR: assets held for a beneficiary and which are protected under applicable insolvency law are **excluded** from bail-in

Some differences between MiCAR and the SRM

MiCAR

- No specific regime to deal with the insolvency of a crypto-asset service provider; no specific **tools** created
- No system of mutual recognition
- Refers to, but does not define, "insolvency" and "recovery" or conditions for determining "deteriorating financial position"

SRM

- BRRD – harmonises bank insolvency law: introduced bail-in (write down, conversion tools)
- SRMR – imposes single regime for the resolution of credit institutions in the EU
- CIWUD – harmonises private international law rules for failing credit institutions and investment firms
- BRRD/SRMR: condition for resolution FOLF (Art 32(4)/Art 18(4):
  - (a) failure to meet authorisation
  - (b) [= balance sheet insolvency]
  - (c) [= cashflow insolvency]
  - (d) extraordinary public financial support required

What can we learn from this analysis?

- SRM is highly technical. Legislation sometimes requires national transposition (CIWUD, BRRD) sometimes not (SRMR) → **patchwork**
- Regulatory law is enriched with insolvency law as an annex → **no comprehensive system**
- Pure crypto-custodians will not fall within the scope of the SRM unless they can be defined as a credit institution or investment firm → **EIR required**
- MiCAR touches on restructuring and insolvency issues a lot, but lacks a comprehensive system

We could also observe:

1. The current iteration of the SRM is a result of adaptations to address:
   - the special role that credit institutions play in society e.g. the provision of deposit-taking and payment services and maintaining those services
   - the consequences of the insolvency of institutions that are “Too Big To Fail” post-Lehman i.e. the danger of contagion and systemic risk across the global banking system from “SIFIs”
   - the need for non-public financial solutions to bank recapitalisation e.g. bail-in

2. CASP such as crypto-custodians
   - are not providing any special services to the public
   - are – currently – unlikely to be “Too Big To Fail” and unlikely to cause a systemic risk
   - are unlikely to have any significant assets capable of being bailed-in

→ SRM less suitable than the EIR

But is the EIR the ideal solution?

- Shortcomings:
  - Credit institutions or investment firms licensed under MiFID II which also offer crypto-asset services are excluded from the scope of the EIR (Art 1(2)) → **patchwork**
  - Determining whether the EIR exclusion applies to CASP requires detailed analysis of their business model → **uncertainty**
  - Determining the *situs* of crypto-assets as a decisive question for secondary insolvency proceedings is challenging → **uncertainty**
  - The EIR may not be the ideal framework **for all** CASP

What about a bespoke insolvency regime for CASP?

- Advantages
  - It would be designed for the peculiarities of the markets in crypto-assets
- Disadvantages
  - It would add further complexity to the already extensive restructuring and insolvency legislation on the statute books
  - The terminology and the developments in this area are not yet settled, so there is a danger of obsolescence
  - Other key markets, such as automotive, AI and energy, also lack bespoke insolvency regimes

But where is the jam you promised us?

Strengths of the EIR:

- The legislation has been tried and **tested** for almost a quarter of a century
- It is **well understood** by a sophisticated body of insolvency lawyers within:
  - the EU insolvency community (the judiciary, the courts, insolvency practitioners)
  - many third countries (e.g. UK, US), especially those that have adopted the UNCITRAL Model Law (it follows similar principles)
- It has **conflicts of law rules** that are widely accepted and work well
- EIR's regime is more **manageable** [92 articles] compared to the BRRD [132] + SRMR [99] + CRR [521] + CIWUD [35] (= 787 in total)
- In conjunction with the EIR, national laws permitting the general **realisation** of the debtor's assets will permit the specific realisation of the debtor's crypto-assets wherever they are situated (Art 7, 19-21, 32 EIR)

Final recommendations

- The EIR is a good starting point for most CASP insolvencies (*the best kind of jam*)
- However, it could be improved (*by putting cream on top?*)
- In our CERIL Report the Working Party recommends that:
  - the EU legislator should make a proper assessment of the correct approach for CASP insolvencies
  - the EIR should be amended to remove uncertainties that might delay insolvency proceedings involving crypto-asset service providers by:
    - including an autonomous **definition** of crypto-assets
    - narrowly interpreting **Art 1(2) EIR** to ensure that pure crypto-custodians are not excluded from the EIR
    - making it explicit that the ***lex libri siti*** applies only to those blockchains subject to the supervision of a public authority; and
    - providing a waterfall mechanism for determining where crypto-assets are **situated**

Thank you for listening

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