

SWITZERLAND

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## Enabling bankruptcy-remote custody of crypto assets

As the interest of institutional and retail investors in crypto assets such as bitcoin or ether is gaining further momentum, the regulation of virtual asset service providers providing custody services for crypto assets (custodial wallet providers) has become a priority issue for regulators and legislators around the world. While some jurisdictions have put in place bespoke regulatory frameworks for custodial wallet providers, other jurisdictions still struggle to determine the right measures for a risk-based yet innovation-enabling regulation of custodial wallet providers.

The Swiss Financial Market Supervisory Authority FINMA, the Swiss watchdog for the financial industry at large, pursues a technology-neutral 'same risks, same rules' approach and applies its existing regulatory framework based on the activities pursued by a custodial wallet provider. The Swiss legislator is supportive of this approach and is ready to amend existing rules in order to ensure a robust legal framework for crypto assets and other fintech developments.

### Customer protection: a growing international concern

A growing concern for national and international regulators and legislators is the protection of holders of crypto assets in the insolvency of a custodial wallet provider. As custodial wallet providers often do not require a banking or securities firm license in order to offer custody services for crypto assets, customers of custodial wallet providers lack the protection conferred by regulatory capital requirements, bank depositor protection schemes and other rules ensuring the preferential treatment of customers in the insolvency proceedings of a bank or securities firm.

Policymakers therefore increasingly call for adequate customer protection measures

in the crypto space, including e.g. by requiring custodial wallet providers to publish unambiguous risk disclosures to promote transparency for customers or by ensuring that customer assets are held in a bankruptcy-remote manner protected from claims of other creditors of the custodial wallet provider.

Against this background, Switzerland is set to introduce an amendment of its insolvency laws which will enable the segregation of 'crypto-based' customer assets in the event of a bankruptcy of a custodial wallet provider. The amendment is part of a larger revision of Swiss law aimed at further enhancing the legal and regulatory environment for DLT-based projects in Switzerland. While some of the revisions have already been enacted in the beginning of the year, the segregation rules are expected to enter into force as of August 1 2021.

### Segregation rules: applicability

The new segregation rules do not distinguish between different categories of crypto-based assets and apply in our view with regard to all types of tokens irrespective of their qualification as a payment token, asset token, utility token or a hybrid form of these tokens. However, in order to qualify as a 'crypto-based' asset, access to the tokens must be conveyed through a cryptographic protocol.

Furthermore, the custodial wallet provider must hold on behalf of its customers all cryptographic keys that are necessary to access and dispose of the relevant tokens on the distributed ledger. If the customer independently holds some or all of the cryptographic keys that are necessary to access the tokens (for example as part of a multi-signature address), the tokens in question will usually not form part of the custodial wallet provider's bankruptcy estate, in which case the segregation rules are redundant. However, the customer will still be entitled to claim the cryptographic keys that are held by the (bankrupt) custodial wallet provider.

### Individual vs omnibus custody

Custodial wallet providers either hold their customers' tokens in individual addresses on a distributed ledger or operate under an omnibus structure, meaning that customers' tokens are held collectively in one or several omnibus addresses on the distributed ledger.

In order for the segregation rules to

apply, the custodial wallet provider must be able to allocate the tokens held on-chain to each of its customers individually or at least be able to determine the proportional entitlement of each of its customers to the tokens held in an omnibus address. It is sufficient if the customer-by-customer allocation is established at the internal books and records level of the custodial wallet provider rather than on-chain.

Irrespective of the custody structure used, the custodial wallet provider is required to keep the tokens available for its customers at any time and may not carry out proprietary or own-account transactions with customer assets. The custodial wallet provider is accordingly precluded from engaging in lending and similar commercial activities with the assets of its customers in order to ensure the customer privilege stemming from the segregation rules.

### Committed to responsible innovation

With the implementation of the new segregation rules for custodial wallet providers, Switzerland proves once again that it is committed to be at the forefront of responsible innovation in the DLT space.

The new rules are expected to further strengthen Switzerland's position as a leading hub for DLT projects as they will enable Swiss-based custodial wallet providers to offer their customers a bankruptcy-remote custody of crypto assets, albeit at the cost of refraining from certain commercial activities.

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