

Transferring digital assets in a search for yield: legal risks for investment managers

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Overview

An increasing number of hedge fund managers are now considering investments in digital assets, including strategies designed to generate yield from those assets. Yield-generation in the digital assets space can take a number of forms (for example ‘staking’ or use of ‘DeFi’ applications), but commonly involves the digital asset being transferred to a third party. There is significant uncertainty regarding the legal implications of such arrangements, and many are untested before the English courts.

In this article we draw out some of the key legal issues arising. These include the risk that ownership of the digital asset is disputed, the risk of regulatory scrutiny of the arrangements, and the risk of unforeseen tax liabilities.

Introduction and key terms used

Decentralised finance (“DeFi”) refers to financial infrastructure built on blockchain technology; it enables peer-to-peer financial transactions without the need for centralised intermediaries. DeFi transactions will often use smart contracts. These are contracts in which some or all of the contractual obligations are defined in and/or performed automatically by computer code. DeFi applications can be used to generate yield for investors, for example by offering a return to those willing to provide liquidity in the form of a temporary transfer of their digital assets. According to Forbes, as at June 2021, the total locked value of liquidity pools in DeFi projects was almost USD 8 billion.

Staking involves the validation of transactions on blockchains that operate a ‘proof of stake’ protocol. The incentive to validate transactions (honestly) is that by doing so parties can earn newly minted digital assets that operate on that protocol. However, a condition of the validation process is that some digital assets must be ‘staked’ – essentially locking those assets into the protocol for a period of time as security against honest transaction validation.

The need to stake digital assets as part of the validation process – and the potential reward for doing so – creates an incentive structure for asset owners to transfer their assets to parties wishing to be involved in the validation process, and to be paid for doing so. An investor might transfer digital assets to another party who will stake them, in return for a share of the returns generated by the transaction validation.

DeFi and staking transactions can take a multitude of different forms. A common feature is that the investor transfers control of its assets to another party or, in the case of DeFi, to a decentralised application via smart contracts. The word “transfer” is used neutrally – in legal terms, and depending on the language (or code) use, this could in theory involve “lending” the asset (whilst retaining beneficial interest) or could involve a sale and repurchase of the asset (with beneficial interest passing along with each transfer).

This could be compared to stock lending or cash deposits in the traditional financial system. However, unlike in the case of stock lending or deposits, it is unclear – in the case of DeFi and staking – precisely what rights the investor would have in the event that something went wrong, what regulatory risks it might be running and how the transaction would be viewed for tax purposes.

Litigation risk

Blockchain and smart contract technology provide solutions in many areas that traditionally give rise to disputes, such as non-performance of a contract. In the case of smart contracts, performance is automatic, provided the relevant conditions are met. In some situations this serves to increase legal certainty, but not always.

These new technologies do not – of themselves – answer all the difficult legal questions that can arise when things go wrong (for example, through insolvency, fraud, or other unexpected intervention). And the newness of the technologies can of itself give rise to increased legal uncertainty: there may well be no legal precedent covering a dispute over legal rights in the relevant situation. Where that is the case, Courts have to determine some fundamental questions (e.g. to define what the digital asset is, in legal terms) before the dispute can be resolved.

In the event of something going wrong, an investor – for example in land, or in equity/debt securities, would ordinarily look to the contract they have with their transaction counterparty to understand their legal rights. In the case of DeFi and smart contracts, however, this may not be straightforward.

First, is there a binding legal contract and, if so, what are its terms? The Law Commission has concluded that smart contracts are capable of satisfying the prerequisites of a binding legal agreement, although there may remain challenges and disputes. Smart contracts that exist solely in code form may omit important boilerplate provisions which become key in disputes, such as which law governs the contract and which courts have jurisdiction to determine the dispute, and may not make provision for the circumstances that have arisen.

Second, who is the counterparty to the contract and what ability do they have to satisfy any judgment against them? This might appear an obvious question, but in the case of DeFi there might be considerable uncertainty as to who the counterparty to the investor’s contract is: the party responsible for creating the DeFi application and smart contracts or the other side of the trade intermediated by the DeFi application?

Uncertainty in these respects can have serious consequences for the investor. For example, what if a DeFi protocol is hacked and assets lost? What if staking activities are conducted negligently? What if the staking party becomes insolvent – does it or the investor retain property in the assets? What right to damages would the investor have, from whom would they be claimed, and how (and where) would the investor go about pursuing its claim? How can the investor protect itself against counterparties that lack the assets to pay those damages?

These risks emphasise the importance of understanding who has beneficial ownership of assets that are transferred by the investor to another. If the investor retains beneficial ownership, it will have proprietary rights in the assets themselves and might be able to take action to secure their return. In other words, the investor would not need to pursue a counterparty for damages but could lay claim to the particular assets that were transferred. In the world of blockchain technology such a right may take on a renewed importance; the immutable record created by the blockchain opens up the possibility of claimants being able to track the specific digital assets they own into the hands of whoever holds them following an event like a hack or a commercial dispute.

A recent case before the English courts has considered precisely this issue in the context of staking*. The court held that, in principle, digital assets are capable of being held on trust for a beneficial owner. On the facts of that case no trust arose, because the terms of agreement between the parties were incompatible with a trust. However, in a relationship with different commercial terms an investor may be able to establish that the assets transferred remain “its” property throughout, greatly improving its position should risks crystallise. This has important consequences.

An investor wishing to retain a beneficial interest in assets it transfers will, in broad terms, need to establish certainty regarding the terms on which the transfer takes place. Traditionally, it has been necessary as a matter of English law to show the three “certainties” to establish a trust: certainty of intention (was a trust intended by the parties?); subject matter (which digital assets are to be held on trust?); and object (who are the beneficiaries of the trust?). Some features of DeFi and blockchain technology, such as the ability to identify specific assets even when comingled with other assets, lend themselves to establishing these certainties, while others, such as the anonymous nature of many transactions, may present challenges to an investor seeking to prove that a trust exists.

Hedge funds entering the digital asset space – and which may seek to generate yield through lending / transfer of those assets for staking or DeFi purposes – will need to consider carefully the legal protections to be put in place.

* *Wang v Darby* [2021] EWHC 3054 (Comm).

Regulatory risks

In a DeFi or staking transaction an investor may in practice be allowing its assets to be pooled with assets from other, unknown, parties who are using the same protocol to generate yield. This can present regulatory risks for the investor, should some of the assets pooled along with its assets be tainted by financial crime. For example, money launderers might seek to use the pooling and yield-generation of a DeFi protocol as a means of concealing the origin of assets that derive from crime. Depending upon the nature of the transaction in question, the investor might receive out of the asset pool digital assets linked to financial crime, rather than the “same” specific digital assets that it put into the pool.

The pooling of assets in this manner may also present regulatory risks should the structure fall within the definition of a regulated investment for which regulatory permission or authorisation is required. For example, arrangements in which assets are pooled and managed collectively may in England constitute a ‘collective investment scheme’, within the meaning of the Financial Services and Markets Act 2000. This would principally be a risk for the operator of the protocol, who may trigger an obligation to be authorised, but could nevertheless present risks for the investor owing to the unlawful nature of the arrangement.

Beneficial ownership of digital assets may again become relevant in the regulatory context; if an investor can show that it has at all times maintained ownership of specific digital assets which have been returned to it, it may reduce the risk that its assets have been exchanged for those tainted by crime or pooled in a way that triggers regulatory obligations.

Tax risks

The tax consequences of transferring digital assets to another should also be explored. A significant recent development in the UK has been the publication of guidance by HMRC stating that the transfer of digital assets to a DeFi platform or protocol, including for the purposes of staking, may be classed for tax purposes as a disposal of that asset. This means that the transaction will be subject to Capital Gains Tax reporting at that moment, even though the investor may consider the assets to remain “theirs”. This may be contrasted with stock lending, for example, which is not treated as a disposal for tax purposes.

For an investor which regularly uses DeFi or staking transactions to generate yield this tax treatment could give rise to considerable risks and tax liabilities. Once again, the existence of a trust may be highly significant, it generally being the case that an asset is not disposed of if beneficial ownership of it is retained.

Conclusion

There has been a rush of investment into digital assets by investment funds. Alongside the considerable potential for returns, fund managers should be cautious and diligent in the legal protections around any arrangement by which digital assets are transferred on an interim basis in search of yield.

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