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Custody and Staking of Crypto Assets

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Key Take-aways

1.
Staking refers to a validation process used in blockchains based on a proof-of-stake consensus mechanism by blocking native Crypto Assets against a reward. Staking can be provided as a service by custodians for their clients.

2.
In its recent guidance, FINMA clarifies safe harbor rules that must be met by regulated custodians in order to provide such staking services "off-balance sheet" without triggering regulatory capital requirements for deposits.

3.
Staking remains possible for custodians that are not licensed by FINMA as banks or FinTech licensees, to the extent they are providing this service directly and cryptocurrencies/payment tokens are held on a segregated basis.

1 Introduction

Where a blockchain provides for a **proof-of-stake** consensus mechanism (such as Ethereum 2.0, Cardano or Tezos) as opposed to **proof-of-work** (such as Bitcoin), holders of tokens in the sense of the FINMA Guidelines for enquiries regarding the regulatory framework for initial coin offerings (ICOs) of 16 February 2018 (**Crypto Assets**) can participate in the blockchain validation process and, as a result of such process, earn rewards. This process is commonly referred to as **"staking"**. For **wallet-providers** (the **Custodians**), the offering of services allowing their clients to stake their tokens has become an important part of their service offering given the wider use of blockchains with proof-of-stake consensus mechanisms.

With its **Guidance 08/2023 on Staking** (the **Guidance**), the Swiss Financial Market Supervisory Authority (**FINMA**) clarifies some key regulatory questions in this context. The Guidance addresses, in particular, (i) the **licensing** requirements Custodians must comply with in this context; and (ii) for Custodians that are licensed under the Federal Act on Banks and Savings Institutions (the **Banking Act**), to what extent staked Crypto Assets are considered to be "**on-balance sheet**" and, thus, subject to **regulatory capital requirements** for deposits (with the relevant risk weight, which is currently 800% and may be increased up to 1250% in the context of the implementation of the revised Basel rules).

We are providing a brief overview of the regulatory framework applicable to **staking-as-a-service**. For a regulatory classification of Crypto Assets more generally and the licensing process for FinTech licensees, we refer to our earlier newsletters.

2 Custody services for Crypto Assets under Swiss regulation

Custody services for Crypto Assets typically consist of providing the technical infrastructure to access the so-called **public addresses** to which Crypto Assets are registered and to facilitate or manage on behalf of the client their access to the private keys that are required to dispose of the Crypto Assets. Depending on the control of the private keys, the following distinction applies:

- **Non-custodian wallet providers do not have control over the private keys** relating to the Crypto Assets of their users and, thus, do not have the power to dispose of the Crypto Assets of such users. They are, as a result, **not subject to a license requirement** by FINMA in Switzerland. However, they may be financial intermediaries for the purposes of the Swiss Anti-Money Laundering Act (**AMLA**).
- **Custodian wallet providers have control over the private keys** relating to the Crypto Assets of their clients and, thus, have the power to dispose of the Crypto Assets of such clients. The relevant regulatory regime depends on the way the Crypto Assets are held in custody for the clients. If Crypto Assets are held for each client **on a segregated basis** by using separate public addresses and private keys, there is no license requirement by FINMA in Switzerland and the activity falls only within the scope of the AMLA. However, if the Crypto Assets of several clients are held in an **omnibus custody account** by using one public address for several clients, **a bank or FinTech license** from FINMA pursuant to the **Banking Act** is required for Crypto Assets qualifying as **cryptocurrencies/payment token** or hybrid tokens qualified **as having** the predominant characteristics of a cryptocurrency/payment token.

FINMA defined safe harbor criteria in order not to trigger regulatory capital requirements for FINMA licensed custodians.

3 Segregation of the Crypto Assets from the insolvency estate of the Custodian

Aiming at improving investor protection, the Federal Act on the Adaptation of the Federal Law to Developments in Distributed Ledger Technology, which fully entered into force on 1 August 2021 (please see our earlier newsletter in this respect), among other amendments, clarified the Swiss Debt Enforcement and Bankruptcy Act (**DEBA**) and the Banking Act by allowing **the segregation of Crypto Assets held in custody by a Custodian in its insolvency** if the following conditions are met:

i. the Crypto Assets are held either (a) for each **client individually by using separate public addresses** for each client or (b) for several clients together in an **omnibus custody** by using one public address for several clients, provided that the holdings of each client in such omnibus custody are **identifiable**; and
ii. the Custodian is obliged to have the Crypto Assets **readily available for the clients at all times**.

If these conditions are met, the following segregation processes apply:

For Custodians that are **licensed by FINMA under the Banking Act**, such Crypto Assets would qualify as custody assets within the meaning of article 16 no. 1bis of the Banking Act with the result that they are **segregated by the liquidator from the bankruptcy estate of the Custodian** in accordance with the provisions of the Federal Act on Intermediated Securities.

For Custodians that are not licensed under the Banking Act, **the clients would have to request the segregation of their Crypto Assets** from the bankruptcy administration in accordance with the DEBA.

4 Providing staking-as-a-service

According to the Guidance, staking refers to the **blocking** of native Crypto Assets at the staking address of a validator node in order to participate in the **validation process of a block-**

chain that is based on a **proof-of-stake consensus mechanism** (such as Ethereum 2.0). Holders of the staked Crypto Assets earn rewards for participating in the validation process. However, if the staked Crypto Assets are used by a validator node for wrongful validation activities, they may be deleted in part or in full (so-called **slashing**). In order to release Crypto Assets from staking, a so-called withdrawal key is typically required and the staked Crypto Assets may be subject to a lock-up/exit period before being released from staking.

Staking as such is not subject to regulation in Switzerland. However, providing staking-as-a-service has regulatory consequences, to the extent a Custodian **controls the private keys or withdrawal keys of the Crypto Assets** for the purpose of staking them (**Custodial Staking**). This would not be the case where the Custodian does not exercise such control (e.g. to the extent that it offers a non-custodian wallet and the user does not transfer Crypto Assets to the Custodian for the purposes of providing a staking service).

Custodial Staking can be provided in the form of **direct staking**, where the Custodian either operates itself the validator node or outsources the technical operation thereof to a third party, provided that the **Custodian maintains at all times the withdrawal keys to return the staked Crypto Assets** of its clients.

Alternatively, Custodial Staking can also be provided in a **fiduciary setup within a staking chain**, where the Custodian is authorized to **transfer the Crypto Assets to a third party that operates a validator node and holds the withdrawal key to the staked Crypto Assets**.

5 Impact of Custodial Staking for Custodians licensed as a bank or FinTech licensee

If Custodial Staking is offered by a bank or FinTech licensee under the Banking Act, specific requirements as defined in the Guidance have to be met in order **to avoid** that the staked assets qualify **as "on-balance sheet" deposits** for the purposes of the **regulatory capital** analysis.

5.1 Direct staking setup

If the Crypto Assets are subject to **"slashing"** or a **"lock-up period"**, it is unclear whether staked assets of clients can still be considered to be **"readily available for the clients at all times"** in the sense of the prerequisite for an insolvency segregation (see under (3) above). To the extent the insolvency segregation is not available, the staked Crypto Assets would have to be qualified as **"on-balance sheet"**. To eliminate this uncertainty, FINMA defined in the Guidance the following **safe harbor criteria that must be met in order not to trigger regulatory capital requirements for deposits**:

i. the Client provided **instructions** regarding the type and amount of Crypto Assets to be staked;
ii. appropriate measures have been taken to ensure that the Crypto Assets transferred for staking to a particular staking address and, after unstaking, to a particular payout address, can be **unambiguously attributed to the client**;
iii. the client is transparently and clearly informed of **all risks** (including slashing, lock-up periods and insolvency risks);
iv. appropriate steps are taken to mitigate the **operational risks** of operating a validator node (including business continuity management) to avoid slashing and other penalties; and
v. a **Digital Asset Resolution Package** (**DARP**) allowing FINMA to effect the segregation and delivery of the Crypto Assets in an insolvency event of the Custodian is prepared to ensure appropriate risk management.

The Guidance also specifies that the DARP has to specify the key information required to identify and secure staked Crypto Assets, e.g. a description of the custody setup, the contact persons having access to the private keys and information on third parties involved. In addition, the DARP should ensure that a liquidator can quickly return the staked Crypto Assets to investors in an insolvency of a Custodian in order to mitigate expenses and administrative efforts to a minimum.

Direct staking remains possible by non-licensed Custodians, e.g. for cryptocurrencies held on a segregated basis.

5.2 Fiduciary / staking chain setup

Where the **Custodial Staking** is structured as a **fiduciary "staking chain"**, the Custodian engages a third party to provide the staking and, by doing so, has a **claim against the third party regarding the restitution of the staked Crypto Assets**. Such a claim qualifies as **fiduciary claim** held for the clients **pursuant to article 16 no. 2 of the Banking Act**. As a result, the bank or FinTech licensee may qualify such assets as being held **"off-balance sheet"**, provided that the Custodian enters into a fiduciary agreement with the client regarding the Crypto Assets to be staked that meets the requirements analogous to those defined in the Directives of the Swiss Bankers Association on fiduciary investments of 2016. In particular, the Custodian must:

i. limit counterparty risks by selecting an **institution subject to prudential supervision** with a good credit standing, or a subsidiary of a consolidated and prudentially supervised financial group with a good credit standing;
ii. ensure by means of specific due diligence that the **third-party providing the staking service** (1) is not conducting its business on an **unauthorized basis**, (2) **holds** the relevant **withdrawal keys** itself or has equivalent control over the withdrawal keys, (3) informs the Custodian about the **staking addresses** which it has to register internally, and (4) has taken measures **to limit operational risks** regarding the operation of validator nodes; and
iii. enter into a **DARP** to ensure adequate risk management (as above).

5.3 Fiduciary holding of Crypto Assets

To the extent that a bank or FinTech licensee is not itself holding wallets for Crypto Assets, but holds such assets for clients on a fiduciary basis, it may also be authorized to use such assets for staking purposes. The Guidance does not further specify the rules applicable in this context. However, these scenarios should in our view be treated in analogy to section 5.2 above, with the need to adapt a DARP to the specificities of such use-case.

6 Staking by Custodians that are not licensed by FINMA as banks or FinTech licensees

For Custodians that are not licensed as a bank or FinTech licensee under the Banking Act, the provision of staking services is limited to the **direct staking setup** and requires that the **staked Crypto Assets in the sense of cryptocurrencies/ payment tokens are held on an individually segregated basis for each client**, i.e. by using a separate staking address and withdrawal address for each client. Moreover, to ensure that the staked Crypto Assets remain "readily available for the clients at all times" even if the staked Crypto Assets were subject to slashing or lock-up or exit periods and, thus, can be segregated in the insolvency of the Custodian, we would recommend complying with the safe harbor requirements as specified in section 5.1 above.

While custody services may therefore still be provided by non-licensed Custodians on an individual basis for clients, the provision of such a service is further limited by minimum amounts that may apply for the operation of a validator address (e.g. of currently ETH 32 for Ethereum) which may – at least for retail clients – limit the viability of such a business case.

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