

ScalingFunds

by  Brickblock

Comments on the German Electronic Securities Act (eWpG-E) from Brickblock Digital Services GmbH

Colin Nimsz
CSO & General Counsel
colin.nimsz@brickblock.io

Jakob Drzazga
CEO
jakob@brickblock.io

Tara Sisneros
Business Affairs Manager
tara.sisneros@brickblock.io

Mark Lasia
Business Affairs Associate
mark.lasia@brickblock.io

Brickblock Digital Services GmbH
An der Kolonnade 11-13
10117 Berlin, Germany

Introduction

The statements below will focus on the Crypto Registry aspects of the law from an application viewpoint. Important signals on the overall application of digital securities are derived from the aspects of the law that focus on CSDs. We utilize blockchain, distributed ledger, and private key/public key cryptography in real world applications of these laws. Therefore, our comments below focus more on broader practicality and theory than details impacting other aspects of German law.

The statements we make are not simply theoretical. They are not only possible, they are currently in use in our systems. When we make these statements on what is possible they are supported by the systems that we are currently operating in multiple jurisdictions including other EU territories.

Several key points stand out:

- The term "bearer bond" as a translation of *Inhaberschuldverschreibungen* is not accurate. These are not bearer instruments, these are transferable registry instruments and should just be referred to as "bonds."
- No mention of "tokens" or private keys in the law makes perfect sense. *Inhaberschuldverschreibungen* are not bearer issuances, the "token" or private key is not important and not relevant when utilizing a Crypto Registry unless the Registrar chooses to make it so.
- "Security Tokens" don't exist or don't matter, and they shouldn't. The registry and Registrar is what matters and how the Issuer/Registrar chooses to use public-private key cryptography is a technical detail. A private key does not equal ownership, being named on the registry does.
- A Crypto-registry is not a blockchain, yet it can and likely does include blockchain technology as part of its construction.
- This falls in line with how markets operate already and as such is actually a nice clarification more than a big shift.

Comments on the Draft

Bearer vs Registry

While the law focuses on creating digital versions of securities, more importantly, it acknowledges a philosophical shift in theory from bearer issuance (ownership is fully controlled by possession of a physical thing) to registry issuance (ownership is controlled by the recorded owner on the registry). While the translation of *Inhaberschuldverschreibungen* generally translates to “bearer” bond by most law firms, this is no longer accurate. While this law creates a legal fiction of a digital bond, ownership is controlled by the registry and not something in possession of the investor. This is inline with market practices in place for decades which previously utilized CSD’s, nominees, and custodians to run such registries while banking the paper version of the security.

This focus on a registry based theory allows the law to elegantly avoid many pitfalls. The law does not mention keys, tokens, or wallets. This allows a broader application of the theory rather than focusing on terms that are poorly defined or understood. A “token” is already a legal fiction and issuing a “security token” is unnecessary to run a Crypto Registry for digital securities. We have proven this. The terms “token” and “security token” arose from a bearer based theory, which were poorly applied to a registry based system like a securities market.

Understanding this theoretical shift allows for an easy understanding of the application of the law. The securities are the product of the Issuer. The registry determines their ownership, not a “key”, (§29). The Registrar supervises the registry and therefore the ownership, which is a financial service and requires supervision. There is no necessary need for a custodian as there is nothing to hold custody of (§4); a “key” (or “token”) does not need to be issued to an investor and does not secure ownership even if it is issued. Certain investors may need to prove ownership or have a third party control their securities, which may necessitate the use of an investor side custodian. This is the choice and in the realm of the investor, not the Issuer, but if so utilized, the custodian would logically need a traditional custodianship license for holding a security.

Certain organizations have called for differing interpretations, modifications or exceptions to this understanding. This would be a mistake. Allowing an Issuer, whose regular course of business is not the issuance of securities and does not have the relevant financial licensing to issue and control their own securities will lead to unnecessary risks to market integrity. A party with proper supervision and a significant amount of capital at risk (730,000 EUR or more) reduces the temptation of undertaking unnecessary risk and will bring more acceptance to the market. If an Issuer can meet this then so be it, but more than likely this will be a third party Registrar.

Technological Understanding

Crypto Registries are revolutionary new tools, but the tools still need to be utilized, supervised, and implemented within legal realities. There are several misunderstandings published about how the combinations of these three technologies (public/private key cryptography, distributed ledger, and blockchain) and how they combine with traditional software to run a Crypto Registry. Some of these misunderstandings stem from the over reliance on the technology rather than applying proper legal theories in utilizing it as a tool. This materializes when conversations of “tokens”, “wallets”, “smart contracts”, or “minting and burning” drive the discussion. For example, an Ethereum based registry can be utilized, allowing the Registrar to control ownership of securities throughout their lifetime without investors utilizing “wallets” or “minting” or “burning” “tokens.” We have demonstrated this in multiple offerings in several EU jurisdictions. Furthermore, a “private key” does not mean ownership, therefore “signing” by utilizing a “private key” is not transfer of ownership by default. This would be determined by the rules and procedures the Registrar implemented in their system, and could utilize such a means of communicating a request, but the Registrar’s control of the registry and the reflected entry in the registry is what delineates ownership.

The underlying blockchain is only part of the technical stack of tools utilized in such a system.

Reference to §16 and commentary does not cause issues with a Registrar under systems like Ethereum. An opinion that puts the tool ahead of the theory by stating the law disrupts certain blockchain based models (typically bearer theory based models) is technology driven ideology rather than a practical one. The operation of a Node is also not required by a Registrar. To put it another way, the blockchain is not the registry, it is a tool which is part of a technical solution that culminates in a Crypto Registry controlled by a Registrar. Ethereum is not the registry and a Registrar does not have to have control over Ethereum to use it as a tool. This is not theoretical as we have proven this and we are happy to see the law is careful to avoid this assumption. We caution against such commentaries.

After understanding that these technologies are not limited in such a manner, the law shows its elegance in setting a theory and allowing the tools to be utilized to meet the theory. We advise to continue with this solid work, and not be swayed by terminology that is still misused. “Smart Contracts” are not contracts, digital signatures do not necessarily prove a *bona fide* request, a “private key” does not constitute ownership and therefore is not a “security token” nor a digital representation of a security. The registry creates and controls the digital security, the rest are details of implementation by the Registrar. The nomenclature of the current industry is misleading and creates assumptions that are not wholly true. We caution to continue to stay away from these assumptions.

Finally, exchanges and custodians are also not an issue. Allowing them to be the name on record and then act as a nominee/custodian for their users is easily implemented as we have done. To do so would require these intermediaries to have the appropriate licensing for holding securities, not just crypto-assets as they would be the name on the registry. The “keys” are again not necessarily relevant. These organizations would likely have to offer passthrough AML/KYC information for the Registrar to meet their requirements. We don’t see any issues with such entities under this law.

Clarifications and Improvements

Most importantly this law should apply to alternative investment fund units/shares (Sondervermögen, Investmentkommanditgesellschaft and Investmentaktiengesellschaft) from the start. Alternative investment fund units/shares have protections built in for retail investors and are more standardized than equity instruments. Therefore, they should have a higher priority for implementation. Limiting the law to *Inhaberschuldverschreibungen* limits Germany's competitiveness in the overall fund landscape. Particularly with the UK leaving the European Union, it is advisable to update German legislation to match already existing concepts in other EU jurisdictions. Otherwise, Germany potentially risks losing jobs and pushing established FinTechs to relocate to other territories, causing jurisdictional arbitrage which is counter productive to the goal of this initiative. We should not miss this chance to lead this technical innovation and facilitate companies to build intellectual property while operating within Germany.

Further clarification needs to be made in connecting the AML/KYC requirements to the Registrar. Currently, there is no direct contractual relationship between the Registrar and the investor. Theoretically, there is a relationship created through an unregulated Issuer subcontracting to the Registrar to run the registry. This third-party or sub-contractual relationship can be used to oblige the Registrar to continuously run checks on the investors and meet modern AML standards. Alternatively, the opportunity to solidify this obligation and relationship could be more clearly codified in this law.

Another area of clarification is who this law shall apply to. Should it apply to Issuers that are located in Germany, or entities that are addressing the German market? The latter will then allow companies to opt-in by addressing the German market. This should help prevent jurisdictional arbitrage and help set a standard for a greater EU marketwide system. An allowance for non-German companies to be Registrars could be made with reasonable standards and for such companies to opt in. Registered Transfer Agents in Luxembourg come to mind as an example of parties that are properly equipped to offer such services.