

7 March 2019

## **Key-issues paper on the regulatory treatment of electronic securities and crypto tokens – Allowing for digital innovation, ensuring investor protection –**

### **I. Background and objectives**

Increasingly, the financial market is being shaped by digital technologies and innovations such as blockchain. In response, the German government is pursuing the goals set out in the coalition agreement of 12 March 2018: to tap the potential of blockchain technology, prevent possible abuse and strengthen Germany's role as one of the world's leading digital technology and fintech locations. The coalition agreement also sets out the federal government's plans to develop a blockchain strategy.

The present paper is the first measure to be implemented as part of the blockchain strategy. The goal is to permit electronic securities while ensuring investor protection and creating the necessary legal certainty and application security under civil and regulatory law. This key-issues paper goes beyond the blockchain strategy in that it proposes that electronic securities also be permitted outside blockchain and comparable technologies. Given that other countries allow the use of blockchain technology for financial instruments, opening up legislation in this area will safeguard Germany's attractiveness as a financial location. Germany does not intend to wait for EU-wide harmonisation, which would take several years, especially considering that material law governing securities is not harmonised across the EU. Nevertheless, European and international discussions on Initial Coin Offerings (ICOs) will be taken into account to avoid a situation where Germany strikes out on its own and subsequently has to backtrack in the event of an EU-wide harmonisation. This consultation paper does not address the need for rules to prevent money laundering, which arises with crypto tokens of all kinds. That matter is dealt with in the legislation implementing the 5th Anti-Money Laundering Directive (EU) 2018/843 of 30 May 2018.

Guided by the Federal Debt Management Act (*Bundesschuldenwesengesetz*), this key-issues paper presents core aspects related to digital securities and discusses regulatory options and regulatory challenges associated with crypto tokens, especially what are known as utility tokens.

The plan is to open German legislation to electronic securities. In other words, the current rule whereby securities must be represented by physical certificates will no longer apply across the board. Even though the current system of security certificates works very effectively and without any significant problems, there is no need to cling to physical certificates, which generally remain in central securities depositories and are never shown or handed over to the holders of the rights attached to them. However, the aim is to introduce the electronic issuance of securities as an option, not an obligation. Issuers will remain free to use the tried-and-tested system of securities certificates. Rules on electronic securities will be technologically neutral, i.e. the use of blockchain technology will not be privileged in any way, especially in view of the high current energy needs of public blockchain technologies and their negative effects on the climate.

## **II. Electronic securities**

### **1. Scope of regulation: electronic debt securities**

The proposed legislation will take the form of an omnibus act that will contain legal provisions on electronic securities and amend current regulatory law. To begin with, the change will be restricted to electronic debt securities; rules on electronic shares may be introduced at a later stage. In view of the fact that technical standards and requirements can change quickly, the legislation will include an authorisation to issue ordinances specifying technical details. In addition, the law will contain an amendment to the Debt Securities Act (*Schuldverschreibungsgesetz*), which currently also presupposes the existence of a certificate, to allow for changes to the terms of electronic debt securities in particular.

### **2. Securities register**

As is the case under the Federal Debt Management Act, electronic securities will be created by means of an entry in a register. Also along the lines of the Federal Debt Management Act, it might make sense to declare electronic securities to be property by legal fiction, meaning that all provisions for the protection of property rights would automatically apply, particularly in the event of enforcement or insolvency. An alternative option would be to follow the example of the Swiss Book-Entry Securities Act (*Bucheffektengesetz*) and make electronic securities a *new sui generis* right. However, this would require the creation of new rules equivalent to property protection provisions. In any case, separate provisions governing the purchase and transfer of electronic securities as well as the protection of good faith should be introduced.

In the case of the proposed electronic securities, the documentation function of the security certificate will be replaced by an electronic securities register. The core functions of a security are:

- Legitimation function (a legal presumption in favour of the creditor is linked to the holding of the security)
- Discharging effect (payment to the holder of the security frees the debtor from his/her obligation unless he/she has positive knowledge of ineligibility)
- Transfer function (the right arising from the paper follows the right to the paper)

In the case of electronic securities, entry in the register will preserve these core elements under civil law. In this context, it is important to ensure the securities' authenticity (i.e. the identity of the originator) and integrity (i.e. that they have not been altered since they were drawn up). For this reason, high demands must be placed on the reliability of the way in which the register is maintained and the accuracy of the register's contents.

The terms of all debt securities are to be recorded in the register, and further information about the register is to be made available to all free of charge via the Internet. The technical details regarding the electronic securities register will be laid down in an ordinance.

To prevent any possibility of manipulation, the issuer should generally not be permitted to maintain the securities register. Instead, the register should be kept by a (central) government agency or an agency that is under government supervision.

If the use of blockchain technology eliminates the possibility of subsequent unauthorised changes to entries in the securities register from a point of time to be defined – in other words, if the technology guarantees the authenticity and integrity of securities to the same extent as tried-and-tested systems and procedures – it should be possible for the issuer or a third party instructed by the issuer to maintain the register, provided that there is no requirement for the securities to be recorded in a central securities depository. In this context, issuers and investors must be given legal certainty (e.g. by including the blockchain securities register in a public directory) that the assets in the blockchain securities register are securities as defined under civil law.

However, maintaining a securities register on a blockchain raises questions concerning compatibility with EU rules. Depending on whether a public or private blockchain is used, there is the question of whether the activities performed can be classified as those of a central depository as set out in the provisions of the EU regulation on central securities depositories (EU No 909/2014). Further assessment is needed, especially regarding the conditions that need to be met for the functions of a blockchain to be classified as those of a central depository for which an operator would have to be authorised under existing law. Depending on the results, there is also the question of whether issuers should be permitted to maintain the securities registers on the blockchain and what regulatory requirements should be placed on them or whether an intermediary or infrastructure provider needs to be used.

In terms of private international law, the applicable law should be the national law of the state under whose supervision the securities register is placed, since it is not possible in the case of electronic securities to determine the applicable law based on the location of the asset/security certificate, and since it is difficult to determine the geographic location of a register that is maintained electronically.

### 3. Safekeeping of electronic securities

Even intangible property, such as electronic securities, can be held in safe custody. If electronic securities are booked to a securities account, e.g. for the purpose of trading, provisions governing the safekeeping of securities apply. In the case of transactions in electronic securities that take place on trading venues as defined in the MiFID (Directive 2014/65/EU), Article 3 (2) of the EU regulation on central securities depositories already stipulates that the relevant securities must be recorded in book-entry form in a central securities depository. However, it should be made clear that the mere recording of electronic securities on a securities register does not represent safekeeping of these securities; rather, the keeper of the register only assumes the documentation function.

### 4. Investor protection in the case of securities registers kept on a blockchain

One central question is how to ensure investor protection for electronic securities, especially if the securities register is maintained on a blockchain by the issuer or a third party instructed by the issuer to maintain the register. In this context, it should be borne in mind that issuers could evade German investor protection provisions by issuing electronic securities under foreign legislation but still offering them to investors in Germany.

To ensure investor protection in the case of debt securities issued via a blockchain securities register (hereinafter referred to as “blockchain debt securities”) and avoid the risk of manipulation by the issuer maintaining the blockchain register, the following options – or a combination of them – should be discussed in an open-ended way:

- Blockchain debt securities may be acquired only by institutional/qualified investors, not by private investors.
- The issuer who maintains the securities register or the third party instructed by the issuer to maintain the register is subject to a certain degree of state supervision.
- Blockchain debt securities may be purchased by private investors only if the relevant blockchain securities register is kept by a credit or financial services institution that is subject to supervision in the EU.

- Private investors are not permitted to acquire blockchain debt securities directly from the issuer or another investor, but must always acquire them via an authorised and supervised intermediary who is responsible for providing information and advice to the investor.
- Private investors are permitted to acquire blockchain debt securities directly from issuers, but issuers are subject to special information and documentation obligations (information in the prospectus or the securities information sheet regarding risks associated with the blockchain; obligation to provide the investor with a written extract from the register on an annual basis and also in the event of any changes to the entry). Resale of blockchain debt securities from one private investor to another is permitted only if the issuer is interposed as a counterparty to ensure that the information and documentation requirements are still met.

## 5. Other capital market provisions

Electronic securities are generally covered by the Securities Trading Act (*Wertpapierhandelsgesetz*), as the definition of the term “security” in section 2 (1) of the Securities Trading Act does not presuppose a physical certificate. This is also true of the Securities Prospectus Act (*Wertpapierprospektgesetz*) and the provisions of the EU Market Abuse Regulation (EU No 596/2014).

### III. Issuance of utility tokens/cryptocurrencies

As a rule, utility tokens are not securities, capital investments or other financial instruments as defined in the Securities Trading Act. In most cases, they will not constitute electronic debt securities in future, either. In contrast to the future issuance of electronic securities, the issuance of such tokens is therefore not subject to the Securities Prospectus Act or the Prospectus Regulation. Nor does the Capital Investments Act (*Vermögensanlagengesetz*) apply. In other words, there is currently no legal obligation to publish a prospectus or information sheet prior to the public offering of utility tokens. So-called “white papers” are routinely published nevertheless, but these are not comparable information and liability documents. They frequently contain only insufficient information about the project, the risks, the rights associated with the tokens and any potential conflicts of interest. As a result, they do not help investors to make an informed investment decision. At the same time, investing in utility tokens involves substantial

risk.<sup>1</sup> The need to create adequate risk-disclosure obligations was also highlighted by the European financial regulator ESMA in its recent advice to the European Union institutions on initial coin offerings and crypto-assets (ESMA50-157-1391), which was issued on 9 January 2019.

Against this backdrop, the possible courses of action are as follows:

- a) Germany waits for European rules to be introduced on the basis of the ESMA recommendation and plays an active role in this European legislative process. A common framework for the issuance of utility tokens is needed in order to establish a European digital single market, and this can only be achieved by means of European rules. In its advice to the European Union institutions, ESMA therefore speaks out against national regimes.
- b) As an interim solution until such a time as a European regulatory regime is created, the public offering of utility tokens could be regulated on the national level. Issuers could be legally required to publish an information sheet before offering utility tokens to the public. The contents of the information sheet and the sequence of the information could be stipulated by law, and there could be a requirement for the publication to be authorised by the Federal Financial Supervisory Authority (BaFin).

#### **IV. Next steps**

A public consultation on this key-issues paper will be conducted and then evaluated. Afterwards, the plan is to produce a ministry draft of legislation, taking due account of the feedback received on this paper and the various possible courses of action suggested in it.

---

<sup>1</sup> According to a study published by Ernst & Young in autumn 2018 (“Initial Coin Offerings, The Class of 2017 – one year later”), 86% of tokens issued in 2017 were below their original listing price and 30% had lost nearly all value. On average, 2017 ICOs had lost 66% compared with their peak prices.