



March 7th, 2019

Key points for the regulatory treatment of electronic securities and crypto token

- Enabling digital innovations - Ensuring investor protection -

I. Background and goals

The financial market is increasingly characterized by digitization effects and innovative technologies such as blockchain. Accordingly, the Federal Government is pursuing the goals laid down in the coalition agreement of 12 March 2018, namely to tap the potential of blockchain technology, to prevent opportunities for misuse and to strengthen the role of the Federal Republic as one of the leading digitisation and FinTech locations. The coalition agreement also stipulates that the federal government will develop a blockchain strategy.

This key issues paper is the first measure to be implemented within the framework of the blockchain strategy. The aim is to make electronic securities possible while maintaining the requirements of investor protection and to create the necessary legal and application security in civil and supervisory law. The key issues paper goes beyond the block-chain strategy to the extent that electronic securities are also to be made possible outside block-chain technology and comparable technologies. In view of the fact that other states also permit the use of blockchain technology for financial instruments, regulation in Germany will ensure the attractiveness of the local financial location. However, there will be no waiting for EU-wide harmonisation, which would take several years, especially as substantive securities law is not harmonised in the EU. Nevertheless, the discussions on Initial Coin Offerings (ICOs) at European and international level will be taken into account; a "German special path", which would have to be abandoned in the event of a later EU-wide harmonisation, is to be avoided in this way. The need for regulation in the area of the prevention of money laundering, which applies to all forms of cryptotoken, is not the subject of this consultation paper; these issues are addressed within the framework of the Implementation Act for the 5th Money Laundering Directive (EU) 2018/843 of 30 May 2018.

In the following, this key issues paper presents core aspects of digital securities modelled on the Federal Debt Act and discusses regulatory options and the regulatory challenges of cryptotokens, in particular so-called utility tokens.

German law should generally be opened up to electronic securities, i.e. the currently mandatory embodiment of securities in a document should no longer apply unrestrictedly. Although the current system of securities certificates functions in practice without significant problems and very effectively, there is no need to maintain a physical document which is regularly physically stored at the CSD and is never shown or given to the holders of the rights embodied therein. However, only one option and no obligation to issue securities electronically should be introduced; issuers should be allowed to maintain the tried and tested system of securities certificates. The regulation of electronic securities should be technology-neutral, i.e. the use of blockchain technology should not be privileged, particularly in view of the high energy requirements of public blockchain technologies and their climatic effects, which are in part high according to the current state of development.

II. electronic securities

1. Scope of Regulation: Electronic Debt Securities

As an article law, the draft law is to contain civil law provisions on electronic securities on the one hand and adapt the applicable supervisory law on the other. The opening will initially be limited to electronic bonds; the regulation of electronic shares may take place at a later date. In view of the fact that technical standards and requirements can change rapidly, provision should be made for authorisation to regulate the specific technical details by means of a statutory instrument. The Act will also contain an amendment to the German Bond Act, which currently also requires the existence of a deed, in particular to enable changes to the terms and conditions of the bonds issued by electronic bonds.

2. securities register

Following the model of the Federal Debt Act, electronic securities are to be created by registration in a register. Like the Federal Debt Act, it might also be appropriate to declare electronic securities to be property by virtue of legal fiction; in this case, all provisions for the protection of ownership of property would automatically apply, in particular in the event of enforcement or insolvency. Alternative

electronic securities could be made into a new *sui generis* right - along the lines of the Swiss Book-Entry Securities Act; in this case, however, protection provisions equivalent to property protection would have to be expressly created. In any case, independent rules on the acquisition and transfer of electronic securities and protection of good faith should be provided for.

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

- The legitimization function (this means that the legal presumption in favour of the creditor is linked to the ownership of the paper),
- the debt recovery effect (i.e. by making payment to the person who owns the document, the debtor is released from his obligation to pay - unless he has positive knowledge of the non-eligibility), and
- the transfer function (this means: the right from the paper follows the right from the paper)

In the case of electronic securities, these core elements of civil law should be guaranteed by entry in the register. The authenticity (i.e. determination of the originator) and integrity (i.e. authenticity since production) of the securities must be ensured. For this reason, high demands must be placed on the reliability of the register management and the accuracy of the register contents.

The electronic securities register shall keep the bond terms and conditions of all bonds included in it as well as more detailed information about the register on the Internet available to anyone free of charge. The technical details of the electronic securities register are to be regulated in a statutory regulation.

In order to avoid possibilities of manipulation, the respective issuer should in principle not be able to keep the securities register itself, but the register should be kept by a (central) state or a body under state supervision.

If the use of block-chain technology precludes the possibility that entries in the securities register may be subsequently altered without authorisation from a point in time to be defined, i.e. the authenticity and integrity of the securities is guaranteed by the technology in the same way as by proven systems and procedures, it should be possible for the issuer itself or a third party commissioned by it to maintain the register, provided that no entry in the securities register at a central securities depository is required. In this case (e.g. by taking up the

Blockchain securities register into a public register) for issuers and investors that the assets recorded in the Blockchain securities register constitute securities within the meaning of civil law.

However, keeping the securities register on a blockchain raises EU law issues. Depending on the use of a public block-chain or a private block-chain, the question arises as to whether this provides the activities that are to be classified as central depository within the meaning of the European provisions of the EU Regulation on central securities depositories (EU No. 909/2014). In this respect, further checks are required, in particular with regard to the fulfilment of the requirements which could lead to the classification of the functions performed by the respective block chain as centralised storage, for which an operator would have to be approved *de lege lata*. The assessment of whether the issuer may also keep the securities register on the blockchain and which regulatory requirements it must be subject to or whether an intermediary or infrastructure provider must be used also depends on these checks.

With regard to private international law, since, in the case of electronic securities, a provision of the applicable law does not apply to the location of the asset/securities certificate, and the register is also difficult to locate in the case of electronic register maintenance, the law of the country under whose supervision the securities register is kept shall prevail.

3. custody of electronic securities

Non-physical objects, including electronic securities, may also be held in safe custody. If electronic securities are booked to securities accounts, e.g. for the purpose of stock exchange trading, the regulations on the safekeeping of securities apply. If transactions in electronic securities are carried out on a trading venue within the meaning of MiFID (Directive EU 2014/65), Article 3(2) of the EU Regulation on central securities depositories already stipulates that the securities must be included in book entry transactions, i.e. booked with a central securities depository. However, it should be made clear that the mere recording of electronic securities in a securities register does not constitute a safekeeping of these securities, but that the registry administrator only assumes the documentation function.

4. investor protection when keeping the securities register on a blockchain

One of the central questions is how investor protection can be ensured for electronic securities, in particular when the securities register is kept on a blockchain by the issuer or a third party appointed by the issuer to keep it. It should also be borne in mind that issuers could evade domestic investor protection by issuing electronic securities under foreign law and then nevertheless offer them to investors in Germany.

In order to take account of investor protection in the case of bonds issued in a blockchain securities register (hereinafter referred to as "blockchain bonds") with regard to the risk of manipulation by the issuer maintaining the blockchain securities register, the following options - possibly also cumulative - may be considered in particular, which are initially to be discussed open-ended:

- Blockchain bonds may only be acquired by institutional/qualified investors, not by private investors.
- The issuer keeping the securities register or the third party entrusted by it with keeping it is subject to a certain degree of state supervision.
- Blockchain bonds may only be purchased by retail investors if the relevant blockchain securities register is maintained by a credit or financial services institution supervised in the EU.
- Private investors may not acquire Blockchain bonds directly from the issuer or another investor, but must always acquire them through an authorised and supervised intermediary who provides information and advice to the investor.
- Private investors may acquire blockchain bonds directly from the issuer, but the issuer is subject to special information and documentation obligations (information in the prospectus or securities information sheet on the risks of the blockchain; obligation to send the investor an extract from the register in text form once a year and additionally in the event of changes to the respective entry in the securities register). Blockchain bonds may only be resold by a private investor to another private investor via the issuer as an intermediary counterparty, so that information and documentation obligations are also ensured here.

5. application of further provisions of capital market law

Electronic securities are generally subject to the scope of application of the German Securities Trading Act (WpHG), as the term "securities" in Section 2 (1) WpHG does not require physical securitisation. This also applies to the German Securities Prospectus Act (WpPG) and the provisions of the Market Abuse Ordinance (EU No. 596/2014).

III. issuance of utility tokens / crypto currencies

As a rule, utility tokens do not constitute securities, investments or other financial instruments within the meaning of the Securities Trading Act and will in most cases not constitute electronic bonds in the future. Thus, unlike the future issue of electronic bonds, the issue of these tokens is not subject to the German Securities Prospectus Act or the Securities Prospectus Ordinance. The scope of application of the Asset Investment Act is also generally not open. Therefore, there is currently generally no legal obligation to publish a prospectus or information sheet prior to the public offering of utility tokens. The so-called "whitepapers", which are nevertheless published regularly, do not constitute a comparable information and liability document. They regularly contain insufficient information about the project, the risks, the rights associated with the tokens and potential conflicts of interest. They therefore do not regularly allow informed investor decisions. At the same time, investing in utility tokens involves considerable risks.¹ The need to create adequate risk disclosure obligations is also stressed by the European Financial Markets Authority ESMA in its recent Recommendation to the European Institutions on initial coin offerings and crypto-assets (ESMA-157-1391) of 9 January 2019 on ICOs and crypto-assets.

Against this background, the following options for action arise: a) The European regulation to be expected on the basis of the ESMA recommendation is awaited and Germany is actively involved in this European legislative process. Only with European regulation will the uniform framework for the issuance of utility tokens, which is necessary for the single digital market, be achieved. In its recommendation to the European institutions, ESMA therefore speaks out against national regulatory regimes.

¹ According to a study published in autumn 2018 (Ernst & Young, "Initial Coin Offerings, The Class of 2017 - one year later" of 19 October 2018), tokens issued by 2017 were 86% below their first price fixing; 30% have almost lost their full value. On average, ICOs from 2017 show a loss compared to the peak price reached in the previous year.-
from 66%.

b) As a bridging solution, the public offer of utility tokens could be regulated nationally until the creation of a European regulatory regime. To this end, it could be stipulated by law that a public offer of utility tokens may only be made if the provider has previously published an information sheet. The content of the information sheet and the order of the information should be determined by law and publication must be permitted by BaFin.

IV. Further action

Once the public consultation on this key issues paper has been carried out and evaluated, it is planned to prepare a draft paper which will take appropriate account of the feedback on this paper and the options for action proposed therein.