

ICOs and Token Regulation from a German Perspective



IN SHORT

The Situation: In February 2018, Germany's Federal Financial Supervisory Authority ("BaFin") published an advisory letter on the classification of tokens as financial instruments, which was widely criticized for being too vague.

The Result: Members of BaFin's department of financial technology innovations recently authored and published an article that responds to this criticism and further elaborates on the classification of tokens from a regulatory perspective.

Looking Ahead: While BaFin sets forth its view on the applicability of the existing general legal framework to tokens, the German government aims to promote a specific regulatory framework on a European and global level for the offering and trade of cryptocurrencies and tokens.

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What Are the Different Types of Tokens?

Tokens are created using blockchain technology and can have various features and functionalities. While an advisory letter published by BaFin on February 20, 2018 (Ref. no.: WA 11-QB 4100-2017/0010, the "Circular") remained silent on any possible categorization of tokens, an article titled "Blockchain Technology—Thoughts on Regulation," published in the biannual series *BaFin Perspectives* on August 1, 2018 ("BaFin article") distinguishes among the following categories:

- **Payment tokens**, used as means of payment, or traded and exchanged for traditional and virtual currencies on specialized trading platforms;
- **Equity (or investment) tokens**, conferring membership rights or shares in the issuer's future revenues, similar to shares or debt securities; and
- **Utility tokens**, used for the purchase of services or goods that the fundraiser develops.

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What Are the BaFin Article's Most Important Conclusions?

Issuers who want to avoid being subject to any regulatory requirements usually claim their tokens to be "pure utility tokens." According to the BaFin article, pure utility tokens entitle their owners exclusively to the acquisition of a real economy service or good and not to any financial compensation. Such pure utility tokens are usually not subject to any regulatory provisions. However, utility tokens tend to have a hybrid nature and often combine elements of equity or payment tokens as well. Therefore, BaFin would first ascertain whether the token qualifies as a payment token or as an equity token. BaFin would conclude that the token qualifies as a pure utility token only if it determines that the token is neither a payment token nor an equity token.

The Circular was widely criticized for not providing clear criteria specifically for the differentiation between equity tokens and utility tokens. It stated that tokens might qualify as a "security" within the meaning of the German Securities Trading Act (*Wertpapierhandelsgesetz*, "WpHG") and the Directive 2014/65/EU on Markets in Financial Instruments ("MiFID II"), if they: (i) are transferable; (ii) are tradable on a financial or capital market; (iii) embody shareholder rights or creditor claims or claims comparable to shareholder rights or creditor claims; and (iv) do not meet the requirements of a payment instrument.

For the differentiation between equity tokens qualifying as a security and pure utility tokens that are not subject to any regulatory requirements, the requirement "embodied shareholder rights or creditor claims or claims comparable to shareholder rights or creditor claims" is the decisive one. While the Circular had

remained silent on the exact application of this requirement, the BaFin article states that the line must be drawn between financial instruments (security) and instruments that primarily need to be attributed to the real economy (no security).

Such attribution to the real economy would, in particular, be questionable if the promised goods or services may not yet be purchased at the time the token is issued. In this case, the token primarily serves financing purposes and therefore might instead be qualified as a security. The U.S. Securities and Exchange Commission recently took a similar position in its report published in July 2017 on the ICO of the German startup "The DAO," as did the Swiss Financial Market Supervisory Authority FINMA in its ICO guidelines published in February 2018.

THREE KEY TAKEAWAYS

1. Although the BaFin article of August 2018 provides some additional clarity as to the regulatory classification of so-called "utility tokens," companies envisaging an ICO should seek legal advice in order to avoid any risks.
2. Participants should allow sufficient time for contacting BaFin to clarify questions relating to the applicability of regulatory requirements.
3. Legislative initiatives and administrative practice in view of ICO and token regulation are expected to evolve, so market participants should closely monitor further developments.

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Stefanie Stöhr
Munich



Stefan Schneider
Munich

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