

FINANCE WORKING GROUP

STATEMENT ON TOKEN REGULATION WITH A FOCUS ON TOKEN SALES

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1. Introduction

1.1 Distributed Ledger Technology

Distributed ledger technology (“DLT”, e.g. blockchain) allows the creation of Tokens¹ that are unique. It provides the possibility to organize markets where Tokens represent “digital property”. The fundamental problem solved by this technology is that double-spending of digital assets is effectively prevented, even in a system where no governing central authority exists that would control the double-spending issue. In other words, Tokens are digital assets which cannot be double-spent and exist in a digital system. Decentralized systems (permissionless DLT) enshrine the rules for the Tokens in a protocol. This needs to be opposed to central systems where a central authority (e.g. a classical security exchange or a central bank) organizes the asset and assures that market participants comply with the rules. However, even centralized structures may use the mere technology to enhance their processing of digital assets (permissioned DLT).

Consequently, based on DLT a scarce digital asset emerges, which can be created, transferred or destroyed (so called “burning” of Tokens). In case such scarce digital assets experience demand from purchasers, a price will be established by matching supply and demand in a capital market-like exchange (so called “crypto exchange”). Because the tracing of such assets by DLT involves cryptographic techniques, the term “crypto assets” established for such DLT-based digital assets.

Crypto assets can originate in two main ways: First, origination based on the creation of a dedicated computing network and, second, origination based on generating Tokens (mostly via smart contract) which are assigned independent of any correlation to dedicating computing power.

In the first case, a dedicated computing network is created where nodes provide the required computing power for the network. Permissionless DLT allow for nodes to join and leave the network as they desire. Within permissioned DLT, a central authority decides which nodes establish the network. Nodes that help operating the network can be rewarded with Tokens.² When such feature is used, Tokens are generated through operating the network. Hence, the key feature of this first option is, that Token generation is associated with a dedicated physical (!) computing network.

In the second case, Tokens are originated independently from dedicating computing power but rather by a person or entity which may assign such created Tokens to any participant it nominates accordingly in the genesis block. Such assignment may be based upon a Token sale³, which is regularly based upon a smart contract as a piece of computer code running on a specific DLT. Leveraging smart contracts, project owners therefore are empowered to sell or otherwise assign Tokens via entirely online-mediated offerings, mostly in exchange for other Tokens.

¹ Please cf the definition in section 1.4 (*Categorization of Tokens*).

² Kindly note that certain publication differentiate between “tokens” and “coins”. We will not adopt such approach for the purposes of this paper. For the definition of “Token” please see section 1.4 (*Categorization of Tokens*).

³ Other commonly used terms are “initial coin offering” (ICO) and “token generation event”.

1.2 Opportunities

Given its potential not only to disrupt the existing start-up financing ecosystem, but also to provide funding to socially and economically meaningful projects that usually lack to attract investors today (such as the development of open source protocols), we definitely support this new tool set. At the same time, we recognize the challenges for ensuring market stability and preventing malpractice opposing unforeseeable risk at participants involved. However, we appreciate the following potential opportunities of DLT and, especially, funding via Token sales.

1.2.1 Flexible ecosystem design

Tokens are a fundamental shift in how value is assigned and transferred in ecosystems. They offer a solution for the known issue that many transactions today inside and between ecosystems are not or only implicitly valued. Further, Token-based incentive schemes enable companies not only to introduce novel services and products but also entirely new user-driven ecosystems. Fixed-supply combined with immutable ledgers keeping track of these transactions could be a game changer for a number of applications.

1.2.2 Positive network effects

Token sales can generate positive network effects vitalising and strengthening decentralized applications. They are usually built to create a large user base that can sustain the operation, security and vitality of the decentralized network. Often, successful Token sales therefore involve the establishment of a large community of users.

1.2.3 New fundraising mechanisms

(a) Issuer's perspective

In addition to the classic instruments of financing (VC financing, crowdfunding, capital market instruments and loans), Token sales represent an additional flexible financing tool the transaction costs of which are regarded to be significantly lower. As regards the intermediaries who are currently involved in the financing models and/or processes, not all of them might longer be required.

(b) Investor's perspective

At least European crowd sourcing instruments failed to gain strong market acceptance due to limited structures available and high costs caused by necessary intermediaries. Token sales offer to some extent participation to a wider public which is currently excluded from financing start-ups. The high level of standardization provides significant liquidity of crypto exchanges. This offers exit opportunities for early stage investors which are usually reserved to conventional early stage investors.

1.3 Purpose and scope of the assessment

The purpose of this paper is to analyse the status quo of the current regulation of Token sale related matters under EU law. Where we deem it sensible as to picture national specifics and/or problems that arise from applying (EU law based) German law we will also give an overview on the same.

The assessment is divided into six parts, the first of which is this introduction. In part two, we will assess if and when Tokens may be regarded as securities because the findings relating hereto to some extent set the course for the assessment in the following sections. The following parts will to some extent follow the “lifecycle” of a Token: Part three will review the regulation dealing with the issue of Tokens, specifically focussing on information obligations of the issuer as well as obligations resulting from anti-money-laundering regulation. Part four shall analyse the existing regulation regarding the trade of Tokens on secondary markets. Part five will review which approval requirements exist with respect to certain business models relating to Tokens. Where we deem necessary, each section will contain specific proposals for a Token focussed regulation. Part six will provide an overview of our findings as well as our recommendations. Kindly note that this paper may not be regarded as legal advice.

1.4 Categorization of Tokens

Though still subject to ongoing discussions and likely to be incomplete, the following categorization seems to represent a minimum common ground in terms of terminology among both practitioners and scholars, which we will adopt for the following remarks.⁴ For the purposes of this paper any of the following shall be regarded as “**Tokens**”:

“**Cryptocurrency Tokens**” mean tokens that are meant to function as a means of payment for goods or services (*inter alia*) external to the platform or not only exclusively between the platform and its users but also between users.

“**Utility Tokens**” mean tokens that are supposed to convey some functional utility to token holders other than/in addition to payment for goods or services, in the form of access to a product or service offered or at least intended to being enabled or created. These tokens come with particular rights, such as: (i) a right of access to a (future) service (once developed); (ii) a right to redeem the token for another token or service; (iii) voting rights which often are designed to shape the functionality of the product.

“**Security Tokens**”: Tokens that are comparable to conventional instruments set out in Art. 4 (1) (44) MiFID, especially to conventional debt and equity instruments.⁵

Please note that we adopt this way of categorization primarily for illustration purposes. It does not anticipate any legal or regulatory qualification. Any Token always needs to be assessed and regulated as to its substance irrespective of its form or label (**substance over**

⁴ Cf e.g. *Hacker/ Thomale*, Crypto-Securities Regulation: ICO’s, Token Sales and Cryptocurrencies under EU Financial Law, posted 30 November 2017, last revised 13 December 2017, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3075820, page 12. Kindly note that instead of the term “Security Token” they use the term “investment token”.

⁵ For further details please see section 2.4.1 (*Security Tokens*).

form approach). Also, in practice Tokens usually bear more than one of the above-mentioned features which makes a clear-cut classification even more difficult.

2. Tokens and capital market law

Many discussions focus on the question whether Tokens are “securities”. Such categorisation may trigger various consequences ranging from the obligation to issue a prospectus to the treatment of the Tokens’ trade under tax laws. Therefore, the answer to such question shall be prioritised.⁶ The following section intends to provide an overview as to when a Token may be regarded a regulated security. Having said that, it is important to point out that there is no universal interpretation of what a security is. Where the term is used, its interpretation depends on the context and goals of the respective regulation in question which is characterised by the different backgrounds and approaches taken to regulate certain phenomena in the respective national laws.

Before any categorisation of Tokens is possible, it therefore is necessary to provide a brief overview regarding the various definitions of securities under the regulations which are relevant for the purposes of this paper, thus focussing on the use of the term under European and German capital market law dealing with the issuance and trade of securities.⁷ Once the characteristics ascribed to a security regulated for these purposes have been elaborated, we will assess which Tokens meet these.

2.1 Securities under European capital market law

European capital market law refers to securities both under the “Markets In Financial Instruments Directive” (“**MiFID**”)⁸ as well as under the “Market Abuse Regulation” (“**MAR**”)⁹.

2.1.1 MiFID

MiFID does not apply to all kinds of securities but only to transferable securities. In Art. 4 (1) (44) it defines such transferable securities as

‘those classes of securities which are negotiable on the capital market, with the exception of instruments of payment, such as:

- shares in companies and other securities equivalent to shares in companies, partnerships or other entities, and depositary receipts in respect of shares;
- bonds or other forms of securitised debt, including depositary receipts in respect of such securities;
- any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures.

⁶ Kindly note, however, that even if a Token is not regarded as a security, supervisory law still may apply to it if it is regarded as (other) financial instrument. As Tokens in most cases will not be regarded as financial instrument under MiFID/MAR (other than under German law), the section will focus on the categorisation of Tokens as securities.

⁷ For the purposes of this section and with respect to German law we therefore exclude civil law as well as under supervisory law which does not focus on the issuance and trade of securities, i.e. the Securities Deposit Act (the *Depotgesetz*).

⁸ Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014.

⁹ Regulation (EU) 2014/596 of the European Parliament and of the Council of 16 April 2014.

As a result, it employs three rational formal criteria and one more substantive criterion to define a transferable security: The formal ones are transferability, standardization and negotiability on capital markets (with negotiability, however being a subcase of transferability).¹⁰

(a) Transferability

Transferability means that the units can be assigned to another person at all, irrespective of whether certificates exist that register or document the existence of the units. If Tokens lack transferability by technical limitations, Tokens are likely not securities.¹¹

(b) Negotiability on a capital market

Securities need to be negotiable on a capital market pursuant to Art. 4 (1) (44) MiFID.

(i) Negotiability

While transferability refers to the mere fact of passing on ownership in securities, their negotiability concerns the ease with which an instrument can be transferred. Negotiability in fact implies transferability. The European Commission has offered guidance concerning the interpretation of negotiability: If the securities in question are of a kind that is capable of being traded on a regulated market or multilateral trading facility, this will be a conclusive indication that the instruments in question are transferable securities.¹² However, even instruments that are incapable of being traded on multilateral trading facilities or regulated markets may be considered negotiable.¹³ Therefore, the fact that Tokens are actively traded on crypto exchanges is a clear indication that they are negotiable on a market.¹⁴

(ii) On a capital market

While negotiability on a market seems obvious for Tokens transferable on crypto exchanges, the question arises whether this can be equated with being “negotiable on a capital market” as required by Art. 4 (1) (44) MiFID. The term “capital market” is neither defined within MiFID, nor is there a legal debate about this term in the context of MiFID. Legal literature discusses the term in the wider context of capital markets regulation and concludes that a capital market is one on which equity and debt instruments can be traded.¹⁵ Capital markets are distinguished from other markets like money, foreign

¹⁰ Assmann, in Assmann/Schneider, Wertpapierhandelsgesetz Kommentar, 2012, § 2 para.10.

¹¹ Hacker/Thomale, page 20.

¹² European Commission, Your questions on MiFID (updated version 2008) Question No. 115.

¹³ European Commission Question No. 115

¹⁴ Hacker/Thomale, page 21 seq.

¹⁵ Veil/Veil, Europäisches Kapitalmarktrecht, 2011, § 3 I. 1; similar: Grunewald/Schlitt, Einführung in das Kapitalmarktrecht, 2014, § 1 I. 1.

exchange or derivatives markets.¹⁶ Not further discussed as this seems obvious, the term capital market does also not include commodity markets. The differentiation by the content traded on an exchange (market) is further supported by court rulings of the European Court of Justice relating to the freedom of movement of capital (in this case commodities versus services).¹⁷ Therefore, not any liquid market qualifies as capital market. Decisive remains whether equity or debt instruments are traded.

Existing crypto exchanges do not (yet) seem to distinguish properly between equity/debt and other instruments. Hence, there might be crypto exchanges providing for trading of Tokens representing equity/debt instrument equally to other instruments. Therefore, it remains unclear, whether such (factual) trading of all sorts of Tokens on one exchange creates a “capital market” for only equity/debt Tokens or if other kinds of Tokens traded on the same crypto exchange requalifies such non-equity/debt Tokens as security.

(c) Standardization

The units need to be defined by common characteristics so that it is sufficient to refer to the type and number of units to trade them.¹⁸ This should be the case with any kind of Token.

(d) Functional comparability with shares or other forms of securitized debt

In order to adequately qualify novel types of investment products, the non-exhaustive list of examples that do constitute securities in Art. 4 (1) (44) MiFID gets into focus. These include three broad categories

- Shares and equivalent issued units;
- Bonds and other forms of securitised debt; and
- any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies or other indices or measures (stock options).

There is little doubt that Tokens not only fulfilling the three initial criteria of transferability, negotiability on a capital market and standardization, but also being comparable to the listed examples should qualify as transferable securities under European capital market laws.

The question arises whether Tokens that meet the criteria of transferability, negotiability on a capital market and standardization without being

¹⁶ *Veil/Veil*, Europäisches Kapitalmarktrecht, 2011, § 3 I. 1.; Grunewald/Schlitt, Einführung in das Kapitalmarktrecht, 2014, § 1 I. 1.

¹⁷ European Court of Justice, Peter Jägerskiöld v Torolf Gustafsson, C-97/98, Judgement, EU: C:1999:515, at margin no 34, 36.

¹⁸ *Hacker/Thomale*, page 22.

comparable to the listed examples may be regarded as transferable securities within the meaning of Art. 4 (1) (44) MiFID (comparability as sufficient vs. necessary criteria). One view in legal literature requires comparability to the listed examples to be considered as additional criterion, thus limiting the scope of the securities definition under MiFID.¹⁹

We agree with such approach. Taking into account the point raised in section 2.1.1(b)(ii), i.e. the reference in the definition of transferable securities to their negotiability on a capital market, we are of the opinion that the scope of the term “transferable securities” under Art. 4 (1) (44) MiFID shall only include instruments which are comparable to the securities already set out in the list, thus representing equivalents to tradable equity and debt instruments.

2.1.2 MAR

MAR does not contain a direct link to the concept of securities. It refers to financial instruments which it defines in Art. 2 (1) No. 1 by reference to Art. 4 (1) (15) MiFID. Reference is again made there to Annex I, section C. This category includes the term “transferable security” as described above.

In addition, Art. 3 (2) of the MAR contains a further definition of securities, which is limited only to the application of Art. 5 of the MAR. This definition also reflects the comparability criterion developed above. Pursuant to Art. 3 (2) MAR ‘securities’ means:

- shares and other securities equivalent to shares;
- bonds and other forms of securitised debt; or
- securitised debt convertible or exchangeable into shares or into other securities equivalent to shares.

2.2 Securities under German capital market law

In German law, the term “securities” is defined in, inter alia, the German Securities Trading Act (*Wertpapierhandelsgesetz*) (hereinafter also referred to as the “**WpHG**”), the German Securities Prospectus Act (*Wertpapierprospektgesetz*) (hereinafter also referred to as the “**WpPG**”), the German Securities Deposit Act (*Depotgesetz*) (hereinafter also referred to as the “**DepotG**”) and the German Capital Investment Code (*Kapitalanlagegesetzbuch*) (hereinafter also referred to as the “**KAGB**”). The WpHG and the WpPG both substantiate the MiFID definition.

2.2.1 German Securities Trading Act

¹⁹ Hacker/Thomale, page 25.

Pursuant to section 2 para. 1 WpHG, securities within the meaning of the German Securities Trading Act are, even if no (paper) certificates are issued, all classes of transferable securities with the exception of payment instruments and which are tradable on the financial markets, in particular

- shares in companies;
- other shares in domestic or foreign legal entities, partnerships and other companies, to the extent that they are comparable with shares, as well as certificates representing shares in companies;
- debt instruments, in particular, participation certificates and bearer bonds and registered bonds as well as certificates representing debt securities as well as other securities which entitle the holder to acquire or dispose of securities in accordance with the items set out above or which give rise to a cash payment determined on the basis of securities, currencies, interest rates or other income, commodities, indices or measures.

2.2.2 German Securities Prospectus Act

Pursuant to section 2 No. 1 WpPG, securities are transferable securities that can be traded on a market, in particular

- shares and other securities which are comparable to shares or shares in corporations or other legal entities, as well as certificates representing shares;
- debt securities, in particular bonds and certificates representing securities other than those referred to in the item above;
- any other securities which entitle the holder to acquire or dispose of such securities or which give rise to a cash payment determined on the basis of transferable securities, currencies, interest rates or yields, commodities or other indices or measures,

with the exception of money market instruments with a maturity of less than twelve months.

2.2.3 German Capital Investment Code

The KAGB is the legal framework for funds in Germany. It uses the term securities in connection with the investment provisions for UCITS (section 193 KAGB) and the investment provisions for special investment funds with a defined investment strategy (section 284 KAGB) without defining it.²⁰ For the purpose of the term securities in section 193 KAGB, the definition of securities defined in the UCITS

²⁰ *von Rom*, in Baur/Tappen(Ed.), *Investmentgesetze*, Band 1, 3d Ed. 2015, § 193 at m.no. 4.

Directive (2009/65/EC) and in the implementing Commission Directive 2007/16/EC applies. Pursuant to Art. 2 (1) (n) of that act, 'transferable securities' means:

- shares in companies and other securities equivalent to shares in companies (shares);
- bonds and other forms of securitised debt (debt securities); and
- any other negotiable securities which carry the right to acquire any such transferable securities by subscription or exchange.

Art. 2 of implementing Commission Directive 2007/16/EC substantiates that definition.

For the interpretation of the term securities in section 284 KAGB the interpretation of the term securities in section 2 para. 4 No. 1 German Investment Act, which was the legal framework for German funds prior to the KAGB, can be used.²¹ Based on the legislative materials the term securities in section 2 para. 4 No. 1 German Investment Act should be interpreted in an economic way with the focus on the liquidity and transferability of the relevant security and includes in particular stocks, securities comparable to stocks, bonds, promissory notes that can be assigned at least twice, and other debt instruments or other marketable securities.²²

2.3 Conclusion – characteristics of regulated securities under European and German law

European capital market law, i.e. MiFID and MAR, intend to regulate securities if they are (i) transferable, (ii) negotiable and (iii) standardized. The German WpHG and the WpPG both substantiate such approach. These three criteria therefore have been adopted in the legal literature as a requirement for a regulated security under German law,²³ and thereby form the basis for something to be regarded as security under the respective regulations set out above.

Based on this prevailing understanding of the concept of securities, not any instrument which is standardized and negotiable/tradeable may be regarded as a regulated security. In addition, they must be comparable with the instances mentioned in the various regulations and thus have similarities to equity and debt instruments. Where the statutory provisions do not contain a catalogue of samples and equivalents, this follows additionally from the constituent element of tradability on the capital market in the overall abstract definition. The latter is effectively linked to the trade with equity/debt instruments.

Taking shares and bonds as prototypes for a comparison, the instrument in question needs to promise its holder some sort of (i) participation right in some kind of profit or return, or (ii) financial claim, in each case towards the issuer of such instrument. Even though all regulations in question make use of examples which are non-exclusive, none of these contains an instrument which is not in its very essence linked to some sort of revenue right

²¹ Von *Livonius/Riedl*, in *Moritz/Klebeck/Jesch*, KAGB, § 284 m.no. 24 ff.

²² BT Drucks.15/1553 S. 75; *Zingler*, in *Baur/Tappen* (Ed.), *Investmentgesetze*, Band 2, 3d. Ed. 2015, § 284 at m.no. 12.

²³ Cf. *Assmann*, in *Assmann/U.H. Schneider*, WpHG, 6th Ed. 2012, § 2 at m.no. 7-8.

or some other sort of financial claim against the issuer of such instrument (e.g. a good). This implies that the regulator(s) intended to focus on equity and debt instruments and certain derivatives.

2.4 Application of the securities concept on Tokens

2.4.1 Security Tokens

We already defined Security Tokens as Tokens that are comparable to conventional instruments set out in Art. 4 (1) (44) MiFID by, e.g., promising a right to receive future profits from the company (like a dividend). According to the above requirements, generally speaking, such Tokens have to be considered securities under both European and German law.²⁴

2.4.2 Utility Tokens

Utility Tokens usually give its holder a right to make use of certain services on the platform. These forms of Tokens may therefore be regarded as “other forms of securitized debt” within the meaning of Art. 4 (1) (44) (b) MiFID. “Other forms of securitized debt”, interpreted solely by its wording can be any debt and does not imply any financial claim to be granted. However, we would not regard these kinds of Tokens as transferable securities, the main reason being that “securitized debt” – if interpreted systematically in accordance with section 2.3 (*Conclusion – characteristics of regulated securities under European and German law*) above – needs to transfer some sort of financial claim on the respective Token’s holder.²⁵

In addition, there is no need from a purchaser’s perspective for these pure types of Tokens to be dogmatically regarded as transferable security. One could argue that even with respect to these Tokens a prospectus is needed (and that for such reason Utility Tokens from an investor protection’s perspective need to be regarded as transferable securities) in order to protect the purchaser from information asymmetries with respect to some sort of direct revenue/risk assessment. However, as regards the process of issuing these sorts of Tokens, such protection is not needed. In the end, the purchaser buys (the future right of) a service. Any expectation as regards potential gains would only refer to gains from trading the instruments on the secondary market but would not be based on an analysis of the Token “as is”. Information asymmetries on the secondary market need to be targeted by, e.g., ad hoc information duties but not by ways of a prospectus when issuing the Tokens. With respect to the purchase, the purchasers of Utility Tokens do in fact need information as to the consumptive aspects and functionality of the Tokens, i.e. how they can use the latter. This is something that consumer protection law is to cover and already does by imposing substantial information duties.²⁶

²⁴ Kindly note that in German literature there are discussions as to whether an instrument needs to be capable of being acquired in good faith for such instrument to be regarded as securities within the meaning of the WpHG and the WpPG.

²⁵ Please cf *Hacker/Thomale*, page 29.

²⁶ For details see section 3.1.3 (*European consumer protection and E-Commerce laws*). With the same result *Hacker/Thomale*, page 29.

We, however, acknowledge that Utility Tokens are subject to intense trading on various crypto trading venues. As set out below²⁷, the financial interest and any potential information asymmetries with respect to such trade can be /are, however, sufficiently addressed by including the Utility Tokens in the scope of MAR.

2.4.3 Cryptocurrency Tokens

One further type of instrument is explicitly exempted from the definition of a security in Art 4 (1) (44) MiFID: instruments of payment. Therefore, we understand that Cryptocurrency Tokens shall be exempt from the definition of transferable securities.²⁸

2.5 Result and conclusion

Tokens which promise a direct financial return from the issuer to the Tokens' holder (comparable to traditional equity/debt instruments) have to be regarded as regulated securities under the respective regulation set out above. This would then cause certain obligations for their issuers when issuing the Tokens as well as with respect to their trade. Cryptocurrency Tokens and Utility Tokens may not be regarded as transferable securities.

In practice, Tokens often combine different functionalities ("**Hybrid Token**"). Therefore, there is a risk that issuers of such Hybrid Tokens will need to comply with capital market law as well as with classic consumer protection law depending on how developed the additional functionalities of the Hybrid Tokens are at the time of the issuance.

²⁷ Cf section 4.1.1 (MAR).

²⁸ *Hacker/Thomale*, pages 29 et seq.

3. Regulation as regards the issuance of Tokens

The following section will assess which obligations apply to the issuer of Tokens during a Token sale under both European as well as under German law. It will particularly focus on the question which information obligations apply to such Token's issuer as well as whether Token sales are covered under anti-money laundering laws.

3.1 Information requirements

3.1.1 Obligation to provide a prospectus

Under German law, prospectus requirements are established in the German WpPG (for securities as defined by MiFID) and pursuant to the German-specific Investment Products Act (*Vermögensanlagegesetz*) (hereinafter referred to as the "**VermAnlG**").

On a European level the requirements will be set out in the "European Prospectus Regulation"²⁹ which is fully and directly applicable in all EU member states. Most of its provisions will apply as of 21 July 2019. As such it has to be seen how the German legislator adapts the current regulatory regime as described in section 2.2.2 (*German Securities Prospectus Act*) above.

The European Prospectus Regulation is applicable to securities when offered to the public or admitted to trading on a regulated market situated or operating within a EU member state. The 'securities' definition refers to the 'transferable securities' definition in MiFID with the exception of money market instruments as defined in Article 4 (1) (17) MiFID, having a maturity of less than 12 months.

Therefore, the issuers of Security Tokens will be required to publish a prospectus both under the existing German law as well as under the European Prospectus Regulation provided, however, that – with respect to the latter – such Token sale is not exempted from the application of the European Prospectus Regulation.

3.1.2 Civil law

Lack of information may put the Token holders' (financial) interests at stake because they might not be able to make a comprehensive, well-informed decision when investing in Tokens. A reasonable assessment of expectations of profit is possible only if an investor has access to relevant information, including such circumstances that the issuer only knows of. Under German civil law, pre-contractual information obligations exist with regard to circumstances that are relevant for a contracting

²⁹ means the regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 which will replace and repeal the directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 and its corresponding measures.

party for the conclusion of a contract. As principle, obligations of one party to provide information to the other prior to or during the contract negotiations are triggered if

- they concern special and additional circumstances that are known only to one party;
- of which that party is or must be aware that the decision of the other party may be influenced;³⁰ and
- of which the other party may expect in good faith to be informed on.³¹

This applies in particular, but not exclusively, to circumstances that may frustrate the purpose of the contract of the other party.³² This principle is reflected in German case law with regard to investment decisions. According to German courts, an investor must be provided with a correct picture of the investment object for its decision to invest.³³ This means that the investor before or during contract negotiations has to be informed about all circumstances which are or may be of major importance for its investment decision in a comprehensible and complete manner, including information about circumstances which could frustrate the purpose of the contract.³⁴ Risks arising from speculative features of Tokens may be circumstances that are subject to the issuer's disclosure obligations. This may also apply to any other circumstances that are essential for an investor's well-informed assessment of expectations of profit.

3.1.3 European consumer protection and E-Commerce laws

Even if securities regulations do not apply, additional legal regimes that protect the interest of the purchaser may well do. In particular, selling Tokens may trigger additional consumer protection laws as well as e-commerce laws.

(a) European sources of law of statutory information obligations

Issuers of Tokens being offered via the internet have to comply with information duties under distance selling and e-commerce laws. The European directive on consumer rights (2011/83/EU) and the directive on electronic commerce (e-commerce) (2000/31/EC) set out certain information obligations for contracts concluded via the internet. Further, the directive concerning the distance marketing of consumer financial services (2002/65/EC) formulates certain information obligations with regard to financial services. The full list of information which has to be disclosed is enclosed as Schedule 1 (*Information requirements under European e-commerce and consumer protection laws*).

³⁰ *Staudinger/Feldmann/Löwisch*, BGB (2012), § 311 at margin no. 117, 126.

³¹ German Federal Supreme Court (*BGH*), ruling dated 11 August 2010, XII ZR 192/08.

³² *BGH*, ruling dated 10 October 2008, V ZR 175/07.

³³ *BGH*, 21 June 2016, II ZR 331/14, DE:BGH:2016:210616UIZR331.14.0, at margin no 11; *Schneider*, MDR 2016, 496.

³⁴ E. g. *BGH*, 9 July 2013, II ZR 9/12, at margin no 33; LG Hamburg, 20 July 2017, 333 O 210/16, DE:LGHH:2017:0720.333O210.16.00 at margin no 44.

(i) Directive on consumer rights

The directive on consumer rights defines specific information obligations for entrepreneurs if they conclude contracts with consumers ("**Consumer Contracts**"), depending on the type of contract that the parties intend to conclude and on the type of service that the entrepreneur provides. In general, distance contracts are included in the regime of the directive. Distance contracts are contracts for which the entrepreneur and the consumer exclusively avail themselves of means of distance communication in negotiating and concluding a contract. Thus, any contract negotiated and concluded via the internet may be regulated by the directive on consumer rights.

(ii) Directive concerning the distance marketing of consumer financial services

The type and scope of information the entrepreneur has to provide to the consumer differ depending on the type of service provided. In particular, additional information obligations exist for financial services being any service of a banking, credit, insurance, personal pension, investment or payment nature.

(iii) Directive on e-commerce

The directive on e-commerce refers to contracts in the area of e-commerce, namely to contracts concluded by electronic means ("**E-Commerce Contracts**"). In addition to general information obligations, the directive sets out special information obligations with regard to internet contracts concluded with consumers.

With regard to the offer of Tokens within Token sales, information obligations under European law apply in general with regard to E-Commerce Contracts.

(b) German law sources of statutory information obligations

(i) information obligations resulting from selling the Tokens on the internet

Information obligations according to the directive on e-commerce with regard to design of contract, websites and order process are implemented into German law in section 312i German Civil Code ("**BGB**") and section 246c German Introductory Act to the Civil Code ("**EGBGB**"). According to the wording of section 312i BGB, it applies to contracts for the supply of good or the rendering of services only. Goods are defined as any tangible movable items, whereas service is considered any service other than supply of goods. With view to the underlying directive on e-commerce which does not differentiate between goods and services, the term of service is understood

to encompass any contractual object. The offer of Tokens at a Token sale can therefore be considered a contract in the meaning of section 312i BGB.

(c) Information obligations resulting from consumer protection law

Additional information obligations exist with regard to Consumer Contracts according to section 312i, 312d BGB and Art. 246a EGBGB: Information obligations under the directive on consumer rights apply because the underlying contract for the acquisition of Tokens may be defined as a distance contract. Finally, provided that the issue of Tokens or any other services in connection with Tokens can be considered a financial service, further information duties as set out in section 312d BGB and Art. 246b EGBGB have to be observed.

3.1.4 Conclusion and recommendation

Both, the Token issuers as well as the Token buyers, would significantly benefit from a clear global regulatory landscape determining which investor and consumer protection regimes apply. At the EU as well as on a global level, the most urgent task is to provide guidance and legal certainty to Token sellers and Token buyers alike. The diversity and uncertainty of regulatory regimes currently applying put Token sellers at a non-transparent risk and Token buyers in a position of unknown rights which make those difficult to pursue.

(a) Formation of an international convention on Token regulation

We propose that, on an international level a convention is formed to bestow certainty about the application of their respective securities regulation regimes to Token sales to avoid regulatory overkill and overlapping and partially contradicting legislation. In the end, only a joint international regime can efficiently balance investor protection and investor access in the face of the novel generation of global, decentralized digital application.³⁵

(b) Minimum information requirements with regard to Token sales

Besides some technical issues like how to prevent any kind of fallacies in the code, the main issue noted in the Token market so far from an investor's perspective is that Token sale projects are mostly characterized by strong information asymmetry and opaqueness. We believe that the availability and quality of the information regarding prospective Token sale projects matters to potential contributors and positively affects the probability of a Token sale success. The currently required content of securities prospectuses does not seem to be sufficient to adequately inform investors in Token sales. Hence, we recommend to establish specific minimum requirements for Token sale disclosures within the existing European Prospectus Regulation. In the meantime, prior to an official amendment of the commission prospectus

³⁵ We therefore fully comply with the proposals made by *Hacker/Thomale*, page 2.

regulation being passed, the European Securities and Markets Authority (ESMA) should introduce guidelines in its frequently revised Q&A document on prospectus regulation that go beyond the generic comments issued recently.

We suggest to identify circumstances which are or may be of major importance for the decision to purchase Tokens so that the scope of information and disclosure obligations can be precisely defined. As an example, we suggest that all circumstances that are essential for an investor's well-informed assessment of expectation of profits, such as risks in connection with the tradability on second markets can be considered circumstances on which the respective issuer of Tokens should inform. We aim to publish a proposal of disclosure requirements with respect to Token sales in due course, taking into account the various self-regulation proposals currently discussed.

(c) Pre-contractual information obligations under European law

With respect to European law, we are of the opinion that, as far as special prospectus requirements under European securities regulation do not apply,³⁶ certain (pre-contractual) obligations to provide and disclose information shall be in place. Under German civil law, pre-contractual information and disclosure obligations exist with regard to circumstances that are relevant for a contracting party for the conclusion of a contract. With regard to investment decisions, this implies that an investor must be provided with a correct picture of the investment object for its decision to invest.

3.2 Obligations regarding the prevention of money laundering

Potentially, Token issuers may have to comply with anti-money-laundering laws in addition to the information obligations set out above.

The European anti money laundering directive (the “**AMLD**”)³⁷ and the existing legal framework in Germany that aims to prevent from money laundering and which transforms the aforementioned directive into national law, i.e. the *Geldwäschegesetz* (“**GWG**”) both take a wide approach in identifying money laundering sensitive business models as can, inter alia, be seen in Art. 1 (3) AMLD and section 10 para. 3, 3 GWG. Both in the end aim at preventing any property that derives from a criminal activity to be implemented into the economic circle. “Property” within the meaning of the AMLD (cf Art. 3 (3)) is not only money but any asset of any kind, whether corporeal or incorporeal, movable or immovable, tangible or intangible, and legal documents or instruments in any form including electronic or digital, evidencing title to or an interest in such asset. Therefore, Tokens (irrespective of their characteristics)

³⁶ See above section 3.1.1 (*Obligation to provide a prospectus*).

³⁷ Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing.

may be regarded as property within the meaning of the AMLD and – provided they are linked to a criminal act – can be the object of money laundering activities.³⁸

That said, even though the purposes of the AMLD and the GWG indicate that Tokens in general may be the object of money laundering, as of today, the issuance of Tokens is explicitly governed neither under the AMLD nor under the GWG.

3.2.1 Status quo – European level

Whether a Token sale is nonetheless covered by the AMLD and – as a consequence – will be covered by the GWG depends on the specifics of each such issuance and will therefore have to be decided on a case by case basis. If, e.g., the conditions under which a Cryptocurrency Token is issued allow for such Tokens to be qualified as e-money, the issuer is to be regarded as a financial institution within the meaning of Art. 3 (2) (a) of the AMLD. The obligations resulting thereof and which are set out in Art. 10 AMLD et seq., inter alia, ask for a customer due diligence to be conducted when entering into the business relationship and/or in case of a transaction amounting to at least EUR 15,000.00. The same will apply, if, e.g., the conditions of the Token sale constitute the provision of custodial services through the issuer. However, in most cases Token sales will be structured in a way that the issuer will neither be regarded as a financial institution nor a credit institution.

Whether or not obligations of the AMLD can nonetheless be applied to a Token sale will therefore in most cases depend on whether the sale and purchase of the Token can be regarded as trade of goods and whether it thereby triggers the obligations of a person trading in goods within the meaning of Art. 2 (1), (3), (e) AMLD. Neither the term “goods” nor the term “person trading in goods” is defined in the AMLD. This leads to uncertainty as to whether the Token sale during an ICO is covered hereunder. Even though one might argue that “goods” and the defined term “property” shall not be identical this leaves the term “goods” vague in the end. In addition, one might argue that even if a Token can be regarded not only as “property” but also as a “good”, the sale of Tokens would not be covered under the AMLD with the issuer acting as person trading in goods. The reason is that the AMLD only applies to a person trading in goods in case such person makes or receives cash payments in an amount of at least EUR 10,000.00 or more (cf. para. 6 of the preamble and Art. 11 (c) AMLD). Therefore, the regulations set out in the AMLD with respect to a person trading in goods may only apply to an ICO where the Tokens are issued in exchange for fiat currencies. This, however, will in most cases not be the case.

3.2.2 Status quo – German level specifics

The AMLD has been incorporated into German law through the GWG. In general, what has been stated above with respect to the AMLD applies under German law as well. If for some reason the Token sale is structured in a way that the issuer is to be regarded as credit institution or as financial institution, they will have to be regarded as obliged entities under section 2 para. 1 GWG, thus having to comply with the

³⁸ With respect to the GWG, cf the definition of Vermögensgegenstand in section 1 para. 7 GWG.

obligations as set out in section 10 GWG et seq. (e.g. obligation to identify the counterpart).

The question whether the issuer in a Token sale can be regarded as person trading in goods, however, is rather complex from a dogmatic point of view under German law. As opposite to the AMLD, the GWG has defined the term in section 1 para 9 GWG. However, the definition remains vague as its main component – “goods” – remains undefined. The Federal Ministry of Finance in 2012 issued an interpretation pursuant to which one of the main characteristics of a person trading in goods within the meaning of the GWG shall be that such trade is effected by entering into a sale and purchase agreement within the meaning of section 433 of the German Civil Code (as opposite to a service agreement).³⁹ Where the Tokens are exchanged against fiat currencies this mostly will be the case. This brings up the question whether a payment in Token (which usually is the case in the Token sales to date) can be regarded as payment of the purchase price within the meaning of section 433 para. 2 of the German Civil Code. Such question is currently being discussed.⁴⁰ Denying this would lead to the issuer not to act as person trading in goods.⁴¹ There are good reasons to argue that the sale and purchase agreement-criteria does not reflect what was intended when introducing the definition of the person trading in goods in the GWG.⁴² One main argument would be that the obligations of the person trading in goods refer to “transactions” within the meaning of the GWG. Inter alia, the person trading in goods has to apply a customer due diligence in case a transaction is suspicious (cf section 10 para. 3, 3 GWG). “Transaction” is defined very widely as any transfer of value (cf section 1 para. 5 GWG). This again shows the wide approach when determining money laundering sensitive areas. Strictly restricting the definition of the person trading in goods to a certain types of legal agreements underlying such transaction would contradict such approach. Therefore, the issuer, i.e. the seller, in an ICO may well be regarded as person trading in goods within the meaning if the GWG.

Please note that the GWG slightly deviates from the AMLD as it constitutes said obligation to comply with the obligations under the GWG/AMLD not only in case of cash payments exceeding EUR 10,000.00 but also in case the person suspects money laundering.

3.2.3 Recommendation

We assume that a generally accepted understanding of Token’s treatment under the current legislation on European and on the German law level may not develop quickly. This legal uncertainty regarding potential obligations of the distributed-ledger-ecosystem’s participants on the one hand inhibits the further development of such ecosystem, especially with respect to solutions for payments, and on the other hand poses a threat to the necessary prevention of money laundering. Even though

³⁹ Cf Schreiben des Bundesfinanzministeriums vom 24.4.2012; VII A 3 – WK 5023/11/10021.

⁴⁰ Cf, e.g. *Beck/König* JZ 2015, 130, 133 ff.

⁴¹ With respect to Bitcoin-Token, i.e. a Cryptocurrency Token, cf *Spindler/Bille*, WM 2014, 1357, 1362; *Engelhardt/Klein*, MMR 2014, 355, 359 understand the underlying agreement not to be sale and purchase agreement.

⁴² Cf *Zeidler*, CCZ 2014, 105, 108 ff.

recent research indicates that – as opposed to common reception – the use of Tokens for the purpose of money laundering is lower than expected,⁴³ we propose the following with respect to the EU-regulation, thereby taking into account that the market currently is developing a best practice to precautionary at least take KYC measures (i.e. identify the customer) anyway:

- (a) It should be clarified that the issuer of Tokens in an ICO are subject to the obligations of a person trading in goods within the meaning of the GWG and the AMLD. The AMLD shall be set in line with the mechanics under German law so that the issuer shall have to comply with the general duties of care in case there are indicators raising suspicions of money laundering and terrorism financing.
- (b) The obligations set out above shall also apply to the recipient of any Token payment in case the Tokens' market value equals at least EUR 10,000.00 irrespective of any suspicion that might have arisen. The restriction to payments received in cash therefore shall not apply in favour of the person trading in goods. As set out in preamble 6 of the AMLD, the EUR 10,000.00 cash pre-condition was included because the regulator expected these kinds of payments to be highly vulnerable to money laundering. This shows that the regulator intended to take a risk assessed approach. There is a great risk that Token sales can be misused for money laundering. One may argue that DLT conceptually allows for any transaction to be traced back and thereby per se prevent from any such Token to get lost within the economic cycle, thus technically already providing for a mechanism which the AMLD and the GWG try to achieve legally. However, technical implementations such like mixer which aim at anonymising transactions show that this is not convincing.
- (c) Wallet provider shall be regulated as „obliged entity“ within the meaning of Art. 2 AMLD in accordance with the proposal of the commission dated 5 July 2016 (2016/0208 (COD)).
- (d) We also propose to introduce a transparency register, listing wallet provider which are AMLD compliant. Regulators and industry should discuss whether an obligation of the issuer shall be introduced to the AMLD pursuant to which the consensus algorithm of the distributed ledger which forms the basis of the respective Token shall ensure that any transfer of Token in such Token sale may only be made to an AMLD compliant wallet provider.

⁴³ Cf. HM treasury, National risk assessment of money laundering and terrorist financing 2017, p. 40.

4. The regulation as regards the trade of Tokens on the secondary markets

The following section shall assess which regulation applies with respect to the trade of Tokens on the secondary market.

4.1 Capital markets law

The vibrant secondary markets of publicly traded Tokens on crypto exchanges raises the question whether and to what extent secondary market regulation regime applies to issuers and intermediaries of Token sales.

4.1.1 MAR

(a) Material Scope

Pursuant to Art. 1 MAR, it

“establishes a common regulatory framework on insider dealing, the unlawful disclosure of inside information and market manipulation (market abuse) as well as measures to prevent market abuse to ensure the integrity of financial markets in the Union and to enhance investor protection and confidence in those markets.”

Although Tokens are not yet traded on regulated markets, they might qualify as object of Multilateral Trading Facilities (MTF) or Organised Trading Facilities (OTF) within the scope of Art. 2 (1) (b) or (c) MAR, even if trading on these platforms takes place without or even against the will of the issuer.

According to Art. 3 (1) (7) MAR in conjunction with Art. 4 (1) (22) MiFID

““multilateral trading facility” or “MTF” means a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract in accordance with Title II of this Directive.”

According to Art. 3 (1) (8) MAR in conjunction with Art. 4 (1) (23) MiFID

““organised trading facility” or “OTF” means a multilateral system which is not a regulated market or an MTF and in which multiple third-party buying and selling interests in bonds, structured finance products, emission allowances or derivatives are able to interact in the system in a way that results in a contract in accordance with Title II of this Directive;”

As long as Tokens do not qualify as interests in bonds, structured finance products, emission allowances or derivatives, crypto exchanges listing such Tokens do not qualify as OTF according to these definitions. MTFs require

that financial instruments are traded. With regard to the definition of financial instruments, Art. 3 (1) (1) MAR refers to Art 4 (1) (15) MiFID and further to Annex I, Section C of MiFID.

In the eleven-point final catalogue of such annex, only transferable securities might include certain classes of Tokens. But as outlined above, Utility Tokens and Cryptocurrency Tokens are not covered under MiFID's securities term in applicable law. These Tokens do neither qualify as financial instruments according to MiFID and MAR.

In this context, please note that the term financial instrument pursuant to MiFID and MAR deviates from the same term under the German Banking Act (*Kreditwesengesetz*) (hereinafter also referred to as the “**KWG**”). The German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht – the “**BaFin**”) qualified cryptocurrencies as financial instruments pursuant to the KWG. This interpretation does not relate to the term of financial instruments according to MiFID and MAR.

Since MTFs relate only to financial instruments pursuant to MiFID and MAR and this term is based on the concept of securities, crypto exchanges listing (only) Tokens not qualifying as securities are no MTFs. This means that they fall outside the scope of MAR. Meanwhile, trading facilities where Tokens are traded that qualify as securities fulfil the characteristics of an MTF.

(b) Territorial scope

Unlike the MiFID, MAR does not restrict its scope and definitions to the territory of the Member States of the European Union. Pursuant to Art. 2 para. 4 MAR, its prohibitions and requirements shall apply to actions and omissions, in the European Union and in a third country, concerning the regulated instruments.

MAR only takes into account the international legal boundaries of the state sovereignty of the Member States and the European Union in the competence provisions and thus indirectly regulates its territorial scope of application.

Pursuant to Art. 22 Sentence 2 MAR

“The competent authority shall ensure that the provisions of this Regulation are applied on its territory, regarding all actions carried out on its territory, and actions carried out abroad relating to instruments admitted to trading on a regulated market, for which a request for admission to trading on such market has been made, auctioned on an auction platform or which are traded on an MTF or an OTF or for which a request for admission to trading has been made on an MTF operating within its territory.”

If electronic trading platforms such as crypto exchanges were to qualify as MTFs or OTFs, the difficult question would have to be answered from where these trading platforms are operated. This question will become more complex if distributed ledger technologies and smart contracts allow the autonomous self-operation of these trading platforms independent of financial institutions. Here too, is therefore a need for action on the part of the European legislator.

(c) Extended scope of the MAR's ban on market manipulation

The provision of Art. 2 (2) MAR extends the scope of the regulation for the provisions on market manipulation in Articles 12 and 15.

Those Articles shall also apply to

- spot commodity contracts, which are not wholesale energy products, where the transaction, order or behaviour has or is likely or intended to have an effect on the price or value of a financial instrument referred to in para 1;
- types of financial instruments, including derivative contracts or derivative instruments for the transfer of credit risk, where the transaction, order, bid or behaviour has or is likely to have an effect on the price or value of a spot commodity contract where the price or value depends on the price or value of those financial instruments; and
- behaviour in relation to benchmarks.

Since Tokens typically do not represent credit risks or reflect reference values, they are usually not covered under the second and third bullet point above. However, Tokens can embody rights of use, copyrights or services and make these values tradable like commodities. Pursuant to Art. 3 (1) (15) MAR

“‘spot commodity contract’ means a contract for the supply of a commodity traded on a spot market which is promptly delivered when the transaction is settled, and a contract for the supply of a commodity that is not a financial instrument, including a physically settled forward contract”

and according to Art. 3 (1) (14) MAR in conjunction with Art. 2 (1) of the Commission Regulation 1287/2006/EC

“‘commodity’ means any goods of a fungible nature that are capable of being delivered, including metals and their ores and alloys, agricultural products, and energy such as electricity;”

The purpose of this extended scope is to prevent indirect market manipulation of underlying assets. For this purpose, it would be advisable to

extend the ban on manipulation to all assets traded on liquid markets where there is a comparably high risk of market manipulation. However, this wide understanding, although it may be desirable, is not covered by the wording of the provision.

The wording of this commodities definition refers to deliverable material goods and thus excludes the services, rights of use and copyrights typically associated with Tokens. It refers exclusively to physical objects and energy. In addition, the contracts must have an impact on financial instruments that fall within the scope of the MAR. This is also unlikely to be the case for trade in Utility Tokens, which generally embody services, rights of use and copyrights. As a rule, the extended scope of MAR is also not applicable. Since there is a fundamental risk of market manipulation on the secondary markets for Tokens, a possible extension of the scope of MAR *de lege ferenda* should be considered.

4.1.2 German Securities Trading Act

German securities trading law regulates in particular the provision of investment services, the provision of data provision services and abusive market practices in stock exchange and off-exchange trading in financial instruments. Pursuant to section 1 para. 2 WpHG, its territorial scope also covers acts and omissions abroad where they relate to an issuer domiciled in Germany, financial instruments traded on a domestic organised market, a domestic multilateral trading system or a domestic organised trading system, or investment services or ancillary securities services offered in the domestic market. Here, too, the question of the domestic concept arises again for trading platforms.

The term 'financial instrument' is defined in section 1 (4) WpHG and is more broadly defined as the term 'financial instrument of MAR and MiFID. It also includes investments within the meaning of section 1 (2) VermAnlG.

With regard to market abuse monitoring, the WpHG expands MAR's scope of application. Pursuant to section 25 WpHG, Article 15 in conjunction with Article 12 (1) to (4) of the MAR shall apply *mutatis mutandis* for

- goods within the meaning of section 2 para. 5 WpHG; and
- foreign currency within the meaning of section 51 of the Stock Exchange Act (*Börsengesetz*),

traded on a domestic stock exchange or comparable market in another Member State of the European Union or in another Contracting State to the Agreement on the European Economic Area.

The definition of the goods in section 2 para. 5 WpHG corresponds to the above-mentioned definition of MAR and therefore again does not include any services, copyrights and rights of use. The literal meaning of "fungible goods" and examples of

rules do not include services, copyrights, etc. In our opinion, the sole purpose of section 25 WpHG, i.e. to include manipulation of underlying assets in the protection of commodity derivatives, is not sufficient to extend it to other value categories.

Therefore, national legislators should also consider extending the scope of secondary market regulation to include (i) tokenised rights which are traded on crypto exchanges, like right of use, services and copyrights typically embodied by Utility Tokens and/or (ii) Utility Tokens themselves.

4.2 German Criminal Law

Market manipulation is also covered by the criminal provisions on fraud (*Betrug*) pursuant to section 263 German Criminal Code (*Strafgesetzbuch*), and breach of trust (*Untreue*) pursuant to section 266 German Criminal Code.⁴⁴ A violation of these provisions may also give rise to civil liability under § 823 para. 2 BGB (German Civil Code). Irrespective of the question as to whether the criminal provisions can be applied alongside and outside the scope of MAR and the German provisions of the WpHG, criminal market manipulation can only be manipulation by improper means. It is unclear when there will be market abuse if trading is not covered by MAR and the WpHG.⁴⁵ In order to eliminate legal uncertainties, legislative steps are required.

4.3 Competition law

For any communication and statements of the issuer with regard to its business and business model including Tokens (European) competition law⁴⁶ may apply. In particular, it provides for a general prohibition of unfair commercial practices. Particularly, such practices encompass any commercial practices which contain false or deceiving information on the main characteristics of a product, its benefits, risks, usage, etc. Thus, any deceiving and/or untruthful statements of the issuer with regard to (excessive) prospects of success and development on secondary markets may be faced with unfair completion claims.

Furthermore, at least according to German civil law, contractual parties are obliged, in principle, to act truthfully. Consequently, a contractual party may be held liable for giving false and misleading information to the other party.⁴⁷

4.4 Conclusion and recommendation

Market participants need clarification whether and under which conditions (i) Tokens actually qualify as security or financial instrument in accordance to the provisions of MAR and (ii) the application of MAR is limited to Tokens qualifying as financial instruments that are traded at a trading venue operated within the EU.

Without prejudice to the foregoing, from a policy perspective, there are strong arguments to have at least a basic regulatory framework applied to secondary Token markets available for any kind of Tokens, even those which may be agreed to not represent financial instruments.

⁴⁴ See *Vogel*, in Assmann/Schneider, 2012, Section 20a WpHG, marginals 9 et seq.

⁴⁵ See *Hefendehl*, MüKO-StGB, 2014, § 263 StGB m.no. 153.

⁴⁶ Unfair Commercial Practices Directive 2005/29/EC and Directive 2006/114/EC concerning misleading and comparative advertising.

⁴⁷ *Emmerich*, in Münchener Kommentar zum BGB, 2016, § 311 Rn. 65.

The EU regulatory framework on insider dealing, the unlawful disclosure of inside information and market manipulation (market abuse) is intended to ensure the integrity of financial markets in the EU and to enhance investor protection and confidence in those markets. These considerations basically apply to highly liquid Token secondary markets *mutatis mutandis*.

However, any regulation of secondary Token markets needs to adequately take into account that the level of necessary disclosure may differ from the one provided for under the current laws with respect to conventional financial instruments for a couple of reasons.

Firstly, Tokens are usually sold by early-stage companies seeking (pre-)seed money to fund the actual development of the product. Such investments that sometimes even lack an early version or minimal viable product are highly risky by its very nature, with investors/buyers setting their contribution for a potential total loss.

Secondly, given the companies' early stage and the currently often inefficient secondary Token markets, any (minor) development at a product level may be likely to have a significant effect on the prices of those Tokens which, as a consequence, would qualify as insider information to be made available to the public as a general rule. Scenarios in which such reports are not the exception but the rule may not only exaggerate the compliance burden of these companies but also may turn out to be more confusing than informative.

Thirdly, depending on the specific Token design, scenarios are conceivable where the investment opportunity associated with a Tokens' appreciation may not be the primary motivation to acquire a Token but rather the Token's utility function. From a buyer's perspective, there may be scenarios (e.g. the true Utility Token) where a consumer product information rather than a financial information regarding the issuer is a more suitable and efficient way to serve the legitimate protection of the purchaser.

Last but not least, crypto exchanges are likely to become more and more decentralized as technology evolves which will require further clarifications as to which rules apply to such decentralized trading systems.

5. Regulation of business models focussing on Tokens

For the purpose of assessing some license requirements, we assume the following qualification of Tokens taking into account the current administrative practice of the BaFin:

Security Tokens: Qualification as financial instruments under the KWG and the WpHG and as securities under the WpHG but not as securities under the KWG for purpose of the Security Deposit Business (*Depotgeschäft*) in the meaning of section 1 para. 1 sentence 2 no. 5 KWG.

Utility Tokens: In our opinion, it may be possible that Utility Tokens do not qualify as a financial instrument under the KWG and the WpHG although the BaFin seems to be of the opinion that any kind of Token qualifies as unit of account and therefore as financial instrument under the KWG.

Cryptocurrency Tokens qualify as financial instruments (units of accounts) under the KWG but not as financial instrument under the WpHG.

5.1 Investment Advice (section 1 para. 1a sentence 2 no. 1a KWG)

Investment advice is the provision of personal recommendations regarding transactions in specified financial instruments as defined under the KWG to customers or their representatives, provided that recommendations are based on an examination of the investor's personal circumstances or presented as being suitable for the investor and are not exclusively announced through information distribution channels or to the public.

Anybody who provides investment advice with regard to financial instruments requires a licence from the BaFin under the KWG. Hence, providing investment advice with regard to Security Tokens or Cryptocurrency Tokens qualifies as a regulated activity and requires a prior license from BaFin.

Providing investment advice with regard to Utility Tokens that do not qualify as financial instruments is in general not a regulated activity under the KWG. But in most of such cases the investment advice will refer to an acquisition of the Utility Tokens in exchange for Cryptocurrency Tokens. In such cases the investment advice to buy the Utility Token in exchange for a Cryptocurrency Token like bitcoin consists of two advices. The first one to buy the Utility Token and the second one to sell the Cryptocurrency Token. As the second advice refers to a financial instrument the activity would qualify as investment advice in the meaning of the KWG as it also refers to a financial instrument. So irrespective of the current uncertainty regarding BaFin's opinion towards Utility Tokens, any advice regarding the exchange of an Utility Token against a Cryptocurrency Token requires a proper license.

Only in cases in which the investment advice refers to a transaction in which no financial instrument is involved (like the acquisition of a Utility Token that does not qualify as a financial instrument in exchange of euros) the activity will not qualify as investment advice.

5.2 Portfolio management (section 1 para. 1a sentence 2 no. 4 KWG)

The same principles apply to the provision of portfolio management (Finanzportfolioverwaltung) pursuant to section 1 para. 1a sentence 2 no. 4 KWG.

5.3 Investment Brokerage (section 1 para. 1a sentence 2 no. 1 KWG)

Investment Brokerage is the brokerage of transactions involving the purchase and sale of financial instruments as defined under the KWG.

Based on the administrative practice of BaFin investment brokerage includes (i) the transmission of orders regarding the acquisition or disposal of a financial instrument from the buyer or the seller to the respective other person or (ii) to encourage the willingness of a person to acquire a specific financial instrument.

The transmission function can take place in form of an electronic platform, which transfers offers regarding the acquisition or disposal of a financial instrument from one member to another member of the platform.

Like the provision of investment advice, the provision of investment brokerage requires a prior written licence from BaFin under the German banking Act. Hence, anybody who runs an (electronic) platform that transmits orders with regard to the acquisition of Security Tokens, Currency Tokens or Utility Tokens that qualify as a financial instrument from one participant to another participant will require a prior license from BaFin.

The provision of investment brokerage with regard to Utility Tokens that do not qualify as a financial instrument (however, please note the uncertainty whether BaFin qualifies any Token as financial instrument) would not qualify as a regulated activity under the KWG provided that the Utility Token will not be acquired or disposed in exchange of Security Tokens or Cryptocurrency Tokens. As in such case the activity would qualify as investment brokerage with regard to the relevant Cryptocurrency Token or Security Token.

5.4 Multilateral trading facility pursuant to section 1 para. 1a sentence 2 no. 1b KWG

The same principles apply to the operation of a multilateral trading facility pursuant to section 1 para. 1a sentence 2 no. 1b KWG, which also requires a license should any of the Tokens included in such multilateral trading facility qualify as financial instruments in the meaning of the KWG.

In the case of multilateral trading platforms not based in Germany, the question arises as to the applicability of German banking law. Only domestic banking and financial services rendered in Germany are subject to a licensing requirement pursuant to section 32 KWG. In the case of electronic trading platforms, it is controversial which domestic reference is required. The prevailing view presupposes a physical presence in Germany or the active targeting of the German market in form of offering its services to person based in Germany. The mere possibility for German customers to use an electronic trading platform which is not based in Germany is not sufficient to trigger a license requirement in Germany.⁴⁸

5.5 Security Deposit Business (section 1 para. 1 sentence 2 no. 5 KWG)

Security deposit business is the safe custody and administration of securities for others. Securities in this context are only securities in the meaning of section 1 para. 1 DepotG.

⁴⁸ *Fischer/Müller*, in *Boos/Fischer/Schulte-Mattler*, KWG, CRR-VO, 2016, § 32 KWG m.no. 19.

Securities in the meaning of the DepotG are certificates, which represent a right in a way that only the holder of the certificate can exercise the right.⁴⁹ All of the aforementioned Tokens are not represented in a certificate and therefore do not qualify as security in the meaning of the DepotG. Therefore, the safe custody of Tokens for others do not qualify as security deposit business under the KWG.

Please note that the security deposit business is also an ancillary investment service (*Wertpapiernebdienstleistung*) in the meaning of section 2 para. 9 no. 1 WpHG. The definition of the security deposit business under the WpHG differs from the one in the KWG. Security deposit business in the meaning of the WpHG is the safekeeping and administration of financial instruments (in the meaning of the WpHG) for the account of others, including services connected thereto.

Pursuant to section 84 WpHG an investment service undertaking (*Wertpapierdienstleistungsunternehmen*) in the meaning of section 2 para. 10 WpHG has to take measures to protect the ownership rights of its customers to financial instruments which are held by the investment service undertaking (section 84 para. 3 WpHG). Such an investment service undertaking is obliged to forward securities which it receives in performing investment services to a credit institution which is licensed under the KWG to conduct security deposit business. If this provision would directly apply with regard to Tokens that do qualify as securities in the meaning of the WpHG but not in the meaning as the KWG such investment service undertaking will most likely face the problem that such Tokens are currently not accepted by credit institutions for safe keeping. Also, we do not recognize a need for safekeeping of Tokens with banks specifically licensed to conduct security deposit business. Therefore, with regard to Tokens we are of the opinion that section 84 para. 3 WpHG has to be interpreted in a way that the relevant investment service undertaking has to take measures to ensure that the decisive economic power (*wirtschaftliche Verfügungsgewalt*) with regard to the Tokens remains with the relevant customer. A transfer of the Tokens to a credit institution for safe-keeping is not required as the Tokens do not qualify as securities in the meaning securities in the meaning of section 1 para. 1 DepotG.

Please note further, that investment service undertakings pursuant to the WpHG are only credit institutions or financial service providers that provide investment services under the WpHG exclusively or together with ancillary investment services. Therefore, the provision of only ancillary investment services does not lead to a qualification as investment service undertaking under the WpHG.

Hence, companies that only provide the safe keeping of Tokens do not require a license under the KWG and do not qualify as investment service undertakings under the WpHG and therefore do not have to comply with the organisational duties for investment service undertakings (which section 84 WpHG is part of).

Companies that provide other investment services like investment advice, investment brokerage or portfolio management with regard to Tokens and therefore are licensed as a financial institution under the KWG do qualify as investment service undertaking and therefore will be obliged to comply with the relevant organisational duties. We are of the

⁴⁹ Scherer, Depotgesetz, 2012, § 1 m.no. 2

opinion that this means they are obliged to take measures to ensure that the decisive economic power (*wirtschaftliche Verfügungsgewalt*) with regard to the Tokens remains with the relevant customer. A transfer of the Tokens to a credit institution for safe-keeping is not required as the Tokens do not qualify as securities in the meaning securities in the meaning of section 1 para. 1 DepotG.

5.6 Trading on own account (section 32 para. 1a sentence 2 KWG)

Trading on own account (*Eigengeschäft*) is the purchase and sale of financial instruments for own account other than dealing on own account (*Eigenhandel*). Trading on own account only requires a prior license under the KWG in certain circumstances. Pursuant to section 32 para. 1a sentence 2 KWG a license is required if the trading on own account is conducted as a member or participant of a regulated market or a multilateral trading facility. Crypto exchanges generally meet the definition of a multilateral trading facility. Furthermore, users of such crypto exchanges place their orders directly at the relevant exchange and different to stock exchanges not via a financial intermediary. Therefore, the users of crypto exchanges qualify also as members or participants of a multilateral trading facility. Which means that based on the wording of section 32 para. 1a sentence 2 KWG a person based in Germany that commercially purchases or sales Tokens on a crypto exchange may require a prior license under the KWG.

The license requirement for trading on own account as a member or participant of a regulated market or a multilateral trading facility was included in the KWG as part of the second financial market amendment act (*2. Finanzmarktnovellierungsgesetz*) and transposed Art. 2 para. 1 lit. d ii) of MiFID into national law. Pursuant to Art. 2 para. 1 lit. d ii) of MiFID the Member States should take measures that person which deal on own account as member or participant of a regulated market or multilateral trading facility in financial instruments in the meaning of Annex I section C of MiFID require a prior license.

The definition of financial instruments in Annex I section C of MiFID differs from the definition of financial instruments under the KWG and does not include units of accounts. Therefore, with the license requirement for trading on own account with regard to units of accounts the German legislator has expanded the license requirement on activities not covered by the Directive 2014/65/EU.

The legislator has stated in the legislative materials that its intention is to transpose MiFID 1:1 into national law.⁵⁰ Where the legislator has introduced additional requirements or stricter rules than in the MiFID these additional regulations are clearly mentioned in the legislative materials. The legislative materials do not provide any indication that the legislator had the intention to extend the license requirement of section 32 para. 1a sentence 2 KWG to constellations not covered by the scope of MiFID. Therefore, there are strong indications that the legislator has unintentionally introduced a license requirement for trading on own account with Tokens as a member or participant of a multilateral trading facility, which requires to limit the scope of the license requirement as part of the teleological interpretation of the provisions to cases that are covered by the license requirement of MiFID. Therefore, we are of the opinion that only the trading on own account in Securities Token as a member

⁵⁰ BT-Drucks. 18/10936, p. 3.

or participant of a regulated market or multilateral trading facility requires a license under the KWG.

5.7 Conclusion and recommendations with respect to German law

With regard to the provision of investment advice, investment brokerage and portfolio management, we do not see a demand for additional regulation. The provision of such services concerning most of the Tokens require a license under the KWG. Even with regards to Tokens that may not qualify as financial instruments under the KWG, such services in most cases involve also the provision of the relevant service pertaining to a Token that qualifies as a financial instrument. Furthermore, it is likely that the relevant servicer will not limit its services to Tokens that do not qualify as financial instruments as this would exclude the major Cryptocurrency Tokens like bitcoin.

In view of safekeeping of Tokens for others, we currently do not see an immediate requirement for additional regulation, although such activity is currently not regulated with regard to most of the Tokens. This view is based on the fact that Token holders are not required to make use of a servicer to store their Tokens. Any Token holder could store its Tokens on an individual wallet for which only the Token holder holds the private key. This is a material difference between the safekeeping of Tokens and the safekeeping of securities. For most of the securities the holder of the securities is not able to safe keep the relevant securities by itself and therefore requires a servicer who safe keeps the securities on his regard.

Nevertheless, we do see a demand from professional investors for safekeeping of Tokens as a professional service. Such professional investor will request a certain standard of professional organisation and controls from the relevant servicer. In case that such demand from professional investors further increases together with the volume of the safe kept Tokens an additional legal regulation of such service might be helpful and could take into account the market practice established so far by the demand of professional investors.

With regard to the license requirement for trading on own account as a member or participant of a regulated market or multilateral trading facility a clarification from BaFin or the German legislator in line with the findings above that such license requirement only applies to trading on own account in Securities Token would be highly desirable.

6. Conclusion and recommendations

ICOS are a new approach to financing which comes with various advantages for issuers and purchasers. Token based ecosystems which are usually funded through ICOs may also have benefits for the economy as they enable new business models. Therefore we welcome the concept of financing through ICOs.

In this paper we have set out the legal “pain-points” under the existing legal frameworks and have also set out recommendations on how to approach these. As opposite to common believe, ICOs partially are covered under the existing legal framework (e.g. capital market law, consumer protection law). However, such framework does not fully suit ICOs and the Tokens granted therein. This leads to uncertainty which may prevent the further development of distributed ledger based models and a healthy ecosystem.

Schedule 1

Information requirements under European e-commerce and consumer protection laws

1. Information obligations under e-commerce law

The entrepreneur must inform the customer

- of the individual technical steps that lead to the conclusion of a contract;
- whether the contract text is stored by the entrepreneur after the conclusion of the contract and whether it is accessible to the customer;
- how the customer can identify and correct input errors before submitting the contract declaration;
- the languages available for the conclusion of the contract;
- on all relevant codes of conduct to which the entrepreneur is subject and on the possibility of electronic access to these rules; and
- restrictions of delivery and the different payment methods.

2. Information obligations under consumer protection law

2.1 Information obligations with regard to distance contracts

The entrepreneur must inform the consumer on

- the essential characteristics of goods and services;
- his identity, e. g. his commercial name, address, telephone number, telefax number and e-mail address and the address and identity of the entrepreneur he acts on behalf of;
- where appropriate, the address of the entrepreneur or the entrepreneur he acts on behalf of, for complaints if it differs from the address above;
- the total price in case of unlimited contracts or subscriptions;
- the term of the contract or the conditions of termination in the case of unlimited contracts or contracts that are prolonged automatically;
- any additional costs for the use of means of distance communication which are used for the conclusion of the contract, if there any additional costs imposed on the consumer;
- the terms of payment, delivery and service conditions, the deadline by which the entrepreneur must deliver the goods or provide the service and, where appropriate, the entrepreneur's procedure for dealing with complaints;
- the existence of a statutory right of liability for defects of goods;
- where appropriate, the existence and conditions of customer service, after-sales service and guarantees;
- where appropriate, the existence of a code of conduct referring to specific commercial practices or sectors and on how exemplars of this code of conduct can be obtained;
- where appropriate, the term of the contract or the conditions of termination in the case of unlimited contracts or contracts that are prolonged automatically;

- where appropriate, the minimum period of obligations that the consumer is subject to;
- where appropriate, the fact that the entrepreneur may require the consumer to provide a security deposit or other financial collateral, and the conditions of such deposit or other financial collateral;
- where appropriate, the functioning of digital content, including any technical safeguards applicable to such content;
- where appropriate, any significant restrictions on the interoperability and compatibility of digital content with hardware and software, insofar as the entrepreneur is or must be aware of such restrictions;
- where appropriate, that the consumer may use out-of-court appeal and redress procedures to which the entrepreneur is subject and the conditions for access to them; and
- the existence of a right of revocation, the conditions, deadlines and procedures of revocation and, where applicable, the costs of revocation and the conditions of early expiration of the right of revocation.

2.2 Information obligations with regard to financial services

The entrepreneur must inform the consumer on

- its identity and the commercial register and registration number;
- its main business activity and the supervisory authority responsible for its approval;
- the identity of the entrepreneur's representative in the Member State in which the consumer is domiciled, if there is such a representative, or the identity of a commercial person other than the entrepreneur, if the consumer has business dealings with that person, and the capacity in which that person acts vis-à-vis the consumer;
- its address and the name of its representatives if the entrepreneur is a legal person;
- the essential characteristics of the financial service and information on how the contract is concluded;
- the total price of the financial service including all connected elements of costs and taxes that are deducted by the entrepreneur or, if it is not possible to name a precise price, the calculation basis so that the consumer can assess the price;
- where applicable, additional costs and the indication of additional taxes and costs that are not deducted by the entrepreneur or are invoiced to the entrepreneur;
- where applicable, the indication of the fact that the financial service relates to a financial instrument which, because of its specific characteristics are subject to specific risks or the price of which is subject to fluctuations in the financial market which cannot be influenced by the entrepreneur, and that the past income is no indicator for future income;
- a limitation of the period of validity of the information provided, e. g. the period of validity of fixed-term offers, in particular with regard to the price;
- details on payment and fulfilment of the contract;
- any additional costs for the use of means of distance communication which are used for the conclusion of the contract, if there any additional costs imposed on the consumer;

- the existence or non-existence of a right of revocation, the conditions of this right, in particular the name and address of the entity to which the revocation shall be addressed, and on the consequences of revocation including information on the amount payable for any service that has been provided already;
- the minimum term of the contract if it involves a continuous or recurring service;
- the contractual termination terms and conditions, including any contractual penalties;
- the Member States of the European Union, the law of which the entrepreneur uses for establishing relations with consumers prior to the conclusion of the contract,
- the contractual clause stating the applicable law and competent court;
- the languages in which the contract terms and the prior information referred to in this provision are communicated and the languages in which the entrepreneur undertakes to communicate, with the consumer's consent, during the term of this contract;
- where appropriate, that the consumer may use out-of-court appeal and redress procedures to which the entrepreneur is subject and the conditions for access; and
- the existence of a guarantee fund or any other regulations on compensation.