Regulation of Security Tokens: EU Legislative Package – Latest Developments

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Introduction

There is broad consensus among international regulators and practitioners that crypto assets as an emerging new asset class and related distributed ledger/blockchain technology (DLT) will have an immense potential for innovation and efficiency gains in the financial sector. Crypto assets and tokenization might revolutionise the financial markets in similar ways as has securitization in the past.[1i]

In the EU, crypto asset regulation is treated as an integral part of the Commission's digital finance strategy[2]. The EU expects from the crypto asset sector a significant contribution to tackling the economic effects of the COVID-19 outbreak.

On 24th November 2021, the EU Council adopted its position in respect of regulatory proposals on crypto assets and mandated its Presidency to initiate formal "Trilogue" procedures with the Parliament and the Commission to finalize the legislative process.[3]

In summary, a token issue is intended to link values or rights with an entry in a digital register. A Security Token is not a deed laid down in a written document. Rather, it can be seen as dematerialised security that is issued through distributed ledger or similar technologies.[4] It is effectively a means to represent ownership of security assets via DLT by saving information through a distributed ledger, i.e. a repeated digital copy of data available at multiple locations, such as Blockchain. As opposed to traditional book-entry securities, Security Tokens use an alternative way of recording ownership through the use of cryptography, Distributed Ledger Technology (DLT) or similar technologies, rather than recording ownership through the account of a central securities depository /CSD/custodian. Commonly, they refer to a right existing outside the blockchain. As asset/investment tokens' they represent assets such as shares in real values, companies, earnings, or debt securities and are normally issued for capital raising through ICO ("Initial Coin Offering") procedures and show similarities to traditional debt and equity instruments, or refer to traditional securities or other assets that have been registered on a blockchain ("tokenization").[5)]

Current EU regulatory treatment

The ESMA's guiding principle in qualifying crypto assets as financial instruments is "substance over form"; they would have to be standardised, transferable and tradable in financial

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[1] Follak, 'Crypto Assets under Private Law and Supervisory Regulation: European Perspectives', ÖBA 2020, 712.

[2] European Commission, Communication on a Digital Finance Strategy for the EU, COM (2020) 591 final

[3] Council press release 886/21 of 24/11/2021.

[4] Basel Committee on Banking Supervision, Consultative Document, Prudential treatment of cryptoasset exposures, June 2021, 2 FN 5. .

[5)] Houben/Snyers, Crypto-assets – Key developments, regulatory concerns and responses', Study for the Committee on Economic and Monetary Affairs, Policy Department for Economic, Scientific and Quality of Life Policies, PE 648.779, April 2020 (available at: http://www.europarl.europa.eu/supporting-analyses, 21.

markets. Under MiFID II (Directive 2014/65/EU) Art 4(1)(15)/Annex I sect. C, these are typically transferable securities, money market instruments, units in collective investment undertakings and certain derivatives. In case a crypto asset qualifies as a financial instrument, a set of specific regulatory frameworks is applied:

- Markets in Financial Instruments framework (MiFID – Directive 2014/65/EU and MiFIR Regulation (EU) 600/2014);
- Alternative Investment Fund Managers Directive (AIFMD – Directive 2011/61/EU);
- Prospectus Directive and Regulation (Directive 2003/71/EC and Regulation (EU) 2017/1129);
- Transparency Directive (2013/50/EU);
- Market Abuse and Short Selling Regulation (EU) 596/2014);
- Investor Compensation Directive (97/9/EC);
- Settlement Finality Directive (2009/44/EC);
- Central Securities Depositories Regulation (EU) 909/2014.

Draft EU package on crypto asset regulation

On 24 September 2020, the EU Commission finally published a package of legislative proposals with the aim to create an EU framework on markets in crypto assets, tokenization of traditional financial assets and the use of distributed ledger technology (DLT) in financial services[6] as part of the EU digital finance strategy. Basically, this regulation can be characterized as a MiFID-type framework to cover crypto assets falling outside existing EU financial services regulation, as well as e-money tokens. Hence, It is meant to

- "establish uniform rules for crypto-asset service providers and issuers at EU level…"
- "establish specific rules for so-called 'stablecoins', including when these are e-money…"[7]

It includes

- an addendum to the "MiFID II" Directive 2014/65/EU clarifying that the existing definition of "financial instruments" includes "instruments issued by means of distributed ledger technology";
- a proposal for a Regulation on Markets in Crypto-Assets ("MiCA regulation) to cover crypto assets falling outside existing EU financial services regulation, including "stablecoins" as well as e-money tokens;[8]
- a proposal for a Regulation on a Pilot Regime for Market Infrastructures based on distributed ledger technology;[9]
- an "EU passport" for crypto assets .

By way of addenda to the "MiFID II" Directive 2014/65/EU **[10],** the proposal includes:

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[6] Proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-assets (COM(2020) 593/3, = 2020/0265(CO) – "MiCA Regulation", Explanatory Memorandum, 2.

[7] MiCA Regulation, Explanatory Memorandum, 10.

[8] FN 6.

[9] COM (2020) 594 final = 2020/0267 (COD).

[10] Amendment to Art. 4(1) point 15 of Dir. 2014/65/EU: Proposal of the European Parliament and of the Council, COM (2020) 596 final = 2020/0268 (COD), Art. 6.

- an amendment to Art. 4(1) point 15 of Directive 2014/65/EU **(**MiFID II) clarifying the existing definition of "financial instruments" as specified in Annex I sect. C: "including such instruments issued by means of distributed ledger technology";
- amendments to Art. 16 para. 4 and 5, Art. 17 para. 1 and 7, Art. 19 para. 3, Art. 47 para. 1 and Art. 48 para. 1, 6 and 12 of the MiFID II Directive defining requirements in respect of systems, ICT and other technologies to ensure compliance with the proposed Regulation on Markets in Crypto-Assets and the proposed Regulation on a Pilot Regime for Market Infrastructures based on distributed ledger technology.

Security Tokens within the future system of EU Crypto Asset regulation

Due to the intention to fill regulatory gaps, the scope of the MiCA Regulation is limited by Art. 2, excluding assets qualifying as financial instruments under Art. 4(1) point 15 of the MiFID II Directive 2014/65/EU, electronic money as defined in Art. 2 point (2) of Directive 2009/110/EC, and certain other instruments.

The MiCA regulation includes assets and activities as defined in Art. 3:

The generic asset category is determined as 'crypto asset' – "a digital representation of value or rights which may be transferred and stored electronically, using distributed ledger technology[11] or similar technology" (Art. 3 para.1 (2). The Commission's draft definition of a 'crypto asset' so far includes, inter alia,'asset-referenced tokens': "a type of crypto-asset that purports to maintain a stable value by referring to the value of several fiat currencies that are legal tender, one or several commodities or one or several crypto-assets, or a combination of such assets" (Art. 3 para.1 (3). Commonly, this asset type is referred to as "stablecoins" and has to be clearly distinguished from tokenized securities classified as financial instruments by amendment of the MiFID Regulation.

As a result, Security Tokens would be normally captured by and integrated into the MiFID II Regulation rather than being regulated by the MiCA framework. Nevertheless, the proposed EU Regulation on a Pilot Regime for Market Infrastructures based on distributed ledger technology would also apply to crypto assets that qualify as financial instruments/transferable securities under MiFID II, as specified and limited in Art. 3 of the draft regulation, and insofar to Security Tokens.

According to the general principles of EU legislation, private law such as national classification as property, integration into bankruptcy and heritage estates, enforcement as collateral, seizure, trust etc. is not harmonised and hence subject to national legislation. In particular, Liechtenstein – an EEA Member State which will have to adopt the draft EU regulatory package - has successfully enabled the full deployment of crypto assets and their underlying technology. Insofar, EU legislators will have to take care with a view to existing comprehensive national regulations to avoid any setback

[11] Distributed recording of encrypted data as defined by Art. 3 para. 1. (1) of the MiCA Regulation.