Advisory letter (WA)

Ref. no.: WA 11-QB 4100-2017/0010

Supervisory classification of tokens or cryptocurrencies underlying "initial coin offerings" (ICOs) as financial instruments in the field of securities supervision

Given the rising number of queries to BaFin's Securities Supervision/Asset Management Directorate (WA) seeking to ascertain whether the tokens, coins or cryptocurrencies underlying "initial coin offerings" (ICOs)[1] (for the purposes of this advisory letter hereinafter referred to as "**tokens**") are deemed financial instruments in the field of securities supervision, BaFin states its position on the regulatory classification of tokens in the field of securities supervision as follows in this advisory letter:

BaFin (WA) determines on a case-by-case basis whether a token constitutes a financial instrument within the meaning of the German Securities Trading Act (*Wertpapierhandelsgesetz* – WpHG) or the Markets in Financial Instruments Directive (MiFID II), a security within the meaning of the German Securities Prospectus Act (*Wertpapierprospektgesetz* – WpPG), or a capital investment within the meaning of the German Capital Investment Act (*Vermögensanlagengesetz* – VermAnlG). BaFin bases its assessment on the criteria set out in the statutory provisions under securities supervision law, i.e. in particular the WpHG, WpPG, Market Abuse Regulation (MAR), VermAnlG as well as other relevant laws and applicable national and EU legal acts in the field of securities supervision.

Market participants providing services related to tokens, dealing with tokens or publicly offering tokens must give careful consideration to whether the tokens constitute a regulated instrument, i.e. for instance a financial instrument within the meaning of section 2 (4) of the WpHG, or a security within the meaning of section 2 (1) of the WpPG, so that they can fully comply with any legal requirements. This is also emphasised in the respective warning issued by the European Securities and Markets Authority (ESMA) on 13 November 2017.[2] The duty to comply with the legal provisions is particularly relevant with regard to possible authorisation requirements pursuant to the German Banking Act (*Kreditwesengesetz* – KWG), the German Investment Code (*Kapitalanlagegesetzbuch* – KAGB), the German Insurance Supervision Act (*Versicherungsaufsichtsgesetz* – VAG) or the German Payment Services Supervision Act (*Zahlungsdiensteaufsichtsgesetz* – ZAG). In cases where there is doubt as to whether authorisation is required pursuant to the KWG, KAGB, VAG or ZAG, the competent department at BaFin is the Department for Authorisation Requirements and Enforcement relating to Unauthorised Business (EVG) (part of the Resolution Directorate).

The content of this advisory letter relates exclusively to the legal provisions applying to securities supervision. The two guidance notices on financial instruments ("*Merkblatt Finanzinstrumente (Aktien, Vermögensanlagen, Schuldtitel, sonstige Rechte, Anteile an Investmentvermögen, Geldmarktinstrumente, Devisen und Rechnungseinheiten)*"[3] and "*Merkblatt Finanzinstrumente (Derivate)*"[4] (both only available in German)) remain unaffected.

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[1] For background information on ICOs see part 5 below
[2] https://www.esma.europa.eu/sites/default/files/library/esma50-157-828_ico_statement_firms.pdf
[3] https://www.bafin.de/dok/7852552
[4] https://www.bafin.de/dok/7852554

1. Financial instruments within the meaning of section 2 (4) of the WpHG / Section C of Annex I to MiFID II

Depending on its specific design, a token may be deemed a financial instrument within the meaning of section 2 (4) of the WpHG or Section C of Annex I to MiFID II. Depending on its features in the individual case a token may be classified as a security (section 2 (4) no. 1 in conjunction with section 2 (1) of the WpHG, or Article 4(1)(44) of MiFID II), as a unit in a collective investment undertaking (section 2 (4) no. 2 of the WpHG in conjunction with section 1 (1) of the KAGB, or point (3) of Section C of Annex I to MiFID II), or as a capital investment (section 2 (4) no. 7 of the WpHG in conjunction with section 1 (2) of the VermAnlG[5]).

In addition, a token can serve as the underlying asset for a **derivative contract** (section 2 (3) of the WpHG, or point (4) and points (9) to (10) of Section C of Annex I to MiFID II). In cases where a token is the underlying asset for a derivative contract, the derivative contract is to be classified as a financial instrument. With regard to authorisation requirements, the guidance notice "*Merkblatt Finanzinstrumente" (Derivate)*[6] is applicable in this context.

A precise **case-by-case assessment** is required to determine a token's legal classification. In order to decide if a token may be classified as a financial instrument within the meaning of the WpHG or MiFID II, it is not a decisive factor whether or not the same token would be classified as a unit of account within the meaning of section 1 (11) sentence 1 no. 7 of the KWG. Units of account are – unlike under the KWG – not regarded as financial instruments pursuant to section 2 (4) of the WpHG.

a) Security within the meaning of section 2 (1) of the WpHG / Article 4(1)(44) of MiFID II

To be deemed a security within the meaning of section 2 (1) of the WpHG or Article 4(1)(44) of MiFID II, a token has to meet the following criteria in particular:

- transferability,
- negotiability on the financial market or capital market; trading platforms for cryptocurrencies can, in principle, be deemed financial or capital markets within the meaning of the definition of a security,
- the embodiment of rights in the token, i.e. either shareholder rights or creditor claims or claims comparable to shareholder rights or creditor claims, which must be embodied in the token, and
- the token must not meet the criteria for an instrument of payment (as set out in section 2 (1) of the WpHG or Article 4(1)(44) of MiFID II).

Pursuant to section 2 (1) of the WpHG and Article 4(1)(44) of MiFID II, it is not mandatory for a token to be a certificated security in order to qualify as a transferable security. Rather, it is sufficient if the holder of the token can be documented, for example by means of distributed ledger or blockchain technology, or through comparable technologies.

There is no general answer to the question of whether a token meets these criteria; a **case-by-case assessment** based on the circumstances of the respective individual case is always required. In the assessment, the specific structure of the rights embodied in the

[5] The VermAnlG is not based on MiFID II.
[6] https://www.bafin.de/dok/7852554

token is the decisive factor. Taken by itself, the mere labelling of a token, for instance, as a "utility token", is not relevant to the outcome of the legal analysis.

The classification of a financial instrument as a security within the meaning of section 2 (1) of the WpHG is generally also decisive in determining whether the WpPG and other applicable capital market laws and EU regulations (for instance MAR) which refer to the concept of a "transferable security" within the meaning of section 4(1)(44) of MiFID II are to be applied.

b) Unit in a collective investment undertaking within the meaning of section 1 (1) of the KAGB / point (3) of Section C of Annex I to MiFID II

Depending on the individual case, a token may, under certain circumstances, be deemed a unit in an investment fund (section 1 (1) of the KAGB) or a unit in a collective investment undertaking (point (3) of Section C of Annex I to MiFID II). If the token is in fact based on a unit in a collective investment undertaking, it also constitutes a financial instrument within the meaning of the WpHG and MiFID II.

In its interpretative note on the scope of the KAGB and the term "investment fund" (*Auslegungsschreiben zum Anwendungsbereich des KAGB und zum Begriff des „Investmentvermögens*" – only available in German),[7] BaFin summarises the criteria for an investment fund.

c) Capital investment within the meaning of section 1 (2) of the VermAnlG

Depending on the specifics of the case, tokens may, in the alternative, be deemed capital investments within the meaning of the VermAnlG, and hence a financial instrument within the meaning of the WpHG. As stipulated by section 1 (2) of the VermAnlG, this only applies if the token is not a security within the meaning of the WpPG. In addition, the token must not constitute a unit or share in an investment fund within the meaning of section 1 (1) of the KAGB, and the acceptance of the funds must not qualify as deposit business (section 1 (1) sentence 2 no. 1 of the KWG). Depending on its legal structure, a token may be deemed, among other things, a shareholding in a company (section 1 (2) no. 1 of the VermAnlG), a profit participation or subordinated loan (section 1 (2) nos. 3 or 4 VermAnlG), a participation right (section 1 (2) no. 5 of the VermAnlG) or another investment (section 1 (2) no. 7 of the VermAnlG).

A case-by-case assessment needs to be undertaken for each token to determine whether the legal criteria are met for the VermAnlG to apply.

2. Security within the meaning of section 2 no. 1 of the WpPG

Depending on their specific features, tokens may also be classified as securities within the meaning of section 2 no. 1 of the WpPG. In this respect, too, the classification requires a **precise case-by-case assessment**. With regard to the criteria for classifying specific tokens as securities within the meaning of section 2 no. 1 of the WpPG, the explanations given under 1. a) ("Security within the meaning of section 2 (1) of the WpHG / Article 4(1)(44) of MiFID II") apply *mutatis mutandis*.

3. Consequences of classification as a financial instrument or a security within the meaning of the WpPG

[7] https://www.bafin.de/dok/7851552

If a token meets the criteria for a financial instrument within the meaning of the WpHG or MiFID II, or for a security within the meaning of the WpPG, this can result in the legal provisions applicable in the field of securities supervision, including the supervisory requirements specified in these provisions, being applied to a market participant. In particular, this may include the WpHG, the WpPG, MAR, the Markets in Financial Instruments Regulation (MiFIR), the VermAnlG, as well as other relevant laws and applicable national and EU legal acts in the field of securities supervision. In cases where tokens meet the criteria for a unit or share in an investment fund (see 1. b above)), the KAGB is applicable.

With regard to the scope of application of MAR, it should be noted that the criteria for the application of MAR are based on the term "financial instrument" within the meaning of Section C of Annex I to MiFID II. In addition, the requirements under Article 2 of MAR, in particular whether the tokens are traded, or planned to be traded, on a trading venue covered by MAR, also need to be considered.

Affected market participants should allow sufficient time to clarify any doubts about the regulation of tokens with the competent BaFin divisions before proceeding with planned projects or business. The competent divisions can be found in BaFin's schedule of responsibilities.[8]

If applicable regulatory requirements are not complied with, this can result in the respective projects or business being prohibited by BaFin. In addition, such violations may, under certain circumstances, constitute administrative offences which are punishable by the imposition of fines. If there are indications that criminal offences have been committed, the matter is passed on to the competent law enforcement authorities for the purpose of prosecution.

4. Authorisation requirement pursuant to the KWG, the KAGB, the VAG or the ZAG

Pursuant to section 32 (1) of the KWG, trading with tokens may, depending on their features, be subject to an **authorisation requirement** as banking business, namely as principal broking services (section 1 (1) sentence 2 no. 4 of the KWG) or underwriting business (section 1 (1) sentence 2 no. 10 of the KWG), or as a financial service, namely as investment broking, investment advice, operation of a multilateral or organised trading facility, placement business, contract broking, portfolio management, proprietary trading or asset management (section 1 (1a) sentence 2 nos. 1 to 4 and 11 of the KWG). In each individual case, a key factor in determining if an authorisation requirement exists is whether the token qualifies as a financial instrument within the meaning of section 1 (11) of the KWG. The KWG's concept of a financial instrument is broader than that of the WpHG, particularly as it also covers foreign exchange and units of account, and thereby means of payment created **under private law** ("cryptocurrencies") which are intended to be used in computer networks as an **alternative currency** (synthetic alternative to legal tender). Anyone conducting banking business or providing financial services without authorisation pursuant to section 32 (1) sentence 1 of the KWG, can, under section 54 (1) no. 2 of the KWG, be punished by a term of imprisonment of up to five years or by a fine.

In certain cases, a token may qualify as a unit or share in an investment fund (see 1. b) above). In such cases, the authorisation requirement pursuant to the KAGB may apply.

Consistent court rulings have defined insurance business as the provision, against payment, of specific benefits upon the occurrence of an uncertain event, where the

[8]https://www.bafin.de/dok/7859566

transferred risk is spread among multiple persons exposed to the same risk, and the acceptance of the risk is based on a calculation on the basis of the law of large numbers. This does not include, however, agreements which are closely connected to a legal transaction of a different nature from which the agreements' proper legal character is derived. This is the case if an agreement is linked to a main contract which itself is not an insurance contract and if the agreement is to be regarded as a dependent side agreement to the main contract (cf. judgment of 23 November 2016, IV ZR 50/16 *inter alia*. of the Federal Court of Justice – *Bundesgerichtshof* (BGH)). Under section 8 (1) of the VAG, conducting insurance business is subject to an authorisation requirement.

If a third party (for instance an internet platform where virtual money can be exchanged for legal tender) is involved, the criteria for the operation of a multilateral trading facility pursuant to section 1 (1a) sentence 2 no. 1b of the KWG may be met, in addition to which an authorisation requirement pursuant to **section 10 (1) of the ZAG** may arise for providing payment services. If the third party, at the request of the acquirer, transfers the real equivalent value of the token via its own account to the recipient, the third party is deemed to be conducting money remittance business (section 1 (1) sentence 2 first alternative of no. 6 of the ZAG). If the third party acts at the request of the recipient of the payment, it may, under certain circumstances, meet the criteria for acquisition business within the meaning of section 1 (1) sentence 2 second alternative of no. 5 of the ZAG. A combination of the two is also conceivable if the payment services provider acts on behalf of both parties to the exchange deal, which can often be the case with internet platforms. As always when assessing whether or not an authorisation requirement exists, the specific contractual arrangements between the contracting parties are decisive.

5. Background to initial coin offerings

An initial coin offering (ICO) is a method of raising capital using "tokens". An ICO can also be referred to as an initial token offering or a token sale. In an ICO, a company or an individual issues tokens and sells them in exchange for traditional currencies, such as, for instance, euros, or, more frequently, for virtual currencies like bitcoins or ether.

The properties and purpose of tokens can vary from one ICO to another. Some tokens facilitate the use or purchase of services or products that the issuer develops with the proceeds from the ICO. Others confer voting rights or shares in the issuer's future revenues on the buyer. Some tokens have no particular additional value. Other tokens, once issued, are traded and can be exchanged for traditional or virtual currencies on specialised trading platforms for cryptocurrencies.

ICOs are carried out online, i.e. via the internet or social media. Tokens are usually generated and distributed using distributed ledger or blockchain technology (DLT). ICOs are used to raise capital for a variety of projects, including business using DLT.