Security Token Offerings in Europe

A definitive guide to security tokens in Europe from a legal and compliance viewpoint.

Simone D. Casadei Bernardi

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In this guide you’ll learn:
• What security tokens are
• The different types of tokens
• The pros and cons of security tokens
• Where to run an STO from
• How to have your STO greenlighted by the regulator.

The Current State of Security Token Offerings 4
What Are Security Tokens? 5
Different Types of Tokens 7
Is a Security Token Offering Your Best Choice? 10
Legal Background and Key Requirements in Europe 13
Where to Run Your STO From? 18
How to Get an STO Greenlighted by the Regulator 23
The Future of Security Tokens 25

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The Current State of Security Token Offerings (STOs)

Type ‘security tokens’ into Google now, and you’ll find a series of articles with contrasting opinions. On the one hand, you’ll have some crypto and blockchain enthusiasts speculating about the potential profits you can make by investing in them. While on the other, you’ll have non-conformists stating that they are a fad and a significant risk.

One of the main reasons why people can’t agree on the matter is down to the fact that there’s some confusion about what security tokens are.

The problem doesn’t lie in grasping the concept itself; it’s the legal and compliance grey areas that seem to be making it hard for people to understand the difference between security tokens, utility tokens, initial coin offerings (ICOs) and all other aspects of blockchain.

Researches suggest that 90% of utility tokens listed on crypto exchanges around the world are now worth less than their initial price offering. To make matters worse, the initial hype of ICOs in 2018 has diminished, with more scamming and fraudulent activity cases cropping up.

With this in mind, it’s hardly surprising when you see a non-conformist instantly taking a dislike to something new within the blockchain community.

However, those who choose to discard security tokens without learning about what they are and taking into consideration the current legal stance in Europe could be missing out on a big opportunity.

The issues surrounding ICOs has paved the way for STOs to come to the forefront. This fundraising mechanism designed to issue security tokens is deemed safer and more reliable – two words we don’t always hear in the world of blockchain.
What Are Security Tokens?

After the fatal stock market crash of 1929, the Securities and Exchange Commission (SEC) was founded. The purpose of this organisation is to protect investors and to make sure that trading in securities is secure and controlled from a legal viewpoint.

When ICOs started to take off a couple of years ago, SEC began to notice the new trend and the worrying number of fraudulent start-ups.

Securities are defined as tradable financial assets such as bonds, options, equities and warrant. Where the confusion lies is that security tokens meet the same requirements and are classed under the same security umbrella.

To help determine whether something is a security or not, the Supreme Court created the Howey test for SEC, whereby, if a token meets the following criteria, it’s classed as a security token:

- The token is a financial investment.
- The investment goes to a company or group of companies.
- The investor expects to make a profit by acquiring the token.
- The expected profit is generated by the work of third parties.

If the token meets all four points, then the company must meet all requirements applicable to traditional securities. This includes all prospectus requirements, ad hoc reporting responsibilities, and being liable for providing false information.

The Howey test is just one of the tools to qualify a token as a security or rule out the application of securities law and regulations to it.

In layman’s terms, security tokens are the digital representation of certain rights, such as shares in a company or the ownership certificate of a high-ticket good (e.g. real estate, precious metals, artworks, and so on.)
The table below will make things clear. The example is based on tokens issued by a company (‘Alpha Ltd.’) whose corporate purpose is to offer access to a platform that provides the users with detailed information about companies.

<table>
<thead>
<tr>
<th>Security Token</th>
<th>Utility Token</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Investor/Subscriber Perspective</strong></td>
<td>Investors buy Alpha’s shares</td>
</tr>
<tr>
<td><strong>Motivation</strong></td>
<td>Investors expect Alpha makes high revenues and distributes copious amounts of dividends</td>
</tr>
<tr>
<td><strong>Process</strong></td>
<td>STO (Security Token Offerings)</td>
</tr>
<tr>
<td><strong>Alpha’s Customers Perspective</strong></td>
<td>Customers decide to benefit from the information provided by Alpha and pay a fee</td>
</tr>
</tbody>
</table>

| Investor Liquidity | ☑ | ☑ |
| Community Development | ☑ | ☑ |
| Regulatory Oversight | ✗ | ☑ |
Different Types of Tokens

With a lot of crowd subscribers feeling like they’re left high and dry after backing an ICO crowdfunding project offering utility tokens in exchange, the blockchain industry seems to be moving away from this “pump and dump” idea and favouring security tokens.

The question is, what makes them so different from other digital tokens?

Generally speaking and certainly oversimplifying, tokens can be roughly divided into utility and security tokens. Distinguishing between these two is imperative, as they function in very different ways.

Utility Tokens

The best way to describe a utility token is that it’s a coin backed up by a project.

Typically, when users buy utility token, they want to receive some definable benefit in return – whether that’s in the form of a profit or service.

There’s an upper cap on the maximum utility token availability, causing the value of them to go up because of the supply-demand equation.

The idea of supply-demand is that the higher the demand for an asset, the smaller the supply is going to be. This then causes the price of the token to shoot up. To draw a parallel, you’ll notice the same thing happening with everyday products on Amazon, with sellers increasing their asking price when the demand is high, and the supply is limited.

Security Tokens

In contrast, a security token doesn’t need to have a utility attached to it. This type of token is a digital form of traditional securities, such as (to name a few) an ownership position in a company, bonds, derivatives, and other ownership rights. In other words, security tokens are securities in a tokenised form.
From a legal and compliance viewpoint, the major difference between utility and security tokens comes down to one factor; **security tokens are much more heavily regulated by governments and organisations than utility tokens.**

This is why running security token offerings (STOs) is becoming an increasingly popular way of investing in a blockchain company as opposed to an ICO offering volatile forms of utility tokens.

As of today, there are five types of security tokens:

- **An equity token** – these represent the value of shares issued by a company on the blockchain. The only difference between this type of token and a traditional stock is in how the ownership is recorded. A conventional stock is logged on a database and records are represented by a paper certificate, whereas an equity token is registered on an immutable blockchain. Based on its nature, owning an equity token gives you a portion of the company’s profits, in some cases together with the right to vote in General Meetings.

- **A debt token** – these tokens represent debt instruments like real estate mortgages and corporate bonds. Debt security tokens typically produce a regular dividend based on the payments of the underlying debt instrument and are subject to the risks of default of the
Security Token Offerings in Europe

debtors or drastic changes in the valuation of the debt. A smart contract can represent a debt security token and can include repayment terms and different risk factors associated with the underlying debt.

A **real asset token** – this token represents ownership of a particular asset like real estate or commodities. Blockchain technology ensures there’s a transparent record of complicated transactions, helping to track goods and reduce fraud.

A **hybrid/convertible token** – this token converts between debt and equity-based on their behaviour.

A **derivative token** – this token derives its value from underlying tokens or assets.

Once the ownership of a security token is verified, holders can trade away their tokens for other assets, use them as a bargaining chip for a loan or store them in different wallets.
To answer the question ‘To STO or not to STO?’, it’s useful to summarise both the advantages and disadvantages of security tokens, to preliminary understand if your decision to tokenise certain assets makes sense or not.

Advantages of security tokens

Trust – security tokens are permanently stored on a blockchain; hence, they are immutable and unerasable. Further, as soon as a security token is transferred on a blockchain, it can be traced, no matter how old is it or how many times it has been exchanged.

Transparency – the transfers of the security tokens are transparent, and their owners can easily demonstrate they are allowed to exercise the rights attached to them just showing such tokens are in their wallets.

Fractional ownership – security tokens can be fractioned into almost infinitesimal small units of them. Just as an example, a real estate property that costs GBP 500,000 can be an unaffordable investment for only one person. But if its ownership is represented by 500,000 security tokens, which can be fractioned, the same opportunity can be offered to dozens of thousands of persons, each of them investing a relatively small amount of money in turn of partial ownership of the property. Being impossible to reunite so many people at the same time and in the same place (for example, to sign a deed in front of a notary), it can be said that fractional ownership is available for the first time to such an extent.

Security – broadly speaking, storing assets on a blockchain is much safer than relying on centralised systems, and exposes security tokens to risks of failure to a much lower extent.

Worldwide adoption – security tokens can be quickly adopted worldwide and integrated into various distribution platforms, provided that they are implemented with an interoperable standard. Of course, compliance with
different jurisdictions' law and regulations is a topic that must be addressed. At the same time, security tokens can be traded on a globalised network, which is time-zone independent.

Opening the market – financial services and issuance of financial products have been a field in which banks and other financial institutions operated in a monopoly or oligopoly situation. The issuance of security tokens can be done by any licensed legal entity, so more and more players are entering the market. The price competition which stems from this scenario is beneficial for the entire market.

Lean clearing and settlement – the execution of each transaction is done on a blockchain. Therefore, there’s no need for third-parties and their large and expensive infrastructures.

Easy post-offering administration – security tokens and smart contracts can automate many post-offering tasks, such as the payment of dividends.

Disadvantages of security tokens

Lack of or unclear regulation – the companies which issue security tokens have to comply with regulations. In some jurisdictions, the issuance and administration of security tokens can be a burdensome activity. There’s a reasonable expectation that, in the next future, the process will become more and more manageable, thanks to increasingly widespread adoption of legal and regulatory standards.

Lack of culture – for the time being, many investors aren’t familiar with the technology. It must be remembered that the investor himself holds his security tokens and that he can’t rely on the custodial services offered by his bank, for example. The lack of culture might result in a ‘barrier to entry’ that must be kept into considerations by the companies which plan to launch an STO.
Removal of experienced professionals – while the absence of intermediaries is usually perceived as a pro, it’s a risk at the same time. Security tokens don’t require third parties which, in several cases, offer their experience and ensure a high level of security to the entire market.

The bad reputation of the blockchain – security tokens can’t be compared to cryptocurrencies or utility tokens. But a side effect of the lack of culture we mentioned before is the risk that the bad reputation ICOs is mixed up into security tokens.
The shift from ICOs to STOs is well and truly in motion, with the blockchain market appearing to favour a more secure means of investing in a company.

Businesses and investors can see the value in STOs. Offering these assets alongside cryptocurrency enables them to establish themselves as early adopters and broaden their portfolios.

Having the ability to mix assets and change depending on the state of the market provides peace of mind. Naturally, this has lead to governments and organisations across the EU taking a keener interest in the legal and compliance measurements.

**Understanding MiFID II**

An excellent place to start when talking about securities and regulation is the MiFID II – Financial Instruments Directive (2014/65/EU). This defines what constitutes a security and is used to regulate EU member states.

European law regarding issuing and trading securities are still being integrated into various investments and financial instruments. Nonetheless, issuing, offering and trading security tokens are now compliant across Europe.

As of today, all investment firms require authorisation in their home member state. Once this is obtained, they can then get a passport across the entire single market. The MiFID II regulation also deals with investor protection and the function of the markets.

In regards to investor protection, the MiFID II is there to distinguish between retail clients, professional clients and eligible counterparties (in increasing order of sophistication). While for the function of the markets, the regulation establishes the difference between regulated exchanges, multilateral trading facilities (MTFs) and organised trading facilities (OTFs).
The directive covers primary services like:
• reception, transmission and execution of trading orders;
• portfolio management and investment advice;
• underwriting and placement of financial securities;
• operating of trading facilities.

The MiFID II is one of the most important pieces of regulation as far as securities go, with everyone wanting to trade legally required to follow the stipulations.

While the application of MiFID to crypto-assets and tokens is still unclear, with them not being considered as financial instruments, it’s always advisable for businesses and investors to familiarise themselves with its main provisions.

Furthermore, to remain compliant when issuing transferable securities as a part of an STO, companies might have to provide a prospectus to investors.

**The Prospectus Regulation**

To coincide with the switch from ICOs to STOs, the **Prospectus Regulation** (2017/1129) has come into full effect across the EU from 21st July 2019.

This move follows the first directive in 2003 and the revised version in 2009.

The new regime means that companies must provide a legal document, otherwise known as a prospectus, to potential investors about the securities they are issuing and about themselves. It should also contain detailed information about the company's finances, shareholding structure and business.

The idea is that it will give investors true transparency on who they're dealing with. These stipulations should simplify the rules, streamline related administrative procedures and make it more cost-effective for SMEs to
access capital markets via STOs.

Who’s exempt from the Prospectus Regulation?

Security issuers operating in EU member states can be exempt from having to draw up a prospectus if the value falls under certain thresholds – as per Article 3.3(b) of the Prospectus Regulation.

According to the European Securities and Markets Authority (ESMA), the thresholds for certain countries is as follows:

- €1 million threshold – Slovakia, Romania, Latvia, Hungary, Czech Republic, Cyprus and Bulgaria
- €2.5 million threshold – Poland and Sweden
- €3 million threshold – Slovenia
Security Token Offerings in Europe

- €5 million threshold – Austria, Belgium, Croatia, Estonia, Germany, Greece, Iceland, Ireland, Lithuania, Luxembourg, Malta, Netherlands, Norway, Portugal and Spain
- €8 million threshold – UK, Italy, France, Finland and Denmark.

Those countries who have opted for higher thresholds are arguably more STO friendly, giving smaller crypto start-ups easier access to funding.

If an EU company doesn't fall under the exemption thresholds and want to issue security tokens, they can do so by utilising a new simplified prospectus regime called “EU Growth Prospectus”.

To qualify for this, Article 15 of the Prospectus Regulation states that SMEs must meet at least two of the following criteria:
- The company has less than 250 employees on average during the year;
- The company’s total balance sheet doesn’t exceed €43 million;
- The company’s annual net turnover doesn’t exceed €50 million.

Non-SMEs can also benefit from the “EU Growth Prospectus” if they fall under the following criteria:
- Any other issuer whose securities are traded or are to be traded on an SME Growth Market and they have an average market capitalisation of less than €500 million based on end-year quotes for the previous three calendar years.
- Any other issuer providing that
  - the offer of securities to the public is of a total consideration in the EU below €20 million over 12 months;
  - they have no securities trading on a Multilateral Trading Facility; and
  - they have an average number of employees averaging no more than 499 during the year.
The identification of the best jurisdiction to run an STO from is one of the critical steps of your project and requires you to seek professional advice. No one-fit-all answers are available, because the choice must be made based on the specific characteristics of your project. Further, when it comes to security tokens, many countries are slowly but gradually exiting the regulatory grey area in which they are.

While it must be remembered that the vast majority of European regulators approve STOs on a case-by-case basis, at the time of writing (September 2019) some European jurisdictions seem to be more interesting than others.

We continuously study the status of Blockchain-related regulations globally and have developed our Blockchain Compliance Rank (BCR) — A 10-0 indicator that synthesises, for each country, the current national regulations applicable to crypto-projects, the ‘ease of doing business’ and the overall country risk.

Our website shows the updated BCR, which is also available on our monthly Blockchain Compliance Bulletin, which can be downloaded for free at blockchainconsultus.io.
Estonia

Estonia is home of a considerable amount of blockchain-related projects, and its regulator shows proofs of its willingness towards such business ideas.

The country offers one of the highest thresholds in Europe to benefit from an exception to file a prospectus. Dealing with the Estonian regulator Financial Supervision Authority (EFSA) is usually a hassle-free activity.

France

During the Paris Blockchain Week in April 2019, the French Minister of Economy and Finance, as well as the Secretary of State in charge of digital affairs, have reiterated their wish for France to become the first European technological hub for blockchain.

With Decree number 2018-1226 dated 24th December 2018, France was one of the first countries to enable the registration of securities on blockchain, attaching the same legal value to them as regular titles.
Since July 2018, Article 211-2 of the General Regulations of the French financial regulator (Autorité des Marché Financiers) provides that offers of financial securities for total consideration up to 8 million euros don’t constitute a public offer, hence are exempt from submitting a prospectus.

**Germany**

After over 130 security token prospectus was submitted to the German regulator, BaFin eventually approved the first projects.

**Liechtenstein**

The Liechtensteiner Blockchain Act provides a legal basis for security tokens, ownership of any digital assets, transfer of ownership of digital assets, security token exchanges and storage of digital assets. While the Principality is not a member of the European Union, it participates in the EU internal market, agencies and programmes.

**Lithuania**

The current Lithuanian Law on Crowdfunding and Brokerage/Investment advisory activity regulation allows the local licensed brokers and crowdfunding platform operators to raise the capital of their clients also through security token offerings.

Operating within the EU, Lithuanian licensed operators are allowed to distribute securities and other tokenised instruments all over the Union, offering them to a wide range of investors.
Luxembourg

On 14th February 2019, Luxembourg legalised the use of blockchain technology in financial services with the passing of Bill 7363.

Amongst other things, Bill 7363 also allows Luxembourg to make transferring securities much more efficient by significantly reducing the number of intermediaries. The law refers to security tokens as ‘dematerialised securities.’

Malta

Under the Maltese current regulatory regime, all digital assets can be placed in one of four categories:
- Virtual tokens (utility tokens)
- Financial instruments (including security tokens)
- Electronic money
- Virtual financial assets.

The Financial Instrument Test (FIT) is the tool to understand in which category your token falls.

Security tokens offerings fall outside the scope of the Virtual Financial Assets Act (VFAA) and are regulated under the EU directives, the Malta Investment Services Act and the Malta Companies Act.

Netherlands

The Netherlands is emerging as an attractive jurisdiction for the issuance of security tokens, and the legal burden associated with it is currently relatively low. The flexibility of the Dutch corporate law and the low issuance requirements applicable to fundraising efforts are the
two main factors to be taken into consideration by STO issuers.

**Switzerland**

According to the Swiss financial regulator, FINMA, security tokens are subject to the same regulations as other securities (such as stocks, bonds and derivatives.) Further, STOs are subject to the so-called ‘Big Fives’ Swiss banking regulations (Stock Exchange Regulation Act, Anti-Money Laundering Regulations, Banking Regulations, Financial Market Infrastructure Regulations and Collective Investment Scheme Regulations.)

Sales activities relating to security tokens may trigger:
- Swiss securities dealer licence requirements, under the Swiss Stock Exchange and Securities Trading Act;
- Swiss trading platform regulations under the Financial Market Infrastructure Act; or
- Swiss prospectus requirements.

Entities creating security tokens may become ‘issue houses’ or ‘derivative firms’ and therefore require a securities dealer licence.
How to Get an STO Greenlighted by the Regulator

Broadly speaking, STO issuers and the professionals involved in such an activity have no guidelines to follow. In any case, the experience gained in the field allows us to identify a 3-step process.

Step 1: Get your business in order

Regulators aren’t easy-going entities: obtaining their approval isn’t easy, both for ‘traditional’ financial products and DLT-based solutions.

Even before you start your relationship with them, you must clarify your motivations within your business: why you believe that an STO is the most efficient method of fundraising for your goals? Which added value would be brought by a large pool of international investors if compared to a small pool of sophisticated investors or experienced venture capitalists?

Step 2: Talk to the regulator. And listen to them

As we wrote above, regulators rule on a case-by-case basis and, especially with emerging technologies, the applicant must talk to them, not just about the product it’s building but on the ecosystem at large.

Therefore, you must take into account to have to go back and forth with the regulator for a series of conversations about different topics: how the transactions work, which additional risks come with the blockchain, which opportunities are offered by DLTs, which unique features your product is going to offer to the market, which security measures will be put in place, and so on. In some cases, the officers you will talk with will know the answers to their own questions, but use them to understand your trustworthiness.
During such conversations, to listen to them is critical. It will help you to focus on the regulator’s concerns and provide them with reassurances about them.

This step might require time. Up to one year, in some cases. So, be prepared, and be sure that this timeframe fits your business’ needs.

**Step 3: Draft a prospectus**

The prospectus must identify your target market and its characteristics and cover all conceivable risk factors that exist for investors. They have been one of the topics of your previous conversations with the regulator.

The prospectus must also make (and justify) projections, with assets and liabilities clearly declared and broken down.

An extensive history of the issuer and its business activities must be laid out, in a language that the investor will understand.
The Future of Security Tokens

Over the next couple of years, there are some fantastic opportunities for European security offering as existing laws continue to be modified for the integration of distributed ledger technology, plus easier access.

Some companies have already sold and issued their security tokens by using the countries’ regulatory stipulations to navigate themselves to the best possible outcome successfully.

Looking ahead, Mesh, a Finnish company specialising in “pay later” solutions and consumer lending will incorporate in Finland as their home base. While the blockchain-based lending platform, BitBond is expected to build upon their recent regulated STO success, having raised €2.1 million in funding.

With investors seemingly preferring the transparency of security tokens and its regulatory ties, the future of this commodity is bright within the blockchain space.
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Blockchain ConsultUs Ltd.
Kemp House, 160 High Road
London EC1V 2NX, England
contact@blockchainconsultus.io
+44 (0)20 8798 0253

blockchainconsultus.io
linkedin.com/company/blockchain-consultus
t.me/blockchaincompliance

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