Germany Introduces Electronic and Crypto Securities

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After having published its blockchain strategy in September 2019, the German Government has now taken a first step to deliver on its promise to allow electronic and blockchain based securities[1] and issued a draft law introducing digital securities (***Gesetz zur Einführung von elektronischen Wertpapieren, "eWpG"***).

For now, the eWpG introduces two types of digital bonds only. The limitation of the eWpG to digital bonds is intended as a test phase. The German Government intends to extend the eWpG to cover other securities, such as stocks or investment fund units, at a later time after gaining some experience with digital bonds.

The German Government aims at having the final law passed by the end of 2020.

Traditional Paper-based Securities Framework

To date, German law generally requires most securities to be paper-based, i.e., when new securities are issued a physical certificate either in the form of a global certificate (*Globalurkunde*) or in the form of an individual certificate (*Einzelurkunde*) needs to be issued. The rules governing the transfer of such securities are the same rules that govern in-rem transfers of objects. This means that the securities holder acquires the rights embodied in the securities certificate by way of acquiring the ownership, or in the case of a global certificate, the co-ownership in the certificate. This principle is also described as "the right from the paper follows the right on the paper" (*das Recht aus dem Papier folgt dem Recht am Papier*).

The eWpG now dematerializes the securities but subjects them to the same rules as traditional paper-based securities.

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[1] See our client update of April 27, 2020 available at:
https://www.debevoise.com/insights/publications/2020/04/blockchain-2019-year-in-review.

Two Types of Digital Securities

Although the idea of introducing digital securities is part of the German Government's blockchain strategy, the eWpG takes a two-pronged approach by introducing two relatively different types of digital securities:

- **Electronic Securities**: digital securities that will be registered in a central securities register and that use the same custody and trading infrastructure as traditional paper-based securities; and

- **Crypto Securities**: digital securities that will be registered in a crypto securities register and that will require an entirely new custody and trading infrastructure based on distributed ledger technology ("DLT") or similar technology, yet to be developed.

Central Electronic Register

The central electronic register must be administered by a central securities depository ("CSD"), which is licensed in accordance with Article 16 of the Central Securities Depository Regulation ("CSDR") and provides its core services as set out in the CSDR in Germany.[2]

Upon the registration of the Electronic Securities in the central electronic register, they will be incorporated into the existing book entry system (*Effektengiroverkehr*) of the CSD. This will enable the Electronic Securities to be traded in the same way as traditional securities on the German and EU capital markets venues. As with traditional securities, the CSD will become the legal owner of the registered Electronic Securities but will hold them as a trustee for the benefit of the beneficial owners.

The CSD must ensure that the central electronic register entries include specific information with respect to the registered Electronic Securities, such as: (i) the material terms of the rights conferred by the Electronic Securities, (ii) the total volume of the issuance, (iii) the nominal amount of each bond, and (iv) the issuer.

As Electronic Securities are designed to use the existing infrastructure for collective deposit of securities (*Girosammelverwahrung*), the eWpG only allows Electronic Securities to be issued as collective (or global) entries, similar to the global certificate in the case of paper-based securities.

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[2]   Clearstream Banking AG would be such an eligible CSD.

In principle, the eWpG permits the central electronic registers to be based on a decentralized recoding system, such as DLT, provided that the records of the administrator of the central electronic register must prevail and the administrator must have the ability to make any final decisions regarding the processing and validity of recorded transactions. This requirement and the fact that CSDs are regulated by the CSDR make it rather unlikely that any CSDs will utilize this option.

Crypto Securities Register

The crypto securities register must be administered by a licensed crypto custody service provider, or by the issuer itself, provided that the issuer has obtained the required regulatory license. As opposed to central electronic registers, crypto securities registers allow global entries as well as single entries for individual holders. It is expected that the single entries approach will prevail for Crypto Securities as this will allow utilization of one of the key advantages of a blockchain based system—the reduction of the need for intermediaries.

A key difference of the Crypto Securities infrastructure from the Electronic Securities infrastructure is that the crypto securities register will register the initial issuance of Crypto Securities and any subsequent transfers of such securities to new holders. The central electronic registers, in contrast, will only record the initial issuance of Electronic Securities, but any further transfers of such securities will be recorded by way of book entries in the existing book-entry system (*Effektengiroverkehr*) of the CSD.

Regulatory Framework

From a regulatory perspective, the administration of a crypto securities register will be considered a financial service within the meaning of the German Banking Act (*Kreditwesengesetz*) and will thus require a license under the German Banking Act. The administrators of crypto securities registers will therefore be subject to supervision by the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht,* "BaFin").

To obtain a crypto securities register license, the administrator must comply with a number of requirements generally applicable to providers of regulated financial services, including:

- capital adequacy requirements, i.e., an initial capital of EUR 730,000;

- reporting obligations;

- organizational requirements, such as the minimum requirements for risk management as issued by BaFin;

- qualifying holdings control rules; and

- anti-money laundering regulations. In principle, the holders of Crypto Securities can be registered using a hash, but nevertheless, the administrator needs to be able to appropriately identify each individual holder, i.e., the actual wallet holder.

Unlike Electronic Securities, Crypto Securities registered on a crypto securities register, and their terms, must also be published in the German Federal Gazette and notified to the BaFin. This requirement is designed to ensure a sufficient level of transparency and to allow the verification of registration information in the case of an unauthorized tampering with, or the unavailability of, the crypto securities register system.

The eWpG clarifies that the safe custody of Crypto Securities is considered as "usual" safe custody business (*Depotgeschäft*) within the meaning of the German Banking Act and covered by the safe custody business license. Service providers offering safe custody of private keys relating to Crypto Securities that do not have a safe custody business license will require the crypto assets custody business license, which was specifically introduced under the German Banking Act as from 1 January 2020 in order to regulate the safe custody of blockchain tokens that qualify as securities.

Depending on the services provided by the administrator of a crypto securities register, it is also conceivable that the administrator will be considered as a CSD for purposes of the CSDR and will therefore need a CSD license.

Technical Design Requirements

As opposed to central electronic registers, there is no existing regulated infrastructure for crypto securities registers. The eWpG therefore provides for particular requirements regarding the technical design of crypto securities registers. In particular, a crypto securities register must:

- be decentralized and based on a state-of-the-art technology;

- provide for protection against unauthorized deletion, subsequent modification or any forms of forgery;

- provide for a mechanism of transaction recording that ensures that transactions are recorded in the order that they have been received;

- sufficiently ensure the finality of transactions recorded on the system (this requirement is not entirely clear yet, but it may prove problematic in the case of public permissionless blockchain systems based on probabilistic finality); and

- allow the differentiation between Crypto Securities within the meaning of the eWpG and other private tokenized rights that are stored on the same system but do not constitute Crypto Securities.

The German Government indicates that, based on current state-of-the-art technology, DLT based systems, including private permissioned and public permissionless systems, are considered to be in the best position currently to meet the technical requirements for crypto securities registers. However, the eWpG is expressly designed in a technology-neutral way, i.e., crypto securities registers based on other digital technology will be permitted as long as they can comply with the requirements.

The information to be included in crypto securities register entries goes beyond the information required for central electronic registers and includes in addition: (i) clarification if it is a global entry or an individual entry, (ii) (anonymized) identification of the holder of the Crypto Securities, (iii) information about any transfer restrictions applicable to the Crypto Securities, e.g., due to insolvency of a holder, and (iv) information on any rights of third parties in relation to the Crypto Securities, such as pledges or other security rights.

Civil Law Treatment of Digital Securities

Transfer like an Object (and Paper-based Securities)

As indicated above, the eWpG provides that digital securities will, from a civil law perspective, be treated as "objects" and are thus subject to the same rules governing the transfer of traditional paper-based securities. However, as digital securities lack a physical certificate, a transfer of digital securities requires a digital equivalent for the otherwise physical act of transfer. To this end, registration of the digital securities in a register replaces the physical certificate. Qualifying digital securities as "objects" is perhaps the legislators' most momentous decision under the eWpG as for the first time in Germany—and possibly the world—a digital good is legally considered an object or respectively treated as such.

In order to enable the transfer of digital securities as "objects," the eWpG creates a specific act of transfer of ownership supplementing the existing civil law in-rem transfer provisions and providing for a perfection of the transfer by way of registration by the administrator of (i) the removal of the former holder of the digital securities from the

respective register, (ii) followed by the entry of the transferee as the new holder in the register.[3] The transfer will not become effective before the transferee has been registered as the new holder.

Good Faith Acquisition Rules

A key effect of the qualification of digital securities as objects and of subjecting them to the existing concept of in-rem ownership under German civil law is the application of bona fide rules (*Gutglaubensschutz*) to the acquisition of digital securities. These rules enable an acquirer to rely on the authorization of the seller of digital securities as long as such seller is registered as the holder of such digital securities. In order to achieve such reliance, the eWpG expressly provides, among other things, that (i) the content of the register is deemed to be correct and complete and (ii) the registered holder is legally authorized to dispose of the digital securities. Such bona fide rules do not apply if any transfer restrictions are registered in the respective register or the acquirer has knowledge, or grossly negligently lacks the knowledge, that the registration is incorrect.

The German Government also points out that the bona fide function of the register may, in the future, enable automated settlement procedures where the purchase price is automatically released to the registered holder upon the registration of the new holder, or vice versa, the registration of the new holder is automatically triggered upon the payment of the purchase price to the registered holder. This feature could, particularly in the case of blockchain based crypto securities registers, allow utilization of smart contracts for settlement of transactions.

Crypto Securities vs. Security Tokens

One last question to answer is what is the relationship between Crypto Securities and security tokens, i.e., tokens that have the characteristics of securities.

In Germany, it is a long-standing view of BaFin that blockchain tokens having the characteristics of securities, including debt securities such as bonds and equity securities such as stocks, are to be treated as securities for purposes of German securities regulations.[4] As a consequence, the issuance of such security tokens is subject to

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[3]   In the case of Electronic Securities, the transfer is effected by way of changes to the book entries in the book-entry system of the CSD.

[4]   See BaFin, "Initial Coin Offerings: Advisory letter on the classification of tokens as financial instruments" (Mar. 28, 2018), *available at* https://www.bafin.de/SharedDocs/Downloads/EN/Merkblatt/WA/dl_hinweisschreiben_einordnung_ICOs_en.html and "Second advisory letter on prospectus and authorisation requirements in connection with the issuance of crypto tokens, *available at* https://www.bafin.de/SharedDocs/Downloads/EN/

prospectus requirements and other capital market regulations. In this respect, the eWpG again takes an open approach. It does not subject all security tokens to the new rules, but it introduces Crypto Securities as an additional option. It remains in the discretion of the issuers which regime to use.

A key advantage of Crypto Securities is that the underlying civil law and securities regulatory framework has been specifically created or modified to address them. Other security tokens, on the other hand, continue to face legal uncertainty as the applicable legal framework was not created with blockchain tokens in mind and their treatment under the existing legal framework still raises a number of questions.

Outlook

To date, the draft law has received very good reviews from both the business and the legal communities. It has the potential to finally conform the German securities market to international standards and to introduce innovative technologies to the market. In our view, the two-pronged approach of the new law is a good feature. While the use of the existing infrastructure for Electronic Securities may be more appealing to institutional investors, the Crypto Securities framework may be able to attract private investors and consumers and allow the utilization of the benefits of blockchain.

Still, a lot of work is ahead. First, the eWpG is only a draft law and may be altered in the course of the legislative process. Once passed, it will require additional regulations and guidance as to the technological requirements. It also remains to be seen if the existing CSDs will be willing to adapt their infrastructure to cover Electronic Securities.

Regarding Crypto Securities, a key question is whether the public permissionless blockchain systems based on probabilistic finality will be able to comply with the draft law's requirements regarding transaction finality. The statements of the German Government in this regard suggest that this is not the case, but that additional technical measures to be implemented by administrators may be viewed as equivalent.

Another question is whether the option for issuers of Crypto Securities to administer the associated crypto securities register themselves is a viable one. Such self-administration would be crucial to achieve one of the ultimate goals of blockchain technology—independence from intermediaries. Given the licensing requirements for administrators of crypto securities registers and the associated costs, it appears doubtful that this is an economically viable proposition for issuers.

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