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Information Letter (WA)

GZ: WA 11-QB 4100-2017/0010

Supervisory classification of tokens or cryptocurrencies underlying so-called Initial Coin Offerings (ICOs) as financial instruments according to securities supervision laws

In light of increased inquiries to BaFin's department of securities supervision / asset management (WA) regarding the question as to whether tokens or coins or cryptocurrencies (for purposes of this information letter all referred to as "tokens") underlying the so-called Initial Coin Offerings (ICOs)¹ constitute financial instruments according to securities supervision laws, this information letter provides information on the regulatory treatment of tokens:

In case of tokens, BaFin (WA) will assess in each individual case whether they constitute a financial instrument according to the German Securities Trading Act (WpHG) or the Markets in Financial Instruments Directive II (MiFID II) or a security according to the German Securities Prospectus Act (WpPG) or an asset investment according to the German Asset Investment Act (VermAnlG). This assessment depends on the legal requirements according to securities supervision laws, i.e. particularly the WpHG, WpPG, Market Abuse Regulation (MAR), VermAnlG as well as other relevant laws and applicable national and EU laws regarding securities supervision.

Market participants that are providing services regarding tokens, trade tokens or publicly offer tokens, are requested to carefully check if it constitutes a regulated instrument, this means, e.g. a financial instrument in accordance with Sec. 2 para. 4 WpHG or a security in accordance with Sec. 2 No. 1 WpPG in order to completely adhere to applicable legal requirements. This is also stated in the warning note of the European Securities and Markets Authority (ESMA) dated 13 November 2017.² The obligation to adhere to applicable legal requirements particularly applies in light of applicable authorisation requirements according to the German Banking Act (KWG), Capital Investment Act (KAGB), Insurance Supervisory Act (VAG) or Payment Services Supervisory Act (ZAG). For any questions whether an authorisation is required according to the KWG, KAGB, VAG or ZAG, the Authorisation Requirement and Pursuit of Prohibited Dealings Unit (*Abteilung Erlaubnispflicht und Verfolgung unerlaubter Geschäfte - EVG*) of BaFin (*business area transaction*) is the responsible body.

The information provided in this information letter is limited to the laws applicable to securities supervision. It does not affect the *Guidance Note on Financial Instruments (Shares, Asset Investments, Debt Securities, Other Rights, Shares in Investment Assets, Money Market Instruments, Foreign Currencies and Accounting Units)*³ or the *Guidance Note on Financial Instruments (Derivatives)*⁴.

¹ See No. 5 below for background information on ICOs.

² https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Anlage/anlage_meldung_171109_ICOs_esma_firms.html

³ https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Merkblatt/mb_111220_finanzinstrumente.html

⁴ https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Merkblatt/mb_120521_finanzinstrumente_derivate.html

1. Financial Instruments in accordance with Sec. 2 para. 4 WpHG / Annex I Part C MiFID II

Depending on their characteristics in each individual case, tokens may be regarded as financial instruments in accordance with Sec. 2 para. 4 WpHG or Annex I Part C MiFID II. Again, depending on their characteristics in each individual case, tokens may be regarded as a security (Sec. 2 para. 4 No. 1 in connection with Sec. 2 para. 1 WpHG or Art. 4 para. 1 No. 44 MiFID II), as a share in investment assets (Sec. 2 para. 4 No. 2 WpHG in connection with Sec. 1 para. 1 KAGB or Annex I Part C (3) MiFID II) or as an asset investment (Sec. 2 para. 4 No. 7 WpHG in connection with Sec. 1 para 2 VermAnlG⁵).

Additionally, a token can also constitute the basic value for a **derivative transfer** (Sec. 2 para. 3 WpHG or Annex I Part C (4) or (9) to (10) MiFID II). If a token forms the basic value as part of a derivative transfer, the derivative transfer is to be regarded as a financial instrument. For details on any authorisation requirements in this case, please refer to the *Guidance Note on Financial Instruments (Derivatives)*⁶.

The legal classification of tokens requires a precise **assessment in each individual case**. When considering the question whether a token constitutes a financial instrument in accordance with the WpHG or MiFID II, it is not a determining factor whether the same token is to be regarded as an accounting unit in accordance with Sec. 1 para. 11 1st sentence No. 7 KWG. According to Sec. 2 para. 4 WpHG, accounting units are – contrary to the KWG – no financial instruments.

a. Security in accordance with Sec. 2 para. 1 WpHG / Art. 4 para. 1 No. 44 MiFID II

The requirements for a token to be regarded as a security in accordance with Sec. 2 para. 1 WpHG or Art. 4 para. 1 No. 44 MiFID II, include in particular:

- it needs to be transferable;
- it needs to be able to be traded on the financial market or the capital market, whereby cryptocurrency exchange platforms can generally be regarded as financial markets or capital markets in accordance with the securities definition;
- the token must embody rights, i.e. shareholders' rights or contractual rights or rights comparable with shareholders' rights or contractual rights that are embodied in the token; and
- the token must not fulfil the requirements of a payment instrument as stipulated in Sec. 2 para. 1 WpHG or Art. 4 para. 1 No. 44 MiFID II).

A securitisation of the token in a certificate is not a strict requirement of a transferable security in connection with Sec. 2 para. 1 WpHG and Art. 4 para. 1 No. 44 MiFID II. It is sufficient if the holder of the token can be documented, for example by reference to the distributed ledger or blockchain technology or based on similar technologies.

Whether a particular token fulfils these requirements cannot be answered in general but always requires an assessment of the characteristics in **each individual case**. The key factor is the characteristics of the rights embodied in the token. A mere labelling as a token, e.g. as a "utility token" is not relevant to the legal analysis.

The classification of a financial instrument as a security in accordance with Sec. 2 para. 1 WpHG is generally also relevant for the assessment whether and to what extent the WpPG applies or any other capital market laws and EU regulations (e.g. MAR) that refer to "transferable securities" in accordance with Art. 4 para. 1 No. 44 MiFID II.

⁵ The German VermAnlG is not based on MiFID II.

⁶ https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Merkblatt/mb_120521_finanzinstrumente_derivate.html

b. Share in investment assets in accordance with Sec. 1 para. 1 KAGB / Annex I Part C (3) MiFID II)

Depending on the situation in each individual case, a token can also be regarded as a share in investment assets (Sec. 1 para. 1 KAGB) or in a system for shared investments (Annex I Part C (3) MiFID II). If there is a share in a system for shared investments underlying the token, this would also constitute a financial instrument in accordance with the WpHG or MiFID II.

BaFin has summarised what constitutes investment assets in its *Interpretation Letter Regarding the Application of the KAGB and the Term "Investment Assets"*⁷.

c. Asset investment in accordance with Sec. 1 para. 2 VermAnlG

Depending on the circumstances, tokens can also be regarded as asset investments in accordance with the VermAnlG and therefore as a financial instrument in accordance with the WpHG. This requires, as stipulated in Sec. 1 para. 2 VermAnlG, that the token must not constitute a share in accordance with the WpPG. Additionally, the token must not represent a share in investment assets in accordance with Sec. 1 para. 1 KAGB and the acceptance of the monies must not be classified as a deposit (Sec. 1 para. 1 2nd sentence No. 1 KWG). Depending on the legal characteristics, a token can be regarded, among others, as a share in a company (Sec. 1 para. 2 No. 1 VermAnlG), as a shareholder loan or as a subordinated loan (Sec. 1 para. 2 No. 3 or 4 VermAnlG), as a participation right (Sec. 1 para. 2 No. 5 VermAnlG) or as another form of investment (Sec. 1 para. 2 No. 7 VermAnlG).

Whether the legal requirements are met so that the VermAnlG applies, needs to be assessed individually for every token.

2. Security in accordance with Sec. 2 No. 1 WpPG

Depending on their characteristics, tokens may also be classified as securities in accordance with Sec. 2 No. 1 WpPG. This classification also requires a **precise assessment in each individual case**. With respect to the requirements to classify tokens as securities in accordance with Sec. 2 No. 1 WpPG in each individual case, the same details as set out in para. 1) a. above (Security in accordance with Sec. 2 para. 1 WpHG / Art. 4 para. 1 No. 44 MiFID II) apply.

3. Consequences of classification as a financial instrument or as a security in accordance with the WpPG

If a token satisfies the requirements of a financial instrument in accordance with the WpHG or MiFID II or those of a security in accordance with the WpPG, market participants may be subject to the relevant securities laws as well as the supervisory rules contained therein. This particularly applies to the WpHG, WpPG, MAR, Markets in Financial Instruments Regulation (MiFIR), VermAnlG as well as other relevant laws and applicable national and EU laws on securities supervision. If a token satisfies the requirements of a share in investment assets (see part 1) b. above), the KAGB will apply to such token.

⁷ https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Auslegungsentscheidung/WA/ae_130614_Anwendungsber_KAGB_begriff_invvermoegen.html

It should be noted that the requirements of whether or not MAR is applicable depend on the definition of a financial instrument in accordance with Annex I Part C MiFID II. Additionally, the requirements of Art. 2 MAR need to be considered, particularly a planned or current trade with the tokens on one of the markets covered by MAR.

If there are any regulatory questions regarding tokens, affected market participants should align with the relevant BaFin experts well before any planned projects or transactions. The relevant experts can be found on the BaFin *Organisational Allocation Plan*.⁸

If applicable regulatory requirements are not adhered to, this may result in BaFin prohibiting the relevant projects or transactions. Additionally, such infringements may constitute administrative offences which may carry fines. To the extent there is any indication of offences being committed, the matter will be referred to the competent prosecution service.

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

Depending on the circumstances, trading with tokens as a bank business, namely principal broking services (Sec. 1 para. 1 2nd sentence No. 4 KWG) or underwriting business (Sec. 1 para. 1 2nd sentence No. 10 KWG) or as a financial service, namely in the form of investment broking, investment advice, operating a multi-lateral or organised trading facility, placement business, contract broking, financial portfolio management, own-account trading or investment management (Sec. 1 para 1a 2nd sentence Nos. 1-4, 11 KWG), may be subject to the **obligation to seek prior permission** in accordance with Sec. 32 para. 1 KWG. This authorisation requirement depends in each individual case on whether the token is to be classified as a financial instrument in accordance with Sec. 1 para. 11 KWG. The definition of financial instrument contained in the KWG is broader than that in the WpHG, particularly as it also includes foreign currencies and accounting units and therefore also methods of payments created **under private law** (so-called cryptocurrencies) that are intended to be used in computer networks as **secondary money** (synthetic alternatives to legal methods of payment). Those operating a banking business in accordance with Sec. 32 para. 1 sentence 1 KWG or offering financial services without the relevant licence, may face imprisonment of up to five years or a fine, as stipulated in Sec. 54 para. 1 No. 2 KWG.

In individual cases, tokens may also qualify as a share in investment assets (see part 1) b. above). This may require prior permission in accordance with the KAGB.

According to settled case law, it constitutes an insurance business if certain services are taken on for a certain price and in case of an uncertain event occurring, whereby the risk taken on is spread amongst numerous persons facing the same danger and whereby the risk is accepted based on a calculation based on the law of averages. However, this does not include agreements that have an internal connection with a contract of a different kind and which are legally shaped by this other contract. This is the case where the relevant agreement is connected with another contract that is not an insurance contract and where the agreement is to be classified as an ancillary agreement of this main agreement (see BGH judgment of 23 November 2016, IV ZR 50/16 with further references). Carrying on insurance business requires a licence in accordance with Sec. 8 para. 1 VAG.

If third parties are involved (e.g. an internet platform operating as an exchange to convert virtual money into legal tender), it is not only the operation of a multi-lateral trading facility which requires a licence in accordance with Sec. 1 para. 1a 2nd sentence No. 1b KWG but a licence may also be required for offering payment services in accordance with Sec. 10 para. 1 ZAG. If the third party transfers the

⁸ https://www.bafin.de/SharedDocs/Downloads/DE/Liste/dl_organigramm.html?nn=7854478

real value of the token at the request of the acquirer to the exchange recipient via its own account, it is the third party that is operating the money remittance business (Sec. 1 para. 1 2nd sentence No. 6 1st alternative ZAG). If it acts at the request of the payment recipient, this may also constitute an acquisition business in accordance with Sec. 1 para. 1 2nd sentence No. 5 2nd alternative ZAG. A combination of both is also possible, for example if the payment services provider is acting for both sides of the exchange transaction, which can often be the case for internet platforms. The key factors are the individual agreements between the relevant parties, as is always the case when evaluating whether or not an authorisation is required.

5. Background information on Initial Coin Offerings

An Initial Coin Offering (ICO) is a method to raise capital with the help of so-called “tokens”. An ICO is also sometimes called an Initial Token Offering or a Token Sale. In case of an ICO, a company or an individual issue tokens and sell them in exchange for legal tender, such as Euros, or even more frequently in exchange for virtual currencies such as Bitcoin or Ether.

The characteristics and the purpose of the tokens can differ from one ICO to another. Some tokens allow for the usage or the purchase of services or products which the issuer develops with the money received from the ICO. Others transfer voting rights or shares in future profits of the issuer. Some tokens do not have a concrete market value. Other tokens are traded and/or can be exchanged into regular or virtual currencies on specialised cryptocurrency dealing platforms after they have been issued.

ICOs are carried out online, i.e. on the internet or via social media. The tokens are usually generated and spread using the distributed ledger or blockchain technology (DLT). ICOs are used to generate means for a number of different projects, among others for transactions using DLT.

Please contact us if you have any questions on the BaFin information letter or the regulation of tokens, token sales or ICOs in general.



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As co-initiator of an international alliance of fintech lawyers and a board member of the European [Fintech Alliance](#), a platform representing the strategic interests of the Fintech Industry in Europe, Frank has built strong relationships with industry stakeholders, regulators, and international payment specialists. His passion for the agile fintech and payment industry is the key driver of this blog of which he is the co-founder, publisher and author. Frank speaks regularly at national and international payment and fintech conferences (e.g. at the [Money20/20 Europe](#)).

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