Tokenizing SME Equity

An introduction to the legal classification and the technological implications for issuing security tokens in the Netherlands and the EEA

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The Netherlands

Infloat

Infloat is a research and advisory firm specializing in tokenizing businesses and developing innovative funding models. We fuse our business, financial, and blockchain know-how with market research to develop solutions for over 20 forward-thinking clients from 7 countries.

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New Means of SME financing

With blockchain-enabled cryptocurrencies, small and medium-sized enterprises (SMEs) have recently introduced a new addition to their fundraising toolbox. By so-called 'Initial Coin Offerings' (ICOs), startups were able to to issue a new cryptocurrency to investors in exchange for existing cryptocurrencies or fiat money. More than $12.2 billion was raised in this way, but due to market forces and disappointing results, the amounts raised through public ICOs in Q4 2018 has dwindled.

Replacing this ICO Wild West is a new trend, that may well professionalize the cryptocurrency industry. Cryptocurrencies and the highly regulated nature of traditional securities come together in so-called security tokens. According to some industry enthusiasts, security tokens "hold the potential to unlock trillions of dollars in illiquid assets", and can "unlock a multi-billion dollar liquidity premium market".

But what are security tokens? And how may such benefits materialize for small or medium-sized business?

From facilitating the transfer of company shares to dividend payment and blockchain-based voting, this report provides clarity on security tokens in light of European and Dutch legislation. This report is to be used as a basis for the exploration of improved means for SME equity financing by using blockchain technology and cryptographic tokens.

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1 DEFINING TOKENIZED SECURITIES

A tokenized security is the digital representation of an underlying asset in the form of a cryptographic token. While tokenized securities can represent a wide range of assets, this report focuses on company shares. From a legal point of view, a cryptocurrency or cryptographic token actually qualifies as a security if it meets the legal definition. This qualification of a token as a security is very significant, since it triggers all kinds of regulation. Therefore, we first zoom in on the question: What makes a token a security? In the following paragraphs we discuss some of the consequences of such a qualification.

When a Token Qualifies as a Security

A token qualifies as a security from a legal point of view if it is a digital representation of a share or a share-like instrument, a bond or a derivative instrument regarding the two aforementioned instruments. Furthermore, to qualify as a security the token needs to be negotiable.

Let us dive deeper into each of these aspects.

Share-like instruments are instruments — in this case tokens — that do not represent shares themselves but have the same characteristics, such as the right to receive dividends (a part of a company's profit) or voting power regarding certain decisions which are to be made by a company.

A bond is a fixed income investment. In the case of a tokenized bond, the token represents a loan to a company which borrows the funds for a defined period of time at a variable or fixed interest rate.

Tokens are highly standardized and often created for the purpose of being transferred. Therefore, tokens are in most cases negotiable by nature, unless a token is made non-transferable on the protocol level of the underlying blockchain. The fact that a specific token is not listed on an exchange or even the circumstance that there is no market for it, does not make the token non-negotiable. After all, the token can always be transferred peer-to-peer.

The definition of a security under Dutch law is derived from EU regulations, more specifically the Prospectus Directive[1] and MiFID II[2]. Therefore, this definition is basically the same for all EU countries. However, there are several countries that (will) have extra regulations for tokens that do not qualify as a security, such as payment tokens or utility tokens[3]. Examples of such countries are Malta, Lithuania and France.[4]

Tokenized Depositary Receipts

Tokens can be digital representations of shares in a company. However, under Dutch law — and most other European jurisdictions — shares in a company that are not listed on a regulated market (for example a stock exchange) can only be transferred by means of a notarial deed. This means that it is not possible to transfer these shares via the transfer of tokens on a blockchain.

The transfer restriction does not apply to so-called depositary receipts (share certificates) created by a trust office foundation. In such a structure, a company issues all or a part of its shares to a trust office foundation, which is consequently a shareholder of the company. This foundation in turn issues depositary receipts for the shares it holds. These receipts embody the economic profit rights and the voting rights of the underlying company. Whether the depositary receipts are negotiable or not, depends on the trust conditions under which the trust office foundation issues the receipts. Consequently, the depositary receipts can be made negotiable. In most cases, the depositary receipts only embody profit rights, whereas the voting rights in the underlying company remain with the sole shareholder, being the trust office foundation, which in turn is governed by its board of directors.

Tokens can digitally represent transferable depositary receipts. Since the receipts embody the profit rights of a company, the tokens have the same characteristics and consequently qualify as securities in the context of the previous paragraph. Such tokens can in most cases be transferred freely peer-to-peer. Platforms that facilitate secondary trading are strictly regulated and have to conduct different ongoing checks regarding its clients and their trades. This regulatory framework is beyond the scope of this report.

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[1] Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, soon to be replaced by Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/ECText with EEA relevance.

[2] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU Text with EEA relevance.

[3] For a description of different token qualifications, see https://infloat.co/blog/an-overview-of-different-cryptoasset-categories/

[4] For more on these examples, see https://medium.com/watson-law/lithuania-malta-and-switzerland-how-3-european-nations-are-planning-to-become-blockchain-e74098094e87

The Prospectus Directive and its Exemptions

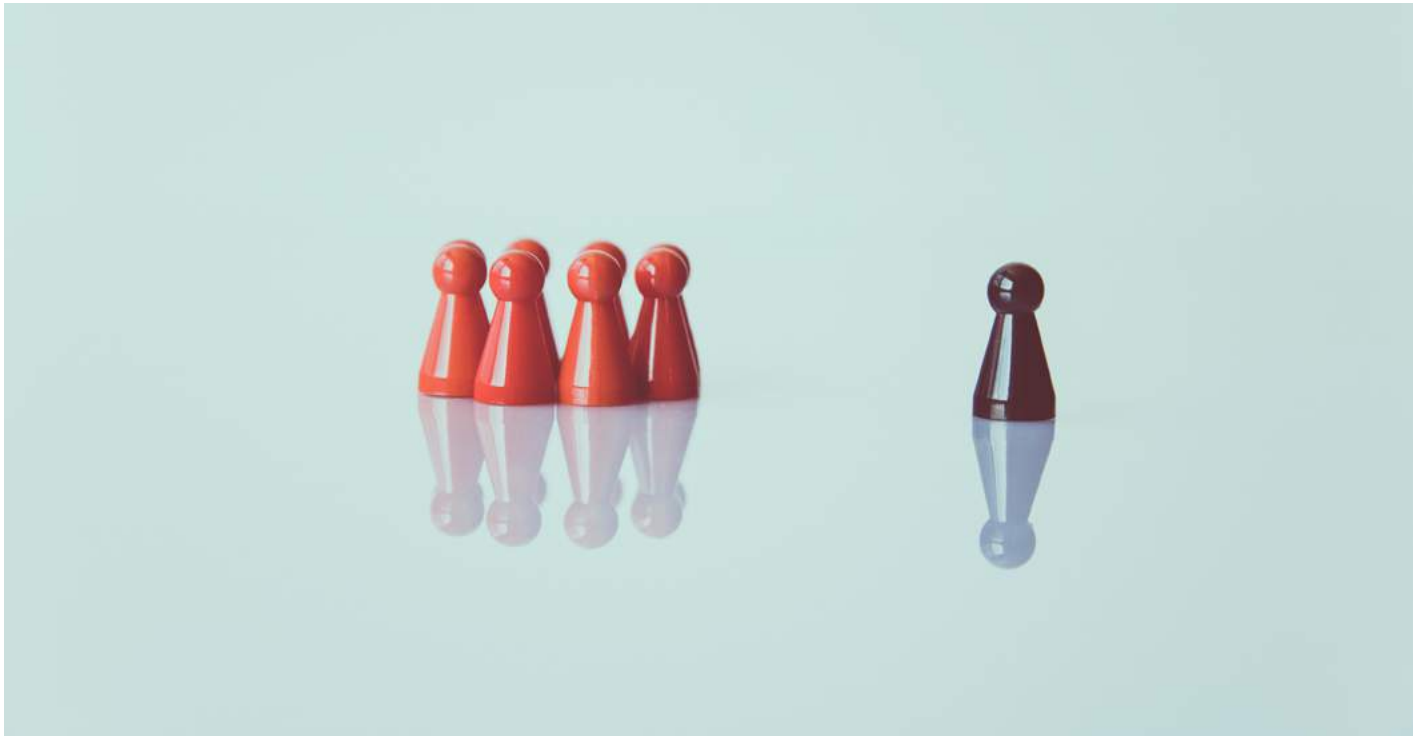
As the offering of securities is strictly regulated, a company is not allowed to freely offer securities to the public. For such an offering a prospectus is required, which has to be approved by the governing authorities. A prospectus is a regulated information document containing information regarding the issuing company and the securities itself. This prospectus rule is derived from the Prospectus Directive. Consequently, it is prohibited to offer tokens that qualify as securities to the entire EU market, without an approved prospectus. This goes for both tokens that represent the depositary receipts from the previous paragraph, tokens that alternatively embody profit rights in a company, or any other form of token that falls within the aforementioned definition of a security.

The prospectus rule derived from the Prospectus Directive does not apply to certain offerings and has several exemptions. The most important offerings to which the rule does not apply are offerings that are solely addressed to qualified investors or offerings that offer securities with a total consideration of less than € 1.000.000,-, which limit is calculated over a period of 12 months.

Furthermore, the Prospectus Directive features certain exemptions to the obligation of publishing an approved prospectus. The exemption that is relevant for the offering of security tokens applies to offerings of which the total consideration over a period of 12 months does not exceed € 8.000.000,-. Member states of the EU can implement this exemption, but are not obliged to do so. The Netherlands has done so, with a threshold of € 5.000.000,-. To make use of this exemption, certain requirements need to be met, including the publishing of an information document. This information document is far less extensive than a prospectus. Furthermore, a so-called 'exemption certificate' — a prescribed image containing a warning that the offering is not regulated — needs to be published on the offering documents and marketing materials relating thereto[5].

[5] https://www.afm.nl/en/professionals/doelgroepen/aanbieders-beleggingsobjecten/conditions-using-exemption-notice

2 TOKENIZED SHAREHOLDER RIGHTS



In the Netherlands and most other countries in the European Economic Area (EEA), it is often an important regulatory requirement to know and control who owns a security at all times. This means that token transfers should have restrictions in order to accomodate regulatory requirements. The exact requirements that need to be accomodated depend on the type of security that is being tokenized, among others.

Transfers can be restricted both during the initial issuance of the token, as well as in the secondary market. Technological advancements allow companies to build restrictions into the blockchain on a protocol level, into the token (smart contract) itself or to keep the transfers within a certain environment (e.g. an approved exchange). Most smart contracts can include a white- or blacklist with approved or disapproved addresses. This means the issuer of the security can ban specific potential holders of the security token, such as decentralized exchanges or non-KYC approved investors.

Facilitating Dividend Payments using Blockchain technology

The company management can decide to have the company share its profit by paying dividends to its shareholders. As a consequence of such a decision, a debt of the company towards its shareholders arises. The company needs to pay this debt in accordance with the general rules regarding the payment of debts. As a consequence thereof, the obligation of a company to pay dividends cannot be fulfilled in cryptocurrency, since bitcoin and other cryptocurrencies are not considered legal tender in the Netherlands, as well as in most European countries. Payout of dividends in cryptocurrency is therefore only possible if a specific shareholder expressly agrees to such a payout. For the same reason, a payment of dividends in cryptocurrency cannot be forced upon a shareholder.

Types of Dividend Payment

Provided that shareholders do agree to a payout of dividends in cryptocurrency, the dividend can be paid in the cryptocurrency native to the blockchain used to issue the security token on. In face of the current prevalence of Ethereum-based security tokens, this will be the Ethereum blockchain in most cases. Since all token holders hold the security in an Ethereum address, the dividend can be easily sent in Ether.

Depending on the company's and shareholders' preferences, dividend can also be paid in a so-called 'stablecoin'. Coins such as Dai or Tether are considered stable, since their value is commonly tied to a fiat currency, such as the dollar or the euro. Most stablecoins are issued on the Ethereum blockchain, and as such allow the company to easily pay dividend to current token holders.

A third option is to pay dividend in security tokens. In the case of tokenized depositary receipts using a trust office foundation, the company would essentially issue shares as a form of dividend. This is possible if certain internal procedural requirements are met. It is beyond the scope of this report to discuss these requirements.

Lastly, companies can opt for the traditional way and pay dividends in fiat currency. This requires information on the bank accounts associated with the holders of the token. In general, with stringent KYC requirements and a controlled trading environment, this is not an issue. But when shares are traded over-the-counter or on decentralized exchanges, it may be a challenge to identify the shareholder and bank account behind the wallet address that is holding the token.

Shareholding Voting with Tokenized Securities

How does shareholder voting work in trust office foundations? During the annual general meeting of shareholders (AGM) of a typical company, depending on the structure of the shares, shareholders can have both a right to dividend and a right to vote. However, usually these rights do not apply to depositary receipts in trust office foundations. As indicated earlier, most companies that are issuing such tokenized depositary receipts through a trust office foundation structure, include economic rights, but exclude voting rights.

However, including voting rights in these tokenized 'certificates' is possible, on basis of an agreement between the company and its new shareholders. In this case, the smart contract that issues the tokens should include a voting function. On a self-appointed time, company management can issue a statement to its shareholders, for which shareholders can vote yes or no.

Challenges and Benefits of On-Chain voting

The voting process for token holders has several requirements. First, voting requires shareholders to hold their tokenized shares (or depositary receipts) in a wallet that they control. This means that one cannot vote in case tokens are held on a cryptocurrency exchange. Second, putting up a statement for a vote is considered a transaction and therefore requires a minimum amount of the cryptocurrency native to the blockchain the security token is issued on (e.g. Ether). Third, on-chain voting requires an access point such as MyEtherWallet or MetaMask, that facilitates interactions between the token holders and the smart contract of the company. Considering these restrictions, on-chain voting is currently not user-friendly.

However, shareholder voting using blockchain technology also has significant upsides. Currently, non-blockchain remote voting is already the most-used voting tool during annual general meetings. Common issues with remote voting relate to transparency, identification, and verification. Especially in the context of cross-border and electronic voting, there is high uncertainty that information is correctly and reliable channelled between shareholders and companies. As such, this method of voting does not offer full transparency or a solid proof to shareholders that their vote has actually been exercised.

On-chain voting may resolve some of these issues. The open nature of blockchain technology nature increases the transparency in the voting process. This does not mean that shareholders can see the content of each other's votes; however, it does allow them to see how many shareholders voted yes or no, and to verify their own voting decision. In addition, it is impossible for token holders to vote twice for the same issue. Together, these aspects of on-chain voting may reduce potential fraud.

Further, it is expected that voting via blockchain technology increases voting engagement, as it removes certain voting barriers. Normally, small shareholders have relatively little incentive to engage in voting, as their costs are oftentimes higher than the benefits they may expect from voting. However, blockchain technology reduces the need to rely on middlemen that facilitate the voting process, and as such, decreases costs, which potentially results in improved engagement from small shareholders. Note that a lot more has been written on the potential benefits of on-chain governance and voting[6].

Safe Token Storage

Regardless of legal obligations, it is imperative for the company issuing the shares and its investors to store their tokens safely and securely. This is particularly the case for large shareholders, who hold significant value in terms of the depositary receipts themselves, and dividend and voting rights. One of the most secure methods of storing tokenized shares is using a multi-signature cold wallet. Such cryptocurrency wallets are 'cold' in that they are not connected to the internet. In addition, a multi-signature wallet allows token transactions to only occur when multiple parties approve. As an additional layer of security, one or multiple signatures of such a wallet can be stored at, for example, a notary's office. Note that such safety measures should not inhibit shareholders from taking specific actions, such as claiming dividend or voting for a proposal of the company. The best way to store tokens safely therefore differs on a case-by-case basis.

[6] See for instance https://ecgi.global/sites/default/files/working_papers/documents/finallafarrevanderelst.pdf and https://medium.com/validitylabs/how-to-vote-safely-with-an-erc20-token-518adadbf923

3 BENEFITS AND LIMITATIONS OF TOKENIZED SECURITIES

Benefits of Tokenized Securities

Aside from decreased friction in voting, tokenizing a security, such as a share-like instrument or bond, may result in a wide range of other benefits. Putting the restrictions of local jurisdictions aside, most arguments in favor of tokenizing any security revolve around speed, liquidity, and cost reductions.

First, cryptocurrency trades are fast. A transaction on the Ethereum network is generally settled under the hour, and often takes just a few minutes to effectuate. Other blockchains such as Stellar increase settlement speed to a few seconds. In contrast, the settlement of transactions of traditional securities generally takes one to two days. There are different reasons for this longer settlement time, but it shows that blockchain technology can make the process more efficient.

Second, security tokens are expected to offer increased liquidity. Due to the international nature of cryptocurrencies, speed, lower cost and peer-to-peer transactions (e.g. in case of a decentralized exchange), investors can more easily buy or sell securities. On the one hand, companies will have increased access to an international pool of investors. On the other, investors will benefit from security tokens unlocking liquidity in traditionally illiquid markets such as startup equity or real estate.

Third, due to the decentralized nature of blockchain technology, fewer middlemen are required to process the security transaction. This is expected to make issuing a tokenized security cheaper than issuing a security in the traditional way. As such, reducing the cost of raising capital may well allow SMEs to more easily acquire funds, resulting in (economic) growth.

These are the obvious benefits of tokenized securities. There are likely many more benefits that will be discovered over the next few months or years. We encourage experimentation.

Limitations to these Benefits

The expected benefits of tokenizing securities include transaction settlement speed, increased liquidity and decreased cost of raising capital. However, whether these benefits materialize is highly dependent on local regulation. As indicated in the first part of this paper, in the Netherlands, privately-held company shares can only be transferred by means of a notarial deed. While tokenized depositary receipts represent shares in the underlying company, legally and practically they are not the same. As a result, while the aforementioned benefits of tokenized securities do apply to tokenized depositary receipts, they do not apply to the actual shares of the company as these cannot be tokenized. Note that other limitations to the benefits of tokenized securities may apply, depending on local regulation.

In addition, the liquidity benefit of tokenized securities is based on the assumption that there are extensive secondary markets for these securities. Whether these secondary markets will indeed appear, is largely dependent on investor appetite for this new type of financial product. At the moment of writing, it is too early to tell whether investor appetite will materialize.

Lets Collaborate

The best way to help further develop and implement security tokens is to ensure that there is clarity on the current treatment of tokenized securities, and that security tokens are not automatically forced into regulatory structures that are (1) designed by incumbents for incumbents, and (2) for traditional models of finance. We should recognize that cryptographic tokens are programmable securities that have a variety of capabilities (such as digital multi-signature escrow) and as such, can offer much more flexibility and reliability when it comes to responding to the needs of SME equity funding and investor protection compared to traditional securities.

If you treat security tokens similar to traditional securities, you miss out on the opportunities to create better solutions for a very broad range of players.

The purpose of this report was to provide clarity on how tokenized securities are currently classified in the context of European and Dutch regulation, by touching upon a wide range of topics, such as tokenized depositary receipts and on-chain voting. This report does not state what the optimal classification should be. Watson Law and Infloat are actively exploring improved means of SME equity financing using opportunities that blockchain technology and cryptographic tokens bring.

We are aware that we are entering unexplored territory from a technological, business and regulatory perspective. We must collaborate to find common grounds and explore solutions for optimal value creation for entrepreneurs and society in general.

Come and join us. Tokenization is already a reality.

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