

Issuing Equity Tokens on the Blockchain

Legal reimaginging



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Andrew Henderson and James Burnie from Eversheds Sutherland, and Jack Thornborough from 20|30 Group, explain how existing law and regulation required adaptation to accommodate a new technology for issuing and settling equity.

Key points

- An Equity Token is a digital representation of the right to participate in a liquidation of a company and possibly further rights, such as voting and dividends.
- Equity Tokens confer beneficial interests in the share on the Equity Token holder which can be transferred to a third person without the consent of the holder of the legal title in the share.
- Classifying an Equity Token as a certificate under Art 80 FSMA (2000) (Regulated Activities) Order seems appropriate and makes it easier to justify the maintenance of an Equity Token register.
- The technological ability to settle via a notional exchange of two different types of token on the Blockchain represents perhaps the most exciting aspect of the model.

The Blockchain's role in capital markets transactions has been discussed elsewhere in this journal as has its application to the recording and safeguarding interests in securities¹. With the first primary distribution and settlement of digital representations of equity interests, known as 'Equity Tokens, on a Blockchain as part Cohort

Four of the FCA 'Sandbox' this role has taken a step forward. The distribution of Equity Tokens, which includes both the primary issuance of Equity Tokens *and settlement* of those Tokens in a Blockchain environment, is not without regulatory and legal challenges which required the adaption of existing regulatory and legal concepts².

Regulatory clarity: basic classification

Regulatory clarity is necessary both for determining whether activities carried on with respect to Equity Tokens, eg arranging for the issuance, are regulated activities under Part IVA of the Financial Services and Markets Act 2000 (FSMA) and whether the issuance is subject to the securities regime under Part VI of FSMA, eg whether an approved prospectus is required.

The FCA's Guidance on Cryptoassets (FCA Guidance)³, which it consulted on in January 2019⁴, has affirmed that the tripartite classification of cryptoassets set out in the Crypt asset Taskforce Final Report, is the starting point for locating Equity Tokens⁵:

¹ See Cohen, Smith, Arulchandran, and Sehra 'Automation and Blockchain in Securities Issuance' (2018) 3 JIBFL 144 and Henderson and Burnie 'Sake-keeping crypto-assets: a push for principle' (2018) JIBFL 690, respectively.

² The challenges to which the secondary trading of Equity Tokens, including those that arise under the EU Central Securities Depository Regulation 909/2014 are not considered here.

³ https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752070/cryptoassets_taskforce_final_report_final_web.pdf

⁴ <https://www.fca.org.uk/publication/consultation/cp19-03.pdf>

⁵ For discussion, see Henderson and Burnie 'The Cryptoasset Taskforce: more breadth required' 2019 JIBFL 101.

- **Exchange Tokens** – tokens for buying and selling goods and services without traditional intermediaries, not issued or backed by any central authority. Bitcoin and Litecoin are examples. These are usually unregulated.
- **Utility Tokens** – Tokens that grant holders access to a current or prospective product or service but do not grant holders rights that are the same as those granted by specified investments. These are unregulated unless they meet the definition of e-money.
- **Security Tokens** – Tokens with specific characteristics that mean they meet the definition of a 'specified investment' in the Financial Services and Markets Act (2000) (Regulated Activities) Order (RAO)⁶.

While the more novel aspects of the FCA Guidance focuses on Exchange tokens and Utility Tokens, the FCA discusses in differing levels of detail the application of the RAO Article 76 definition of shares, Article 77 definition of debentures, Article 79 definition of warrants, Article 80 definition of certificates representing certain securities and Article 81 definition of units in a collective investment scheme.⁷ The nature of an Equity Token as a digital representation of equity would exclude it from Article 77 and the fact that it is a representation of existing equity and not the right to subscribe for future equity would exclude it from Article 80. This leaves the other three types of security token.

Equity Tokens as direct substitute for shares?

As an Equity Token is, at base level, a representation of the shares or token in the capital of a body corporate giving the Equity Token holder the right to participate in a liquidation of that body corporate, Article 76 of the RAO is the natural first port of call. This throws up the question of whether the Equity Tokens *are shares*. The nature of Equity Tokens as digital representations of the right to participate in a liquidation of that body corporate, however, raises the question of whether the Equity Tokens can be direct substitute for the shares. This throws up the further question of whether all of the rights can 'travel with' or be 'stapled' to the Equity Token in a manner similar to a bearer instrument.

Bearer shares, or share warrants to bearer, which are unregistered shares owned by whoever physically holds the share warrant, are, however prohibited under UK law. This is a result of an amendment to the Companies Act 2006 resulting from the Small Business, Enterprise and Employment Act 2015.

The effect of this is that an Equity Token issuer could not transfer the legal title in a share to which an Equity Token is stapled to the Equity Token transferee: it could only transfer the beneficial interests. The consequence of this is that an Equity Token cannot be said to be a direct substitute for a share in that an Equity Token does not represent all of the rights and interests in the share; rather, the Equity Token confers beneficial interests in the share on the Equity Token holder which can be transferred to a third person without the consent of the holder of the legal title in the share.

If not a share, then what?

The next type of security, the Certificates Representing Certain Securities in Article 80 (a 'Certificate') requires examination.

Article 80 of the RAO defines a Certificate broadly which is, in summary: a certificate or other instrument which confers contractual or property rights: in respect of any share or other Transferable Security held by a person other than the person on whom the rights are conferred by the certificate or instrument; and the transfer of which may be effected without requiring the consent of the first person. The Equity Tokens have these characteristics in that they confer rights on the body corporate's shares which can be transferred without the consent of the shareholder. Certificates seems, therefore, to be the most appropriate classification.

The classification also addresses the question of whether an Equity Token would be a unit in a collective investment scheme (CIS) insofar as Schedule 3, Item 15 of the Financial Services and Markets Order (Collective Investment Schemes) 2001 excludes from the definition of a unit in a CIS, a Certificate within the meaning of Article 80 of the RAO. This exclusion makes reliance on the more straightforward Article 89 of the RAO, rights to or interests in investments which includes the right to or interest in any specified investment, including a share in Article 77 of the RAO, more questionable. Placing Equity Tokens within the Article 89, notwithstanding that it is not identified expressly in the FCA Guidance, has the same effect as Article 80. Further, insofar as an Equity Token is no more than a representation of the beneficial interest in a share, it may be argued that describing it as a 'certificate' gives it more substance than it is due⁸. Against this, in addition to the exclusion from the CIS definition, is the argument that giving an Equity Token a more distinct existence than the

⁶ FCA Guidance, section 2.5.

⁷ FCA Guidance, section 3.47.

⁸ This may also help mitigate tax issues which designation as a Certificate might give rise to. See Jones, Nathwani, Henderson and Burnie 'Taxing token generation events' Tax Journal, October 2018, 8.

Share to which it gives rights makes questions in connection with the maintenance of a distributed register as distinct from a company register and the safekeeping and administration to which this may give rise more easy to identify and respond to. This is important when looking at how Equity Tokens are held.

Safekeeping and settlement

The disruptive effect on a more traditional model for issuing equity of the requirement for the separation of legal and beneficial ownership of the shares for an equity Token to be capable of transfer highlight the requirement for two register solution discussed before: the ledger or register in or on which the real asset, in this case the share, is recorded and the ledger or register in or on which the cryptoasset, in this case the equity Token, is recorded⁹. As noted before, for crypto-voucher tokens where the token is a representation of and gives rights to an asset, the value of the underlying asset, the token's exchangeability for that asset and the proper safekeeping of that asset and proper maintenance of the digital representation of that asset become important for users¹⁰.

The final and important aspect of the Equity Token issuance is the question of settlement. Settlement on the Blockchain notionally involves: (a) the recording of the rights to or interests in the Shares as Equity Tokens in a distributed securities register maintained on the Blockchain; (b) the recording of interests in money as Cash Tokens in a distributed cash register maintained on the Blockchain in the name of those wishing to subscribe for the Equity Tokens; and (c) the exchange of the Equity Tokens for Cash Tokens and vice versa by two sets of debits and credits on the Blockchain. This is contrasted with the use of money in the form of fiat currency held outside the Blockchain to settle subscriptions for Equity Tokens on the Blockchain¹¹.

In keeping with the need for the proper safekeeping of the underlying asset, in this case cash, and the proper maintenance of the digital representation of that asset, the maintenance of cash in a client money account in accordance with the FCA Client Money Rules by an FCA authorised firm with the appropriate permission is vital. The technological ability to settle via a notional exchange of two different types of token on the Blockchain represents perhaps the most exciting and potentially revolutionary commercial aspect of the model outlined above: this highlights the importance of dealing with the legal and regulatory issues in a manner which, if not revolutionary, required a fresh approach.

FT Innovative Lawyers 2019

Eversheds Sutherland have been shortlisted for the Financial Times Innovative Lawyer Awards Europe 2019 for the second successive year in a row in the category 'Innovation in legal expertise: Accessing new markets and capital'. for the work with 20|30 Group on the first use of blockchain technology to settle an equity issuance.

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⁹ Henderson and Burnie 'Sake-keeping crypto-assets: a push for principle' loc cit.

¹⁰ Ibid, 691. See also See Andrew Burnie, James Burnie, Andrew Henderson 'Developing a Cryptocurrency Assessment Framework' 10.5915/LEDGER.2018.121.

¹¹ In practice, the process is simultaneous rather than sequential.

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