

DIFC CONSULTATION PAPER ON REGULATION OF SECURITY TOKENS

On 29 March 2021, The Dubai Financial Services Authority ("**DFSA**") published its Consultation Paper No. 138 relating to the regulation of security tokens ("**Consultation Paper**"). For a period of 30 days, the regulator will be collecting feedback from the public on its proposed regulatory framework around security tokens ("**Security Tokens**"), a specific form of crypto asset/token being characterized by the following:

- it digitally represents rights and obligations that are created, stored and susceptible of electronic transfer through distributed ledger technology ("**DLT**") or similar technology; and
- it confers rights and obligations which are the same as or substantially similar to traditional investment instruments (e.g. share, debenture, future, option, etc.).

The core of this initiative therefore revolves around the innovation brought by DLT, of which blockchain is undoubtedly one of the most notorious application. The Consultation Paper defines it as "*a class of technologies that support the recording of encrypted data held on a distributed ledger, electronically accessible by a network of participants from multiple locations, and that can be updated by those participants, based on agreed consensus, protocol or procedures (i.e. distributed consensus)*".

The Consultation Paper represents a remarkable step for the DFSA which, in September 2017, issued a general investor statement on cryptocurrencies stating that it was not regulating tokens, nor granting license to firms in the Dubai International Financial Centre ("**DIFC**") to undertake token-related activities and considered them to be high-risk.

While drafting the Consultation Paper, the DFSA benchmarked the exercise against other jurisdictions and organisations having developed analogous regulatory responses, such as the UK, EU, ADGM and IOSCO. The DFSA's objective is clear: clarify the application of the financial services regime to persons that carry out business in relation to Security Tokens and implement appropriate regulations to such business in order to address essential components (e.g. investor protection, market integrity and financial stability risks and AML/CTF).

For the time being, it is to be noted that alternative types of tokens, such as exchange tokens and utility tokens, are not covered by the Consultation Paper but will be subject to separate proposals to be shared by the DFSA in the future.

The table below will provide a high-level overview of some key findings and proposals contained in the Consultation Paper.

TOPIC	CURRENT DFSA REGIME	DFSA PROPOSAL
Definitional issues relating to Security tokens		
Addition of Security Tokens to DFSA Regime	<ul style="list-style-type: none"> Regulation of activities conducted in or from the DIFC and related to Investments (defined as either securities or derivatives in the DFSA General Module for persons who: <ul style="list-style-type: none"> offer securities to the public or seek to have their Securities admitted to trading on a market, to meet the prospectus disclosure obligations; and conduct financial services activities to be licensed and regulated by the DFSA. 	<ul style="list-style-type: none"> Definition of Security Token as <i>"a cryptographically secured digital representation of rights and obligations, issued, stored and transferred using DLT or other similar technology that confers the same rights and obligations as those conferred by one or more existing Securities or Derivatives or confers substantially similar rights and obligations or has a substantially similar purpose or effect to one or more existing Securities or Derivatives"</i>. Issuance of a guidance clarifying that the DFSA considers a Security Token to be an Investment, as defined in the DFSA General Module, if it confers rights and obligations as noted above and setting forth factors to be considered when determining whether a Security Token is a particular type of Securities or Derivatives.
Financial Services		
License	<ul style="list-style-type: none"> Financial services relating to Investments, by way of business, require to be licensed by the DFSA, unless expressly excluded from regulation. Financial services relevant in the context of Security Tokens include: <ul style="list-style-type: none"> Dealing in Investments as Principal; Dealing in Investments as Agent; 	<ul style="list-style-type: none"> Application of the current regime to the activities relating to Security Tokens where such Tokens are Investments. Addition of external independent audit of technology governance to these persons regarding their services based on DLT/similar technology.

	<ul style="list-style-type: none"> - Arranging Deals in Investments; - Managing a Collective Investment Fund; - Managing Assets; - Advising on Financial Products; - Providing Custody; - Arranging Custody; - Operating an Exchange; - Operating a Clearing House; - Operating an Alternative Trading System; - Operating a Crowdfunding Platform; and - Acting as a Representative Office. 	
Operating facilities for trading and clearing Security Tokens		
License	<ul style="list-style-type: none"> • Operating an exchange requires to be licensed as an authorised market institution ("AMI"). • Operating a clearing house requires to be licensed for that activity as an AMI. • Operating a multilateral trading facility ("MTF") requires to be licensed as an operator of an alternative trading system ("ATS"). • An AMI that is licensed to operate an exchange can also undertake the activity of operating a MTF if its licence is endorsed to do so. • Operating an organised trading facility ("OTF") requires to be licensed as an operator of an ATS. • An operator of an ATS can operate a MTF or an OTF. 	<ul style="list-style-type: none"> • AMI or ATS allows to operate an exchange, MTF or OTF for the trading of Security Tokens, subject to enhanced requirements as referred to in the next section. • AMI license allows to operate a clearing house to clear and settle transactions in Security Tokens, subject to enhanced requirements as referred to in the next section.

Enhanced requirements	<ul style="list-style-type: none"> • Current requirement for operating trading facilities vary depending on whether its operator is an AMI or an ATS operator. • DFSA General Module contains general requirements (e.g. human resources, corporate governance, systems and controls for managing risks, etc.) that the authorised person must meet to obtain and maintain its license to conduct any financial services. • DFSA AMI Module contains additional requirements applicable to persons operating an exchange or a clearing house. • ATS operators are subject to additional requirements contained in Conduct Of Business Module (“COB”). 	<ul style="list-style-type: none"> • Enhancements to the current regime, focused on the following areas: <ul style="list-style-type: none"> - IT-related requirements (technology governance and design, and DLT implementation/rules/protocols); - external independent audit of technology governance; - allowing direct access to facilities for trading and clearing Security Tokens; - allowing direct access in conventional markets; - investment criteria to admit Security Tokens for trading/clearing; - proper markets related requirements; - business rules and operating rules; - AML/CTF; - clearing and settlement function; and - custody of Security Tokens – digital wallets.
Issuance of Security Tokens		
Prospectus disclosure - public offer or admission to trading of Security Tokens	<ul style="list-style-type: none"> • Issuance of securities requires to have a prospectus in place in line with the DFSA requirements for: <ul style="list-style-type: none"> - making an offer of its securities to the public; or - admitting its securities to trading. • A prospectus for public offer, or listing and trading, must contain certain disclosures indicated in the DFSA Markets Rules Module and be approved by the DFSA. 	<ul style="list-style-type: none"> • Addition of disclosures in the prospectus in case of public offer or admission to trading of Security Tokens: <ul style="list-style-type: none"> - type of rights and interests attaching to the Security Tokens offered; and - in case of capital being raised from investors to create a new type of token, detailed information about:

		<ul style="list-style-type: none"> o underlying venture; o recipient of the capital raised; o features of the new token; o timeline of the operation; and o specific risks. <ul style="list-style-type: none"> • Addition of disclosures in the prospectus in case of offer to the public of, or for admission to trading on a facility for Security Tokens: <ul style="list-style-type: none"> - nature of the DLT/similar technology being used; - details relating to the facility and the person responsible for the operation of that facility (e.g. type and features of smart contract, settlement); - custody of assets/digital wallets; - evidence of title of Security Tokens; - governance of the underlying technology; - cyber-attack risks and means for mitigation; - any information relevant for investors to make an informed judgement about investing in the Security Tokens offered; and - sign-off by a technology expert regarding the authenticity, validity and workability of the underlying technology.
Fund prospectus	<ul style="list-style-type: none"> • Issuance of fund units requires to have a prospectus in place in line with the DFSA requirements for: <ul style="list-style-type: none"> - making an offer of its units to the public; or - admitting its units to trading. • A prospectus for public offer, or listing and trading, must contain certain disclosures indicated in the DFSA Collective Investment Rules Module and be approved by the DFSA. 	<ul style="list-style-type: none"> • In case of offer to the public, or admission to trading of units which are Security Token, addition of the same prospectus disclosures as indicated in the previous section, even if an information memorandum is used (instead of a full prospectus) for an offer by means of private placement (i.e. exempt fund and qualified investor fund).

		<ul style="list-style-type: none"> In case the fund itself invests in Security Token or other types of tokens, the prospectus/investment memorandum will also need to contain the addition disclosures as referred to previously in respect of its underlying assets.
Market abuse	<ul style="list-style-type: none"> Provisions on the prevention of market abuse contained in the DFSA Markets Law in respect of all Investments:: <ul style="list-style-type: none"> fraud and market manipulation; use of fictitious devices and other forms of deception; false and misleading conduct and distortion; insider dealing and providing inside information; inducing persons to deal through statements which are misleading, false or deceptive, and misuse of information. 	<ul style="list-style-type: none"> Application of the current regime where Security Tokens are Investments, with guidance on its practical implementation in a DLT/similar technology environment.
Financial promotion	<ul style="list-style-type: none"> Prohibition of financial promotion set out in the DFSA regulatory Law in respect of financial products (including Investments) and services unless specific requirements provided under the DFSA General Module. This allows financial promotions to be carried out by regulated firms or other persons, under limited circumstances and addition conditions. 	<ul style="list-style-type: none"> Application of the current regime where Security Tokens are Investments. offers of Security Tokens via website accessible by potential investors in the DIFC fall within the scope, unless there is a disclaimer stating that it is not intended for prospective investors in the DIFC and will not allow DIFC based investors to accept those offers.

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