The DFSA Rulebook

General Module

(GEN)

….

3. FINANCIAL PROMOTIONS

3.3 Definition of a Financial Product

3.3.1 Pursuant to Article 41A(4) of the Regulatory Law, "financial product" in Article 41A(3)(b) of the Regulatory Law is hereby prescribed to mean:

(a) an Investment, a Credit Facility, a Deposit, a Profit Sharing Investment Account, a Contract of Insurance, a Crowdfunding Loan Agreement, ~~or~~ rights under an Employee Money Purchase Scheme; or

(b) a Token, whether or not it is an Investment, which is held out or referred to in a relevant communication as an 'investment token', 'security token', 'derivative token' or using any other name that suggests or implies that it is an Investment or a particular type of Investment.

Guidance

Examples of other names that, when used in any marketing material or other Financial Promotion, would suggest or imply that a Token is an Investment for the purposes of Rule 3.3.1(b), include terms such as 'share token', 'bond token', 'futures token' or 'option token'.

….

3.5 Additional Rules for Financial Promotions

….

3.5.3 A Person must not make or approve a Financial Promotion in or from the DIFC, that refers to a Token as an 'investment token', 'security token', 'derivative token' or uses any other name that suggests or implies it is an Investment or a particular type of Investment, unless the Person has reasonable grounds to believe that it is an Investment, or the particular type of Investment (as the case may be), as defined in App 2.

Guidance

A Person making or approving a Financial Promotion relating to a Token referred to in Rule 3.5.3 will also need to ensure that other aspects of the Financial Promotion are clear, fair and not misleading.

….

APP2   INVESTMENTS

A2.1   General definition of investments

Investments

A2.1.1   (1)   An Investment is, subject to (3), either:

(a)   a Security; or

(b)   a Derivative,

as defined in Rule A2.1.2 or Rule A2.1.3.

(2)   Such a Security or Derivative includes:

(a)   a right or interest in the relevant Security or Derivative; ~~and~~

(b)   the Security or Derivative in the form of a cryptographically secured digital representation of rights and obligations that is issued, transferred and stored using Distributed Ledger Technology or other similar technology;

(c)   a cryptographically secured digital representation of rights and obligations that is issued, transferred and stored using Distributed Ledger Technology or other similar technology and:

(i)   confers rights and obligations that are substantially similar in nature to those conferred by a Security or Derivative; or

(ii)   has a substantially similar purpose or effect to a Security or Derivative; and

(~~b~~d)   any instrument declared as a Security or Derivative pursuant to Rule A2.4.1(1).

(3)   In these Rules, a Security Token means an instrument specified in (2)(b) or (c).

(3̶4)   Where a Rule provides that a Security or Derivative has a different classification for a specified purpose, it shall have that effect for that specified purpose and no other purpose.

Guidance

1.   A Token is defined in GLO as a cryptographically secured digital representation of value, rights or obligations, which may be issued, transferred and stored electronically, using Distributed Ledger Technology or other similar technology.

2.   Rules A2.1.1(b) and (c) specify when a Token will be an Investment. A Token that is an Investment may be either a Security or a Derivative and will be treated under the Rules as being the particular type or particular types of Security or Derivative to which

it is substantially similar in nature. A Token that is an Investment is defined in these Rules as a Security Token.

3.   GEN App 6 sets out further Guidance relating to the analysis of whether a particular Token is a Security Token.

4.   An example of the application of Rule A2.1.1(34) is Rule A2.1.2(2), where a Derivative is treated as a Security for the purposes of the requirements in PIB.

….

APP6 SECURITY TOKENS

Guidance

Purpose of this Guidance

1.   A Person who carries on certain activities relating to Security Tokens, in or from the DIFC, will require DFSA approval or authorisation, or will need to comply with applicable requirements in DFSA administered laws or Rules. Those activities may include:

    a.   carrying on a Financial Service (as defined in GEN section 2.2.) which relates to a Security Token (such as operating a facility on which Security Tokens are traded or cleared, or giving advice on, or arranging deals in such Security Tokens);

    b.   making a Financial Promotion relating to a Security Token;

    c.   making an Offer to the Public of a Security Token; or

    d.   applying for a Security Token to be admitted to the Official List of Securities.

2.   The Person proposing to carry out such activities relating to a Token, is responsible for analysing and determining whether a Token is a Security Token and, if so, which type or types of Investment it constitutes. The Guidance in this Appendix is intended to assist a Person conducting such an analysis by indicating how the DFSA will approach that question.

3.   A Person who wishes to obtain an approval or authorisation from the DFSA to conduct activities which relate to Security Tokens, will need to include in its application sufficient information to demonstrate how those Security Tokens meet the definition of one or more specific Investments, taking into account the Guidance in this Appendix.

What is a Token?

4.   A Token is defined in GLO as a cryptographically secured digital representation of value, rights or obligations, which may be issued, transferred and stored electronically, using Distributed Ledger Technology or other similar technology.

What is a Security Token?

5.   A Security Token is a Token which falls within the definition of one or more types of Investment. An Investment is defined in Rule A2.1.1(1) as a Security or a Derivative. Such a Security or Derivative includes a Token which falls within paragraph (b) or (c) of Rule A2.1.1(2).

6.   A Token will be a Security Token under Rule A2.1.1(2)(b) where it falls within the definition of a specific Security in Rule A2.2.1, or the definition of a specific Derivative in Rule A2.3.1, or falls within more than one of those definitions.

7.   A Token will be a Security Token under Rule A2.1.1(2)(c) if it does not fall within the definition of a specific Security or Derivative, but confers rights and obligations that are substantially similar in nature to those conferred by one or more specific Securities or Derivatives, or has a substantially similar purpose or effect to one or more specific Securities or Derivatives.

8.   A Security Token will therefore, depending on the nature of the rights and obligations it confers, fall into one or more existing categories of Security or Derivative. The differentiating feature between a conventional Security or Derivative, on the one hand, and a Security Token on the other, is that the latter confers rights on holders that are issued, stored and transferred using cryptography and Distributed Ledger Technology.

9.   A Security Token may confer rights and obligations that go beyond those conferred by one specific Security or Derivative and doing so will not prevent it from falling within the definition of a Security Token, or from falling within the relevant category of Security or Derivative. Where a Security Token confers rights and obligations that are substantially similar in nature to those conferred by more than one specific Security or Derivative, it may fall within more than one existing category of Security or Derivative (sometimes referred to as hybrid Security Tokens) and be subject to the requirements under these Rules applicable to each of those categories.

When does a Token confer rights and obligations that are substantially similar in nature to those conferred by a specific Investment?

10.   For a Token to confer rights and obligations that are substantially similar in nature to those conferred by a specific Security or Derivative, it should confer rights and obligations that give it most of the main characteristics of the relevant type of Security or Derivative. That is, it is not enough to confer part only of the rights and obligations that are characteristic of the relevant Security or Derivative, or to confer hybrid rights or interests that are not typical of either one type of Security or Derivative or another. As noted in paragraph 9 above, it is possible for a Security Token to confer additional rights and obligations that go beyond those conferred by one specific Security or Derivative.

11.   The DFSA considers that key factors to take into account when determining whether a Token is a Security Token and, if so, which particular type (or types) of Security or Derivative it constitutes include:

a.   in substance, what rights and interests are given to holders of such a Token;

b.   who is required to meet the corresponding duties and obligations arising from the rights and interests referred to in (a);

c.   how such a Token may reasonably be viewed by investors;

d.   how the offer documents or other marketing material describe the Token (although this is not a conclusive indicator); and

e.   how such Tokens are classified in other jurisdictions.

12.   The remainder of the Guidance in this Appendix sets out key examples of Investments that a Token might constitute

When is a Security Token a Share?

13.   A Share is defined as a 'a share or stock in the share capital of any Body Corporate or unincorporated body but excluding a Unit', in GEN Rule A2.2.1(a). We consider a Token to be a Share if the holder has rights associated with ownership and/or control that are characteristic of a Share, such as:

   a.   the ability to share in profits, revenue or other benefits generated by the Body Corporate or unincorporated body (legal entity), for example, a right to a declared dividend of the legal entity;

   b.   a right to participate in the assets of the legal entity in its winding up; and

   c.   a right of control, such as the right to vote on significant matters relating to the management and operation of the business of the legal entity, to appoint or remove directors or senior managers or determine their remuneration, or to agree to a merger, or reconstruction or arrangement to satisfy creditors of the legal entity.

14.   For a Token to be a Share we would generally expect the holder of that Token, as a person having a 'share in the share capital' of the legal entity, to have rights to participate in profits and benefits, assets in a winding up or voting rights, which are proportionate to the value of the share capital, represented by the tokens held or owned by the person. For example, if the legal entity has a share capital of $10 million, divided into Tokens of $100 each, each holder will have *pro rata* rights to distributions and voting rights, based on the number of tokens held.

15.   Whether a Token is a Share will also depend on the operation of company and corporate law. It may be that even if a Token is labelled or called a share by the Issuer, as a matter of law this might not be possible or accurate (e.g. if the company law governing the Issuer specifies requirements for a Share that have not been met). This may not, however, prevent the Token from constituting another type of specified Investment nonetheless (such as a Certificate or Unit in a Fund, if, in substance, the rights and obligations conferred by the Token are similar to those conferred by a Certificate or Unit in a Fund).

16.   While generally a right to participate in profits, assets or rights of control (voting on significant matters) go hand-in-hand, it is possible for rights to participate in profits and assets, without control, or *vice versa* to be conferred by a Share, and similarly, by a Security Token that is considered a Share.

Example 1

17.   A Token holder, A, has a right to receive a share of profits or revenue of Company B (a legal entity), to be distributed annually. A can also vote on matters relating to the governance and business direction of Company B. These rights are proportionate to the share of the capital represented by the Token held by A. A can also transfer the Token to another person, who will have the same rights as A by being the holder of that Token. This is a Security Token that confers rights and obligations that are substantially similar in nature to those conferred by a Share and will be considered to be a Share.

Example 2

18.   A holds a Token in Company B which gives A the right to vote on matters relating to the governance and business of Company B, but no right to participate in the profits, or assets in a winding up, of Company B. This is a Security Token that confers rights and obligations substantially similar in nature to those characteristic of a director's Share, and will be considered to be such a Share.

Example 3

19.   Company B issues a Token that is described in its white paper as being a Token other than a Security Token (e.g. a 'pure utility Token'). The Token allows the holder to (i) access a product or service Company B is still developing, and (ii) gives a right to share in the profits of the company, proportionate to the number of Tokens held, once the product is launched. Such a Token confers rights and obligations substantially similar in nature to those conferred by a Share in the capital of Company B and is a Security Token that is considered to be a Share.

When is a Security Token a Debenture?

20.   A Debenture is an instrument creating or acknowledging indebtedness, whether accrued or not, but does not include certain instruments specified in Rule A2.2.1(b) (such as a cheque or a letter of credit).

21.   A Token that creates or acknowledges indebtedness by representing money owed to the Token holder, but does not fall within the exclusions mentioned above, is considered a Debenture and constitutes a Security Token.

Example 1

22.   Company B issues a Token to A, creating or acknowledging that Company B owes money to A (other than to defray any costs of goods or services bought by Company B from A). This instrument confers on A the right to the return of the money owed by Company B, together with any interest (and the corresponding obligation on Company B to pay to A the money owed, together with any interest). This is a Security Token and is considered a Debenture as it confers rights substantially similar in nature to those conferred by a Debenture.

Example 2

23.   Company B issues a Token to A, acknowledging that Company B owes money to A. In addition to conferring a right to receive interest payments, the Token gives A the right, following a triggering event at a future point in time, to participate in the profits and assets of Company B, and to exercise control of the company through voting rights. This is a Token that gives A substantially similar rights to those conferred by convertible debt, with corresponding obligations imposed on Company B. This is a Security Token that is considered a Debenture, until such time it is converted to a Share in the capital of Company B, at which point it becomes a Security Token that is considered a Share.

When is a Security Token a Warrant?

24.   A Warrant is an instrument that confers, on the holder, a right to acquire an unissued Share, Debenture or Unit in a Fund.

25.   A Token that confers on the holder a right to acquire an unissued Share, Debenture or Unit will be a Security Token that is considered a Warrant. This will be the case regardless of whether the unissued Share, Debenture or Warrant to be acquired by exercising those rights is a Security in its conventional form, or is itself a Security Token.

Example

26.   Company B issues a Token to investors, which gives the holder a right (but not an obligation) to acquire a new Share or Debenture to be issued by Company B at a future point in time. This confers on the holder a right to have the new Share or Debenture issued, and the obligation on Company B to issue that Share or Warrant, which are substantially similar in nature to those conferred by a Warrant. The Token is therefore a Security Token that is considered a Warrant.

When is a Security Token a Certificate?

27.   A Certificate is an instrument which confers on the holder contractual or property rights over Shares, Debentures, Units or Warrants held by a Person, where the holder of the instrument can effect the transfer those rights without the consent of that Person. For example, the following is a typical example of a Certificate:

   a.   B holds Shares, Debentures, Units or Warrants;

   b.   B issues an 'instrument' to A, giving A rights in respect of the Shares, Debentures, Units or Warrants held by B (such as dividends or distributions); and

   c.   A does not need the consent of B to transfer the instrument, and with it the rights to the Shares, Debentures, Units or Warrants held by B).

Example

28.   B issues a Token to A, conferring rights to Shares, Debentures, Units or Warrants held by B. A can sell that Token and so transfer the rights to those Shares, Debentures, Units or Warrants, without needing the consent of B. As the Token confers rights on A and obligations on B that are substantially similar in nature to those conferred by a Certificate, it is a Security Token that is considered a Certificate.

When is a Security Token a Unit in a Fund?

29.   A Unit is a unit in or share representing the rights or interests of a Unitholder in a Fund. Under the Collective Investment Law, a Fund is an arrangement, where:

   a.   the purpose or effect of the arrangement is to enable the persons taking part in that arrangement ('participants') to receive income or profit arising from the property of the arrangement;

   b.   participants do not have the day-to-day control over the management of the property; and

   c.   either the property of the arrangement is managed as a whole, or the investors' contributions and the profits or income thereof are pooled, or both.

30.   Some arrangements, even though they meet the above criteria, are excluded from the definition of a Fund; see CIR Chapter 2.

31.   If a Token confers the rights to participate in an arrangement that meets the criteria in paragraph 29, it confers rights that are substantially similar in nature to those conferred by a Unit in a Fund and, therefore, it is Security Token that is considered a Unit.

Example

32.   An arrangement is in place under which people contribute their money on the invitation of Firm B (the Fund Manager in this example), in exchange for Tokens. These people make their contributions in the expectation that Firm B will pool those contributions to buy fine art, manage a business of hiring the fine art for corporate events to generate income, and also sell some art to make capital gains. The further expectation is that Firm B will distribute such income and capital gains to the contributors, *pro rata* to the amounts they contributed. This arrangement is a Fund. If the Tokens issued by Firm B to participants confer on them the rights to participate as expected in the profits and income of the arrangement, such a Token confers on the participants rights that are substantially similar in nature to a Unit in a Fund and so it is a Security Token that is considered a Unit.

When is a Security Token a Structured Product?

33.   A Structured Product is an instrument comprising rights under a contract where:

a.   the gain or loss of each party to the contract is determined by reference to the fluctuations in the value or price of an underlying factor, (such as gold, an index, an interest or exchange rate, in relation to which there is readily available public information);

b.   the gain or loss of each party is settled by cash or set off between the parties; and

c.   each party is not exposed to any contingent liabilities to the other (i.e. there is no leverage).

34.   If the rights and obligations of the parties to a contract that meets the above criteria are conferred by a Token, the Token confers rights and obligations that are substantially similar in nature to a Structured Product, and so the Token is considered a Security Token that is a Structured Product.

Example

35.   Firm B enters into a contract with its client, A. The contract provides that A will receive a profit or incur a liability to Firm B, based on whether the underlying price of gold has moved up or down between the opening day, and the closing day, of the contract. The contract does not contain any leverage (for example, where the profit or loss of A would be 50 times the amount of margin A posted with B to open the position). This is a Structured Product. The terms of the contract are embedded in a Token issued by Firm B, and the contract is created when A accepts those terms by accepting ownership of the Token. As the Token confers the rights and obligations of the contract, it confers rights and obligations substantially similar in nature to those conferred by a Structured Product. The Token is therefore a Security Token that is considered a Structured Product.

When is a Security Token an Option?

36.   An Option is an instrument that confers on the holder, upon exercise, a right to:

a.   acquire or dispose of:

i.   a Security (other than a Warrant);

ii.   a contractually based investment (e.g. a Future);

iii.   currency of any country or territory; or

iv.   a commodity of any kind; or

b.   receive a cash settlement determined by reference to the value or price of an index, interest rate, exchange rate or any other rate or variable; or

c.   a right to acquire or dispose of an Option under a) or b).

37.   If a person issues a Token that confers on the holder rights that meet the criteria in paragraph 36 a), b) or c) which the holder may, but is not required to exercise, the Token is a Security Token that is an Option.

Example

38.   B owns an issued Share in a company. B issues a Token to A which confers on A the right to buy that Share from B at a set price on a certain date, should A choose to do so. The Token confers rights and obligations that are substantially similar in nature to those conferred by a call Option and is therefore a Security Token that is considered to be an Option.

When is a Security Token a Future?

39.   Futures are instruments comprising rights under a contract which meets the criteria in the definition in Rule A2.3.1(b). There are two types of Futures; those covered under Rule A2.3.1(b)(i), referred to in this Guidance as 'commodity Futures', and those covered under covered under Rule A2.3.1(b)(ii), referred to in this Guidance as 'financial Futures'. Financial Futures are sometimes referred to as Contracts for Difference, or CFDs.

40.   If a Token confers rights and obligations that are substantially similar in nature to those conferred by a contract meeting the definition of a Future, the Token is a Security Token that is a Future.

Example 1

41.   This example relates to a commodity Future under Rule A2.3.2(b)(i). Firm B arranges for its client, A to purchase a Token on a regulated exchange. Embedded in that token are the terms of a contract between the holder of that Token and Company C, which A accepts by purchasing the Token. The contract is for Company C to deliver a specified type and quantity of a commodity at a future date and at a specified price to be paid by A. A is entering the contract for investment purposes, as he has no use for the commodity but believes that its value will rise and he will be able to sell the rights under the contract (or settle them with Company C in cash) to make a profit on or before the delivery date. The Token confers rights and obligations substantially similar in nature to a contract falling within the definition of a Future at Rule A2.3.1(b)(ii). Therefore, the Token is a Security Token and is considered a Future.

Example 2

42.   This example relates to a financial Future or CFD under Rule A2.3.1(b)(ii). Firm B enters into a contract with its client, A. The contract provides that A or B will receive a profit or incur a loss, based on the difference between the value of the FTSE 100 index on the opening day, and the closing day, of the contract. The contract is leveraged such that the profit or loss of A will be 5 times the amount of margin A posted with B to open the position. Under this contract, A's and B's right to a profit or loss will depend on whether the value of the FTSE 100 index moved up or down from the

opening day to the closing day. If the rights conferred under that contract are represented by a Token issued by B, the Token confers rights and obligations substantially similar in nature to a contract falling within the definition of a Future at Rule A2.3.1(b)(ii). Therefore, the Token is a Security Token and is considered a Future.