Security token

This section provides a general explanation of innovative technological trends (DAO, DeFI, NFT, tokens, etc.) that may be related to the provision of financial services or similar activities.

This information does not constitute legal advice or an explanation. We recommend that related parties assess and legally qualify their activities in advance, if necessary, with the help of a professional legal adviser. Consumers of innovative solutions are advised to assess the risks they may be exposed to when using their financial means.
We also recommend that you consult the draft EU Regulation on Markets in Crypto-assets (MiCA) and related proposals.

A security token is an asset based on distributed ledger technology (DLT) that represents the ownership right of an instrument, which can be either a freely convertible security, i.e. a security subject to the MiFID Regulation, or the so-called non-MiFID security (see also Securities Market Act). Both a security initially issued as a token and a token that complies with the price of one or more securities may qualify as a security token. Therefore, tokenized shares, bonds, derivatives, investment fund units, and tokenized variants of other instruments that qualify as securities are classified as security tokens. Also, tokens that comply with commodity prices can be defined as derivatives under security tokens.

Under MiFID II, an instrument qualifies as a transferable security (i.e. an instrument covered by the Regulation) if it is:

1. freely transferable;
2. traded on the capital market;
3. standardized;
4. similar to a typical transferable security.

What distinguishes a security token from a utility token is that in exchange for a utility token, the investor does not merely receive specific rights to a service, product or benefit, but acquires an instrument defined as a security. However, if a company issues tokens that the company itself calls utility tokens, but the token gives the investor an expectation of an income or a stake in the company, it is still a security token.

Companies may be interested in offering securities in the form of security token offerings (STOs), as they do not need intermediaries in the form of underwriters, which makes the offering more favourable for the company. STOs can also be made attractive by the fact that tokenized securities can be traded around the clock and these are not subject to traditional fees due to the fact that transactions take place on a blockchain. In addition, security tokens are used to sub-divide some other assets, such as the ownership of an NFT, which opens up the possibility for its owners to increase the liquidity of their assets without selling the entire NFT.

Legal definition

The Finantsinspektsioon recommends carrying out a legal analysis before issuing tokens. There is currently no harmonised regulation in the European Union specific to security token offerings, nor is there a uniform definition of a security token, but this does not mean that an instrument cannot qualify as a security. In many EU countries (including Estonia), the security token offering is regulated on the same basis as the offering of other securities, as tokenized securities are essentially ordinary securities, having only the technical characteristics of an instrument, not the substantive characteristics.

Companies providing related investment services or ancillary investment services are therefore required to apply for an investment firm activity licence under the Securities Market Act. A prospectus and information document must also be filed in a public offering of a security token in the absence of exemptions. Also, the MiFID securities regulation may differ from that of non-MiFID securities, for example, in terms of whether they are subject to an obligation to be registered in a central securities register. For more information about which tokens are most likely to qualify as securities, please see the information text provided by the Finantsinspektsioon on the legal status of ICOs .

Risks

Cyber risks – The risks posed by blockchain technology in tokenized securities. As security tokens are deposited in digital blockchain-based wallets, there is a risk that they could be stolen or that the wallet provider’s systems could fail. There is also an actual risk that the blockchain on which the token is based will be attacked, either by the blockchain validators themselves or by outside forces.

There are different types of security tokens – Before investing in a security token, it is important to find out what rights and obligations the investor will acquire. Security tokens can be, for example, shares in a company giving the holder the right to vote at general meetings, derivative instruments and fund units tracking a share, and other types of securities. For example, if one wants to buy shares in a company, they must make sure that they are buying a security guaranteeing voting rights and not a derivative that does not carry such rights.

Issuer of the token may be unreliable – As with any other investment in securities, one needs to check the background of the issuer when buying a security token. As with traditional securities, the underlying asset of a token (be it a share, a bond, part of the ownership of a piece of art or real estate, or anything else) can change value or be destroyed; it can also be fraudulent from the outset. As the majority of cryptocurrency offerings are unregulated, fraudsters can also claim that an underlying virtual currency is a security token, when in fact it is not.

Third-party risk – In addition to the token provider, a security token needs a platform where its underlying assets are held and which, if necessary, also manages the cash flows associated with the assets. While these platforms will be rated when offering regulated securities, it cannot be excluded that they will be manipulated by their own administrators or that a cyber risk will materialise.

Volatility of value – While security tokens, unlike most other virtual currencies, have underlying assets on which their price should directly depend, they are expected to be more volatile than conventional securities. However, as these are DLT-based currencies, demand for security tokens is influenced by the general sentiment in the cryptocurrency market, which is generally more volatile than traditional securities markets. Therefore, when investing in them, it should be borne in mind that

the value of security tokens is not only affected by the estimated value of the underlying assets, but also by the state of the traditional securities and crypto markets.

Future of security tokens

Security tokens can be widely used to offer shares in companies or other rights. However, there is currently no uniform European approach and regulation of the token concept. If these bottlenecks can be overcome, security tokens may in the future have a greater potential to integrate traditional securities trading into the DLT system, as well as to split ownership of other assets.

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