

Equity tokens and shares: similar but not quite so



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A digital world calls for digital assets. Investors' interest in equity tokens as a new way to invest and get ownership in a company is on the rise. As traditional stock or shares, equity tokens are subject to specific legal considerations if they are to be issued under Luxembourg law.

What are equity tokens?

Several European and national authorities, including the EBA and ESMA, have expressed their view in respect of the classification of digital assets (also referred to as crypto-assets or tokens) into different categories, taking into account the specific features pertaining and common to each digital asset. Frequently recognised digital asset categories, as described in a recent working paper published by the Luxembourg House of Financial Technology in collaboration with several Luxembourg law firms, consist of the following:

- security-like digital assets, which are usually designed to represent an equity or debt claim towards primarily (the assets of) the digital asset issuer, offering their holders benefits similar to those of equity or debt instruments;
- utility digital assets, which are usually designed to give access (rights) to a service or product provided (or to be provided) by an organization or ecosystem (in most cases related to the entity creating the digital assets); and
- payment digital assets, which serve as an alternative means of payment generally accepted by third parties.
- Broadly speaking, equity tokens would be security-like digital assets representing an ownership interest in a company, which is typically materialized in the form of stock or shares. In practice, the main goal of a company issuing equity tokens is to give investors/shareholders a certain amount of digital assets representing an ownership interest in such company.

This new investment mechanism has raised a lot of interest among investors as it intends to

attach traditional equity rights (such as entitlement to a dividend or voting rights) to digital assets, thereby allowing investors to benefit from the advantages of distributed ledger technology (“DLT”).

A substitute for shares?

Given that equity tokens are intended to be a digital representation of shares, the opening question is whether a company could issue equity tokens that would grant a tokenholder the exact same rights as a shareholder.

To answer this question, one first has to determine whether a company can issue new shares in the form of equity tokens. Luxembourg law does not specifically foresee this possibility (nor does it forbid it), but it should be noted that a recent amendment to the modified Law of 1 August 2001 on the circulation of securities, clarified that DLT can be used for the purpose of transferring securities, including in the form of digital assets. However, neither the CSSF (Luxembourg’s supervisory authority) nor the country’s legislators have come up with any specific legislation related to the issuance of securities or digital assets on a distributed ledger. Legal clarification by the authorities around this question would be very helpful.

Given the legal uncertainty surrounding the issuance of digital assets, and the limitation around issuing new or future shares by way of issuing equity tokens, the next consideration would be around equity tokens that would represent already existing shares in the company. This would imply creating an additional instrument (the equity token), which would necessarily have a distinct existence from the share to which it gives rights, and would confer rights on the share that could be transferred without the consent of the shareholder.

In view of the distinct existence of the equity tokens, another legal consideration would be around the method of recording ownership. The ownership of a traditional share is typically recorded in the shareholders’ register of the company if it is in registered form, or with a custodian in case of a bearer or dematerialized share, while the ownership of an equity token would fundamentally be recorded on a distributed ledger. There are ongoing initiatives to merge both registers, in order to have both instruments linked and registered solely using DLT, thus facilitating the task of recording ownership.

To sum up

In essence, in view of the current legal challenges associated with the issuance of equity tokens, it can be concluded that, for the time being, an equity token could constitute a representation of the beneficial interest in a share, having its own rights attached to it, and as such it would be an instrument different from a share. This would explain why, besides a couple of recent experiments under the initiative of certain EU authorities, the adoption of equity tokens and their implementation in the legal framework has yet to be developed.

Finally, other legal considerations could be examined, such as the qualification of equity tokens

as securities or the attachment of equity rights (e.g. dividends, share premium, share classes, voting rights, etc.) to digital assets, but these are discussions for another time.

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