

Finance Malta Conference
'Financial Instrument Test in the context of the VFA Act '
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LEGAL

Nature of Financial Instruments:

- What is a Transferable Security?
 - What is a CIS?

Financial Instrument Test

MFSA issued “Guidance Note to the Financial Instrument Test” on 24 July 2018.

Such Guidance was issued in accordance with Article 47 of the Virtual Financial Assets Act (Act xxx of 2018):

“Without prejudice to any other powers assigned to the competent authority in terms of this Act, the competent authority shall introduce a test applicable to issuers, VFA agents and licence holders for the purpose of determining whether a DLT asset qualifies as electronic money, a financial instrument, virtual financial asset or virtual token:

Provided that such test shall be applicable prior to the submission of the whitepaper to the competent authority or the provision of a VFA service, as the case may be.”

Financial Instrument Test

The Guidelines are therefore applicable to:

- (i) issuers offering DLT assets to the public in or from within Malta, or applying for admission of a DLT asset on a DLT exchange; and
- (ii) persons providing any service and/or performing any activity, within the context of either the VFA Act or traditional financial services legislation, in relation to DLT assets whose classification has not been determined for any reason whatsoever, including inter alia because the offering of the said DLT asset was conducted abroad.

OBJECTIVE: TO DETERMINE WHETHER RELEVANT DLT ASSET IS:

- *Electronic Money;*
- *Financial Instrument;*
- *Virtual Financial Asset;*
- *Virtual Token.*

Financial Instrument Test

Importance and implications of Test:

- (i) To determine whether activities are subject to regulation or not (e.g. public offerings, exchange listing / trading, execution of orders, management, advice);
- (ii) If subject to regulation, which regulation?
 - Financial Institutions Act in case relevant asset qualifies as electronic money;
 - Investment Services Act and/or Prospectus Directive (as transposed into Companies Act) in case of financial instrument;
 - Virtual Financial Assets Act in case of a virtual financial asset.

MFSA adopts substance over form approach

Financial Instrument

VFA Act defines the term by reference to the ISA:

“shall have the same meaning assigned to it under the Second Schedule to the Investment Services Act, whether or not issued in Malta”.

Second Schedule to ISA in turn defines / lists the financial instruments as set out in Section C of Annex I of MiFID 2 (2014/65/EU), including:

- Transferable Securities;
- Money Market Instruments;
- Units in CISs;
- Financial Derivative Instruments

Today we are concentrating only on **Transferable Securities** and **CIS**, these being probably the two assets which may come closer (and so create borderline cases and potential confusion) with Virtual Financial Assets.

UNITED STATES

“An investment contract is an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others”

Release No. 81207 / July 25, 2017 Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO

Securities and Exchange Commission v. W. J. Howey Co. (1946)

**What is a transferable
security?**

EU Legal Backdrop

MiFID 2- Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments

PSD2- (Directive (EU) 2015/2366 of the European Parliament and of the Council of 25 November 2015 on payment services in the internal market)

TRANSFERABLE SECURITIES

means those classes of securities which are **negotiable on the capital market, with the exception of instruments of payment**, such as:

- **shares in companies** and other securities equivalent to shares in companies, partnerships or other entities, and depositary receipts in respect of shares;
- **bonds or other forms of securitised debt**, including depositary receipts in respect of such securities;
- any **other securities** giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures.

TRANSFERABLE SECURITIES

EU Commission Q&A issued under MiFID 1 (2004/39/EC) provide some useful insights on the notion and definition of ‘transferable security’ which remain equally relevant under MiFID 2. For example:

“The notion of ‘capital market’ is not explicitly defined in MiFID. It is a broad one and is meant to include all contexts where buying and selling interest in securities meet.

‘Instruments of payment’ [which are excluded] are securities which are used only for the purposes of payment and not for investment. For example, this notion usually includes cheques, bills of exchanges, etc.”.

*“In order to be financial instruments, those shares have to be transferable securities within the meaning of Article 4(1)(18) of MiFID and in particular be ‘negotiable on the capital market’. **Those terms have to be understood in a broad manner in the sense that only under limited circumstances will a share that is negotiated not fall under the definition of financial instrument.**”*

TRANSFERABLE SECURITIES

Analysis:

Is it a 'payment instrument'- a personalised device(s) and/or set of procedures agreed between the payment service user and the payment service provider and used in order to initiate a payment order? **YES? Caught by FIA.**

Is it a money market instrument? **YES? Caught by ISA.**

TRANSFERABLE SECURITIES

Analysis:

Is the DLT asset negotiable on the capital market?

This is to be interpreted in a **broad manner**. The securities need only be capable of being traded on the capital markets, in whatever context. The existence or otherwise of a secondary market for a particular instrument should not be a determining factor. Shares which are **conditionally negotiable**, such as shares of private companies, are **still deemed to be transferable securities** notwithstanding and pre-emption rights or any other the applicable restrictions on their transferability.

TRANSFERABLE SECURITIES

*“The key determinant, therefore, is whether such interests ... are negotiable on the capital markets. If the securities in question are of a kind that is capable of being traded on a regulated market or MTF, this will be a conclusive indication that they are transferable securities, even if the individual securities in question are not in fact traded. Conversely, if they are **not capable of being traded** in such multilateral systems this may indicate that they are not transferable securities, **but this is not conclusive.** ... The concept of negotiability contains the notion that the instrument is tradable. If restrictions on transfer prevent an instrument from being tradable in such contexts, it is not a transferable security.”*

TRANSFERABLE SECURITIES

What rights does the DLT asset possess?

In every case, **a detailed assessment of the rights attached to the asset is required** in order to determine whether or not the instrument under review effectively renders such **DLT asset akin to a share** in a company, partnership or other entity, and depository receipt in respect of share/s, **or bond** or other form of securitised debt or gives the right to acquire or sell any such transferable securities or gives rise to a cash settlement determined by reference to, inter alia, transferable securities.

IMPORTANT!!

Substance OVER Form

TRANSFERABLE SECURITIES

Any one or more of the following rights are required in order for a DLT asset to qualify as a share/ security:

- **Participation in the capital** of the issuer;
- **Right to receive proceeds** from the liquidation of issuer in excess of nominal value; or
- **Entry in the register of shareholders.**

TRANSFERABLE SECURITIES

Any one or more of the following rights are required in order for a DLT asset to qualify as a bond or other form of securitised debt:

- **Principal amount due** of fixed sum with **fixed/ variable maturity**; or
- **Entry in the register of debenture holders.**

What is a CIS?

CIS

MFSA could not here rely on a MiFID definition (MiFID does not cover CISs) nor on some legal definition in an EU Directive, since different EU laws regulate different types of CIS (UCITS, AIF) with their respective definitions.

“Further to G1-3.2.1, the Test focuses on the definitions included under MiFID, with the exception of Units in a Collective Investment Scheme (‘CIS’), given that the definition under the ISA captures all the mandatory elements of the various permutations of CISs available under existing EU legislation”

CIS – Definition under ISA

The term Collective Investment Scheme is defined in article 2 ISA as follows:

“any scheme or arrangement which has as its object or as one of its objects the collective investment of capital acquired by means of an offer of units for subscription, sale or exchange and which has the following characteristics:

- (a) the scheme or arrangement operates according to the principle of risk spreading; and either*
- (b) the contributions of the participants and the profits or income out of which payments are to be made to them are pooled; or*
- (c) at the request of the holders, units are or are to be repurchased or redeemed out of the assets of the scheme or arrangement, continuously or in blocks at short intervals; or*
- (d) units are, or have been, or will be issued continuously or in blocks at short intervals:*

Provided that an alternative investment fund that is not promoted to retail investors and that does not have the characteristic listed in paragraph (a) hereof shall only be deemed to be a collective investment scheme if the scheme, in specific circumstances as established by regulations under this Act, is exempt from such requirement and satisfies any conditions that may be prescribed .”

CIS – Definition under AIFMD

The AIFMD (Alternative Investment Fund Managers Directive) sought to harmonise rules and regulate at EU level Managers of funds established or promoted in the EU, reaching all sorts of funds, except those which qualify as UCITS under the UCITS Directive.

The AIFMD defines an Alternative Investment Fund as a:

- Collective investment undertaking (including investment compartments thereof / sub-funds);
- which raises capital;
- from a number of investors;
- with a view to investing same in accordance with a defined investment policy for the benefit of those investors; and
- which do not require authorisation as UCITS.

N.B.: The diversification requirement does not form part of the definition of AIF.

N.B.: In August 2013 ESMA has issued Guidelines on the Key Concepts of AIFMD (ESMA/2013/611) in which it has extensively elaborated on the definition of AIF.

CIS – Exemption from licensing under ISA – SL 370.02

Exempt “schemes and arrangements”

The following CISs are **exempted from the CIS licensing requirement**:

- A scheme involving participants, each of which carries on a business other than that which constitutes an investment service and enters into the arrangement for commercial purposes related to that business;
- A scheme which operates according to the principle of risk spreading or in respect of which the contributions of the participants and the profits or income out of which payments are made to them are pooled, but only if the general purpose of the scheme is commercial and not for investment purposes;
- Employee share schemes;
- NAIFs;
- Investment undertakings, such as family office vehicles, which invest the private wealth of investors without raising external capital,

subject to determination in writing by the MFSA.

CIS – Exemption from licensing under ISA – SL 370.02

Exempt “schemes and arrangements”

- It is interesting to note that the Investment Services Act (Exemption) Regulations (SL 370.02) do not exempt the above from the definition of CIS under the ISA, but refers to them as “collective investment schemes” which are exempt from the licensing requirement under the ISA. So by admission these are deemed to fall within the very wide definition of CIS under the ISA, and need an exemption from licensing requirement.
- Most exemptions are based on the purpose of the scheme / arrangement.
- This is also the approach adopted by MFSA in its Guidelines on FI Test, where purpose of one of the main factors for assessment.
- The ESMA Guidelines on Key Concepts of AIFMD should come in very useful in this respect, and apart from the fact that they are being used to interpret the scope of the exemptions from the licensing requirement , it seems that they have been used by MFSA in drawing up the FI Test Guidelines.

CIS – FI Test Guidelines

In order to determine whether a DLT asset qualifies as Unit in a CIS, Users would have to focus on whether the undertaking qualifies as a CIS, taking into consideration the following criteria:

i. Purpose

The DLT asset in issue [i.e. unit in CIS] should enable investors to participate in or receive profits or income arising from the acquisition, holding, management or disposal of such DLT asset [This should presumably be referring to underlying assets held by the scheme / arrangement, and not the DLT asset' which should here refer to the unit in the CIS] and the objective of the issue should be the collective investment of capital.

ii. Arrangements

The undertaking should also have one of the necessary arrangements which equate the DLT platform to a CIS.

CIS – FI Test Guidelines

Pursuant to point i of G1-3.6.1, Users should not consider general commercial or industrial purposes as the collective investment of capital.

Provided that general commercial or industrial purposes shall refer to the purpose of pursuing a business strategy which includes characteristics such as running predominantly:

- i. a commercial activity, involving the purchase, sale, and/or exchange of goods or commodities and or the supply of non-financial services;*
- ii. an industrial activity, involving the production of goods or construction of properties; or*
- iii. a combination thereof.*

CIS – ESMA Guidelines

This is taken ‘verbatim’ from the definition of the concept of ‘**general commercial or industrial purpose**’ in ESMA Guidelines on Key Concepts of AIFMD. This concept is used by RESMA Guidelines as a basis of analysis of the first component of the definition of ‘AIF’ under AIFMD.

“The following characteristics, if all of them are exhibited by an undertaking, should show that the undertaking is a collective investment undertaking mentioned in Article 4(1)(a) of the AIFMD. The characteristics are that:

(a) the undertaking does not have a general commercial or industrial purpose;

(b) the undertaking pools together capital raised from its investors for the purpose of investment with a view to generating a pooled return for those investors; and

(c) the unitholders or shareholders of the undertaking – as a collective group – have no day-to-day discretion or control. The fact that one or more but not all of the aforementioned unitholders or shareholders are granted day-to-day discretion or control should not be taken to show that the undertaking is not a collective investment undertaking.”

CIS – FI Test Guidelines

For a DLT asset to qualify as a Unit in a CIS, the User should assess whether the DLT asset meets the following criteria:

- i. the undertaking should constitute a scheme or arrangement which has as its object or as one of its objects the collective investment of capital;*
- ii. the raising of such capital should be done through offer of DLT assets for subscription, sale or exchange; and*
- iii. satisfy at least one for the following arrangements:*
 - a. the contributions of the participants and the profits or income out of which payments are to be made to them are pooled;*
 - b. the DLT assets are or are to be repurchased or redeemed out of the assets of the issuing entity, continuously in blocks at short intervals at the request of the holders of the DLT assets; or*
 - c. the DLT assets are, or have been, or will be issued continuously or in blocks at short intervals.*

Thank you for your attention.



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