

GERMANY AIMS TO INTRODUCE DIGITAL BONDS

On 11 August 2020 the German Federal Ministry of Finance and the Federal Ministry of Justice and Consumer Protection have published a draft law which aims to digitalize corporate financing in the capital markets by introducing the concept of a digital bond which no longer requires the embodiment of the respective claim in a physical certificate. The draft law is not reduced to technical innovation but it applies existing German property law requirements to a digital value by defining digital bonds as goods (*Sachen*) under the German Civil Code. Rather than implementing a new regulatory regime for digital bonds, the draft law also confirms that digital bonds qualify as securities and generally fall within the scope of existing regulation. This briefing summarises the key measures imposed by the draft law.

Key issues

- The draft law allows the issuance of electronic securities without a physical certificate
- Requirement to issue certificate is replaced by entry into electronic securities register
- Electronic securities can be switched to "traditional" security and *vice versa*
- Electronic securities are treated as goods under the German Civil Code and subject to existing German property law requirements

ELECTRONIC SECURITIES

As central element, the draft law introduces the German Act on Electronic Securities (*Gesetz über elektronische Wertpapiere*, "eWpG"). The eWpG only applies to debt securities payable to the bearer (*Inhaberschuldverschreibungen*), not to shares or fund units. However, "debt securities" is a broad term under German civil law and includes, besides classical bonds (with fixed or floating interest rate and fixed redemption amount) also securitised derivatives (where the coupon or the redemption amount is linked to an underlying, e.g. a share or an index) as well as hybrid securities such as profit participation certificates (*Genussscheine*). According to its reasoning, the eWpG has been drafted with the intention that it may be opened to include further securities at a later stage.

CHANGES TO GERMAN LAW REGIME

So far, the issuance of a bearer debt security pursuant to section 793 et seq. of the German Civil Code (*Bürgerliches Gesetzbuch*, "BGB") requires (i) an issuance agreement between the issuer and the initial holder of such bearer debt security and (ii) the issuance of a certificate by the issuer. The holder of a bearer debt security has an *in-rem* title in the certificate (or, in case of a global note, an *in-rem* co-ownership interest in such global note). Title to a bearer debt security is transferred through the *in-rem* transfer of the title to the (global) certificate.

The eWpG replaces the requirement for the issuance of the certificate (item (ii) above) by a two-part process consisting of (i) the filing (*Niederlegung*) of the terms and conditions and (ii) the registration of the securities, in each case in the relevant electronic securities register (*Elektronisches Wertpapierregister*). The eWpG further provides that any such electronic security is deemed to be a "good" within the meaning of the BGB. Accordingly, even though no longer evidenced by a certificate but by a register entry, the provisions under German law governing securities in general (including their *in-rem* transfer) are applicable to electronic securities as well.

FILING OF TERMS AND CONDITIONS

The eWpG requires the issuer to make the terms and conditions available to the public through the relevant electronic securities register in a durable electronic form so that such terms and conditions can be accessed directly and repeatedly. This "filing" has to occur prior to the entry of the relevant electronic securities in the electronic securities register and would, hence, be a further step to be considered in the issuance process.

REGISTERS

Under the eWpG electronic securities registers can be (i) a central register operated by a central securities depository ("**CSD**"), or (ii) a decentralized crypto register (*Kryptowertpapierregister*) which may be operated by any adequately licensed person named by the issuer (in case the issuer does not name any such person, the issuer itself will be regarded as administrator of the crypto securities register for the relevant security). The operation of a crypto register is defined as licensable financial service under the German Banking Act (*Kreditwesengesetz*, "**KWG**"). Hence, the operators require a banking licence under the KWG and will be supervised by the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, "**BaFin**") as financial service institutions (*Finanzdienstleistungsinstitut*). From a technical point of view, crypto securities registers are defined fairly broad as a decentralized and secure recording system where data is stored in chronological sequence and in a manner, which does not allow unauthorized deletion or subsequent change. Even though this definition would include DLT technology it is technological neutral and does not exclude other technical procedures. The relevant electronic securities register has to be administered using state of the art technology. The eWpG provides that the administrator must ensure that the relevant electronic securities register always reflects the "legal situation". If this is not the case, the administrator will be liable to the entitled person for any accountable damage.

BEARER AND ENTITLED PERSON

The eWpG provides that the bearer of an electronic security entered into a central register for electronic securities will always be the administrator of the relevant register. To ensure that the person that has actually purchased the relevant electronic security gets title to the rights evidenced by such electronic security the eWpG introduces the concept of an "entitled person" (*Berechtigter*). Such entitled person holds the rights evidenced by the electronic security and holds a (*in-rem*) co-ownership interest in the relevant electronic security in case such electronic security is evidenced by a global electronic security entered into a central register. Accordingly, in case of an

electronic security entered into a central register, the bearer of the security is the CSD acting as a "trustee" for the respective entitled persons.

Regarding electronic securities entered into a crypto securities register (*Kryptowertpapier*, "**Crypto Security**"), either the custodian named by the issuer for the relevant security or the ultimate holder can be entered into the relevant register as bearer. The latter case will, for mere administrative reasons, only be suitable for issuances with a smaller number of holders (e.g. private placements), but may allow banks or other frequent issuers to provide for their own electronic registers, act as their own paying agent (which banks generally do already now) and, thus, might be able to keep third party costs much lower as under the current legal regime.

TRANSFER OF ELECTRONIC SECURITIES

While electronic securities registered in the name of a CSD in a central register generally follow the rules of securities held in collective safe custody with a CSD, the transfer of Crypto Securities requires an agreement between the entitled person and the acquirer to the effect that the claim evidenced by the relevant electronic security shall transfer from the entitled person to the acquirer. In addition, the electronic security has to be registered in the name of the acquirer upon the instruction of the entitled person. A good faith acquisition in an electronic security is, accordingly, possible by placing reliance on the relevant electronic securities register regarding, inter alia, the bearer which may also be regarded as the entitled person except to the extent the acquirer has (or does not have due to its own gross negligence) different knowledge.

SWITCH OF FORM

The eWpG allows for bearer debt securities to be issued as electronic securities, while keeping the possibility to issue them "traditionally" in the form of (global) note certificates. Accordingly, the eWpG also allows for a switch of form from (global) certificate to electronic security and *vice versa*. The switch from global certificate to electronic security entered into a central register for electronic securities can be done without consent of the holders (provided that such consent is not expressly required pursuant to the terms and conditions of the relevant securities). Given that both, global certificates as well as central registers for electronic securities can only be held in safe custody or, respectively, administered by, CSDs, there is no need to protect the relevant entitled persons in case of such a switch. In addition, the reasoning for the eWpG provides that such switch does not result in any requirement to open new accounts for the entitled person. The entitled person still can hold its interests in the relevant securities through its custodian. The switch of form from an electronic security to a security evidenced by a certificate requires (i) the consent of the respective entitled person or (ii) a general permission in the terms and conditions to have such a switch of form without consent of the entitled person. In case a security evidenced by a certificate is supposed to be switched into a Crypto Security, the consent of the entitled person is always required.

AMENDMENTS TO GERMAN REGULATORY LAWS

In principle, the draft law confirms that electronic securities qualify as "securities" and hence fall within the scope of existing regulation.

However, the draft law also provides for amendments of German regulatory laws including the German Securities Prospectus Act (*Wertpapierprospektgesetz*, "**WpPG**"). In this respect, it should be noted that "digital securities not evidenced by a certificate" are mentioned as another category of digital securities in the WpPG which does not qualify as electronic security in the sense of the eWpG. This seems to imply that even the legislator considers, in addition to the electronic securities pursuant to the eWpG, other forms of security tokens to be relevant as well.

OUTLOOK

As the draft law is currently just a ministerial proposal (*Referentenentwurf*) it remains to be seen what changes will occur during the legislative process and whether open questions will be further addressed.

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