

CONSULTATION PAPER ON THE FINANCIAL INSTRUMENT TEST

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MFSA

MALTA FINANCIAL SERVICES AUTHORITY

THESE PROPOSALS ARE NOT BINDING AND ARE SUBJECT TO CHANGES AND REVISIONS FOLLOWING REPRESENTATIONS RECEIVED FROM LICENCE HOLDERS AND OTHER INVOLVED PARTIES. IT IS IMPORTANT THAT PERSONS INVOLVED IN THE CONSULTATION BEAR THESE CONSIDERATIONS IN MIND.

CONTENTS

1	INTRODUCTION	1
2	THE FINANCIAL INSTRUMENT TEST	2
2.1	PURPOSE.....	2
2.2	SCOPE.....	2
2.3	DEFINITIONS	2
2.4	REQUIREMENT WITHIN VFSA	4
2.5	METHODOLOGY	4
3	FINANCIAL INSTRUMENT TEST AND THE PROPOSED VIRTUAL FINANCIAL ASSETS ACT.....	6
3.1	VIRTUAL TOKEN	6
3.1.1	DEFINITION	6
3.1.2	APPLICABILITY WITHIN THE DLT CONTEXT	6
3.1.3	APPLICABILITY WITHIN THE TEST.....	7
4	FINANCIAL INSTRUMENT TEST AND THE EXISTING LEGAL FRAMEWORK	8
4.1	TRANSFERABLE SECURITIES.....	8
4.1.1	DEFINITION.....	8
4.1.2	APPLICABILITY WITHIN THE DLT CONTEXT	9
4.1.3	APPLICABILITY WITHIN THE TEST.....	10
4.2	MONEY MARKET INSTRUMENTS	13
4.2.1	DEFINITION.....	13
4.2.2	APPLICABILITY WITHIN THE DLT CONTEXT	13
4.2.3	APPLICABILITY WITHIN THE TEST.....	14
4.3	UNITS IN COLLECTIVE INVESTMENT SCHEMES	16
4.3.1	DEFINITION.....	16
4.3.2	APPLICABILITY WITHIN THE DLT CONTEXT	16
4.3.3	APPLICABILITY WITHIN THE TEST.....	17
4.4	FINANCIAL DERIVATIVES	19
4.4.1	DEFINITION.....	19
4.4.2	APPLICABILITY WITHIN THE DLT CONTEXT	20
4.4.3	FINANCIAL INSTRUMENT C(IV)	21
4.4.4	FINANCIAL INSTRUMENT C(IV) – C(VII) - COMMODITY DERIVATIVES	23
4.4.5	FINANCIAL INSTRUMENT C(VIII)	26
4.4.6	FINANCIAL INSTRUMENT C(IX).....	26
4.4.7	FINANCIAL INSTRUMENT C(X).....	27
4.4.8	OTHER DERIVATIVE FINANCIAL INSTRUMENTS.....	31
4.5	EMISSIONS ALLOWANCES CONSISTING OF UNITS RECOGNISED FOR COMPLIANCE WITH THE REQUIREMENTS OF DIRECTIVE 2003/87/EC (EMISSIONS TRADING SCHEME)	38
4.5.1	DEFINITION.....	38

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4.5.2	APPLICABILITY WITHIN THE DLT CONTEXT	38
4.5.3	APPLICABILITY WITHIN THE TEST	39
5	CONCLUDING REMARKS	40

1 INTRODUCTION

One of the central points for discussion outlined in the MFSA [Discussion Paper On Initial Coin Offerings, Virtual Currencies And Related Service Providers](#) (Reference No. 08-2017), ('the Discussion Paper'), issued on the 30 November 2017, proposed the introduction of a 'Financial Instrument Test' ('the Test'). The objective of the Test is to determine whether a Distributed Ledger Technology ('DLT') asset¹, based on its specific features, is encompassed under (i) the existing EU legislation and the corresponding national legislation, (ii) the proposed Virtual Financial Assets Act ('VFAA') or (iii) is otherwise exempt.

It is envisaged that the Test will be applicable both within the context of an Initial Coin Offering as well as during the intermediation of DLT assets by persons undertaking certain activities in relation to such assets in or from within Malta.

This Consultation Paper presents an analysis of the definitions of the financial instruments listed under Markets in Financial Instruments Directive² ('MiFID') as well as their relevance and implications to DLT assets. The methodology underpinning the Test's determination as well as the considerations which should be taken into account within the context of the EU and national legislative frameworks are also presented.

Following this introduction, Section 2 outlines the objective, scope and methodology behind the Test and the respective considerations within the existing framework. Section 3 discusses the Test within the context of Virtual Tokens, while Section 4 discusses the Test within the context of those DLT assets falling within scope of current EU and national legislation. Lastly, the conclusion is presented under Section 5.

¹ Previously referred to as Virtual Currency ('VC')

² Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU

2 THE FINANCIAL INSTRUMENT TEST

2.1 Purpose

The objective of the Test is to reach a determination on how a DLT asset should be classified. It is being proposed that the Test will consist of two stages, wherein the first stage would effectively determine whether a particular DLT asset qualifies as a Virtual Token ('VT')³. Subject to a negative determination during the first stage, the second stage would determine whether the DLT asset would qualify as a financial instrument under Section C of Annex 1 to MiFID. Should a negative determination be reached again during this stage, then the DLT asset would qualify as a Virtual Financial Asset ('VFA') under the VFAA.

2.2 Scope

The Test shall be applicable to issuers of ICOs conducted in or from within Malta, so as to determine whether the respective activity should fall within the context of the applicable EU and respective national legislative and regulatory frameworks or otherwise. Concurrently, DLT assets whose classification has not been determined for any reason whatsoever, including *inter alia* because the issuance of the said asset was conducted abroad, entities should, prior to providing any service and/or performing any activity in relation to that particular DLT asset, conduct the Test.

2.3 Definitions

Distributed Ledger
Technology or DLT

means a digital or electronic database or ledger which ordinarily is

–

- (a) distributed, shared and replicated;
- (b) public or private or hybrids;
- (c) permissioned or permissionless or hybrids;
- (d) protected with cryptography or equivalent forms of encryption; and
- (e) auditable:

Provided that this term shall also include any other technology that achieves the same ends.

³ Previously referred to as utility token.

DLT asset	<p>means –</p> <ul style="list-style-type: none">(a) a virtual token;(b) a virtual financial asset; or(c) a financial instrument <p>that is intrinsically dependent on, or utilises, Distributed Ledger Technology.</p>
Initial Virtual Financial Asset Offering or Initial VFA Offering	<p>means a method of raising funds whereby an issuer is issuing virtual financial assets and is offering them in exchange for funds.</p>
Issuer	<p>means a legal person duly formed under any law for the time being in force in Malta which issues or proposes to issue virtual financial assets in or from within Malta.</p>
Smart contract	<p>means a form of technology arrangement consisting of an agreement concluded wholly or partly by electronic communications or wholly or partly in an electronic form, which is automatable and enforceable by tamper-proof execution of computer code, although some parts may require human input and control and which may be also enforceable by ordinary legal methods or by a mixture of both.</p>
Virtual financial asset	<p>means any form of digital medium recordation that is used as a digital medium of exchange, unit of account, or store of value and that is not –</p> <ul style="list-style-type: none">(a) electronic money;(b) a financial instrument; or(c) a virtual token.
Virtual token	<p>means a form of digital medium recordation that has no utility, value or application outside of the DLT platform on which it was issued and that cannot be exchanged for funds on such platform or with the issuer of such DLT asset;</p>

2.4 Requirement within VFAA

The Authority is proposing the introduction of the Test as a mandatory requirement under the VFAA, applicable to potential issuers of Initial Virtual Financial Asset Offerings and to Virtual Financial Asset Licence Holders, which would include exchanges and investment intermediaries. Non-licenced persons providing a service or performing an activity in relation to a DLT asset, in or from within Malta, shall also conduct the Test to determine the applicable regulatory framework.

2.5 Methodology

As illustrated in *Figure FIGURE 2.5-1*, for the determination to occur, the user of the Test would be required to sequentially and systematically assess the features of a DLT asset compared with a set of predetermined checklists.

On the basis of the user's input, the Test would determine whether that DLT asset falls within scope of the existing EU legislative and regulatory frameworks or otherwise. It is also being proposed as a requirement that the Test and the respective determination be confirmed by an external reviewer.

The Test shall consist of twelve checklists, the first of which focuses on VTs under the VFAA while the remaining focus on the various financial instruments under MiFID. In this respect, Section 3 discusses VTs and the rationale behind their exemption from the VFAA's scope. Thereafter, Section 4 discusses the definitions of the various financial instruments under the existing legal framework and the considerations that must be taken into account when applying the Test.

Question 1

Do you agree with the purpose and scope of the Financial Instrument Test?

Question 2

Do you agree that the Financial Instrument Test should be a mandatory requirement under the proposed legislative and regulatory framework?

Question 3

Do you agree with the MFSA's proposed methodology of the Financial Instrument Test?

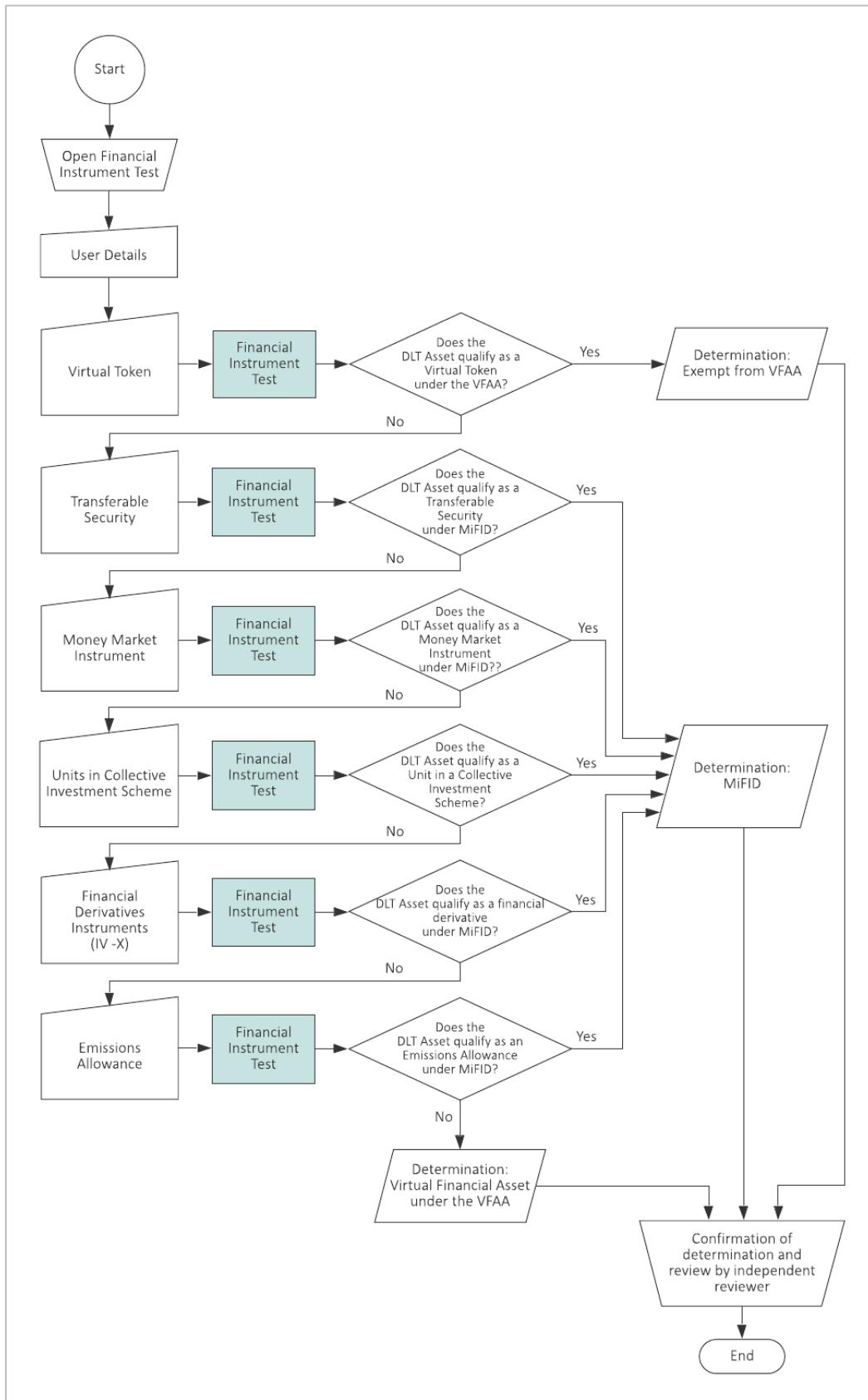


FIGURE 2.5-1: FLOW CHART OF THE FINANCIAL INSTRUMENT TEST

3 FINANCIAL INSTRUMENT TEST AND THE PROPOSED VIRTUAL FINANCIAL ASSETS ACT

Following on the proposal presented in Section 2.1, the first stage of the Test will include the determination of whether the DLT assets qualifies as a VT under the VFAA.

Such determination is being made in view of the proposal that VTs which are not exchangeable directly for legal tender, bank credit, or other DLT assets shall fall outside the scope of the Act.

3.1 Virtual Token

3.1.1 Definition

The proposed definition of a virtual token or VT under the VFAA, is a DLT asset which:

“...has no utility, value or application outside of the DLT platform on which it was issued and that cannot be exchanged for funds on such platform or with the issuer of such DLT asset...”

The above definition identifies two key features of VTs. Firstly such assets have utility, value or application solely within the context of DLT Platform on which it was issued. Additionally, such assets are unidirectional in nature, in that their utility, value or application may not be exchanged for funds on the platform or with the issuer.

3.1.2 Applicability within the DLT context

On the basis of the above definition, the following features should be identified to determine whether a DLT asset qualifies as a VT for the purposes of the VFAA:

- 1. Purpose**

The key characteristic is that it has no utility, value or application outside of the DLT platform on which it was issued.

- 2. Exchangeability**

In view of the proposal that exchangeable or bidirectional DLT assets should be considered as VFAs, the Test should determine whether there is capability for the value of the VT to be exchanged directly against legal tender, bank credit, or another DLT asset. Hence, only unidirectional DLT assets shall be considered as VTs for the purposes of the VFAA.

3.1.3 Applicability within the Test

On the basis of the above definitions, as illustrated in *Table* **TABLE 3.1-1**, the following features should be identified in order to determine whether a DLT asset qualifies as a VT for the purposes of the VFAA.

TABLE 3.1-1: CHECKLIST FOR VIRTUAL TOKENS UNDER THE VFAA

<i>Ref.</i>	<i>Feature</i>	<i>Requirement</i>
V1_1	The DLT asset has no utility, value or application outside of the DLT platform on which it was issued and that cannot be exchanged for funds on such platform or with the issuer of such DLT asset.	Mandatory

Logic: The Test would require V1_1 as a mandatory element.

Question 4

Do you agree with the MFSA's definition for Virtual Tokens?

Question 5

Do you agree that Virtual Tokens which can be exchanged for legal tender, bank credit or other DLT assets should fall within the scope of the Virtual Financial Assets Act?

Question 6

Do you agree with the proposed checklist for Virtual Tokens?

4 FINANCIAL INSTRUMENT TEST AND THE EXISTING LEGAL FRAMEWORK

The second stage of the Test determines whether a DLT asset qualifies as a financial instrument under MiFID and includes (1) transferable securities; (2) money market instruments; (3) units in collective investment schemes; (4) financial derivative instruments, which include a number of financial instruments, and (5) emission allowances consisting of units recognised for compliance with the requirements of Directive 2003/87/EC (Emissions Trading Scheme).

In terms of equivalence, whilst the Second Schedule of the Investment Services Act⁴ transposes all the financial instruments listed under MiFID, it includes two additional instruments, as follows:

- i. certificates or other instruments which confer property rights in respect of any instrument falling within said Schedule; and
- ii. foreign exchange acquired or held for investment purposes.

In this regard the Test excludes these instruments, given that they are either captured indirectly through the respective definitions of financial instruments under MiFID or not applicable within the context of DLT assets, such as in the case of foreign exchange acquired or held for investment purposes which deals specifically with fiat currencies.

Further to the latter, it should be noted that the Test focuses on the definitions presented under MiFID, with the exception of Units in a Collective Investment Scheme ('CIS'), given that the ISA definition captures all the mandatory elements of the various permutations of CISs available under current EU legislation.

4.1 Transferable Securities

4.1.1 Definition

Article 4(44) of MiFID defines 'transferable securities' as follows:

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

- (a) shares in companies and other securities equivalent to shares in companies, partnerships or other entities, and depositary receipts in respect of shares;*
- (b) bonds or other forms of securitised debt, including depositary receipts in respect of such securities;*

⁴ Chapter 370 of the Laws of Malta

- (c) *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, currencies⁵, interest rates or yields, commodities or other indices or measures;*

Further to the above, while instruments of payment are not defined within MiFID or any other EU law, the same definition notes that such instruments are excluded from MiFID, notwithstanding their negotiability on the capital markets. Therefore, for the purposes of the above definition and this Consultation Paper, instruments of payment shall be considered those instruments which do not establish a claim on the issuer and either function as a medium of exchange or have been established as means of payment to initiate or conclude one or more transactions to buy goods or services as agreed between two or more parties.

The Committee of European Securities Regulators ('CESR') has also determined in one of its Q&As⁶ that transferable securities do not include money market instruments as defined under MiFID.

4.1.2 Applicability within the DLT context

The Discussion Paper on investment-based crowdfunding⁷ issued by the Authority on 3 November 2016 includes the Authority's position on 'transferable securities', according to which the said term should be interpreted in a broad manner and only in very limited circumstances should a security be deemed to be non-transferable.

Further to the above, ESMA has also stated in its Advice on investment-based crowdfunding⁸ that "transferable, securities need only to be capable of being traded on the capital markets, in whatever context, and the existence or otherwise of a secondary market for a particular instrument is not a determining factor". Therefore, shares which are conditionally negotiable, such as shares of private companies, are still deemed to be transferable securities notwithstanding the applicable restrictions on their transferability.

In view of the above considerations, the Test would determine whether the DLT asset is:

1. Negotiable on the capital market

This determination is central, given that if the DLT asset in question is not negotiable on the capital market, it does not fall within the definition of a transferable security.

⁵ For the purpose of this Consultation, the term "currencies" shall refer solely to fiat currencies.

⁶ [CESR/09-559 – CESR Q&A on MiFID complex and non-complex financial instruments for the purposes of the Directive's appropriateness requirements](#)

⁷ [Discussion Paper on Investment-Based Crowdfunding](#)

⁸ [ESMA/2014/1560](#)

2. Rights

A DLT asset's classification as a transferable security is further subject to the assessment of the rights attached to it in order to determine whether these effectively render 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.

3. Instrument of Payment

In view of the consideration that the definition of transferable securities under MiFID excludes instruments of payment, a DLT asset which qualifies as such shall not be considered as a financial instrument under MiFID.

4.1.3 Applicability within the Test

As discussed in Section 4.1.2, the first criterion to be assessed is the negotiability of a DLT asset on the capital markets. Therefore, it has been established that such a feature is a *sine qua non* for a DLT asset's classification as a transferable security. In this respect, the Test also determines whether the transferability of the DLT asset is restricted solely to the issuer, given that only under such a scenario would the DLT asset be considered as non-transferable. For the purposes of this determination, the negotiability feature shall also apply to DLT assets which have not yet been issued, should such assets be designed to be negotiable on the capital market at issuance.

Notwithstanding the fact that equity and non-equity securities are issued by a company formed and registered in terms of the Companies Act⁹, the Authority has decided to adopt a substance-over-form approach in regards to the Test. Therefore, and in order to be determined as a transferable security, the DLT asset should embed certain criteria and/or confer certain rights which render it equivalent to shares, bonds or other transferable securities.

Pursuant to the Companies Act, shares may carry a spectrum of rights including, *inter alia*, voting rights, dividend rights and right to a claim on the net asset value. Nevertheless, such rights are not viewed as determining features given that (i) these may also be found in other asset classes and (ii) certain shares do not carry all, or even any, of these rights. Therefore, although such rights are embedded in many DLT assets, such assets should not be determined to qualify as shares solely due to such rights.

In view of the aforementioned considerations, any one or more of the following rights are required in order for a DLT asset to qualify as a share:

- i. Participation in the capital of the issuer;
- ii. Right to receive proceeds from the liquidation of issuer in excess of nominal value; or

⁹ Chapter 386 of the Laws of Malta

TABLE 4.1-1: CHECKLIST FOR TRANSFERABLE SECURITIES

<i>Ref.</i>	<i>Feature</i>	<i>Requirement</i>
Maturity		
T1_1	The DLT asset has a maturity at issuance of more than 397 days	Mandatory
Instrument of Payment		
Is the DLT asset... [T1_2 or T1_3] ...to initiate or conclude transaction/s to buy goods or services as agreed between two or more parties, and has no claim on the issuer?		
T1_2	... function as a medium of exchange...	Select only one (If Yes, the DLT asset is excluded from MiFID)
T1_3	...an established means of payment...	
IF NOT AN INSTRUMENT OF PAYMENT...		
Features of Transferable Security		
Does the DLT asset have the following features:		
T1_4	Negotiable on the capital markets notwithstanding whether it has been issued or not	Mandatory
T1_5	Right to participate in the capital of the issuer	At least one or more
T1_6	Right to receive proceeds from the liquidation of issuer in excess of nominal value	
T1_7	Entry in the register of shareholders	
T1_8	Right to a principal amount due of fixed sum with fixed/ variable maturity	
T1_9	Entry in the register of debenture holders	
T1_10	Right to acquire or sell a transferable security	
T1_11	Right to an amount settled in cash determined by reference to transferable securities, currencies ^[1] , interest rates or yields, commodities or other indices or measures	

Logic: The Test would require (i) T1_1 as a mandatory element and (ii) that both T1_2 and T1_3 are not satisfied and (ii) one or more of T1_4, T1_5, T1_6, T1_7, T1_8, T1_9, T1_10 and/or T1_11.

Note:

- [1] For the purposes of this Test, currencies shall refer to fiat currency which is legal tender in the country in which it is issued.

- iii. Entry in the register of shareholders.

Meanwhile, in relation to bonds and other forms of securitised debt, after an in-depth analysis of the economic features of a bond, any one or more of the following rights would need be embedded in a DLT asset in order for it to qualify as a debt security:

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

The checklist would also determine whether the DLT asset confers the right to acquire or sell any such transferable security or gives rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures.

Lastly, in view of the view that instruments of payment are excluded from MiFID, DLT assets which establish no claims on the issuer, and either function as a medium of exchange or have been established as means of payment to initiate or conclude one or more transactions to buy goods or services as agreed between two or more parties.

Therefore, as illustrated in *Table TABLE 4.1-1*, in order for the Test to determine that a DLT asset falls within the definition of a transferable security, it would require (i) a maturity at issuance greater than 397 days [T1_1]; (ii) that is not an instrument of payment [T1_2 or T1_3]; and (iii) have the features of a transferable security, which would require the element of negotiability, as has been described above, [T1_4] and any one of the rights attached to transferable securities [T1_5, T1_6, T1_7, T1_8, T1_9, T1_10 and/or T1_11].

Question 7

Do you agree with the MFSA's interpretation of transferable securities, as defined under MiFID, within the DLT context?

Question 8

Do you agree with the proposed checklist for determining whether a DLT asset qualifies as a transferable security, as defined under MiFID?

4.2 Money Market Instruments

4.2.1 Definition

In line with the MiFID definition¹⁰, the ISA defines ‘money-market instruments’ as “those classes of instruments which are normally dealt in on the money market, such as treasury bills, certificates of deposit and commercial papers and excluding instruments of payment”.

Further to the MiFID definition, Article 11 of Commission Delegated Regulation (EU) 2017/565¹¹ specifies the characteristics which money-market instruments and any other instruments with substantively equivalent features should satisfy. In this respect, such instruments should:

- i. have a value that can be determined at any point in time;
- ii. are not derivatives; and
- iii. have a maturity at issuance of 397 days or less.

Additionally, these instruments should also have features substantively equivalent to treasury bills, certificates of deposit and commercial papers. Therefore, it is implied that the key features underlying such instruments would be similar to those of short-term obligations to the issuer obtained through on-balance sheet and/or off-balance sheet activities.

It should be noted that the Companies Act does not distinguish between bonds and money market instruments but encompasses both under the umbrella term ‘debentures’¹².

4.2.2 Applicability within the DLT context

Therefore, in view of the aforementioned considerations, the Test would effectively need to assess the DLT asset’s:

1. Maturity

As noted above, the distinguishing factor between a transferable security and money market instrument is its maturity. Therefore, following the criteria presented in Article 3 of Commission Directive 2007/16/EC, the determination on whether such an asset would be classified as a money market instrument would be based on whether the DLT asset has a maturity at issuance of up to 397 days or less.

¹⁰ Article 4(1)(17) of MiFID

¹¹ [Commission Delegated Regulation \(EU\) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive](#)

¹² Article 2 of the Companies Act (Chapter 386 of the Laws of Malta)

2. Rights

Further to the MiFID definition and the Commission Delegated Regulation (EU) 2017/565, the Test should also assess whether the DLT asset's features are similar to those of other instruments falling within the definition's scope, including *inter alia* treasury bills, certificates of deposit and commercial papers and other instruments with substantively equivalent features. This is subject to the condition that the DLT asset does not qualify as a derivative.

3. Accurate valuation

The Commission Delegated Regulation (EU) 2017/565 stipulates that such instruments should have a value that can be determined at any point in time.

4. Instrument of Payment

The definition of money market instruments excludes instruments of payment; hence, a DLT asset which qualifies as such shall be excluded from MiFID.

4.2.3 Applicability within the Test

In view of the above considerations, as illustrated in *Table* TABLE 4.2-1, in order for a DLT asset to qualify as a money market instrument, the following would be required:

- i. have a maturity at issuance of 397 days or less [T2_1];
- ii. not qualify as an instrument of payment [T2_2 and T2_3];
- iii. not qualify as a derivative [T2_4];
- iv. have a value that may be accurately determined at any point in time [T2_5]; and
- v. either give rise to an obligation to the issuer obtained through on-balance sheet and/or off-balance sheet activities [T2_6] or embed the rights attributable to debenture holders [T2_7].

TABLE 4.2-1: CHECKLIST FOR MONEY MARKET INSTRUMENTS

<i>Ref.</i>	<i>Feature</i>	<i>Requirement</i>
Maturity		
Does the DLT asset have a...		
T2_1	maturity at issuance of 397 days or less?	Mandatory

Instrument of Payment

Is the DLT asset... [T1_2 or T1_3] ...to initiate or conclude transaction/s to buy goods or services as agreed between two or more parties, and has no claim on the issuer?

TABLE 4.2-1: CHECKLIST FOR MONEY MARKET INSTRUMENTS

<i>Ref.</i>	<i>Feature</i>	<i>Requirement</i>
T2_2	... function as a medium of exchange...	Select only one (If Yes, the DLT asset is excluded from MiFID)
T2_3	...an established means of payment...	

IF NOT AN INSTRUMENT OF PAYMENT...

Features of Money Market Instrument

Does the DLT asset have the following features:

T2_4	The DLT asset does not qualify as a derivative	Mandatory
T2_5	The DLT asset's value can be accurately determined at any point in time	
T2_6	Does the DLT asset give rise to either an on-balance sheet or off-balance sheet obligation to the issuer?	At least one or more
T2_7	Entry in the register of debenture holders	

Logic: The Test would require (i) T2_1 as a mandatory element and (ii) that both T2_2 and T2_3 are not satisfied and (ii) one or more of T2_4, T2_5, T2_6 and/or T2_7.

Question 9

Do you agree with the MFSA's interpretation of money market instruments, as defined under MiFID, within the DLT context?

Question 10

Do you agree with the proposed checklist for determining whether a DLT asset qualifies as a money market instrument, as defined under MiFID?

4.3 Units in a Collective Investment Schemes

4.3.1 Definition

The definition of a CIS as presented under Article 2(1) of the ISA, is 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.”

Further to the discussion presented in Section 4, the aforementioned ISA definition encompasses both subsets of CISs, being (i) undertaking for collective investment of transferable securities (‘UCITS’) and (ii) alternative investment funds (‘AIFs’).

4.3.2 Applicability within the DLT context

In view of the above considerations, in order to determine whether a DLT asset represents a unit in a CIS, the determination would have to focus on whether the undertaking qualifies as a CIS in terms of the above definition. The Test would include:

1. Purpose

The DLT asset in issue should enable investors to participate in or receive profits or income arising from the acquisition, holding, management or disposal of such DLT asset and the objective of the issue should be the collective investment of capital.

2. Arrangements

The undertaking should also have one of the necessary characteristics outlined under points (b) to (d) of the CIS definition above.

4.3.3 Applicability within the Test

As illustrated in *Table TABLE 4.3-1*, in order for the Test to determine that a DLT asset qualifies as a CIS unit, the fulfilment of all mandatory features and at least one of the other criteria mentioned below would be required.

TABLE 4.3-1: CHECKLIST FOR UNITS IN A COLLECTIVE INVESTMENT SCHEME

<i>Ref.</i>	<i>Feature</i>	<i>Requirement</i>
Features of Units in a Collective Investment Scheme		
Does the DLT asset qualify as a Unit,...		
T3_1	...in an undertaking that constitutes a scheme or arrangement which has as its object or as one of its objects the collective investment of capital,...	Mandatory
T3_2	...and in which the capital is raised through offer of DLT assets for subscription, sale or exchange from one or more investor	
T3_4	... in which the contributions of the participants and the profits or income out of which payments are to be made to them are pooled	At least one or more
T3_5	...which are or are to be repurchased or redeemed out of the assets of the issuing entity, continuously or in blocks at short intervals at the request of the holders of the DLT assets?	
T3_6	...which are, or have been, or will be issued continuously or in blocks at short intervals?	

Logic: The Test would require (i) T3_1, and T3_2 as mandatory elements and (ii) one or more of T3_4, T3_5 & T3_6.

Note:

- [1] For the purposes of the Test, 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 nonfinancial services, or (ii) an industrial activity, involving the production of goods or construction of properties, or (iii) a combination thereof.

Pursuant to the definition presented in Section 4.3.1, and in view of the fact that certain collective investment schemes are allowed to derogate from the risk diversification principle (e.g. professional investor funds promoted to qualifying investors), it is the Authority's opinion that the said principle should not be seen as a decisive factor for the purposes of the Test. Moreover, the classification of a

scheme as (i) open-ended or closed-ended or (ii) retail or non-retail should also be deemed irrelevant for the purposes of the Test.

In regards to the mandatory features, (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 [T3_1], and (ii) the raising of such capital should be done through offer of DLT assets for subscription, sale or exchange [T3_2].

Additionally, in order to determine whether a DLT asset qualifies as a CIS unit, one of the following requirements needs also to be met:

- i. the contributions of the participants and the profits or income out of which payments are to be made to them are pooled [T3_3] or
- ii. 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 [T3_4] or
- iii. the DLT assets are, or have been, or will be issued continuously or in blocks at short intervals [T3_5].

Question 11

Do you agree with the MFSA's interpretation of units in a Collective Investment Scheme, as defined under the ISA within the DLT context?

Question 12

Do you agree with the proposed checklist for determining whether a DLT asset qualifies as a unit in a Collective Investment Scheme, as defined under the ISA?

4.4 Financial Derivatives

4.4.1 Definition

Article 2 (29) of Regulation (EU) No 600/2014 defines ‘derivatives’ as those financial instruments defined in point (44)(c) of Article 4(1) and Annex I, Section C (4) to (10), to MiFID.

In this respect, point (44)(c) of Article 4(1) of MiFID refers to ‘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’. Meanwhile, point (4) to (10) of Annex I, Section C, to MiFID make reference to the financial instruments under the said Directive which are presented in *Table TABLE 4.4-1*. The latter is further supplemented by the Commission Delegated Regulation (EU) 2017/565.

To simplify the complexities present within these financial instruments, it has been determined that the Test should break into a separate section for each Financial Instrument. Additionally, given the complexities presented by ‘other derivative contracts relating to currencies’ and ‘other derivative financial instruments’, the Test shall also include a separate section dedicated to such contracts. The definitions and the respective relevant criteria for the determination of a DLT asset as financial derivative is presented below.

TABLE 4.4-1: FINANCIAL DERIVATIVES AS PER SECTION C OF ANNEX 1 OF MIFID II

<i>Para.</i>	<i>Financial Instrument</i>	<i>Reference</i>
(4)	Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, emission allowances or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash	C(IV)
(5)	Options, futures, swaps, forwards and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event	C(V)
(6)	Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market, a MTF, or an OTF, except for wholesale energy products traded on an OTF that must be physically settled	C(VI)
(7)	Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in point 6 of this Section and not being for commercial purposes, which have the characteristics of other derivative financial instruments	C(VII)
(8)	Derivative instruments for transfer of credit risk	C(VIII)

TABLE 4.4-1: FINANCIAL DERIVATIVES AS PER SECTION C OF ANNEX 1 OF MIFID II

<i>Para.</i>	<i>Financial Instrument</i>	<i>Reference</i>
(9)	Financial contracts for differences	C(IX)
(10)	Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event, as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, <i>inter alia</i> , they are traded on a regulated market, OTF, or an MTF	C(X)

Source: Official Journal of the European Union, 2014

4.4.2 Applicability within the DLT context

In order to determine whether a DLT asset qualifies as a financial derivative under MiFID, the following features of such DLT asset should be taken into consideration for C(IV) to C(VIII) and C(X) financial instruments:

1. Contract type

The Test would firstly need to determine whether the DLT asset is akin to an option, future, swap, forward rate agreement or any other derivative contracts currently available in the markets. Moreover, with reference to certain ‘other’ derivative contracts, the Test should also determine whether the DLT asset has the characteristics of other derivative financial instruments in accordance with Article 7 of the Commission Delegated Regulation (EU) 2017/565.

2. Underlying

Additionally, the Test should also establish whether the underlying, qualify as one of the several underlying assets captured within MiFID’s scope.

3. Settlement

Lastly, the Test would also need to determine whether the DLT asset is settled in accordance with the settlement conditions applicable to the specific financial derivative in terms of MiFID.

Meanwhile, for C(VIII) and C(IX) financial instruments only the following consideration should be applicable:

4. Purpose

The Test should also establish the underlying purpose of the contract, so as to identify whether the DLT asset qualifies as a C(VIII) and C(IX) financial instrument.

Lastly, it should be noted that the user of the Test should take into consideration not only the DLT asset but also any accompanying documentation in order to determine whether either of the two qualifies as a financial instrument under this section.

4.4.3 Financial Instrument C(IV)

4.4.3.1 Definition

Financial instrument C(IV) captures options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, emission allowances or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash.

4.4.3.2 Applicability within the Test

In order to determine whether a DLT asset qualifies as a C(IV) financial instrument, the Test shall consider the (i) contract type, (ii) underlying; and (iii) terms of settlement. In this respect *Table* **TABLE 4.4-2** presents the aforementioned considerations in further detail.

Therefore, when determining whether a DLT asset should qualify as a C(IV) financial instrument, the following criteria are required to be satisfied:

- i. the DLT asset is akin to an option [T4_1], futures/forward rate agreement [T4_2], swap [T4_3] or any other derivative contract [T4_4];
- ii. the DLT asset relates to securities [T4_5], currencies [T4_6], interest rates or yields [T4_7], emission allowances [T4_8] or other derivatives instruments, financial indices or financial measures [T4_9]; and
- iii. the DLT asset can be settled physically or in cash [T4_10].

Should the Test determine that the DLT asset is in relation to currencies [T4_6], a further determination needs to be made, as further discussed under Section 4.4.8.1.

TABLE 4.4-2: CHECKLIST FOR C(IV) FINANCIAL INSTRUMENTS UNDER MIFID

<i>Ref.</i>	<i>Feature</i>	<i>Requirement</i>
Contract Type Is the DLT asset,...		
T4_1	Option: ...termed as an option or has features equivalent to options?	Select only one
T4_2	Future/Forward rate agreement: ...termed as a future/forward rate agreement or has features equivalent to futures /Forward rate agreements?	
T4_3	Swap: ...termed as a <u>swap</u> or has features equivalent to swaps?	
T4_4	Other derivative contracts?	

Underlying
Does the DLT asset give rise to an economic exposure based one of the following underlying assets?

T4_5	securities	Select only one
T4_6	Currencies ^{[1][2]}	
T4_7	interest rates or yields	
T4_8	emission allowances	
T4_9	other derivative instruments, financial indices or financial measures	

Settlement
Can the DLT asset be ...

T4_10	...settled physically or in cash?	Mandatory
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Logic: The Test would require one from T4_1, T4_2, T4_3 and T4_4 and (ii) one of T4_5, T4_6, T4_7, T4_8 and T4_9 and (iii) T4_10.

Notes:

[1] In the event that T4_6 is selected the user shall also have to perform and proceed to test the Other Derivative Contracts relating to Currencies, as presented in *Table TABLE 4.4-7*.

[2] For the purpose of the Test, currencies shall refer to any fiat currency which is legal tender in the country in which it is issued.

4.4.4 Financial Instrument C(IV) – C(VII) - Commodity Derivatives

4.4.4.1 Definition

Article 2(30) of the Markets in Financial Instruments Regulation¹³ (MiFIR) defines commodity derivatives as those financial instruments defined in point (44)(c) of Article 4(1) of MiFID (*as discussed above under Section 4.1.1*); which relate to a commodity or an underlying referred to in Section C(10) of Annex I to MiFID (*as discussed in below in Section 4.4.7*); or in points (5), (6), (7) and (10) of Section C of Annex I thereto (*as discussed in the below Sections 4.4.4.1.1 to 4.4.4.1.3 and Section 4.4.7, respectively*).

Therefore, the following commodity derivatives fall within MiFID's scope:

- i. derivatives in relation to commodity derivatives C(IV) (this is discussed in Section 4.4.3);
- ii. cash-settled commodity derivatives C(V);
- iii. physically settled commodity derivatives traded on certain markets or facilities C(VI);
- iv. other commodity derivatives capable of physical settlement and not for commercial purposes and which have characteristics of other derivative financial instruments C(VII).

For the purposes of the above, point (6) of Article 2 of Commission Delegated Regulation (EU) 2017/565 defines a commodity as “any goods of a fungible nature that are capable of being delivered, including metals and their ores and alloys, agricultural products, and energy such as electricity”. Furthermore, Recital 26 of MiFIR stipulates that “the concept of commodity should not include services or other items that are not goods, such as currencies or rights in real estate, or that are entirely intangible”. Therefore, in view of the latter, for the purposes of the Test, DLT assets should not constitute commodities due to their intangible nature. This notwithstanding, a DLT asset with an underlying that is a commodity under MiFID may constitute a commodity derivative under MiFID.

4.4.4.1.1 Financial Instrument C(V)

Financial derivatives falling under C(V) are commodity derivatives which must be settled in cash or provide the option for cash settlement by one of the parties, excluding reasons of default or other termination events.

4.4.4.1.2 Financial Instrument C(VI)

Financial derivatives falling under C(VI), relating to commodity derivatives that can be physically settled¹⁴ and traded on a regulated market, a MTF, or an OTF, except for wholesale energy products traded on an OTF, that must be physically settled.

¹³ Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012

¹⁴ Article 5(7) of the Commission Delegated Regulation (EU) 2017/565, defines ‘physically settled’ as at least: (a) physical delivery of the relevant commodities themselves; (b) delivery of a document giving rights of an ownership nature to the relevant commodities or the relevant quantity of the commodities concerned; (c) other methods of bringing about the transfer of rights of an ownership nature in relation to the relevant quantity of goods without physically delivering them, including

Further to the above, Article 6 of the Commission Delegated Regulation (EU) 2017/565 further specifies the energy derivative contracts relating to oil and coal as well as which derivative contracts have the characteristics of wholesale energy products.

4.4.4.1.3 Financial Instrument C(VII)

Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled, not otherwise mentioned herein and not being for commercial purposes, which have the characteristics of other derivative financial instruments.

4.4.4.2 Applicability within the Test

In order to determine whether a DLT asset qualifies as a C(V) to C(VII) financial instruments, the Test shall consider the (i) contract type, (ii) underlying and (iii) terms of settlement. In this respect, *Table TABLE 4.4-3* presents the aforementioned considerations. .

When determining whether a DLT asset should qualify as a C(V), C(VI) or C(VII) financial instrument under MiFID, the Test would need to determine whether:

- i. the DLT asset is akin to one of the derivative contract types [T5_1, T5_2, T5_3 or T5_4,];
and
- ii. the DLT asset relates to a commodity [T5_5].

Further to the latter, the decisive feature distinguishing between the three commodity derivatives is the settlement terms. Therefore, where the DLT asset can be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event [T5_6], it would qualify as a C(V) financial instrument.

Meanwhile, if the DLT asset can be physically settled, and provided that they are traded on a regulated market, a MTF or an OTF, except for wholesale energy products traded on an OTF that must be physically settled [T5_7], such DLT asset would qualify as a C(VI) financial instrument.

Lastly, should the DLT asset be in relation to commodities falling outside the scope of a C(VI) financial instrument and having the characteristics of an 'other' derivative financial instrument [T5_4], a further determination needs to be made, as discussed in further detail under Section 4.4.8.2, as to whether the DLT asset qualifies as an 'other' derivative financial instrument under C(VII).

notification, scheduling or nomination to the operator of an energy supply network, that entitles the recipient to the relevant quantity of the goods.

TABLE 4.4-3: CHECKLIST FOR C(V) - C(VII) FINANCIAL INSTRUMENTS UNDER MIFID

<i>Ref.</i>	<i>Feature</i>	<i>Requirement</i>
Contract Type Is the DLT asset ...		
T5_1	Option: ...termed as an option or has features equivalent to options?	Select only one
T5_2	Future/forward: ...termed as a future/forward or has features equivalent to futures/forwards?	
T5_3	Swap: ...termed as a swap or has features equivalent to swaps?	
T5_4	Other derivative contracts?	
Underlying Does the DLT asset give rise to an exposure based one of the following underlying asset?		
T5_5	Commodities ^[1]	Mandatory
Settlement Can the DLT asset be ...		
T5_6	...settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event?	Select only one
T5_7	...physically settled provided that they are traded on a regulated market, a MTF or an OTF, except for wholesale energy products traded on an OTF, that must be physically settled?	
T5_8	...physically settled and not having the features of T5_7 and have the characteristics of other derivative financial instruments? ^[2]	

Logic: The Test would require anyone from T5_1, T5_2, T5_3 or T5_4 and (ii) T5_5, and (iii) either one of T5_6, T5_7 or T5_8.

Notes:

[1] For the purposes of the Test, DLT assets should not qualify as commodities due to their intangible nature.

[2] In the event that T5_8 is selected the user shall also have to perform and proceed to test the Other Derivative Financial Instrument, as presented in *Table* **TABLE 4.4-8**.

4.4.5 Financial Instrument C(VIII)

4.4.5.1 Definition

Derivative instruments for the transfer of credit risk, as referred to in C(VIII), refer to financial derivatives designed solely to transfer credit risk from one party to another.

4.4.5.2 Applicability within the Test

In order to determine whether a DLT asset qualifies as a C(VIII) financial instrument, the Test would need to consider the purpose of the DLT asset and whether such DLT asset or smart contract allows for the transferring of credit risk from one party to another.

Therefore, as illustrated in TABLE 4.4-4, in order for a DLT asset to qualify as a C(VIII) financial instrument under MiFID, the Test would solely require that the DLT asset is designed and/or used for the purposes of transferring credit risk from one party to another [T6_1].

TABLE 4.4-4: CHECKLIST FOR C(VIII) FINANCIAL INSTRUMENTS UNDER MIFID

<i>Ref.</i>	<i>Feature</i>	<i>Requirement</i>
Contract Purpose Is the DLT asset...		
T6_1	...designed and/or used for the sole purposes of and/or result in the transferring of credit risk from one party to another?	Mandatory

Logic: The Test would require T6_1 as a mandatory element.

4.4.6 Financial Instrument C(IX)

4.4.6.1 Definition

In its Addendum Consultation Paper to MiFID/MiFIR¹⁵, ESMA defines a financial contract for difference ('CFD') as "a derivative product that gives the holder an economic exposure, which can be long or short, to the difference between the price of an underlying asset at the start of the contract and the price when the contract is closed". The latter is notwithstanding where the CFD is deliverable or not.

This would also encompass CFDs giving the holder an economic exposure to the difference in the price of two different underlying assets.

¹⁵ ESMA/2015/319

4.4.6.2 *Applicability within the Test*

In order to determine whether a DLT asset qualifies as a C(IX) financial instrument, the Test would need to consider the purpose of the DLT asset, and whether such DLT asset gives the holder an economic exposure equivalent to a CFD contract, deliverable or otherwise.

TABLE 4.4-5: CHECKLIST FOR C(IX) FINANCIAL INSTRUMENTS UNDER MIFID

<i>Ref.</i>	<i>Feature</i>	<i>Requirement</i>
Contract Purpose Does the DLT asset...		
T7_1	Contract for Difference: ...termed as a Contract for Difference or give the holder an economic exposure, which can be long or short, to (i) the difference between the price of an underlying asset at the start of the contract and the price when the contract is closed or (ii) the difference in the price of two different underlying assets?	Mandatory

Logic: The Test would require T7_1 as a mandatory element.

Hence, as shown in *Table TABLE 4.4-5*, in order for a DLT asset to qualify as a C(IX) financial instrument under MiFID, the Test would solely require that the DLT asset either be termed as a CFD or give the holder an economic exposure, which can be long or short, to the difference between the price of an underlying asset at the start of the contract and the price when the contract is closed [T7_1].

4.4.7 *Financial Instrument C(X)*

4.4.7.1 *Definition*

Financial derivatives falling under C(X) captures two types of instruments. The first type relates to options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event. The second captures other derivative financial instruments relating to underlying assets as stipulated by Articles 8 of Commission Delegated Regulation (EU) 2017/565, which include:

- i. telecommunications bandwidth;
- ii. commodity storage capacity;

- iii. transmission or transportation capacity relating to commodities, whether cable, pipeline or other means;
- iv. an allowance, credit, permit, right or similar asset which is directly linked to the supply, distribution or consumption of energy derived from renewable resources;
- v. a geological, environmental or other physical variable;
- vi. any other asset or right of a fungible nature, other than a right to receive a service, that is capable of being transferred;
- vii. an index or measure related to the price or value of, or volume of transactions in any asset, right, service or obligation; and
- viii. an index or measure based on actuarial statistics¹⁶.

Further to the above, in order for derivative contracts relating to any of the aforementioned underlying assets to qualify as 'other' derivative financial instruments, Article 7 of the Commission Delegated Regulation (EU) 2017/565 stipulates that such contracts must at least satisfy one of the following criteria:

- i. must be settled in cash or may be settled in cash at the option of one or more of the parties, otherwise than by reason of a default or other termination event;
- ii. must be traded on a regulated market, an MTF, an OTF, or a third country trading venue that performs a similar function to a regulated market, MTF or an OTF; or
- iii. must satisfy the conditions applicable to 'other derivative financial instruments' pursuant to Article 7(1) of the Commission Delegated Regulation (EU) 2017/565, as discussed under Section 4.4.8.2.

4.4.7.2 *Applicability within the Test*

In view of the considerations and complexities outlined above, the checklists applicable to such DLT assets have been divided into two: (i) one for options, futures, swaps, forward rate agreements and (ii) another focusing on the characteristics of 'other' derivative financial instruments, which shall be further discussed under Section 4.4.8.2.

As illustrated in *Table* **4.4-6**, in order to determine whether a DLT asset qualifies as a C(X) financial instrument, the Test would need to consider the (i) contract type, (ii) underlying; and (iii) terms of settlement.

In order for a DLT asset to qualify as a C(X) financial instrument under MiFID, the Test would need to determine:

- i. whether the DLT asset is akin to one of the derivative contract types [T8_1, T8_2, T8_3 or T8_4];

¹⁶ In accordance with Recital (6) of the Commission Delegated Regulation (EU) 2017/565, the inclusion of actuarial statistics as one of the underlying assets does not extend to insurance and reinsurance contracts.

- ii. whether the DLT asset, is in relation to one of the underlying asset or measures under MiFID specific to this financial instrument [T8_5, T8_6, T8_7, T8_8, T8_9, T8_10, T8_11, T8_12, T8_13, T8_14 or T8_15]; and
- iii. whether the DLT asset (i) can be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event [T8_16]; or (ii) is traded on a regulated market, a MTF, an OTF, or a third country trading venue that performs a similar function to a regulated market, MTF or an OTF [T8_17]; or (iii) fulfils the characteristics of an ‘other’ derivative financial instrument [T8_18].

In relation to point (iii) above, it should be noted that where a DLT asset satisfies either one [T8_16] or [T8_17], it should also be considered as an ‘other’ derivative financial instrument under MiFID. Otherwise, in the event that the DLT asset does not satisfy the aforementioned conditions, a further determination would need to be made as to whether the said DLT asset qualifies as an ‘other’ derivative financial instrument subject to conditions discussed in further detail under Section 4.4.8.2.

TABLE 4.4-6: CHECKLIST FOR C(X) FINANCIAL INSTRUMENTS UNDER MIFID

<i>Ref.</i>	<i>Feature</i>	<i>Requirement</i>
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Contract Type
Does the DLT asset...

T8_1	Option: ...termed as an option or has features equivalent to options?	Select only one
T8_2	Future/Forward rate agreement: ...termed as a future/forward rate agreement or has features equivalent to futures /Forward rate agreements?	
T8_3	Swap: ...termed as a swap or has features equivalent to swaps?	
T8_4	Other derivative contracts?	

Underlying

Does the DLT asset give rise to an economic exposure based one of the following underlying asset?

T8_5	climatic variables	Select only one
T8_6	freight rates or inflation rates	
T8_7	other official economic statistics	

TABLE 4.4-6: CHECKLIST FOR C(X) FINANCIAL INSTRUMENTS UNDER MIFID

<i>Ref.</i>	<i>Feature</i>	<i>Requirement</i>
T8_8	telecommunications bandwidth	Select only one
T8_9	commodity storage capacity	
T8_10	transmission or transportation capacity relating to commodities, whether cable, pipeline or other means	
T8_11	an allowance, credit, permit, right or similar asset which is directly linked to the supply, distribution or consumption of energy derived from renewable resources	
T8_12	a geological, environmental or other physical variable	
T8_13	any other asset or right of a fungible nature, other than a right to receive a service, that is capable of being transferred	
T8_14	an index or measure related to the price or value of, or volume of transactions in any asset, right, service or obligation	
T8_15	an index or measure based on actuarial statistics	

Settlement/Characteristics of Other Derivative Financial Instruments
Can the DLT asset...

T8_16	...be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event?	Select only one
T8_17	...be traded on a regulated market, an MTF, an OTF, or a third country trading venue that performs a similar function to a regulated market, MTF or an OTF?	
T8_18	...have the characteristics of other derivative financial instruments ? ^[1]	

Logic: The test would require (i) one of T8_1, T8_2, T8_3 or T8_4 and (ii) either one of T8_5, T8_6, T8_7, T8_8, T8_9, T8_10, T8_11, T8_12, T8_13, T8_14 or T8_15 and (iii) either one of T8_16, T8_17 or T8_18.

Note:

- [1] In the event that T8_16 and T8_17 are not satisfied, the user shall also have to perform and proceed to test the Other Derivative Financial Instrument, as presented in *Table* **4.4-8**, to determine whether the conditions applicable to T8_18 are applicable.

4.4.8 Other Derivative Financial Instruments

4.4.8.1 Other derivative contracts relating to currencies

4.4.8.1.1 Definition

C(IV) financial instruments includes other derivative contracts relating to currencies. The characteristics of such contracts are further specified within Article 10 of the Commission Delegated Regulation (EU) 2017/565. In this respect, other derivative contracts relating to currencies shall not qualify as ‘other’ derivative contracts relating to currencies when they are:

- i. a spot contract; or
- ii. a means of payment.

Article 10 (2) Commission Delegated Regulation (EU) 2017/565 defines a ‘spot contract’ as a contract for the exchange of one currency to another currency, under the terms of which delivery is scheduled to be made within the longer of the following periods:

- i. 2 trading days¹⁷ in respect of any pair of the major currencies¹⁸;
- ii. for any pair of currencies where at least one currency is not a major currency, the longer of 2 trading days or the period generally accepted in the market for that currency pair as the standard delivery period; or
- iii. where the contract for the exchange of those currencies is used for the main purpose of the sale or purchase of a transferable security or a unit in a collective investment undertaking, the period generally accepted in the market for the settlement of that transferable security or a unit in a collective investment undertaking as the standard delivery period or 5 trading days, whichever is shorter.

Meanwhile, Article 10 (1) of the Commission Delegated Regulation (EU) 2017/565, further specifies that for a contract to qualify as a means of payment it should:

- i. be settled physically otherwise than by reason of a default or other termination event;
- ii. be entered into by at least a person which is not a financial counterparty within the meaning of Article 2(8) of Regulation (EU) No 648/2012 of the European Parliament and of the Council;
- iii. be entered into in order to facilitate payment for identifiable goods, services or direct investment; and

¹⁷ In accordance with Article 10(4) of Commission Delegated Regulation (EU) 2017/565, a trading day shall mean any day of normal trading in the jurisdiction of both the currencies that are exchanged pursuant to the contract for the exchange of those currencies and in the jurisdiction of a third currency where any of the following conditions are met: (a) the exchange of those currencies involves converting them through that third currency for the purposes of liquidity; (b) the standard delivery period for the exchange of those currencies references the jurisdiction of that third currency.

¹⁸ According to Article 10(3) of Commission Delegated Regulation (EU) 2017/565, major currencies shall only include the US dollar, Euro, Japanese yen, Pound sterling, Australian dollar, Swiss franc, Canadian dollar, Hong Kong dollar, Swedish krona, New Zealand dollar, Singapore dollar, Norwegian krone, Mexican peso, Croatian kuna, Bulgarian lev, Czech koruna, Danish krone, Hungarian forint, Polish złoty and Romanian leu.

- iv. not traded on a trading venue.

Pursuant to the above, Recital 13 of the Commission Delegated Regulation (EU) 2017/565 further stipulates that such contracts should be understood as relating to a direct and unconditional exchange of those currencies. Additionally, in the event of contracts requiring multiple exchanges, each exchange should be considered separately. Additionally, the aforementioned Recital also stipulates that an option or a swap on a currency should not be considered a contract for the sale or exchange of a currency and therefore could not constitute either a spot contract or means of payment, regardless of the duration of the swap or option and regardless of whether it is traded on a trading venue or not.

4.4.8.1.2 Test for Other Derivative Contracts Relating To Currencies

Therefore, in order for a DLT asset to qualify as an ‘other’ derivative contract relating to currencies, the Test shall have to assess whether it is either a spot contract or a means of payment in terms of the Commission Delegated Regulation (EU) 2017/565.

Hence, as presented in *Table* **TABLE 4.4-7**, in order for a DLT asset to qualify as a spot contract relating to currencies, the determination would only require only one of T9_5, T9_6 or T9_7. However, in order for a DLT asset to qualify as a means of payment, all the criteria presented under T9_1, T9_2, T9_3 and T9_4 need to be satisfied.

TABLE 4.4-7: CHECKLIST FOR C(IV) FINANCIAL INSTRUMENTS – OTHER DERIVATIVE CONTRACTS RELATING TO CURRENCIES

<i>Ref.</i>	<i>Feature</i>	<i>Requirement</i>
Spot Contract^[1]		
Are the terms of the DLT asset which is designed/used for the purposes of exchanging one fiat currency to another fiat currency, such that delivery of the fiat currency is scheduled to be made within the longer of the following periods...		
T9_1	...2 trading days ^[2] in respect of any pair of the major currencies ^[3] ?	Select only one (If either one of the criteria is yes, then the DLT asset would qualify as a spot contract)
T9_2	...for any pair of currencies where at least one currency is not a major currency, the longer of 2 trading days or the period generally accepted in the market for that currency pair as the standard delivery period?	
T9_3	... where such DLT asset is used for the main purpose of the sale or purchase of a transferable security or a unit in a collective investment undertaking, the period generally accepted in the market for the settlement of that transferable security or a unit in a collective investment undertaking as the standard delivery period or 5 trading days, whichever is shorter?	

OR

TABLE 4.4-7: CHECKLIST FOR C(IV) FINANCIAL INSTRUMENTS – OTHER DERIVATIVE CONTRACTS RELATING TO CURRENCIES

<i>Ref.</i>	<i>Feature</i>	<i>Requirement</i>
Means of Payment		
Does the DLT asset qualify as a means of payment where it is understood that such DLT asset relates to a direct and unconditional exchange of those fiat currencies, which...		
T9_4	...is settled physically otherwise than by reason of a default or other termination event?	Mandatory (IF all criteria are yes, then the DLT asset would qualify as a means of payment)
T9_5	...is entered into by at least a person which is not a financial counterparty?	
T9_6	...is entered into in order to facilitate payment for identifiable goods, services or direct investment?	
T9_7	...is not traded on a trading venue?	

Logic: The Test would require either (i) one of T9_1, T9_2 or T9_3 **or** (ii) all of T9_4, T9_5, T9_6 and T9_7.

Notes:

- [1] In accordance with Article 10(2) of Commission Delegated Regulation (EU) 2017/565, a contract shall not be considered a spot contract where, irrespective of its explicit terms, there is an understanding between the parties to the contract that delivery of the currency is to be postponed and not to be performed within the period set out in T9_5, T9_6 and T9_7.
- [2] In accordance with Article 10(4) of Commission Delegated Regulation (EU) 2017/565, a trading day shall mean any day of normal trading in the jurisdiction of both the currencies that are exchanged pursuant to the contract for the exchange of those currencies and in the jurisdiction of a third currency where any of the following conditions are met: (a) the exchange of those currencies involves converting them through that third currency for the purposes of liquidity; (b) the standard delivery period for the exchange of those currencies references the jurisdiction of that third currency.
- [3] According to Article 10(3) of Commission Delegated Regulation (EU) 2017/565, major currencies shall only include the US dollar, Euro, Japanese yen, Pound sterling, Australian dollar, Swiss franc, Canadian dollar, Hong Kong dollar, Swedish krona, New Zealand dollar, Singapore dollar, Norwegian krone, Mexican peso, Croatian kuna, Bulgarian lev, Czech koruna, Danish krone, Hungarian forint, Polish złoty and Romanian leu.

4.4.8.2 C(VII) & C(X) financial instruments – Other derivative financial instruments

4.4.8.2.1 Definition

In accordance to Article 7(1) of the Commission Delegated Regulation (EU) 2017/565, ‘other’ derivative contracts falling within the scope of C(VII) financial instruments, which relate to commodity derivatives and C(X) financial instruments, which relate to commodity derivatives referred to in Section 4.4.7.1, shall be considered as ‘other’ derivative financial instruments provided that they satisfy the following conditions:

- i. are not spot contracts;
- ii. are not for commercial purposes; and
- iii. have the characteristics of other derivative financial instruments, which satisfy the following criteria:
 - (a) they are standardised so that the price, the lot, the delivery date and other terms are determined principally by reference to regularly published prices, standard lots or standard delivery dates; and
 - (b) meet one of the following criteria:
 - 1. they are traded on a third country trading venue that performs a similar function to a regulated market, an MTF or an OTF;
 - 2. they are expressly stated to be traded on, or are subject to the rules of, a regulated market, an MTF, an OTF or such a third country trading venue; or
 - 3. they are equivalent to a contract traded on a regulated market, MTF, an OTF or such a third country trading venue, with regards to the price, the lot, the delivery date and other contractual terms.

Article 7 (2) of the Commission Delegated Regulation (EU) 2017/565 specifies that in order for an 'other' derivative financial instrument not to qualify as a spot contract, the terms of delivery should be scheduled to be made within the longer of the following periods:

- i. 2 trading days; or
- ii. the period generally accepted in the market for that commodity, asset or right as the standard delivery period.

Meanwhile, Article 7 (3) Commission Delegated Regulation (EU) 2017/565 stipulates that contracts should be considered to be for commercial purposes if they meet both of the following criteria:

- i. they are entered into with or by an operator or administrator of an energy transmission grid, energy balancing mechanism or pipeline network,
- ii. they are necessary to keep in balance the supplies and uses of energy at a given time, including the case when the reserve capacity contracted by an electricity transmission system operator as defined in Article 2(4) of Directive 2009/72/EC is being transferred from one prequalified balancing service provider to another prequalified balancing service provider with the consent of the relevant transmission system operator.

4.4.8.2.2 Test for Other Derivative Contracts Relating To Currencies

Therefore, as illustrated in *Table* **TABLE 4.4-8**, in view of the above considerations, the test would need to determine whether the DLT asset:

- i. is not a spot contract [T10_1 or T10_2];
- ii. is not designed/used for commercial purposes [T10_3 and T10_4];
- iii. is standardised so that the price, the lot, the delivery date and other terms are determined principally by reference to regularly published prices, standard lots or standard delivery dates [T10_5]; and
- iv. satisfies one of the following conditions:
 - (a) is traded on a third country trading venue that performs a similar function to a regulated market, a MTF or an OTF [T10_6];
 - (b) is expressly stated to be traded on, or is subject to the rules of, a regulated market, a MTF, an OTF or such a third country trading venue [T10_7]; or
 - (c) is equivalent to a contract traded on a regulated market, MTF, an OTF or such a third country trading venue, with regards to the price, the lot, the delivery date and other contractual terms [T10_8].

TABLE 4.4-8: CHECKLIST FOR C(VII) AND C(X) FINANCIAL INSTRUMENTS – OTHER DERIVATIVE CONTRACTS RELATING TO CURRENCIES

<i>Ref.</i>	<i>Feature</i>	<i>Requirement</i>
Spot Contract^[1]		
Are the terms of delivery of the DLT asset such that delivery of the underlying, commodity, asset or right is scheduled to be made within the longer of the following periods...		
T10_1	...2 trading days?	Select only one (If either one of the criteria is yes, then the DLT asset would qualify as a spot contract)
T10_2	...the period generally accepted in the market for that commodity, asset or right as the standard delivery period?	
AND		
Commercial Purpose		
Is the DLT asset designed/used for commercial purposes, where...		
T10_3	...it is entered into with or by an operator or administrator of an energy transmission grid, energy balancing mechanism or pipeline network?	Mandatory (If all criteria are yes, then the DLT asset would qualify as having a commercial purpose)
T10_4	...it is necessary to keep in balance the supplies and uses of energy at a given time, including the case when the reserve capacity contracted by an electricity transmission system operator as defined in Article 2(4) of Directive 2009/72/EC is being transferred from one prequalified balancing service provider to another prequalified balancing service provider with the consent of the relevant transmission system operator?	
AND		
Standardised Contract		
Is the DLT asset...		

TABLE 4.4-8: CHECKLIST FOR C(VII) AND C(X) FINANCIAL INSTRUMENTS – OTHER DERIVATIVE CONTRACTS RELATING TO CURRENCIES

<i>Ref.</i>	<i>Feature</i>	<i>Requirement</i>
T10_5	...standardised so that the price, the lot, the delivery date and other terms are determined principally by reference to regularly published prices, standard lots or standard delivery dates?	Mandatory
AND		
Tradability/Capability of being Traded/Equivalence		
Is the DLT asset, or the smart contract where one is embedded therein,...		
T10_6	...traded on a third country trading venue that performs a similar function to a regulated market, a MTF or an OTF?	Select only one
T10_7	...expressly stated to be traded on, or is subject to the rules of, a regulated market, a MTF, an OTF or such a third country trading venue?	
T10_8	...equivalent to a contract traded on a regulated market, MTF, an OTF or such a third country trading venue, with regards to the price, the lot, the delivery date and other contractual terms?	

Logic: For the Test to determine that the DLT asset has the characteristics of other derivative financial instrument, it would require that (i) T10_1 or T10_2 are not satisfied, (ii) T10_3 and T10_4 are also not satisfied, whereas (iii) T10_5 is required a mandatory element plus (iv) one of T10_6, T10_7 or T10_8.

Note:

- [1] In accordance with Article 7(2) of Commission Delegated Regulation (EU) 2017/565, a contract shall not be considered a spot contract where, irrespective of its explicit terms, there is an understanding between the parties to the contract that delivery of the currency is to be postponed and not to be performed within the period set out in T10_1 or T10_2.

Question 13

Do you agree with the MFSA's interpretation of C(IV) to C(X) financial instruments, as defined under MiFID, within the DLT context?

Question 14

Do you agree with the proposed checklist for determining whether a DLT asset qualifies as a C(IV) to C(X) financial instrument, as defined under MiFID?

Question 15

Should DLT assets be allowed as a means of payment within the context of cash settlement under MiFID?

Question 16

Should transfer of ownership of an underlying through the updating of a ledger maintained using DLT be deemed as physical settlement under MiFID?

Question 17

For the purposes of the Financial Instrument Test, what should in your opinion be deemed as appropriate standard delivery periods within the DLT context?

4.5 Emissions Allowances consisting of units recognised for compliance with the requirements of Directive 2003/87/EC (Emissions Trading Scheme)

4.5.1 Definition

Emissions allowances financial instruments relate to units recognised for compliance with the requirements of Directive 2003/87/EC (Emissions Trading Scheme). In this respect, 'Emissions' are defined in Article 3(b) of Directive 2003/87/EC¹⁹ as the release of greenhouse gases into the atmosphere from sources in an installation.

Article 3(a) of the same Directive defines 'allowance' as an allowance to emit one tonne of carbon dioxide equivalent during a specified period, which shall be valid only for the purposes of meeting the requirements of the said Directive and shall be transferable in accordance with the provisions of this Directive. Further to the later, Article 3(j) specifies that a 'tonne of carbon dioxide equivalent' refers to one metric tonne of carbon dioxide (CO₂) or an amount of any other greenhouse gas listed in Annex II with an equivalent global-warming potential.

Article 3(c) of Directive 2003/87/EC also defines 'greenhouse gases' as the gases listed in Annex II of the Directive, which include:

- i. Carbon dioxide (CO₂);
- ii. Methane (CH₄);
- iii. Nitrous Oxide (N₂O);
- iv. Hydrofluorocarbons (HFCs);
- v. Perfluorocarbons (PFCs); and
- vi. Sulphur Hexafluoride (SF₆).

In accordance with Article 11(4) of Directive 2003/87/EC, emissions allowances are issued by the competent authority as identified in Article 18 of the same Directive.

4.5.2 Applicability within the DLT context

In view of the above definition, for a DLT asset to qualify as an emission allowance, the key features should focus on:

- 1. Issuer**

In order for the DLT asset to qualify an emissions allowance it should also be issued by the national competent authority in accordance with Article 18 of Directive 2003/87/EC.

¹⁹ Directive 2003/87/EC Of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC

2. Definition

The DLT asset should in substance be equivalent to an emission allowance in terms of Article 3(b) of Directive 2003/87/EC as well as meet all the necessary requirements, *inter alia*, of transferability, in accordance with the provisions of the same Directive.

4.5.3 Applicability within the Test

In view of the above considerations, as presented in *Table* **TABLE 4.5-1**, for a DLT asset to qualify as an emission allowance, the test should as mandatory determine that the allowance was issued by the national competent authority in terms of Directive 2003/87/EC which therefore qualifies the DLT as an emissions allowance in terms of Article 3(a) of the Directive 2003/87/EC, as well as meet all the necessary requirements, *inter alia*, of transferability, in accordance with the provisions of the same Directive.

TABLE 4.5-1: CHECKLIST FOR EMISSIONS ALLOWANCE

<i>Ref.</i>	<i>Feature</i>	<i>Requirement</i>
T11_1	The DLT asset is issued by the national competent authority in terms of Directive 2003/87/EC	Mandatory

Logic: The Test would require T11_1 as a mandatory element.

Question 18

Do you agree with the MFSA’s interpretation of emissions allowances, as defined under MiFID, within the DLT context?

Question 19

Do you agree with the proposed checklist for determining whether a DLT asset qualifies as an emissions allowance, as defined under MiFID?

5 CONCLUDING REMARKS

The MFSA is seeking feedback from the industry before proceeding with the issuance of the final version of the Financial Instrument Test. A feedback statement shall be issued in due course following the analysis and evaluation of the feedback received from interested parties.

The consultation is open to the public from 13 April 2018 until the 4 May 2018. Industry participants and interested parties are invited to send their responses through an online survey ([link](#))²⁰, developed specifically for this purpose, by not later than **4 May 2018**.

While interested parties are requested to submit their feedback through the online survey, any queries in relation to this Consultation Paper should be directed to fintech@mfsa.com.mt.

Communications Unit
Malta Financial Services Authority
MFSA Ref: 04-2018
13 April 2018

²⁰ Link: <https://www.surveygizmo.com/s3/4308059/MFSASurveyFITest>