

REGULATORY OPTIONS FOR CRYPTO ASSETS IN UGANDA



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1.0 Background

The development of financial technology (Fintech) over the past several years has seen an accelerating rate of adoption of the technology in the provision of financial services. Among the various financial technology innovations, crypto assets have become widespread because of their ability tackle the challenges of traditional market infrastructure and significantly reduce the need for reconciliation, thereby minimizing errors, delays, risk, and capital inefficiencies. Crypto assets, are not only a medium of exchange, but have also given rise to innovative ways to raise capital via crypto-exchanges and token sales.

Fintech in Uganda is still in its early stages but it's hugely popular and there is a lot of enthusiasm for fintech among the younger generation. This is mainly attributed to the high usage of mobile money and payment systems.² The popularity of crypto assets is also growing in Uganda. Crypto assets are completely unregulated and the Bank of Uganda issued a warning that anyone trading or investing in them does so at his or her own risk. The central bank governor notes that crypto assets do not have the privileges of a legal tender and are not backed by the central bank which ensures that supply of currency is always adequate to meet the demand.³

Quite notably, Initial coin offerings (ICOs) are also unregulated. There has yet to be an ICO in Uganda⁴ but, there are a number of fintech companies looking to raise capital through ICOs, it is probably only a matter of time before this milestone is reached.

The Capital Markets Authority (CMA) has in recent times received applications from innovators to introduce financial products facilitated by technology. The applications have ranged from approval of crypto asset exchanges, testing of innovative products using technology as delivery medium and fundraising through issuance of security tokens (ICOs). This has been in the absence of a regulatory framework to deal with financial innovation and yet regulations are a crucial factor for the growth of any industry. A case in point, recently, CMA issued a letter in response to request to

²Brian Kalule (September 2018). Fintech flourishes in Uganda as regulation remains hands-off for now

³<http://www.monitor.co.ug/News/National/Museveni--Mutebile-split--new-currency-mode--/688334-4577034-2t0oyuz/index.html>

⁴Brian Kalule (September 2018). Fintech flourishes in Uganda as regulation remains hands-off for now

establish and operate a crypto asset exchange by Binance Limited. In the letter dated 15th August 2018, CMA notes, to the extent that Binance’s business doesn’t involve exchange of securities or securities related assets, this would fall outside CMA’s jurisdiction. This points to the fact that even in the absence of an enabling regulatory framework for crypto assets, crypto-assets and other digital assets are a reality.

In seeking to fulfill CMA’s vision of positioning Uganda’s capital market as the most efficient and trusted center for attracting and providing capital in Africa, a regulatory framework to deal with regulated activity facilitated by technology is critical. In regulating activities’ driven by technology, focus should be on the conduct of the regulated activity and not the technology facilitating the activity.

2.0 Introduction to Crypto Assets

A crypto asset can be defined as a digital representation of value that can be digitally traded and functions as a medium of exchange, a unit of account or a store of value, but does not have legal tender status in any jurisdiction.⁵ It is neither issued nor guaranteed by any jurisdiction, and fulfils the above functions only by agreement within the community of users of the crypto asset and is distinguished from fiat currency⁶ and e-money.⁷ Crypto-assets can also be referred to as tokens (digital representation of access rights to ownership rights of an asset)⁸ and the two words can be used interchangeably.

2.1 Types of Crypto Assets

There are various forms of crypto assets with different properties. There is no generally recognized classification of crypto assets globally. The following categorization is based on the underlying economic function of the assets as tokens.

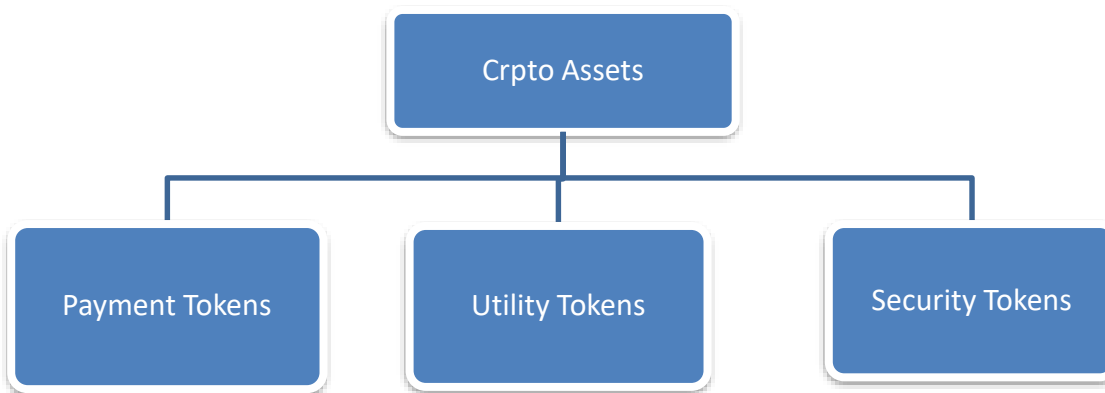
⁵Abu Dhabi Financial Services Regulatory Authority. (June 2018). Guidance – Regulation of Crypto Asset Activities in Abu Dhabi Global Market

⁶Fiat currency means government issued currency that is designated as legal tender in its country of issuance through government decree, regulation or law.

⁷e-money means a digital representation of fiat currency used to electronically transfer value denominated in fiat currency.

⁸Financial Services Commission, Mauritius. (September 2018). Guidance Note Recognition of Digital Assets as an asset-class for investment by Sophisticated and Expert Investors

Figure1. Categorization of Crypto Assets (Tokens)



Source: Abu Dhabi Financial Services Regulatory Authority

a) Payment Tokens (Cryptocurrencies)

Cryptocurrencies and payment tokens can be used interchangeably. Payment tokens are tokens which are intended to be used, now or in the future, as a means of payment for acquiring goods or services or as a means of money or value transfer.⁹ They are not bound by geography because they are internet based; their transactions are stored in a database called block-chain, which is a group of connected computers that record transactions in a ledger in real time. Over the past decade, these currencies have grown in usage and utility as they exhibit advantages relative to conventional currencies.¹⁰

Payment tokens make it easier to transfer funds between two parties in a transaction; these transfers are facilitated using public and private keys for security purposes. The innovation behind most famous cryptocurrencies today is Bitcoin. Cryptocurrencies such as the bitcoin are mined using tremendous computer resources to run trillions of computations that process and catalogue a batch of transactions which, when fully-

⁹Swiss Financial Market Supervisory Authority. (February 2018)Guidelines for enquiries regarding the regulatory framework for initial coin offerings (ICOs)

¹⁰Austin Knutson, Menglu Liu and Derek Schlenker. The Digital Asset of the Future, Bitcoin & Ether

processed, will become the next block in the block-chain.

b) Utility Tokens

Utility tokens are tokens which are intended to provide access digitally to an application or service by means of a block-chain-based infrastructure.¹¹

c) Security Tokens

Security tokens represent assets such as a debt or equity claim on the issuer. Security tokens promise, for example, a share in future company earnings or future capital flows. In terms of their economic function, these tokens have characteristics of equities, bonds or derivatives. Tokens which enable physical assets to be traded on the block-chain also fall into this category.¹² It is noteworthy that the focus of this paper is on the issuance and dealing in security tokens

2.2 Technical Aspects of Crypto Assets (Tokens)

a) Distributed Ledger Technology and Block Chain Technology

Distributed Ledger Technology (DLT) based on a distributed ledger represents a fintech development that offers potential improvement in the area of financial record keeping. DLT networks are being considered as an efficient means to create, exchange, and track ownership of financial assets on a peer to peer basis. Potential benefits include: greater accuracy, transparency, and security in record keeping; faster transfer of ownership; and peer to peer interactions. However, the technology is not fully secure, and breaches in privacy and data protection are possible. In addition, the processes underlying DLT generally require massive amounts of energy to verify transaction activity.¹³

A distributed ledger is a type of database that may be shared among entities in a network. In a distributed ledger, entries are recorded, stored and distributed across a

¹¹Swiss Financial Market Supervisory Authority. (February 2018) Guidelines for enquiries regarding the regulatory framework for initial coin offerings (ICOs)

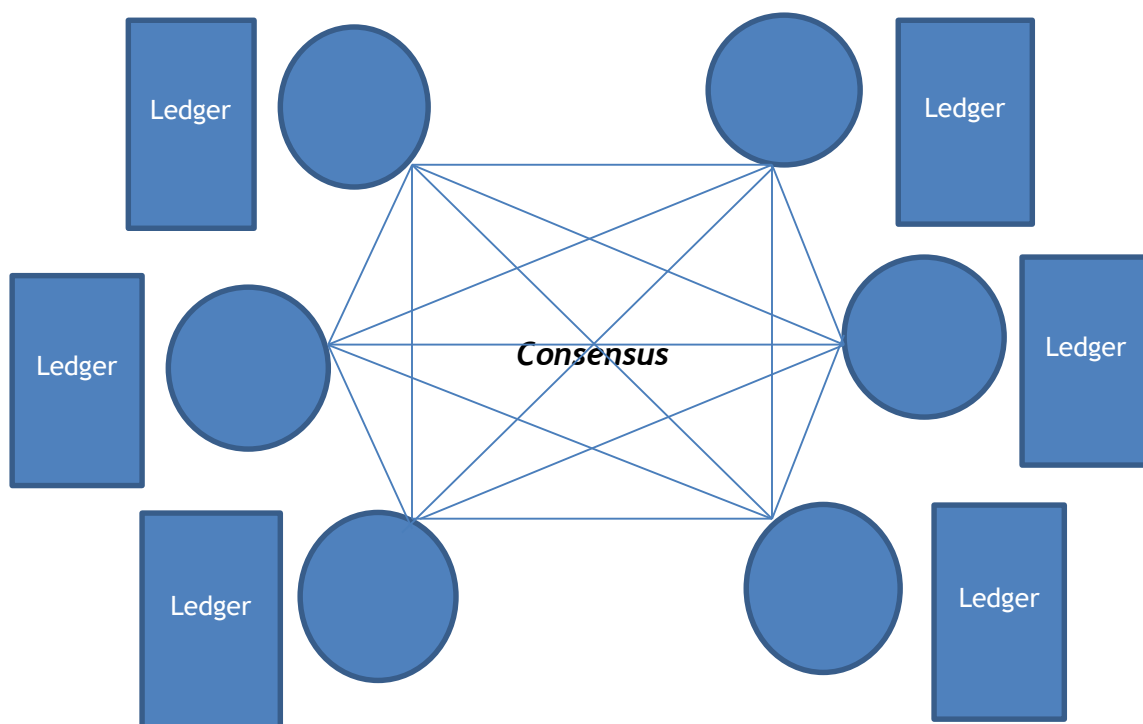
¹²*id*

¹³CFA Level 2. Quantitative Methods (2018)

network of participants so that each participant has a matching copy of the digital database. Basic elements of a DLT network include: a digital ledger, a consensus mechanism used to confirm new entries, and a participant network.¹⁴

The consensus mechanism is the process by which the computer entities (or nodes) in a network agree on a common state of the ledger. Consensus generally involves two steps: transaction validation and agreement on ledger update by network parties. These features enable the creation of records that are, for the most part, considered immutable, or unchangeable, yet they are transparent to network participants on a near real-time basis.¹⁵

Figure2. Distributed Ledger Network Setup



Source: CFA Level 2. Quantitative Methods (2018)

¹⁴CFA Level 2. Quantitative Methods (2018)

¹⁵*Id*

Block-chain is a type of digital ledger in which information, such as changes in ownership, is recorded sequentially within blocks that are then linked or “chained” together and secured using cryptographic methods. Each block contains a grouping of transactions (or entries) and a secure link (known as hash) to the previous block.¹⁶

New transactions are inserted into the chain only after validation via a consensus mechanism in which authorized members agree on a transaction and the preceding order, or history, in which previous transactions have occurred.¹⁷

3.0 Capital Markets and Crypto Assets

3.1 Initial Coin Offerings (ICOs)

Many start-ups globally are now building entire businesses on block-chain technology and also turning to tokens for funding through ICOs’. ICOs are the initial issue of tokens to investors by companies seeking to raise funds. ICOs act as fundraisers: a company looking to raise capital launches an ICO. Interested investors buy into the offering, either with fiat currency or with pre-existing tokens like ether.¹⁸ In exchange, investors receive a new token specific to the ICO which may be connected with the right to receive, e.g. a dividend, a voting right, a license, a property right or a right to participate in the future performance of the issuer. On the side of the token issuer, the collected funds are often used to finance a specific project (e.g. the building of a software), or for general funding purposes.¹⁹ When tokens or coins are generated and afterwards used within a digital ecosystem, in particular where they are listed on a token exchange and actively traded within the market, these tokens can be considered as security tokens.

While ICOs have historically allowed financial technology start-ups, and the crypto asset community to raise funds, in 2018, legacy businesses with established businesses

¹⁶ CFA Level 2. Quantitative Methods (2018)

¹⁷ *id*

¹⁸ Arjun Kharpal (2018). How cryptocurrency start-ups have raised over \$12 billion this year via a much-hyped funding route

¹⁹ Ressos Legal Pte. Ltd. (2018). How to do an Initial Coin Offering (ICO) in Singapore: The legal and regulatory framework, key structuring considerations and documentation requirements

and products increasingly used ICO fundraising to finance their business activities.²⁰

3.1.2 How an ICO Works

ICOs are typically launched or announced through online platforms, such as cryptocurrency forums, websites or through other online channels. The Issuer will usually make a technical white paper available online to set out the details of his project, the key terms (i.e. the structure and key features of the tokens offered, economic terms, subscription details, etc.) plus the legal and commercial terms of the proposed ICO. The white paper will typically inform the reader about the status of the project, key team and external advisors. In addition to the whitepaper, the ICO documentation may also include a token purchase agreement, which will set out the terms and conditions applicable to the tokens.²¹

The investor is usually required to make a transfer of virtual currency to the issuer in order to subscribe tokens as part of an ICO. This transfer is made to designated addresses of the respective cryptocurrency (similar to account number) or an electronic wallet of the issuer. The subscription process is completed online in a short period of time. Tokens will be issued as part of a token generation event to the investor in consideration of his/her investment or contribution. As a bonus, the investor may receive additional tokens for marketing the token on cryptocurrency online forums. Upon completion of the ICO, the investor's tokens will be transferred to his/her designated addresses or online wallet, thereby completing the token issuing process. Issuers can also list tokens on cryptocurrency online exchanges and trade them against other cryptocurrencies.²²

3.1.3 Regulatory Concerns on ICOs

Different regulators have been evaluating possible risk factors associated with ICOs since the emergence of the ICO market to protect investors. The regulators are particularly motivated by several ICO risk factors for retail investors that are outlined

²⁰Wulf A. Kaal (2018). Initial Coin Offerings: The top 25 jurisdictions and their comparative regulatory responses

²¹Ressos Legal Pte. Ltd. (2018) How to do an Initial Coin Offering (ICO) in Singapore: The legal and regulatory framework, key structuring considerations and documentation requirements

²²*id*

below:²³

- i) Unlike shareholders in the traditional corporate structure who are able to vote for or against directors or to nominate directors, ICO investors have no control over the promoters whatsoever. Token holders typically invest in the future promise of an idea or future infrastructure product associated with the platform they invest in without having access to a tangible underlying product.
- ii) Unlike traditionally listed businesses that have a long history of business success before being listed on a stock exchange, most ICO issuers are usually start-ups without a clear track record.
- iii) ICO investors have no preemptive rights or other anti-dilution protections. If the promoters decide to issue more reserve tokens to additional investors, the ICO investors may be diluted in the future. The only real control token holders have to protect themselves is to sell their tokens post-ICO.
- iv) ICOs are subject to very high volatility, with prices rising and falling without a clear link to fundamentals such as growth and risk of issuer.
- v) Token holders typically have no protection in the case of bankruptcy or termination of the platform they invested in. In cases of bankruptcy, token holders typically have no recourse at all after the debt holders and outside creditors are satisfied with the liquidation value of the entity.

4.0 Market Intermediaries Dealing in Tokens

The issuance and trading of security tokens at the primary and secondary markets involves market intermediaries usually licensed by a securities regulator. Key market intermediaries include:

a) Crypt Asset Exchange

A crypto asset exchange is any system that operates on the basis of trading cryptocurrencies with other assets. Like a traditional securities exchange, the

²³Wulf A. Kaal(2018) Initial Coin Offerings: The top 25 jurisdictions and their comparative regulatory responses

cryptocurrency exchange's core operation is to allow for the buying and selling of these crypto assets. It is required to have in place, among other things, the following: market surveillance; settlement processes; transaction recording; transparency and public disclosure mechanisms; and exchange-like operational systems and controls.²⁴

b) Crypto Asset Custodian

A crypto asset custodian is responsible for the safeguarding of clients' crypto assets and provides this service mainly through crypto asset wallets.

c) Crypto Asset Dealer

A crypto asset dealer engages in crypto-trading, the act of buying and selling crypto assets through a cryptocurrency exchange (trading platform).

5.0 Regulatory approaches in different countries

5.1 Switzerland

The Swiss Financial Market Supervisory Authority (FINMA) has the power to regulate securities within Switzerland. FINMA published guidelines for regulation of ICOs in February 2018. As a first step, FINMA assesses whether an ICO constitutes an offer of securities to the public. FINMA determines whether tokens qualify as securities. Legally, securities are standardized certificated or uncertificated securities, derivatives and intermediated securities, which are suitable for mass standardized trading, i.e. they are publicly offered for sale in the same structure and denomination.²⁵ If FINMA comes to the conclusion that the tokens of an ICO constitute securities, they fall under securities regulation.

The issuing of tokens that are analogous to equities or bonds can also result in prospectus requirements under the Swiss Code of Obligations. FINMA has no direct

²⁴Financial Services Regulatory Authority (June 2018). Guidance – Regulation of Crypto Asset Activities in Abu Dhabi Global Market

²⁵The Swiss Financial Market Supervisory Authority. (February 2018). Guidelines for enquiries regarding the regulatory framework for initial coin offerings (ICOs)

responsibility in this area but expects ICO organizers to themselves clarify these requirements.

5.2 Singapore

Monitory Authority of Singapore (MAS) is the regulatory authority in Singapore. The general regulatory position taken by MAS is that tokens are generally not regulated unless they can be construed as securities or other regulated financial products under the Securities and Futures Act (SFA).²⁶ Where a digital token is regulated, additional legal requirements need to be satisfied to ensure that issuance of such a token through an ICO is in compliance with applicable laws relating to the securities regulations and financial market conduct.

MAS examines the structure and characteristics of, including the rights attached to, a token in determining if the digital token is a type of capital markets products under the SFA. For instance, a token may constitute: a share, where it confers or represents ownership interest in a corporation; a debenture, where it constitutes or evidences the indebtedness of the issuer of the digital token in respect of any money that is or may be lent to the issuer by a token holder; or a unit in a collective investment scheme (“CIS”), where it represents a right or interest in a CIS, or an option to acquire a right or interest in a CIS. A person may only make an offer of digital tokens which constitute securities or units in a CIS (“Offer”), if the offer is accompanied by a prospectus.

MAS also regulates the conduct of the following types of intermediaries who facilitate offers and trading of security tokens: operators of platforms on which one or more offerors’ of tokens may make primary offers; providers of financial advice in respect of tokens; and operators of platforms on which tokens are traded (“trading platform”).²⁷

Tokens that perform functions which may not be within MAS’ regulatory purview may nonetheless be subject to other legislation for combating money laundering and terrorism financing.

²⁶Monetary Authority of Singapore. (2017). A Guide to Digital Token Offerings

²⁷Monetary Authority of Singapore.(2017). A Guide to Digital Token Offerings

5.3 Gibraltar

The Gibraltar Financial Service Commission (GFSC) is in charge of regulating crypto assets in Gibraltar under the Financial Services (Distributed Ledger Technology Providers) Regulations 2017.²⁸ The DLT framework applies to activities, not subject to regulation under any other regulatory framework, that use DLT for the transmission or storage of value belonging to others.²⁹

GFSC defines tokens as digital representations of an asset, whether tangible or intangible. As such, they are distinct from any underlying object. Much like derivatives, trading tokens is not necessarily the same activity as trading its underlying asset (where one exists). The legislative framework provides for regulation of: the promotion, sale and distribution of tokens; operation of secondary market platforms trading in tokens; and provision of investment and ancillary services relating to tokens. Under the framework, GFSC regulates: authorized sponsors of public token offerings; secondary token market operators; and token investment and ancillary service providers.

The public offering of tokens that are not securities and that do not constitute outright gifts or donations are, typically, offers of commercial products and services (which, at the time of sale, may or may not yet exist). Such tokens are sometimes referred to as utility or access tokens. In circumstances where a token constitutes a product or service that does not yet exist (or is not, at the time of sale, substantially functional), it represents, in effect, no more than a hope or ambition to deliver that product or service in the future.

5.4 Abu Dhabi

The Financial Services Regulatory Authority (FSRA) of Abu Dhabi Global Market (ADGM) set out its approach to Initial Coin/Token Offerings (ICOs) and virtual currencies under the Financial Services and Markets Regulations (FSMR) by issuing a guidelines note. The Guidelines basically sets out FSRA's approach to token issuers seeking to raise

²⁸<http://www.gfsc.gi/news/statement-on-initial-coin-offerings-250>

²⁹<http://www.fsc.gi/dlt?print>

funds through ICOs, and market intermediaries or operators dealing in or offering services in virtual tokens and currencies.³⁰

FSRA has adopted a technology-neutral approach to regulation, where regulatory requirements are applied to the conduct of regulated activities, as opposed to the technological means used to execute a regulated activity. To the extent that virtual tokens are used as a mechanism to enable or facilitate a regulated activity to be carried out, they are generally permitted.³¹

Whether an ICO is to be regulated is assessed by FSRA on a case-by-case basis. To this end, if the tokens in an ICO are assessed to exhibit the characteristics of a security, FSRA may deem the tokens as a security. Not all ICOs constitute an offer of securities. Where tokens do not have the features and characteristics of securities such as shares, debentures or units in a fund, the offer of such tokens is unlikely to be an offer of securities, nor is the trading of such tokens likely to constitute a regulated activity.

When an issuer wishes to make an offer of securities to the public in or from Abu Dhabi Global Market, the requirements for offers of securities apply. These include, for example, the obligation to publish a prospectus. An issuer however may make an offer of securities to the public without a prospectus where any one of the following conditions, amongst other conditions in that rule, is met:

- (i) An offer is directed at professional clients other than natural Persons;
- (ii) Fewer than 50 Persons in any 12-month period, excluding Professional Clients who are not natural persons; or
- (iii) Where the consideration to be paid by a person to acquire securities is at least USD100,000.³²

³⁰Abu Dhabi Financial Services Regulatory Authority. (June 2018). Guidance – Regulation of Initial Coin/Token Offerings and Crypto Assets under the Financial Services and Markets Regulations

³¹Abu Dhabi Financial Services Regulatory Authority. (October 2017). Supplementary Guidance – Regulation of Initial Coin/Token Offerings and Crypto Assets under the Financial Services and Markets Regulations

³² Abu Dhabi Financial Services Regulatory Authority. (June 2018). Guidance – Regulation of Initial Coin/Token Offerings and Crypto Assets under the Financial Services and Markets Regulations

Under FSRA’s regulatory framework for crypto assets, any market operator, custodian or intermediary dealing in crypto assets is required to be approved by FSRA.

6.0 Key Consideration for CMA when Dealing with Crypto Assets (Tokens)

In dealing with crypto assets (tokens), CMA should consider the following aspects as highlighted in table 1.

Table 1: Recommendation for CMA Uganda

Consideration	Recommendation
Regulation should focus on tokens having security characteristics	If the tokens are assessed to exhibit the characteristics of a security (such as equity, debt or CIS), CMA may deem the tokens as security tokens. The requirements for offers of securities shall apply in case of such an ICO. Consequently, an issuer seeking to launch an ICO in or from Uganda should approach CMA at the earliest opportunity.
ICOs’ should target Professional Investors	Issuance of tokens remains a risky area as regulators globally are in the process of understanding this complex area that however could revolutionize access to capital markets. In light of this, ICOs should target professional investors in the interim as capacity is built in the area.
ICOs’ should target foreign Investors	ICOs should in the interim target mostly foreign based investors to attract foreign exchange and improve the current account balance.
Principles for regulation of market intermediaries dealing in security tokens	CMA should develop principles for the regulation of the conduct of intermediaries involved in the issuance and dealing in security tokens (<i>see annex 1 for proposed principals</i>). The principles shall be applied proportionately and on a risk-based approach.
Provision for technology	The prospectus regulations currently being reviewed

<p>facilitates offering in the Prospectus regulation</p>	<p>should have a provision that recognizes technology facilitated offerings.</p>
<p>Issuance of a guidelines for issuance of ICOs</p>	<p>CMA should develop guidelines for the issuance of ICOs (<i>see annex 2</i>) to inform prospective issuers on how applications shall be handled. The guidelines will ensure uniformity in the treatment of applications. Additionally, guidelines provide a flexible regulatory framework owing to the ease of review and amending.</p>

ANNEX 1: GENERAL PRINCIPLES FOR REGULATION OF MARKET INTERMEDIARIES DEALING IN SECURITY TOKENS

1.0 Principle based regulatory framework

Principles-based regulation is more flexible and more sensitive to context, but potentially less certain. Rules are generally considered to be more precise and certain, but may be rigid, reactive, and insensitive to the needs of particular situations.

Principles are more flexible, more sensitive to context. Advocates and practitioners of principles-based securities regulation argue that principles can produce better regulation - meaning more effective regulation, at a lower cost. Under a principles-based system, legislation is drafted in plain language and often substantially reorganized; less detail is provided and more is left to be filled in through the authority's rulemaking powers.³³ The nine principles set out below will be applied to regulating the conduct of market intermediaries dealing in security token will ensure that CMA regulatory outcomes are achieved.³⁴

2.0 Principles for regulation of market intermediaries dealing in security tokens

1. Market intermediaries must conduct their business with honesty and integrity.

Market intermediaries dealing in securities tokens, including the persons associated with them will need to demonstrate that they are fit and proper to undertake the required activities. The basic elements in assessing market intermediaries and persons associated with them include:

- a. Honesty, integrity and reputation
- b. Skill, competence, care and experience
- c. Financial position

³³Sekitoleko, I. (2017). Policy Paper in developing guidelines for issuance of fintech products in Uganda. CMA: Kampala.

³⁴HM Government of Gibraltar. Ministry for Commerce. Gibraltar Finance. (May 2017). Proposals for a DLT Regulatory Framework

2. Market intermediaries must pay due regard to the interests and needs of each clients and must communicate with their client in a manner which is fair, clear and not misleading.

Market intermediaries will be expected to devote as much time and consideration to protecting client interests as their own, and dedicate sufficient resources necessary to protect consumers. Market intermediaries will be required to ensure that the information is presented in a way that is likely to be understood by the target customer and does not disguise, diminish or obscure important items, statements or warnings

3. Market intermediaries must maintain adequate financial and non-financial resources.

Market intermediaries will be expected to maintain sufficient financial resources to ensure that their firm can support business activities. Capital level will need to be commensurate with the risk associated with activities undertaken.

4. Market intermediaries must manage and control their business effectively, and conduct their business with due skill, care and diligence; including having proper regard to risks to their business and customers.

5. Market intermediaries must have effective arrangements in place for the protection of client assets and money.

Market intermediaries will be expected to take all reasonable precautions to protect customer assets in their custody. Custodial assets will need to be segregated from the market intermediaries' own assets.

6. Market intermediaries must have effective corporate governance arrangements.

Market intermediaries will need to have sound good corporate governance practices. Market intermediaries will need to deliver and maintain a corporate culture consistent with the best practice in corporate governance.

7. Market intermediaries must ensure that all systems and security access protocols are maintained to appropriate high standards.

8. Market intermediaries must have systems in place to prevent, detect and disclose financial crime risks such as anti-money laundering and countering terrorist financing (AML/CFT).

Market intermediaries must adequately apply anti-money laundering and counter terrorist financing preventive measures which are commensurate with their risks, and report suspicious transactions. Market intermediaries will need to be aware of the vulnerabilities of their products and services to financial crime risks and ensure that they implement measures to mitigate the risks. Market intermediaries will need to comply with any guidelines issued by the CMA.

9. Market intermediaries must be resilient and must develop contingency plans for the orderly and solvent wind down of business.

Market intermediaries will need to develop, test and maintain adequate business continuity, disaster recovery and crisis management plans. Preparedness for any potential threats or loss should form part of the disaster recovery plans as well as a well-managed and structured business continuity management process. Testing of the plans and its embedded processes should form part of the business model.