BANKING
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Searching for clarity

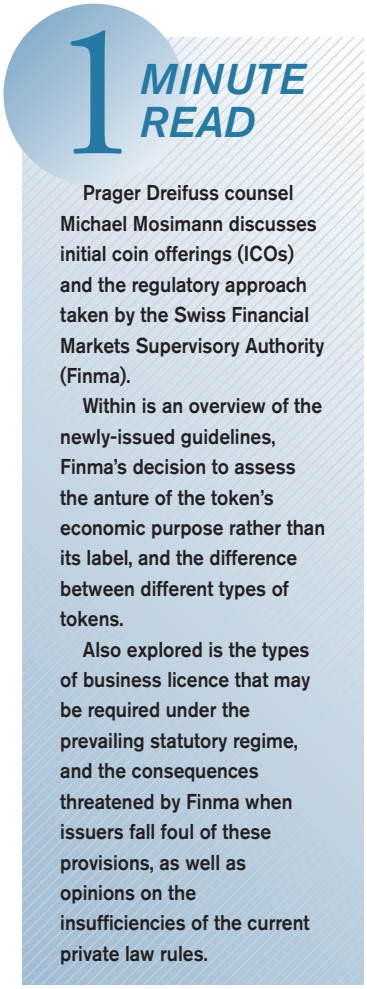
Prager Dreifuss counsel Michael Mosimann, who advises startups on public offerings, reviews how Switzerland's legislative framework stands up to blockchain

"We want to do an ICO without regulation." – This was a sentence that was heard many times in 2017 when potential clients were told that their public token sale (or ICO), and potentially also their business model could be subject to Swiss financial market regulations. It certainly did not come as a surprise to many lawyers when the Swiss Financial Market Supervising Authority (Finma) released a public announcement in September 2017 stating that the Swiss financial market regulations were 'technology neutral' and therefore potentially applicable to ICOs and blockchain-based business models. Other market participants, however, were taken aback. Since then, Finma and other financial market supervising authorities around the world have emphasised and clarified this further.

On February 16 2018, Finma released its guidelines (ICO guidelines) on how it would treat blockchain-based coins issued in an ICO under the existing Swiss financial market regulations. In the ICO guidelines, Finma generally distinguished between asset, payment, and utility tokens while acknowledging that hybrid forms may exist. Practice has shown that in fact tokens to be issued are very likely to fit into more than one single category. Consequently, the relevant issuer would be required to follow all applicable rules. While some regulators and commentators argued that all tokens were securities, Finma emphasised that tokens would not qualify as securities unless their functionality was similar to traditional securities (ICO guidelines, section 3.2.1).

Independently, the Federal Council of Switzerland (national government) launched a survey asking market participants to comment on the digital suitability of Swiss laws.

Although this report was not directly intended to tackle blockchain-related issues, some of the comments obviously related to this nascent business sector. While some regulatory relief regarding innovative companies in the financial sector was proposed (report, section 3.7.1), it seems more work is required with regard to private law aspects, specifically, how tokens should be become deemed qualified under



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Michael Mosimann practices in the areas of M&A and contract law, as well as commercial and corporate law, and is the head of Prager Dreifuss' venture and ICO team. His particular interests are socially-responsible investments (SRI), focusing especially on impact investments; the topic of his PhD thesis.

In addition, he is an expert on regulatory and corporate legal matters pertaining to blockchain technology. He advises founders of cryptocurrency companies in all legal matters and assists them with the planning, preparation and execution of their private and public token offering (so-called initial coin offering, or ICO). He is a regular speaker in his practice areas.

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Swiss private law (e.g., as assets or claims, and so on) and how ownership in a token can be validly transferred. A discussion on legislative activities appears later in this article.

Since the legislative process has only just started and is not expected to result in new laws coming into effect any time soon, this article discusses the status quo legal framework applicable to token offerings and outlines other areas where legislative work is required.

ICO, TGE, STO and CO

In the past two years, public offerings of tokens have been labelled ICOs and 'token generation events'. More recently, doing a security token offering (STO) seems to be in vogue and people emphasise that they are not doing an ICO, but an STO. The plethora of abbreviations merits a short discussion in order to avoid misunderstandings.

Traditionally, public token offerings were labelled ICOs regardless of what rights were associated with the relevant token. Hence, it may be considered an umbrella term, whereby the proximity to the abbreviation IPO (initial public offering) was not unintended. After all, both events refer to a first-time public offering. However, as ICOs received more and more unwelcomed attention by financial market supervising authorities, the proximity no longer seemed so desirable. Other terms such as token generation events (TGE) emerged in order to distinguish the coin offerings from public share offerings, although they related to the same phenomenon and the term ICO thus still prevailed.

With regulators around the globe cracking down on issuers owing to violations of financial market regulations, other terms were sought to lose the negative connotation that ICO has received over time. One solution was including the different token classification in the term, which is why terms such as security token offerings, payment token offerings and utility token offerings have emerged. While labelling a token offering based on the rights associated with it obviously has its merits, it can also be misleading if used inappropriately. For example, using the term security token offering or STO suggests compliance with a certain standard and would be wrong where the token did not qualify as a security, but rather as a means of payment.

When applied appropriately, using the term security token offering of course helps by distinguishing the offering from a utility or payment token offering. However, it does not necessarily help in distinguishing it from an ICO. In the early days of ICOs, tokens that qualified as security were issued under the term ICO. Furthermore, the term was not exclusive to utility token offerings, although many claimed to offer a utility token only. In summary, the term ICO may still be used nowadays, but certainly only as an umbrella term without binding indication of the token characteristics underlying the offering. In the following, the term ICO is used in this sense.

Token classification according to FINMA

Preliminary remarks

In its ICO Guidelines, Finma made it clear that the assessment and classification of a token depends 'on the underlying economic purpose of an ICO' (ICO guidelines, section 3). By applying its 'substance over form' principle, Finma made it clear that it would not be guided solely by a specific branding of a token. In other words, simply labelling a token a utility token does not necessarily make it a utility token.

Finma nevertheless went on to establish three different categories of tokens, those being payment, asset, and utility tokens (ICO guidelines, section 3.1). It is important to note that this distinction only applies in cases where the token to be issued is already fully functional at the time it is publicly offered (ICO guidelines, section 3.1 and 3.2.3). The pre-functional issuance or offering will be discussed below.

There is no strict definition or interpretation of the meaning of 'fully functional'. In order to determine whether a token is fully functional at the time of issue, Finma relies heavily on the statements made in the issuer's white paper (the document that describes the key facts of the token issuer's business, the rights associated with the tokens, the token allocation, use of ICO proceeds, and so on). If, for example, the issuer issues the token, but the token cannot yet be used as intended because the underlying platform is still under construction, the token would not qualify as being fully functional.

While this case seems to be quite clear, others are not so obvious. In a recent case, Finma held that if the issuer already at the time of issue promised in the white paper to add certain features to the platform later on by way of an upgrade although the token could immediately be used as a means of payment, the token would not qualify as being fully functional. In doing so, Finma relied on the significance given to the relevant upgrade in the white paper. Hence, it is relevant whether an additional feature is presented as a key feature in the main text of the white paper or just as an ancillary feature in a footnote.

However, to be clear, it does not help to refrain from disclosing to Finma planned substantial upgrades after the ICO while still using that planned upgrade for marketing purposes before the ICO. Finma's ruling

would not be binding if key aspects were not disclosed. Obviously, this puts the issuer in a squeeze. On the one hand, promoting also future features of an issuer's project as much as possible helps attract more token purchasers and hence more financing. On the other hand, in order to avoid a pre-functional qualification, the issuer would have to focus on features that are already available at the time of issue and would probably lose some potential purchasers.

This does not mean that Finma prohibits updates or upgrades in general, but the issuer has to be aware that if substantial additions are promised, the token could qualify as being pre-functional by either Finma's fintech desk before the ICO or its enforcement department post ICO.

As noted at the outset, Finma acknowledges that tokens may meet the requirements of several categories, in which case they would qualify as hybrid tokens and the issuer would have to comply with all applicable laws (ICO guidelines, section 3.1).

Finally, it has to be emphasised that these rules only apply to offerings to persons residing in Switzerland. Wherever an offering of a Swiss-based issuer is also targeted at or is at least accessible by persons residing outside of Switzerland, the token must comply with the laws of all the jurisdictions in which the token is deemed to be offered. Having said this, this rule would also apply to offerings from a foreign issuer to persons residing in Switzerland, in which case the token nevertheless has to qualify according to the laws of Switzerland.

Classification of fully functional tokens

Payment tokens

If a token is 'intended to be used, now or in the future, as means of payment for acquiring goods or services or as a means of money or value transfer' and does not create any claims of the token purchaser towards the issuer (such as profit sharing rights, and so on), it qualifies as a payment token (ICO guidelines, section 3.1. These tokens are crypto currencies in the narrowest sense, like Bitcoin, Ether, Litecoin, and so on).

Issuing a payment token that can be transferred on a blockchain results in the issuer qualifying as a financial intermediary under article 2 paragraph 3 sub-paragraph B of the Swiss Anti Money Laundering Act (AMLA). Hence, the issuer must comply with the due diligence requirements prescribed by the AMLA. On the one hand, the issuer must become a member of a self-regulatory organisation or submit to the direct supervision by Finma (Article 14 AMLA). On the other hand, the issuer must identify the contractual counterparty (i.e., each token purchaser regardless of a certain threshold) and the beneficial owner, in other words, any potential beneficial owner on whose behalf a nominee acts as token purchaser (Articles 3 and 4 of AMLA).

An issuer is relieved from becoming an affiliate to a self-regulatory organisation and doing the due diligence if the funds received in exchange for the issuance of the tokens are accepted via an already supervised financial intermediary (e.g., a bank) which completes the identification on behalf of the issuer (ICO guidelines, section 3.7). This is particularly interesting for issuers who would not qualify as financial intermediaries other than in connection with the issuance of the tokens.

Utility tokens

Finma deems that tokens qualify as utility tokens if they 'are intended to provide access digitally to an application or service by means of a blockchain-based infrastructure' (ICO guidelines, section 3.1). Critical here is that the token can actually be used to access the infrastructure at time of issue (ICO guidelines, section 3.2.2).

Assuming that a token meets all these requirements and hence qualifies as a utility token, the token would not be subject to financial market regulations. This means that the issuer would neither qualify as financial intermediary nor be required to prepare a prospectus.

Asset tokens

This token category is probably the broadest one and hence applies in many cases. According to Finma, the following would qualify as an asset token:

- Tokens that 'represent assets such as a debt or equity claim on the issuer', eg, promises to participate in future earnings or cash flows of a company; or,
- Tokens that 'enable physical assets to be traded on the blockchain' (ICO guidelines, section 3.1).

Finma deems that asset tokens qualify as securities according to article 2 sub-paragraph b of the Swiss Financial Market Infrastructure Act (FMIA) 'if they represent an uncertificated security (or a derivative) and the tokens are standardised and suitable for mass standardised trading' (ICO Guidelines, Section 3.2.3).

Unless the asset token qualifies as a derivative, the self-issuance of its own asset token is essentially unregulated

Where the asset tokens essentially represent equity shares or bonds, the issuer would have to comply with the prospectus requirements set forth in the Swiss Code of Obligations (CO). It is noteworthy that these prospectus requirements only apply in the case of a public offering. Other than that, unless the asset token qualifies as a derivative, the self-issuance of its own asset token is essentially unregulated under Swiss law. This is particularly true for private offerings, which require neither a prospectus, nor a registration with Finma, nor any other financial market licence. However, it is good practice to provide at least an information memorandum with regard to the public token issuance, in particular in view of the upcoming broader prospectus requirement according to the draft Financial Services Act (ICO Guidelines, Section 3.3).

Classification of pre-functional tokens

In the past, the more relevant issue has been (and still is) the classification in the case of a pre-functional offering. Actually, most ICOs conducted in 2017 and 2018 fell into this category since the issuers promised to develop a tool or a platform with the funds raised in an ICO. In other words, the tokens or rights

offered in connection with such promises are most likely not fully functional yet.

In cases where tokens are offered before being fully functional, Finma distinguishes three possibilities, those being:

- offering and issuance of the actual tokens that can be transferred on a pre-existing blockchain, but the tokens cannot be used as intended yet;
- offering and granting of rights to receive tokens at a later point in time when the tokens and/or the underlying platform have been fully developed; and,
- offering and issuance of tokens that entitle the purchaser to receive the actual tokens at a later point in time – like a derivative on the actual token (ICO guidelines, section 3.1).

However, regardless of which of the above forms of pre-functional offering is applied and what the token could qualify as if it were offered once fully functional, Finma considers the offering a security offering in cases where the item offered (i.e., the contractual claim, the non-functional token or the derivative token) is standardised and suitable for mass standardised trading. From a regulatory perspective, the same rules applicable to the issuance of asset tokens apply to pre-functional offerings (ICO guidelines, section 3.2.3).

It has become common practice to conduct a (public and/or private) pre-sale before the actual ICO. As far as the public pre-sale is concerned, reference may be made to the remarks above on pre-functional ICOs as the qualification as a public offering does not depend on whether it is branded as a pre-sale or as an ICO.

Contrary to this, in the case of a private pre-sale and therefore the strict avoidance of any activities that could qualify as a public offering, such offering to purchasers residing in Switzerland would generally not be regulated.

Business models requiring financial market licences

Another aspect to be aware of is the fact that the underlying business model could be subject to financial market regulations, regardless of whether it is blockchain-based or whether a token offering is envisioned or not.

This is particularly true for crypto exchanges. Depending on how the exchange works (e.g., automated match-making, central counterparty, and so on) and what kind of tokens will be exchanged (only payment or utility tokens, or also asset [i.e., security] tokens), the operator of such an exchange may require a licence under the FMIA.

The rise in ICOs has also seen the emergence of so-called ICO advisors. These are service providers that help with structuring the tokens and preparing the ICO, providing support in drafting the white paper, marketing and promoting the ICO, and so on. While the self-issuance of own asset tokens is more or less unregulated in Switzerland, issuing or offering asset tokens and hence securities on behalf of the issuer requires a licence as an issuing house according to article 3 paragraph 2 of the Swiss Stock Exchange Ordinance. Hence, the ICO advisors are well advised to ensure that they do not unintentionally help offering securities without having the necessary licences. Operating the business of an issuing house without having obtained the necessary licence is a criminal offence under Swiss law.

Another example would be business models where the issuer promises to invest the funds received (in shares, other companies, real estate, and so on) and to let the token holders participate in the issuer's profit or revenue. In this case, the issuer runs the risk of qualifying as a collective investment scheme, that is, an investment fund. Operating a fund or offering shares therein without having the relevant licences under the Swiss Collective Investment Schemes Act may be construed as criminal offences. The same may be true for business models offering 'asset-backed stable coins' where the token holders participate in the issuer's profit from holding these assets.

In summary, even if a service provider in the ICO industry did not intend to create and issue a token, his/her business could be subject to financial market regulations under Swiss law.

With effect from January 1 2019, Swiss legislation has created a so-called 'Fintech licence' for innovative companies by amending Article 1b of the Swiss Banking Act. This permits fintech companies outside the banking sector to accept public deposits of up to CHF 100 million ($99 million) without qualifying as a bank in the statutory sense and being required to obtain a banking licence. However, due to the restrictions on how the money can be used by the fintech company according to Section 14f of the Swiss Banking Ordinance, the licence is probably only relevant for crowd funding and lending entities (see also report, section 3.7.1). It remains to be seen how this new licence develops in practice.

Legislative activity

While the financial market aspects of ICOs have been and remain highly regulated in Switzerland, more legislative work is required with regard to private law aspects. It is unclear whether digital tokens should qualify as a tangible asset (*Sache*), a claim (*Forderung*), as data (*Daten*) or as something else. In its report on the recent survey, the Federal Council clarified that it does not see any reason to fundamentally overturn Switzerland's common practice of not deeming digital data as qualifying as a tangible asset – although some survey participants argued that tokens should qualify as tangible assets. Others argued that the laws on tangible assets should be applied by analogy to blockchain-based tokens (see in general report, section 3.3.2).

The practical consequence of this discussion is what rules apply to the transfer of tokens. If tokens qualify as claims, the transfer of tokens would require a written declaration of assignment under Swiss law, which is rather impractical in a decentralised world. (The difficulties caused by old formal requirements in the modern world have also been mentioned by survey participants outside the blockchain space and acknowledged by the Federal Council [report, section 3.2.1]).

Besides that, the decentralised world also challenges existing laws. For example, unless they are working as freelancers, developers no longer all sit together in one office, but are spread around the globe. This raises questions regarding the applicability of Swiss employment laws and the suitability of certain provisions therein (report, section 3.4). Furthermore, it is unclear how tokens (and digital, cloud-based data in general) would have to be treated in bankruptcy proceedings (report, section 3.3.2).

Outlook

Although Finma's ICO guidelines have provided some clarity on the regulatory qualification of tokens, other legal aspects still remain unclear. In particular, many questions relate to the transferability of tokens and the valid transfer of ownership therein. Besides that, it has to be remembered that the business model itself could be subject to financial market regulations, regardless of the token issuance.