Demystifying blockchain regulation in Switzerland

Innovation in distributed ledger technology will be balanced with investor protection under proposed new rules

On February 16 2019, the Swiss Financial Market Supervising Authority (FINMA) was the first regulator to release guidelines on how to treat blockchain-based coins issued in an initial coin offering (ICO) on February 16, 2019. Finma generally distinguished between asset, payment, and utility tokens while acknowledging that hybrid forms may exist. Practice has shown that tokens issued are very likely to fit more than one single category. Consequently, the relevant issuer would be required to follow all applicable rules. While some regulators and commentators argue that all tokens were securities, Finma emphasised that it would not qualify tokens as securities unless their functionality was similar to traditional securities. Regardless of the ICO guidelines, uncertainties have remained. In particular, it remained unclear if and to what extent existing regulation applies to the underlying business models.

Independently, the Federal Council of Switzerland, the executive branch of the national government, launched a survey asking market participants to comment on the digital suitability of Swiss laws. Although this 2018 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, more work is required on the private law aspects. For example, how should tokens be qualified under Swiss private law as assets or claims and how can ownership in a token be validly transferred.

Following the 2018 report, the Federal Council published a proposal to amend federal law in accordance with the development of the distributed ledger technology (DLT) on March 22 2019, and invited interested stakeholders to comment on it. On November 27 2019, the Federal Council published the updated proposal of the new law and sent it to the national assembly for consideration. This article outlines the core proposals of the DLT report and the proposed new law which includes changes to civil law, insolvency law as well as financial markets regulation.

1 MINUTE READ

Michael Mosimann and Christian Schönfeld of Prager Dreifuss outline the changes the Swiss legislator intends to introduce in order to provide more clarity to the legal framework for distributed ledger technology (DLT) business models. These include the introduction of DLT securities and changes to laws on financial regulation and insolvency. This article follows up on some topics raised in Michael Mosimann's article Searching for clarity in the February/March 2019 issue of IFLR.

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Introduction of DLT securities

The most significant amendment relates to the introduction of purely register-based intermediated securities (DLT securities), which are added to the existing mix of securities, such as negotiable securities (*Wertpapiere*), uncertificated securities (*Wertrechte*) and intermediated securities (*Bucheffekten*).

In order to qualify as a DLT security, the register based on which the relevant security is issued must meet certain requirements:

- it must grant the creditor of the relevant security the power to dispose of it;
- it must be protected from unauthorised amendments by way of technical and organisational measures, for example, through the joint administration by several independent participants on a distributed ledger or blockchain;
- the content of the security, the functionality of the register and the registration agreements are recorded either in the register or in associated repositories; and
- the creditors must be able to review and inspect all information and register entries related to them as well as the integrity of the register entry pertaining to them independently without the support of a third party.

If the register meets these requirements, a DLT security is a valid security and the creditor of the relevant DLT security indicated by the register may enforce its claim towards the issuer. It also means that the issuer may only satisfy the claim represented by the relevant DLT security by performance to the creditor indicated by the register. The DLT security is validly created and issued based on the relevant register and can only be enforced and transferred through the register.

In particular, the amendment provides clarity on transferability through the register. According to existing laws, the transfer of most securities under Swiss law requires a written assignment declaration or an equivalent declaration on the security itself. The only exception are intermediated securities, which are created by way of credit by a custodian such as a bank or security dealer to a securities account. The custodian accepts certificated securities, global certificates, or uncertificated securities into custody and then credits the relevant rights to one or more securities accounts that belongs to the owner of the security. In this system, intermediated securities are validly transferred by way of credit to the securities account of the acquirer upon instruction of the transferor. Most securities issued on a blockchain do not qualify as intermediated securities and would always require a written assignment declaration in order to be validly transferred. The transfer of tokens representing blockchain-based securities without a written assignment declaration is potentially invalid.

As proposed, the DLT law would allow for a similar system as intermediated securities by essentially deferring to the rules on transferability of the relevant register based on which the DLT security has been issued. Therefore, the register rules could provide for a valid transfer of the DLT security if the token representing the DLT security was credited to the acquirer's wallet upon instruction of the transferor.

Changes to insolvency law

Segregation of cryptobased assets

The Federal Council identified in its 2018 report a clear need for the possibility to segregate crypto-based assets in a bankruptcy. However, it is unclear under the current Swiss insolvency regime whether this is possible. The Federal Council, therefore, proposed that a new provision be introduced into the Swiss Debt Enforcement and Bankruptcy Act (DEBA). This new provision is intended to address the question of segregation of crypto-based assets.

Under this new provision, it is possible to segregate crypto-based assets from a bankrupt estate if these assets are either allocated individually to a third party or if there is a

joint allocation to third parties and it is evident what the exact share of a specific third party will be.

It is worth noting that the preliminary draft in the 2018 report had previously only provided for a segregation right limited to means of payment (*Zahlungsmittel*). This has been widely criticised. As a result, the Federal Council's draft proposal now offers the possibility to segregate all kinds of crypto-based assets (*Vermögenswerte*).

The Federal Council does not share FINMA's view. Rather, it argues for a strict separation of private law questions and questions of banking regulation, the latter of which will be addressed in the relevant financial market regulation, in particular the Swiss Banking Act (SBA). Consequently, the Federal Council proposes to address this issue by amending the SBA.

Access to data in bankruptcy

Furthermore, the DLT report proposes to create a legal basis which would allow for access to data over which a bankrupt estate has control if a person is able to prove his or her legal or contractual personal entitlement to the data in question.

Changes to financial markets law

While the DLT report acknowledges that there are various points of contact between applications based on DLT and financial market law and regulation, including banking law, the law of collective investment schemes, regulation of financial infrastructures, it concludes that no fundamental amendments to Swiss financial market law are required at the moment. However, selective amendments are deemed to be beneficial, namely to provide more legal flexibility to potential providers of DLT–based financial services.

Namely, the DLT report expands on Swiss financial markets infrastructure law by providing a new licensing category for infrastructure providers in the area of DLT.

In essence, the DLT trading system should enable the simultaneous exchange among several participants for the purpose of concluding contracts pursuant to non-discretionary rules with respect to DLT securities.

The Federal Council's proposed expansion of the Federal Act on Financial Infrastructures and Market Conduct in Securities and Derivatives Trading (FinMIA) strikes a balance between the market's need for flexibility and the desire to protect customers with stringent rules. The Federal Council expressly rejected further liberalisation, for instance the introduction of entirely unregulated areas. While this might further increase potential innovation, it would jeopardise the protective goals of financial market regulation as well as lead to unfair competitive advantages of certain financial service providers over others, incentivise regulatory arbitrage and, thus, affect the reputation of the Swiss financial centre. Furthermore, the Federal Council is of the opinion that Switzerland's attractiveness for projects in the area of DLT benefits more from a comprehensive and sensible regulatory framework than it would from the absence of regulatory requirements in the name of further liberalisation.

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Also, an amendment to the definition of securities firms in the Federal Act on Financial Institutions (FinIA) which entered into force on January 1, 2020 stipulates that service providers which employ DLT only to run an organised trading system without pursuing further securities trading activities may apply for a licence as a securities firm nonetheless.

Furthermore, the amendment to DEBA regarding the possibility to segregate crypto-based assets from a bankrupt estate will have to be mirrored for banks in the Swiss rules on banking insolvency. Also, in view of the possibility to segregate crypto-based assets the scope of the SBA will be extended. In the future, the SBA will not only apply to the traditional banking activity of accepting deposits from the public but also to anyone accepting crypto-based assets. The exact details of this new rule will be laid down by the Federal Council in the ordinance to the SBA.

The Federal Council's draft proposal in the DLT report suggests some minor amendments to other statutes, including the Federal Act on Combating Money Laundering and Terrorist Financing and the Federal Act on the Swiss National Bank.

It is worth pointing out that except for a merely technical amendment to the definition of the term securities, the Federal Council refrains from any further amendments to the Federal Act on Financial Services (FinSA). Rather, it expressly acknowledges the need for financial service providers that use DLT to adhere to the obligations to provide comprehensive information about the financial services offered to customers due to the novelty nature of crypto-based assets as well as the fact that their evaluation may be more difficult in comparison to traditional asset classes.

Further clarity needed

The draft proposal pursuant to the DLT report expressly refrains from dealing with some questions in connection with DLT under Swiss financial market law and regulation. The Federal Council states that these issues will be examined at a later point in time, if the need arises, as it fails to see any urgent need to address them now. The questions to be postponed include the following:

- The application of DLT in the area of collective investment schemes. While this has been a hot topic, practical implementation of the discussed ideas remain at an early stage. Therefore, not only is there no need for action at the moment but it is also too early to definitively assess the changes that DLT will bring to the area of collective investment schemes regulation.
- The same holds true for potential applications of DLT insurance. The Federal Council will revisit these issues at a later time.

In the area of financial infrastructure law, the Federal Council limits the proposal in the DLT report to what is described as the

most urgent questions. Further amendments which may have wider consequences will be assessed in the course of a general assessment of the effects of the FinMIA which the Federal Council will conduct over the next couple of years. Potential amendments to be assessed may include general decreases in regulatory requirements for all types of regulated financial infrastructures. The Federal Council intends to coordinate this general assessment with developments on financial market regulation on an international level as well as with technological developments which might make amendments to the FinMIA necessary.

In anticipation of regulatory changes

The introduction of DLT securities would provide clarity to the legal validity of transfer of ownership of blockchain-based securities. While the current law providing for written assignment declarations is not practical in a distributed ledger environment, the DLT law would provide for legally valid transfers by way of transfer on the blockchain.

The proposed amendments of DEBA clarify whether crypto-based assets may be segregated in bankruptcy proceedings and, thereby, increase legal certainty for investors. In addition, the proposed right to access data increases the rights of creditors in bankruptcy proceedings.

Furthermore, the proposed amendments to Swiss financial markets law aim to enable financial service providers to implement solutions based on DLT. However, at the same time, the Federal Council endeavours to ensure adequate protection of investors and the financial market by not abandoning regulation of DLT service providers entirely. In addition, the Federal Council is proceeding carefully with amendments of Swiss financial markets regulation and expressly reserves the right to revisit further potential issues at a later point. It remains to be seen to what extent the proposed amendments will make it through the parliamentary process and what effect they will have if and once they enter into force.

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