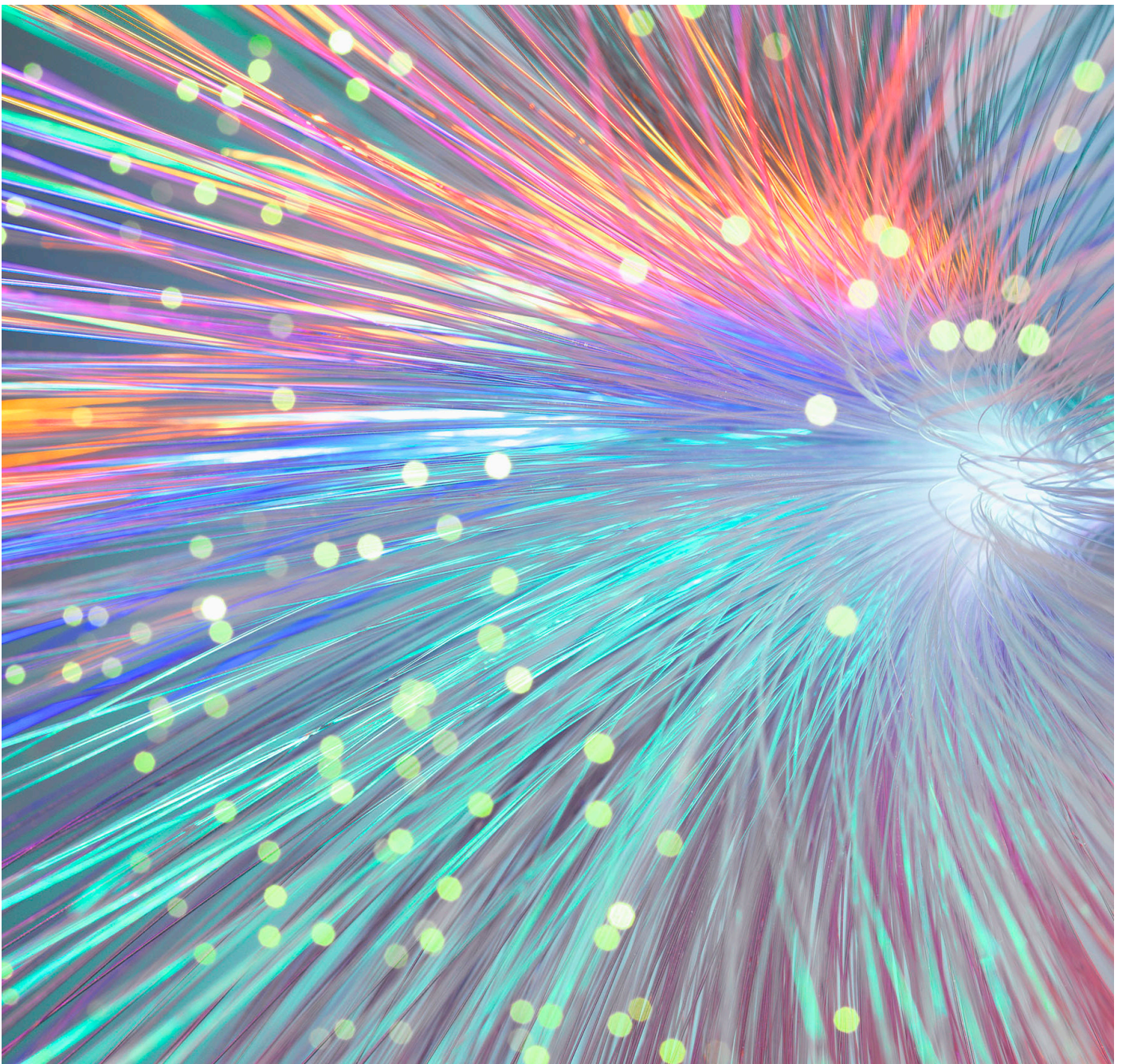


Regulatory Aspects of Initial Coin Offerings (ICOs) in Switzerland





INTRODUCTION

Switzerland is currently in the midst of the global cryptofinance boom and Swiss-related ICOs are attracting worldwide attention. The Swiss Financial Market Supervisory Authority (**FINMA**) has already taken a stance. On 29 September 2017, it announced through a press release that it was investigating whether regulatory provisions had been violated in several ICOs. At the same time, it released guidance on the regulatory treatment of ICOs (Guidance 04/2017). It followed up with its ICO Guidelines published on 16 February 2018 (**FINMA ICO Guidelines**).¹ Compliance with Swiss financial market laws must always be ensured for ICOs. Otherwise, an enforcement procedure may be triggered. Additionally, foreign financial market regulations should be considered when conducting an ICO from Switzerland.

Based on the definition used by FINMA, the abbreviation «ICO» as used herein refers to events where a number of investors transfer funds, usually in the form of cryptocurrencies, to an ICO organizer. In return they receive a quantity of blockchain-based tokens, which are created and stored in a decentralized form, either on a blockchain specifically created for the ICO or through a smart contract on a pre-existing blockchain. There is no generally recognized classification of ICOs and the tokens that result from them. FINMA has based its own categorization on the underlying economic function of the token and distinguishes the following three categories plus «hybrid» tokens:

■ **Payment tokens:** Payment tokens (synonymous with cryptocurrencies) are tokens which are intended to be used as a means of payment for acquiring goods or services or as a means of money or value transfer. Cryptocurrencies give rise to no claims against their issuer.

- **Utility tokens:** Utility tokens are tokens which are intended to provide access to an application or service by means of a blockchain-based infrastructure.
- **Asset tokens:** Asset tokens represent assets such as a debt or equity claim against the issuer. Asset tokens contain a promise – for example, a share in future earnings of a company or a project. In terms of their economic function, these tokens are analogous to equities, bonds or derivatives. Tokens which enable physical assets to be traded on the blockchain (**tokenized assets**) also fall into this category.
- **Hybrid Tokens:** The individual token classifications set out above are not mutually exclusive. For instance, asset and utility tokens can also be classified as payment tokens.

In some ICOs, tokens are already put into circulation at the point of fundraising. This takes place on a pre-existing blockchain. In other types of ICOs, investors are offered only the prospect that they will receive tokens at some point in the future and the tokens or even the underlying blockchain are to be developed at a later stage (pre-financing). Likewise, it is possible that investors receive tokens which entitle them to acquire different tokens at a later date (pre-sale).

¹ <https://www.finma.ch/en/~media/finma/dokumente/dokumentencenter/myfinma/1bewilligung/fintech/wegleitung-ico.pdf?la=en>.

I. OVERVIEW OF APPLICABLE SWISS FINANCIAL MARKET LAWS

In Switzerland, ICOs are regularly confronted with the following financial market acts:

- Banking Act (BA) and Banking Ordinance (BO): licensing requirement in case of public contributions;
- Financial Market Infrastructure Act (FMIA) and Financial Market Infrastructure Ordinance (FMIO): qualification as security; licensing requirements for trading systems, derivatives reporting and trading rules etc.;
- Federal Intermediated Securities Act (FISA): qualification as intermediated security; compliance with certain rules/specifications regarding transfer, etc.;
- Stock Exchange Act (SESTA) and Stock Exchange Ordinance (SESTO): securities dealer licensing requirement (later to be transposed to the Financial Institutions Act, which is not in force yet);
- Collective Investment Schemes Act (CISA): licensing requirement;
- Code of Obligations (CO): public offer of debt or equity securities, prospectus requirement and liability;
- Anti-Money Laundering Act (AMLA): Know Your Customer (KYC) duties and responsibilities to verify and report suspicious activities; and
- Financial Services Act (FinSA, *not in force yet*): financial instrument regulation, documentation, conduct and information requirements for issuance and distribution.

Foreign regulations must also be taken into account. In particular, US securities law requires precise analysis before any tokens are offered to US persons (see box text at the end of this contribution).

ICO founders, issuers and operators as well as banks that offer services in connection with ICOs are well advised to thoroughly check each token in advance for compliance with financial market and securities regulations.

II. REGULATORY ANALYSIS

Switzerland has a relatively fintech-friendly regulatory framework. In view of the rapidly increasing number of ICOs, FINMA issued a supervisory notification (04/2017) at the end of 2017. On 16 February 2018, FINMA published its ICO Guidelines, which set out how FINMA intends to apply financial market legislation in handling enquiries from ICO organizers. The FINMA ICO Guidelines also define the information FINMA requires to deal with such enquiries and the principles upon

which it will base its ruling (if FINMA agrees with the regulatory assessment presented by the applicant, this is in effect a «no enforcement action letter»).

In its communications, FINMA clarified that there are currently no specific ICO regulations in Switzerland. Neither relevant case law nor consistent legal doctrine directly address ICOs. The applicable provisions are principle-based and apply to ICOs on account of the technology-neutral design of Swiss financial market regulation. Given the wide variety of types of token and ICO set-ups, it is not possible to generalize regulatory assessments. The specific circumstances must be considered in each individual case. FINMA notes that the various points of contact with the applicable supervisory legislation have to be assessed based on the underlying economic purpose and the specific characteristics of the issued tokens, in particular if there are indications of an attempt to circumvent existing regulations. These regulatory issues are discussed below.

1. Banking Act

An entity conducting an ICO that accepts or publicly advertises to accept more than 20 deposits from the public may trigger banking licensing requirements. As the ICO is publicly advertised in advance, the advertisement criterion is met on a regular basis. This leaves the question as to whether the ICO project amounts to the taking of public deposits. As a matter of principle, all liabilities to customers are regarded as deposits from the public, unless one of the exceptions specified in the Banking Ordinance applies (Art. 5 para. 2 and 3 BO). In the case of an ICO, the term «liabilities» applies whenever a repayment obligation of the ICO organizer toward token holders or other parties arises. Insofar as the participants receive their invested capital back by handing over the tokens, there is usually a public deposit in accordance with the Banking Act (BA) and thus, the obligation to obtain a banking license applies.

The FINMA ICO Guidelines state that the issuing of tokens is not generally associated with claims for repayment on the ICO organizer and such tokens do not generally fall within the definition of a deposit. To this extent there is no violation of Swiss banking regulation. However, FINMA also points out that if there are liabilities with debt capital character (e.g. promises to return capital with a guaranteed return), the funds raised may be treated as deposits. Accordingly, only a bank would be permitted to issue such tokens.

2. Legal Qualification of Token as a Security

a. Four Types of Securities

Under Swiss law, the following are regarded as tradeable securities (*Effekten*) if they are unified and suited to mass trading (Art. 2 para. b FMIA):

- certified securities (*Wertpapiere*);
- uncertificated securities (*Wertrechte*);

- derivatives; and
- intermediated securities (*Bucheffekten*).

The criterion «unified and suitable for mass trading» applies if the securities are offered to the public in the same structure and denomination or are placed with more than 20 clients (Art. 2 para. 1 FMIO). ICOs will likely meet this criterion on a regular basis. Therefore, it needs to be examined whether tokens qualify as one of the four security types set out above. A token, being immaterial by its nature, will not qualify as a (physically) certificated security (*Wertpapier*) under Swiss law. Therefore, the other three types of securities need to be considered.

Uncertificated securities (*Wertrechte*) are defined as rights which are (i) based on a common legal basis (articles of association or issuance conditions), (ii) issued or established in large numbers and (iii) generically identical (Art. 973c para. 1 CO). Under the CO, the only formal requirement for uncertificated securities is the keeping of a book by the issuer in which the number and denomination of the uncertificated securities issued as well as the respective creditors are recorded (Art. 973c para. 3 CO). According to the FINMA ICO Guidelines, this requirement can be accomplished digitally on a blockchain.

Derivatives are financial contracts whose intrinsic value depends on one or more underlying assets and which do not represent a cash transaction (Art. 2 lit. c FMIA). Assets of any kind are eligible as underlying assets. However, what exactly qualifies as a financial contract is not defined in the law. In practice, only instruments associated with the financial market are considered financial contracts. Transactions that occur in a predominantly corporate legal context (corporate transactions) usually do not meet this condition. Whether the tokens issued to the participants as part of an ICO will qualify as derivatives cannot be answered in general terms, as it will depend on the actual use of the tokens and the rights tokenholders can derive from the token.

Intermediated securities are regulated in the FISA. This act defines intermediated securities as personal or corporate rights of a fungible nature against an issuer which are credited to a securities account and may be disposed of by the account holder. Only certain types of regulated entities can act as FISA-custodians and create such book-entry securities. Clearly, the tokens *per se* do not constitute intermediated securities, as they merely represent «register entries» on the blockchain and are not associated with one of the FISA-custodians. However, ICO organizers will often offer participants the opportunity to keep their private keys (access keys to the token on the blockchain) in their own cryptowallet and credit the tokens to a separate account. Such business models can lead to the creation of intermediated securities, depending on their design. In any case, however, a regulated entity has to be in play for the creation of intermediated securities.

b. Qualification of Tokens

The FINMA ICO Guidelines state the following on the qualification of tokens as securities:

Payment Tokens: Where payment tokens are designed to act as a means of payment and are not functionally analogous to traditional securities, FINMA does not treat them as securities. This is consistent with FINMA's current practice, e.g. in relation to Bitcoin and Ether.

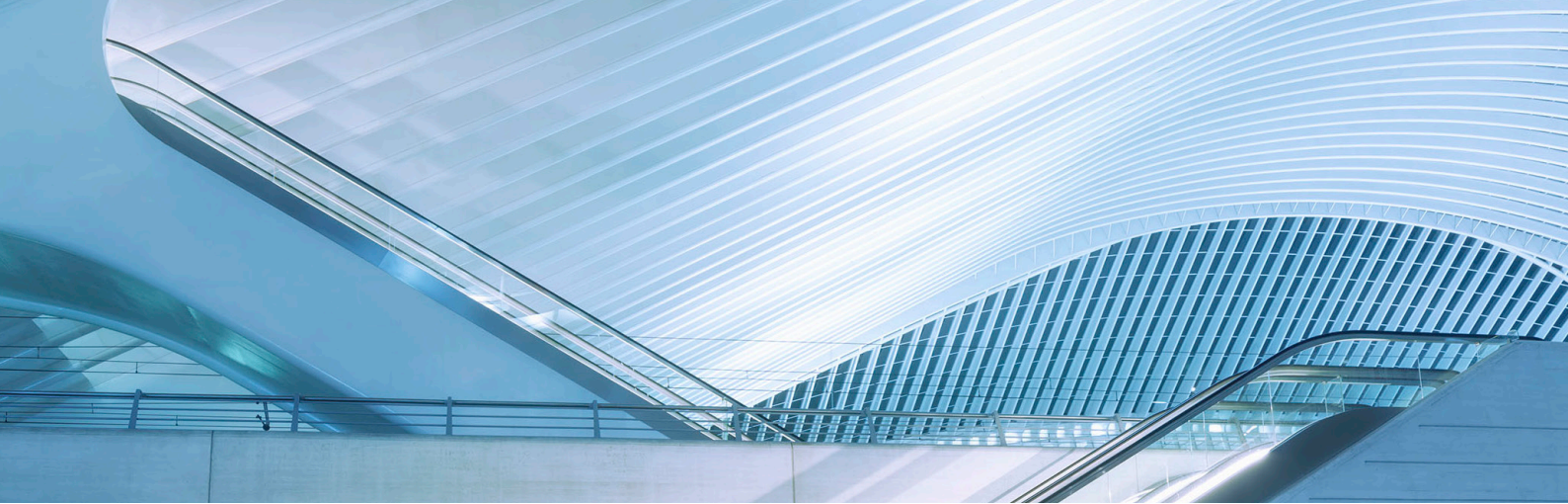
- **Utility Token:** If the sole purpose of the token is to confer digital access rights to an application or service (access token) and if the token can actually be used in this way at the point of issue, FINMA will not treat such utility token as a security. In these cases, the underlying function is to grant access rights and the connection with capital markets, which is a typical feature of securities, is missing. However, if a utility token additionally has an investment purpose at the point of issue, FINMA will treat such tokens as securities.
- **Asset Token:** FINMA treats asset tokens as securities. Asset tokens constitute securities within the meaning of Art. 2 let. b FMIA if they represent an uncertificated security (*Wertrecht*) and the tokens are standardized and suitable for mass trading. An asset token also qualifies as a security if it represents a derivative (i.e. the value of the conferred claim depends on an underlying asset) and the token is standardized and suitable for mass trading.
- **Token pre-sale:** In pre-financing and pre-sale phases of an ICO, where claims to acquire tokens in the future are issued, these claims will also be treated as securities if they are standardized and suitable for mass trading.

It seems questionable to apodictically treat asset tokens as securities. This is based on an economic view and a overly extensive interpretation of the notion of the uncertificated security (*Wertrecht*) that lacks a legal basis. First, the token itself can only be a mere registration of an asset on the blockchain and not an uncertificated security itself. Therefore, it can be argued that the token *per se* falls outside of the definition of a security. Second, and more importantly, not all tokenized assets are backed by an uncertificated security (*Wertrecht*) or are itself an uncertificated security. This is a specific term set out in civil law (Art. 973c CO). It cannot be applied to any asset without differentiation. Third, if the tokens were indeed uncertificated securities within the meaning of Art. 973c CO, they could only be validly transferred in written form under civil law, rendering the blockchain moot.

c. Regulatory implications

If tokens of an ICO constitute securities, they fall within the scope of securities regulation:

- Under the SESTA, book-entry of self-issued uncertificated securities are essentially un-



regulated, even if the uncertificated securities in question qualify as securities within the meaning of FMIA. The same applies to the public offering of securities to third parties.

- However, the creation and issuance of derivative products to the public on the primary market is regulated (Art. 3 para. 3 SESTO).
- Furthermore, underwriting and publicly offering tokens constituting securities of third parties on the primary market, is a licensed activity if it is conducted as a professional activity (Art. 3 para. 2 SESTO).
- Lastly, trading platforms for tokens may be in scope of the financial market infrastructure regulation, in particular if a non-discretionary matching of orders is used. This can mean that such platforms must apply for the respective trading facility license under the FMIA.

3. Investment Funds

If the assets collected as part of an ICO are managed externally, there may be points of contact with the collective investment schemes regulation (CISA). Operating companies that run businesses are excluded from the scope of the CISA. If a start-up company conducts an ICO to fund its own project, it will usually be deemed to be an operating company. If the financial resources of an ICO flow into the implementation of a project and not into an externally managed investment which can be quickly restructured or liquidated within the context of portfolio management, an operating company is assumed.

The FINMA ICO Guidelines confirm that the provisions of the CISA are relevant only if the funds accepted in the context of an ICO are managed by third parties.

4. Public Offer of Debt or Equity Securities

If shares or bonds are offered for public subscription, a prospectus within the meaning of Art. 652a CO must be published. This rule may also be applicable if equity or debt securities are registered on a blockchain and issued in token form. While the necessary content of

the prospectus primarily relates to technical information about the issuer, it is above all the prospectus liability set out in Art. 752 CO that must be observed for ICOs. Prospectus liability is not limited to public offers or the securities prospectus in the proper sense. Liability also applies to private placements, for example, if documentation similar to a prospectus is voluntarily submitted to investors. Accordingly, it is also possible that a court would apply prospectus liability in accordance with Art. 752 CO to white papers describing ICOs. As a result, any person involved in the preparation of a white paper (including consultants) would be potentially liable for incorrect or misleading information contained in the white paper.

5. Know Your Customer (KYC) Duties and Responsibilities

The objective of the anti-money-laundering regulation (AMLA) is to protect the financial system from money laundering and the financing of terrorism. The AMLA covers financial intermediaries and individuals and legal entities that trade in goods on a commercial basis and accept cash in doing so. The former category includes all prudentially supervised financial intermediaries (banks, securities dealers, fund management companies, insurance companies, central counterparties, casinos, etc.) as well as individuals or legal entities that professionally store, transfer, accept or invest third-party assets. If a person or legal entity falls within the scope of the AMLA, they are obliged to identify the parties involved in a transaction as well as the actual beneficial owner (KYC). In addition, they must ensure that appropriate documentation is provided to enable subsequent tracking of the transaction for criminal prosecution purposes. If a substantiated suspicion of money laundering or terrorist financing exists, the financial intermediary must issue a report to the Money Laundering Reporting Office Switzerland (MROS) and block the corresponding accounts. Financial intermediaries subject to AMLA must also join a self-regulatory organization (SRO) or register with FINMA as a directly supervised financial intermediary (DSFI).

FINMA determines the following in its ICO Guidelines:

Payment Tokens: The sale of payment tokens constitutes the issuing of a means of payment and is subject to the AMLA as long as the tokens can be transferred on a blockchain infrastructure. This may be the case at the time of the ICO or only at a later date.

Utility Token: In the case of utility tokens, anti-money laundering regulation is not applicable as long as the main reason for issuing the tokens is to provide access rights to a non-financial application of blockchain technology.

Under current FINMA practice, the exchange of a cryptocurrency for fiat money or a different cryptocurrency falls under Art. 2 para. 3 AMLA and thus triggers the AMLA regulation. The same applies to the offering of services to transfer tokens if the service provider maintains the private key (custody wallet provider).

6. Financial Instrument

Finally, a token may qualify as a financial instrument under the FinSA, which has not yet entered into force. The act will regulate the offering of financial instruments in detail and establish various documentation, behavioral and information obligations in connection with the issue and sale of financial instruments.

III. CONCLUSIONS

Switzerland can be considered a rather liberal jurisdiction. Although FINMA is accommodating to blockchain applications and fintech in general, it needs to apply the law as set out in the various financial market acts. Whether an ICO falls within the scope of Swiss financial market regulation has to be determined carefully in each individual case and ruled with FINMA, as the answer to this question strongly depends on the functionalities and rights of the offered token.

RESTRICTIONS OF U.S. SECURITIES LAW ARE ALSO RELEVANT FOR SWISS ICOS


In the US, regulators such as the Securities Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) have taken decisive action with respect to ICOs and cryptocurrencies. The SEC has focused, in the context of ICOs, on whether a «security» is involved. If a «security» is involved, the SEC has a basis upon which to assert jurisdiction. The SEC's initial action with respect to ICOs occurred in July 2017, when the SEC issued a Section 21(a) Report in respect of «The DAO». In the report, the SEC detailed its approach to determine whether an ICO constitutes a securities offering. In particular, the SEC's analysis focused on whether the tokens were an «investment contract», a form of a security under the federal securities laws.

The SEC found that the DAO tokens did constitute an investment contract, and thus a security, subject to the federal securities laws, because the ICO involved (i) an investment of money (ii) in a common enterprise (iii) with a reasonable expectation of profits (iv) to be derived from the entrepreneurial or managerial efforts of others. Since the SEC issued its report with respect to «The DAO», the SEC has sought to halt a number of ICOs and brought fraud-based actions against ICO issuers and unregistered markets.

The CFTC has also been very active in the cryptocurrency space. It has determined that virtual currencies are «commodities» (not currencies) under the Commodity Exchange Act. As a result, derivatives contracts based on cryptocurrencies and certain retail leveraged spot contracts are subject to the CFTC's jurisdiction. Like the SEC, the CFTC has brought enforcement actions involving virtual currencies centered on fraud charges and for unregistered activities.

Other US regulators have also shown an interest in – or taken action with respect to – cryptocurrencies, including Financial Stability Oversight Council, the Financial Crimes Enforcement Network (FinCEN), FINRA, the Consumer Financial Protection Bureau and the Internal Revenue Service, in addition to state banking regulators. Moreover, recently, Congress has held public hearings on the role and use of cryptocurrencies and ICOs. We expect additional regulation to ensue, but are hopeful that it will not hamper innovation in the industry.

In any case, the restrictions of U.S. securities regulation should be carefully examined before launching a (public) ICO.



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