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SPOTLIGHT

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Initial Coin Offering (ICO) & Co. – A Swiss Law Perspective

Initial Coin Offerings (ICOs) or Token Generating Events (TGEs) are perceived as an unregulated means of raising funds by issuing virtual coins or tokens (hereinafter: Tokens) intended to become a new *cryptocurrency.* Many start-ups consider ICOs or TGEs as an alternative to the expensive traditional capital-raising processes.

Tokens issued in an ICO/TGE, however, are still subject to legal scrutiny and ICOs/TGEs have come into the focus of the regulators in the USA (SEC) and Singapore (MAS) regarding their compliance with existing *capital markets regulations*.

Relevant Issues

Tokens are created and disseminated using distributed ledger or blockchain technology. The start-ups create a so called *whitepaper* which explains the project to be funded by the ICO/TGE in detail. Token purchasers fund the development of a digital platform, software or other projects. The Tokens may be used to access the platform, use the software or otherwise participate in the project or give a right to participate in a share of the returns provided by the project. Once issued, the Tokens may be traded on *a secondary market*, virtual currency exchanges or other platforms.

- The obvious purpose of most ICOs/TGEs is to raise money from the public. Under Swiss law the Tokens qualify as securities or financial instruments if they fit into one of the categories outlined in Art. 3 of the draft Federal Law for Financial Services: equity securities (equity or a derivative on equity, ownership and voting rights), loans, units in collective investment undertakings, structured products, derivatives, deposits of which the reimbursement value is depending on certain variable financial criteria, bonds and securities.
- A qualification as a financial instrument/security is always likely if the investor simply purchases a Token and then passively waits and observes what happens on the secondary market. In this case, the ICO/TGE is subject to banking law, securities law or collective investment scheme law and its strict regulative schemes.
- For newly issued Tokens which neither qualify as a security nor as a financial instrument, Swiss law currently knows no specific regulation.

Criteria to Assess the Token Design

The Tokens must be analysed on a case by case basis. The assessment is based on the description of the Token in the whitepaper. The following criteria might serve as examples:

A Token with one or more of the following rights will in all likelihood not meet the definition of security/financial instrument:

1. Rights to program, develop or create features for the distributed ledger;
2. Rights to access the system;
3. Rights to contribute labour or effort to the system;
4. Rights to use the services of a system and its outputs at no charge;
5. Rights to sell the products of the system; and
6. Meaningful voting rights, free information and possibility of exchanging opinions among Token holders.

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A Token with one or more of the following rights will in all likelihood qualify as a security/financial instrument:

1. An investment of money in a start-up
   a. with a reasonable expectation of profits, such profits consisting of dividends, periodic payments or the increased value of the investment; or
   b. if the profits are to be derived from the entrepreneurial or managerial efforts of others (i.e. of the founders); or
   c. the voting rights of the Token holders do not provide a meaningful control over the start-up.
2. Share of profits and/or losses, or assets and/or liabilities;
3. Status as equity holder, creditor or lender;
4. Claim in bankruptcy as equity interest holder or creditor;
5. Holder of a repayment obligation from the issuer of the Token; and
6. Management or board of the issuer have the effective control over the project.

If there are any doubts regarding any of the criteria above, we strongly recommend contacting the Swiss regulator Financial Market Supervisory Authority (FINMA).

The Swiss Regulator's Approach

For the time being FINMA's approach is as follows:

- Bitcoin (BTC) and Ether (ETH) are considered as means of payment and can be traded on respectively transferred to a wallet, provided the rules for the prevention of money laundering (AML Rules) are respected;
- FINMA assesses new financing tools such as ICO/TGE in accordance with the existing legal basis for financial markets, because in Switzerland no specific rules for ICOs/TGEs or similar business models exist;
- Regarding the applicability of the financial markets law (in particular Banking Act, Anti-Money Laundering Act and Ordinances, Securities Trader and Stock Exchange Act, Collective Investments Scheme Act) one question among many is decisive: Do the Tokens offered qualify as financial instruments/securities? If yes, the relevant laws for banks, securities, collective investment schemes etc. apply.

Based on this background, FINMA invites the parties interested in launching an ICO/TGE to submit detailed information on the planned Token offering for an assessment of the need for authorisation.
Depending on the level of intensity and details of the information provided, FINMA will charge fees for its evaluation.
FINMA does not assess questions of civil law (prospectus) or tax law in the context of ICOs/TGEs.

AML, Secondary Market, Custody

The AML Rules for the prevention of money laundering apply. The "*know your customer*" (KYC) process is cumbersome because it mostly relies on a face-to-face contact between the parties. In the virtual world, this is considered an obstacle. Several jurisdictions have implemented KYC procedures which avoid the need for a face-to-face contact (e.g. video identification). The KYC procedures of one country, however, might not be accepted in other countries.

Custody, *distribution* as well as *secondary market trading* of the Tokens are relevant and need to be in line with applicable local laws. Again, compliance with the laws of one country does not automatically mean that the Tokens can be distributed in other countries without the approval by local regulators. Finally, the type of investor who is allowed to purchase Tokens must be defined (consumers, qualified investors, etc.) for each jurisdiction.

Corporate Form of the Issuing Entity

Based on previous examples, most developers aim for a foundation such as Ethereum Foundation.
The advantage of a foundation in an early phase (complete independence of any ownership since there are no shareholders), contrasts with the disadvantages in the long term such as governmental supervision, "locked box" (no chance to ever get the funds out again other than for promotion of the foundation's purpose), rigid structure or no tax benefit per se (only in case of a charitable foundation, a status seldom granted). In addition, although there is no formal ownership, whoever controls the board of the foundation controls the foundation itself. There is no transparency regarding the founders in public registers.
The suitable corporate form needs to be evaluated in each case. A limited liability company, for example, would provide full transparency on the ownership due to the required registration of the shareholders in the public commercial register.
Irrespective of the corporate form chosen, a re-characterisation by the courts cannot be excluded if the activities of the start-up correspond to the activities regulated by financial markets laws.

Conclusion

ICO/TGE is a new form of contributing to or investing in start-ups. Due to the diversity of Tokens, general qualifications cannot be made and each Token has to be assessed on an individual basis. If it mainly serves the purpose of financing the start-up, the existing laws and regulations for financial instruments apply.