



ICOs in Switzerland – A New Way of Project and Venture Financing

I **Martin BERWEGER**

Intel decision in 2004, there has been a split of authority in the lower federal courts on whether Section 1782 applies to allow judicial assistance for proceedings before international arbitral tribunals.

4 *Compare, In re Servotronics, Inc.*, 2018 U.S. Dist. LEXIS 189423, 2018 WL 5810109 (D. S.C.); *In re TJAC Waterloo, LLC*, 2016 U.S. Dist. LEXIS 56381, 2016 WL 1700001 (N.D. Ind. 2016); *In re Dubey*, 949 F. Supp. 2^d 990, 993-94 (C.D. Cal. 2013); and *In re Arbitration between Norfolk S. Corp & Gen. Sec. Ins. Co.*, 626 F. Supp. 2^d 882 (N.D. Ill. 2009) (holding that Section 1782 does not allow for judicial assistance for international arbitration tribunals), with *In re Pola Mar. Ltd.*, 2017 U.S. Dist. LEXIS 138926 (S.D. Ga., 2017); *Kleimar V.V. v. Benxi Iron & Steel Am., Ltd.*, 2017 U.S. Dist. LEXIS 124437, 2017 WL 3386115 (N.D. Ill. 2017); *Chevron Corp. v. Shefftz*, 754 F. Supp. 2^d 254 (D. Mass. 2010); *In re Application of Babcock Borsig AG*, 583 F. Supp. 2^d 233 (D. Mass. 2008); *In re Hallmark Capital Corp.*, 534 F. Supp. 2^d 951, 955 (D. Minn. 2007); and *In re Roz Trading Ltd.*, 469 F. Supp. 2^d 1221, 1224 (N.D. Ga. 2006) (holding that Section 1782 allows judicial assistance for international arbitration tribunals).

5 Of note, however, are three decisions of the U.S. Courts of Appeals for the Sixth, Seventh and Eleventh Circuits. The first of these is the Sixth Circuit's recent order in *JSC MCC Eurochem v. Chauhan*, 2018 U.S. App. LEXIS 26226 (6th Cir.), in which the appeals court refused to stay, pending appeal, an order of a Tennessee district court granting discovery where there was both pending litigation and a related London arbitration. The Seventh Circuit's case, *GEA Group AG v. Flex-N-Gate Corp.*, 740 F. 3^d 411, 419 (2014), implied in *dicta* that an international arbitration tribunal could be within the scope of Section 1782. Lastly, the Eleventh Circuit in *Consortio Ecuatoriano de Telecom. S.A. v. JAS Forwarding (USA), Inc.*, 747 F.3^d 1262, 1268 (11th Cir. 2014), affirmed the discovery order issued by the district court where there were both civil and criminal court proceedings contemplated (in addition to an international arbitration that was actually pending), noting that the district court had concluded that the arbitral tribunal was "likely within the purview of Section 1782." While none of these cases squarely holds that an international arbitral tribunal is an "international tribunal" within the meaning of Section 1782, the trend of recent decisions is that Section 1782 allows U.S. courts to provide judicial assistance in international arbitration cases. In addition, there also may be a distinction between private international commercial arbitration tribunals and investment arbitration tribunals, with investment cases being deemed closer to involving a government related tribunal and thus more likely to be viewed as an "international tribunal." See, S.I. Strong, *Discovery under 28 U.S.C. §1782: Distinguishing International Commercial Arbitration and International Investment Arbitration*, 1 Stan. J. Complex Litig. 295 (2013).

À ce jour, les ICO (Initial Coin Offering) sont l'application la plus pertinente de la technologie du grand livre distribué (blockchain) au niveau économique et elles sont devenues un moyen important de financement de projets et de capital-risque. Cet article vise à donner une introduction et une vue d'ensemble sur les ICOs en Suisse en mettant l'accent sur le Crypto Valley Zoug. Il souligne la pertinence des ICOs, l'évolution du marché des ICOs ainsi que les caractéristiques de base et les enjeux des ICOs en droit suisse.

The ICO Boom and the Current Crisis

One of the first ICOs was conducted in 2013 by Omni Layer. In order to finance a platform built on the bitcoin blockchain for creating and trading digital assets and currencies, Omni Layer raised bitcoins in exchange for newly created Mastercoins. About 500 investors participated in that ICO and transferred around 5,000 bitcoins (at that time at the equivalent of USD 500,000). In 2014, the Foundation Ethereum, domiciled in Zug, Switzerland, launched its ICO by issuing

Hence, for profit-oriented projects, corporations appear to be often the most suitable legal entity under Swiss law for conducting an ICO.

ICOs, Smart Contracts and Tokens

ICO stands for «Initial Coin Offering» and is a form of crowdfunding. In an ICO, investors transfer funds to a certain organization. The funds commonly consist of popular cryptocurrencies or legal currencies. Those funds shall be used to realize a specific project or business case as described by the organization in their white paper¹. As consideration for their funds, the investors receive tokens created by a self-executing application called smart contract on a pre-existing blockchain (often Ethereum) or on a blockchain specifically developed for that project. The rapidity and efficiency of raising large amounts of money without diluting the owner or giving up control to investors are the main reasons for the success of ICOs. At the beginning of the ICO boom, tokens often purely represented a means of payment, so-called coins. Nowadays, in order to be attractive for investors, tokens usually contain additional features, e.g. access to a certain service or an interest in an asset or a share in future profits of the organization.

Ether (ETH) tokens for the development and operation of Ethereum, currently the most important platform that runs smart contracts. Ether is today the cryptocurrency with the second largest market capitalization, after bitcoin. In the following years, ICOs experienced a boom: Worldwide, USD 256^m were raised in 2016, USD 5^{bn} in 2017 and even USD 17^{bn} in 2018 (ICOs on average raised USD 6^m in 2016, USD 16^m in 2017 and USD 26^m in 2018)². ICOs have outperformed the traditional way of venture financing in this period. In 2018, though, the prices of cryptocurrencies collapsed dramatically, plunging the ICO market into a global crisis. The demand for new tokens declined sharply because investors lost a significant part of their crypto fortune, reducing their ability and willingness to invest in ICOs and to diversify their portfolio. In addition, the cryptocurrencies have not yet succeeded in reaching a broader public and shedding their ambivalent reputation. A majority of the crypto scene takes the current crisis calmly and is confident that the market correction will help to develop more sustainable projects. Stakeholders believe that launching high quality projects will increase demand again.

The Crypto Valley Zug

A few years ago, Zug, Switzerland, has become one of the main locations for ICOs, since then also referred to as the Crypto Valley. How did that happen? Surely, the Foundation Ethereum raising USD 18^m in 2014, the Tezos Foundation raising USD 232^m in 2017 as well as other ICO projects launched in Zug have contributed to this success. Though, these are not the only reasons. Zug is a fertile ground for technology ventures. According to the Atomico report «The State of European Tech 2018», Zug is the fastest-growing tech hub in Europe. It has visionary entrepreneurs, offers deep pools of capital, low taxes and proximity to leading universities such as the ETH Zurich, the EPFL and the HSG.³ Supportive circumstances are Switzerland's reliable and predictable legal framework, neutral and decentralized political system, a good infrastructure as well as a high quality of life. A further reason was the openness of Swiss authorities towards cryptocurrencies when they were introduced. As early as in June 2014, the report of the Federal Council on virtual currencies stated that «the mere use of bitcoins as a means of payment for goods and services is not regulated by the financial market legislation. This is true from the perspective both of the person paying for such services in bitcoins and of the person receiving payment in bitcoins». Since summer 2016, the City of Zug accepts bitcoin as a means of payment for governmental services up to a maximum of CHF 200. This peculiarity caused public awareness all over the world. Finally, a cluster of blockchain specialists and service providers contributed to a blockchain competence hub, supporting and developing the Crypto Valley Zug. Despite the many advantages Zug offers to entrepreneurs, ICO clients often struggle to open a bank account in Switzerland. Consequently, other places over the world were able to catch up, fostering an ongoing competition between those hubs. Currently, the main places for ICOs apart from Switzerland are the United States, Singapore, Hong Kong and the United Kingdom (the Cayman Islands, British Virgin Islands and Gibraltar).

Regulatory Challenges

From a regulatory perspective, ICOs are subject to considerable uncertainty because

they are new, complex and global. In order to create clarity, at least in Switzerland, it is possible to request a no-action letter from the Swiss Financial Market Supervisory Authority (FINMA) in advance, in order to establish whether and how a specific ICO is regulated under Swiss financial market laws. In February 2018, FINMA published guidelines for enquiries regarding the regulatory framework of ICOs in Switzerland. FINMA was the first regulator to publish a comprehensive assessment of the regulatory treatment of ICOs in a jurisdiction. According to these guidelines, FINMA distinguishes between three categories of tokens based on the underlying economic function: Payment tokens, asset tokens and utility tokens. Each of these categories of tokens are subject to specific rules (it is also possible that a token qualifies as a hybrid token which falls into two or even all three categories as described below):

1. Payment tokens are tokens which might be used as means of payment for acquiring goods or services or as means of value transfer. Payment tokens do not give rise to a (repayment) claim against its issuer. The issuing of payment tokens as a means of payment constitutes a service for payment transactions and therefore falls within the scope of the Anti-Money Laundering Act (AMLA). The applicability of the AMLA requires the issuer of the tokens, among other things, to affiliate to a self-regulatory organization (SRO) and to identify the contracting party and the beneficial owner (KYC) of the paid-in funds. In many cases, the due diligence requirements are met by a professional service provider affiliated to an SRO (thus there is no more need for the issuer of the tokens to be affiliated to an SRO itself). FINMA considers most of the tokens, due to their transferability, as (potential) means of payment. As a result, the issuer must comply with the AMLA.
2. Asset (or security) tokens represent assets such as debt or equity claims against the issuer or physical assets to be traded on the blockchain. Asset tokens promise, for example, a share in future profits of the organization or an interest in a specific object. FINMA considers asset tokens generally as uncertificated securities since they are standardized and

suitable for mass trading. Under applicable Swiss law, the self-issuance of securities is essentially unregulated but requires the issuer to publish a prospectus. It must be noted, though, that the qualification as security has far-reaching consequences on the secondary trading, such as the authorization requirement of security dealers, stock exchanges, multilateral trading facilities (MTFs) as well as organized trading facilities (OTFs).

3. Utility tokens are tokens providing access to a blockchain-based application or service. Utility tokens are in general not regulated under the Swiss financial market laws, however, if a utility token has an investment purpose, FINMA will treat such token as security.

Apart from the AMLA and provisions on securities, the issuer of tokens should clarify whether banking law, provisions on collective investment schemes or other regulatory rules apply. In any case, it is highly recommended that legal experts assess the ICO and apply for a no-action letter from FINMA prior to the ICO. Without such “ruling”, the risk that the FINMA enforcement division initiates investigations are considerable. The omission of obtaining a no-action letter might lead to significant expenses, uncertainty and time-consuming proceedings.

Appropriate Legal Entity for an ICO

In addition to regulatory issues, further legal challenges arise, depending on the specific set up of the project. It is crucial to choose the appropriate legal structure to conduct an ICO. At the beginning of the ICO boom in Switzerland, many ICOs were conducted by Swiss foundations. Foundations were mainly chosen for tax reasons. Under Swiss law, non-profit foundations may be relieved from paying certain types of taxes if they pursue a public or charitable purpose – but almost all foundations conducting an ICO did not meet the necessary requirements. Nevertheless, they can still benefit from lower income tax rates compared to corporations. Apart from lower taxes, the absence of ownership resulting in increased trust in the legal entity is considered to be another advantage of foundations. This might be in particular the case for projects

that wish to set up an independent platform. Needless to mention that foundations also have major disadvantages, explaining their decreasing popularity. Firstly, the missing possibility of an exit due to the absence of ownership prevents the sale of the foundation and the distribution of profit to the founders. Secondly, foundations are supervised by an authority and require in general an auditor, making them more expensive in their operation than corporations. Thirdly, foundations feature an inflexible legal structure with a limited scope of action and the adaption of the foundation statute including its purpose is only possible to a very limited extent. This rigidity is unsuitable for many of the legal entities conducting an ICO as the distributed ledger technology and the environment are facing rapid changes. Therefore, corporations such as the company limited by shares (Ltd.) or the limited liability company (LLC) are nowadays more commonly used. Corporations allow their owners to realize an exit or to pay out dividends and to adapt the structure to a changing environment. Even though the Swiss corporations are less advantageous as foundations regarding the tax burden, profit and capital taxes are often lower in Switzerland compared to other jurisdictions. Finally, the association is an additional alternative to a foundation. The legal structure of a Swiss association is basically more adaptable than that of a Swiss foundation. Besides its more flexible legal structure, associations are not supervised by an authority, are less expensive in operation and do not need to be registered with the commercial register in most cases. Associations, however, are inappropriate for realizing an exit and cannot have a commercial purpose and run a business at the same time. Hence, for profit-oriented projects, corporations appear to be often the most suitable legal entity under Swiss law for conducting an ICO. However, careful considerations of the various advantages and disadvantages must be carried out in each case.

Further Legal Challenges

For all forms of legal entities, taxes and particularly the taxation of the ICO profits are of relevance. In Switzerland, ICO proceeds are generally subject to income taxes. Initially, revenues from the ICO may be neutralized by forming a provision

in the amount of the ICO proceeds. Such provision may be recognized due to the obligation of the organization to realize the project, as described in the white paper. However, such provision must be released in the following years dependent on the progress of the project. Taxable income arises when a higher amount of the provision is or must be released than expenses incurred for the project in a tax period. The Swiss tax authorities usually require a release of the cost actually incurred plus 5%. Thus, for the entire period until the proceeds from the ICO are used up, the organization will generally be taxed on a profit of 5% of the revenues from the ICO. Comparable to the FINMA no-action letter, a tax ruling might be agreed in advance with the competent tax authorities, defining the tax consequences of an ICO. Such tax ruling is recommended and may avoid unwanted surprises. Other challenges arise from contract law, e.g. the formally valid transfer of tokens. Under Swiss law, a written assignment declaration is generally required to transfer rights. Another issue is data protection, such as the right of rectification or deletion of personal data, as a blockchain usually does not provide for the possibility to modify or delete transactions. The most challenging task, however, is to comply with foreign laws as a consequence of the global reach of ICOs. If a token, for example, is not a security according to Swiss law, it could still be considered as a security by the authorities of another country, requiring the issuer to comply with the security laws of these jurisdictions. In this respect a close cooperation with foreign lawyers, a careful instruction of clients, the disclosure of potential risks, the focus on relevant ICO markets, respectively the exclusion of investors from certain jurisdictions and a risk assessment is essential.

Conclusion

ICOs, the most relevant application of the distributed ledger technology so far, have disrupted the traditional project and venture financing – other areas will follow. An ICO is a complex, expensive and elaborate undertaking providing the opportunity to raise millions for financing projects or business cases. From a legal point of view, an ICO is an interdisciplinary area requiring expertise in regulatory law, corporate law, tax law, compliance and

other disciplines. The fact that investors from all over the world might participate in an ICO requires compliance with rules from all over the world. For this reason, international cooperation among law firms is of great importance to successfully advise and accompany ICO clients in the age of blockchain.

Martin BERWEGER
Attorney at Law & Civil Law Notary
Wenger & Vieli Ltd.
Zug, Switzerland
m.berweger@wengervieli.ch

¹ The white paper is an information memorandum which usually describes the customer needs or problems and how the project shall satisfy respectively solve them, a market analysis, the organization and its team, the roadmap, conditions and technical aspects of the ICO, the number, use, functionality and distribution of the tokens and when they are issued, how the raised funds are going to be used as well as a disclaimer and compliance aspects.

² Figures according to <https://www.coindesk.com/ico-tracker>. Similar figures contained in Initial Coin Offerings. A strategic perspective. PwC in collaboration with Crypto Valley, June 2018 Edition, p. 2. Calculations based on currency exchange rates on end date of the ICOs.

³ ETH Zurich is the Swiss Federal Institute of Technology in Zurich, EPFL the Swiss Federal Institute of Technology in Lausanne and HSG the University of St.Gallen in St.Gallen.