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Digital Assets: Are they reflected in current Swiss laws and regulations?

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Tailor-made laws and regulations?

- **No tailor-made laws** specially drafted for distributed ledgers or for assets built on this technology
- **Existing rules** are applied to new technologies
- Broad room for **interpretation**, no precedents by courts/no case law so far, dissenting opinions in legal teaching
- Few tailor-made provisions
 - **Guidelines for initial coin offerings** (ICO) by Swiss Financial Market Supervisory Authority (**FINMA**)
 - Amendment of the Banking Ordinance for **FinTech companies** by Swiss Federal Government
- **Reports by Federal Government** (2014 and expected for end of 2018, consulting interested parties from 31 August until 20 September 2018) as means of interpretation

Existing laws

Overview

- Federal laws
 - Banking Act
 - Stock Exchange Act
 - Collective Investment Scheme Act
 - Financial Market Infrastructure Act (FMIA)
 - Anti Money Laundering Act (AMLA)
 - Federal Intermediated Securities Act (FISA)
 - Civil Code/Code of Obligations and Civil Procedural Code
 - Criminal Code and Criminal Procedure Code
- Cantonal law
 - Taxation on Cantonal and Local level



Banking Act: What is Banking Activity?

- Banking activity is defined as **accepting deposits from the public on a commercial basis**
- **Duty to reimburse** the investors (**repayment obligation**)
 - Bond issues do not qualify as deposits if a proper prospectus is published
 - Capital contributions (equity) to a company do not lead to a repayment obligation
- **Acting on a commercial basis**
 - Deposits of more than 20 investors
 - Publicly advertising the willingness to accept funds to a non-limited number of persons
- All deposits are **deposits from the public by default**
 - Exemptions are defined in the Banking Ordinance

Banking Act: The example of ICO

- Promise to the token holders of reimbursing the token price (e.g. **future profits, buy back of tokens**) = **repayment duty**?
- ICOs are always using the **internet** to publish their **whitepaper** and mark their presence
 - This is considered **public advertising** and acting in **commercial capacity**
- Various ICOs use **third parties** for **marketing** and **sales**
 - For the company performing the ICO, this may constitute **improper advertising**
 - For the third party involved, an unauthorized **distribution** or **underwriting activity**
- The **Enforcement Department** of FINMA might intervene and request information, start official inquiry procedures which might ultimately lead to the liquidation of the ICO provider

Oversight of Swiss FinTech Regulations

Swiss approach: No special legislation for a new category of financial institutions, but **carving out from** the requirements for **fully fledged banks**

Compliance with AML requirements for all categories		
Specific adjustments to the regulations	Innovation area	New license category "bank license light", <i>as of 1 January 2019</i>
Extension and statutory definition of the holding period for funds in settlement (pass through) accounts to 60 days	<ul style="list-style-type: none"> • Maximum of CHF 1 million in public deposits from an unlimited number of persons • No investment activity / no payment of interest, if primarily active in the financial sector • Duty to inform about the absence of deposit protection / no supervision by the FINMA 	<ul style="list-style-type: none"> • Maximum of CHF 100 million in public deposits from an unlimited number of persons • No investment activity / no payment of interest • Duty to inform about the absence of deposit protection
→ no license	→ no license	→ license , but: lower requirements than for full banking activity, e.g., minimum capital of CHF 300'000 or 5% of the deposits accepted, maximum 5'000'000 CHF

Criteria for Collective Investment Scheme

- Pool of assets raised from at least two investors independent of each other as a result of public advertising
- For the purpose of collective investment
- Assets are managed by the fund management company for the account of the investors, i.e. any profits come from the efforts of a third party and not from the contribution of the investors
- Investment needs of the investors are met on an equal basis

Collective Investment Scheme: Example

- SwissRealCoin is designed as a security token **linked to a portfolio** of **Swiss commercial real estate**
 - The issuing company invests in Swiss commercial real estate = investment done by the **Fund Manager**
 - The investors get a token, the **token value is linked to a portfolio** of Swiss commercial real estate
 - **No redemption**, only liquidation of the real estate portfolio
 - Tokens should be traded on selected crypto exchanges = secondary market (ETF?)
- FINMA expressed concerns whether this is not a **collective investment scheme**
- Prepaid investments were reimbursed, the ICO of the SwissRealCoin is **postponed**, the structure will be changed to a collective investment scheme

Stock Exchange Act (SESTA)

- **Securities:** standardised certificated and uncertificated *securities*, *derivatives* and *intermediated securities*, which are suitable for **mass trading**
- Suitability for mass trading means that the securities are:
 - **publicly offered** for sale in the same structure and denomination, or
 - are placed with **more than 20 clients**
 - insofar as they have not been created especially for individual counterparties (e.g. OTC derivatives)
- Securities dealers:
 - own-account dealers
 - issuing houses (underwriters)
 - derivative house
 - market makers
 - client traders (brokers)

Examples

- **Self-issuing of tokens** (book-entry securities) does not require a FINMA license (but prospectus obligation)
- **Public offering of securities to third parties** does not require a FINMA license (but prospectus obligation)
- Creation and issuance of **derivative products** to the public on the primary market is regulated (license as **derivative house**)
- **Underwriting** and offering tokens issued by third parties publicly on the primary market conducted in a professional capacity, is a licensed activity. **ICO Accelerators?!**

Financial Market Infrastructure Act (FMIA)

- Subject to a license as **financial market infrastructure** are trading venues, i.e.:
 - **Stock Exchanges**
 - **Multilateral Trading Facilities**
 - **Organised Trading Facilities**
- Only **securities** as defined above can be traded on these trading venues
 - Tradable are **non-native tokens** qualifying as uncertificated securities or as derivatives
 - **Native Tokens** such as cryptocurrencies (e.g. BTC, ETH) are not covered by the FMIA; only derivatives on BTC and ETH can be traded on licensed trading venues in accordance with the FMIA

Crypto Exchanges

For a crypto exchange for Native Tokens (e.g. BTC / ETH) only, two aspects are important:

- **Full compliance** with **Swiss AML regulations**
- Is the exchange providing **only matching** or also **accounts** for users?
- Keeping accounts means **taking deposits** from the public; a **banking license** is needed if the crypto exchange
 - offers accounts to its customers, and
 - does not keep them in a way that private keys can be segregated in case of insolvency of the exchange (see below, Custody)

As of 1 January 2019 **Banking License Light** up to CHF 1 Mio might help

Custody

Custody – FINMA approach

Based on considerations in line with **bankruptcy law** FINMA has developed the following approach:

- If the funds of the investors are all held in **one wallet** (pooling, similar to an "**omnibus customer account**" structure), then the investor cannot segregate its assets in case of insolvency of the service provider
→ banking licence needed
- The funds of the investor can be segregated from the bankruptcy estate of the provider if the private keys are allocated to separate wallets for each investor/client held by the provider (similar to "**individual customer account**" structure)
→ no licence needed
- Technical criteria are decisive in order to decide whether segregation is possible in case of bankruptcy or not

Anti Money Laundering

Anti Money Laundering Law (AMLA)

- The AMLA applies to **regulated entities** (banks, securities trader etc.) and to financial intermediaries; **financial intermediaries** are **persons** who:
 - on a professional basis **accept** or **hold** on deposit **assets belonging to others** or
 - assist in the *investment* or *transfer* of such assets
- Financial intermediaries must:
 - become a **member of a self-regulatory organisation** (VQF in Zug)
 - **comply with KYC** including duty to know the beneficial owner's identity
 - **comply with the diligence requirements**, i.e.
 - duty to keep records,
 - clarification of the economic background and purpose of a transaction if it appears unusual,
 - investigate and report suspicious transactions

FINMA Circular 2016/07

- The requirements for the fulfillment of the KYC obligations under the AMLA have been adjusted to **be on a par** with **in-person identification** in the **FINMA Circular 2016/07 “Video and Online Identification”**
- **Technical means** are used to replace **physical presence**
- The KYC obligations can be fulfilled through:
 - a **video communication**, or
 - by **means of online identification** (e-mail submission of documents) confirmed by a bank transfer from a reputed bank
- Operationally cumbersome in practice

Initial Coin Offerings



Eidgenössische Finanzmarktaufsicht FINMA
Autorité fédérale de surveillance des marchés financiers FINMA
Autorità federale di vigilanza sui mercati finanziari FINMA
Swiss Financial Market Supervisory Authority FINMA

FINMA Guidelines for enquiries regarding the regulatory framework for initial coin offerings (ICOs) of 16 February 2018

<https://www.finma.ch/en/news/2018/02/20180216-mm-ico-wegleitung/>

Structuring of Tokens according to FINMA

Payment Tokens	Utility Tokens	Asset Tokens
Bitcoin, Ether	Digital Access to services / application	Equity / Debt Coins
> Not securities > Not banking activity > Means of payment under the Anti-Money Laundering Act (AMLA)	> Not securities (unless investment function) > Not banking activity > Not means of payment, if: <ul style="list-style-type: none"> • the payment function is only accessory, and • the blockchain is not utilized for financial sector purposes 	> Securities (prospectus requirement) > Not banking activity > Not means of payment
> Full AML, KYC / now, also affiliation with a self-regulatory organization (SRO)!	> Not subject to the AMLA	> Not subject to the AMLA

- FINMA **does not prohibit ICOs**, but lays down requirements
- Tokens are not standard products – each ICO is a special case and requires a separate assessment
 - Time for preparation of an ICO: at least 2 - 4 months

Category of Payment Tokens

«Means of payment» function if the token:

- Can be used to **purchase goods** or **services**; and
- Serves to **transfer money** and **value** on the blockchain.
- Does **not** give claims against the issuer

Examples: virtual currencies such as BTC and ETH

Classification under Swiss law

→ Subject to AMLA

Intake of funds by the issuer itself	Intake of funds by a financial intermediary that is subject to the AMLA in Switzerland
SRO affiliation or directly FINMA subordinated financial intermediary	Neither SRO affiliation nor directly FINMA subordinated financial intermediary necessary
Due diligence obligations: <ul style="list-style-type: none">- Full KYC- Establishing identity of the beneficial owner (BO)- Organisational measures- Record retention and documentation obligation- etc.	Due diligence obligations: <ul style="list-style-type: none">- Full KYC- Establishing identity of the BO- Organisational measures- Record retention and documentation obligation- etc.

Category of Utility Tokens

The token confers:

- The right to use
- The right to access
- The right of participation in

... a platform based on the blockchain and its functionalities/applications
(decentralised application)

Category of Utility Token – Swiss law

- Not a securities if:
 - Sole purpose is to confer a **right to access/use/participation** in a blockchain platform or DApp
 - Can be used in this way and **functions at the time of the ICO** (i.e., if the token has **no** investment function)
- No prospectus requirement

- Not subject to the AMLA if:
 - The main purpose is the use of a digital service **outside of the financial sector**, and
 - Payment function is only an accessory/subordinate service

Accessory Service

- Requirements (on a cumulative basis):
 - The accessory service is integrated into the contractual relationship for the primary service (which must be **unrelated to the financial sector**)
 - **Same Provider**: The contracting party who provides the primary service also provides the accessory service
 - The accessory service is of **subordinate importance** to the primary service (**no additional income** generated by the accessory service)
 - The provision of the main service is **closely connected** to the accessory service (i.e. the payment aspect of the token)

Examples: GAS, Mining Fees ???

Category of Asset Tokens

If token confers the following rights:

- **Rights to participate in profit or revenues** (e.g., digital participation certificate, dividend entitlement)
- **Membership rights** under company law, such as voting rights
- **Derivative rights** (financial contracts whose *value depends* on one or several *underlying assets* and which are not cash transactions, e.g. forward: claim to delivery in the future of currencies / securities / commodities)

Classification Asset Tokens – Swiss law

= Securities under Art. 2(b) of the FMIA

Derivative or uncertificated security

- Standardised and
- Suitable for mass trading (more than 20 investors)

→ Prospectus requirement

→ Obligation to obtain license as a securities dealer if derivatives are self-created and publicly offered on the primary market for the own account or for the account of a third party

≠ Securities under Art. 2(b) of the FMIA

Derivative or uncertificated security

- Limited or closed target audience (FFFs or less than 20 investors)
- Cannot be traded or transferred

→ No prospectus requirement

→ No licensing obligation

Hybrid Token

For Hybrid Tokens **all requirements** of the respective token class **apply jointly**

- **Utility Token ↔ Payment Token**
 - Subject to the AMLA, unless the payment aspect is only accessory/subordinate
- **Asset Token ↔ Payment Token**
 - Subject to the AMLA, unless the payment aspect is only accessory/subordinate
 - Prospectus obligation, unless token cannot be traded / transferred and is only offered to a limited target audience
- **Utility Token ↔ Asset Token**
 - Prospectus requirement, unless token cannot be traded / transferred and is only offered to a limited target audience

Classification in Pre-Sale/Pre-Functional

Pre-Financing	Pre-Sale (Voucher Token)	Pre-Functional	ICO/TGE	Secondary Market
Sale of tokens that are not yet in existence	Sale of tokens that confer an entitlement to real tokens in connection with ICO	Sale of tokens that are not yet able to function / be utilized due to lack of platform	Sale of fully functioning tokens	Professional currency exchange (crypto vs Fiat) or transfer of money (if the service provider manages the private key)
Uncertificated security (or possibly Forward / Derivative?)	Derivative = Security	Uncertificated Security (or possibly Forward / Derivative?)	Classification under FINMA Guidance for ICOs (cf. further above)	= Payment Token
⇒ Prospectus requirement <u>only</u> if issued on standardised basis (to more than 20 investors) and suitable for mass trading. Recommendation: preclude assignment/trading!		⇒ Potentially subject to licensing obligation as dealer in derivatives		
⇒ Not subject to the AMLA because no payment token exists yet at this stage		⇒ Subject to the AMLA if payment token		
				⇒ Subject to the AMLA

Civil Law aspects

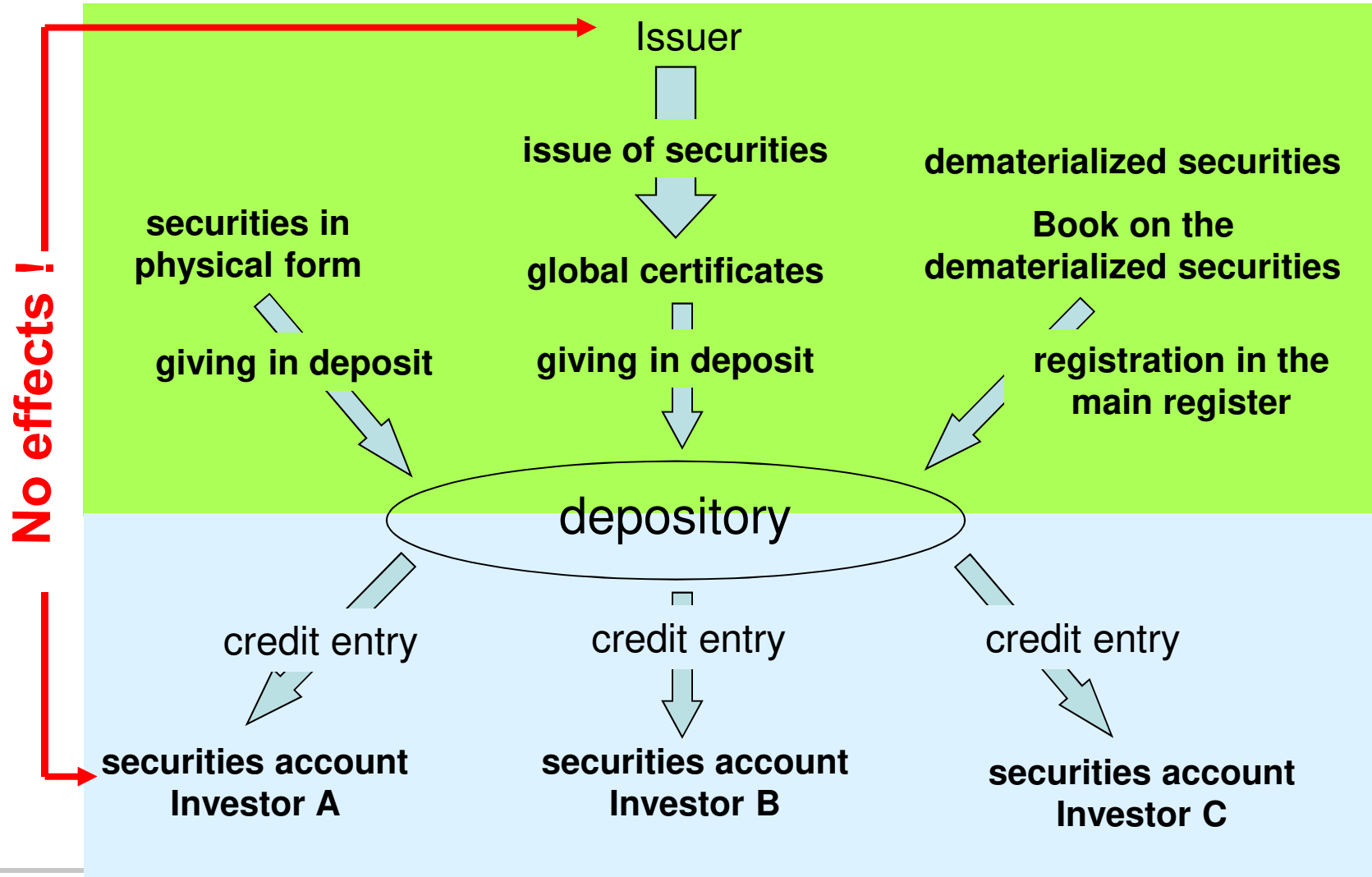
Legal nature of tokens

- The term “**token**” is used for any type of asset **recorded on a distributed ledger**, irrespective of the underlying distributed ledger and content and comprises
 - **native digital coins** (exist only on the DLT such as BTC and ETH) or
 - **non-native digital-linked assets** (asset tokens, payment tokens)
- Tokens are **digital units containing information**, i.e.data.
- Some Swiss lawyers tried to characterise tokens as **goods**, in order to apply the regulations for physical goods. The majority of legal teaching is not of this opinion.
- Tokens can be characterised as uncertificated securities, derivatives, or even as commercial securities depending on the individual token

Problem of legal form of token transfer

- **Claims**: assignment needs signature (Art. 164 et seq. CO)
 - Digital written form possible (qualified electronic signature under Art. 14 para. 2bis CO)
 - «Genussrecht» unter German law does not require a specific form for the transfer of the right
- **Goods/objects (*right in rem*)**: transfer of possession (Art. 922 et seq. SCC)
 - In principle not possible in digital form, only physical
- **Intermediated securities**: (Federal Intermediated Securities Act, FISA),
Necessity of a regulated custodian
 - instruction to a regulated custodian and
 - credit entry in the books of regulated custodian

Federal Intermediated Securities Act



Intermediary held securities

- **Book on dematerialised securities** and **main register of the depository**: **on the distributed ledger**
- **Instruction** as basis of the disposition, can be done **electronically**
- **Perfection of disposition by**
 - **Credit entry** into the securities account of the transferee / of the security taker with a **custodian**
 - Credit entry is a **simple booking in a database**
- **Creation of intermediary held securities** and **all dispositions** can be made on a **distributed ledger**
- The FISA is only applicable if the custodian is a **regulated depository** such as bank, securities trader, fund managers

Forms of transfer of tokens: options

Proposed Solutions

Contract between all participants of the DLT

multi-party transaction

Everyone participating in a DLT accepts the rules of the DLT. No relevance of assignment, given that the distributed consensus matters

Extensive interpretation contrary to the wording of securities law in order that a token is deemed to be a security

Interpretation of data as goods (right in rem)

Legislation

Explicit classification of tokens as securities under the Code of Obligations (see proposal for Art. 973d CO)

REJECTED

Tax

High level overview – each case different

- No specially drafted tax regime for tokens exist
- Payment and Asset Tokens are not subject to VAT given that they are treated as foreign currency respectively as securities (which both are exempt from VAT), only Utility Tokens are subject to VAT.
- Generally, a company is taxable on its profit and net equity. The basis for the calculation of taxable income is the profit and loss statement, to which certain adjustments may be made (e.g., for losses carried forward).
- ICO proceeds count as profit, but are mostly netted against provisions made for future development/services.

Conclusion

-
- **No** special regulations for the digital world so far.
 - **Interpretation of existing laws** by authorities is pragmatic and attractive for digital industry; prohibition of tokens is unlikely. But there is no *carte blanche*.
 - **Understanding of DLT technology** etc. **takes time**, legal assessment is **not consistent** so far.
 - No **legal certainty** as long as Switzerland does not have
 - specific laws
 - court precedents
 - **Report by the Federal Government** announced for the end of 2018 might bring more legal certainty
 - **Cantonal initiatives** to foster the digital world in ZG, ZH, GE



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Many thanks!

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