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Token-Generating Event - Initial Coin Offering in Switzerland: A regulatory overview

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1. Executive summary

During 2017, both the Swiss capital market and Swiss Financial Market Supervisory Authority (FINMA) saw a sharp increase in the number of initial coin offerings (ICOs). In tandem with ICOs, the value of Bitcoins (BTCs) and the value of Ether (ETHs) have skyrocketed in the market for cryptocurrencies, a market based on the blockchain-technology. Depending on the entities' business models and how such ICOs are structured, regulatory requirements must be complied with. In other words, any entity or person intending to market and issue tokens in or from Switzerland may, under certain conditions, be subject to Swiss financial market laws.

FINMA has started investigating ICOs and has published its Guidance 04/2017 regarding their regulatory treatment. On 16 February 2018 FINMA published its new ICO-guidelines, which define the information FINMA requires when dealing with entities or persons intending to market and issue tokens in or from Switzerland. Notably, marketing tokens, distributing tokens, or exchanging tokens for fiat currencies, BTCs or ETHs may very likely qualify as banking activity, securities dealers activity, collective investment schemes activity, or otherwise a regulated activity.

Hence, circumstances must be analysed on a case-by-case basis to adequately assess the regulatory risks of ICOs. To facilitate such a regulatory risk assessment, FINMA has categorised the tokens into three types:

- Payment ICOs or payment tokens (Zahlungs-Tokens/ Jetons de paiement / cryptomonnaies);
- Utility ICOs or utility tokens (Nutzungs-Token / Jetons d'utilité); and
- Asset ICOs or asset tokens (Anlage-Tokens / Jetons d'investissement).

In light of the aforesaid, in section 2, we will provide a summary of the Swiss regulatory regime and the most critical issues that should – at least – be considered prior to an ICO.

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2. Applicability of Swiss financial market laws

2.1 Swiss regulation on ICOs

Currently, Switzerland has no specific regulation on ICOs or virtual currencies. Public ICOs may, however, trigger certain disclosure obligations under the Swiss Code of Obligations ("CO") if the tokens qualify as equity or debt securities. In such a case, a token-issuing entity may be required to draw up a prospectus, pursuant to the CO.

FINMA stated that payment tokens, which are designed to be used as a means of payment and are not analogous in their function to traditional securities, will not be treated as securities. Further, utility tokens will not be treated as securities not only if their sole purpose is to confer digital access rights to an application or service but also if the utility tokens can actually be used in such a way at the point of issue. By contrast, FINMA has announced that it would treat asset tokens as securities if the asset tokens represent uncertified securities and are standardised and suitable for mass standardised trading. FINMA will specifically focus on the tokens' (economic) function and transferability.

For example, a token-issuing entity that intends to operate a blockchain-based service platform, on which advisory services or IT services can be provided, may issue utility tokens without being subject to the prospectus requirements. If such utility tokens, however, also have an investment purpose at the point of issue, FINMA may treat the utility tokens as securities in the same way as asset tokens. Likewise, utility tokens may be treated as securities if the ICO functions as pre-financing or pre-sale.

2.2 Swiss regulation on securities dealing

Swiss regulation may require that the token-issuing entity obtain a securities dealer license if the tokens qualify, respectively are treated by FINMA, as securities and/or the token-issuing entity operates a business model that qualifies as securities dealing activity.

FINMA stated that when the token-issuing entity issues book-entry securities (self-issuance) or uncertified securities, it is not subject to the Swiss Stock Exchange Act ("SESTA"), even if these securities are standardised and suitable for mass standardised trading. A licensing requirement to operate as a securities dealer, however, may apply subject to SESTA if a token-issuing entity (or its business model) is classified as securities dealer. Under the SESTA, five categories of securities dealers exist: (i) securities traders for their own account, (ii) issuing houses, (iii) derivatives houses, (iv) market makers, and (v) client dealers. While securities traders, trading for their own account, issuing houses, and derivatives houses are subject to the Swiss securities trading regime, as long as they are primarily active in the financial sector, market makers and client dealers are deemed to be securities dealers, even if they are not primarily active in the financial sector.

For example, even if the self-issued tokens are not subject to SESTA, the issuer may fall within its scope if either the issuer or its service platform qualifies as issuing house as long as it conducts, in a professional capacity, firm underwritings and offerings of tokens that qualify as securities. Further, issuers intending to operate platforms to create and issue derivative products - such as futures, options, or structured products - to hedge positions or to speculate

on cryptocurrencies' market value may qualify as derivative houses and thus be subject to SESTA's licensing requirements.

2.3 Swiss regulation on banking

Swiss banking regulation may require that the token-issuing entity not only verify whether its activity qualifies as taking deposits from the public but also that it obtain a bank license if the issuer, as part of its business activities, accepts monies on a commercial basis from clients and keeps these funds in its own accounts. The same may apply to token providers who accept BTCs or ETHs from clients and administer holdings of tokens or cryptocurrencies for those clients.

FINMA is of the view that as long as the tokens do not confer a repayment directly to the token holders, the tokens are not considered deposits. In particular, a licensing requirement to operate as a bank may apply if the ICO qualifies as the issuer taking deposits from the investors. The taking of more than 20 deposits from the public on a professional basis is, in general, subject to a banking license. The term "deposit" comprises any undertaking for ones own account to repay any amount of debt, subject only to the exhaustive list of exceptions set forth in article 5(2) and 5(3)(a) to (f) of the Banking Ordinance (the "BO"). Acceptance of deposits is conducted on a professional basis if a company accepts, on an ongoing basis, more than 20 deposits from the public or solicits deposits from the public, even if fewer than 20 deposits are eventually made (article 6 of BO) and if, in any case, that the accepted funds exceed CHF 1 million.

For example, an issuer that intends to raise funds exceeding CHF 1 million to finance the development of a blockchain-based payment service may be required to obtain a bank license if it promises - at the point of issue - to repay the invested capital to the token holders and/or if its payment services provide wallet applications in which cryptocurrences may be stored or secured with the issuer.

2.4 Swiss regulation on asset management

Swiss regulation on asset management may require the token-issuing entity to obtain permission if it intends to operate, manage or distribute collective investment schemes or units thereof. Collective investments schemes are assets that are pooled for collective investments managed for the investors' accounts to satisfy the investors' investment needs in an equal manner.

FINMA stated that the Collective Investment Schemes Act ("CISA") is relevant only if the funds raised through an ICO are managed by third parties. To determine whether an issuer will become subject to the CISA, certain factors may be relevant: the company's purpose; its business model; its risk exposure; the company's income and market presence (image), its means of creating economic value; and the number of investors. From a mere technically legal perspective, operating companies that are engaged in business activities, but also foundations established under the Swiss Civil Code which manage the foundation's assets, do not fall within the scope of the CISA, in particular article 7 et seqq. of CISA.

For example, an operating company or a foundation that intends to issue utility tokens or asset tokens in Switzerland, and whose corporate purpose is to produce or procure the development of goods and/or (blockchain-based) services, may, in principle, not fall under the scope of the CISA because its board of directors or its management usually administers the company's assets on its own behalf and account. On the other hand, an issuer that intends to provide a blockchain-based investment advisory ecosystem to token holders may be subject to the CISA if the issuer or its platform carries out investment decisions that have not been directly influenced by the token holders.

In practice, one must carefully assess, on a case-by-case basis, what the issuer's management de facto does, or intends to do, and how the management implements the underlying business model, irrespective of the token-issuing entity's legal form.

2.5 Swiss regulation on anti-money laundering

Swiss regulation on anti-money laundering may apply to a token-issuing entity if the tokens issued constitute payment instruments or assets managed by the issuer or its business model for the token holders.

FINMA stated that the issuance of payment tokens is subject to the Swiss Anti-Money Laundering Act ("AMLA") if such tokens can be transferred on a blockchain infrastructure. Pursuant to AMLA, financial intermediaries are persons who, on a commercial basis, accept or hold assets belonging to others or who assist in the investment or transfer of such assets. Also, persons who engage in various activities and services (e.g., credit transactions, services related to payment transactions, money changing, and asset management) qualify as financial intermediaries and, as such, either require FINMA authorization or must be members of a recognized self-regulatory organization.

For example, the payment tokens issuer that intends to operate a trading platform (or exchange) or professional crypto-brokers that carry out exchange transactions or secondary trading of tokens in exchange for fiat currencies, ETHs or BTCs may be subject to the AMLA. Also, a utility tokens issuer, with an additional investment purpose, respectively utility tokens whose sole purpose is not to provide access rights to a non-financial application of a blockchain technology, may be subject to the AMLA.

2.6 Swiss regulation on financial market infrastructures

Swiss regulation on financial market infrastructures may require the token-issuing entity to obtain permission if it intends to operate a platform on which tokens may be exchanged, cleared, and settled and/or qualify as securities.

A licensing requirement to operate a financial market infrastructure may be needed if the token-issuing entity qualifies as a stock exchange, a multilateral trading facility, a central counterparty, a central securities depository, a trade repository, or a payment system, pursuant to the Swiss Financial Market Infrastructures and Market Conduct in Securities and Derivatives Trading Act ("FMIA").

For example, if the issuer operates a trading venue that specializes in trading asset tokens, this activity may fall under the FMIA. Whereupon issued blockchain tokens qualify as cryptocurrency, and considered an economically significant payment system that is facilitated by the token-issuing entity, this issuer may be required to obtain a license as payment system from FINMA. A payment system is based on uniform rules and principles for payment transactions, respectively the transfer of money or money instruments between the participants of the system (article 81 of FMIA).

3. Bottom Line

The above analysis shows the risk that an ICO constitutes a regulated activity and/or that the tokens are subject to regulation or prospectus requirements. A sound regulatory analysis is, of course, crucial from a Swiss law perspective. One should, however, also consider foreign (non-Swiss) regulatory requirements.

A case-by-case analysis is required, and strongly recommended to adequately assess the tokens and the token-issuing entity's legal and regulatory risks and to provide guidance regarding whether the issuer will liaise with FINMA so that the intended ICO complies with the Swiss regulatory regime.

This article does not assess, per se, Swiss civil law, Swiss tax law and/or Swiss criminal law aspects of ICOs, all of which may be relevant if the token-issuing entity makes, for example, forward statements - or even false statements - while raising funds.

Please find below an overview concerning the classification of tokens, pursuant to the new FINMA ICO guidelines.

CLASSIFICATION OF TOKENS

Payment Token / Payment ICO	Payment tokens (synonymous with cryptocurrencies) are tokens which are intended to be used, now or in the future, 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 on their issuer. FINMA will not treat payment tokens as securities. However, if payment tokens were to be classified as securities through new case law or legislation, FINMA would accordingly revise its practice.
Utility Token / Utility ICO	Utility tokens are tokens which are intended to provide access digitally to an application or service by means of a blockchain-based infrastructure. FINMA will not treat utility tokens as securities if their sole purpose is to confer digital access rights to an application or service and if the utility token can actually be used in this way at the point of issue. In such a case, FINMA is of the view that 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 utility tokens additionally or only have an investment purpose at the point of issue, FINMA will treat such tokens as securities in the same way as asset tokens.

Asset Token / Asset ICO	Asset tokens represent assets such as a debt or equity claim on the issuer. Asset tokens promise, for example, a share in the future company earnings or future capital flows. In terms of their economic function, therefore, these tokens are analogous to equities, bonds or derivatives. Tokens which enable physical assets to be traded on the blockchain also fall into this category. Hence, FINMA will treat asset tokens as securities within the meaning of Article 2 let. b FMIA if they represent an uncertificated security and the tokens are standardised and suitable for mass standardised trading.
Hybrid Tokens	Hybrid tokens are asset and utility tokens which also classify as payment tokens, or vice versa. Hence, the individual token classifications are not mutually exclusive. FINMA considers hybrid tokens to be both securities and means of payment.

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