Financing of High Growth Businesses in the Digital Age: Traditional VC vs. ICOs, TGEs and the like
A brief overview and legal snapshot - Switzerland

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Introduction

Financing of high growth businesses and companies

Traditional fundraising (equity / VC, debt financings)

New business models, drivers for new fundraising forms

New forms like initial coin offerings (ICOs), token generating events (TGEs)

Use of blockchain technology for ICOs / TGEs

Emerging of technology / blockchain hubs around the world / new ecosystems

Stakeholders and their interests
Case Study – The Fundraising Picture at a Glance
Simplified overview

Traditional VC Fundraising

- F&F Investors
- Business Angels
- VC Funds
- Corp. VC Funds

IA / SHA

Founders

Swiss Company**

New Digital Forms

The «Crowd» Participants

- P2P Network
- Digital services providers
- ICO organizer

ICO / TGE Token sale

Flow of funds
IA = investment agreement
SHA = shareholders’ agreement

** Swiss AG

Digital tokens
Characteristics of New Fundraising Forms

Description of ICO**

«In an ICO, investors transfer funds, usually in form of cryptocurrencies, to the ICO organizer. In return, investors receive a quantity of blockchain-based coins or 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.»

Characteristics of ICO

(1) Sale of coins / tokens to investors / participants
(2) Coins or tokens are blockchain-based («digital assets»)
(3) Decentralized ledgers (no intermediaries / «gate keepers»); distributed ledger technology (DLT)
(4) Peer-to-peer network

Pre-sale of tokens vs. issuance of tokens at ICO

** Guidelines for enquiries regarding the regulatory framework for initial coin offerings (ICOs) of Swiss Financial Market Supervisory Authority (FINMA) published on 16 February 2018 (ICO Guidelines FINMA)
## Comparison: Traditional VC Fundraising vs. new Forms (ICOs, TGEs)

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Traditional VC Fundraising</th>
<th>Initial Coin Offerings (ICO) / Token Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Instruments</strong></td>
<td>Shares (e.g. common, preferred shares), debt (e.g. convertible loans)</td>
<td>Tokens / coins (e.g. utility token, asset token, cryptocurrency)</td>
</tr>
<tr>
<td><strong>Investors / participants</strong></td>
<td>Small investor base; qualified selected investors only; not public</td>
<td>Large base of potential participants (jurisdictions, where ICO is admissible); public or private</td>
</tr>
<tr>
<td><strong>Issuer / organizer</strong></td>
<td>Swiss company (e.g. AG)</td>
<td>Swiss company (e.g. AG)</td>
</tr>
<tr>
<td><strong>Issuance of instruments</strong></td>
<td>Capital increase (e.g. EGM, implementation by board, registration in commercial register); publicity</td>
<td>ICO / TGE; automated / digital processes</td>
</tr>
<tr>
<td><strong>Legal relationships; documentation</strong></td>
<td>Investment agreements (IA, SHA); corporate documents; share register, BO register, kept by company</td>
<td>White paper (or prospectus), token sale terms, distributed ledgers (blockchain-based)</td>
</tr>
<tr>
<td><strong>Rights of investors</strong></td>
<td>Contractual rights (IA, SHA; convertible loan); investor rights based on corporate / securities laws (e.g. ownership, membership and financial rights)</td>
<td>No special investor rights (utility token, cryptocurrencies); tailor made contractual and other rights (e.g. asset / security token)?</td>
</tr>
<tr>
<td><strong>Governance, reporting, investment control</strong></td>
<td>Investor directors or board observers; reserved matters (qualified majorities etc); investor / shareholder rights</td>
<td>Often no direct representation of participants</td>
</tr>
<tr>
<td><strong>Exit, options to monetize</strong></td>
<td>IPO, trade sale, secondary sale, MBO; contractual framework; timeframe of approx. 5-7 years to exit</td>
<td>Sale or exchange of tokens (e.g. on crypto exchanges, public trading)</td>
</tr>
<tr>
<td><strong>Regulatory</strong></td>
<td>Swiss / international securities laws (in relevant jurisdictions)</td>
<td>Financial market / securities regulation (incl. AML); ICO Guidelines FINMA; also in other jurisdictions</td>
</tr>
</tbody>
</table>
ICOs/TGEs raise a variety of legal issues.

At present, no ICO specific statutory regulation in Switzerland.

Typical fields of law relevant for ICOs/TGEs

1. Financial market / securities regulation
2. Corporate law / securities law
3. Contract law / code of obligations
4. Civil law (e.g. property law)
5. Debt enforcement and bankruptcy Act (DEBA)
6. Other fields (international private law, data protection, tax law, etc.)

March 22, 2019: Swiss Federal Council published draft law concerning blockchain and distributed ledger technologies («DLT Draft Law») >> consultation period
### Categories / types of tokens (ICO Guidelines FINMA)

<table>
<thead>
<tr>
<th>Payment tokens</th>
<th>Utility tokens</th>
<th>Asset tokens</th>
<th>Hybrid tokens</th>
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</thead>
</table>
| ▪ Synonymous with cryptocurrencies.  
  Tokens 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 no claims against their issuer.  
  *Examples:* Bitcoin, Ether. | ▪ Tokens intended to provide access digitally to an application or service by means of a blockchain-based infrastructure. | ▪ Represent assets (e.g. as debt or equity claim on the issuer).  
  Asset tokens promise, e.g. a share in future earnings or future capital flows.  
  Economically, analogous to equities, bonds or derivatives.  
  Also tokens, which enable trading of physical assets on blockchain. | ▪ Individual token classifications are not mutually exclusive.  
  Asset and utility tokens can also be classified as payment tokens (i.e. hybrid tokens).  
  Combinations possible. |

> For a fundraising in setting of hypothetical case study
Legal and Practical Challenges of ICOs/TGEs

Regulatory and securities law aspects

Swiss Financial Market Authority (FINMA) applies principle-based approach

**Issue 1: Classification of tokens as securities?**

Securities regulation: purpose of ensuring that market participants can base investment decisions (e.g. equities or bonds) on reliable and defined set of information.

Legal definition of «securities»

Classification of token categories:

- **Payment tokens** (cryptocurrencies): Disputed / various legal views, if payment tokens qualify as securities. FINMA does **not** treat payment tokens as securities (current practice).
- **Utility tokens**: If sole purpose is to confer digital access rights to an application or service and such use is possible at the point of issue/sale, then **not** treated as securities by FINMA.
- **Asset tokens**: FINMA treats asset tokens as **securities**.

Legal implications of treatment as security >> Securities regulation applies

1. Book-entry of self-issued uncertificated securities, **public offering** of securities to third parties, essentially unregulated from a regulatory perspective in Switzerland. But issuance of derivatives is regulated.
2. Underwriting and **offering of tokens** constituting securities of third parties >> licensed activity.
3. Prospectus requirements under Swiss Code of Obligations (in future, based on Financial Services Act (FinSA))

**According to ICO Guidelines FINMA.**
Legal and Practical Challenges of ICOs/TGEs

Regulatory and securities law aspects

<table>
<thead>
<tr>
<th>Issue 2: Classification as deposits?**</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Purpose of Banking Act is to protect the public, in particular, bank creditors and their deposits.</td>
</tr>
<tr>
<td>• Usually, issuance of tokens is not generally associated with claims for repayment on the ICO organizer.</td>
</tr>
<tr>
<td>• If not qualified as deposit, then to this extent no requirement to obtain a banking license.</td>
</tr>
<tr>
<td>• But if tokens have debt capital character (e.g. promise to return capital with a guaranteed return), license question under Banking Act arises.</td>
</tr>
</tbody>
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<thead>
<tr>
<th>Issue 3: Applicability of Collective Investment Schemes Act?**</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Purpose of Collective Investment Schemes Act (CISA) is to protect investors with respect to investment fund products.</td>
</tr>
<tr>
<td>• CISA only relevant if funds accepted in ICO are managed by a third party for the account of the investors.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Issue 4: Applicability of Anti-Money Laundering Act (AMLA)?**</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Objective of Anti-Money Laundering Act (AMLA): protect financial system from money laundering / financing of terrorism.</td>
</tr>
<tr>
<td>• Financial intermediary (FI): anyone who provides payment services or who issues or manages a means of payment is FI, subject to AMLA.</td>
</tr>
<tr>
<td>• Issuing of payment tokens (i.e. a means of payment) is subject to AMLA regulation.</td>
</tr>
<tr>
<td>• For utility tokens, AMLA not applicable as long as main reason for issuing token is to provide access rights to a non-financial application of blockchain technology.</td>
</tr>
<tr>
<td>• Compliance with AMLA: Affiliation to self regulatory organisation or FINMA, DD/KYC requirements (e.g. BO identification)</td>
</tr>
</tbody>
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Regulatory framework is key in structuring and implementing ICOs

Assessment of regulatory / securities law aspects

- Qualification / classification of tokens
- Review / clarification of regulatory / securities law aspects of token sale in all relevant jurisdictions
- In Switzerland:
  - Request / enquiry to FINMA regarding regulatory assessment / requirements for ICO
  - Aim to obtain a «no enforcement action letter»

Practical means / attempts to mitigate regulatory risks in practice

- Decision regarding public or private token sale (i.e. like a «private placement»)
- Description of tokens and classification in white paper, token sale terms and other materials
- Disclaimers and restrictions on offering and distribution (e.g. excluded jurisdictions), inclusion in white paper and token sale terms
- Establish registration requirements for ICO participants (e.g. KYC procedures)
- Contractual means, ICO organizer asks for specific reps / warranties from participants in token sale
- Compliance with prospectus / registration requirements (if applicable)

Lack of standardization

- Each investment requires due diligence
Choice of legal entity and related considerations

(1) Criteria (examples)
   - «Usability» for VC fundraising and/or ICOs/TGEs
   - Flexible capital structure
   - Limitation of liability
   - Exit considerations
   - Expectations of investors and market practice

(2) Swiss legal entity for start-up / investment setting
   - Swiss company (e.g. share corporation (Aktiengesellschaft, AG))

(3) Excursus
   a. Swiss foundation (Stiftung) pursuant to Swiss Civil Code?
   b. Use of Swiss company and foundation?
Legal and Practical Challenges of ICOs/TGEs

Civil law issues

Token sale
- Bilateral contractual relationship between token issuer and participant (e.g. utility token, asset token)
- Often mixed contracts

Attempt of a legal qualification of tokens (civil law)
- Token consists of digital data (no general ownership right in data, but data protection)
- **No** physical / moveable property
- **No** security paper (*Wertpapier*)
- **Payment token** is purely factual «digital asset»

**Utility token / asset token:**
- Usually, token is an obligation arising from contract (if tokens have same terms, then fungible claims)
- Blockchain serves as documentation for sequence of transactions, may fulfill requirements of a register of uncertificated rights, thus, fungible tokens could qualify as uncertificated rights (*Wertrechte*)

Legal requirements for transfer of tokens
- Requirements for assignment of claims (written form) applicable to tokens?
- Transfer of tokens by mutual tripartite transfer agreement (contract sui generis)?

Proposal in DLT Draft Law
- Establish concept of DLT rights (*DLT Wertrechte*) / framework for issuance of DLT rights
Legal and Practical Challenges of ICOs/TGEs

Third party services and related legal issues

Storage of tokens
- Storage of tokens often with third party custodians (e.g. wallet providers)
- Contractual basis between customer (token holder) and wallet provider

Treatment of tokens and data in bankruptcy proceedings of wallet provider
- Segregation of tokens and data in case of bankruptcy of wallet provider
- Do tokens fall into bankruptcy estate?
  - Exclusive factual control over asset
  - Does customer keep and have access rights to tokens (e.g. access key)
  - Access to tokens via multiple keys / multi-signature solutions
- Right of segregation of customer?

Proposal in DLT Draft Law: Segregation of crypto assets in favor of relevant creditors/investors in insolvency of custodian provided that crypto assets can be unambiguously allocated to individual party

Risk of «theft» or misappropriation of tokens
Realization of investment, exit related aspects

- No specific contractual exit arrangements among token holders
- Viability of a joint exit by token holders like in VC financings?
- Rights of token holders in future issuance of new tokens or other financings?
- Trading of tokens on (crypto) exchanges as exit option
- Traditional IPO at international stock exchange for an ICO financed company viable?
Current Trends and Developments
Selected aspects of evolving ICO / blockchain ecosystem

Security Token Offerings (STOs): Sale of tokens with features similar to traditional securities, compliant with regulation and accepted in at least one jurisdiction

Hybrid fundraising approaches: Combination of VC fundraising with ICO/STO (e.g. seed/early-stage with VC, later stage ICO)

Legislative / regulatory developments:
ICO Guidelines FINMA; Report of Swiss Federal Council on legal basis of DLT technology and blockchain in Switzerland; DLT Draft Law in consultation process

Transaction practice: Developments regarding approaches, documentation / process and timing

Legal doctrine: Intensive review / coverage, articles of practitioners in legal journals, etc.; ICO position paper

Industry associations: *Examples:* Crypto Valley Association; Digital Switzerland

Conferences / events dealing with topics around blockchain-based business models / FinTech

Incubators / accelerators for start-ups focusing on blockchain-based technologies and business models

Service providers: Technology partner / blockchain support; wallet providers; audit and advisory firms; etc.

Exchanges / initiatives: SIX Swiss Exchange (plans regarding SIX Digital Exchange)

Other trends

Tokenization of assets (e.g. tokens backed by real-world assets); initiatives for tokenization of equities

Dynamic and emerging ecosystem >> legal developments
Discussion and Q&A

- Legislative / regulatory developments on ICOs in different jurisdictions?
- Are traditional VC fundraising and new forms like ICOs fundamentally different?
- Are ICOs only a temporary phenomenon?
- Will «hybrid approaches» become a fundraising form accepted in practice?
Franz Schubiger is a partner and member of Pestalozzi’s Corporate / M&A and Life Sciences Groups in Zurich. His practice focuses on corporate law, M&A, corporate finance, private equity and venture capital, complex restructurings as well as general contract and commercial law. Franz Schubiger regularly advises in the fields of life sciences, including pharma, consumer healthcare and medtech, as well as consumer goods and retailing industries, e-commerce and online business.

**No legal or tax advice**

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