



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)

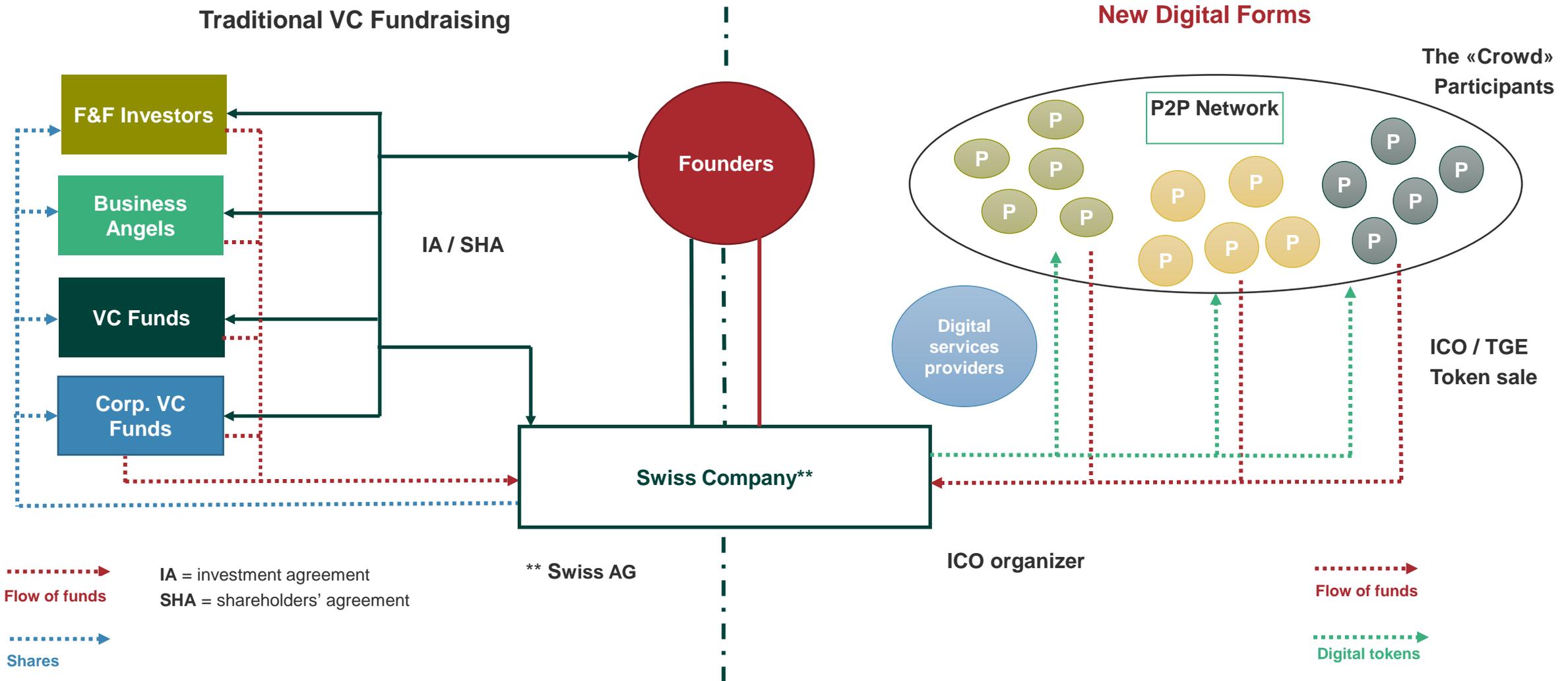
Use of blockchain technology for ICOs / TGEs

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

Stakeholders and their interests

Case Study – The Fundraising Picture at a Glance

Simplified overview



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)

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

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

Categories / types of tokens (ICO Guidelines FINMA)

Payment tokens

- 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.

Utility tokens

- Tokens intended to provide access digitally to an application or service by means of a blockchain-based infrastructure.

Asset tokens

- 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.

Hybrid tokens

- 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

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.

Issue 2: Classification as deposits? **

- Purpose of **Banking Act** is to protect the public, in particular, bank creditors and their deposits.
- Usually, issuance of tokens is not generally associated with claims for repayment on the ICO organizer.
- If not qualified as deposit, then to this extent no requirement to obtain a banking license.
- But if tokens have debt capital character (e.g. promise to return capital with a guaranteed return), license question under Banking Act arises.

Issue 3: Applicability of Collective Investment Schemes Act? **

- Purpose of **Collective Investment Schemes Act (CISA)** is to protect investors with respect to investment fund products.
- CISA only relevant if funds accepted in ICO are managed by a third party for the account of the investors.

Issue 4: Applicability of Anti-Money Laundering Act (AMLA)? **

- Objective of **Anti-Money Laundering Act (AMLA)**: protect financial system from money laundering / financing of terrorism.
- **Financial intermediary (FI)**: anyone who provides payment services or who issues or manages a means of payment is FI, subject to AMLA.
- Issuing of payment tokens (i.e. a means of payment) is subject to AMLA regulation.
- 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.
- Compliance with AMLA: Affiliation to self regulatory organisation or FINMA, DD/KYC requirements (e.g. BO identification)

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?

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

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

Legal trends

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

Other trends

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)

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



Dynamic and emerging ecosystem >> legal developments



- **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?**

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