Stach Rechtsanwälte

Regulation of Initial Coin Offerings

Initial Coin Offerings (ICOs), also called "Token Generating Events" (TGEs) or "Token Sales", enable start-up companies to raise capital in a new way. The number of ICOs is increasing due to the current demand of cryptocurrencies and the misleading assumption that ICOs are unregulated. Before launching an ICO, there are several regulatory and legal requirements which have to be considered on a case-by-case basis.

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What is an ICO?

ICOs are getting increasingly popular amongst start-ups and other companies to raise capital at an early stage. In an ICO, project operators issue crypto-tokens in exchange for fiat currencies (USD, EUR, CHF, etc.) or cryptocurrencies (Bitcoin, Ether, etc.). A token represents a holder's right of benefit or performance towards the issuer. Tokens may also be used for payment to the issuing company for its services and products.

At the moment, there is no generally accepted classification of tokens, neither in Switzerland nor internationally. The Swiss Financial Market Supervisory Authority FINMA sets up its own approach in classifying the tokens based on the underlying economic function.[1] There are payment, utility and asset tokens. The *payment tokens* (= cryptocurrencies) are tokens which are intended to be used as a means of payment for offered goods or services or as a means for the transfer of money or value. Cryptocurrencies are not coupled with any claim against the issuer. *Utility tokens* are tokens which are intended to provide access digitally to an application or service on a blockchain-based infrastructure. *Asset tokens* represent a specific asset or claim, such as a debt or equity claim on the issuer. Asset tokens promise, for instance, a share in future company profits or future capital flows. Therefore, these tokens are, based on their economic function, similar to equities, bonds or derivatives. Tokens which enable physical assets to be traded on the blockchain also fall into this category. There is the possibility that utility and asset tokens are combined with payment tokens, which then classify as *hybrid tokens*.

The underlying technology of the tokens is based on blockchain which is maintained by a network of participants and computers. The blockchain is an electronic distributed and generally fraud-resistant ledger, in which transactions are part of a protocol without a central authority. Utilizing cryptography to record transactions, blockchains process, verify and track the trade of the relevant tokens securely across independent network participants.

It is currently market practice that the project operators publish a whitepaper on its website and certain virtual platforms before launching an ICO. In the whitepaper, the token issuer normally describes its business operations as well as the functionalities of the tokens and the rights associated with. The documentation of the ICO may also comprise a token purchase agreement stipulating the terms and conditions according to which investors can acquire the tokens. After purchasing the tokens, investors usually can trade the tokens on the secondary market on digital currency exchanges.

The accelerated growth of the ICO market has caught the attention of the Swiss regulator FINMA. Despite there is no specific regulatory framework applicable to ICOs, does not mean that ICOs are completely unregulated. FINMA is applying existing financial market regulations to ICOs and just provided regulatory guidance to issuers and project organizers.

To be in compliance with the regulatory framework, project organizers should seek legal advice to comprehensively analyze the legal issues arising when setting up the project.

Legal Classification of Tokens

As the features of tokens generated in the realm of ICOs can widely vary, every project has to be assessed on its individual merits. The regulatory status of tokens largely depends on the rights associated with the token. Up to now, there is no definite opinion under what circumstances tokens would qualify as securities.

[1] FINMA, ICO Guidelines, 16.02.2018, available under: https://www.finma.ch/en/news/2018/02/20180216-mm-ico-wegleitung/

FINMA qualifies the tokens as securities according to the following legal definitions. Securities in the sense of the Financial Market Infrastructure Act are standardized certificated securities or uncertificated securities as well as derivatives and intermediated securities, which are suitable for mass standardized trading, in other words, they 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.

Uncertificated securities are defined as rights which, based on a common legal basis (articles of association/issuance conditions), are issued or established in large numbers and are generically identical. Under the Code of Obligations, the only formal requirement is to keep a book (securities register) in which details of the number and denomination of the uncertificated securities issued and of the creditors are recorded. This can be kept in digital form on a blockchain.

Correspondent to FINMA and consistent with its practice, payment tokens do not qualify as securities given that payment tokens are conceived to act as a means of payment and are not equal in their function to traditional securities.

Utility tokens will not be considered as securities as long as their function is limited to confer digital access rights to an application or service and if the utility token can actually be used in this way at the time of issue. In these cases, the purpose is to grant the access rights and the connection with capital markets (= typical feature of securities) is missing. Nevertheless, FINMA will treat utility tokens as securities if the economic purpose of the token has an investment component.

Asset tokens constitute securities if they represent an uncertificated security or a derivative and the tokens are standardized and suitable for mass trading.

Furthermore, claims in the case of pre-financings and pre-sales of an ICO can classify as securities. Pre-financing is the promise to investors of a future token issuance where the tokens or the underlying blockchain are still in development. Pre-sale is a distribution of tokens entitling investors to acquire different tokens at a later date.

Regulatory Questions of an ICO

The Swiss Financial Market Supervisory Authority has published an initial market guidance in late September 2017 (FINMA Guidance 04/2017). Depending on the structure of an ICO, FINMA determined that i.a. supervisory regulations, collective investment scheme legislation and banking law provisions may be applicable to ICOs. It further confirmed that it follows a principle-based and technology neutral approach.

In the guidelines for enquiries regarding the regulatory framework for ICOs, published on February 16, 2018 by FINMA, prospective and existing market participants are provided with key information on how FINMA will deal with enquiries regarding the supervisory and regulatory framework for ICOs and sets out the principles of the assessment of the individual projects.

If the tokens of an ICO constitute securities due to their economic function, they fall under securities regulation. Under the Stock Exchange Act, book-entry of self-issued uncertificated securities is essentially unregulated, even if the uncertificated securities in question qualify as securities within the meaning of FMIA. The same applies to the public offering of securities to third parties. The creation and issuance of derivative products as defined by FMIA to the public on the primary market is however regulated. Underwriting and offering tokens constituting securities of third parties publicly on the primary market, requires, if conducted in a professional capacity, a securities dealer license.

The issuing and creation of tokens that are analogous to equities or bonds can also result in prospectus requirements under the Swiss Code of Obligations. Particularly if tokens are linked with financial rewards, if they are projected as equity or debt instruments as well as if they are spread to the broad public, it has to be evaluated whether a prospectus has to be prepared. As of yet, FINMA has no responsibility in this area. However, token issuer shall clarify to themselves to meet these requirements. With the come into effect of the new Financial Services Act (expected mid-2019), the prospectus regulations will become part of supervisory law, which will also influence the requirements for prospectuses in the context of ICOs.

There is no requirement to obtain a banking license, as long as the issuing of tokens does not qualify as a deposit. The issuing of tokens is not generally associated with a repayment obligation of the ICO organizer. Hence, such tokens do not fall within the definition of a deposit. If, however, there are liabilities with debt capital character (e.g. promises to return capital with a guaranteed return), the funds raised fall within the definition of deposits and there is a requirement under the Swiss Banking Act to obtain a license unless specific exceptions apply.

The provisions of the Collective Investment Schemes Act are relevant only if the funds raised in the connection with an ICO launch are managed externally by third parties on behalf of the token holders.

The issuing of tokens can fall within the scope of the Anti-Money Laundering Act (AMLA) and thus certain parties involved need to comply with its provisions. Anyone who provides payment services or who issues or manages a means of payment is a

financial intermediary subject to the AMLA. The issuing of payment tokens constitutes the issuing of a means of payment applying the AML regulation as long as the tokens can be transferred technically on a blockchain infrastructure. This may be the case at the time of the issuance or at a later date. In the case of utility tokens, anti-money laundering regulation is not applicable as far as the main purpose of the token issue is to provide access rights to a non-financial application of blockchain technology. Asset tokens do not fall within the scope of the AML regulation, as long as it is not an issuance of payment instruments.

In general, financial intermediaries must become a member of a recognized Swiss self-regulatory organization (SRO) for AML purposes or submit to direct supervision (DUFI) by FINMA. Moreover, they have to identify the contractual counterparty and the beneficial owner of the assets. According to the ICO Guidelines, it is sufficient that the committed funds in a token distribution are collected by a financial intermediary. In that case, the token issuer itself does not need to submit to AML regulation and can overcome the AML hurdles with reasonable expenditure.

All in all, it is strongly recommended to obtain a no-action letter from FINMA before launching the project, in order to ensure compliance with the applicable financial market laws.

Corporate Structure of an ICO

The launch of an ICO also begs the questions of the ideal corporate structure for the project. In the beginning of the ICO hype, a foundation was often chosen as the appropriate legal form. While it does offer some advantages such as the independence of activities from ownership, stability and reliability as well as the governmental supervision, the restrictions to distribute funds may also turn out to be a disadvantage in certain set-ups. Thus, a limited liability company (GmbH) or a corporation (AG) might be more advisable in some cases, depending on the specific features desired in the case under consideration.

The incorporation of a limited-liability company requires a minimum capital of CHF 20'000, whereas for the corporation a minimum capital of CHF 100'000 is necessary. However, not only the capital requirements can be a challenge, but also the identification of the persons behind the project or the association. In a corporation, the shareholders are generally not known to the public, while the quotaholders of a limited liability company are published in the trade register.

Consequently, the suitable corporate structure depends on the favored constellation by the project organizers. The tokens and their various characteristics can also have an influence on the choice of the appropriate legal form. Therefore, it is essential to assess the structuring of the ICO in advance to meet the needs and preferences of the organizers.

Swiss Tax Law Aspects of an ICO

Only a few Swiss tax authorities have issued official guidance on the Swiss tax aspects of cryptocurrencies by now. All of this guidance has been on how cryptocurrencies should be declared in case of the personal income tax. Cryptocurrencies must be declared in the personal income tax return for income and wealth-tax purposes. Moreover, the mining of Bitcoins is regarded as a self-employed activity, and therefore requires the payment of income taxes and also of social security contributions.

Considering ICOs, Swiss tax authorities have yet to provide specific guidance. In principle, the payment of the token holders to the issuing company is regarded as income for the purposes of corporate income tax. Thus, organizers should structure their legal form regarding the corporate income tax aspects to cut down their tax expenses. Depending on the specific characteristics of the tokens, the ICO may be exempt from Swiss VAT; or may be considered as a supply of services subject to Swiss VAT. The distribution of the tokens also poses new issues regarding how the proceeds are dealt with from an accounting point of view, because the issuing company will have to document the returns on its books in some form.

Generally speaking, Swiss tax residents must declare tokens received from an ICO in their personal income tax. In the end, the effective payment of income and wealth taxes depends on how much the tokens are worth. However, the declaration of the actual worth of the tokens can be difficult. In order to avoid any issues, Swiss residents are well-advised to examine in advance how the tokens are regarded for income tax purposes and what their counter value is.

Conclusion

ICOs are an attractive and increasingly important method for start-ups to raise capital. The assumption of some market participants that the launch of an ICO-backed project is unregulated is deceptive. Although there is yet no specific ICO regulation established, project organizers need to comply with the existing legal framework. A diligent assessment of the regulatory framework is necessary to identify and ensure legal compliance with all applicable laws prior to launching an ICO. Regardless of the token functionalities and their categorization, the issuing company needs to provide investors as initial purchaser of tokens with sufficient and well-documented information and reveal such information in a clear and comprehensible format to allow an investor to make a rational investment decision.

Non-compliance with any of the above-mentioned regulations may enforce a range of legal consequences for a project organizer. It is strongly advisable to seek qualified legal advice at all stages of an ICO, beginning with its structuring throughout its completion, including documentation thereof. With such a comprehensive analysis, structuring and documentation, an ICO might become an important source in the financing mix of start-ups and other companies.

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