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Switzerland's Financial Regulator Clears the Path for ICO's

As previously communicated by MME, the Swiss Financial Market Supervisory Authority FINMA has published guidelines ("Guidelines"), dated February 16, 2018, setting out how it intends to apply financial market legislations in handling enquiries regarding the applicable regulatory framework for initial coin offerings ("ICO"). The Guidelines complement FINMA's earlier Guidance 04/2017, published on September 29, 2017.

By issuing the Guidelines, FINMA takes an important step forward to further clarify the applicability of the current legal and regulatory framework related to the organisation of ICOs or Token Generating Events ("TGE") in Switzerland. In doing so, FINMA becomes the first global regulator to provide detailed and principle-based rules on how it intends to treat enquiries from ICO organisers.

Great news upfront: FINMA's Guidelines recognise the innovative potential of blockchain technology by creating a positive and (lightly) regulated environment for this highly dynamic market. By means of this most recent Guideline, FINMA informs ICO organisers what information is required to be submitted along with enquiries, allowing FINMA to respond more effectively, and of greater importance, it clarifies the principles on which FINMA will base its response to such enquiries or ruling requests.

As the Guidelines aim to provide a high-level guidance, they also leave a degree of ambiguity in relation to a number of legal questions. The Guidelines provide a general framework as to how FINMA currently interprets the regulatory landscape, however in our view, many market participants may nevertheless require further clarity on the regulatory treatment of their token or ICO, obtained by means of a non-action letter. The Guidelines further do not detail the reasoning behind FINMA's legal analysis. It therefore remains to be seen to what extent future case law and further regulations will continue to support FINMA's approach as the technology and markets mature. Finally, the Guidelines focus largely on traditional issuer / investor relationships and do not take into account aspects of decentralized funding models, community-based projects and open-source software developments.

1. Classification

1.1 Token Classification

One of the key elements of the Guidelines is its token classification model. FINMA remains more or less within the framework discussed by leading practitioners, including the MME Blockchain Crypto Property Classification model ("BCP"), however in a simplified version by grouping all token forms into three categories.

FINMA distinguishes between Payment Token, Utility Token and Asset Token:

- **Payment Tokens** are synonymous with “cryptocurrencies” and have no further functions or links to other development projects. In certain cases, Tokens may develop the necessary functionality and become accepted as a means of payment over a period of time. According to FINMA, cryptocurrencies give rise to no claims on their issuer.
- **Utility Tokens** are tokens which are intended to provide digital access to an application or service.
- **Asset Tokens** represent assets such as participations in real physical underlyings, companies, earnings streams or an entitlement to dividends or interest payments. In terms of their economic function, the tokens are analogous to equities, bonds or derivatives. Tokens that enable physical assets to be traded on the blockchain also fall into this category.

FINMA further points out that the individual token classifications are not mutually exclusive. Thus, Asset and Utility Tokens can also be classified as Payment tokens (referred to as Hybrid Tokens).

Comment MME: *FINMA has broadly defined the term Payment Token, which includes tokens with an application-based peer-to-peer settlement function. According to FINMA, this category also includes Ether (ETH), although its intended function is limited to providing access to the Ethereum Blockchain and to use its implemented functionalities (such as smart contracts). This shows that the classification of a Token that is generated for a specific purpose (e.g. access to protocol) can change over time depending on its actual use (e.g. participation in ICOs).*

According to FINMA’s Guidelines, all tokens with no legal counterparty (i.e. “give rise to no claims on their issuer”) and a payment function may qualify as Payment Token. Utility Tokens, on the other hand, are intended to provide digital access rights to an application or service, however it remains unclear who the legal counterparty of such access rights would be in the context of decentralized, open-sourced and community-based projects.

1.2 Token Development Stages

FINMA recognises that not every token will be functional from their issuance and that certain contracts only convey a right to receive future tokens. FINMA distinguishes the following “development stages”:

- **Pre-Financing:** Contributors are offered only the prospect that they will receive tokens at some point in the future, as the tokens or the underlying blockchain has yet to be developed. At this stage, a contributor has no transferable asset on a distributed ledger. As part of the MME BCP Classification, this is referred to as Pre-BCP Development stage and constitutes the recording of contribution by a single agreement, a ledger entry or a passphrase.

- **Pre-Sale Token (Voucher Token):** In this case, investors receive tokens which entitle them to acquire other different tokens at a later date (BCP Voucher).
- **Pre-Functional Token:** Even though not explicitly mentioned by FINMA, the Guidelines imply that some tokens are transferable via a protocol, but cannot yet offer their intended utility function. Instead of a conversion, they require a completion of the underlying protocol, infrastructure and/or application to become fully functional. In the MME BCP Classification, these tokens are referred to as Pre-Operational BCP.
- **Functional Token**: The token is functional with regards to its main function (Operational BCP).

2. FINMA's Regulatory Guidelines

2.1 Guiding Principles

The Guidelines have been drafted based on the following guiding principles:

- **Case by Case Analysis:** According to FINMA, financial market law and regulations are not applicable to all ICOs. Circumstances must be considered on a case-by-case basis and will depend on the manner in which the ICO is designed.
- **Economic Function is Decisive**: In assessing ICOs, FINMA will focus on the economic function and purpose of the tokens (i.e. the blockchain-based units). The key factors are the underlying purpose and the ultimate use of the token (as highlighted in the above ETH case), as well as whether they are already tradeable or transferable.
- **Regulatory Focus:** FINMA's analysis indicates that anti-money laundering and securities regulations are the most relevant for ICOs. Projects which would fall under the Banking Act (governing deposit-taking) or the Collective Investment Schemes Act (governing investment fund products) are not typical.

Comment MME: *Based on our analysis of the Guidelines, we understand that the focus of FINMA was to impose appropriate controls on the secondary market, as evidenced by the consideration put towards tradability.*

2.2 Issuing of Payment Token

Securities Regulations: According to FINMA, Payment Tokens do not qualify as Securities under Swiss law.

Anti-Money Laundering ("AML") Regulations: The generation of Payment Tokens constitutes the issuing of a means of payment within the meaning of the Swiss AML regulations, as long as the tokens can be transferred technically on a blockchain infrastructure.

The Anti-Money Laundering Act ("AMLA") contains requirements for financial intermediaries and aims to protect the financial system against the risks of money laundering and the financing of terrorism via various means of payment. Consequently, anyone issuing a Payment Token qualifies as a financial intermediary, as is therefore subject to Swiss AML regulations. As such, the issuer has a range of due diligence requirements, including the requirement to establish the identity of the beneficial owner and the obligation to either affiliate with a Self-Regulatory Organisation ("SRO") or to be subject to FINMA's direct supervision. Finally, FINMA confirms its current practice that the secondary market trading of such Payment Tokens would also be subject to the AMLA. This does not only include the exchange of Payment Tokens for legal tender (fiat money) but also the exchange of Payment Tokens for other Payment Tokens (i.e. crypto currency to crypto currency). In any case, FINMA does not qualify the issuance of a Payment Token as the implementation of a payment system according to Article 81 of the Swiss Financial Market Infrastructure Act (FMIA). Thus, there is no respective license needed.

MME Comment: *By applying the discussed broad definition of Payment Tokens, FINMA adopts a very broad understanding of the term "means of payment" within the meaning of the AMLA. At the same time, the Guidelines announce an unexpected easement on the application of the AML regulations: according to FINMA, the AML requirements can also be fulfilled by having the funds accepted (and possibly also the tokens allocated) via a financial intermediary which is already subject to the AMLA in Switzerland and exercises the corresponding due diligence requirements on behalf of the ICO organiser. In these circumstances, an ICO organiser does not have to be affiliated to an SRO or to be licensed directly by FINMA. Thus, in order to ease the regulatory burden for market participants, FINMA adapted a solution that is not only very pragmatic, but also constitutes a liberal interpretation of the AML regulations. Details on how the due diligence requirements are to be complied with will need to be established. As the ICO is a one-time event, we believe that with the end of the issuing process, the ICO organiser will not face further due diligence obligations, to the extent that he is no longer involved in the operation of the protocol or application, due to its decentralised nature.*

2.3 Issuing of Utility Token

AML Regulations: According to the Guidelines, a Utility Token that functions only as a means of access does not trigger the application of AML regulations. Also, the secondary market trading of such Utility Tokens would not be regulated under the AMLA.

In practice however, most BCP Utility Tokens also offer a peer-to-peer settlement function or can be used as a means of payment by users (regardless of the respective intention of the issuer). Such tokens are likely to qualify as Hybrid Tokens. Even though not stated directly in the Guidelines, one would expect FINMA not to treat Hybrid Tokens as Payment Tokens if the underlying payment functionality is of an ancillary nature only. Otherwise, practically every Hybrid Token would be subject to AML regulations at initial issuance. Where such secondary or ancillary payment function of a Utility Token relates to financial applications however, FINMA has clearly stated that the AMLA will apply to the token's issuance. It remains to be seen what criteria FINMA will develop in evaluating whether settlement functions are ancillary to the utility, thereby obligating issuers to comply with the AMLA.

Securities Regulations: FINMA clarifies in the Guidelines that Utility Tokens shall not be treated 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". FINMA therefore leaves room to qualify Utility Tokens as securities under Swiss law in certain cases:

- FINMA announced that it will treat a Utility Token as a security where the Utility Token serves only as an investment, or fulfils both a utility and investment purpose. In our opinion, FINMA thereby again emphasizes that it will focus on the economic function and purpose of the tokens. If the function of the token objectively aims at achieving the same economic result as an Asset Token (i.e. right of participation in future earnings, future cash flow etc.), FINMA will treat the token as an Asset Token. However, even though it is not clearly stated in the Guidelines, the mere expectation of the user that the token will gain in value should not have an effect on the token qualification, as such interpretation would, in our view, not be in line with Swiss securities laws.
- The Guidelines further remain ambiguous with regards to the question of a pre-functional Utility Token which would also be treated as a security. Given the fact that the very concept of an ICO is about the collection of funds to develop software technology, practically all application tokens are being issued in a pre-functional mode. Their qualification as securities, in our view, will only be possible based on a case-by-case assessment (see below).

MME Comment: *The regulatory classification of Utility Tokens therefore will need further definition and clarification with regards to the potential application of Swiss AML and securities regulations. Market participants will be required to obtain a ruling from FINMA prior to proceeding with the ICO or to comply with both AML and securities regulations when issuing the Utility Token. In our opinion, securities regulations may only apply to very limited token designs, which represent a claim in capital, equity or a corporate membership right.*

2.4 Issuing of Asset Token

Securities Regulations: Asset Tokens, by definition, represent a claim against a counterparty, i.e. participations in companies, earning streams or an entitlement to dividends or interest payments. In terms of their economic function, the tokens are indeed analogous to equities, bonds or derivatives. FINMA generally qualifies Asset Tokens as uncertificated securities (Wertrechte) to the extent that they are standardised, suitable for mass trading and publicly offered, criteria which apply to most tokens as part of an ICO.

The issuance of uncertificated securities that represent a debt or equity right is subject to a prospectus obligation, an obligation which can easily be met and does not currently require any regulatory approval.

MME Comment: *Most Asset Tokens will not represent a debt or equity right, but a participation in future earnings, cash-flow or other forms of revenue share. Under the existing regulations, the issuance of such uncertificated securities does not, in our view, trigger any licensing or prospectus requirements or other regulatory constraints. However, the secondary market trading of such securities is subject to a license requirement.*

2.5 Legal Implication of Development Stages

The Guidelines also address the legal implications on the different stages of the funding process:

- **Pre-Financing**: Pre-financing a project principally does not provide the contributor with a claim to receive a token that constitutes a transferable or tradeable asset. According to our understanding of the Guidelines, pre-financing in any non-tradeable form (often seen in the form of early contribution agreements, SAFT - Simple Agreements for Future Tokens, or donation-based crowdfunding) does not raise regulatory concerns by FINMA, neither regarding securities or AML regulations.
- **Pre-Sale Token (Voucher Token):** In this case, investors receive liquid tokens that entitle them to acquire other different tokens at a later date. FINMA qualifies such tradable rights for a future token as an uncertificated security, independent of the future functionality of the token to be issued at a later stage.

  MME Comment: *However, in our view, the final token function would need to be taken into consideration when assessing the regulatory qualification of a Pre-Sale Token.*
- **Pre-Functional Token:** FINMA implies, but does not explicitly state, that Pre-Functional Tokens may be treated as uncertificated securities. The practical implications of such a qualification cannot be underestimated.

  MME Comment: *It is difficult to imagine that it was indeed the intention of FINMA to indirectly qualify all Pre-Functional Tokens as securities. Moreover, uncertificated securities may only represent a claim in capital, equity or a corporate membership right. The prospect of receiving or having access to a functional software application is - in our view - not one of these legal rights. We believe that FINMA will establish the criteria under which a Pre-Functional Token can qualify as an uncertificated security on a case-by-case basis, thereby taking into consideration both the development stage of the project, as well as the final functionality of the token in question.*

3. Taxation

Taxation issues have – rightfully – not been addressed by FINMA as part of the by Guidelines. Nevertheless, while regulatory discussions are of highest relevance, taxation question are vital to the same extent. Luckily, the Swiss tax system is generally very beneficial for corporate structures, offering effective income tax rates between 8 – 24%, depending on business activity and location.

Blockchain-based crowdfunding, however, is still in its infancy in Switzerland. Although the individual forms of funding are essentially nothing new under civil law, many uncertainties remain under tax law. The main problem affecting not only those involved in the transactions (e.g. backers, recipients of the funds and brokerage platforms), but also the tax authorities, is a lack of relevant experience. Yet taxation represents a significant transaction cost, which must be reflected in business plans and financial planning. It is therefore vital that anyone entering into a crowdfunding transaction clarify the tax situation at the onset of the project.

The difficulty of crowdfunding is that the tax implications differ widely, depending on the form it takes. While for equity and debt-based structures, transactional taxes like stamp duties and withholding taxes are of major relevance, income tax exemption or gift tax must be considered for donation-based models. In addition, reward-based crowdfunding could be subject to VAT. Moreover, countless combinations (including profit participating loans, reclassification of debt as equity, mixed donations, and so forth) and cross-border issues are possible, which further complicates matters.

Therefore, no general comments about specific tax consequences of ICOs can be made. Only a case by case analysis may identify the exact circumstances and particularities of a specific project. Furthermore, this would enable the tax implications to be discussed with the relevant authorities ahead of time, in order to avoid any unpleasant surprises down the road that could jeopardise the very existence of the project.

However, the Swiss tax authorities are generally very progressive with regard to blockchain-based technologies such as cryptocurrencies, tokens and ICOs. Responding to the formal request of some Swiss bitcoin organizations in 2015, the Swiss Federal Tax Administration (SFTA) confirmed that it would treat Bitcoin the same way as the Swiss Franc or other FIAT currencies, i.e. trading in Bitcoins is neither a delivery, nor a service for the purpose of Swiss VAT, but rather a means of payment and as a result, not subject to VAT. Recently, they have even mentioned orally that all BCP Class 1 Tokens (i.e. tokens with no claim towards a legal counterparty) would receive the same VAT treatment.

In addition, the SFTA has published an "official" exchange rate for Bitcoin since December 31, 2015. This exchange rate is a recommendation to the cantonal tax authorities for net wealth tax purposes. In 2017, the SFTA added nine additional cryptocurrencies - Ethereum, Ripple, Bitcoin Cash, Litecoin, Cardano, NEM, Stellar, IOTA and TRON - to their exchange list, which is unprecedented in the rest of Europe or the US.

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MME

Your Team

Dr. Andreas Glarner
Legal Partner

+41 44 254 99 66
andreas.glarner@mme.ch

Dr. Luka Müller
Legal Partner

+41 41 726 99 66
luka.mueller@mme.ch

Thomas Linder
Tax Partner

+41 44 254 99 13
Thomas.linder@mme.ch

Prof. Dr. Andreas Furrer
Legal Partner

+41 41 254 99 66
andreas.furrer@mme.ch

Christine Gschwend
Senior Compliance Advisor

+41 44 254 99 66
chris.gschwend@mme.ch

Dominik Hofmann
Legal Associate

+41 41 726 99 66
dominik.hofmann@mme.ch

Michael Kunz
Legal Associate

+41 44 254 99 66
Michael.kunz@mme.ch

Stephan Meyer
Junior Associate

+41 44 254 99 66
Stephan.meyer@mme.ch

MME is an integrated, cutting-edge law, tax and compliance firm We represent companies and individuals in all business related matters. Our partners assist clients with personal and thorough attention – in Switzerland and internationally.

Office Zurich
Zollstrasse 62 | P.O. Box 1412 | CH-8031 Zurich
T +41 44 254 99 66 | F +41 44 254 99 60

Office Zug
Gubelstrasse 11 | P.O. Box 7613 | CH-6302 Zug
T +41 41 726 99 66 | F +41 41 726 99 60

www.mme.ch
office@mme.ch