

Security Token Offering “done right”

1. Starting Position

1.1 Overview

The ICO boom has cooled down and the number of projects has decreased significantly since Q2 of 2018. The funds raised during the ICOs have also reduced (source: <https://www.icodata.io/stats/2018>). It is noticeable that there are fewer utility token projects and it seems that the wind has actually turned. But does this mean the end of blockchain and DLT euphoria? The answer is quite clear: No. However, there are clear signs that a new development is on the doorstep; The era of asset tokens (or security tokens) has begun.

1.2 Asset Token

In its ICO guidance dated February 16, 2018, FINMA defines asset tokens as tokens representing assets and/or relative rights. It explicitly mentions that asset tokens are analogous to and can economically represent shares, bonds or derivatives. But what is the legal nature of asset tokens? Since asset tokens can qualify as securities, it is obvious we need to consider the legal attributes relevant to securities. The focus here is on the Stock Exchange Act, the Banking Act, the Financial Market Infrastructure Act, the Act on Collective Investment Schemes and the Anti-Money Laundering Act. Once in force, the Financial Services Act and the Financial Institutions Act must also be considered. The (long) list of relevant financial market laws shows that we have "something different" here, more so than with Payment and Utility Token projects. In fact, the legal and regulatory requirements are significantly higher for asset token projects and the error tolerance is low. If an asset token is actually qualified as a security, it may be necessary to obtain regulatory approval before starting a business. If the regulatory requirements are not observed, FINMA may impose sanctions (e.g. initiate enforcement proceedings).

1.3 Terminology

The term ICO (Initial Coin Offering) is well known and the process is used to raise capital in connection with payment and utility tokens. Further, the term TGE, which stands for "Token Generating Event", has also established itself. The term STO or "Security Token Offering" currently predominates for raising capital by issuing asset tokens. Unfortunately, the perception of the term "token" is biased, since tokens and coins were not perceived positively in the past. Because asset tokens and the collection of funds associated with their public offering takes place in a highly regulated area, a new term is required. Such a term shall clearly distinguish itself from payment and utility tokens, respectively token and blockchain / DLT. Therefore, regarding the offering of security token (respectively the synonym “asset token”) the term "Digital Public Offering" is suggested. By this, the proximity to the term IPO (Initial Public Offering) is accentuated.

2. Business Model of B. AG

The following statements are based on the business model of B. AG and are made with the explicit consent of B. AG. However, the below makes no claim to the completeness or correctness of the information provided on the B. AG project.

B. AG enables so-called "crowd sales" of real estate based on the Ethereum Protocol. In order to participate in this crowd sale, B. AG has created a real estate platform on which investors can invest in real estate with small contributions. Property owners can also use the platform and offer their properties via crowd sale. The platform will be monetized by charging an initial fee of 1%. The fee is due when a property is either bought or sold via the platform. In order to participate in such a crowd sale as an investor, the investor must acquire tokens of the properties offered via the platform. To enable token holders to trade their tokens, B. AG has provided a bulletin board. This bulletin board is similar in its basic function to a bulletin board on which offers and requests are published. Overall, B. AG has succeeded in lowering the entry hurdles in the attractive "real estate" asset class.

3. Legal Objectives

During the structuring of B. AG, investor protection was paramount. It was necessary to find a structure that was legal and watertight. In addition, the intention was to link the underlying, i.e. the platform's participation certificates offered for sale (see section 4.2) and the properties offered for sale in the future (see section 5) as closely as possible to the respective tokens. It seems obvious that the STOs (of the platform and the properties) should comply with the applicable regulations. Therefore, the challenge was to ensure that the tokens could be transferred as freely and easily as possible, i.e. without written requirements.

4. Legal Structuring

4.1 Overview

B. AG has chosen a bi-jurisdictional approach and implemented parts of the business model in Switzerland and Liechtenstein. B. AG is domiciled in Switzerland and operates the aforementioned platform. The properties are held by a fund in Liechtenstein.

4.2 Tokenization of PS Capital and STO of the Platform

B. AG has a nominal capital of CHF 400,000, divided into share capital of CHF 320,000 and bearer participation capital of CHF 80,000. In other words, the participation capital amounts to 20% of the nominal capital. The participation capital is the subject of the STO (PS Token of B. AG).

It was decided that a global certificate would be created and all bearer participation certificates would be securitised accordingly. The respective participants are entitled to an arithmetical quota of this global certificate held in "modified" co-ownership. The participants may then transfer this share without adhering to any formal requirements by means of an ownership transfer order (*Besitzanweisung*). This will be conducted by means of transferring the token.

Pursuant to Art. 973b para. 1 CO, global certificates may be issued if authorisation has been granted in the conditions of issue, in the Articles of Association or by the consent of the depositors. This authorisation was reflected accordingly in the Articles of Association of B. AG. Since each co-owner is only entitled to a purely arithmetical quota, the individual participation certificates do not have to be assigned to a specific co-owner. Therefore, it causes no harm that the tokens based on the ERC-20 standard cannot be individualized. The "token balance" of a token holder in relation to the total number of tokens corresponds to the proportional entitlement to the global certificate. The terms and conditions ("Terms") and the prospectus defines the transfer of tokens from one holder to another as an ownership transfer order within the meaning of Art. 924 Para. 1 ZGB. By accepting the Terms, the parties agree that the indirect ownership by transfer of the tokens can only take place to "whitelisted addresses". Whitelisting is carried out by B. AG and consists of an identity check and agreement to the Terms and the prospectus.

An application of Art. 924 para. 1 ZGB, means that with the transfer of tokens, the indirect ownership of the corresponding co-ownership quota (or fractions thereof), passes to the acquirer (Art. 714 para. 1 ZGB). By agreeing to the Terms, each party agrees to be bound by them and consequently:

- (i) that any future transfer of Tokens to him or her will result in the transfer of ownership and ownership of the relevant co-ownership interest; and
- (ii) by transferring the tokens, he or she transfers indirect ownership and ownership of the respective co-ownership interest to the recipient of the token.

In order to avoid "double spending" the terms stipulate that the ownership of the respective co-ownership shares can only be transferred through the transfer of token(s).

Pursuant to Art. 697i para. 1 CO, every purchaser of an unlisted bearer share (and thus also of a corresponding bearer participation certificate) must notify the company:

- (i) that it has acquired the shares;
- (ii) his or her first and last name or company name; and
- (iii) his or her address.

This reporting obligation (based on requirements on the Financial Action Task Force) can easily be fulfilled by "whitelisting" the permitted wallets.

The approach outlined above of creating a global deed and a transfer of ownership promises a very high level of legal certainty. In comparison to other structuring approaches, this solution is already "legally proven", since it essentially corresponds to the widespread model that was applied before the Book-Entry Securities Act came into force. It is therefore not surprising that the Federal Council's report published on 7 December 2018 regarded this solution as legally secure.

4.3 Alternative Structuring Options

4.3.1 Value Rights and Contract Transfers

A possible alternative approach is to issue uncertificated securities in accordance with Art. 973c of the Swiss Code of Obligations. These uncertificated securities can be transferred by means of contract transfers as so-called tripartite legal transactions. The transfer requires three declarations of intent between the issuer, the original acquirer and the subsequent acquirer, each of which must be received. These declarations of intent are intended to ensure that the original contract is transferred between the issuer and the original purchaser and that the transfer between the issuer and the subsequent purchaser is valid. The advantage of this solution, as in the case of the global certificate described above, is that no written requirements are necessary for the transfer. However, the Federal Council's report of 7 December 2018, explicitly states that it is controversial whether consent can be given in advance for the transfer of a contract and mentions a ruling by the High Court of the Canton of Zurich which explicitly denies this possibility. Finally, it is questionable whether corporate relationships can be transferred with the transfer of the contract. Overall, the contract transfer in the form usually discussed for the structuring of shares (tokens) in the blockchain / DLT environment would still have to be significantly refined.

4.3.2 Electronic Signature (ZertES)

In order to satisfy the requirement of the written form as set out in Art. 165 para. 1 CO, it is possible that an electronic signature (ZertES) can be used. The associated procedure is cumbersome and so far only Swisscom has developed a customer-friendly implementation. However, this approach requires the purchase of a Swiss SIM card from Swisscom. Therefore, this approach is not recommended in the international context.

4.3.3 Book effects

Finally, it is possible to create intermediated securities for easier transfer and to structure the tokens as instructions within the meaning of Art. 15 of the Intermediated Securities Act. The creation of intermediated securities requires that a credit be made to a securities account managed by a depository. Whether a blockchain is sufficient as a securities account is currently the subject of controversy. B. AG is not and neither does it operate as a custodian, therefore a book-entry securities solution can be disregarded.

4.4 Distribution

As tokens were offered under the STO which qualify as securities, an issue prospectus was prepared in accordance with Art. 652a of the Swiss Code of Obligations. The preparation of the issue prospectus contained various complexities, in particular because it had to be shown how the tokens offered within the framework of the STO are linked to the underlying, i.e. the bearer participation certificates or the global certificate securitising them.

5. Fund Structure and future STOs of the Properties

An umbrella fund with sub funds shall be set up in Liechtenstein. These sub funds hold the properties that are sold on the platform via crowd sale. The sub fund is registered as the owner of the properties. Currently, there are ongoing discussions with land registries and it is being evaluated whether Smart Contracts (with the respective token holders) can be entered directly in the land register. An STO is performed for each sub fund equipped with a property (see the overview below).

In Liechtenstein, the transfer of tokens, which are structured as uncertificated securities, is simpler than in Switzerland, as the requirement of the written form of the assignment pursuant to Art. 165 para. 1 CO does not have to be observed.

6. Technology meets Legal Requirements

Both the real estate tokens (shown above as "T1", "T2" and "T3") and the PS tokens of B. AG are assets or security tokens. For various legal reasons, it must be clear who the owners are and how many shares they own in the property or in the company, at any given time. Technically, B. AG has solved this ingeniously on the Ethereum Blockchain.

The solution consists of the implementation of several Smart Contracts. As mentioned above, B. AG has tokenised 20% of its nominal capital. On the Ethereum Blockchain, this amount can be found in the form of tokens. The tokens can be viewed on etherscan.io. A total of 1 million tokens were issued and synchronized with 1 million bearer participation certificates (documented in the global certificate).

Another Smart Contract, "Whitelist Smart Contract", registers the wallets of the identified investors. In order for a whitelisting of the wallet to take place, the onboarding process of B. AG must first be successfully completed. This was developed in cooperation with a bank and BlockID played an important role in the process. Each investor must go through this process and without it, tokens cannot be purchased during the STO or on the secondary market. Why not? Quite simply, every interaction with the token (e.g. purchase or sale), requires the Smart Contracts from B. AG to carry out checks to see whether both wallets (sender and recipient) are on the whitelist, if this is not the case, then the transaction fails.

Each Smart Contract allows the holders of the tokens to be viewed. The corresponding register is updated with every transaction and is therefore constantly up to date. Thus, the (pseudonymous) register of B. AG participation certificate holders exists on the blockchain within the Smart Contract. Since all wallets (i.e. investors) at B. AG are known, the current token holders or holders of the participation certificates can be identified at any given time by supplementing the wallets with the data from the Smart Contract.

The mechanism works in exactly the same way in connection with the properties. As mentioned above, B. AG has one unique token per property (T1, T2, T3 etc). You can see on the Ethereum Blockchain (pseudonymously) which wallet holds, what percentage of the respective property. B. AG can also match the wallets (or the respective investors) with the data from the Smart Contract and thus knows at any given time, the number of shares an investor owns in a property.

7. Appreciation

The legal structure outlined above meets all the objectives. It is secure, tried and tested and enables the informal transfer of tokens, until such time as appropriate legal adjustments are made to facilitate the transfer of tokens, the solution with the global certificate and the ownership transfer order. With the ingenious use of Smart Contracts, B. AG has succeeded in creating a functioning product for the tokenisation of real estate and at the same time in designing the technology that also enables a "share register on the blockchain".

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