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Newsletter

Special Edition

Initial Coin Offerings - from Cryptocurrencies to Entrepreneurial Financing:

The Swiss financial regulator FINMA has published new guidelines on the application of the financial market legislation on initial coin offerings (ICO). Inter alia, FINMA puts forward its own classification of tokens in three different categories, but fails in defining clear demarcation lines that would enhance legal certainty for ICO organisers. Yet, combined with a favourable tax regime on certain ICO structures, the guidelines may further boost ICOs as means of financing for start-ups and corporates in general. From a corporate finance perspective, we very much welcome the said guidelines and the approach of FINMA on ICOs executed in Switzerland.

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Initial Coin Offerings - from Cryptocurrencies to Entrepreneurial Financing

In 2017, fund raising via initial coin offerings (ICOs) has outpaced venture capital financing in terms of figures. We believe that ICOs will not entirely replace "smart money", where a venture capitalist dedicates know-how and strategic advice to the company in addition to the financial support. However, ICOs will likely continue to serve as an important source of financing to start-ups and corporates in general. The latest FINMA guidelines on the application of financial market legislation will help ICO organisers to navigate through regulation and may further support the role of ICO in entrepreneurial financing.

FINMA ICO Guidelines

On 16 February 2018, the Swiss Financial Market Supervisory Authority FINMA has published new guidelines (the **Guidelines**) for enquiries regarding the regulatory framework for initial coin offerings (**ICOs**). The Guidelines follow a first communication by FINMA on the same topic published on 29 September 2017, which did not shed much clarity on the intended treatment of ICOs (see our Newsletter Special Edition of October 2017). First of all, the purpose of the Guidelines is to inform market participants on the information required for FINMA to issue non-action letters and on the ruling process in general. Second and more interestingly, FINMA puts forward its own classification of tokens in three different categories, but fails in defining clear demarcation lines that would enhance legal certainty for ICO organisers. In fact, the regulator states that projected ICOs will be qualified by a holistic approach, taking all individual elements and characteristics into consideration. Hence, there is no uniform regulatory approach on ICOs, but the need to seek guidance from FINMA in each individual case remains.

FINMA further emphasizes that it will base its assessment on the underlying economic purpose of an ICO. This is a clear signal to the market that artificial structures and disclaimers, that do not reflect the actual economic expectations of investors, are essentially worthless.

This boils down to a de facto pre-approval requirement of any ICO by FINMA. This being said, the situation for market participants after the publication of the Guideline does not seem to have significantly improved. Carrying out an ICO without entering into a dialogue with FINMA remains a risky affair, unless the ICO organiser structures the token to strictly fall within one of the categories of tokens set out in the Guidelines and complies with the requirements pertaining to the public offering of securities and/or Swiss anti-money laundering regulation.

Token categories

FINMA identifies three token categories in its Guidelines:

a. *Payment tokens (cryptocurrencies)*: "Payment tokens are tokens which are 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 rise to no claims on their issuer."

b. *Utility tokens*: "Utility tokens are tokens which are intended to provide access digitally to an application or service by means of a blockchain-based infrastructure."

c. *Asset tokens*: "Asset tokens represent assets such as a debt or equity claim on the issuer. Asset tokens promise, for example, a share in future company earnings or future capital flows. In terms of their economic function, therefore, these tokens are analogous to equities, bonds or derivatives. Tokens which enable physical assets to be traded on the blockchain also fall into this category."

These categories reiterate more or less the nomenclature that has been developed by legal scholars and practitioners including our firm so far. Unfortunately, the distinguishing criteria between the three categories remain somewhat vague.

The definition of a payment token is very broad, it embraces all use cases where goods and services can be acquired by means of a token and where the debtor is not the issuer. Utility tokens on the other hand are intended to provide access to an application or service. In fact, utility tokens may also be a means of payment in consideration for a service, i.e. the functionality of the application. Hence, according to the definition devised by FINMA, each utility token used for accessing an application where the counterparty is not the issuer may at the same time be a payment token.

Since genuine blockchain-enabled applications are decentralized networks, this double dip will be accomplished in many scenarios. Rather than stating in the Guidelines that "cryptocurrencies give rise to no claim on their issuer", it should read: "the function of cryptocurrencies is exhausted in their existence as a digital resource, they do not entail any claim on their issuer or another counterparty."

On the other hand, the definition of an asset token representing a debt or equity claim on the issuer is remarkably clear. Unfortunately, the definition is beefed-up by inclusion of the category of tokens "which enable physical assets to be traded on the blockchain". This latter category has nothing to do with a claim against the issuer and should not fall within the same category; it is unnecessary. If an asset (e.g., precious metal or any other commodity) is tokenized by an issuer and can be redeemed by a token holder, the token represents a claim against the issuer (or the holder of the respective assets) and is therefore an asset token. However, if a token merely enables a (tokenized) physical asset to be traded on a decentralized market place, it should be qualified as a utility and not as an asset token.

Application of the regulatory framework on the token categories

Payment tokens (cryptocurrencies)

According to the Guidelines, the issuance of payment tokens constitutes the issuing of a means of payment, provided that the tokens may be transferred from one holder to another holder on the blockchain infrastructure. Anyone who provides payment services or who issues or manages a means of payment is deemed a financial intermediary subject to Swiss anti-money laundering regulation. A financial intermediary subject to Swiss anti-money laundering regulation has either to affiliate with a self-regulatory organisation (SRO) or submit to the direct supervision of FINMA for anti-money laundering purposes. Also, it has to identify the contractual counterparty and the beneficial owner of the assets. The identification may be executed via digital channels in accordance with the FINMA Circular 2016/7 "Video and online identification". This circular is currently subject to revision. FINMA intends to implement further easements on the identification process. The consultation period for providing comments on the changes to the circular runs until 28 March 2018.

When it comes to the application of the said anti-money laundering requirements on ICO organisers, the Guidelines foresee in important easement. According to FINMA, the ICO organiser would comply with the regulation if it accepts the funds via a third party service provider which is affiliated with an SRO or subject to FINMA supervision. However, the ICO organiser would not have to affiliate with an SRO or to be licensed directly by FINMA itself. This analysis of FINMA is, albeit welcome, quite a liberal interpretation of the Swiss anti-money laundering act, which simply requires all financial intermediaries to affiliate with an SRO or be licensed by FINMA (whereas all other duties may be outsourced to a service provider).

No other financial market regulation in addition to anti-money laundering regulation applies on payment tokens. FINMA confirmed such tokens do not qualify as securities under Swiss law. Therefore, no prospectus requirements apply on the creation and issuance of payment tokens.

Finally, FINMA emphasizes that the exchange of a cryptocurrency into fiat money or into any different cryptocurrency would be subject to anti-money laundering regulation. The same would apply on entities providing token transfer services, if such service providers maintain the private key (e.g., a custody wallet provider). On the other hand, intermediaries on the secondary market do not fall under the Swiss Financial Market Infrastructure Act and do not require a securities dealer license.

Utility tokens

The issuance of utility tokens shall not be subject to anti-money laundering regulation, provided that the main functionality of the token is the access right to a non-financial application of the blockchain technology. As mentioned above, many utility tokens may also be a means of payment in consideration for a service provided on the respective platform. In order not to undermine the token categorisation of FINMA, it would be fair to say that the payment function shall by default be an accessory function of any utility token. Otherwise, the issuance of virtually all utility tokens would be subject to Swiss anti-money laundering regulation.

Similar to the application of the anti-money laundering regulation, some uncertainty remains regarding the qualification of utility tokens as securities. FINMA states in its guidelines that utility tokens shall "not be treated as securities provided that 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". In the event the utility token would, however, entail an investment purpose component, FINMA would treat such token as a security.

FINMA's approach that a utility token which "additionally or only has an investment purpose at the point of issue" will qualify as a security lacks in our view legal basis. FINMA seems to be inspired by the notion of a security under US securities regulations, but the financing of a project with the expectation that the token will gain value once the blockchain network is launched does not in itself qualify it as a "security" under Swiss law. In addition, FINMA's approach has some awkward consequences on the secondary token market. Strictly applying the Guideline, the exchange of utility tokens bearing an investment element in a professional capacity would require a securities dealer license. However, as soon as the utility token became fully functional, it would cease to be a security.

Needless to say that in most instances a utility token is being issued at a time the platform has not been established yet in its full functionality. In many cases, the funds raised in the respective ICO will (at least partially) be used to pay the development costs of the platform. In our view, it would undermine the token categorisation of the Guidelines should all utility tokens which grant access to a not yet fully developed platform be qualified as securities.

Given the above, the structuring of a utility token may cause the most headaches when it comes to the potential application of the Swiss anti-money laundering regulation and securities law. The Guidelines are lacking a criterion of demarcation to draw a sharp line between utility tokens and the other two token categories. An ICO organiser is, despite of the Guidelines, left with either complying with both the securities and anti-money laundering regulation or pre-discuss the ICO with FINMA.

Asset tokens

Asset tokens generally carry the right of participation in the future earnings of a company or in the future capital cash flow. FINMA generally qualifies such tokens as securities.

Securities are standardised certificated and uncertificated securities, derivatives, and intermediated securities which are publicly offered for sale in the same structure and denomination or are placed with more than 20 clients, provided that they have not been created especially for individual counterparties.

Uncertificated securities are rights which are based on a common legal basis and issued under identical terms. According to the Swiss Code of Obligations, uncertificated securities are created with the entry in the book and continue to exist only in accordance with such entry. FINMA follows our firms's previously published view that uncertificated securities can be recorded on the blockchain. The entry on the blockchain constitutes the required book on uncertificated securities.

The public offering of uncertificated securities which represent a *debt or equity right* is subject to prospectus requirements according to the Swiss Code of Obligations. The disclosure requirements for a Swiss prospectus are fairly low. The prospectus does neither have to be registered nor approved by FINMA or any other authority for the time being. The required Swiss disclosure wording can be implemented into a white paper used in an ICO. Prospectus requirements applicable in each jurisdiction were investors are solicited must be adhered to as well. However, underwriting and publicly offering securities of third parties on the primary market, is, if conducted in a professional capacity, an activity which requires a securities dealer license.

Derivatives are financial contracts whose price is derived specifically from (i) assets such as shares, bonds, commodities and precious metals or (ii) reference values such as currencies, interest rates and indices. The creation and issuance of derivative products to the public on the primary market is regulated and requires a FINMA license as securities dealer.

The public issuance of tokens which represent a participation in future earnings of the issuing company or in future capital cash-flow of the issuing company (e.g., a synthetic EBIT participation) do, in our view, neither require a prospectus nor a securities dealer license. Such tokens do neither qualify as debt or equity rights nor as derivatives because the price does not derive from a specific asset or a reference value. Hence, the respective asset tokens qualify as uncertificated securities, whose issuance is not regulated. However, the above conclusion may be

thwarted depending on how FINMA intends to apply its own Guideline. The Guideline argues that "the issuing of tokens that are analogues to equities or bonds" will be regarded as securities. It is all but clear how broadly such analogy, in FINMA's view, would be conceived.

Corporate income tax at the level of the asset token issuing entity

On the long run, we believe that tokens will in many instances be issued in an ICO as asset tokens in order to finance a business idea, a start-up or even an existing business. Acquirers of such tokens are less driven by the hope to sell the tokens later at a higher price (as it may be in respect to payment and utility tokens); rather they would like to participate in the income generated by the issuing entity.

There are different sub-categories to such an income-sharing token which qualify as asset token under the categorisation of FINMA. In one form, the token holder receives payments which correspond to a share in the future income according to the profit and loss statement (either before or after tax) of the issuing entity. In other cases, the token holder receives payments if the issuing entity, for example, generates a positive EBIT or distributes dividends to its shareholders.

Apart from the regulatory treatment of ICOs under the Guidelines, the tax implications are of outmost importance. The payment of the token holders to the issuing company is generally treated as income for accounting purposes at the level of the company. This would trigger corporate income taxes, since Swiss tax law, as a general rule, follows accounting law. The company should however be allowed to record provisions in the same amount as the received funds neutralizing the income from issuing the tokens. There are at least two conceivable justifications for such a provision.

First, the provisions are justified in all three model cases as the issuing company is obliged to use the proceeds for the development of the new technology. As the development leads to tax deductible expenses at the level of the issuing company and is directly linked to the income from the issuance of the token, the income should be neutralized by a provision for these future expenses.

Second, in the case of income-sharing tokens, there is another justification as the issuance of income-sharing and royalty-sharing tokens is not only linked to future expenses for the development of the technology, but also linked to an expectation of future payments to be made to the token holders depending on the development of a reference value. Therefore, at the time of the issuance of the tokens, the funds generated are linked to these future payments representing tax deductible expenses at the level of the issuing company.

In conclusion, the recording of a provision in or near the amount of the collected funds should avoid triggering substantial corporate income taxes at the level of the issuing company at the time of the ICO. However, the actual acceptance of the provisions depends on the individual case and requires a detailed analysis of whether provisions in the amount of the funded revenues are justified.

Withholding tax and income tax treatment at investor level

Regarding the qualification of the income from tokens for income and withholding tax purposes, it is first important to note that the tokens can be understood as an evidence for a contractual agreement between the issuing company and the investors, i.e. tokens are certainly not corporate rights from a civil law perspective.

Under Swiss income tax law, the payments of the investors at the time of issuance against the issuance of the income-sharing tokens are qualified as tax neutral at the level of the investors. However, it is the current understanding of the Swiss Federal Tax Administration that all future payments made by the issuing company to the token holders be regarded as taxable "compensation payments" to the investor. This means that not only payments exceeding the invested amount, but all future payments to the token holders, should be subject to income taxation. However, a published practice is not available yet. Individual cases should be discussed with the relevant tax authorities.

On the other hand, no withholding tax should be levied on income from tokens issued by entities in Switzerland, even though the token might from a substance-over-form perspective have elements of a share or a bond subject to Swiss withholding tax.

Conclusion

When it comes to entrepreneurial financing, ICOs will likely play an increasingly important role. Along with enhanced certainty on the tax treatment of ICOs, the Guidelines provide further clarity on the application of the financial market regulation on the issuance of tokens by ICO organisers. Unfortunately, much uncertainty remains in respect of utility tokens given that they may include characteristics of both payment tokens and asset tokens. Respective ICO organisers are well advised to obtain a non-action letter from FINMA prior to the issuance of utility tokens (or comply with both anti-money laundering regulation and securities law).

Directing the light on the upsides of the Guidelines, FINMA clarified that the issuance of tokens which fall within the category of asset tokens is not subject to Swiss anti-money laundering regulation. Such tokens shall be treated as uncertified securities recorded on the blockchain. Asset tokens which carry a debt or equity right are subject to prospectus

requirements. Assets tokens which provide for a synthetic participation in the EBIT of a company would not require a prospectus under Swiss law.

Based on our experience, the purpose of many recent ICOs was the financing of a business idea, a start-up or an existing company. However, the respective tokens have been structured as utility tokens (or even as cryptocurrencies) to circumvent applicable regulation. FINMA has now clarified that it reviews the economic purpose of the ICO and the created tokens when it comes to the application of the respective regulation. The Guidelines do not, however, set up new rules on ICOs but, in a pleasantly calm and technology-neutral way, apply existing financial market regulation to ICOs. Not inspite of but thanks to the Guidelines and the favourable tax regime Switzerland remains a very attractive jurisdiction for ICOs.

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