Initial Coin Offering ("ICO"): The Swiss Model

ICO is a term describing a fundraising event occurring in a limited offering period, usually a few weeks (the **"Offering Period"**), in which a company looking for financing through an ICO campaign (the **"ICO Beneficiary"**) sells to the public (the **"Acquirers"**) a certain number of so-called "digital tokens", or "token generating events", which technically are nothing more than a unique string of characters (in other words, a code) (the **"Tokens"**).

ICOs are becoming increasingly popular among companies of any size, from well-established and long-lasting reputable corporations to start-up companies (mainly active in the ICT business[1]).

During the Offering Period, Acquirers participating in the ICO transfer standard currencies (Euro, USD, CHF, etc.) or virtual currencies (e.g., Bitcoins or Ether, the most well-known "cryptocurrencies")[2] in exchange for Tokens, which are ultimately stored online or locally on Acquirer's computers by means of an account held by the single Acquirer with an *ad hoc* "wallet provider" (so-called "e-wallet").

ICO transactions use either existing blockchain platforms (i.e., Ethereum © or Waves Platform ©) or a custom one. By participating in the ICO, there is an expectation that if the ICO Beneficiary or the project to be funded through the ICO is successful, the value of the Tokens will appreciate and Acquirers can sell them at a profit. In general, Tokens are used or exchanged by means of other blockchain platforms for other Tokens, cryptocurrencies or various goods or services; however, some kind of Tokens may represent a holder's right of benefit or performance vis-à-vis the ICO Beneficiary itself.[3]

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[1] A recent Swiss ICO campaign carried out by Modum, a blockchain-based "Internet of the Things" supply chain solution start-up, raised 4 million CHF in only 10 minutes and, globally, over 50 ICOs were launched in 2017, with over 1.2 billion USD raised.

[2] In such a case, a Bitcoin or Ethereum address for receiving funds is created and the ICO Beneficiary publishes it on a web page. Acquirers send Bitcoins or Ethers to the published address in return for the new Tokens.

[3] Terms and functionality of the Tokens are often defined by means of the so-called "smart contracts" which, in a definition adopted by the International Swaps and Derivatives Association, is "*an automatable and enforceable agreement. Automatable by computer, although some parts may require human input and control. Enforceable either by legal enforcement of rights and obligations or via tamper-proof execution of computer code*". However, the enforceability of smart contracts from a legal perspective is still being debated.

ICO campaigns are increasingly attracting the attention of legislators worldwide: the Swiss Financial Market Supervisory Authority (FINMA), in its guidance No. 04/2017 released on September 29, 2017 (the **"FINMA ICO Statement"**), stated that *"ICOs are currently not governed by any specific regulation, either globally or in Switzerland"*, at the same time pointing out that *"due to underlying purpose and specific characteristics of ICOs, various links to current regulatory law may exist depending on the structure of the service provided"*.

Despite a self-regulation framework currently under development by cryptocurrencies and blockchain operators and their communities, at a global level, the regulatory landscape is still in a larval and ambiguous stage. In such a globally uncertain scenario, Switzerland is pursuing step-by-step the implementation of a favorable regulatory environment for ICOs: for example, Swiss regulators have already approved the operation of Bitcoin Suisse AG, a crypto asset manager, miner, financial service provider and advisor which, among other activities, assists firms in launching and carrying out ICOs. Furthermore, the Swiss entity named "Crypto Valley Association" has published a "Code of Conduct"[4] surrounding Token launches, in order to *"help companies fulfil their legal and moral obligations and give investors a clear understanding of the risks involved"*.

Nowadays, the specific structure of the ICO affects significantly the applicable law and the requirements to be fulfilled by the ICO Beneficiary and a case-by-case regulatory assessment appears crucial for the success of an ICO campaign.

On February 16, 2018, also in light of the "sharp increase in ICO projects" and of the significant numbers of enquiries received, FINMA released the *"Guidelines for enquiries regarding the regulatory framework for initial coin offerings"* (the **"FINMA ICO Guidelines"**). Such guidelines do not constitute a binding legal text, but (i) contain the general principles underlying FINMA's approach to requests regarding the supervisory and regulatory framework for ICOs to be carried out in Switzerland, and (ii) expressly grant the possibility to submit an *ad hoc* enquiry to FINMA for operators interested in carrying out ICO transactions in order to conduct an *ex-ante* compliance assessment on the conformity of the specific ICO transaction with Swiss financial laws.

Usually, an ICO involves, without limitation, the following main steps:

- structuring the ICO under a financial point of view; typically the practice provides two kinds of approaches: (a) the "capped funding" ICO, when Tokens are sold at a fixed price, and (b) the "uncapped funding" ICO, when the Tokens' price is established as a last step for the ICO's completion;

[4] Available online at: https://cryptovalley.swiss/codeofconduct/ .

- drafting the white paper describing, *inter alia*, the ICO Beneficiary (core business, governance, *etc.*), the overall project, the ICO Beneficiary's business plan, the ICO campaign, the Offering Period, the method of investment, the purchase price and the commissions, the methods of payment accepted, any applicable lock-up periods, date of delivery of the Tokens, the Token allocation policy, any risks associated with the purchase of Tokens, to the ICO Beneficiary and to the specific project to be financed (the **"White Paper"**)[5];

- drafting of several service agreements with service providers engaged for the implementation of the ICO (*e.g.*, manager of the blockchain platform underlying the ICO, e-wallet service providers, etc.);

- collecting cryptocurrencies such as Bitcoins or Ethers from Acquirers by the ICO Beneficiary based on the White Paper in one or more investment rounds; and

- issuance of the Tokens to the Acquirers.

As far as the legal treatment of ICOs in Switzerland is concerned, from the FINMA ICO Guidelines it appears that FINMA will treat ICOs and the relevant Tokens issued on the basis of their underlying economic function and effective contents. In particular, the FINMA ICO Guidelines classify Tokens in three categories, as follows[6]:

- **Payment Tokens:** 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;

- **Utility Tokens:** tokens which are intended to provide access digitally to an application or service by means of a blockchain-based infrastructure; and

- **Asset Tokens:** tokens which 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.

Furthermore, Tokens may also be structured as a combination of the above-mentioned categories; thus, asset and utility tokens can also be classified as payment tokens (referred to as hybrid Tokens).

[5] Please note that generally the publication of a White Paper including information on Tokens issued in the context of the ICO should not constitute investment advice.

[6] FINMA ICO Guidelines, paragraph 3.1.

Uncertainty in Relation to the Law Applicable to Tokens

Despite the already existing practice of the operators, due to an uncertain legal and regulatory environment, ICOs face significant challenges, which are amplified because the law applicable to ICOs will likely be affected by the nationality or registered offices of the Acquirer or other persons and entities involved. Furthermore, most governments have not issued a definitive statement on how ICOs will be regulated (moreover, statements already issued are quite contradictory[7]).

Generally speaking, an ICO could be considered, *inter alia*, as a sale of security or a sale of commodity and involve deposit-taking, e-money issuance, derivatives, collective investment scheme activities or crowdfunding, depending on its structure. That is the reason why ICOs, in principle, should be ultimately subject to some sort of prospectus or other disclosure requirements. In this respect, the FINMA ICO Statement reports that "*due to the close proximity in some areas of ICOs and token-generating events with transactions in conventional financial markets, the likelihood arises that the scope of application of at least one of the financial market laws may encompass certain types of ICO model*".[8]

The FINMA ICO Guidelines specify that (i) Payment Tokens will not be treated as securities[9], (ii) Utility Tokens "*will 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*"[10] and (iii) Asset Tokens will be treated as securities in the following cases: (a) if they represent an uncertificated security and the tokens are standardised and suitable for mass standardized trading; or (b) if they represent a derivative (i.e., the value of the conferred claim depends on an underlying asset, e.g., gold, diamond, securities, cash, real estate) and the token is standardized and suitable for mass standardized trading.

Should Tokens be classified as securities, FINMA concludes that "*a licensing requirement to operate as securities dealer may exist*". Furthermore, the issuance of

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[7] For instance, if, according to the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungs-aufsicht*), Tokens in an ICO qualify typically as financial instruments in the form of units of accounts (*Rechnungseinheiten*) within the meaning of Sec. 1, para. 11, no. 7 of the German Banking Act (*Kreditwesengesetz*), the UK's Financial Conduct Authority is of the opinion that many ICOs will fall outside the regulated space, although Tokens may constitute transferable securities.

[8] FINMA ICO Statement, paragraph 2.

[9] FINMA ICO Guidelines, paragraph 3.2.1.

[10] FINMA ICO Guidelines, paragraph 3.2.1.

debt or equity securities to more than 20 Acquirers would require a prospectus (White Papers do not generally address the legal requirements set out for a Swiss prospectus). In addition, please note that:

- according to the FINMA ICO Guidelines[11], if the funds raised through the ICO are managed by third parties, the provisions of the collective investment scheme legislation need to be considered[12];

- depending on the design of the relevant Token, an ICO Beneficiary should consider whether the Tokens qualify as means of payment, thus triggering the applicability of the Payment Service Directives (PSD2) or the relevant applicable Swiss or local legislation;

- the issuance of Utility Tokens shall not ultimately result in the provision of payment services alternative to the ones provided by banks, payment institutions or electronic money institutions; and

- should the ICO concretely not represent a sale of securities, many jurisdictions worldwide also have regulated the so-called crowdfunding activities and, in this regard, an ICO structured similar to crowdfunding transactions should comply with the relevant applicable law.

In light of the above, there are fewer risks that Utility Tokens may be classified as securities or commodities than Asset Tokens, but certain regulators classified Tokens with utility functions as security under the relevant applicable legislation.[13]

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[11] FINMA ICO Guidelines, Paragraph 3.5.

[12] *i.e.*, the Alternative Investment Fund Manager Directive, the UCITS Directive, the Swiss Collective Investment Scheme Act or other equivalent applicable law.

[13] In particular, reference is made to the United States Securities and Exchange Commission (SEC), which issued a cease-and-desist order proceeding with respect to Munchee Inc., a California-based company offering digital Tokens (designated as "MUN" Tokens) to the public through an ICO, considering the "MUN" Tokens as "securities" notwithstanding that the digital Tokens offered and sold in the ICO were intended to have a utility function. The White Paper described the creation of an "ecosystem", in which users of the app, restaurants, and Munchee's advertising business would be connected and would transact using MUN Tokens. App users would be paid in MUN Tokens for writing food reviews and could use MUN Tokens to pay for "in-app" purchases and food at participating restaurants. Restaurants participating in the ecosystem could receive MUN Tokens by selling food to app users and could use MUN Tokens to purchase advertising from Munchee and to pay rewards to app users who reviewed their meals. In such a case, at the time of the offering the ecosystem was not functional and none of these goods or services were available for purchase with MUN Tokens. Munchee stated in its White Paper that it would run its business in ways that would increase participation in the ecosystem, which would lead to increased

Furthermore, an ICO organized in a manner that involves an arrangement between the ICO Beneficiary, on one side, and an intermediary, on the other side, aimed at placing the Tokens (especially Tokens that are likely to be classified as "securities") may trigger the applicability of the European Union's Markets in Financial Instruments Directive (MiFID II) provisions or equivalent Swiss or local legislation, as the transaction might be qualified as a financial service in the form of acceptance and reception of orders.

In light of the above, it seems advisable for an ICO Beneficiary to assess that itself and any third-party service provider exercising, within the context of the ICO, an activity which might be regarded as a regulated activity satisfies the proper authorization/licensing requirements.

Among the consequences of failure to comply with the applicable regulatory requirements are typically, *inter alia*, an injunction by the competent supervisory authorities not to proceed, or interrupt, the ICO and the possibility of being charged with financial penalties and/or criminal offences for violation of the obligation not to carry out financial and/or banking activities without the necessary license. In the absence of an international regulation for ICOs, such regulatory risk may be very high in connection with the different national laws that may be applicable to the transaction.

Furthermore, anti-money laundering (**"AML"**) risks should be considered in an ICO transaction. The Financial Action Task Force, whose recommendations are recognized as the global anti-money laundering and counter-terrorist financing (CFT) standards, released in June 2014 a report pointing out that very often Tokens or cryptocurrencies are purchased anonymously by submitting only the Acquirer's Bitcoin or Ethereum address. This may happen because an Acquirer may resell "privately" to third parties, in total anonymity[14], the Tokens purchased through the ICOs, since no know your customer (KYC) operations are generally carried out by entities issuing virtual currencies or providing relevant trading facilities, which may even be located in jurisdictions that do not have adequate AML/CFT controls.

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value of MUN tokens. Such expectation of the increase of the Tokens' value led the SEC to conclude that "*Even if MUN tokens had a practical use at the time of the offering, it would not preclude the token from being a security. Determining whether a transaction involves a security does not turn on labelling – such as characterizing an ICO as involving a 'utility token' – but instead requires an assessment of 'the economic realities underlying a transaction'*, which are, according to SEC, *inter alia*, "*what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect*".

[14] Indeed, wallet providers do not generally require KYC identification of the account owners.

This may significantly affect the success of an ICO and cause an ICO Beneficiary to indirectly breach AML rules, thus attracting controls from competent supervisory authorities and causing reputational damages.

As a matter of fact, AML/CFT concerns in ICOs are being raised at the international and EU levels,[15] and one jurisdiction[16] had already considered the "virtual currencies service providers" as obliged entities under the domestic AML provisions.

With reference to the tax treatment, most tax authorities do not have specific regulations in place for ICOs. Currently, there are no established guidelines with regard to the income tax treatment of ICO Beneficiaries and the Value Added Tax (VAT) treatment of ICOs; furthermore, the applicable tax law, may be affected by the nationality of the Acquirer, of the e-wallet provider or Tokens exchange/store platform, while the resale of cryptocurrencies or Tokens may give rise to capital gains and, therefore, be subject to capital gains taxation both on the Acquirer and the ICO Beneficiary.

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[15] In this respect, the proposal of the EU Commission No. COM(2016) 450 Final amending the Directive 2015/849 expressly recognized that "*in order to allow competent authorities to monitor suspicious transactions with virtual currencies, while preserving the innovative advances offered by such currencies, it is appropriate to define as obliged entities under the 4AMLD* [i.e., Anti-Money Laundering Directive] *all gatekeepers that control access to virtual currencies, in particular exchange platforms and wallet providers*".

[16] In particular, Italy implemented in advance the above-mentioned EU Commission proposal by enacting Legislative Decree No. 90/2017, which amends Legislative Decree No. 231/2007 on AML/CFT.

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