Update

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FINMA issues guidelines on ICO financial market regulation

On 16 February 2018, FINMA published guidelines (the "Guidelines") on the application of Swiss financial market regulation to initial coin offerings ("ICO"). The Guidelines do not provide new rules, but rather describe how FINMA assesses ICOs from the perspective of existing financial market legislation and the regulator's expectations in terms of information provided as part of submissions made to it. Overall, the Guidelines provide helpful high-level clarifications on the regulatory treatment of different types of tokens.

In a guidance note issued in September 2017, the Swiss Financial Market Supervisory Authority FINMA ("**FINMA**") had indicated that ICOs – sometimes also referred to as "token generation events" or TGE – may raise questions from a financial market regulation point of view.

A "*sharp increase*" in the number of ICOs however led FINMA to revisit the topic and to supplement its 2017 guidance note with "*Guidelines for enquiries regarding the regulatory framework for initial coin offerings*".

The Guidelines are intended to provide more transparency regarding FINMA's practice but also, as their name suggests, to allow FINMA to streamline enquiries as regards possible or existing ICO launches.

1. Token categorization

The most significant aspect of the Guidelines is FINMA's attempt to distinguish general categories of tokens based on their intended or effective functionalities (substance over form). FINMA identifies three general categories of tokens:

- **Payment tokens** are, according to FINMA, tokens intended to be or effectively used as means of payment, that do not have a counterparty or debtor. In FINMA's view, payment tokens are synonymous with cryptocurrencies.
- Tokens meant to provide access to applications or services are **utility tokens**.
- Tokens that represent a financial asset or investment, such as debt or equity, as well as asset-backed or linked tokens are classified generically as **investment tokens**.

Tokens may – and in practice will – fall within one or more categories at the same time, depending on their features, in which case they would be subject to the cumulative requirements applicable to each of the relevant categories (so-

called "hybrid tokens").

Ultimately, FINMA conducts its assessment (when asked to do so or when conducting enforcement proceedings) based on the tokens' underlying economic function and effective usability. Although the Guidelines are a helpful high-level clarification, they reflect the current practice of FINMA, rather than an underlying legal reasoning.

In practice, most ICOs will be "hybrids" and given that ICOs are typically used as a means to raise capital to develop a new project, they will have partly (if not primarily) investment function and hence qualify as "investment tokens".

2. Regulatory assessment

The Guidelines describe a number of regulatory consequences associated with the tokens' features.

a) Tokens as securities

As a matter of Swiss law, issuing securities on the primary market may require a prospectus, typically for public offering of equity or debt securities, as well as for structured products. Unlike in a number of other jurisdictions, issuance prospectuses currently do not need to be filed, registered with or approved by any authority. The Swiss regime is however expected to change in this respect, as the upcoming Financial Services Act (FinSA) aims at aligning – to some extent – Swiss law with European law.

In any event, issuing securities on the primary market is generally not subject to any regulatory licensing requirements, with notable exceptions for derivatives[1] and underwriting of securities[2].

The situation is different on the secondary market – indeed, trading in securities in a professional capacity and operating a trading venue where securities are traded, however, is subject to a FINMA license. In addition, if tokens are characterized as securities, insider trading and market manipulation rules will apply, to the extent the tokens are admitted to trading on a Swiss trading venue.

According to FINMA, pure **payment tokens** are not securities, as they are primarily intended to be means of payment. This is generally undisputed in terms of characterization of payment tokens *per se*.

That being said, depending on the custody model of payment tokens, some features thereof are similar to intermediated securities, especially when held in custody through a depository pursuant to Article 4 of the Law on Intermediated Securities (LTI).

It is less clear how **utility tokens** should be treated in this respect. FINMA indicates that when utility tokens represent a right to an **existing application or service**, they do not qualify as securities, provided that the tokens do not also or exclusively have an investment function. This may well be a rare occurrence in today's practice: the goal of the ICO is generally to obtain funding to develop a product or service that does not exist yet.

FINMA does not explicitly address what happens when the application or service is not yet in existence, only indicating that if a utility token has an **investment purpose**, it will be treated as a security. Although this approach makes perfect sense from a financial market regulation perspective and investor protection, a more detailed and structured legal assessment would have been welcome. Some questions remain open, such as whether the tokens cease to be investment tokens and hence securities once the application or service is finally rolled out and made available to users.

Investment tokens will, as a rule, be treated as securities if they are suitable for mass standardized trading (which, when speaking of tokens on a distributed ledger, would typically by design be the case). The same will be true for

[1] The creation and issuance of derivatives in a professional capacity by an issuer that is primarily active in the financial sector is a securities dealer activity.

[2] Underwriting and offering on the primary market of securities of third parties to the public in a professional capacity also requires a securities dealer license.

claims for future tokens, and pre-sales, assuming that the claims or rights to future tokens are tradeable.

In this respect FINMA adopts a "substance over form" approach.

b) Tokens as means of payment

Issuers of means of payment must, under Swiss law, be financial intermediaries registered with FINMA or a self-regulatory organization (SRO) and perform AML/KYC verifications on users of the means of payment (subject to certain exceptions and limitations).

As FINMA indicates, **payment tokens** will be considered as means of payment, thus triggering AML/KYC requirements. The same will be true of hybrid tokens with the same payment features.

In this context, FINMA takes a pragmatic approach by allowing issuers of payment tokens not to become affiliated with an SRO or FINMA directly, provided that funds are accepted solely through a financial intermediary which is subject to AML requirements in Switzerland, and which performs the requisite verifications (not necessarily a bank). This is a significant simplification of the requirements by contrast with those applicable to issuers of electronic means of payment (e-money and similar providers).

The Guidelines clarify, if there were still any doubts, that the exchange of a cryptocurrency for fiat money or a different cryptocurrency falls under the AMLA.

Incidentally, possibly because cryptocurrencies do not, for the time being, materially affect financial markets or endanger market participants, FINMA does not address the question as to whether operating a distributed ledger or platform allowing payments in cryptocurrencies would constitute a payment system pursuant to Article 81 FMIA.

The Guidelines do not address one of the core AML issues surrounding cryptocurrencies, namely the compliance and risk management framework around accepting cryptocurrencies and how to comply with AML requirements in that context (i.e., verification as to the source of wealth, origin of funds and traceability). Without more clarity on this point, it may be difficult for purchasers of payment tokens to convert back into fiat without significant obstacles from their bank, depending on the amounts involved.

c) Tokens as shares of collective investment schemes

Issuing, managing or distributing shares of collective investment schemes is generally subject to stringent restrictions and license requirement described in the Collective Investment Schemes Act ("**CISA**").

According to the Guidelines, CISA is relevant only if the funds accepted as part of an ICO are managed by a third party, i.e. not by the issuer. The use of special purpose vehicles incorporated in Switzerland therefore presents a risk of being considered a collective investment scheme, provided certain asset management activities by a third party take place.

In this context, FINMA historically adopted a "formal" approach by distinguishing collective investment schemes from other investment products (see for example FINMA FAQ "Structured products" of 10 September 2014).

d) Tokens as deposits

Subject to a range of exceptions, taking deposits from the public is subject to a banking license.

The Guidelines mention that the issuance of tokens is rarely (as of today at least) associated with a claim for reimbursement against the issuer. In these cases at least, there is no deposit. In case tokens representing claims for reimbursement are issued as part of an ICO, the issuer may be subject to a banking license requirement. It should be noted, however, that capital market instruments, such as bonds, are not considered as deposits and do not trigger an obligation to obtain a banking license, provided certain conditions are met, in particular the issuance of a prospectus.

That being said, the discussion in the Guidelines only covers the issuance assessment phase (i.e.,

the ICO itself) and the position of the issuer of tokens. By contrast, the Guidelines do not address the issues surrounding custody models for tokens and cryptocurrencies, and the regulatory consequences thereof, except from a pure AML perspective (see above). Similarly, the Guidelines also do not address issues surrounding secondary market trading and licensing issues that may arise for operators of token trading platforms (in particular trading venue licensing or recognition requirements).

3. Comments

The Guidelines do not dispel the regulatory uncertainties surrounding token issuance, custody and transactions. They also do not address tax and civil law issues, in particular as to when Swiss law actually applies.

These caveats aside, the Guidelines bring helpful clarifications to the emerging field of ICOs, and actually set the standard in terms of level of readiness of a project before approaching the Swiss regulator for a "no action" letter.

In particular, FINMA has now made clear that simply referring to a token as having "utility" is not enough to avoid it being considered as a security. While one can regret that FINMA did not elaborate on the "investment purpose" criterion that it proposes to apply, it is increasingly obvious that the Swiss financial regulator views ICOs whose purpose is to fund projects or corporate development as capital market operations.

This does not mean that ICOs are or should be as complex as initial public offerings. Indeed, the distributed ledger technology (such as blockchain) underlying token offerings considerably reduces organizational constraints that have traditionally been associated with the public offering of financial instruments. What it means is that an ICO should be understood as fitting in a flexible but nonetheless real regulatory framework, and needs to be planned from the outset as potentially involving a large number of investors who may hold the issuer and its directors accountable for the rightful use of the funds that have been contributed through the ICO.

Please do not hesitate to contact us in case of any questions.

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