Fintech Brochure

OA LEGAL

SWISS INNOVATIVE LAW FIRM

Distributed Ledger Technology Overview

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Swiss Regulatory Framework for DLT

Switzerland enjoys an amazing international reputation of being the preferred destination for investors because of its Fintech innovative regulation, industry connections, highly skilled professionals as well as its competitive business environment.

The Swiss FinTech sector is *thriving*

...with a FinTech startup industry that is booming, numerous associations promoting the interest of a digital ecosystem and a Swiss legislator that seeks to create an stimulating framework encouraging the latest technologies...

Switzerland is doing *pioneering work*.

Swiss Regulatory Framework for DLT

The road to an improvement of the legal framework got accelerated when the Swiss National Council accepted in May 2020 the Federal Act on the Adaptation of Federal Law to Developments in the Technology of Distributed Ledgers (hereafter: "DLT Act").

This DLT Act will probably be enacted the upcoming year. With the DLT Act, Switzerland confirms again his regulatory foresight to become world's leading center of Distributed Ledger Technology. Ten different legal documents will be amended by the DLT Act under which the Swiss Code of Obligations, Financial Market Infrastructure Act, the Federal Act on Debt Enforcement and Bankruptcy and The Anti-Money Laundering Act.

The DLT Act will facilitate the use of Distributed Ledger Technology (hereafter: "DLT"), will limit risks and will provide more legal certainty when using decentralized legal technologies. Some examples of changes in the legal framework aiming to improve legal certainty:

- Corporations get the opportunity to register and issue shares in the form of negotiable securities under the Swiss Code of Obligations;
- Introduction of Uncertificated register Securities under the Swiss Code of Obligations;
- A surrender of crypto based assets is now clearly regulated in case of bankruptcy under the Federal Act on Debt Enforcement and Bankruptcy;
- Creation of a new authorization category "DLT Trading Systems" under the Financial Market Infrastructure Act;
- The duties under the Anti-Money Laundering Act now explicitly apply to the issuers of payment systems and trading facilities for DLT securities.

Another initiative to encourage the development on the FinTech sector is the recent development of the FinTech license that allows FinTech companies to exercise banking services (FinTech license) and so reduce market entry barriers for FinTech companies.

The FinTech license also intends an increase of legal certainty in the entire industry. This FinTech license does not only encourage the FinTech companies but also improves the quality of the Swiss financial center and stimulates the growth of the economy.

Classification of tokens

On February 16, 2018, the Swiss Financial Market Supervisory Authority (hereafter:"FINMA") issued guidelines on ICOs in Switzerland and distinguishes three types of digital tokens (i.d. Payment tokens, Utility tokens and Asset tokens) including a mixed form ("hybrid tokens").

Payment Tokens:
" Payment tokens (synonymous with cryptocurrencies) 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. "

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. "

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. "

ICOs/STOs/IEOs

OA Legal experts are at the disposal of issuers which needs to seek advices in order to choose the right path between ICOs,STOs and IEOs depending on its timing, resources, and potential risks.

Initial Coin Offerings (ICOs)

An Initial Coin Offering (hereafter: "ICO") allows for public fund raising in digital form for purposes of the company's activities based on the blockchain technology. In practice, the more general term "token generating event" (hereafter: "TGE") is also used.

At an ICO, contributors buy tokens issued by the issuer and in exchange, they receive digital coins or tokens, which are blockchain-based and which are linked to a project of the issuer. This concerns mainly payment tokens and utility tokens.

Security Tokens Offerings (STOs)

As seen above, the definition of the FINMA guidelines on Asset Tokens (security tokens) is quite large and includes securities such as equity (voting and nonvoting shares), bonds as well as physical (i.e. hard) assets.

We will address below under section Asset Tokens Class the legal framework for each category of security tokens, being specified that the categories of security tokens below are not exhaustive.

Recommendations

Please note that STO issuers should seek professional advice before launching an STO as well as obtaining a no-action letter from FINMA. Do not hesitate to contact our FinTech specialists for more details.

ICOs/STOs/IEOs

Initial Exchange Offerings (IEOs)

As an alternative to ICOs and STOs, the crypto community has come up with an Initial Exchange Offering (hereafter: "IEO"). The main difference with the IEO is the appearance of a third party: the exchange platform.

In order to participate in an IEO, both parties have to create accounts on the relevant exchange platform as it will serve the distribution of the relevant tokens.

The main advantage of an IEO is the fact that the exchange platform takes care both of the transaction’s reliability and marketing of the project. Before allowing the IEO to start, the exchange will verify the credentials and evaluate the chances of the project of becoming successful.

The exchange experts will regulate the IEO, creating a high degree of security for investors. The key security offering is the direct exchange of funds and tokens. The exchange will ensure that the coin matches the requirements to keep the risks at a minimum as well as, somehow, a certain level of liquidity.

The downside of using an IEO lies in high investment minimums, a small choice of IEO platforms, and the necessity to create accounts on the exchange platform.

Asset tokens class

Shares

Description

Shares (Art. 622 CO) are transferable securities conferring to its holder economic and voting rights within the company. In the digital world, it is complicated to trade shares as under the Swiss law the transfer of shares requires a written instrument. Thus, the process of tokenizing shares will consist in wrapping shares into digital tokens. In order to tokenize shares from a legal point of view, the shares would need to be issued in a form of uncertificated securities (meaning that the shares are not incorporated in physical certificates, and are issued in the form of so-called uncertificated securities within the meaning of Art. 973c CO). Such issuance would require the exclusion in the articles of association of the company of the right of shareholders to request the delivery of physical certificates. The future DLT Act proposes the introduction of a new type of uncertificated register securities on distributed ledgers (Art. 973d ppCO).

The tokenization of shares may be done on all or part of the shares of a company. In addition, it may be tokenized at various stages of the company's life, such as at the incorporation of the company, following a capital increase, or as a conversion of existing shares.

From a technical perspective, the action issued in the form of a token will most often require the implementation of a "smart contract" that will govern the functions and attributes of the token. In this sense, we notice that there are quite a few standards, most often set by private organizations, in particular the Capital Market Technology Association.

The CMTA is a non-profit association, which was created in Geneva with the idea that DLT has the potential to simplify the financing of companies and democratize their access to financial markets. One of the main objectives of the CMTA is to promote the issuance and trading of traditional capital market instruments such as equity in the form of digital tokens. The CMTA also seeks to adopt standards and systematize good practice in order to facilitate the treatment of digital assets by financial intermediaries. In this regards, the association issued a blueprint for the tokenization of shares of Swiss corporations.

Asset tokens class

Shares

Project Issuers

Benefits

Among the advantages for project issuers, the DLT first allows an easier transfer of shares by electronic means. In addition, it reduces the number of intermediaries, which is a cost, and increases the number of possible investors on a global Internet scale, which makes the title liquid. The tokenization of shares enables thus the issuers to raise capital and have their shares traded more quickly and more efficiently. Finally, it opens the way for new functionalities by using smart contracts, as well as creating a global and common register allowing synergies between different stakeholders in DLT, in addition to a real-time vision on shareholding.

Drawbacks

The issuers will indeed benefit from a larger number of investors in order to raise its capital but, on the other hand, they may face a large number of different shareholders having the power to vote at the shareholders' meeting of the company. The Issuer should thus analyse whether it would be appropriate to tokenize voting shares or non-voting shares (i.e. participation rights, see the dedicated Chapter here below) before structuring its STO.

Investors

Benefits

For investors, the DLT allows for more direct access by the shareholder to his rights, in particular his voting rights, and potentially access to more projects as well as potentially lower transaction costs. The tokenization of shares will allow the democratisation of private equity for any type of investors, even the smallest ones

Drawbacks

DLT is still in its early stages and there are many concerns, particularly on the issues of scaling-up, system latency and governance modes. From a legal point of view, the tokenization of shares on DLT poses many challenges in light of corporate law, for example, the relative anonymity of systems may create issues in terms of voting rights and the holding of the shareholders' meeting. Moreover, for "token shares", the validity of the transfer is still being challenged by scholars.

Asset tokens class

Participation right certificates

Description

The participation right certificates (Art. 656a CO) are transferable securities conferring to its holder only economic rights within the company. Its particularity is that it does not confer voting rights. Concisely, participation right certificates are non-voting shares.

Thus, the tokenization of participation rights certificate is similar to the one of the shares as mentioned above and the CMTA standards are fully applicable to this type of securities as well. That being said, please note that the participation capital must not exceed an amount equal to double the share capital (Art. 656b CO).

Asset tokens class

Participation right certificates

Project Issuers

Benefits

Among the other benefits as outlined in the Chapter related to the issuance of shares, one of the major benefit for the project issuers to issue non-voting shares is to raise capital to a large number of investors who will benefit only from the economic rights of the company but without voting rights. This would in principle ease the corporate governance of the company and the project as whole.

Drawbacks

As indicated, the number of participation certificates is necessarily limited by the fact that it may not exceed twice the share capital (Art. 656b CO). Although the number of participation certificates are limited, the price of each participation certificate to be sold to the investors can be differentiated. Furthermore, it might be more difficult to raise capital with non-voting shares compared to shares, because the issuers will always have the control on the distribution of dividends. That being said, issuers can grant some representations and warranties to investors in order to mitigate the risk that no dividend will be paid in the event of profits generated by the company.

Project Investors

Benefits

For investors who only wish to obtain economical rights within the company, participating in an STO with the issuance of participation rights certificates could definitely be a correct fit.

Drawbacks

On the contrary, investors who wish to have voting rights within the company would rather prefer to invest in an STO with the issuance of shares. Depending on the type of investors involved in the STO, the issuance of shares or non-voting shares can have some benefits or drawbacks, this is the reason why it is important that project issuers seek advices before structuring their STO.

Asset tokens class

Bonds

Description

Bonds are transferable debt securities issued simultaneously in order for the entity concerned to obtain long or medium term credit. Depending on various criteria, such as the amount to be raised, a prospectus is mandatory. In addition, from a banking regulation perspective, if the borrower targets more than twenty lenders, a prospectus is required in order not to be subject to a prior authorisation as a bank.

Similarly to shares (as detailed in Section “Shares” of the Chapter “Asset tokens”), tokenizing bonds will consist in issuing them in the form of uncertificated securities and wrapping them into digital tokens. A tokenised bond issuance will also most often require the implementation of a "smart contract" governing the functions and attributes of the token.

Furthermore, depending on current market liquidity or solvency of the debtor, the underlying loan is matched by more or less attractive conditions which is why, in this context, “smart contracts” are an exceptionally interesting tool: they can be customized according to the chosen structure for repayment of the loan itself (guaranteed repurchase bonds, staggered repayment loans, convertible loans, indexed loans, etc.) as well as interest payments (deferred loans, premium bonds, variable interest loans, etc.).

Asset tokens class

Bonds

Project owners

Benefits
Among the advantages for project owners, tokenizing bonds will allow them to obtain financing more quickly and more efficiently. DLT also allows for easier transfer of the bonds issued and provides more liquidity to the financial instrument (as its digital form increases the number of possible investors). Finally, the use of smart contracts allows project owners to issue financial instruments corresponding exactly to the modalities of the loan they wish to finance and to automate the implementation of the related interest or loan payments.

Drawbacks
Where bonds with uniform conditions are offered directly or indirectly for public subscription by a borrower, the creditors form a community by law. The latter shall name one or more representative(s). This election process can be more complicated when creditors are numerous and scattered around the globe. However, one could decide to set up an online election process to mitigate this difficulty. It is also possible to authorize the representative to assert the creditors' rights in order to avoid individual creditors having to exercise their rights independently.

Contributors

Benefits
For contributors, DLT allows access to more projects as well as potentially lower transaction costs.

Drawbacks
DLT is still in its early stages and there are many concerns, particularly in light of corporate law; for example, the relative anonymity of systems may create issues in terms of voting rights when holding, if necessary, a creditors’ meeting.

Asset tokens class

Real estate

Description

Real estate crowdfunding involves multiple contributors investing in a real estate project. Those two main investment types to choose from are also categorized under crowdinvesting and crowdlending.

The crowdinvesting may be either direct (i.e. the investor is registered as owner of the real estate) or indirect, by acquiring shares in a Swiss corporation (société anonyme / Aktiengesellschaft) itself owner of the real estate (club deal, provided that the investors make the strategic decisions, that no third part asset manager is involved and that the club deal is limited to 20 investors, in order not to be considered as collective investment scheme (hereafter: "CIS") under the Collective Investment Schemes Act (hereafter: "CISA").

Direct ownership

The representation within a title of a property, which is therefore equivalent to the securitization of a real right in the said title, is only possible under Swiss law within the limit of the real rights' numerus clausus. It is therefore accepted that real estate or its equivalents cannot be represented in a title, and even less in an intangible title on a distributed register. Indeed, given that the land registry is not yet on the blockchain, or even technically compatible with it, it is currently in our analysis not legally feasible to link a token to a real estate property title in Switzerland. However, once the land registry will be partially or totally, on the blockchain, this will be theoretically feasible.

Equity

The issuer of shares shall make sure not be considered as a CIS within the meaning of CISA. To do so, the shareholders shall be in a position to manage their financial interests themselves. In addition, the following requirements apply:

- Investors rights shall be set out in the articles of incorporation;
- The investors shall take the investment decisions
- The investors shall be informed about the status of the investments on a regular basis;
- The number of members shall not exceed twenty (usually called “club deal”).

Asset tokens class

Real estate

Bonds/Loans

In this model, the investor makes a loan to the borrower who owns the property. The investor receives regular interest payments and the nominal amount at the end of the period (duration). From a banking regulation perspective, if the borrower targets more than twenty lenders, a prospectus is required in order not to be subject to a prior authorisation as a bank. If less than 20 lenders are targeted, such transaction is called a “club deal” and no prospectus (neither a banking license) is required. A prospectus is also required in case specific criteria are met, principally the amount of the issuance.

Project owners and contributors

Benefits
The securitization of real estate may provide larger perspective on real estate financing for investors. In addition, DLT makes it possible to avoid certain intermediaries and maintain an inalterable land ownership register.

Drawbacks
The problem, in our opinion, remains that real estate is subject to local regulations. In addition, the lack of identification on the DLT is not compatible with the requirements of Swiss law regarding the purchase of residential real estate by foreigners.

Asset tokens class

Precious metals & commodities

Description

Swiss law does not prevent the tokenization of commodities, including in the form of a security.

On September 11, 2019, FINMA published a Supplement (the “FINMA Supplement”) to the FINMA Guidelines on ICO which covers in particular tokens linked to commodities.

In a nutshell, according to FINMA, if a “stable coin merely evidences an ownership right of the token holder, it generally does not qualify as a security”. In such circumstances, the token is a digital certificate of ownership, linked to the commodities.

According to FINMA, “this presupposes that (i) an ownership right and not merely a contractual claim to the underlying commodities exists, (ii) the transfer of the token results in the transfer of the respective ownership right and (iii) the commodities are not deposited pursuant to Art. 481 CO ”, i.e. are not commingled but segregated.

On the other hand, “when there is a contractual claim on the commodities, the token will generally qualify as a security and possibly as a derivative – insofar as it is linked to a financial market activity”.

The Financial Market Infrastructure Act contains some requirements applicable to derivatives and FinIA contains requirements applicable to the issuer of derivatives, including on the primary market. Indeed, an entity creating a derivative on a professional basis and which offers them to the public on the primary market, for its own account or for the account of a third party, is considered as an issuance house (maison de titres / Wertpapierhäuser) according to Art. 12 let. b FinIA.

Asset tokens class

Precious metals & commodities

The definition of derivatives is the following:

Derivatives are “financial contracts whose value depends on one or several underlying assets and which are not cash transactions. More specifically, derivatives are deemed to comprise financial contracts whose price is derived specifically from:

a. assets such as shares, bonds, commodities and precious metals;

b. reference values suchas currencies, interest rates and indices.”

The common point among these underlyings is that they are all fungible. In other words, they can be replaced by another asset of the same nature (characteristics). As soon as the underlying of a token is a fungible asset, one has to make sure that the smart contract (token) will not be considered as a derivative. One solution to avoid such qualification is to give access directly to the commodities (ownership title) instead of providing the investor with an “option” to buy or receive the commodities.

FINMA has issued a few rulings (no-action letters) for such token in relation to precious metals. This being said, it is highly recommended to address such request by FINMA, given the consequences in case the token is qualified as derivative.

Asset tokens class

Precious metals & commodities

Project owners

Benefits
Tokens linked to commodities or precious metals may provide the project owner with larger “crowd” of potential investors. The DLT may also be used as a register to prove the purity of the commodities or precious metals, as well as their origin.

Drawbacks
Many project owners, ICO or STO have tried to sell coins or tokens linked to commodities or precious metals, and only a few of them had a FINMA ruling and were well structured in our view.

Contributors

Benefits
The investor has not always easily access to direct commodities or direct precious metals. In our view, tokens are a good way to democratize commodity or precious metals markets.

Drawbacks
Historically, commodity and precious metal markets were reserved to institutions and professional investors, and required specific (depending on each commodity and precious metal) and macroeconomic knowledge, which are not easy to grasp.

ERC token standards

The "Ethereum Request for Comments" (hereafter: “ERCs”) are various token standards created to represent the different kind of assets on the Ethereum cryptocurrency platform. Each different token standard enables different features.

The starting point is the submission of "Ethereum Improvement Proposals" (hereafter: "EIPs”) by Ethereum developers. The Ethereum community reviews these EIPs. When the Ethereum community accepts an EIP, it becomes a standard, called an "Ethereum Request for Comments" (hereafter: "ERC”).

Three well-known standards are the ERC-20, ERC-1400, and ERC-721. A recent adopted standard ERC-777 is worth discussing as an improved of the ERC-20 standard. Please see below a chart with the different function of such ERCs.

ERC token standards

	State	Tokens	Focus	Key characteristics	Tradability	Ownership	Transferability	Advantages	Disadvantages
ERC-20	Final (ERC)	Fungible tokens	Implementation of tokens within smart contracts.	Basic functionality to transfer tokens	Freely tradable	Owner tokens change inside smart contract	Two step verification process	Vast majority of smart contracts interact seamlessly	Burns accidently sent tokens
ERC-777	Final (ERC)	Fungible tokens	Improves shortcomings in ERC20 + new features.	Improved tokens transactions	Freely tradable	Similar to ERC-20 but allows for advanced features	Use of register (ERC1820)	Solves lost token issue (ERC-20)	Two seps verification causes high transaction fees
ERC-721	Final (ERC)	Non-fungible tokens	Implementation of non-fungible tokens within smart contracts	Track and transfer non-fungible tokens	Low tradability	Unique ID	Initiated by the owner of a non-fungible token.	carries more information than ERC-20	Inefficient /expensive/time consuming transfer capacity
ERC-1400	Final (ERC)	Security tokens (partly – fungible tokens)	Issuing security tokens,managing ownership and transfer restrictions	Build, issue, trade, and manage security token	Freely tradable	Encrypted verification of ownership	Allows adding transfer information which creates transparency	Limitless range of asset classes across representable jurisdictions	New standards came out with more advanced features

Fintech license

The requirements to obtain a FinTech license are much softer than the requirements to obtain a banking license.

The requirements to obtain a banking license were not tailored to the business model of FinTech companies. FinTech companies do not necessary want to make use of the core banking services (e.g. lending and investing deposits) and they are not always able to meet (and pay) the extensive requirements of the banking license.

Why applying for a FinTech License?

- Being a regulated and supervised Fintech company may give access to a broader collaboration with existing institutionals (such as banks, securities firms or insurance companies)
- Great opportunity for FinTech firms to provide banking-like services (not core banking services) under less restrictive requirements.
  e.g. Deposit taking business
- A FinTech license may be a step before a higher license (for instance a full banking license).
- The FinTech license provides opportunities for:
  - Alternative financing options (in relation to cryptocurrencies);
  - Innovative payment systems;
  - Activities within the framework of investment advice and asset management;
  - Algorithm based data analyses;
  - **Service providers in the field of blockchain technology**
    - storing and trading virtual currencies validating blockchains

Fintech license

What are the **requirements** to obtain a Swiss FinTech License?

As a general remark, the Swiss Banking Act is applicable mutatis mutandis. The Swiss Banking Ordinance describes the requirements to obtain a FinTech license. The FINMA has the authority to interpret those requirements. FINMA assesses the application and decides whether the intended business activity requires a license and whether the planned business activities are possible under the terms of the FinTech license. FINMA can demand the submission of extra documentation and can request a licensing audit report, which is recommended in practice.

Legal structure

Institutions with a FinTech License must be a company limited by shares, a corporation with unlimited partners or a limited liability company with registered office and conducting business activities in Switzerland (Persons pursuant to Art. 1b of the Swiss Banking Act).

Public Deposits

Institutions with a FinTech License are allowed to accept Public Deposit up to maximum. CHF 100 million and they are not allowed to invest the deposits or pay interest on them. Remark: FinTech companies are not subjected to the Capital Adequacy Ordinance or the Liquidity Ordinance because of the fact they do not conduct interest margin business. Deposits with a FinTech company are not covered by the deposit guarantee.

Minimum capital requirement

The minimum capital is 3% of the deposits but cannot be not less than CHF 300.000 fully paid up and retained at all times.

Internal organization should contain compliance, risk management and conflict of interest.

For more information on how OA Legal can assist you, please contact one of our DLT specialists.

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