

SWITZERLAND

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Initial coin offerings

Initial coin offerings (ICOs) are now the focus of both the public's and the regulator's attention. ICOs are a digitalised method of raising capital in which an organisation issues tradable digital units (tokens) to finance a specific project or to develop it further. They are exclusively used to fund early stage projects of startups, often without a clear track record and with unclear success probability. In the course of the offering, the investor receives a token from the issuing organisation in exchange for cryptocurrencies (for example, bitcoin) or standard currencies (also referred to as fiat money). Tokens are created on a blockchain and exist as tradable digital units on distributed ledgers as a part of a protocol. For example, the Ethereum blockchain provides not only the cryptocurrency Ether, but also a platform to write smart contracts on the Ethereum blockchain, which makes it possible for market participants to easily generate and issue their own tokens, mostly on the basis of the ERC-20 token standard.

As most jurisdictions have not issued specific laws or regulations for ICOs and tokens, a large number of legal issues have yet to be resolved. ICOs are usually accessible over the internet from any jurisdiction and trading of tokens has no geographical limits due to the decentralised nature of blockchain technology. As many of the ICOs involve issuers based in Switzerland, this article briefly analyses ICOs from a Swiss capital markets law perspective. The authors believe that established capital markets standards provide a best practice which can be used to refine ICOs and attract more investors, in particular institutional investors, which are largely still shying away from this market.

Tokens

Depending on the main characteristics, five categories can be distinguished (many tokens fall into more than one category): a) usage tokens which give access to a platform,

give the holder a claim to use a service or can be used as payment for specific product offerings; b) work tokens, which give the holder a right to contribute their work; c) profit share tokens, which represent a financial claim against the issuer; d) voting tokens, which give the holder the right to vote; or, e) native cryptocurrency tokens, which do not vest the holder with a specific right or set of rights other than holding and trading the token.

Due to the varying appearances of tokens, a general qualification is not possible and each token has to be qualified on a case-by-case basis taking into account its content and form. Legally, the right embodied by a token can potentially be qualified as a claim (*Forderung*), including claims qualifying as shares or other equity securities. This qualification is relevant for the method of transfer and for determining whether the underlying right can be designed in alternative form such as negotiable securities (*Wertpapiere*), de-materialised securities (*Wertrechte*) and, in a second step, intermediated securities (*Bucheffekten*).

White paper versus prospectus

In connection with an ICO launch, it is customary to publish a so-called white paper. The purpose of a white paper is to describe the project for which tokens are issued in more detail. In cases where the tokens offered qualify as equity or debt securities, an obligation to prepare a prospectus may arise (article 652a, 1156 Swiss Code of Obligations). This is in particular the case if the offering is public, in other words, not limited to a pre-selected group of investors. However, the existing and still applicable content requirements for offering prospectuses are extremely limited under Swiss law and do not provide for adequate disclosure. In fact, they are much more limited than the requirements under the EU prospectus regulation or for a listing of securities on the SIX Swiss Exchange. Hence, if an ICO involves a risk of an economic loss for the investors, issuers are well advised to be guided by prevailing best capital market practice. This would involve third parties conducting a certain degree of business and legal due diligence to identify risks involved that could translate into a loss for the investor as initial purchaser of tokens. In a second step, those risks should be adequately described in the white paper.

Allocation

As the distribution and allocation of tokens in an ICO is not explicitly regulated, token issuers can decide on what terms they want to allocate their tokens. Most issuers have allocated their tokens based on the first-come first-served principle and might even provide early bird discounts to provide additional incentives to first buyers. Based on the first-come first-served principle, a fixed number of tokens are sold at a fixed price to the first buyers. Obviously, this creates pressure on investors to invest and penalises those market participants willing to carefully study a white paper on its merits. This method also lacks transparency as it is unclear from the outset when the offering ends. It may mean that a certain investor gets a full allocation, and an investor submitting a bid seconds later may not receive any allocation at all.

To ensure a certain degree of equal treatment, a fairer method would be to allocate tokens based on a pro rata cut-back basis among the interested investors who have submitted bids within a pre-defined period. An example of this kind of allocation is the ICO of EOS. Another possibility to allocate tokens could be by way of a Dutch auction to maximise the price. For example, Gnosis distributed their tokens by way of a Dutch auction. Alternatively, to optimise rather than maximise the price, an issuer could use the book building process, allowing it to prefer certain pre-defined categories of investors based on objective criteria, but otherwise treating investors equally and curbing them pro rata in case of oversubscription. So far, to our knowledge, only ICOBox has announced that it will establish a platform to enable the distribution of tokens by way of a book building process. The industry would be well advised to consider the way in which tokens are offered and allocated to investors. A general standard of best practice in the form of self regulation – similar to the Allocation Directive for capital market transactions – is recommended and is probably the only way to avoid regulatory action in the mid term. The Swiss Crypto Valley Association recently announced that it is working on an ICO code of Conduct.

Outlook

Blockchain technology, as a base for tokens and many more applications, will have an important role in the future. However, the

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future of ICOs is uncertain. It remains to be seen whether ICOs are just a hype that passes or whether they will become an established way of raising capital. Nevertheless, best market practices in the form of self-regulation should be promoted in order to prevent fraudulent transactions and exuberant governmental regulation.

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