



Swiss Federal Council Dec. 14 2018 report: Legal framework for distributed ledger technology and blockchain in Switzerland

An overview with a focus on the financial sector

TAURUS GROUP SA's PERSPECTIVE

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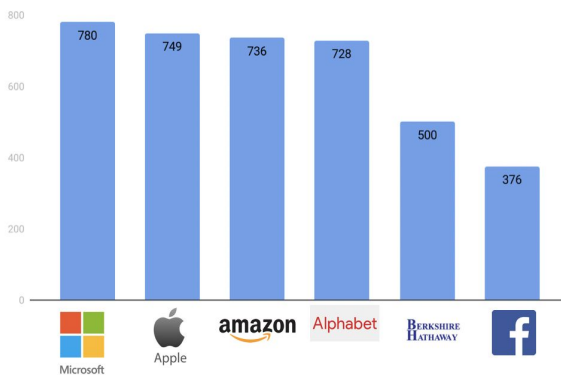
Taurus Group SA
11, rue d'Italie
1204 Geneva, Switzerland
www.taurusgroup.ch

FOREWORD

As of December 31 2018, 5 out of the 6 largest market capitalisations worldwide were made of technology companies, the famous GAFAM¹, representing together more than USD 3.3tn market cap. Twenty years ago, only Microsoft belonged to this club led at the time by oil & gas and pharmaceutical companies. Welcome to the fourth industrial revolution.

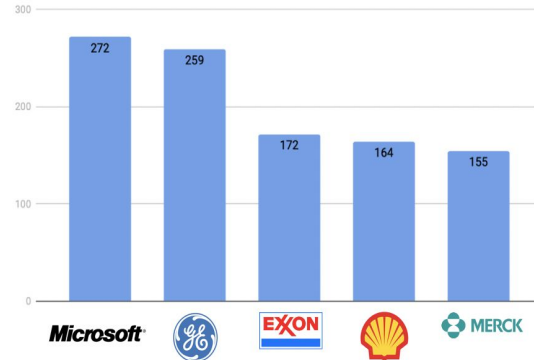
2018 Top 5

Largest companies by Market Cap, USD bn, 2018E



1998 Top 5

Largest companies by Market cap, 1998, USD bn



It is in this context that the Swiss Federal Council Council published a landmark report on December 14 2018. This 162-page document, called *Legal framework for distributed ledger technology and blockchain in Switzerland*, reviews the impact of distributed ledger and blockchain technologies on the Swiss financial sector. This report comprehensively covers legal aspects related to civil law, insolvency law, financial markets law (banking law, collective investment schemes law, LSFIn/LEFin), anti-money laundering law, as well as technological aspects. The Swiss regulator shows that it is on top of the game.

This article aims to summarize the takeaways from the Federal Council report. We first comment on the political message, then review the eight key points we believe are the most interesting, and conclude with a perspective on how to accelerate the pace of reforms.

¹ Google Apple Facebook Amazon Microsoft

THE FEDERAL COUNCIL SENDS A STRONG POLITICAL MESSAGE

The Federal Council’s report follows a series of constructive positions published both by the Federal Council—with the famous 2014 Graber report²—and by FINMA—with the 2017 and 2018 guidelines on cryptocurrencies and initial coin offerings. The new report reveals the Council’s awareness that technologies and blockchain in particular will impact our economy and society. It also demonstrates an understanding and expertise rarely observed with a regulator: the breadth and depth of the analysis is remarkable.

The report also sends a strong message to the political, business, and public sector actors in Switzerland and abroad. Indeed, Switzerland rarely takes such a clear and determined stance in willing to shape an industry, both at a national and international levels. After a few years playing defense in resolving fiscal issues stemming from the past, what if Switzerland is now playing offense?

TOKEN CLASSIFICATION IN SWITZERLAND

FINMA’s February 16 2018 *Guidelines*³ for enquiries regarding the regulatory framework for initial coin offerings (ICOs) segment tokens in three categories:

Token category	Description	Example
1. Payment token	From said guidelines: <i>cryptocurrencies [with] no further functions or links to other development projects. Tokens may in some cases only develop the necessary functionality and become accepted as a means of payment over a period of time.</i>	Bitcoin and Ether tokens
2. Utility token	Represent tokens that are intended to provide digital access to an application or service.	Basic Attention Token (BAT), a token for digital advertising
3. Security token	Represent assets such as participations in real physical underlyings, companies, or earnings streams, or an entitlement to dividends or interest payments. In terms of their economic function, the tokens are analogous to equities, bonds or derivatives	Tokens offered through security token offerings (STO), such as Mt Pelerin in Switzerland

² <https://www.admin.ch/gov/en/start/documentation/media-releases.msg-id-53513.html>



³ <https://www.finma.ch/en/news/2018/02/20180216-mm-ico-wegleitung/>

THE 8 MAIN TAKEAWAYS OF THE FEDERAL COUNCIL'S REPORT

You will find below the 8 main takeaways from the Federal Council's report, in our point of view.

1./ No ad hoc law: The Federal Council does not want to create a special law related to blockchain as it has been done abroad (for example in Malta and Gibraltar). The Swiss regulatory framework follows a technology-neutral and principles-based approach, and hence does not require ad hoc laws.

Gibraltar and Malta jurisdictions highlight

 <p>Gibraltar DLT licence⁴:</p> <ul style="list-style-type: none"> - Category: DLT provider - Who: companies active in DLT (not precised) - Since: Jan 1, 2018 - Obligations: governance, "sufficient" capital, organisation - Exemptions: Financial services act - Accounting and Financial, conduct of business, advertisements, unsolicited calls - SLA: yes - Passporting: no 	 <p>Malta Innovative Technology Arrangements act and Virtual Financial Assets act</p> <ul style="list-style-type: none"> - Category: n/a - Who: exchanges, ICOs, blockchain-based companies - Since: Nov. 1, 2018 - Obligations: governance, capital (EUR 730K for an exchange), organisation - Clarifications: token classification, capital requirements, - SLA: yes - Passporting: no
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2./ The securities law, the backbone of securities transfer in Switzerland, will be adjusted in order to authorize the blockchain-based transfer of tokens that represent securities or a legal position (claim, membership, right *in rem*, *category 3 in the table above*). These amendments have no impact on tokens that do not represent a security or a legal position, i.e., plain vanilla cryptocurrencies which can be transferred freely (category 1 and 2 in the table above).

3./ The insolvency law will clarify how digital data in general, and digital assets (payment tokens, utility tokens, security tokens) in particular, will be dealt with. Regarding the latter, the segregation of digital assets from a bankrupt's estate will need to be clarified, by analogy to the owner's right to segregation under current law. We believe that any process, blockchain-based or not, allowing to distinguish clients' digital assets unambiguously, should be sufficient to segregate digital assets from the bankrupt's estate. This point is critical, as it allows to keep off balance-sheet the digital assets and does not jeopardize banks capital ratios.

⁴ <http://www.gfsc.gi/dlt>

4./ **The banking law** does not include new amendments beyond the ones reported in the Federal Council's "Fintech" report of November 2 2016 (execution accounts delays extended from 7 to 60 days, creation of a "sandbox" environment, new "Fintech" category). However, a number of clarifications are made to the notion of banking deposits. In particular, there is no deposit in the case where digital assets are stored unambiguously, i.e., one address per client. The Federal Council is also open to review rapidly the CHF 100mn deposit limit imposed to the future owners of a "Fintech" licence, which freshly entered into force on January 1 2019.

5./ **The market infrastructure law** will be adjusted to allow for a new infrastructure category focussing on distributed ledger technology—this represents an exception to the technology-neutral approach from the Swiss regulator mentioned above. The new market infrastructure category will allow to target both retail and institutional clients. In addition, the law will also be completed in order to allow securities broker dealers to operate with the only goal of managing an organized trading facility (OTF).

6./ **The collective investment schemes law** will be modified to create a new category of funds (Limited Qualified Investment Funds, L-QIF), which will not require FINMA's approval. This category of funds will only be marketed to qualified investors and will be able to include innovative underlyings such as digital assets. That being said, it is still possible to launch digital assets funds, but the process can be long as it requires to solve the delicate questions of the custodian banks and the safekeeping of digital assets. Some players, some of which are Taurus clients, are positioning themselves and we are expecting to see a couple of funds being launched in 2019—assuming reasonable market conditions.

7./ **In terms of anti-money laundering** requirements, the Federal Council expects decentralized exchanges to abide by the same standards as brokers or centralised exchanges. Decentralized exchanges operating from Switzerland will need to put in place KYC and AML processes.

8./ **Stable coins and e-franc:** it is also interesting to notice that the Federal Council sees potential in using stable coins for settling securities transactions provided legal issues are resolved. We expect to see more concrete answers in the Federal Council's "e-franc" report which will analyse the feasibility of launching a crypto-franc in response to the Wermuth postulate⁵ (18.3159). This report is expected by the end of 2019.

⁵ <https://www.parlament.ch/en/ratsbetrieb/suche-curia-vista/geschaefft?AffairId=20183159>

WHAT'S NEXT?

The Federal Council's report *Legal framework for distributed ledger technology and blockchain in Switzerland* is remarkable and we are convinced that blockchain and distributed ledger champions can be created out of Switzerland. It is already the case in the pharmaceuticals, consumer goods, chemicals and financial services industries.

But competition is fierce.

Hence, priority number 1 is to accelerate the pace of the reforms. In other words, put in place a regulatory process that is swift enough and allows to quickly enter into force relatively less complex amendments (such as L-QIF and LIMF) and that takes more time for more sensitive topics (such as insolvency law) if needed. In particular, the notion of "*deposit*", which has been recognized as being "very wide" by the Federal Council, should allow for justified exceptions and should avoid requiring banking licences systematically due to narrow interpretations. On an equal foot, it will be of utmost importance to be able to absorb the surge in demand for FINMA licences, i.e., be able to distinguish good projects from less good ones early enough and deliver licences rapidly without compromising quality (other jurisdictions' regulators are for example introducing service level agreements).

Important disclosure

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