SWITZERLAND
Bär & Karrer

Daniel Flühmann and Philippe Seiler

ICO financing for startups

Initial coin offerings (ICOs) or token sales as alternative financing methods continue to generate increasing interest – in particular in Switzerland. Initial coin offerings conducted out of Switzerland between January and October 2017 raised between $550 and $650 million, which represents approximately one quarter of the volume of ICOs worldwide (including four of the 10 biggest ICOs so far). In our view, despite certain legal and regulatory challenges, ICOs have to be considered as a potentially attractive financing method, in particular for startups, as certain disadvantages of traditional financing methods may be avoided or mitigated.

Typical disadvantages of traditional financing methods

The key traditional financing methods for startups are: issuance of additional (ordinary or preferred) share capital, loans (including profit participating loans) and bonds. Taking the view of startup entrepreneurs, however, these funding methods may have certain disadvantages.

The issuance of additional share capital leads to founder dilution. Even if the shares can be issued with a low nominal value and a high share premium, minimising dilution, the issuance of additional shares still increases the administrative requirements (for example, more complex procedures for convening and conducting general meetings of the shareholders), which makes the management of the startup more cumbersome.

Loans are generally difficult to obtain for startups and often do not match their needs (for example, repayment of nominal amount and fixed interest irrespective of the performance of the startup, restrictive covenants or administrative burdens).

Bonds, which are in principle loans split into equal parts with equal terms, have similar disadvantages for startups as loans. Some of these disadvantages may be avoided by the issuance of so-called hybrid bonds (that is, subordinated, perpetual bonds with the right of the issuer to postpone or not pay the interest). However, if at all, startups will usually have to issue straight bonds with a fixed interest and a repayment at maturity to generate interest in the market.

ICOs as a potential alternative financing method

According to a definition by the European Securities and Markets Authority (ESMA), in an ICO, "a business or individual issues coins or tokens and puts them for sale in exchange for fiat currencies, such as the Euro, or more often virtual currencies, for example, Bitcoin or Ether".

In Switzerland, depending on the rights assigned to a token in the terms of the token sale, FINMA (the Swiss Financial Market Supervisory Authority) distinguishes three categories of tokens: payment tokens, utility tokens and asset tokens. Tokens used as financing instruments are considered asset tokens if they represent legal claims or assets such as a debt claim against or equity participation/membership right in the issuer (sometimes called the 'organiser'). By issuing an asset token in an ICO, the above disadvantages of traditional financing methods for startups may be (partially) mitigated.

Tokens can be structured in a way that investors are not entitled to equity and thus do not dilute the founders. Furthermore, given the flexibility in structuring the debt represented by the token, the specific needs of a startup can be taken into account (for example, no claim for repayment of a nominal amount but rather a share in future earnings or future cash flows). Unlike loans, but similar to listed bonds, tokens are in principle freely tradable on crypto exchanges, which has the potential to increase the value of such tokens and reduces the threshold for investors to invest as they are not locked in until a certain maturity date. It should be noted that crypto exchanges will likely become subject to elevated scrutiny by regulators in the future as more tokens qualify as securities. However, the issuance of tokens as such is (still) substantially less regulated than the issuance of listed bonds (which are typically not available as a financing instrument for startups) and – based on the figures for 2017 – there seems to be a bigger and more liquid market for tokens than for bonds.

Regulatory and legal challenges

As ICOs are a rather new financing method, various legal (for example, with regard to the transfer of tokens and the underlying entitlements) and regulatory uncertainties exist which will need to be taken into account when considering an ICO.

With regard to financial market regulation, various topics have been clarified by a guidance paper published by FINMA on February 16 2018. The Swiss Financial Market Supervisory Authority reiterated its earlier position that it will apply a principle-based, technology-neutral approach and consider proposed ICO projects on a case-by-case basis: (i) 'Payment tokens' (or 'cryptocurrencies') are solely intended to be used as currency and represent no claim against the issuer. Such payment tokens have to comply with anti-money laundering regulations but are not treated as financial securities. (ii) 'Utility tokens' are intended to provide access to an application or service of the issuer and are not treated as financial securities if they are actually usable in this way at issuance (which will narrow their field of application according to the expected practice of FINMA). (iii) 'Asset tokens' are treated as equity or bond instruments if structured that way. Therefore, asset tokens are subject to securities law requirements as well as civil law requirements under the Swiss Code of Obligations (in particular the duty to issue a prospectus). The specific requirements will need to be assessed on a case-by-case basis.

Outlook

In our view, ICOs have the potential to become an important financing method for startups.

Nevertheless, regulatory developments will need to be monitored, given the warnings issued by financial market supervisory authorities in various jurisdictions cautioning investors on the potential risks of ICOs. Not least because of this, best market practices in the form of self-regulation should be promoted in order to prevent fraudulent transactions and exuberant governmental regulation.

Bär & Karrer
Brandschenkestrasse 90
CH-8027 Zurich
Switzerland
T: +41 58 261 50 00

F: +41 58 261 50 01
E: daniel.fluehmann@baerkarrer.ch
philippe.seiler@baerkarrer.ch
W: www.baerkarrer.ch