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Swiss Federal Council Publishes Draft Framework Legislation Governing Applications of DLT/Blockchain Technology

On 27 November 2019, the Federal Council published the draft bill for a new Federal Act regarding the Adaptation of Federal Law to Developments in the Technology of Distributed Electronic Registers (the "**Draft DLT Act**") along with the accompanying dispatch and a report on the results of the consultation process that ended in June this year.¹ The proposed new law is a framework act intended to introduce pinpoint amendments to Swiss law to provide more legal certainty to business applications of distributed ledger technology (DLT). In its media release, the Federal Council emphasises that it aims to create the best possible conditions for Switzerland to evolve as a leading, innovative and sustainable location for fintech and DLT companies while at the same time taking a firm stance against any potential abuse of the new technologies. The Federal Council considers that specific amendments to the legal framework in key areas are sufficient to achieve these goals and has decided against a full codification in a technology-specific act.

The Draft DLT Act was published within just five months of the end of the consultation process with interested market participants, which was based on a preliminary draft of the new law published in March 2019 (the "**Preliminary Draft**"). The Federal Council has therefore continued on the accelerated path that characterised this project from the beginning. The importance placed by the market on a clearer legal framework for DLT applications is evident from the notably active consultation process: some 80 responses were received and considered in drawing up the Draft DLT Act. The Swiss Parliament is expected to start deliberations on the draft as soon as early in 2020.

¹ See <https://www.admin.ch/gov/en/start/documentation/media-releases.msg-id-77252.html>.

Key Elements of the Draft DLT Act

The cornerstones of the Draft DLT Act remain basically unchanged when compared to the Preliminary Draft² and include the following proposed changes to civil securities law, insolvency law and financial market regulation, respectively:

1. the introduction of uncertificated **register value rights** (previously referred to as DLT uncertificated securities) to create a sound legal basis for the digitisation or tokenisation of assets (rights) such as shares, bonds and other financial instruments as well as for the transfer of such instruments;
2. clarifications on the **segregation of crypto-based assets from the bankruptcy estate** as well as rules on (non-asset) **data access in bankruptcy**, both in general insolvency and bank insolvency;
3. the creation of a **new regulatory licence category for DLT trading facilities**.

However, while the focus areas remain, there have been many changes to the details of the proposed new provisions based on the results of the consultation process.

Register Value Rights

Arguably the most prominent element of the Draft DLT Act is the proposed amendment of civil securities law with the introduction of the new articles 973d *et seq.* of the Code of Obligations (CO) and revision of certain other articles in the law. The amended CO will enable the creation of so-called "register value rights" (*Registerwertrechte; droits-valeurs inscrits*), *i.e.* uncertificated value rights that can serve the same functions as "traditional" paper securities or centrally registered book-entry securities. In line with the principle of private autonomy in Swiss civil law, the amendments to the CO will create a general set of rules on register value rights and their legal effects, in particular on how they can be established, transferred, pledged and cancelled, but leaves the technical details of the implementation in practice to the market participants. Consequently, in contrast to the

Preliminary Draft, the Draft DLT Act no longer delegates any power of the Federal Council to specify technical requirements for eligible registers. In line with this approach, there will be no governmental certification of register value rights or oversight over the persons establishing them, although the Federal Council expects private "token audits" to become standard practice by market participants to manage liability risks.

The rules on register value rights have been significantly revised in the Draft DLT Act as compared to the Preliminary Draft. The Federal Council took up many of the suggestions made by the participants in the consultation process, in particular with regard to making the new rules more technology-neutral and flexible. A comprehensive discussion would exceed the scope of this briefing, but certainly one of the most apparent changes is the variation in the legal terminology from the originally proposed "DLT uncertificated securities" (*DLT-Wertrechte; droits-valeurs d'un registre distribué*) to the technology-neutral term "register value rights". Register value rights are distinguished from "simple value rights" (*einfache Wertrechte; droits-valeurs simples*), previously plainly called "value rights", that do not have the specific features and rights attaching to the former. In the context of the amendments to the CO, the Draft DLT Act generally no longer refers to the term "DLT" or similar technology-specific terms, setting out the relevant requirements for register value rights using technology-neutral descriptions.

The central provision is the proposed new article 973d CO, which requires that, based on a registration agreement among the parties: (a) register value rights must be registered in an eligible register, and that (b) registered rights can only be exercised or transferred by way of such register. For a register to be eligible for the purposes of creating and transferring register value rights, it must fulfil four requirements, which have been significantly revised in comparison to the Preliminary Draft with the aim of increasing practicality and which reflect more realistic and sustainable expectations regarding the qualities of the register (the Preliminary Draft *e.g.* would have required that the functioning of the register and the integrity of the data must be "ensured" using "the latest state of technology"):

² See our earlier briefing on the Preliminary Draft under https://www.baerkarrer.ch/publications/2019_03_BK_Briefing_DLT_Proposal.pdf

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1. The register has to enable the creditors, but not the debtor, to dispose over their rights using technological processes.
2. The integrity of the register has to be protected against unauthorised modifications using adequate technology and organisational measures, such as the collective administration by various independent parties.
3. The content of registered rights, the functionality of the register and the registration agreement have to be saved in the register itself or in linked associated data.
4. The creditors must be able to view the information concerning them as well as the register entries and must be able to verify the integrity of the register content concerning them without the assistance of third parties.

Responding to suggestions in the consultation process, the Federal Council further included a new provision in the Draft DLT Act regarding the transfer of register value rights, which clarifies that the specifics must be governed by the registration agreement. Another request that was heard and implemented in the Draft DLT Act was that for an amendment of the Federal Act on Intermediated Securities with the aim of defining the relationship between this act and the new provisions in the CO.

Compared to the preliminary draft, it is evident that the Draft DLT Act places more emphasis on private autonomy and is generally less prescriptive in light of the fact that the development of DLT is moving at a much faster pace than any legislative process.

Segregation of Crypto-Based Assets in Bankruptcy

The proposed amendments to the Federal Act on Debt Enforcement and Bankruptcy (DEBA) to enable segregation of crypto-based assets from the bankruptcy estate of the bankrupt debtor were almost universally welcomed in the consultation process. The Draft DLT Act is therefore closely in line with the preliminary draft.

One of the changes is a new, broader reference in the proposal for the key provision, the new article 242a DEBA, to segregation of "crypto-based assets" (*kryptobasierte Vermögenswerte; cryptoactifs*), where the preliminary draft referred to "payment instruments and DLT uncertificated securities". The new language is aimed at avoiding discussions about the exact legal nature of assets based on DLT. Furthermore, the requirements for a segregation claim to be valid have been revised in the Draft DLT Act to enable segregation also in scenarios where crypto-based assets are held in collective storage as long as it is possible to identify which part belongs to the specific claimant. This addresses criticism raised by many participants in the consultation process emphasising the prevalence of collective storage of crypto-based assets in the market (e.g. in the context of cold or deep-cold storage). The changes in the DEBA have also been reflected in the proposed amendments to the relevant provisions of the Federal Banking Act (BankA) on custody assets.

The Swiss Financial Market Supervisory Authority FINMA was strongly opposed to enabling segregation of crypto-based assets held in collective storage, viewing the change as problematic because it might indirectly impact the definition of what is considered a deposit from the public in the meaning of banking regulation and, by extension, the scope of activities subject to a Swiss banking or fintech licence requirement. The Federal Council rejected this criticism. However, the Draft DLT Act now includes a new article 4^{sexies} BankA, which vests FINMA with the power to impose a ceiling on crypto-based assets held in custody with a bank if it deems it necessary in view of the associated risks.

The proposed new article 242b DEBA on the access to data in the bankruptcy estate remains largely unchanged in the Draft DLT Act versus the language in the Preliminary Draft.

New DLT Trading Facility Regulatory Licence Type

A further key element of the legislative proposal is the creation of a new regulatory licence type in the

Financial Market Infrastructure Act (FMIA) for the operation of a DLT trading facility, defined as a professionally operated venue for the multilateral trading of DLT securities. In contrast to the proposed new provisions in the CO and elsewhere, this new licence type constitutes an exception to the principle of technology neutrality and, therefore, the references to DLT in the FMIA were kept in the Draft DLT Act.

Some participants in the consultation process requested a regulatory sandbox in the area of crypto exchanges, while others tried to encourage a more flexible regime to lower the market entry barriers for would-be operators of DLT trading facilities. However, the Federal Council remained firm in this area, not wishing to create too great an imbalance between traditional financial market infrastructures and DLT trading facilities and emphasising the importance of preventing abuse and preserving the reputation of the Swiss financial marketplace. Given that, the changes in the Draft DLT Act compared to the preliminary draft are more technical in nature.

Conclusion and Outlook

While the Federal Council generally stayed the course set on the basis of its DLT report of December 2018, it is also evident that it took care to listen to the legitimate concerns raised by participants in the consultation process. In the area of register value rights in particular, the willingness of the Federal Council to rely more comprehensively on the ability of market participants to create adequate registers and to provide for sensible rules in registration agreements based on private autonomy is of note. At the same time, the Federal Council remained firm in the area of financial regulation to limit the risks of DLT being abused for fraudulent or other undesirable purposes.

An important further step in the legislative process for the DLT Act has been taken. Should the so far highly efficient process be continued in the parliamentary debate, the DLT Act could enter into force as early as 2021. In our view, this would be a welcome development for the DLT industry in Switzerland as it is dependent on an appropriate and stable legal framework.

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