

Briefing March 2019

Swiss Federal Council Proposes Revisions to the Legal and Regulatory Framework Governing DLT and Blockchain Applications

Distributed ledger technology ("DLT") and blockchain technology as a subset of DLT are considered by many to offer a significant potential for innovation, enhancing efficiency and transparency in various areas of business, particularly in the financial sector. Switzerland has been at the forefront of the developments in this area, featuring a growing fintech and DLT ecosystem in which numerous established and new market participants work on reshaping financial services.

The principle-based and technology-neutral Swiss legal framework is generally innovation-friendly and well-suited to enable business models based on DLT. Nevertheless, in a report dated 14 December 2018¹, the Federal Council identified a need to enhance legal certainty, remove specific hurdles for DLT applications and limit the risks of the technology being abused for fraudulent or other undesirable purposes. It instructed the Federal Department of Finance (FDF) and the Federal Department of Justice and Police (FDJP) to draw up a legislative proposal.

Only three months later, on 22 March 2019, exhibiting a remarkable pace befitting the high-tech environment of DLT, the Federal Council presented a preliminary draft of a new Federal Act on the Amendment of Federal Laws in light of the Developments regarding DLT (*Bundesgesetz zur Anpassung des Bundesrechts an Entwicklungen der Technik verteilter elektronischer Register / loi fédérale sur l'adaptation du droit fédéral aux développements de la technologie des registres électroniques distribués*) along with an explanatory report.² The preliminary draft is subject to public consultation until the end of June 2019, following which a draft will be prepared for deliberation in the Swiss Federal Parliament. The legislative proposal of the Federal Council underlines Switzerland's commitment to remain a leading hub for businesses in the areas of fintech and DLT. In particular, the new rules should enable useful applications of DLT while preserving the integrity and sound reputation of Switzerland as a financial centre and business location.

Background

Based on the work of a federal expert group established by the State Secretariat for International Financial Matters at the beginning of 2018, the

Federal Council published a report on 14 December 2018 on the legal framework for DLT and blockchain applications in Switzerland (the "**DLT Report**"). The tenor of the report was that the Swiss legal framework does not require a fundamental reorientation to

¹ See the media release of the Federal Council of 14 December 2018, available under: <https://www.admin.ch/gov/en/start/documentation/media-releases.msg-id-73398.html>.

² See the media release of the Federal Council of 22 March 2019, available under: <https://www.admin.ch/gov/en/start/documentation/media-releases.msg-id-74420.html>.

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address these emergent technologies, but that certain amendments of federal law should be considered to bolster legal certainty in key areas and prevent abuse. The report covered the full gamut from civil securities law to insolvency law and financial market regulation and was inter alia intended to serve as a basis for the FDF and the FDJP to prepare a legislative proposal. The focus areas of the report defining the brief for the FDF and FDJP included the following:

- increase legal certainty regarding the transfer of (tokenised) rights using DLT under Swiss civil law;
- introduce clear rules on the segregation of digital assets and data without asset value in bankruptcy (incl. with respect to bank insolvency procedures in particular);
- create a new licence category for DLT based trading facilities.

Furthermore, the report considered certain amendments to anti-money laundering regulation, in particular with regard to decentralised trading platforms.

The preliminary draft act presented for consultation on 22 March 2019 (the "**Consultation Draft**") picks up on all the topics listed above and proposes a series of amendments to various federal acts. It is important to note that, while all of these proposals are combined in one document for the purposes of the legislative process, it is not the plan to introduce a stand-alone "DLT law". Rather, in line with the Federal Council's intentions communicated in the DLT Report, the focus is on targeted amendments of existing legislation.

Introduction of Uncertificated DLT Securities

A core element of the Consultation Draft is the proposal to amend Swiss civil securities legislation in the Code of Obligations ("**CO**") to **introduce a new category of securities in the form of DLT-based uncertificated securities** (*DLT-Wertrechte / droits-valeurs d'un registre distribué*; "**DLT Securities**"³).

The new regime revolves around the proposed new articles 973d to 973h CO and certain associated provisions. In the explanatory report to the Consultation Draft, the Federal Council acknowledges that certain kinds of digital tokens exhibit similar features as traditional certificated securities, making them suitable to facilitate the transfer of rights and evidence the legitimacy of the holder. Appropriately, the proposed new regime is largely analogous to the regime for traditional certificated securities.

The recognition of registers based on DLT in the CO as proposed by the Consultation Draft would be a fundamental change in Swiss law that would enable the creation of digital tokens with many of the same characteristics as those of traditional certificated securities such as certificated shares or bonds, but also certificated warehouse receipts (*Warenpapiere / titres représentatifs de marchandises*). In particular, the new regime would allow for a valid transfer of rights from one party to another by a transaction in a distributed ledger (so-called "transport function" of a security). In other words, the DLT Security would provide a legal instrument tailored to "tokenising" rights and claims which can be represented in a security under Swiss law. This contrasts with the current situation where there is considerable legal uncertainty as to whether a transfer of claims or uncertificated securities can be accomplished by a mere transaction on a blockchain without a written instrument executed by the parties. While some concepts have been developed by legal scholars with the aim of effecting a valid transfer (e.g. the concept of transferring an entire contractual relationship from one party to another based on advance agreement to a change of the contractual counterparty instead of a mere assignment of a claim), it is unclear whether these would actually hold up in a court of law.

The new regime also includes rules as to the legitimisation function of DLT Securities, meaning in particular that the debtor would only be required to perform towards the person identified in the distributed ledger and would be able to rely on such performance constituting effective discharge. Furthermore, DLT Securities would enjoy similar protection as traditional

³ Please note that the DLT Security is a (proposed) term of Swiss civil law. DLT Securities do not per se qualify as securities (Effekten) in the meaning of financial market regulation, but will only qualify as such if they are standardised and suitable for mass trading (see also the section on DLT trading facilities below).

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certificated securities in the sense that the recipient of a DLT Security that was lost by a previous holder is, in the absence of gross negligence or bad faith, protected in his or her acquisition of such DLT Security. To protect the faith in the tokenised rights or claims and to promote reliance on DLT Securities, the debtor would be limited in his or her defences against claims by holders of DLT Securities in a similar manner as he or she would be towards the holder of a traditional certificated security.

In the concept of the Consultation Draft, tokenisation in a DLT Security would be available for all rights and claims that can currently be securitised in a certificated security. In practical terms, this will primarily be relevant for tokens which would in the regulatory categorisation by the Swiss Financial Market Supervisory Authority FINMA⁴ qualify as asset or utility tokens. Pure crypto-currencies such as Bitcoin that do not represent a claim against an issuer, but rather a native unit of value on a blockchain, are not subject to the proposed new rules, since these can already under current Swiss law be transferred validly among users.

To create DLT Securities, there must be an agreement among the parties as to: (i) the registration of the relevant rights or claims in a distributed ledger (the "**Register**"), and (ii) the concept that such rights and claims can only be asserted or transferred via such Register. According to the proposed new article 973d paragraph 2 CO, the Register must have the following properties:

1. the content of the DLT Security, the operating principles of the Register and the agreement governing the Register have to be recorded in the Register or in accompanying data;
2. the Register has to ensure its functional safety in line with the agreement governing the Register as well as the integrity of the data, in each case based on state of the art technology; and
3. the parties must be able to access the Register entries that concern them as well as the information referred to under no. 1 above at any time.

To preserve flexibility, the Consultation Draft provides for the delegation to the Federal Council of the power to further specify the minimum requirements for the Register in a separate ordinance.

The Consultation Draft also includes: (i) a proposed process for a court to have DLT Securities cancelled, (ii) a provision with regard to the creation of security interests over DLT Securities (which provides for exceptions from the relevant provisions set out in articles 899 *et seqq.* of the Swiss Civil Code), and (iii) rules regarding the finality of dispositions over DLT Securities in the context of bankruptcy. Furthermore, the Federal Council proposes to introduce a statutory liability of the debtor (*e.g.* a company issuing shares in the form of DLT Securities) *vis-à-vis* each purchaser of a DLT Security if the former fails to ensure that the Register complies with legal requirements. This new provision could expose issuers of DLT Securities to significant liability risks, in particular because, according to the Consultation Draft, transactions made on a Register that is not compliant with the CO could be null and void. There is an expectation that this provision will face criticism during the consultation process.

Segregation of Crypto-Based Assets and Data in Insolvency Proceedings

The Federal Council proposes amendments to Swiss insolvency laws to clarify the treatment of crypto-assets (which term would include crypto-currencies and other payment tokens as well as DLT Securities) in insolvency proceedings.

One of the key challenges in bankruptcy proceedings is the identification of the assets "belonging" to the debtor and which, as a consequence, form part of its bankruptcy estate, whereas assets belonging to third parties are subject to segregation. In the area of crypto-assets in particular, it is of paramount importance for the holder of a wallet with a certain wallet provider whether the crypto-assets so-held can be segregated in the event of an insolvency of the

⁴ See the FINMA guidelines for enquiries regarding the regulatory framework for initial coin offerings: <https://www.finma.ch/en/news/2018/02/20180216-mm-ico-wegleitung>.

provider or whether the holder will have to file a claim against the estate. In the latter case, the wallet holder will be exposed to prolonged proceedings and is likely ultimately to suffer a loss.

The Consultation Draft aims to create legal certainty in this area by providing for an **explicit right of a third party to request segregation of crypto-based assets from the bankruptcy estate of the bankrupt debtor** in certain cases (proposed new article 242a of the Debt Enforcement and Bankruptcy Act; "**DEBA**"). The new provision is modelled on the existing rules regarding the owner's claim for segregation of physical objects (*Sachen*). However, in contrast to the existing provision, which relies on the concept of property and ownership pursuant to Swiss civil law, the proposed new article specifies itself the requirements for a valid segregation claim: (i) the bankrupt debtor must have the (sole) power to dispose over the relevant crypto-assets, and (ii) the crypto-assets must be individually attributed to the relevant third party in the distributed ledger (Register). The background to addressing this particular situation is that, already under the current legal framework, in case the relevant third party itself has access to the crypto-assets such that it can effect transactions, segregation is neither possible nor necessary. In joint access scenarios (as may be the case with multi-signature wallets), segregation is also not possible in the concept of the Consultation Draft, but the creditor would be entitled to claim segregation of the parts of the access data that are held with the bankrupt debtor pursuant to a **proposed new provision on data segregation in bankruptcy** (proposed new article 242b DEBA).

The new provisions of the DEBA are supplemented by corresponding proposed changes to the insolvency regime for banks.

In principle, the proposed specific right to request segregation of crypto-assets and data can be expected to improve legal certainty greatly for market participants based on mechanics that are largely analogous to the treatment of third-party physical property in the context of bankruptcy. However, it is important to note that the Consultation Draft provides for the cost of segregation to be borne by the request-

ing party. This cost allocation rule might significantly affect the use of the segregation right in practice, as costs could be substantial if the bankruptcy administration discontinued the operations and systems of a bankrupt wallet provider.

Introduction of a DLT Trading Facility Licence Type

Next to the introduction of the DLT Security (as a Swiss civil law concept), the proposed new licence type for multilateral DLT trading facilities ("**DLT Trading Facilities**") is the most anticipated element of the Consultation Draft. In the explanatory report accompanying the Consultation Draft, the Federal Council notes that the current Swiss financial market infrastructures regulation is well-established and does not require a general overhaul. However, the Federal Council also recognises that DLT creates new possibilities and potential for innovation that are not sufficiently addressed by the existing law, including in particular the possibility for financial market infrastructures to serve individuals as clients directly (instead of through the intermediation of regulated entities) and the potential for convergence of trading and post-trading functionalities with one provider.

To address these shortcomings, the Consultation Draft provides for a **new stand-alone licence type for DLT Trading Facilities**. While the new licence type and its licence requirements are largely modelled on the existing concepts and licence types of the Swiss Financial Market Infrastructure Act ("**FMIA**"), the concept of a DLT specific licence represents a major departure from the principle of technology-neutrality. While this clashes with the general principles of Swiss financial market regulation, it allows for the existing rules on traditional financial market infrastructures, which are aligned with international principles, to remain largely untouched. While many of the key provisions of the new licence type refer in significant parts to the rules applicable to other financial market infrastructures, technical details are left open in favour of a competence of the Federal Council to issue an ordinance or delegate regulatory powers to FINMA. Recognising that, in practice, at least in the beginning, DLT Trading Facilities may be smaller players than the

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established financial market infrastructures in Switzerland, the Consultation Draft also provides for the possibility of the Federal Council enacting, or having FINMA enact, certain simplified rules for those DLT Trading Facilities with limited participants, trading or custody volume.

The DLT Trading Facility is described in the Consultation Draft as an institution for the multilateral trading in standardised DLT securities (*i.e.* Swiss law DLT Securities pursuant to the CO that are, in addition, standardised and suitable for mass trading, as well as comparable foreign instruments; "**Standardised DLT Securities**"), the purpose of which is the simultaneous exchange of bids between several participants and the conclusion of contracts based on non-discretionary rules (proposed new article 73a FMIA). Pursuant to the Consultation Draft, the Federal Council will be enabled to impose minimum requirements as to the distributed ledger systems used by the Standardised DLT Securities to be admitted to trading and may prohibit outright the admission of certain instruments such as DLT based derivatives or privacy coins.

A key difference between the envisaged DLT Trading Facility and traditional trading facilities such as stock exchanges and multilateral trading facilities (MTF) would be that the DLT Trading Facility licence type is intended to be a **unified licence allowing also for the provision of certain post-trading services normally reserved to other financial market infrastructures** pursuant to the FMIA, notably central custody / depository services as well as clearing and settlement. The other main distinction of DLT Trading Facilities vis-à-vis traditional trading venues is that the DLT Trading Facility licence type would allow for the admission of private individuals or unregulated legal entities to trading instead of regulated participants only, the prerequisite being that they must declare to be acting in their own name and for their own account and not as intermediaries. The Federal Council may further specify the rules on admission, non-admission and expulsion of participants in an ordinance. The Consultation Draft notes that it is intended to provide for certain client protection rules similar to those of the new Financial Services Act ("**FinSA**") at ordinance level.

In order to prevent the use of the DLT Trading Facility licence outside its intended purpose, the licence would not be available to institutions that only offer trading in traditional securities (but DLT Trading Facilities may in principle, additionally, admit financial instruments other than Standardised DLT Securities). Furthermore, a DLT Trading Facility would be required to at least incorporate one of the additional elements outlined in the foregoing paragraph (*i.e.* act as a central depository, engage in clearing and settlement activities or admit individuals for trading).

Importantly, pursuant to the Consultation Draft, **securities that are admitted to trading on a Swiss regulated DLT Trading Facility would be subject to the insider trading and market manipulation rules of the FMIA** in the same manner as if they were listed or admitted to trading on a Swiss stock exchange or MTF. However, as long as Standardised DLT Securities are not formally listed (*kotiert*) on a stock exchange, the provisions on public takeovers, disclosure of major shareholdings and *ad hoc* rules would not be applicable.

Violations of said rules are subject to regulatory enforcement and criminal liability pursuant to the FMIA. Along with the professionalisation of the infrastructure, this exposure to regulatory and criminal liability, if implemented, can be expected to significantly reshape the Swiss market in tokenised assets.

Some of the key differences and communalities between traditional trading facilities, organised trading facilities and DLT Trading Facilities may be summarised as follows:

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	Stock Exchange	Multilateral Trading Facility (MTF)	DLT Trading Facility	Organised Trading Facility (OTF)
Description	Institution for multilateral securities trading	Institution for multilateral securities trading	Institution for multilateral trading in Standardised DLT Securities (may admit other instruments)	Establishment for: a) multilateral trading in securities or other financial instruments b) multilateral trading in financial instruments other than securities c) bilateral trading in securities or other financial instruments
Purpose	Simultaneous exchange of bids between several participants	Simultaneous exchange of bids between several participants	Simultaneous exchange of bids between several participants	Exchange of bids
Listing of securities (Kotierung)	Yes	No	No	No
Conclusion of contracts	Based on non-discretionary rules	Based on non-discretionary rules	Based on non-discretionary rules	a) For securities or other financial instruments: based on discretionary rules b) For non-securities: based on non-discretionary rules c) For bilateral trading: exchange of bids only
Qualification as financial market infrastructure	Yes	Yes	Yes	No (Operator must be licensed as a bank, securities dealer or trading venue)
Qualification as trading venue (Handelsplatz)	Yes	Yes	No	No

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Admitted Participants/ Users	a) Securities dealers b) Other parties supervised by FINMA subject to equivalent technical and operational conditions c) Foreign participants authorised by FINMA d) The Swiss National Bank	a) Securities dealers b) Other parties supervised by FINMA subject to equivalent technical and operational conditions c) Foreign participants authorised by FINMA d) The Swiss National Bank	Same as for stock exchanges and MTF plus other legal entities or individuals, provided that they declare to be acting in their own name and for own account	–
Ability to provide post-trading services	In principle no; certain ancillary services admissible (A legal entity may operate only one financial market infrastructure, exception being the operation of an MTF by a stock exchange)	In principle no; certain ancillary services admissible (A legal entity may operate only one financial market infrastructure)	Yes, may also engage in central custody/ depository services as well as clearing/ settlement under unified licence	–
Rules on insider trading and market manipulation	Applicable to admitted securities	Applicable to admitted securities	Applicable to admitted securities	–

The Consultation Draft notes that discretionary multilateral trading as well as bilateral trading of tokens qualifying as securities (*Effekten*) is not subject to a licence under the FMIA. However, the operation of an OTF is restricted to licensed banks, securities dealers or trading venues. To enable market participants to seek authorisation as a securities dealer (or "securities house" in the terminology of the new Financial Institutions Act; "**FinIA**") for purposes of the operation of an OTF only (which is currently not possible), the Federal Council proposes an amendment to the relevant definition in the law.

Further Proposed Changes and Aspects not Covered by the Consultation Draft

The Consultation Draft includes proposed changes to several other federal acts, including in particular the Federal Act on International Private Law (to address DLT Securities), the Federal Act on the Swiss National Bank (to address the potential systemic relevance of DLT Trading Facilities acting as central securities depositories or payment systems), the FinIA (various minor amendments) and the Federal Anti-Money Laundering Act (to integrate DLT Trading Facilities as financial intermediaries). Further minor changes to anti-money laundering regulation are planned at the ordinance level.

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On the other hand, the explanatory report accompanying the Consultation Draft points out certain areas of law where the Federal Council did not identify any need for current action. These include, in particular, the regulation of collective investment schemes and insurance regulation as the DLT developments in these areas are still at an early stage. Furthermore, no changes to the FinSA are planned in connection with DLT. However, the Federal Council points out that the information duties under the FinSA will be especially relevant with respect to financial instruments based on DLT, as they are new to many market participants and subject to uncertainties as to their valuation.

Conclusion and Outlook

Overall, the changes proposed by the Federal Council in connection with DLT appear well thought-out, targeted and balanced. In particular, the creation of a DLT Security is a milestone for Swiss law. It can be expected, should the market interest persist, that a robust regime for the tokenisation of instruments such as shares, bonds and other financial instruments will contribute greatly to more professional and uniform issuances of tokens as a means of financing (in particular via so-called Initial Coin Offerings (ICOs) or Security Token Offerings (STOs)). At the same time, the DLT Trading Facility Licence creates an opportunity to establish specialised trading platforms for DLT based assets and to unlock liquidity. Simultaneously, regulatory oversight as well as the application of insider trading and market manipulation rules should ensure a trustworthy market environment in line with Switzerland's reputation as a financial centre. The new rules can also be expected to further level the playing field between token offerings and traditional capital market transactions.

The explanatory report to the Consultation Draft notes that FINMA is preparing for licence applications in order to ensure reasonable times to market for persons intending to set up a DLT Trading Facility. At a more general level, the perception in the market is that the Consultation Draft is bound for an accelerated legislative process in order to finalise and enact the amended rules by the end of 2020. It remains to be seen how the Consultation Draft will be received in the market and what the responses by interested parties during the consultation process will be. However, while there are some potentially contentious points, in particular around liability and cost allocation, we believe that the Consultation Draft provides an effective basis for consensus in a challenging and rapidly evolving field.

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