CENTRE DE DROIT
BANCAIRE ET FINANCIER

Initial Coin Offering

When do investment tokens become securities ?

Par Vaïk Müller le 19 March 2024

In a ruling dated 16 January 2024 (B_4185/2020), the Federal Administrative Court (FAT) upheld a FINMA decision of 19 June 2020 finding that a Swiss company and one of its directors had, as a group, engaged in unlawful securities trading, in the absence of authorisation, as an issuing house that had offered securities in the form of investment tokens to the public on a professional basis.

As part of an initial coin offering (ICO) with a foreign issuer, the Swiss company and one of its directors purchased tokens. These tokens were not fully functional, but were to give entitlement to other tokens that would be functional. The Swiss company offered to buy the tokens via a publicly accessible website. FINMA initiated enforcement proceedings on the grounds that this activity was unlawful. These proceedings culminated in the FINMA decision referred to above.

The central question for the TAF was whether the tokens were securities, despite certain restrictions on transferability contained in the ICO documentation. The fact that the issuer was a foreign company had no material impact on the legal classification of the tokens issued, as they were functionally equivalent to the forms of securities typically issued under Swiss law.

Given their dematerialised form, the tokens could only be rights to securities, as the concept of registered rights to securities was not yet in force at the time of the events. The TAF notes that neither the LIMF nor the OIMF defined security rights (at the time, art. 2 let. b aLIMF did not explicitly refer to the CO). While the concept of security entitlement did appear in the CO, the TAF notes that the concept of security entitlement in the SESTA preceded its introduction in the CO, so that the two concepts are not necessarily the same, even though the majority of legal writers are of the opposite opinion.

The TAF then discussed the question of fungibility, which plays a key doctrinal role in the definition of a security. In the FAT's view, the concept of fungibility in the LTI is similar to that underlying the concept of securities under stock exchange law, except that the concept of securities also requires that the securities concerned be likely to be distributed in large numbers (massenweisen Handel). While the FAT notes that rights must in principle be transferable or assignable, the existence of restrictions on transferability that do not completely eliminate the possibility of assignment or transfer does not cause an instrument to lose its fungible character. Thus, a right that can only be transferred within a restricted circle of persons remains fungible, just as rights that are not likely to be widely distributed may also constitute fungible rights within the meaning of LTI.

With regard to tokens issued on a blockchain, the FAT emphasises that it is necessary to determine the nature of the rights contained in the tokens or of the rights represented by them in order to be able to define the applicable legal provisions (substance over form). Relying on the FINMA Practical Guide to ICOs (cf. Lepori, cdbf.ch/998), the FAT recalls that tokens issued in the context of prefinancing (also known as “voucher tokens”), which are admittedly non-functional but negotiable, must generally be classified, from the point of view of supervisory law, as securities due to their investment nature.

For the TAF, unlike FINMA, however, it is necessary to examine in concreto the transferability of tokens in order to classify them (or not) as securities. The criterion of mass distribution (massenweisen Handel) is a necessary condition for classifying an instrument as a security. If it is impossible to transfer an instrument (token or other), that instrument cannot, at the very least, be a transferable security and, as a result, be unsuitable for mass trading.

In the case in question, however, the TAF did not find a general prohibition on transfer in the ICO documentation : the indications relating to limitations on transferability were more in the nature of warnings than contractual prohibitions. Nor did the issuer’s technical freezing of the tokens make transfer impossible. While a transfer is certainly difficult, it is not legally excluded and remains possible. Finally, the FAT also found that the issuer did transfer the tokens created to the company, which was then to transfer them to the purchasers. According to the FAT, the very circumstances of the case and the attitude of the parties contradict the fact that the tokens were legally or technically non-transferable. In view of the circumstances, the FAT held that the tokens were indeed securities.

In conclusion, this case law is interesting in that it reminds us that the notion of fungibility is intrinsically linked to the notion of transferable securities, but that the total de jure or de facto impossibility of transferability may exclude this qualification. If the Federal Administrative Court were to read the case carefully, however, such an untransferable instrument could still be classified, for example, as a registered security right, or even as a subsidiary security right, if the conditions of art. 973d CO are not met.
