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STARTING AN INITIAL TOKEN OFFERING (ITO, ALSO CALLED INITIAL COIN OFFERING OR ICO) - THINGS TO CONSIDER

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In this first blog of a series on Blockchain Technology we will look at Initial Token Offerings.

Increasingly start-up companies are using initial token offerings (ITO, also called initial coin offerings or ICO) to raise capital for the funding of the development of products and services. The crypto-tokens are created and disseminated using distributed ledger or blockchain technology. Investors may use fiat currency or other crypto-currency to purchase the offered crypto-tokens. The crypto-tokens are accessed through specialised wallets, which manage the private and public keys and addresses and create and sign transactions. It is important to know that the wallet does not contain the crypto-tokens. They are recorded in the blockchain. The owner of the wallet controls the crypto-tokens on the network by signing transactions with the keys stored in the wallet.

Crypto-tokens are sold to buyers either by simpy publishing the public address to which the funds have to be transferred or via crypto-exchanges or crypto-brokers. Once the crypto-tokens are issued, they can be resold to others in a secondary market on crypto-exchanges or other platforms or directly between individuals.

There are many things to be considered before starting an ITO, especially to avoid any undesired legal consequences. The latest warnings and interventions by the Chinese and the US authorities point out how important it is to comply with applicable laws and regulations. The following points are of major importance:

1. Qualify what the crypto-token represents under applicable law

Crypto-tokens can be designed with multiple functionalities such as voting rights, distribution of rewards, rights to obtain services or to digitise tangible, movable objects. Sometimes they promise a reward on the success of the company (equity tokens or future right tokens) and sometimes they can be used for exchange against services or goods once such services or goods are ready

to be marketed (utility tokens). Other crypto-tokens (debt tokens) are designed to be similar to bonds (i.e. limited to a defined period of time with a right to variable or fixed interests).

In the context of utility tokens, the legal qualification is quite simple. The exchange of the crypto-token against goods represents a barter contract (article 237 et seq. CO) and the exchange against services a mandate contract (article 394 et seq. CO).

For tokens that entitle the holder to a monetary reward, the situation is much more complex and a careful assessment of the legal framework is required. Such tokens can qualify as equity tokens, debt tokens or the purchase of a future right tokens (if no repayment obligation exists). For example, if the raised capital is used to invest in several other projects and the equity token holder rewards depend on the success of such investments, it is likely that the construct will be deemed as a collective investment scheme, for which a permission from the Financial Market Authority is required. Even if the funds are only used for the development of the company (issuer of tokens) itself, the crypto-token may represent a company share (or a portion thereof), a derivative, a structured product or, where repayment of the funds have been agreed, a bond, and may be subject to prospectus requirements or other legal, regulatory or tax requirements.

2. Evaluate the appropriate type of legal organisation

Swiss law only recognises the conclusive list of organisation types stipulated in the Code of Obligations (CO) and the Civil Code. Any other form of organisation such as a digital anonymous organisation (also known as DAO), is not existing and might result in a simple partnership (article 530 CO) with unlimited, joint and several liability of the project team that created the digital anonymous organisation. Thus, it is recommended to incorporate a recognised type of organisation such as e.g. a company limited by shares (article 620 et seq. CO), a limited liability company (article 772 et seq. CO) or a foundation (article 80 CC).

3. Incorporate the organisation before you start an ITO

The exchange of newly created crypto-tokens against any existing crypto-tokens such as Ether, Bitcoin or Altcoin forms a contract according to the Swiss Code of Obligations. If such contract is concluded before the incorporation of the organisation, it will be binding between the project team of the ITO as a simple partnership and the investors, with unlimited, joint and several liability of all project members. However, there is an exemption to this rule where the project members expressly act in the name of (i) the company limited by shares (article 620 et seq. CO) or (ii) the limited liability company (article 772 et seq. CO) to be established. In such case, the concluded contracts can be assumed by these types of organisations within three months of their entry in the commercial register without obtaining the consent of the counterparties. As a consequence, the project members will be relieved of their personal liability. The law of foundations (article 80 et seq. CC) does not recognise a similar provision, so that the transfer of a contract requires the consent of the counterparty, which might become burdensome. Based on the aforementioned risks, it is advisable to incorporate the organisation before the start of the ITO.

4. Draft adequate documentation and permissions required for the chosen structure

Depending on the legal qualification, issuance of crypto-tokens requires various documentation and permissions (prospectors, licenses by the Swiss Financial Market Authority etc.). In any case, customised terms and conditions are required that form the contract under which the crypto-tokens are issued. The protocol running on the blockchain (also known as smart contract) that executes the performance of the rights and obligations between the parties cannot substitute the need for such terms and conditions, because it is disputed whether such protocol (smart contract) can form a valid agreement under Swiss law.

First, Swiss law requires a mutual expression of intent (article 1 CO) for the conclusion of a contract. The mutual expression of intent for the exchange of the tokens precedes the execution of the smart contract. Thus, the smart contract is rather the execution assistance for the contract than the contract itself. Second, even if the first argument can be eliminated, in most cases smart contracts are only available in program code without a translation into a general script such as the Latin alphabet. Thus, and even if a smart contract may be more than the execution assistance for a traditional contract, it is very unlikely that a mutual expression of intent can be found, especially where one or both parties are incapable of understanding the program code.

In summary, terms and conditions aligned to the specific project under which the crypto-tokens will be offered are a must. The terms and conditions should stipulate at least a detailed description of the functionalities of the crypto-tokens, the rights and obligations of the parties, the warranties, the applicable law, the arbitration procedure and the panel. In particular, the latter is essential for international crypto-token offerings, because, arbitration awards are recognised in more than 150 countries worldwide and can be enforced based on the rules of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention) without any separate local trial and the arbitrators can be legal and technical experts instead of traditional judges.

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