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# Swiss DLT regulatory framework implementation

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The Digital Regulator



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## Executive summary

During the past few months, the Swiss Parliament endorsed the Federal Act adapting federal laws to distributed ledger technologies (DLTs). The project began in late 2018, and the Swiss Federal Council (FC) adopted the dispatch on the framework conditions for DLTs in November 2019. The FC initiated the consultation on adapting various ordinances on 19 October 2020. The consultation ends on 2 February 2021, as does the process of fundamental adaptation of the Swiss legal framework to DLTs. At that point, Switzerland will feature the most comprehensive and articulated DLT regulatory framework globally. Realised through the adaptation of existing laws, as opposed to introducing a dedicated Act, this framework would offer entrepreneurs, investors, and consumers the highest regulatory certainty in the blockchain space—a primacy likely to persist for some years.

The month of November 2020 recorded some other noteworthy regulatory developments in the digital space. Switzerland's FC created a Green Fintech Network, deemed to strengthen the sustainability of fintech initiatives. The Swiss Financial Market Supervisory Authority (FINMA) began consultation on upgrading video identification guidelines to allow for scanning the biometric passport chip. The Financial Action Task Force (FATF) sent a clear message to peer-to-peer (P2P) crypto exchanges, anticipating Anti-Money Laundering (AML) & Combating the Financing of Terrorism (CFT) standards. China's President asked the G20 nations to support Central Bank Digital Currency (CBDC) initiatives through global standards.

The ongoing consultation on the ordinance in the distributed ledger technologies (DLTs) space is the last step in providing Switzerland with a comprehensive and globally unrivalled DLT regulatory framework.

## 1. Switzerland is about to complete the fundamental adaptation of its legal framework to DLT reality

Switzerland has been developing a regulatory framework for DLTs since 2014, following the principle of ‘technological neutrality’. Consequently, Switzerland has been adapting existing principles-based laws to technological innovation in a pragmatic way, aiming to preserve systemic stability, grant consumer protection and favour sustainable investments in the DLT space. The ongoing consultation on the adaptations to various implementing ordinances of civil and financial laws marks a fundamental milestone, ensuring the legality of assets transactions on DLT platforms, authorising DLT-based trading systems and codifying the treatment of DLT-based assets in bankruptcy procedures. The development of DLT-based regulation has been characterised by regular consultations with the relevant stakeholders and has gained a remarkably high political support. The expectation is therefore for a swift finalisation and approval of the changes to the implementing ordinances and for a timely entry into force of the regulatory framework in 2021.

- **A consistent, pragmatic and efficient gestation**

Switzerland’s notorious favourable business framework conditions (political and economic stability, workforce education, tax efficiency) have attracted DLT-based business since as early as 2012–13. The authorities have supported these innovations following a regulatory process based on technological neutrality and adjusting or complementing the prevailing principles-based legal framework in a pragmatic manner. Key steps have been the removal of barriers to entry for fintech in 2016, the introduction of a sandbox on 1 September 2017, the issuance of Initial Coin Offering guidance by the FINMA in 2018 and 2019 (the latter version clarifying the provision applicable to stablecoin projects), the introduction in October 2018 of crypto prudential rules for banks, the addition of the Fintech License as a new form of authorisation on 1 January 2019, and the introduction of a stringent approach to AML on the blockchain on 26 August 2019 (implementing the decisions taken by the FATF in June 2019). The FC kickstarted the project of a comprehensive DLT legal framework in December 2018, anticipating the need for selective adjustments to achieve best possible framework conditions for DLT business in Switzerland.

- **Core amendments presented by the FC**

The FC identified three core adjustments to federal laws. The first adaptation concerns the Swiss Code of Obligations. The Code misses the recognition of DLTs to act as an electronic register of rights. The adjustment implements such recognition, guaranteeing the function of negotiable securities to such registrations. The result is the creation of legal certainty around the issuance and negotiation of such registered securities over the blockchain. The second change refers to the Financial Market Infrastructure Law, which does not foresee trading systems based on DLT. Thus, this law is being complemented with a new authorisation category allowing DLT-based trading, clearing, settlement and custody of securities. The new authorisation is open to regulated financial institutions and private clients and is subject to the AML Act. The third adjustment covers the Debt Enforcement and Bankruptcy law and regulates the segregation of DLT-based assets in case of the bankruptcy of a custodian. These suggested amendments were unanimously approved by the Swiss Parliament on 10 September 2020.

- **Proposed ordinance-level amendments**

The consequence of the Parliament approval of the suggested laws amendments is the adaptation of several ordinances implementing the laws in practice. The FC initiated the consultation on 19 October 2020. A short summary is given below:

- The procedure governing the restitution of assets laid out in the Federal Debt Enforcement and Bankruptcy Ordinance shall be extended to cover crypto assets.
- The specification of the crypto assets subject to authorisation, and the criteria surrounding such authorisations, shall be added to the Banking Ordinance.
- The Financial Institutions Ordinance shall reflect the new authorisation category allowing the DLT-based trading, clearing, settlement and custody.
- The Financial Market Infrastructure Ordinance shall specify the authorisation conditions and related obligations attached to the new DLT-based trading facilities. These requirements are subject to the proportionality principle and foresee reliefs for smaller venues.
- The Financial Services ordinance shall be modified to account for prospectus obligations related to the issuance of securities on DLT-based trading systems.
- It is also proposed to relax the condition of sole power of disposal on third-party assets governing the application of the AML Ordinance, a proposal likely to generate comments from the private sector.
- Finally, minor changes shall align the current ordinance governing the fees of FINMA to the reality of crypto assets and crypto finance more broadly.

The changes envisaged are expected to increase the attractiveness of the crypto nation, Switzerland, by providing comprehensive legal certainty. This will concern entrepreneurs eager to offer DLT-based products and services, who will also benefit from size-based reliefs concerning governance, capital and liquidity requirements in the case of DLT-based trading systems. It will concern consumers, who will be able to reap the benefits of financial innovation in a protected and transparent environment (reference is, in particular, to bankruptcy rules and transparency requirements as well as the supervisory activity applicable to providers of DLT-based financial services). The overwhelming support for the legislative process since its launch in autumn 2018 and the broad involvement of stakeholders throughout the process would encourage a swift start in enforcing the rules; the industry would wish this to be earlier than 1 August 2021 for the fundamental changes to the Code of Obligations providing legal certainty to the tokenisation business.

## 2. Other noteworthy developments

### Conclusion

The ongoing consultation on the adaptations of several implementing Ordinances in Switzerland is the last step in the process, which began in November 2018, of fundamentally developing the Swiss legal framework to create a supportive and risk-controlled environment for DLT-based products and services. The completion of the process will provide Switzerland with the most comprehensive and articulated DLT regulatory framework globally, realised through the adaptation of current laws as opposed to introducing a dedicated Act.

November 2020 was characterised by several noteworthy regulatory developments in the digital space, including the creation—at the federal level in Switzerland—of a Green Fintech Network aimed to increase sustainability in the fintech space, the start of a consultation by FINMA on upgrading video identification guidelines to account for technological progress, the announcement of AML & CFT standards for P2P crypto exchanges by the FATF, and the call to G20 nations by the President of China to support CBDCs with dedicated global standards.

**Switzerland's FC has created a Green Fintech Network, and the FINMA has begun upgrading its video and online identification requirements. These initiatives reinforce the leadership of the digital nation, Switzerland.**

- The FC decided to complement its fintech initiatives with a sustainability dimension. It has created a Green Fintech Network through its Secretariat for International Finance and endorsed with the mandate to identify areas 'in which the conditions for green fintech in Switzerland could be improved'. The expectation is that, by spring 2021, the Network will submit an action plan and then assist with the implementation of measures.
- FINMA pioneered the globally-online video identification in 2016, when it issued a dedicated Circular. The financial regulator now takes stock of technological progress and has opened consultations on a revised Circular. The proposed revisions would enable financial intermediaries to identify clients by scanning the biometric passport chip.

**The FATF is mulling over AML & CFT standards for P2P crypto exchanges. The industry should welcome this move.**

- During an event organised by the V20, a group that drives collaboration between government regulators and industry to deliver a coordinated response to standards proposed by the FATF, the Chairwoman of the FATF's Virtual Asset Contact Group informed that the FATF is working on AML & CFT standards for P2P crypto-exchanges. So far, P2P exchanges have been able to stay unregulated due to their business model, which matches buyers and sellers directly in a decentralised way rather than through a centralised system. Depending on how such standards will be made mandatory, their issuance would play out positively in the mid-to-long term for the industry.

**The topic of CBDCs continued to record new initiatives, witnessing broad interest of financial regulatory bodies globally.**

- China's President urged the G20 nations to conceive regulations that support CBDCs. The reference is to global standards and principles that would support the issuance and use of central bank digital currencies in a risk-controlled environment.
- In a working paper entitled 'Legal Aspects of Central Bank Digital Currency: Central Bank and Monetary Law Considerations', the International Monetary Fund concluded that most central bank laws are not compatible with the idea of issuing a retail CBDC and that legislative changes are therefore needed to make the issuance of retail CBDC possible.
- The European Central Bank (ECB) announced that the decision on releasing a digital euro should be taken early next year and that if the decision will be to move forward with the project, strict AML & CFT and data privacy requirements will apply. Such a project would probably take 3–4 years to be completed.
- The Spanish Central Bank analysed the risks, the potential and the possible regulation of stablecoins and concluded that regulators could embed supervisory requirements into stablecoin systems themselves. It speculated that stablecoins could provide more effective solutions to the issues that CBDCs are meant to address.

**Several jurisdictions have begun regulatory initiatives aimed to improve crypto finance business conditions, witnessing further steps in the creation of supporting frameworks globally.**

- The Hong Kong Monetary Authority updated its priorities and included CBDC research and Regtech adoption, and the Hong Kong government is proposing to subject all cryptocurrency trading platforms to Securities and Futures Commission licensing requirements.
- The South Korea Financial Services Commission strengthened its AML regulation applicable to virtual asset service providers. These providers will no longer be able to handle privacy coins such as Zcash (ZEC), Monero (XMR), and Dash (DASH).
- The US Securities Exchange Commission increased the limit on fundraising for cryptocurrency firms, allowing them to crowdfund up to USD 5 million and up to USD 10 million, using Rule 504 of Regulation D. These increases in limits should profit securities token offerings (STOs).

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