Traditional Equity vs. Alternative Financing

Startup Days 2018 / Legal Session with Walder Wyss Startup Desk

25 September 2018
Alex Nikitine / Florian Gunz Niedermann

www.startuplaw.ch
www.walderwyss.com
About Walder Wyss Startup Desk
Who We Are

In a Nutshell

Walder Wyss is one of Switzerland's leading law firms and second largest Swiss law firm with 200 lawyers, tax experts, notaries and counsels with offices in Zurich, Lugano, Geneva, Basel, Berne and Lausanne.

We have an established Startup Desk comprising some 20 lawyers and tax experts dedicated to providing advice to founders, the company, their managers and investors alike at affordable rates.

Our Practice covers all areas of law.

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# Recognition

**Top Rated / Bilanz – NZZ/Le Temps Ranking May 2018**

## Private Equity und Venture Capital

<table>
<thead>
<tr>
<th>Kanzlei</th>
<th>Internet-Adresse</th>
<th>Niederlassungen in der Schweiz</th>
<th>Empfehlungen*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Walder Wyss</td>
<td>walderwyss.com</td>
<td>Basel, Bern, Genf, Lausanne, Lugano, Zürich</td>
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<td>Homburger</td>
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<td>swlegal.ch</td>
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<td>Jacquemond Stanislas</td>
<td>jslegal.ch</td>
<td>Genf</td>
<td>★★★★</td>
</tr>
<tr>
<td>Id est avocats</td>
<td>idest.pro</td>
<td>Lausanne</td>
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<td>cms.law</td>
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<td>★★★★</td>
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<td>BianchiSchwald</td>
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<td>Bern, Genf, Lausanne, Zürich</td>
<td>★★★☆☆</td>
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<tr>
<td>Bratschi</td>
<td>bratschi.ch</td>
<td>Basel, Bern, Lausanne, St. Gallen, Zug, Zürich</td>
<td>★★★☆☆</td>
</tr>
</tbody>
</table>

*Empfehlungen* are star ratings indicating the quality of recommendation.
Financing your Startup

Introduction
Introduction (1/7)

Truism

98% of the young entrepreneurs/startups realize soon that...

1. they need funds to finance different *phases* of the venture,
2. it is a challenge to find the right financing *instrument*, and
3. it is a challenge to find the right funding *source* (investors)
Introduction (2/7)

Financing Rounds in 2017 (CH, reported)*

(Total = 101 Rounds)

42 rounds between CHF 2M–10M

Introduction (3/7)

Overview Phases of Venture

**Typical Development Phases**

<table>
<thead>
<tr>
<th>Explore (Concept)</th>
<th>Validate (Pre-Seed)</th>
<th>Build (Seed/Startup)</th>
<th>Launch (Early Stage)</th>
<th>Growth (Mid Stage)</th>
<th>Maturity (Established)</th>
</tr>
</thead>
</table>

- There is no one-size fits all budget for a particular phase; financial needs depend on pursued venture and associated HR, R&D, Marketing (B2B higher than B2C) etc. and other expenses required for each phase.

- «Burn-rate» exceeding CHF 100K/month prior to Launch possible but rather unusual; significantly higher amounts in Life Sciences sector (Pharma, Biotech, MedTech)
### Introduction (4/7)

**Overview Financing Instrument**

<table>
<thead>
<tr>
<th>Typical Financing Instruments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
</tr>
<tr>
<td>Loan</td>
</tr>
<tr>
<td>Convertible Loan</td>
</tr>
<tr>
<td>Initial Coin Offering (ICO) / Crowdfunding</td>
</tr>
<tr>
<td>Grants / Subsidies</td>
</tr>
</tbody>
</table>
## Introduction (5/7)

### Overview Funding Sources

<table>
<thead>
<tr>
<th>Typical Funding Sources</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Co-)founders</td>
<td>Strategic Investors / Corporates</td>
</tr>
<tr>
<td>«FFF» (Friends / Family / Fools)</td>
<td>Public Institutions / Government</td>
</tr>
<tr>
<td>Business Angels</td>
<td>Banks</td>
</tr>
<tr>
<td>Venture Capitalist (VC)</td>
<td>Private Equity Funds (PE)</td>
</tr>
<tr>
<td>«Crowd»</td>
<td>Capital Market</td>
</tr>
</tbody>
</table>
Introduction (6/7)

Correlation Phase & Source

- Concept
- Pre-Seed
- Seed / Startup
- Early Stage
- Growth
- Established

- Own / FFF / Government / Crowd
- Business Angels
- VC
- PE / Corporate
- Banks
- Capital Market
For a successful financing strategy, every founder/startup must...

1. establish budget covering the next 1–2 phases (runway),
2. understand the different financing instruments, and
3. know the focus of founding source (phase, instrument, industry).
Financing Instruments
Share, Loan, Convertible Loan
Financing Instruments (1/2)

Equity vs. Debt

Key distinction when raising funds: Equity vs. Debt

- **Equity**
  - investor makes contribution (in cash, in kind, other) to company
  - company, in exchange, issues new shares (or participation certificates, or increase in nominal value) to investor (exception: mere injection into reserves with no issuance)
  - share capital (and/or reserves) of company increases
  - **no repayment** obligation or redemption (but *distribution* if approved by shareholders and sufficient equity)

- **Debt**
  - investor makes payment (in cash) to company based on (loan) agreement
  - investor has *repayment claim*, company incurs a debt (repayment obligation, such as loan amount, interests)
  - no statutory participation rights
  - share capital not affected
## Financing Instruments (2/2)
### Balance Sheet Analysis (simplified)

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash</strong></td>
<td>Long/short term Loan</td>
</tr>
<tr>
<td>180,000</td>
<td></td>
</tr>
<tr>
<td><strong>Accounts receivable</strong></td>
<td>Total Liabilities</td>
</tr>
<tr>
<td>0</td>
<td>20,000</td>
</tr>
<tr>
<td><strong>Total Current Assets</strong></td>
<td>Share capital</td>
</tr>
<tr>
<td>180,000</td>
<td>100,000</td>
</tr>
<tr>
<td><strong>Real Estate</strong></td>
<td>Legal Reserves</td>
</tr>
<tr>
<td>0</td>
<td>150,000</td>
</tr>
<tr>
<td><strong>Equipment</strong></td>
<td>Accumulated Earnings/Losses</td>
</tr>
<tr>
<td>50,000</td>
<td>-40,000</td>
</tr>
<tr>
<td><strong>Total Long-Term Assets</strong></td>
<td>Total Equity</td>
</tr>
<tr>
<td>50,000</td>
<td>210,000</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>Total Liabilities and Equity</td>
</tr>
<tr>
<td>230,000</td>
<td>230,000</td>
</tr>
</tbody>
</table>

- **Loan increases liability**
- **Share issuance increases share capital and reserves (if issuance above par value)**
Share (1/3)

Description

- Investor subscribes for newly issued shares, pays subscription price to company, company issues shares to investor in exchange
- Most common fund raising technique!
- Investor becomes shareholder, entitled to shareholders rights (voting rights, dividend distribution etc.)
- Typical share investor: all (except for banks and government)
- Note: requires approval by existing shareholders!
- Key upside from investor perspective: higher return upon sale
- Taxation of company: issuance stamp duty (1%) (*Emissionsabgabe*)
- Taxation of investor in case of sale (general, exceptions possible):
  - Tax free capital gain for Swiss natural investors
  - Beneficial tax treatment for legal entities (participation relief)
- **Main issue**: valuation of company (pre-money) – what is the right valuation...?
Share (2/3)  
Valuation Example

iRobot AG, Zurich, has a share capital of currently CHF 200,000, divided into 200,000 shares à CHF 1. No options outstanding.

New investor A invests CHF 1M. How many shares will A get?

<table>
<thead>
<tr>
<th>Valuation</th>
<th>Price per share</th>
<th>No. of shares to A</th>
<th>% held by A</th>
</tr>
</thead>
<tbody>
<tr>
<td>CHF 2.5M</td>
<td>CHF 12.50</td>
<td>80,000 shares</td>
<td>28.6%</td>
</tr>
<tr>
<td></td>
<td>(CHF 2.5M / 200,000* shares)</td>
<td>(1M / CHF 12.50)</td>
<td>(80,000 out of 280,000)</td>
</tr>
<tr>
<td>CHF 4M</td>
<td>CHF 20</td>
<td>50,000 shares</td>
<td>20%</td>
</tr>
<tr>
<td>CHF 9M</td>
<td>CHF 45</td>
<td>22,222 shares</td>
<td>10%</td>
</tr>
</tbody>
</table>

* If options/conversion rights are outstanding, denominator has to reflect corresponding higher number (as if)
Share (3/3)
Classification

<table>
<thead>
<tr>
<th>Aspect</th>
<th>Description</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liability</td>
<td>Risk of investment loss for investor, no actual liability for company</td>
<td>😞嚟</td>
</tr>
<tr>
<td>Rights of Investor</td>
<td>Statutory (law) and contractual (SHA) right, most importantly voting rights</td>
<td>😞嚟</td>
</tr>
<tr>
<td>Documentation</td>
<td>Extensive (investment agreement, shareholders’ agreement (SHA), capital increase documentation, filings with the commercial register)</td>
<td>😞嚟</td>
</tr>
<tr>
<td>Costs</td>
<td>Can be high (20K-80K)</td>
<td>😞嚟</td>
</tr>
<tr>
<td>Complexity</td>
<td>Medium – high (beware of «over-engineering» advisors in SHA)</td>
<td>😞嚟</td>
</tr>
<tr>
<td>Time to Execution</td>
<td>Can take 1-3 months, sometimes even longer</td>
<td>😞嚟</td>
</tr>
<tr>
<td>Limitation on number of investors?</td>
<td>None, unlimited investors possible (in case of collective investment scheme: max. 20 investors to comply with investment club requirement)</td>
<td>😞嚟</td>
</tr>
</tbody>
</table>
Investor (lender) grants cash as loan to company, which owes repayment of loan amount plus interests accrued as per terms

Frequent structure: Founders(s) who «advance expenses» of startup and who would like to be «reimbursed» (i.e. repaid) by the startup

Investor does not become shareholder as result of the loan

Risk characteristics: lower risk (than equity), but no real upside opportunity / typically no significant security in a startup context

No approval by shareholders required

Simple, but lower «quality» than equity from company perspective

Typical investor: banks (but not feasible for early stage), debt funds (rarely seen for early stage), shareholders

Note: used for cash, weakens financial condition of company; usually subordinated to avoid overindebtedness (= technically no liability under art 725 CO)

Occasionally waived/set-off by lender in connection with future equity capital increase (= lender becomes shareholder)
## Loan (2/2)

### Classification

<table>
<thead>
<tr>
<th>Aspect</th>
<th>Description</th>
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</thead>
<tbody>
<tr>
<td><strong>Liability</strong></td>
<td>Risk of recovery loss for lender, repayment liability of company</td>
</tr>
<tr>
<td><strong>Rights of Investor</strong></td>
<td>Lender has contractual rights relating to repayment; limited other rights (information rights), but no shareholder rights</td>
</tr>
<tr>
<td><strong>Documentation</strong></td>
<td>Light (loan agreement)</td>
</tr>
<tr>
<td><strong>Costs</strong></td>
<td>Usually low</td>
</tr>
<tr>
<td><strong>Complexity</strong></td>
<td>Low, if standard terms are being used</td>
</tr>
<tr>
<td><strong>Time to Execution</strong></td>
<td>Short, often used to bridge finance gaps; no authorities involved</td>
</tr>
<tr>
<td><strong>Limitation on number of investors?</strong></td>
<td>Tax driven limitation to 10 lenders under same loan arrangement (and 20 creditors of company in total) to avoid 35% withholding tax on interests!</td>
</tr>
</tbody>
</table>

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**walderwyss attorneys at law**

Walder Wyss Startup Desk 2018
Convertible Loan – General (1/2)

Description

- **Investor (lender) grants cash as loan, which later converts into shares (equity) of the company (borrower) usually in connection with a qualified financing round**
- Later conversion into shares bridges valuation issue!
- Conversion: Right of investor and/or company or mandatory, mostly at **discounted conversion price**
- Duration of loan: usually 3–36 months
- Who has conversion right?
  - Lender, and/or
  - Borrower, and/or
  - Mandatory trigger event
- Approval of shareholders required for subsequent issuance of shares
## Convertible Loan – General (2/2)

### Balance Sheet Analysis

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>180,000</td>
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<tr>
<td>Account receivables</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total Current Assets</strong></td>
<td><strong>180,000</strong></td>
</tr>
<tr>
<td>Convertible Loan</td>
<td>20,000</td>
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<tr>
<td><strong>Total Liabilities</strong></td>
<td><strong>20,000</strong></td>
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<tr>
<td>Share Capital</td>
<td>100,000</td>
</tr>
<tr>
<td>Legal Reserves</td>
<td>150,000</td>
</tr>
<tr>
<td>Accumulated Earnings/Losses</td>
<td>-40'000</td>
</tr>
<tr>
<td><strong>Total Long-Term Assets</strong></td>
<td><strong>0</strong></td>
</tr>
<tr>
<td><strong>Total Equity</strong></td>
<td><strong>250,000</strong></td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td><strong>230,000</strong></td>
</tr>
<tr>
<td><strong>Total Liabilities and Equity</strong></td>
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</tr>
<tr>
<td>Convertible Loan</td>
<td>00,000</td>
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<tr>
<td><strong>Total Liabilities</strong></td>
<td><strong>00,000</strong></td>
</tr>
<tr>
<td>Share Capital</td>
<td>120,000</td>
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<tr>
<td>Legal Reserves</td>
<td>150,000</td>
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<tr>
<td>Accumulated Earnings/Losses</td>
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</tr>
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</table>

**Note:** conversion price can be (i) equal to nominal value of share (like in left example) or (ii) above nominal value (= increase in share capital plus creation of reserves)
Convertible Loan – Pitfalls (1/5)

Discount on Valuation

iRobot AG, Zurich, has a share capital of currently CHF 200,000, divided into 200,000 shares à CHF 1. Convertible loans of CHF 200,000 are outstanding which entitle to a discount of 25% in the next financing round. New investor A invests CHF 1M at a pre-money valuation of CHF 4M «on a fully diluted basis» (in particular after conversion of all outstanding convertible loans)...

- Share price for convertible lender: 3M/200,000?
- Share price of investor A: 4M/200,000?
- Investor will look at convertible loans as if they had converted already
- Share price for investor A = 4M / (200,000 + convertible shares)
- 25% discount on the valuation is typically written
- 25% discount on the share price is typically meant
Convertible Loan – Pitfalls (2/5)

Share Class and Liquidation Preference

- Documentation is often silent or unprecise on share class and details
  - Common shares?
  - Preferred shares?
  - Junior to shares of investor?

- Convertible lender paid earlier and less per share

- Even if convertible lender should get the «same» share class, liquidation preference should be limited to actual payment (and not the same amount per share as investor)
Convertible Loan – Pitfalls (3/5)

Subordination

- Startups do typically not have substantial assets on the balance sheet
- Money from convertible loans is often used for expenses which do not create «assets» on the balance sheet (e.g. salaries without substantial creation of IP)
- Use of money then more or less directly leads to overindebtedness
- Liability of the board in case of insolvency
- «Subordination» in the sense of art 725 para 2 CO is key, but is often forgotten
- Particularly foreign lenders are not familiar with the concept
- Subordination de facto excludes security over assets
Convertible Loan – Pitfalls (4/5)

Conversion if no financing round occurs

- Documentation is typically unclear/silent on the terms of the conversion
- No third party gives you the terms
- Conversion is essential for startups, in particular if no subordination is granted
- «We agree to agree» is not an enforceable concept...
Convertible Loan – Pitfalls (5/5)

Taxation

– Existing shareholders/related parties as convertible lenders:
  – Interest rates typically exceed the rates accepted by the tax administration
  – Withholding tax on interest

– «Thin cap rules»: a significant part of the convertible loans may be deemed «hidden equity» for tax purposes:
  – Withholding tax on the entire interest on such part of the convertible loans

– More than 10 lenders at same terms:
  – Entire interest might become subject to withholding tax
  – Discount applied may be deemed taxable income for investors («dry income»!); subject to withholding tax
Convertible Loan – Wrap-up

When to Use Convertible Loans?

- At the very beginning
  - «Quick and cheap»
  - But: the larger the amounts, the more professional investors will insist on terms as in an equity financing round (warranties, board or observer seats, veto rights, minimum content of future shareholders’ agreement)

- To bridge delay for a financing round
  - Withholding tax on the entire interest on such part of the convertible loans

- Always be super-precise on the terms

- Always be aware of tax risks
# Convertible Loan Classification

<table>
<thead>
<tr>
<th>Aspect</th>
<th>Description</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Liability</td>
<td>Risk of recovery loss for lender, only limited repayment liability of company</td>
<td>😞</td>
</tr>
<tr>
<td>Rights of Investor</td>
<td>Lender has contractual rights relating to repayment; limited other rights (information rights), shareholder rights only upon conversion</td>
<td>😞</td>
</tr>
<tr>
<td>Documentation</td>
<td>More complex that plain vanilla loan</td>
<td>😞</td>
</tr>
<tr>
<td>Costs</td>
<td>Reasonably low; can get higher in case of complex conversion mechanism</td>
<td>😞</td>
</tr>
<tr>
<td>Complexity</td>
<td>Medium</td>
<td>😞</td>
</tr>
<tr>
<td>Time to Execution</td>
<td>Reasonably short; depending on structure, shareholder approval (articles) required</td>
<td>😊</td>
</tr>
<tr>
<td>Limitation on number of investors?</td>
<td>Tax driven limitation to 10 lenders under same loan arrangement (and 20 creditors of company in total) to avoid 35% withholding tax on interests!</td>
<td>😞</td>
</tr>
</tbody>
</table>
Financing Instruments
Select other Instruments
Grants

Description

- Various sponsors support startups by providing cash or in kind contributions without (or limited only) equity/repayment strings attached
- Gifts, awards, sponsoring arrangement, in kind contributions (e.g. office space at ETH)
- Typical source: universities, government, private institutions, family
- Difficult to obtain, amounts usually low, rarely recurring, little involvement by sponsor
- Be clear on legal or «moral» repayment obligations / accounting treatment / taxation (loan or donation etc.)
SAFE (Simple Agreement for Future Equity) (1/2)

Description

- Investor «gives cash» (not loan!), which later «converts» into (preferred) shares of the borrower upon trigger event (usually qualified financing round)
- No loan, no interest, no voting rights, no maturity, no repayment!
- Conceptionally an upfront cash contribution with right to receive shares in connection with future financing round
- US style «quick and dirty 3-4-page» document; SAFE usually lack clarity (= high risk); popular in US, a.k.a. «keep it simple securities» (KISS)
- Often used by founders with US/UK background (also in Switzerland)
«SAFE» (Simple Agreement for Future Equity) (2/2)

Description

- **Legally not possible under Swiss law**
  - Cash contribution has to go to blocked bank account (if not conversion of a loan)
  - Conversion of real liability debt (loan) only, conversion (waiver/set-off) of mere upfront payment likely to be circumvention of mandatory disclosure/capital increase rules, not accepted by notaries/commercial register
  - Equity payment from a non-shareholder is subject to income taxation

- Note: SEC issued warning in May 2017
Initial Coin Offering (ICO) (1/4)

Description

– «Issuance» of (blockchain based) coins («tokens») to «investors» (financial backers) who transfer cryptocurrency to blockchain generated address of issuer (or cash)

– Recent «phenomenon» (Mastercoin in 2013)

– Young companies, seeking working capital

– No listing requirement, but embedded in blockchain based platform/technology

– Issue price set by issuer, no middlemen

– Normally, no voting rights in the issuing company
Initial Coin Offering (ICO) (2/4)

Regulatory Minefield

- Application of existing regulation/new regulation evolving, complex/unclear and subject to frequent changes
- Numerous jurisdictions have implemented ICO rules (e.g. Australia, Canada, China, France, Hong Kong, South Korea, Switzerland, USA)
- CH: FINMA Guidelines Feb. 2018; FINMA Guidance 4/2017, but no ICO specific regulatory requirements
- CH: financial instrument or security?
  - Financial Market Infrastructure Act
  - Anti-Money Laundering Act (if payment instrument is issued)
  - Banking law (in case of public deposits)
  - Securities dealer regulations (if tokens qualify as securities such as derivatives)
  - Collective investment scheme regulations (if collected assets are managed externally)
  - Swiss Code of Obligations
The Investor invests...
- but not to the public without FINMA license!
- Ok. Then donator donates...
- but not without donation tax!
- Does not apply for my investors (donaters?)
- Can you prove where they come from?
- Anyway – then the donator receives tokens...
- Why? This triggers income tax... or even withholding tax at the level of the company?
- Ok, then let’s assume the purchaser purchases...
- but not without VAT .... And the company needs to pay income tax
- But it is a foundation
- Did you apply for tax exemption?...
Initial Coin Offering (ICO) (4/4)

Does it make sense in my case? Does it make sense at all?

- Timing and costs? It is neither fast nor cheap
- ICO to generate first customers? Maybe...
- ICO as poison pill for further financing rounds / future exit?
  - Massive cap table / tokenholders as interest holders
  - KYC
  - Compliance
  - Bank may terminate relationship or put company subject to tight/undue scrutiny!
- The traditional startup project
  - From an idea through hard work, financing rounds, pressure from investors etc. to an exit in several years
- The ICO project
  - How to become rich immediately based on a vague idea without commitment to further pursue the project and without control/ remedy by investors (or donators)
  - ICO as immediate exit transaction?
Initial Public Offering (IPO)

Description

- **Company lists its shares on stock exchange combined with public offering of new/existing ones**
- **Core rationale**
  - Access to capital market: growth financing (equity, bonds); and/or
  - Exit option for shareholders
- **Valuation typically > CHF 150M**
- **Listing vs. Public Offering**
- Listing on SIX Swiss Exchange, NASDAQ, NYSE, BX Swiss, others (e.g. Euronext)
- Example: AC Immune, CRISPR Therapeutics, ObsEva, Molecular Partners, Auris Medical, WISEKey, iQ Power Licensing AG
- **Note: IPO discount (approx. 10%), lock-up agreements, tight disclosure rules, usually only 1 share class (common share)**
- No real option for (early stage) startups
Key Take Aways
Key Take Aways

1. Each financing instrument has its own characteristics
2. Understand what you seek and what you get
3. Beware of commercial and legal traps
Last but not least (1/2)

When you look for financing…
Last but not least (2/2)
«…tell investors the truth…»

«The Theranos story is an important lesson for Silicon Valley,» [...]. «Innovators who seek to revolutionise and disrupt an industry must tell investors the truth about what their technology can do today, not just what they hope it might do someday.»

(SEC San Francisco office director Jina Choi, March 2018)
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