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# ZCHF and FPS token classification

## *Public summary*

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**Re:** Classification of ZCHF and FPS under the FINMA Guidelines and Swiss financial market law

**To:** Frankencoin Association (the "**Association**")

**From:** Christian Meisser and Andrin Hold, LEXR Law Switzerland AG ("**LEXR**")

**Date:** 14 August 2024

### 1 Introduction & disclaimer

The following is a short summary (the "**Summary**") of a memorandum drafted by LEXR for the Association regarding the classification and the regulatory consequences of such classification of the Frankencoin (the "**ZCHF**") and the Frankencoin Pool Share (the "**FPS**") tokens under Swiss financial market law as well as the interpretation thereof by the Swiss Financial Market Supervisory Authority ("**FINMA**"). Please take note of the following:

- **Legal uncertainty in DeFi:** There continues to be an elevated degree of regulatory uncertainty relating to decentralized financial (DeFi) applications, including the classification of tokens that are emitted based on a programmatic logic of such DeFi applications. As such, there is an elevated risk that FINMA and/or a competent Swiss court would come to a different conclusion.
- **No legal advice:** This Summary is not legal advice and the publication of this Summary does not in any way create a legal expectation by any reader to rely on this Summary. Neither LEXR nor the Association are in any way liable for any damages or costs you may incur out of or in connection with your use of this Summary.
- **Limited scope:** This Summary is limited to the regulatory classification of ZCHF and FPS under the FINMA Guidelines (as defined below) and Swiss financial market law.
- **Facts:** The Summary is based on the facts as they were made available on <https://www.frankencoin.com/> on the date of this Summary. Please refer to this website for further facts. Any changes in the facts may change the conclusions of this Summary.



## 2 Summary

### 2.1 ZCHF

**Key facts:** LEXR understands that the ZCHF are freely transferable ERC-20 tokens that are generated by a decentralized and oracle-free protocol (the "**Frankencoin System**") that is not centrally organized or controlled by anyone. The programmatic logic is such that the ZCHF are supposed to be pegged to the Swiss Franc. Users can mint ZCHF by depositing certain collateral in the Frankencoin System.

**Classification:** As per our analysis, the ZCHF qualifies as a **payment token and stablecoin** under the FINMA Guidelines<sup>1</sup> and not as a utility, asset, or security token, neither as per the FINMA Guidelines nor under Swiss financial market law, for the following reasons:

- **Payment token:** The ZCHF clearly fits the description of a payment token under the ICO Guidelines: Its primary function is that of money, specifically to provide a CHF pegged medium of exchange.
- **Stablecoin:** Also, as 1 ZCHF is intended to be pegged to 1 CHF, ZCHF classifies as a currency-linked stablecoin under the Stablecoin Guidelines.
- **No utility token:** It could be argued that ZCHF is intended to provide access to the Frankencoin System as, for example, a minimum of ZCHF 1'000 it is required to make a proposal. However, LEXR is of the view that the primary function of ZCHF, which is to function as money by maintaining the peg, significantly outweighs such ancillary access aspects.
- **No asset token:** The ZCHF neither (i) has a function analogous to an equity, bond, or derivative, nor (ii) enables physical assets to be traded on the blockchain. Additionally, ZCHF does not give rise to a claim against anyone – there is no issuer other than the code of the smart contracts executing the mint function in accordance with the programmatic logic.
- **No security token:** As the ZCHF (i) is not an asset token, (ii) is fully functional, and (iii) does not have any other investment purpose in the sense of a capital market instrument, the ZCHF does not qualify as a security under the FINMA Guidelines. Also, as the ZCHF does not reflect a legal claim, it lacks a basic characteristic required by the legal definition as per art. 2 let. b Swiss Financial Infrastructure Act ("**FinMIA**").

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<sup>1</sup> See FINMA, Guidelines for enquiries regarding the regulatory framework for initial coin offerings (ICOs), published on 16 February 2018 ("**ICO Guidelines**"), FINMA, Supplement to the guidelines for enquiries regarding the regulatory framework for initial coin offerings (ICOs), published on 11 September 2019 ("**Stablecoin Guidelines**"), and FINMA, Stablecoins: risks and challenges for issuers of stablecoins and banks providing guarantees, published on 26 July 2024 ("**Stablecoin Issuer Guidelines**") (together the "**FINMA Guidelines**").



**Regulatory consequences of classification:** Due to its classification as a payment token, the exchange of ZCHF against other currencies (incl. other payment tokens) on a professional basis is **subject to the Swiss Anti-Money Laundering Act**. However, the mere use of ZCHF as a means of payment for acquiring goods or services is generally not subject to Swiss financial market law.

## 2.2 FPS

**Key facts:** LEXR understands that the FPS are freely transferable ERC-20 tokens that are generated by the Frankencoin System. The programmatic logic of the Frankencoin System mints FPS to users that provide ZCHF into a reserve pool. In return for the risk that the ZCHF in the reserve pool may be required to maintain the peg of the ZCHF, the protocol adjusts the price of the FPS upwards as fees and proceeds from liquidations are generated. The FPS has no governance functionalities. The sole additional function is to vote on and veto the creation of new positions (i.e., accepted collateral types).

**Classification:** As per our analysis, the FPS most likely qualifies as a fully functional **utility token** under the FINMA Guidelines and not as a payment, asset, or security token, neither as per the FINMA Guidelines nor under Swiss financial market law.

- **No payment token:** FPS is not intended to be, nor is it designed to be, used now or in the future as a means of payment for acquiring goods or services or as a means of money or value transfer.
- **Utility token:** While there is no clear guidance by FINMA on tokens similar to the FPS, the FPS resembles a utility token most: The FPS is technically required to access the participation functions for the voting on and vetoing of positions and therefore provides access to certain features of the Frankencoin System.
- **No asset token:** The FPS neither (i) has a function analogous to an equity, bond, or derivative (see also next bullet point), nor (ii) enables physical assets to be traded on the blockchain. Additionally, the FPS does not give rise to a claim against an issuer or any other third party – there is no issuer other than the code of the smart contracts executing the mint function in accordance with the programmatic logic.
- **No security token under FINMA Guidelines:** The FPS (i) is not an asset token, and (ii) is fully functional. Also, the FPS does not have any other investment purpose in the sense of a capital market instrument that, under the technology neutral '*same risks same rules*' approach by FINMA, would make it a security in our view:
  - **Speculative nature not decisive / hope of price increase by the buyer not sufficient:** There are many tokens that are not considered securities even though many buyers will view such tokens as an investment with the hope of a future price increase, e.g., tokens representing a physical work of art as well as payment tokens



such as Bitcoin or Ethereum. The *'investment purpose'* in the view of the buyer or the speculative nature of the tokens itself is thus not enough for a classification as a security. The token also needs to have a relationship to the capital markets.

- **No 'capital markets' instrument:** FINMA's reasoning to not qualify payment tokens as securities is that they *'are not analogous in their function to traditional securities'*.<sup>2</sup> Reiterating the same point, the Federal Council states in the context of the securities definition for tokens that *'based on the purpose of [securities law], however, a relationship to the capital market is necessary'*.<sup>3</sup> There is no legal definition of 'traditional' securities or the 'capital markets'. However, a capital market is typically where a project obtains funding from investors, i.e., investors provide funds to a team/entity that then in return uses the funds for its business activity. Unlike a traditional capital market instrument such as bonds or equity, there is no transfer of money to a centralized team/entity when a user provides capital in the reserve pool to mint FPS. The ZCHF provided are simply locked in the reserve pool without access by anyone. Also, unlike many other DeFi projects, the FPS were never used to raise funds, neither to develop the Frankencoin System nor for any other purpose.
- **Different risks:** Also, the risks associated with FPS are materially different from traditional capital market instruments: The ZCHF locked in the reserve pool are locked and not used by any agent such as a manager with related principal-agent / information asymmetry risks (everyone can access all the same information via the blockchain). Also, the holders of FPS are not exposed to the credit/insolvency risk of a centralized counterparty.
- **DAO governance tokens:** There seems to be an unpublished practice by FINMA that DAO governance tokens which enable control over assets held in a smart contract might be considered securities, e.g., where the token holders can vote on the pay-out of the 'DAO treasury' to themselves. This is presumably based on the view that a DAO could be seen as a form of simple partnership and the DAO governance token as a share of such partnership. However, the FPS does not allow for the voting on the distribution of any funds whatsoever and in our view there is no other indication of a 'partnership' between FPS token holders.
- **Description not decisive:** While the FPS are called 'shares' and the website uses terms such as 'invest' and analogies to equity positions to illustrate the functioning of

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<sup>2</sup> See ICO Guidelines, section 3.2.1 and FINMA, Roundtable on ICOs, March 2018, p. 12.

<sup>3</sup> Bericht des Bundesrates: Rechtliche Grundlagen für Distributed Ledger-Technologie und Blockchain in der Schweiz - Eine Auslegeordnung mit Fokus auf dem Finanzsektor, 14 December 2018, section 6.2.3.

the FPS, the words chosen to describe a token do not automatically lead to the qualification of the token as such.

- **No security as per the legal definition:** As the FPS does not reflect a legal claim against anyone (also not against any other users, even if one were to follow FINMA's view that governance token holders in DAOs may form a partnership), it lacks the basic characteristic of a security required by the legal definition as per art. 2 let. b FinMIA. If tokens that do not reflect any claim against anyone should be regulated as securities in the future, it falls in the competence of the legislator to legislate accordingly.

**Regulatory consequences of classification:** As a utility token, the **use and exchange of FPS is not regulated under Swiss financial market law**. If the FPS were treated as a security, securities legislation would apply, most notably to persons selling the FPS or providing investment advice relating to the FPS (e.g., brokers, exchanges, financial advisors).

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