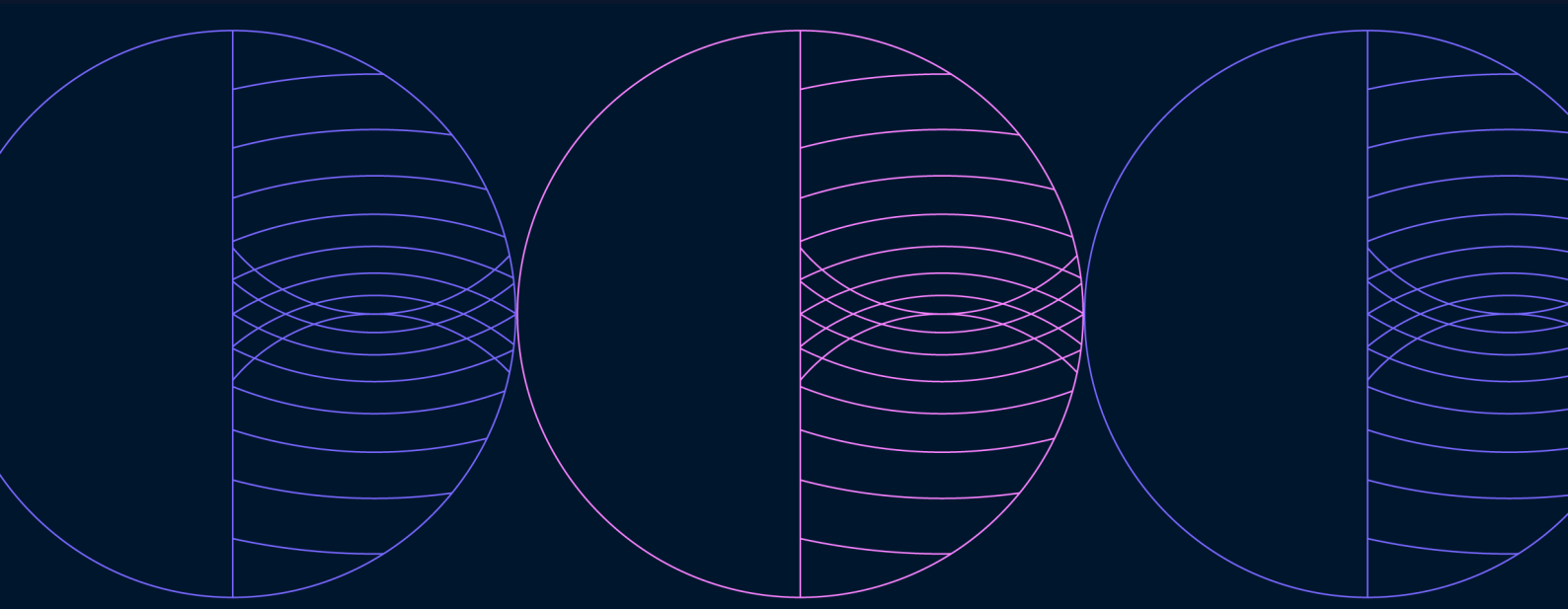
IN-HOUSE VIEW

Legal Technology

REGULATION AND LICENSING OF CRYPTO CUSTODIANS IN SWITZERLAND



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This In-House View: Legal Technology analyses the implications for the legal profession of emerging disruptive technologies, including the transformative power of artificial intelligence, machine learning and the regulation of crypto custodians.

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Regulation and Licensing of Crypto Custodians in Switzerland

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Summary

INTRODUCTION
REGULATION OF CRYPTO CUSTODIANS

Introduction

Applicable laws

Switzerland has not enacted specific legislation governing the provision of custody services for crypto assets. As a result, Swiss financial market laws applicable to custody services for traditional financial assets may also apply to custody services (and related services such as brokerage services) for crypto assets. These laws include, without limitation:

- the Swiss Banking Act of 8 November 1934 (the Banking Act);
- the Swiss Financial Institutions Act of 15 June 2018 (the Financial Institutions Act);
- the Swiss Financial Services Act of 15 June 2018 (the Financial Services Act);
- the Swiss Financial Market Infrastructure Act of 19 June 2015 (the Financial Market Infrastructure Act); and
- the Swiss Anti-Money Laundering Act of 10 October 1997 (the Anti-Money Laundering Act).

That said, Switzerland adopted the Federal Act on the Adaptation of Federal Law to Developments in Distributed Ledger Technology (the DLT Act), which came into force in 2021. The DLT Act introduced various amendments to Swiss laws to take account of the potential offered by distributed ledger technology (DLT).

Notably, the Banking Act and the Swiss Federal Act on Debt Enforcement and Bankruptcy of 11 April 1889 (the Debt Enforcement and Bankruptcy Act) were amended to clarify the conditions for the segregation of crypto assets in the event of a crypto custodian's bankruptcy. These amendments enhance Switzerland's appeal as a jurisdiction for the safekeeping of crypto assets.

Notion of cryptoassets

There is no universally accepted definition of the term ‘crypto assets’. For the purposes of this publication, crypto assets are defined as any type of financial assets, whether natively digital or digitised, registered on a blockchain or another digital, distributed and encryption-based ledger or based on similar technology, including, without limitation, cryptocurrencies as well as digital assets that qualify as or represent securities or other financial instruments.

In this publication, we primarily use the term crypto assets, although we may also refer to them as ‘tokens’ or ‘digital assets’. Unless stated otherwise, these terms are intended to have the same meaning.

Regulatory classification of cryptoassets

In 2018, the Swiss Financial Market Supervisory Authority (FINMA) issued guidance on the regulatory classification of crypto assets (referred to as 'tokens' by FINMA) in its Guidelines on initial coin offerings (the ICO Guidelines).

FINMA identifies three categories of tokens:

- payment tokens, which are intended solely as a means of payment, without granting any claims against an issuer. Bitcoin is an example of a payment token;
- utility tokens, which provide rights to access or use a digital application or service, provided that the application or service is already operational at the time of the token sale; and
- asset tokens, which represent an asset (eg, a debt or equity claim against the issuer or a third party) or a right in an underlying asset.

FINMA has further clarified that tokens can take a hybrid form, incorporating elements from more than one category. These hybrid tokens must comply with the regulatory requirements applicable to each relevant token category. FINMA acknowledges that a token's classification may change over time.

In 2019, FINMA issued supplementary guidance on the regulatory classification of stable tokens (ie, tokens backed by an underlying asset such as a pool of fiat currencies or other assets) in a supplement to the ICO Guidelines. FINMA clarified that stable tokens are not considered a separate type of token category under Swiss regulation. Instead, their classification depends on the rights attached to them, with most stable tokens falling under asset tokens or a hybrid of payment tokens and asset tokens.

Under Swiss law, payment tokens do not qualify as legal tender or official means of payment. However, the Swiss Federal Council has clarified that payment tokens may be used as private means of payment if the parties to a transaction agree on the use of payment tokens as the applicable means of payment for such a transaction.

Notions of custody and crypto custodians

The custody of digital assets generally refers to the generation, management and safekeeping of electronic data, including in particular private keys, seeds and passwords, that enable access to, and control over, public addresses on the blockchain.

In this publication, we use the term 'crypto custodians' to refer to custody service providers that have exclusive possession of the private keys or equivalent security elements, thereby having direct control over the crypto assets entrusted to them. Consequently, this definition excludes providers of non-custodial wallet solutions, which do not have access to private keys or equivalent security elements.

While a distinction can be drawn between custodial wallet providers that exercise exclusive over entrusted crypto assets and non-custodial wallet providers, other custody models also exist. For instance, certain custody service providers may only have partial control over the private keys or equivalent security elements (eg, multi-signature schemes and custody solutions using multiparty computation technology). We will not examine these alternative custody models in this article.

Self-custody v sub-custody

Crypto custody typically follows two main approaches. Pursuant to the first approach, the crypto custodian retains direct control over private keys or equivalent security elements using its own custody solution, either developed in-house or licensed from a third-party vendor (the self-custody model). According to the second approach, the crypto custodian relies on another sub-custodian, which holds the private keys or equivalent security elements on its behalf (the sub-custody model).

Regulation of crypto custodians

Generalities

The activities of Swiss-based crypto custodians may be regulated by different Swiss financial market laws, with various licensing requirements depending on several factors, including without limitation the type of custody model chosen by the crypto custodian as well as the type of crypto assets held in custody. It is therefore necessary to examine the main characteristics of the business model adopted by the crypto custodian in order to determine which Swiss financial market laws, if any, apply. In many cases, it is advisable to seek a regulatory assessment by FINMA before commencing the custody activities.

It is worth noting that providers of non-custodial wallet solutions generally are not subject to any licensing requirement or other regulatory requirements, as long as they do not have any control over the private keys or other equivalent security elements.

We will discuss below some of the key regulatory requirements that may apply to crypto custodians depending on their business model. However, this is by no means an exhaustive presentation and other regulatory requirements may be applicable depending on the specifics of the business model followed.

Licence requirements

Banking licence

According to the Banking Act, a banking licence requirement is generally triggered if a company conducting primarily a financial activity accepts on a professional basis deposits from the public (ie, from more than 20 persons) or publicly advertises this activity. According to the Swiss Banking Ordinance (the Banking Ordinance), entering into any liabilities would generally qualify as a deposit-taking activity, unless one of the exceptions defined in article 5 paragraphs 2 and 3 of the Banking Ordinance applies.

With respect to crypto custodians, article 1a paragraph 2 of the Banking Act specifies that a banking licence is required if, cumulatively, the crypto custodian (1) accepts 'crypto assets defined by the Federal Council' in deposit, or publicly advertises to obtain such crypto assets, and (2) invests or remunerates these crypto assets.

The notion of 'crypto assets defined by the Federal Council' refers to crypto assets held in collective custody in accordance with article 16 paragraph 1-bis letter b of the Banking Act and that are used to a large extent, either actually or according to the intention of the organiser or the issuer, as a means of payment for the acquisition of goods or services, or

which are used for the transmission of funds or values (article 5a paragraph 1 of the Banking Ordinance). Article 16 paragraph 1-bis letter b of the Banking Act refers to crypto assets that the bank has undertaken to keep available for the depositing client at all times and that are allocated to a community and the depositing client's share is clearly determined.

It follows from the above that crypto custodians must generally have a banking licence to provide their custody services if the following cumulative conditions are met:

- they provide custody services to more than 20 clients or publicly advertise such services;
- they hold the crypto assets in collective custody (no segregation, see 'Exemptions' below);
- the crypto assets have a payment purpose (eg, cryptocurrencies); and
- they pay interest on the deposited crypto assets or reinvest them.

A detailed description of the conditions for obtaining a banking licence would exceed the scope of this article. It can nevertheless be mentioned that Swiss banks generally have to meet the following licensing conditions.

- Legal form: the Banking Act does not provide for any special rules regarding the legal form of banks, with the exception of the cantonal banks that are established as public entities or joint-stock corporations under the relevant legislation of the canton pursuant to article 3a of the Banking Act.
- Minimum capital: the bank must have a fully paid-up minimum capital of 10 million Swiss francs (article 3 paragraph 2 letter b of the Banking Act and article 15 of the Banking Ordinance).
- Business activity description: in accordance with article 3 paragraph 2 letter a of the Banking Act and article 9 of the Banking Ordinance, a bank is obliged to precisely define its business area in the articles of association and organisational regulations in terms of subject matter and area of operation. The scope of tasks and the geographical area of operation must be aligned with the financial possibilities and the administrative organisation.
- Organisation: article 3 paragraph 2 letter a of the Banking Act requires that separate bodies must be set up for management and for the supervision and control of at least three members. According to article 11 of the Banking Ordinance, no member of the body responsible for the overall supervision and control may be a member of the management. In accordance with article 12 of the Banking Ordinance, the bank must also ensure an internal separation of functions between trading, asset management and settlement.
- Internal controls: the bank must set up an internal control system and appoint an 'internal audit' function that is independent from the management, in addition to appointing external auditors.
- Fit and proper requirements: members of the management and the material shareholders (ie, shareholders holding at least 10 per cent of the capital or voting rights) must meet the relevant fit and proper requirements.
- Operation in Switzerland: the bank must be managed in Switzerland, with the management being present in Switzerland.

- Foreign-controlled banks: if a foreign shareholder holds at least 50 per cent of the capital or voting rights or otherwise exercises control, FINMA may require the relevant jurisdiction to grant reciprocity.
- Consolidated supervision: if the bank is part of a foreign-controlled financial group, FINMA may require that it is subject to appropriate consolidated supervision by foreign supervisory authorities (article 3b of the Banking Act), and the licence may be subject to the approval of the relevant foreign supervisory authority. Not all jurisdictions meet the requirement of 'adequate consolidated supervision' within the meaning of the Banking Act.

It should be mentioned that pursuant to article 4-sexies of the Banking Act, FINMA may, on a case-by-case basis, limit a bank's ability to accept crypto assets on deposit to a maximum amount, depending in particular on the risk generated by this activity.

Fintech licence

Pursuant to article 1b paragraph 1 of the Banking Act, the fintech licence, which is a type of banking licence with relaxed requirements, is applicable to companies that either accept deposits from the public up to a maximum of 100 million Swiss francs or 'crypto assets defined by the Federal Council' (irrespective of the amount) or publicly advertises such activity, provided in both cases that the deposits or crypto assets are not invested and not interest-bearing.

The notion of 'crypto assets defined by the Federal Council' has the same meaning as the one defined in the 'Banking licence' section above; that is, it refers to crypto assets that serve a payment purpose (eg, cryptocurrencies) and that are held in collective custody. In addition, crypto custodians must have undertaken to keep the crypto assets available for the depositing client at all times and the depositing client's share in the crypto assets held in custody must be clearly determined. If these conditions are not fulfilled, the crypto assets shall be treated as public deposits, and the licensing requirements corresponding to the acceptance of public deposits should be applied (Commentary published by the Federal Council on 18 June 2021 in connection with the amendment of the Banking Ordinance, page 17).

It follows from the above that crypto custodians must generally have a fintech licence to provide their custody services if the following cumulative conditions are met:

- they provide custody services to more than 20 clients or publicly advertise such services;
- they hold the crypto assets in collective custody (no segregation, see 'Exemptions' below), and the conditions set forth in article 16 paragraph 1-bis letter b BA are fulfilled (if the conditions are not fulfilled, a banking licence is generally required);
- the crypto assets have a payment purpose (eg, cryptocurrencies); and
- they do not pay interest on the deposited crypto assets nor reinvest them (if they pay interest or reinvest the crypto assets, a banking licence is generally required).

The fintech licence requires investors to be informed in advance about the business model, the services provided and the risks associated with the technologies used, that the

deposits are not covered by a deposit protection system and that there is no immediate reimbursement in the case of bankruptcy (article 7a of the Banking Ordinance).

A detailed description of the conditions for obtaining a fintech licence would exceed the scope of this article. It can nevertheless be mentioned that the following licensing conditions should generally be met.

- Legal form: the company must be established as a joint-stock corporation, a partnership limited by shares or a limited liability company.
- Minimum capital: the company must have a fully paid-up minimum capital of at least 3 per cent of the deposits or of the crypto assets it has taken in deposit; such capital must be at least 300,000 Swiss francs (article 17a of the Banking Ordinance).
- Business activity description: the company is obliged to precisely define its business area in the articles of association and organisational regulations in terms of subject matter and area of operation. The scope of tasks and the geographical area of operation must be aligned with the financial possibilities and the administrative organisation (article 14b of the Banking Ordinance).
- Organisation: separate bodies must be set up for management and for the supervision and control of at least three members. According to article 14d paragraph 2 of the Banking Ordinance, at least one-third of the members of the body responsible for the overall supervision and control must be independent from the management.
- Internal controls: the company must set up an internal control system and appoint an 'internal audit' function that is independent from the management, in addition to appointing external auditors.
- Fit and proper requirements: members of the management and the material shareholders (ie, shareholders holding at least 10 per cent of the capital or voting rights) must meet the relevant fit and proper requirements.
- Operation in Switzerland: the company must be managed in Switzerland, with the management being present in Switzerland (article 14c of the Banking Ordinance).

Deposits in the form of crypto assets have to be held in the same type of crypto assets (ie, the same cryptocurrency or the same tokens) as they were accepted from the clients (article 14f paragraph 4 letter b of the Banking Ordinance). Subject to a possible exemption granted by FINMA, the crypto assets must be held in Switzerland (article 14f paragraph 4 letter a and paragraph 5 of the Banking Ordinance).

Exemptions

If the crypto custodian does not hold the crypto assets in collective custody but instead stores the crypto assets on a segregated basis in individual blockchain addresses for each of its clients, then neither a banking licence nor a fintech licence is required, provided that the crypto custodian keeps the crypto assets available for its clients at all times, which means in particular that the crypto custodian cannot use the crypto assets held in deposit for operations that would prevent the return of the crypto assets to the client.

Further, if the crypto custodian exclusively holds utility tokens or asset tokens as opposed to payment tokens, then generally neither a banking licence nor a fintech licence is required. The rationale behind this distinction between payment tokens on the one hand, and utility tokens and asset tokens on the other, resides in the fact that payment tokens have certain features that are similar to fiat money. Given that a deposit-taking activity in connection with fiat money in principle requires a banking licence, the Federal Council considers that it is justified to require custodians of payment tokens to also obtain a banking licence or fintech licence (provided that the payment tokens are held in collective custody). On the contrary, the Federal Council considers that the risk of loss is less important for utility tokens, which provide rights to access or use a digital application or service, and for asset tokens, which, from an economic standpoint, have features similar to equities, bonds or derivative products.

In Switzerland, the depositor protection scheme protects clients who deposit fiat money at a Swiss bank against loss in case of the bank's bankruptcy up to the amount of 100,000 Swiss francs. However, clients depositing crypto assets with Swiss crypto custodians are not protected by the depositor protection scheme. For the Federal Council, this is another reason for requiring the licensing of crypto custodians that hold payment tokens in collective custody.

Further, pursuant to article 5a paragraph 2 of the Banking Ordinance, the following crypto assets are not deemed to be 'crypto assets defined by the Federal Council':

- crypto assets that are held in non-interest-bearing client accounts and are used solely to execute client transactions with either (1) precious metal dealers, portfolio managers or similar companies, provided that the execution of the transactions takes place within 60 days or (2) with securities firm or trading systems which are based on the DLT;
- crypto assets that are deposited by Swiss or foreign banks or other companies subject to state supervision; and
- crypto assets that are deposited by institutional investors whose treasury operations are professionally managed.

The custody of the above-listed crypto assets generally does not trigger the need to obtain a banking licence or a fintech licence.

In addition, crypto custodians are not deemed to act in a professional capacity and therefore do not have to obtain a banking licence even if they provide custody services to more than 20 clients or publicly advertise such services, provided that they meet the following requirements:

- the crypto assets have a total value of a maximum of 1 million Swiss francs;
- they do not operate in the interest rate differential business; and
- they inform the depositors in written form or any other form that can be proved by text before the latter make the deposit that (1) they are not supervised by FINMA and (2) the deposits are not covered by the depositor protection scheme.

The above-mentioned exemption is known as the 'sandbox regime', which allows companies, including fintech startups, to test their business models in the market on a small scale without the need to obtain a licence from FINMA.

Authorisation as a securities firm

According to article 2 letter b and b-bis of the Financial Market Infrastructure Act, securities are certificated or uncertificated securities, derivatives, intermediated securities or DLT rights, which are standardised and suitable for mass trading. According to article 2 paragraph 1 of the Financial Market Infrastructure Ordinance, standardised and suitable for mass training means, in this context, that the instruments are offered for sale publicly in the same structure and denomination, or that they are placed with more than 20 clients under identical conditions.

FINMA has specified in the ICO Guidelines that it applies the following rules in connection with the classification of tokens as securities.

- Payment tokens do not qualify as securities given that they are designed to be used as means of payment according to FINMA. Payment tokens cannot fall under the definition of securities as they do not represent any rights that are exercisable against the issuer or third parties.
- Utility tokens may qualify as securities if the platform where they can be used is not operationally ready at the time of the token sale, or if the tokens represent rights that may be enforced against the issuer or a third party.
- Asset tokens qualify as securities provided that they have been offered publicly or to more than 20 persons for sale under identical conditions.

Pursuant to article 41 of the Financial Institutions Act, a securities firm is an entity that, on a commercial basis, either:

- trades in securities in its own name for the account of clients;
- trades in securities for its own account on a short-term basis, operates primarily on the financial market and either (1) could jeopardise the proper functioning of the financial market, (2) is a member of a trading venue, or (3) operates as an organised trading facility under article 42 of the Financial Market Infrastructure Act; or
- trades in securities for its own account on a short-term basis and publicly quotes prices for individual securities upon request or on an ongoing basis (market maker).

While securities firms may act as custodians of clients' securities (article 44 paragraph 1 letter b of the Financial Institutions Act), the mere custody of clients' securities does not trigger a requirement to obtain an authorisation as a securities firm. As a consequence, crypto custodians that exclusively provide custody services in connection with crypto assets that qualify as securities (eg, assets tokens and in certain cases, utility tokens) do not need to be authorised as a securities firm. As indicated in 'Exemptions' above, they do not need to obtain a banking licence or a fintech licence.

That being said, if the crypto custodians provide not only custody services but are also involved in the trading of the crypto assets on behalf of their clients, they must generally be authorised as a securities firm if the crypto assets qualify as securities.

Anti-Money Laundering Act

Under Swiss law, AML regulation consists of the Swiss Anti-Money Laundering Act and the Anti-Money Laundering Ordinance. The Anti-Money Laundering Act applies, inter alia, to financial intermediaries. In short, in addition to entities subject to prudential supervision, anyone accepting, holding or depositing assets belonging to other persons or assisting in the investment of such assets on a professional basis qualifies as a financial intermediary according to article 2 paragraph 3 of the Anti-Money Laundering Act. Further, the Act contains a non-exhaustive list of activities that are considered financial intermediation.

A financial intermediary carries out its activity on a professional basis if it:

- derives gross proceeds of more than 50,000 Swiss francs during a calendar year;
- establishes business relationships not limited to a single activity with more than 20 contracting parties during a calendar year or maintains at least 20 such relationships during a calendar year;
- has unlimited power of disposal over assets belonging to third parties in excess of 5 million Swiss francs at any one time; or
- carries out transactions with a total volume of more than 2 million Swiss francs in a calendar year.

A financial intermediary within the meaning of the Anti-Money Laundering Act must be affiliated with an authorised AML self-regulatory organisation (SRO). Further, a financial intermediary must comply with the obligations defined in the Anti-Money Laundering Act, including, without limitation, identification and know-your-customer (KYC) obligations relating to the contracting party and its beneficial owner, and must file reports to the Money Laundering Reporting Office Switzerland in cases of suspected money laundering or terrorism financing.

In the FINMA Guidance 02/2019 on payments on the blockchain dated 26 August 2019, FINMA specified that financial intermediaries supervised by FINMA must comply with the travel rule for blockchain transactions. This also applies to other financial intermediaries for AML purposes, as a result of their SRO affiliation.

Under the travel rule, the relevant Swiss financial intermediary has to transmit the same information as required for wire transfers in fiat money or, alternatively, it must:

- identify the transferee in accordance with the Swiss AML rules as if the transferee was a client of the Swiss financial intermediary; and
- verify the transferee's power to dispose of the wallet address used by it through appropriate technical measures as defined by the relevant Swiss financial intermediary.

Crypto custodians qualify as financial intermediaries if (1) they act on a professional basis and (2) they have the power to dispose of the private keys or equivalent security elements of the stored crypto assets.

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