

Hong Kong Securities and Futures Commission's Statement on Initial Coin Offerings: Regulating Virtual Tokens within the Existing Regulatory Regimes

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1. Summary

With the emerging trend of using initial coin offerings (ICO) to raise funds in Hong Kong and internationally, the Securities and Futures Commission (SFC) recently issued a [statement](#) on how they are regulated under the securities laws of Hong Kong (**SFC Statement**).

In short, whether a digital token will be regulated as a “security” under the Securities and Futures Ordinance (SFO) will depend on the features of the token. A virtual currency is itself not regulated as a security, but where it has additional features that could characterise it as a share, a debenture or an interest in a collective investment scheme (CIS) (see section 3 below for what these features may be), it may fall within the securities regime and be subject to a higher degree of restrictions or regulation.

Where the tokens offered are treated as securities and the ICO targets the Hong Kong public, any parties - no matter where they are located - dealing in or advising on the tokens will, unless an exemption applies, require a licence from the SFC. A document that offers, to the public in Hong Kong, tokens which are considered shares, debentures or interests in a CIS may also need to be authorised or registered. It may be possible to structure an ICO to avoid these licensing or registration requirements but restrictions will apply (such as the number and type of investors the ICO can target).

The SFC has also taken the opportunity to remind investors of the potential pitfalls of an ICO, which poses heightened risks for fraud, money laundering and terrorist financing.

2. Background

Virtual currencies and tokens are created and often disseminated through blockchain technology. Some businesses (typically “virtual organisations” that are embodied in computer code and executed on a blockchain) have been using ICOs as a means to raise funds by issuing digital tokens in return for fiat currency (e.g. US dollars) or an established virtual currency (e.g. Bitcoin). The funds raised may be used to develop a digital project, with the token holders granted rights to access, use, program or develop features for the project. Recently, some businesses have led investors to expect a return on their investment or have granted other rights such as the right to share in any returns provided by the project. The digital tokens may also be sold by investors in the secondary market on cryptocurrency exchanges.

Until recently, parties involved in ICOs believed they were operating in a regulatory “grey” space. Now regulators across the globe have turned their attention to ICOs, with most making it clear that some tokens may (depending on their features) constitute regulated securities. This approach has been adopted by the SFC, as well as the regulators in the [US](#) and [Singapore](#). [China](#), on the other hand, has issued a blanket ban on ICOs.

3. Hong Kong Regulatory Regime

The SFC Statement clarifies that a digital token offered in typical ICOs is usually characterised as a “virtual commodity” which is not a regulated security. However, not all digital tokens function merely as a virtual currency. Where the digital tokens offered in an ICO:

- represent equity or ownership interests in a corporation (such as the right to receive dividends or participate in the distribution of surplus assets upon winding up), these tokens may be regarded as “shares” under the SFO;
- are used to create or acknowledge a debt or liability owed by the issuer (such as the right for the investor to be repaid principal of their investment on a specified date or upon redemption, with interest), they may be considered as “debentures” under the SFO; or
- raise proceeds that are managed collectively by the ICO scheme operator to invest in projects with an aim to enable token holders to participate in a share of the returns provided by the projects, the digital tokens may be regarded as interests in a CIS.

Shares, debentures and interests in a CIS are all regulated as securities under the SFO. The consequences of a digital token being considered a “security” (we will refer to such security as a “Digital Security” in this briefing) could include the following:

- any party conducting “regulated activities” in relation to Digital Securities will, unless an exemption applies, require a licence from the SFC if they either (directly or via an agent) carry on the activity in Hong Kong or are marketing the ICO to the public in Hong Kong. Note that even if issuers and intermediaries involved in the ICO are located outside Hong Kong, the licensing

requirement may apply if such regulated activities target the Hong Kong public.

The scope of regulated activities includes making an agreement with, or attempting to induce, another person to enter into an agreement to acquire the Digital Securities, advising on whether to invest in the Digital Securities, and managing or marketing a fund investing in such Digital Securities;

- an issue of an advertisement or offering document (such as the white paper that often accompanies an ICO) to the public of Hong Kong to acquire a Digital Security is subject to authorisation by the SFC unless an exemption applies;
- in the case of a Digital Security which is considered a “share” or “debenture” under Hong Kong companies law, the prospectus regime may apply - this applies to both shares and debentures of companies incorporated in and outside Hong Kong. Any document that offers, to the public in Hong Kong, tokens which are considered shares or debentures will need to contain specified content and be registered with the Hong Kong Companies Registry unless an exemption applies;
- parties engaging in the secondary trading of Digital Securities (such as on cryptocurrency exchanges) may also be subject to the SFC’s licensing and conduct requirements as the on-sale of Digital Securities may be a regulated activity under the SFO; and
- certain requirements relating to automated trading services and recognised exchange companies may be applicable to the business activities of cryptocurrency exchanges.

It may be possible to structure an ICO to avoid the licensing and registration requirements that are applicable to an issuer or intermediary of an

ICO. Exemptions may include an offer to no more than 50 persons in Hong Kong and/or to professional investors. The terms and features of each ICO will need to be considered to analyse whether the digital token is likely to be classified as a Digital Security and if so, what exemptions may be available.

4. Conclusion

The SFC Statement gives a warning to all parties involved in the issuing, facilitating, investing and trading of digital tokens to consider the legal and regulatory requirements that may apply. The statement clarifies that not all digital tokens are necessarily securities, but where the tokens are, in substance, a share, debenture or interest in a CIS and are being offered to the Hong Kong public, the securities and prospectus regimes in Hong Kong will need to be considered. Given the potential criminal liabilities (including imprisonment) for breaches of the relevant sections of the SFO, parties involved in ICOs

cannot simply treat this as a “grey area” of law and should consider obtaining regulatory advice when planning or developing ICOs and virtual token projects going forward.

The approach taken by the SFC follows the approaches adopted by the US and Singapore regulators and (with the key exception of Mainland China which has banned ICOs) shows an emergence of a global consensus on how to regulate ICOs. Companies and exchanges operating in the digital token arena, which have been used to the unregulated nature of ICOs and virtual tokens, will likely find their regulatory environment increasingly challenging. It will be interesting to see whether the Hong Kong regulators will develop a new regime to regulate ICOs and virtual tokens in totality instead of trying to fit them into the existing securities and prospectus regimes (which were obviously not designed from the ground up to cater for ICOs and virtual tokens).



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