

REGULATORS AROUND THE WORLD BECOME MORE VOCAL REGARDING THE POTENTIAL RISKS ASSOCIATED WITH ICOS

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Legal Briefings

The rapid rise of initial coin offerings (**ICOs**) this year has prompted heightened scrutiny by regulators globally. On 4 September 2017, seven major regulators governing the finance and technology sectors in China (collectively, the **Chinese Regulators**), jointly published an announcement prohibiting ICOs in China.

The following day, the Hong Kong Securities and Futures Commission (**SFC**) also made a statement on existing regulations which could be applicable to ICOs and explained that digital tokens may be “securities” as defined in the *Securities and Futures Ordinance* (**SFO**), and accordingly subject to the securities laws of Hong Kong. The SFC also warned investors of the potential risks of ICOs.

The announcement by the Chinese Regulators and the statement by the SFC follow similar clarifications and announcements by regulators in the [US](#), [Canada](#), [Singapore](#), [Malaysia](#), [Thailand](#) and [Dubai](#), among other jurisdictions, about their respective positions on ICOs. To date, the Chinese Regulators have been the only ones to issue an outright ban. You can read our e-bulletin on the Monetary Authority of Singapore’s position [here](#).

The UK Financial Conduct Authority also issued a [consumer warning](#) on 12 September 2017 stating that “ICOs are very high-risk speculative investments” and investors “should only invest in an ICO project if [they] are an experienced investor, confident in the quality of the ICO project itself (eg, business plan, technology, people involved) and prepared to lose [their] entire stake”.

In this e-bulletin we highlight the key points in the announcement by the Chinese Regulators and the statement by the SFC and set out our observations on the future of ICOs.

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BACKGROUND

ICOs are essentially a means of crowdfunding by distributing (using distributed ledger or blockchain technology) digital tokens (cryptographically-secured representations of a token-holder's right to receive a benefit or perform specified functions) in exchange for convertible virtual currencies such as bitcoins. They may be structured in many ways with different business propositions. For example, they may seek to develop a new digital platform, while others may offer an opportunity to invest in property, business and assets, or with a promise of certain benefits or monetary returns.

While the first token sale (Mastercoin) occurred in 2013, followed by the first ICO (Karmacoin) in 2014, it was not until earlier this year that the popularity of ICOs increased significantly. As of July 2017, 65 ICOs had been completed in China, and the funds raised through these projects totalled over RMB 2.6 billion (around US\$400 million). Worldwide, approximately 148 ICOs have raised over US\$2.2 billion in 2017 to date compared to 46 ICOs in 2016 which raised approximately US\$96 million (*source: coinschedule.com*).

Amid this surge in popularity, various regulators have stepped in to clarify their respective positions on digital tokens and ICOs. Depending on the specific facts and circumstances, they may be caught by existing securities regulation in some jurisdictions and they potentially give rise to an increased risk of capital loss, financial risk and crimes such as fraud, illegal fundraising and money laundering. The Chinese government is also concerned that Chinese investors have been moving yuan out of China using ICOs and bitcoins in a bid to circumvent the strict rules that limit capital outflows from China.

ANNOUNCEMENT BY THE CHINESE REGULATORS

The key points from the announcement by the Chinese Regulators are as follows:

I. Nature of ICOs

The announcement defines ICOs as illegal public fundraising without authorisation, which could involve illegal and criminal activities such as the illegal sale of alternatives to legal tender, illegal securities issuance, illegal fund raising, financial fraud and pyramid selling.

II. Complete ban on ICOs

Due to the illegality of ICOs, the announcement declares a complete ban on ICOs. In this regard, the announcement provides that no person or organisation shall undertake any types of ICOs and the funds already raised by completed ICO projects shall be refunded to investors.

III. Regulations on digital token trading platforms and financial institutions

According to the announcement, no digital token trading platforms shall engage in exchange between legal currency, digital tokens and virtual currencies, or purchase or sell digital tokens or virtual currencies, or act as a central counter party, or provide intermediary services. Any websites or mobile apps found to be violating the ban will be closed down by telecommunication authorities.

In addition, neither financial institutions nor non-bank payment process agencies shall directly or indirectly provide account opening, registration, transaction, liquidation or settlement services for the purposes of ICOs and virtual currencies. Insurance services covering digital tokens and virtual currencies are also prohibited.

Following the Chinese Regulators' announcement, the price of Bitcoin [plunged](#) 41% from a record high above US\$5,000 at the beginning of September to a low of US\$2,951 on 15 September 2017, according to Coindesk. In addition, three of the largest bitcoin exchanges in China have all [announced](#) that they have or will cease trading.

While China has not officially moved to banning bitcoin mining or peer to peer bitcoin platforms, it was [reported](#) by the Wall Street Journal on 18 September 2017 that a broader clampdown may be in the pipeline, which may include a shutdown of bitcoin platforms, the shutdown of Chinese mining companies and pools, and the blocking of mainland access to websites of foreign bitcoin exchanges. There have also been other [reports](#) from Chinese financial news outlets that the Chinese Regulators plan to shut down the country's bitcoin exchanges by the end of September.

STATEMENT ISSUED BY THE SFC

The key points from the statement issued by the SFC are as follows:

I. Offering of securities

The statement explains that digital tokens offered in typical ICOs are usually characterised as a “virtual commodity”. However, depending on the facts and circumstances of an ICO, the digital tokens that are offered or sold may be “securities” (as defined in the SFO), and therefore subject to the securities laws of Hong Kong, if:

the digital tokens represent equity or ownership interests in a corporation (in which case they are likely to be shares). For example, where token-holders are given shareholders’ rights, such as the right to receive dividends and the right to participate in the distribution of the corporation’s surplus assets upon winding up;

the digital tokens are used to create or to acknowledge a debt or liability owed by the issuer (in which case they are likely to be debentures). For example, where an issuer may repay token-holders the principal of their investment on a fixed date or upon redemption, with interest; or

the digital token proceeds 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 project (in which case they are likely to be interests in a collective investment scheme (CIS)). For example, where token proceeds 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 project.

Shares, debentures and interests in a CIS generally fall under the definition of “securities” in the SFO.

II. Engaging in regulated activity

The statement includes a reminder that parties engaging in regulated activity, including dealing in or advising on digital tokens that fall under the SFO definition of “securities” or managing or marketing a fund investing in such tokens, are required to be licensed by or registered with the SFC irrespective of whether the parties involved are located in Hong Kong, so long as such business activities target the Hong Kong public.

The statement also provides that unless an exemption applies, the prospectus registration regime under the Companies (Winding Up and Miscellaneous Provisions) Ordinance or the CIS authorisation regime under the SFO may also apply if the ICO involves an offer to the public of Hong Kong to acquire digital tokens that may be regarded as shares or debentures, or interests in a CIS.

Secondary trading of digital tokens that fall under the definition of “securities” (eg, on cryptocurrency exchanges) and the business activities of cryptocurrency exchanges themselves may also be caught by existing regulation.

III. Cautionary statement

The statement reminds parties engaging in ICO activities to seek legal or other professional advice if they are in any doubt about the applicable legal and regulatory requirements. SFC licensed corporations and associated entities are also reminded to take all reasonable measures to ensure that proper safeguards exist to mitigate the risk of money laundering and terrorist financing.

Finally, the statement warns investors that they may be exposed to heightened risk of fraud given ICOs and investment arrangements involving digital tokens, and the parties involved, operate online and may not be regulated.

OUR OBSERVATIONS ON THE FUTURE OF ICOS

The rapid rise of ICOs in 2017 brings with it an increased risk of capital loss, financial risk and crimes such as fraud, illegal fundraising, money-laundering and illegal capital movements as referred to above. Regulators are understandably keen to keep such threats to the integrity of financial markets, the investing public and social stability under control (to the extent that their jurisdictions allow).

As such, we can expect that regulators in most jurisdictions will keep a close eye on ICOs going to market (other than in China where a complete ban will be enforced for the time-being) in order to determine on a case-by-case basis whether they may be caught by existing securities regulation. We can also expect enforcement action by some regulators in respect of already completed ICOs where the digital tokens involved were clearly “securities” and relevant securities regulation was not complied with.

Amid this heightened regulatory scrutiny, parties involved in ICOs will likely continue to organise their ICO projects in “ICO-friendly” jurisdictions such as Singapore, Hong Kong and Switzerland and restrict residents from the US and China from participating. Even closer attention will be paid by those structuring ICOs to ensure that the digital tokens do not exhibit any of the characteristics akin to “securities” so as not to fall within the jurisdiction of securities regulators.

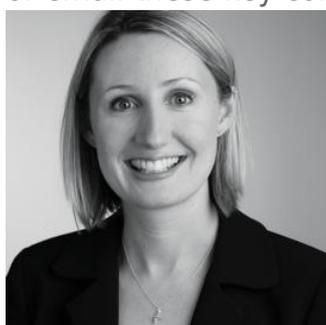
China’s ban on ICOs may turn out to be temporary. However, if it is lifted, we can expect to see a tightening of existing regulation and the introduction of new regulation, which may even require ICOs to be individually approved. Many other regulators will likely follow suit by strengthening their regulation of ICOs and, in particular, domestic trading of digital currencies and reporting of suspicious transactions.

While many ICOs will effectively remain unregulated and outside of the reach of securities regulators, regulatory scrutiny is increasing and parties involved in ICOs should expect to have to prove that the digital tokens involved in the ICO are not “securities”, which may not always be easy.

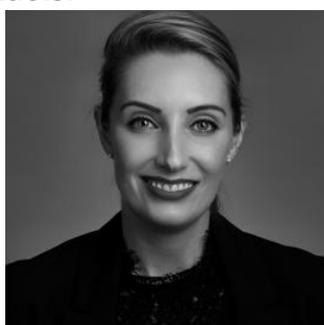
As highlighted by the SFC, parties engaging in ICOs should seek legal or other professional advice if they are in doubt about the applicable legal and regulatory requirements, particularly given that the terms and features of ICOs may differ in each case. Investors on the other hand should be mindful of the potential risks involved and only invest what they are prepared to lose.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



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