

**CRYPTOCURRENCIES
AND
INITIAL COIN OFFERS
(ICOs)
A REGULATORY
PERSPECTIVE**

C H A R L T O N S

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INTRODUCTION

In Hong Kong, as elsewhere, cryptocurrencies, blockchain – the technology which underlies them, and initial coin or token offerings (**ICOs**), are changing just about everything, from banking, payments and capital raising, to commerce, healthcare and education.

In 2017, the combined market capitalisation of cryptocurrencies surged to over US\$60 billion from US\$15 billion, while the price of Bitcoin, the first cryptocurrency, soared 1,500%. ICOs in the first 8 months of 2018 raised US\$ 6.8 billion,¹ more than the US\$6.1 billion raised in 2017. There has been exponential growth in cryptocurrencies, also known as “altcoins”, over the past two years and there are now over 1,900 cryptocurrencies, with a combined market capitalisation of US\$233 billion.²

Bitcoin, like other cryptocurrencies, depends on blockchain technology - an “open distributed ledger” which records transactions between parties in a verifiable and permanent way. Its key advantage is that it allows transactions to be recorded in a digital format which are “stored in transparent, shared databases, where they are protected from deletion, tampering, and revision”.³

The value of Bitcoin grew at a phenomenal rate in 2017 suggesting huge speculative appetite for cryptocurrencies. However, since reaching a record high of US\$19,511 in December 2017, the price of Bitcoin has more than halved. Bitcoins are also still not widely accepted as a medium of exchange, making it unlikely that they will replace fiat currencies in the near term.

WHAT IS AN ICO?

ICOs are a method of crowdfunding for a blockchain-based technology, in which investors are offered newly-issued cryptocurrency coins in exchange for fiat currencies or other cryptocurrencies, typically Ether. However, as The Economist⁴ has noted, ICOs should not be confused with Initial Public Offerings (**IPOs**) which are very different in that ICO investors do not normally receive ownership rights or a share of the platform's profits. Instead, an ICO coin or token typically gives the holder rights to use the technology once it is developed, and in some cases, is exchangeable for fiat currency if the cryptocurrency is accepted for trading by a cryptocurrency trading exchange.

Further, in contrast to IPOs which typically require the publication of a detailed prospectus which includes the company's audited financial statements and has been subjected to due diligence, there are no regulatory requirements governing information disclosure for ICOs in most jurisdictions. ICO issuers are typically start-ups and information describing the technology and details of the coin offer is set out in a relatively short white paper.

ICO REGULATION

Over the past year to eighteen months, regulators around the world have warned consumers of the risks of investing in cryptocurrencies including price volatility, fraud, theft and hacking of cryptocurrency exchanges. Other key concerns are the use of cryptocurrencies for money laundering and terrorist financing. Yet the technology underlying cryptocurrencies – including blockchain – offers tremendous benefits both in the financial industry and many other spheres. The challenge facing

regulators is thus how to protect consumers and stamp out illegal uses of cryptocurrencies without stifling the development of distributed ledger technology (**DLT**). Indeed, as noted by IMF Managing Director, Christine Lagarde, developments in technology, particularly in regulatory and supervisory technology, offer tools to counter criminal involvement in cryptocurrencies.⁵ Artificial intelligence, cryptography and biometrics should improve digital security and facilitate the identification of suspicious transactions while DLT can be used to implement know-your-client and anti-money laundering procedures.

There is currently no unified approach to the regulation of cryptocurrencies. Nor is there any internationally agreed terminology: the terms cryptocurrency, virtual currency, digital tokens, and crypto assets have different meanings when used by different regulators. As discussed below, it was only in June 2018 that a senior official of the US SEC declared that current sales of Ether are not securities transactions, suggesting that initial sales of Ether during the fundraising phase may have been securities transactions. For the purposes of this note, the term “cryptocurrencies” includes digital tokens issued in an ICO.

At the time of writing, China and South Korea are the principal jurisdictions to have declared ICOs to be illegal.⁶ China also prohibits trading of cryptocurrencies on crypto exchanges. Japan is currently the only jurisdiction to have legalised cryptocurrencies as a legal means of payment and Bitcoin is widely accepted by Japanese retailers and also for payment of utilities bills. Financial intermediaries licensed to deal in cryptocurrencies are subject to capital and anti-money laundering requirements. Cryptocurrencies are also subject to Japan’s tax regime. Other jurisdictions, notably Gibraltar, Malta and Switzerland, have implemented or proposed to implement specific ICO regulation aimed at fostering ICOs and their development as ICO hubs.

Most other jurisdictions have not issued cryptocurrency-specific regulation and the trend has been for regulators to state that irrespective of the name given to a cryptocurrency, if it bears the features of a regulated instrument, it will be regulated under the existing laws applicable to that instrument. In 2017, a number of regulators issued statements that cryptocurrencies which have the characteristics typical of securities (e.g. shares, debt and other investment products) will be regulated as such irrespective of the name ascribed to them. Given that cryptocurrencies vary widely, regulators have stressed the need to conduct the legal analysis on a case-by-case basis. In some jurisdictions, such as the US, ICOs may also be regulated under commodities laws.

HONG KONG AND CRYPTO CURRENCIES

Are cryptocurrencies securities?

The key issue under Hong Kong law is whether any particular cryptocurrency is a security for the purposes of Hong Kong's regulatory framework.

On 5 September 2017, Hong Kong's Securities and Futures Commission (the **SFC**) issued a statement on ICOs (the **SFC Statement**) which provides that while digital tokens offered in typical ICOs are usually characterised as a "virtual commodity", depending on the facts and circumstances of an ICO, digital tokens that are offered or sold may be "securities" as defined in the Securities and Futures Ordinance (Cap. 571) (the **SFO**), and subject to the securities laws of Hong Kong.

The SFC Statement outlines three scenarios in which digital coins might constitute “securities”, namely where the coins could be regarded as shares, debentures or interests in a collective investment scheme (**CIS**).

(a) Shares

According to the SFC Statement, digital tokens or coins offered in an ICO may be regarded as “shares” where they represent equity or ownership interests in a corporation, for example where coin 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.

(b) Debentures

Where digital coins are used to create or acknowledge a debt or liability owed by the coin issuer, the SFC may regard them as “debentures”, for example where an issuer may repay coin holders the principal of their investment on a fixed date or upon redemption, with interest paid to holders.

(c) Interests in a CIS

The SFC Statement provides that if token proceeds are managed collectively by the ICO scheme operator to invest in projects with the aim of enabling coin holders to participate in a share of the returns provided by the projects, the digital coins may be regarded as interests in a CIS.

The SFC’s guidance indicates that the essential features of a CIS are:

- it must involve an arrangement in respect of property (property is broadly defined);

- participants do not have day-to-day control over the management of the property (even if they have the right to be consulted or to give directions about the management of the property);
- the property is managed as a whole by or on behalf of the person operating the arrangements, **and/or** the participants' contributions and the profits or income are pooled; and
- the purpose or effect (or pretended purpose or effect) of the arrangement is to provide participants with profits, income or other returns from the acquisition or management of the property.

The definitions of securities and collective investment schemes are however broad and potentially include tokens outside the categories highlighted above. There have been no court decisions on the meaning of “collective investment scheme” in Hong Kong and whether or not any particular ICO falls within the definition will depend on the facts and circumstances of the ICO and ultimately, the courts' interpretation of the statutory definition.

However, the SFC has stopped one ICO, that of Black Cell Technology Limited (**Black Cell**), from being publicly offered in Hong Kong. According to the SFC's press release of 19 March 2018,⁷ the SFC considered that the Black Cell ICO may constitute a CIS since funds raised in the ICO were to be used to fund the development of a mobile application and holders of the tokens would be eligible to redeem equity shares of Black Cell. Black Cell had promoted the ICO to sell digital tokens to investors through its website which was accessible by the Hong Kong public. The SFC had concerns that Black Cell had engaged in potential unauthorised promotional activities and unlicensed regulated activities. Following the SFC's regulatory action, Black

Cell agreed to unwind ICO transactions for Hong Kong investors by returning the relevant tokens to them and undertook not to devise, set up or market any scheme that constitutes a CIS unless in compliance with the relevant requirements under the SFO. Although the SFC has not made public its detailed reasoning in this case, it indicates that the SFC appears to view an ICO which will fund the development of a project as satisfying the first three elements of the CIS definition set out above. In this case, the element of return to token holders was clear – the right to redeem shares in the company, which is unusual. Care should be taken to ensure that ICOs are not represented to provide any form of profit or return to holders and that marketing does not encourage speculation.

In Hong Kong, as in the US and other jurisdictions, ICOs have typically been structured so that the digital coins will represent a right of access to the technology whose development the ICO proceeds will fund. The intention behind this is to characterise the tokens or coins as pre-payment vouchers rather than as securities. White papers thus typically present the digital coins as providing purchasers with the right to use the technology and they sometimes additionally act as the means of payment for use of the services offered by the technology. These are sometimes referred to as “utility tokens”.

On 9 February, 2018, the SFC published a statement warning investors of the potential risks of investing in ICOs and dealing with cryptocurrency exchanges.⁸ The statement also confirmed that the SFC wrote to seven ICO issuers, most of whom confirmed SFO compliance or ceased offering tokens in Hong Kong. The statement describes ICOs as “essentially crowdfunding by blockchain start-ups” and notes that ICO issuers are typically “assisted by market professionals such as lawyers, accountants and consultants” to structure the ICO as an offering of “utility tokens to fall outside the purview of the SFO and to circumvent

the scrutiny of the SFC". The statement thus appears to acknowledge that digital tokens which are "utility tokens" are not "securities" under the SFO.

There is however no legal definition of "utility token". An old-fashioned example would be fairground tokens used to purchase rides. The difficulty with ICO tokens is that it is uncertain whether to be a utility token, tokens must have an actual use on issue (i.e. at the ICO stage) and whether that must be the sole use. ICO Guidelines published by the Swiss Financial Market Supervisory Authority⁹ provide that utility tokens will be treated as securities only if their sole purpose is to confer digital access rights to an application or service and if the utility token can actually be used in this way at the point of issue. If a utility token additionally or only has an investment purpose at the point of issue, it will be treated as a security.

There are also difficult questions as to what would be regarded as a "return" to the token holders. Would, for example, a potential profit on a future sale of tokens be considered to constitute a return? Token issuers must take particular care to ensure that ICOs are not marketed so as to encourage speculation.

(d) Structured Products and Regulated Investment Agreements

Although not specifically mentioned in the SFC's Statement, in certain circumstances, digital coins issued in an ICO might constitute structured products or regulated investment agreements, both of which are "securities" for the purposes of the SFO.

A structured product is broadly defined¹⁰ and includes:

1. Any product where all or part of the return or amount due (or both) or the settlement method is determined by reference to any one or more of:
 - i. changes in the price, value or level (or within a range) of securities, commodities, indices, property, interest rates, currency exchange rates or futures contracts, or any combination or basket of any of these;
 - ii. the occurrence or non-occurrence of any specified event(s) other than an event relating only to the issuer and/or the guarantor of the product; or
2. A regulated investment agreement which is an agreement, the purpose or effect (or pretended purpose or effect) of which is to provide to any party to the agreement a profit, income or other return calculated by reference to changes in the value of any property (e.g. equity linked deposits) (but does not include a collective investment scheme).

This classification is therefore likely to apply where the return on a coin is linked to changes in the price or value of any property, which would include the price of cryptocurrencies such as Bitcoin etc. or of any securities index etc.

(e) Bitcoin futures

Bitcoin futures were launched in the US on two major exchanges, the Cboe and CME, in December 2017. The SFC issued a circular¹¹ stating that Bitcoin futures contracts constitute futures contracts for the purposes of the SFO notwithstanding that Bitcoin itself is not regulated.

Accordingly, parties carrying on a business of dealing in Bitcoin futures, which include those who relay or route Bitcoin futures

orders, are required to be licensed to deal in futures contracts (Type 2 Regulated Activity), in the absence of an applicable exemption. Licensed intermediaries should not directly route Bitcoin futures orders to an exchange which is not authorised by the SFC under Part III SFO.¹² The SFC has also reminded intermediaries of the need to strictly observe the suitability requirement under paragraph 5.2 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (the **Code of Conduct**) and the requirements for providing services in derivative products to clients under paragraphs 5.1A and 5.3 of the Code of Conduct.

Hong Kong Regulation of Securities

Licensing requirements

Dealing in or advising on digital coins regarded as “securities” under the SFO, or managing or marketing a fund investing in such digital coins may constitute a “regulated activity”. Parties carrying on a business in a “regulated activity” in Hong Kong must obtain a licence from the SFC. The prohibition on carrying on a regulated activity without a licence also catches entities which actively market business activities which constitute a regulated activity from outside Hong Kong to the Hong Kong public. There is a limited exemption from the requirement to be licensed to deal in securities where a person, as principal (which in the case of an ICO would be the ICO issuer), deals with institutional professional investors who include licensed investment intermediaries, authorised financial institutions, regulated insurance companies, regulated collective investment schemes, governments and multilateral agencies.

Authorisation requirements

ICOs involving the offer of shares or debentures to the public are subject to the detailed prospectus requirements under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) (**CWUMPO**), unless an exemption applies. The main exemptions which may be available are for:

- i. offers to not more than 50 persons;
- ii. offers only to professional investors:
 - (i) institutional investors including authorised banks, licensed investment intermediaries; authorised funds; authorised insurers; authorised pension schemes etc.; and
 - (ii) “high net worth investors” who include:
 - (a) individuals who have a securities portfolio of HK\$8 million or more;
 - (b) corporations or partnerships with:
 - i. a securities portfolio of HK\$8 million or more; or
 - ii. HK\$40 million in total assets; and
 - iii. investment companies owned by an individual, corporation or partnership who qualify as professional investors where the investment company’s sole business is to hold investments;
- iii. Small offers where the total consideration payable does not exceed HK\$5 million; and

iv. Offers where the minimum consideration payable (for shares) or the minimum principal amount to be subscribed (for debentures) does not exceed HK\$500,000.

ICOs involving an offer to the Hong Kong public to participate in a CIS or to acquire other securities require SFC authorisation, unless an exemption is available, e.g. for offers made only to Hong Kong professional investors and offshore investors.

Are cryptocurrencies money or currency?

E-currencies/ Electronic Money

The Hong Kong Monetary Authority (the **HKMA**) has stated that it regards Bitcoin not as legal tender but as a “virtual commodity”. According to its 11 February 2015 press release,¹³ “As Bitcoin does not have any backing – either in physical form or from the issuer – and its pricing is highly volatile, it does not qualify as a means of payment or electronic money. Bitcoin and other similar virtual commodities are not regulated by the HKMA”. In its statement, the HKMA also reminded the public of the risks involved in Bitcoin trading, and that cases have been reported to the police which may involve fraud or pyramid schemes.

In March 2015, the Secretary for Financial Services and the Treasury of the Hong Kong Government (the **FSTB**) stated¹⁴ in the Hong Kong Legislative Council (**Legco**) that Bitcoin and other kinds of virtual commodities do not qualify as e-currencies, having regard to their nature and circulation in Hong Kong at that time. The Secretary further stated that the Hong Kong Government did not then consider it necessary to introduce new

legislation to regulate trading in such virtual commodities or to prohibit people from participating in such activities.

A further statement by the Secretary for Financial Services before Legco in November 2017¹⁵ provided that digital tokens offered in ICOs which are not “securities” within the SFO, are typically virtual commodities. As such, they are not regarded as currencies, electronic currencies or a means of payment. The statement also confirmed that Hong Kong does not have any targeted regulatory measures on virtual commodities specifically in terms of their safety or soundness, and the trading platforms or operators of such commodities, provided that they are not “securities” under the SFO.

Retail Payment Systems and Stored Value Facilities

The Payment Systems and Stored Value Facilities Ordinance (Cap. 584 of the Laws of Hong Kong) (**PSSVFO**) put in place a regulatory framework for RPS. The PSSVFO defines an RPS as a “system or arrangement for the transfer, clearing or settlement of payment obligations relating to retail activities (whether the activities take place in Hong Kong or elsewhere), principally by individuals, that involve purchases or payments”; and “includes related instruments and procedures”. The term “system or arrangement” intends to apply the definition broadly; not only will it capture a “system”, such as a computer system, or network, or other physical system infrastructure, but also business arrangements. RPS under this definition include, but are not limited to, electronic fund transfer systems and payment card schemes.

The PSSVFO provides that the HKMA can designate an RPS in order to impose various requirements on it. Under section 4(1) of

the PSSVFO, an RPS may be designated if the HKMA is of the opinion that:

1. the system is, or is likely to become, an RPS whose proper functioning is material to the monetary or financial stability of Hong Kong, or to the functioning of Hong Kong as an international financial centre; or
2. the system should be so designated, having regard to matters of significant public interest.

Once designated, an RPS would be subject to requirements including safe and efficient operation of the system, establishment of appropriate operating rules, existence of adequate compliance arrangements and the availability of sufficient financial resources. In August 2017, the HKMA designated as RPS the systems operated by Visa, Mastercard, UnionPay International and American Express for the processing of payment transactions involving participants in Hong Kong.

HKMA is also entitled under PSSVFO to declare a thing to be a medium of exchange for the purposes of the Ordinance.

A “stored value facility” under PSSVFO, in general terms, is a facility which can be used to store the value of an amount of money (which includes any declared medium of exchange) that is paid into the facility from time to time under the rules of the facility. The facility can be used to make payments for goods or services and/or to make payments to another person. As noted above, the HKMA has stated that it does not currently regulate Bitcoin or other virtual commodities.

Anti-Money Laundering (AML) and Counter-terrorist Financing (CTF)

A significant issue is the application to cryptocurrencies of the comprehensive requirements under AML/CTF laws, such as know your client and C&ED reporting obligations. Hong Kong's financial regulators, including the SFC, the HKMA and the Customs and Excise Department (**C&ED**), require financial institutions to assess stringently money laundering and terrorist financing risks associated with virtual commodities in accordance with the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) (**AMLO**). Financial institutions (which include banks and SFC licensed corporations) are required to comply continuously with customer due diligence and record keeping requirements when establishing or maintaining business relationships with customers or clients who are operators of any schemes or businesses relating to virtual commodities.

In January 2014, the HKMA¹⁶, SFC¹⁷ and C&ED¹⁸ issued circulars (to authorised institutions, licensed corporations (**LCs**) and associated entities (**AEs**), and money service operators, respectively) reminding them to ensure that proper safeguards exist to mitigate the money laundering and terrorist financing (**ML/TF**) risks associated with virtual commodities. The circulars note that virtual commodities transacted or held on an anonymous basis present significantly higher ML/TF risks. The regulators thus require increased vigilance in the case of customers that are operators of schemes related to virtual commodities (such as entities operating virtual commodities exchanges, brokerages or transaction processing services (including the provision of machines/channels that facilitate the

sale and purchase of virtual commodities) (**VC Operators**) in assessing the ML/TF risks and the monitoring and detection of unusual or suspicious transactions. ML/TF risks assessments should consider whether a VC Operator has effective controls against ML/TF involving virtual commodities.

There are a number of other laws which companies and other entities must comply with even if they are not a bank or SFC-licensed corporation. Under the applicable ordinances, any persons (including financial institutions, virtual commodity dealers or operators) are required to report any suspicious activities in relation to money laundering or terrorist financing to the Joint Financial Intelligence Unit (**JFIU**) set up by the Police and the C&ED in Hong Kong. A failure to disclose such suspicious transactions to the JFIU may amount to an offence. The applicable ordinances include:

1. the Organised and Serious Crimes Ordinance (Cap. 455);
2. the Drug Trafficking (Recovery of Proceeds) Ordinance (Cap. 405);
3. the United Nations (Anti-Terrorism Measures) Ordinance (Cap. 575);
4. the United Nations Sanctions Ordinance (Cap. 537); and
5. the Weapons of Mass Destruction (Control of Provision of Services) Ordinance (Cap. 526).

Regulation of Crypto Trading Exchanges

Exchanges which provide for the trading of cryptocurrencies which are securities will typically be required to be licensed for Regulated Activity Type 1 (dealing in securities). They may also need to apply for recognition as an exchange company under Part III of the SFO or to be licensed for Regulated Activity Type 7, providing automated trading services. The SFC noted in its February 2018 statement that it had written to seven cryptocurrency exchanges in Hong Kong or connected to Hong Kong notifying them that they should not trade cryptocurrencies which are “securities” as defined under the SFO unless they are licensed by the SFC. Most of the cryptocurrency exchanges contacted by the SFC apparently either: (i) confirmed that they did not trade cryptocurrencies which are “securities” under the SFO; or (ii) immediately rectified the position and ceased trading in cryptocurrencies that are securities.

Otherwise, exchanges trading cryptocurrencies that are not securities, would appear to be unregulated in Hong Kong. In an April 2014 statement, the Money Service Supervision Bureau of the C&ED said that Bitcoin or other similar virtual commodities are not “money” for the purposes of the AMLO, and do not fall within the regulatory regime administered by the C&ED.

A trading platform which operates in Hong Kong whose transactions involve money changing or remittance services is however required to apply to the Commissioner of Customs and Excise in Hong Kong for a “money service operator” (**MSO**) licence under the AMLO. That licence does not however grant any approval or recognition in relation to the business conducted by the platform in relation to virtual commodities. A “remittance service” is defined as arranging for the sending of money to a

place outside Hong Kong, or arranging for the receipt of money from a place outside Hong Kong. Thus a trading platform operated in Hong Kong which sends or receives fiat currency to or from another jurisdiction, for example in relation to a purchase of cryptocurrencies, could be conducting a remittance service. The C&ED will check whether platforms trading cryptocurrencies are involved in unlicensed money service business. A money changing service is defined as a service for the exchanging of currencies. Since Hong Kong's regulators generally regard cryptocurrencies as "virtual commodities" (if they are not securities) and not as "currencies", the trading of cryptocurrencies should not require an MSO licence.

Many crypto trading exchanges in Hong Kong are however generally adopting best practices which include the conduct of know your client procedures and anti-money laundering and counter-terrorist financing checks.

The Hong Kong Fintech Association has published "Best Practices for Token Sales"¹⁹ with suggested practices for the conduct of Hong Kong ICOs which provides a useful starting point for anyone considering conducting an ICO in Hong Kong.

REGULATION IN OTHER KEY JURISDICTIONS

United States (US)

US Securities Laws

In early 2017, tokens were sold in US ICOs on the assumption that they were not securities and that as "utility tokens", they were

similar to projects on Kickstarter, and thus beyond the scope of US securities laws. The position has however changed dramatically following a number of enforcement actions and statements from US regulators suggesting that most ICOs are offers of securities. As a result, many US ICO issuers now offer tokens in reliance on exemptions from the securities law registration requirement, notably under the SEC's Regulation D which allows private placements of securities to US accredited investors, or under Regulation S which allows securities to be offered outside the US to non-US persons. There have been no registered public offerings of ICOs in the US to date.

A troubling aspect of the US regulators' approach is that there is little clarity on whether cryptocurrencies such as Ether, Ripple, Cardano etc. could be regarded as "securities". SEC Chairman Jay Clayton said in an interview that Bitcoin is not a security, stating that "*cryptocurrencies are replacements for sovereign currencies ... [they] replace the dollar, the euro, yen, with Bitcoin. That type of currency is not a security*".²⁰ William Hinman in June 2018 however appeared to open the debate with respect to other cryptocurrencies, in noting how cryptocurrencies can evolve from being securities to non-securities once the network on which they function is sufficiently decentralised that purchasers no longer expect any person or group to carry out essential managerial or entrepreneurial efforts (a requirement under the "Howey test" as discussed below). He stated that he did not consider Ether to be a "security" given the present state of Ether, the Ethereum network and its decentralised structure (where the efforts of a third party are no longer a major factor in ensuring the enterprise's success). He however specifically left out of his analysis the fundraising that accompanied Ether's creation. Ripple Labs, Inc., the issuer of Ripple coin (XRP) one of the largest cryptocurrencies, is facing a number of class action law suits alleging that Ripple violated federal and state securities laws in offering unregistered securities to the public.

The DAO Investigative Report

Since the publication of the DAO investigative report in July 2017 by the US Securities and Exchange Commission (the **SEC**), the US regulators' scrutiny of ICOs has intensified. The DAO investigative report determined that "DAO Tokens" offered and sold by a "virtual" organisation called the DAO were "securities" under the Securities Act of 1933 and the Securities Exchange Act of 1934, and were thus required to be registered with the SEC unless a valid exemption applied. DAO Tokens were offered in exchange for Ether (ETH) and the ETH raised would be used to fund projects. DAO Token holders stood to share in the expected profits from these projects as a return on their investment in DAO Tokens.

The SEC applied the "Howey test" to determine that the DAO Tokens were "investment contracts", a type of security under US securities law. Under the test, an "investment contract" is an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.

The SEC found that the DAO was an investment contract:

6. "an investment of money"

Investors in the DAO used ETH to make their investments. The investment of "money" does not need to take the form of cash, and investment may take the form of goods and services, or some other exchange of value. It had previously been held that an investment of Bitcoin meets this first prong of the test.

7. "in a common enterprise with a reasonable expectation of profits"

Purchasers of DAO were found to be investing in a common enterprise and reasonably expected to earn profits through that enterprise when they sent ETH to the DAO's Ethereum blockchain address in exchange for DAO Tokens. Profits include "dividends, other periodic payments, or the increased value of the investment".

Promotional materials distributed by Slock.it (the platform's creator) and its co-founders informed investors that the DAO was a for-profit entity whose objective was to fund projects in exchange for a return on investment. Depending on the terms of each particular project, DAO Token holders stood to share in the potential earnings from projects funded by the DAO. A reasonable investor would thus have been motivated, at least in part, by the prospect of profits on their investment of ETH in the DAO.

8. "to be derived from the entrepreneurial or managerial efforts of others"

v. The Efforts of Slock.it, Slock.it's Co-Founders, and The DAO's Curators Were Essential to the Enterprise

The DAO's investors relied on the efforts of Slock.it and its co-founders and curators to manage the DAO and put forward project proposals. The issue was whether their efforts were essential managerial efforts which affect the failure or success of the enterprise.

Investors' expectations were primed by the marketing of the DAO as well as the active engagement between Slock.it and its co-founders with the DAO and DAO Token holders (via the DAO website and online forums). The creators of the DAO held themselves out to be experts in Ethereum, and informed investors that curators were selected based on their expertise

and credentials. Through their conduct and marketing materials, Slock.it and its co-founders led investors to believe that they could be relied on to provide the significant managerial efforts necessary to make the DAO a success.

Curators vetted contractors who submitted proposals, determined whether and when to submit proposals for votes, determined the order and frequency of proposals submitted for vote, and determined whether to halve the default quorum for a successful vote for specific proposals. Thus, proposals were subject to control by the curators, and the curators exercised significant control over the order and frequency of proposals.

vi. DAO Token Holders' Voting Rights Were Limited

Voting rights did not provide token holders with meaningful control over the enterprise. Their ability to vote was largely perfunctory, and there were indications that proposals would not have necessarily provided investors with sufficient information to make an informed decision. In addition, the pseudonymity and dispersion of token holders rendered it difficult for holders to join together to effect change or to exercise meaningful control. DAO token holders' voting rights were akin to those of a corporate shareholder.

It was determined that DAO Token holders relied on the significant managerial efforts of Slock.it and its co-founders, and the DAO's Curators. Their efforts were "undeniably significant" and essential to the overall success and profitability of any investment into the DAO.

The SEC stated that whether a particular transaction involves the offer and sale of a security will depend on the facts and

circumstances, including the economic realities of the transaction.

Enforcement actions after the DAO Report

The SEC has brought a number of enforcement actions since the DAO report, including a large number of actions for fraud including:

- i. Actions alleging the defrauding of investors in ICOs by Recoin Group Foundation and DRC World which purported to be backed by real estate and diamond investments. The existence of the businesses was allegedly fabricated by the defendants and promises of significant returns to investors were unsubstantiated; and
- ii. An action against PlexCorps in relation to its ICO of its cryptocurrency “PlexCoin” which had made fraudulent misrepresentations including a promise of a vastly exaggerated investment return to pre-sale purchasers (1,354% in 29 days or less).

Non-fraudulent Actions

In December 2017, the SEC halted the ICO of Munchee Inc. (**Munchee**) for violations of US securities laws. The case shows that the SEC will intervene where it believes there has been a breach of securities laws even when there is no fraud involved. The case is interesting in that it apparently involved a “utility token” issued to raise funds for the improvement of an existing app. The SEC determined²¹ that the MUN tokens were investment contracts under the Howey test. Relevant factors included the following:

- i. Representations were made in the whitepaper and elsewhere that the MUN tokens would increase in value. The whitepaper stated that a tiered membership plan under which holders of greater numbers of tokens would receive more tokens as payment for reviews and Munchee potentially “burning” tokens in the future taking them out of circulation would reduce the supply of the tokens, potentially causing the appreciation of the remaining tokens. Munchee and its agents also made statements on blogs and podcasts that the tokens would increase in value and endorsed other people’s public statements that touted the opportunity to profit. For example, Munchee created a public Facebook posting linked to a third-party YouTube video suggesting how pre-sale investors would likely profit from the ICO;
- ii. Munchee intended that the tokens would trade on a secondary market, representing in the whitepaper that they would be tradable on at least one US-based exchange within 30 days of the conclusion of the offering; and
- iii. The tokens were marketed to crypto-investors (i.e. people with an interest in tokens and digital assets that had created profits for early investors), rather than to existing users of the Munchee App or to the restaurant industry (the supposed intended users of the tokens).

The SEC found that the proceeds of the ICO were intended to be used by Munchee to improve an existing App and to build an ecosystem that would create demand for the tokens which would make them more valuable.

The decision also noted that even if the tokens had had a practical use at the time of the offering, this would not preclude them from being a security. The determination of whether or not a token is a “security” depends on an assessment of “the

economic realities underlying a transaction” and not the label it is given (e.g. a “utility token”).

Recent Statements by US Regulators

SEC Corporate Finance Division Director, William Hinman²² expressed the view that in many cases where promoters raise money to develop networks on which digital assets will operate through an ICO, the economic substance is the same as a conventional securities offering. He noted that “Funds are raised with the expectation that the promoters will build their system and investors can earn a return on the instrument – usually by selling their tokens in the secondary market once the promoters create something of value with the proceeds and the value of the digital enterprise increases”. The SEC generally regards ICO tokens as well as simple agreements for future tokens, or SAFTs, as securities for the purposes of federal securities laws. It thus appears that the analysis of whether or not a cryptocurrency is a security is not determined by technological or technical distinctions.

ICOs vary widely, and whether or not a particular ICO falls within the definition of a “security” will be fact specific.

Regulation of Crypto Exchanges

A trading platform which offers trading of cryptocurrencies which are “securities” and operates as an “exchange” as defined under Federal securities laws must be registered with the SEC as a national securities exchange or be exempt from registration.²³ An exemption is available for an alternative trading system which is registered with the SEC as a broker-dealer and becomes a member of a self-regulatory organisation such as the Financial Industry Regulatory Authority.

There have been media reports that several cryptocurrency exchanges have entered into talks with the SEC about registering as a licensed broker-dealer, but these have not been approved at the date of writing.

The SEC has also noted that trading platforms which do not meet the definition of an “exchange”, but which transact in cryptocurrencies that are securities, or offer digital wallet services to hold them, may trigger other registration requirements including broker-dealer, transfer agent, or clearing agency registration. A platform that offers cryptocurrencies that are securities, may also participate in an unregistered offer and sale of securities if no exemption applies.

Virtual Currencies

If a sale of coins involves a “virtual currency”, the US Department of the Treasury, Financial Crimes Enforcement Network (**FinCEN**) regulations may apply. FinCEN guidelines issued in March 2013 define “virtual currency” as “a medium of exchange that operates like a currency in some environments, but does not have all the attributes of real currency. In particular, virtual currency does not have legal tender status in any jurisdiction.”²⁴ Those guidelines provide that “administrators” and “exchangers” of convertible virtual currencies are considered to be “money transmitters” and therefore “money service businesses” (**MSBs**) which are required to register with FinCEN and comply with federal laws and regulations aimed at countering money laundering and terrorist financing (**AML** and **CTF**). An “administrator” is “a person engaged as a business in issuing (putting into circulation) a virtual currency, and who has the authority to redeem (to withdraw from circulation) such virtual currency”. An “exchanger” is “a person engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency”.

In February 2018, FINCEN wrote to a member of the Senate Committee on Finance²⁵ indicating that it considers certain persons participating in ICOs including ICO issuers and exchanges trading ICO tokens to be money transmitters required to register with FinCEN and comply with federal AML and CTF laws and regulations.

Commodities

The US Commodity Futures Trading Commission (**CFTC**) has designated Bitcoin as a commodity. The CFTC thus has oversight of fraud and manipulation involving Bitcoin traded in interstate commerce as well as the regulation of commodity futures tied directly to Bitcoin.²⁶

Bitcoin ETFs

On 18 January 2018, the SEC issued a staff letter²⁷ outlining investor protection issues they consider relevant in considering the suitability of exchange traded funds (**ETFs**) which invest in cryptocurrencies for retail offering. The key concerns outlined related to valuation, the necessary liquidity to enable daily redemptions, custody arrangements, complying with the obligation to ensure an ETF's market price does not deviate materially from its net asset value and risks of fraud and market manipulation. The staff letter came in response to applications for SEC approval of ETFs investing in bitcoin, which have so far been denied. On 24 August 2018, the SEC rejected nine applications to list ETFs backed by Bitcoin. Key concerns cited by the regulator were the potential for price manipulation and fraud.

People's Republic of China (PRC)

ICOs

The People's Bank of China (**PBoC**) and six other financial regulators in the PRC issued a circular on 4 September 2017 banning ICOs in the PRC. From the date of the circular, all ICOs were required to cease immediately and money already raised through ICOs had to be refunded to investors. The circular declared ICOs to be an unauthorized illegal fundraising activity. The circular states that cryptocurrencies issued in ICOs are not issued by China's monetary authorities, do not have legal status equivalent to that of fiat currencies and should not be used and circulated in the market as currencies.

Crypto Exchanges

Trading platforms are prohibited from engaging in the exchange of fiat currency and cryptocurrency; buying or selling cryptocurrencies; setting cryptocurrency prices and providing information and intermediary services in relation to cryptocurrencies. This prohibits the operations of cryptocurrency trading exchanges. China has also taken steps to block online access to offshore ICOs and crypto exchanges.

Financial institutions and non-banking payment institutions are prohibited from, directly or indirectly, providing services or products relating to ICOs, such as setting up bank accounts, or providing registration, trading, settlement, clearing or insurance. A ban on banks and payment institutions dealing in Bitcoin has been in effect since 2013.

There has been no official justification for China's crackdown on cryptocurrencies, although the move is in line with the Central Government's efforts to reduce financial market risks, as well as attempts to stem outflows of money from China. Fraud appears to have been a key concern – the PBoC noted in its September 2017 circular that 90% of ICOs launched in China were fraudulent. The effect of the clampdown has been to drive up costs as mining companies which originally moved to China to take advantage of cheap electricity and labour, are now relocating to the US and Canada.²⁸

Despite the clamp-down on ICOs, there were reports in October 2017²⁹ that China was considering issuing its own sovereign cryptocurrency.

South Korea

ICOs

South Korea prohibited domestic companies and start-ups from participating in ICOs in September 2017. South Korea's Financial Services Commission (**FSC**) banned all forms of ICOs however they are described. Margin trading of virtual currencies is also illegal.

Crypto Exchanges

After weeks of rumours that the Korean authorities were considering banning cryptocurrency trading exchanges, the FSC instead issued guidelines regulating cryptocurrency trading exchanges on 23 January 2018, designed to counter speculative trading activities. The government also introduced anti-money laundering guidelines for banks dealing with cryptocurrencies requiring them to monitor cryptocurrency exchanges they

service for unusual transactions, and confirm the funding source and transaction purpose where money laundering is suspected. Red flags for money laundering activities include deposits or withdrawals of more than KRW10 million (US\$9,400) per day or KRW20 million (US\$18,800) per week, or a company or an organization depositing or withdrawing money from their bank accounts to trade cryptocurrencies.

Korea implemented a new “real-name account system” with effect from 30 January 2018, to replace a system in which banks opened virtual accounts for the customers of cryptocurrency exchanges for the deposit and withdrawal of money. Under the new system, customers must open an account with the bank providing virtual account services to the cryptocurrency exchange they use. Those who do not have an account at that bank can withdraw money from the virtual account, but cannot make further deposits into it.³⁰

South Korea apparently accounts for some 20% of global Bitcoin transactions and many Koreans have invested a large portion of their savings in cryptocurrencies because of the lack of available high-yield investment options. A recent survey found that three out of ten salaried workers in South Korea have cryptocurrency investments.³¹

J a p a n

Japan was the world’s largest Bitcoin market accounting for over 61% of global trades as of December 2017, twice the trading volume of the United States.³² Japan recognised cryptocurrencies as a legal payment method in April 2017 when the Payment Services Act (the **PSA**) was amended. Virtual currencies are treated as assets which can constitute means of payment rather than as legal currencies.

Crypto Exchanges

The PSA also gave the Japan Financial Services Authority (the **FSA**) the ability to license and regulate cryptocurrency exchanges in Japan. Cryptocurrency exchanges are subject to money laundering regulations and are required to check customer identity when accounts are opened, maintain transaction records and notify authorities of suspicious transactions.

In May 2018, it was reported³³ that the FSA is considering imposing more stringent review standards for registered exchange operators. This comes in response to the hack of Tokyo cryptocurrency exchange, Coincheck, in late January 2018 which saw almost \$500 million in digital tokens stolen.³⁴ The proposals involve regulating cryptocurrency exchanges under the Financial Instruments and Exchange Act (**FIEA**) rather than the Payment Services Act which would oblige exchanges to manage customer funds separately from corporate assets and generally provides more robust investor protection including rules on insider trading. If implemented, the proposals would classify cryptocurrencies as a “financial product”. New restrictions would also be imposed on the kinds of cryptocurrencies that will be allowed on government-registered exchange operators. For example, highly anonymous cryptocurrencies will most likely not be allowed.

If introduced, the new framework will apply to existing operators as well as new applicants.

ICOs

The FSA issued a statement on ICOs³⁵ on 27 October 2017 warning of the risks of fraud and price volatility and outlining the possible regulatory treatment of ICOs. In summary, depending on how an ICO is structured, it may fall within the scope of the Payment

Services Act and/or the Financial Instruments and Exchange Act.
Thus:

- i. Where a coin issued in an ICO is a virtual currency under the PSA, any business which provides exchange services for virtual currencies on a regular basis must be registered with the Local Finance Bureau; and
- ii. An ICO which has the characteristics of an investment and “the purchase of a token by a virtual currency is practically deemed equivalent to that of legal tender”, the ICO will be subject to the Financial Instruments and Exchange Act.

On 4 April 2018, Tama University’s ICO Business Research Group, which is backed by the Japanese government, published a report proposing to regulate ICOs in Japan³⁶ (the “**Tama Report**”) as a means to establish ICOs as a sustainable financing method. The report proposes regulation covering all stages of ICO issuance and financing, including both preliminary activities – that is private sales of tokens as well as the public sale. The report identifies three principal types of ICOs:

- i. *Venture Company type* – i.e. tokens are issued by small venture companies that find it difficult to access the main capital market or obtain venture capital. Buyers tend to be investors seeking a higher return than is available on conventional equities and are willing to take a higher degree of risk.
- ii. *Ecosystem type* – i.e. tokens issued by multiple collaborating companies and/or local governments to form a new market through an ecosystem, which will give rights of participation in the ecosystem on advantageous terms.

iii. *Large company type* – i.e. tokens issued by companies to raise funds for higher-risk in-house projects (e.g. development of new products). Token purchasers tend to be those who seek special offers from the issuers or want to express support for their projects.

The trading of ICO tokens in the secondary market is already regulated under Japan's Payment Services Act (discussed above). The Tama Report thus focusses on regulation of ICO issuance and is proposing the adoption of two key principles and guidelines for ICO issue and five trading principles aimed at protecting purchasers of tokens.

I. Proposed Principles for ICO Issuance

1. **Issuance principle 1** - Issuers should define and disclose:
 - i. conditions for the provision of conveniences such as services and
 - ii. rules on the distribution of procured funds, profits, and residual assets to token purchasers, shareholders, and debt holders;
2. **Issuance principle 2** – Issuers should define and disclose a means for tracking the progress of white papers. The rationale for the principle is that token purchasers need to be able to ascertain the progress of the plans described in the white paper. The Tama Report notes that the information disclosed need not necessarily be financial statements. The report further emphasizes the need for transparency around white papers including provision for their revision and making a revision history available to token holders.

II. Proposed Guidelines for ICO Issuance

1. **Guideline 1** - ICOs should be designed to be acceptable to existing shareholders and debt holders. The intention behind the proposed guidelines is that ICOs should not be used as a means to bring advantage or disadvantage to specific stakeholders.
2. **Guideline 2** - ICOs should not provide a loophole in existing financing methods. The report notes that ICO use should not be allowed to avoid financial laws.

III. Proposed Principles for Investor Protection around Token Purchase and Sale

5 principles are proposed to protect purchasers of ICO tokens.

1. **Trading Principle 1** - Token sellers would need to confirm the identity (**KYC**) and suitability of customers.
2. **Trading Principle 2** - Administrative companies supporting token issuance should confirm issuers' **KYC**.
3. **Trading Principle 3** - Cryptocurrency exchanges should establish and adopt an industry-wide minimum standard for token listing.
4. **Trading Principle 4** - After listing, insider trading and other unfair trade practices should be restricted.
5. **Trading Principle 5** - All parties involved in the trading of tokens including issuers, trading exchanges and administrative companies should take measures to ensure cyber security.

Bloomberg reports that the Financial Services Agency of Japan will consider the guidelines outlined in the report in late April 2018, but that implementation could take a few years.

Singapore

ICOs

Following an increase in the number of ICOs in Singapore, the Monetary Authority of Singapore (**MAS**) issued a media release in August 2017 on the regulation of digital token offerings. In November 2017, MAS issued a guide³⁷ to the application of Singapore securities laws to offers or issues of digital tokens. It noted that offers or issues of digital tokens in Singapore may be regulated by the MAS if the digital token is a type of capital markets product under the Securities and Futures Act (Cap. 289) (the **SFA**). Capital markets products include securities, futures contracts, and contracts or arrangements for the purposes of foreign exchange trading or leveraged foreign exchange trading.

In March 2014, MAS stated that it does not regulate virtual currencies per se as these are not considered to be securities or legal tender, but does regulate virtual currency intermediaries in relation to money laundering and terrorist financing risks requiring them to identify customers and report suspicious transactions.³⁸ It has since reiterated that position, but noted that it regards virtual currencies as those used as “a medium of exchange, a unit of account or a store of value” examples of which include Bitcoin, Ether and Litecoin.³⁹ The MAS has however noted that the function of some digital tokens has developed beyond being solely a virtual currency and its November statement makes clear that digital tokens may constitute:

- shares where they represent ownership in a corporation, liability of the token holder in the corporation and mutual covenants with other token holders in the corporation inter se;
- a debenture, where they constitute or evidence the indebtedness of the issuer of the digital token in respect of money lent to the issuer by a token holder; or
- units in a collective investment scheme (**CIS**) where they represent a right or interest in a CIS, or an option to acquire such a right or interest.

Where digital tokens constitute securities or units in a CIS, they must be offered in compliance with the prospectus requirements of the SFA and an offer in relation to units in a CIS may be subject to authorisation and recognition requirements. A person operating a platform in Singapore on which primary offers or issues of digital tokens are made may need to be licensed for one or more regulated activities under the SFA (unless exempt). Persons providing financial advice in Singapore in relation to any digital token that is an investment product must be authorised under the Financial Advisers Act (Cap. 110) (unless exempted).

Crypto Exchanges

A person who establishes or operates a trading platform for digital tokens which constitute securities or futures contracts in Singapore, may be establishing or operating a market which requires approval by MAS as an approved exchange or recognition by MAS as a recognised market operator under the SFA, unless exempted.

On 24 May 2018, MAS warned eight digital token exchanges in Singapore not to facilitate trading in digital tokens that are

securities or futures contracts without MAS' authorisation. It also warned an ICO issuer to stop the offering of its digital tokens in Singapore.⁴⁰

The Singaporean authorities have been concerned that ICOs are susceptible to AML/CTF risks given their anonymous nature. The MAS is currently consulting⁴¹ on new regulation which will regulate both e-money (which is denominated in fiat currency) and virtual currencies. The proposed definitions are as follows:

- i. "E-money" will be defined as electronically stored monetary value that represents a claim on the e-money issuer that has been paid in advance for the purpose of making payment transactions through the use of a payment account and is accepted by another person other than the e-money issuer. A consumer purchases e-money from a business to allow him to transfer money to participating individuals or to purchase goods or services from merchants who accept such e-money;
- ii. "Virtual currencies" will be defined as any digital representation of value that is:
 - (c) **not** denominated in fiat currency;
 - a. is accepted by the public as a medium of exchange, to pay for goods or services, or discharge a debt; and
 - (d) can be transferred, stored or traded electronically.

The MAS is proposing to combine the existing Payment Systems (Oversight) Act (Cap. 222A) and the Money-Changing and Remittance Business Act (Cap. 187). The key proposals would:

- i. introduce a single payment services licence to regulate existing and new payment services;
- ii. implement a regulatory structure for significant payment systems and retail payment services; and
- iii. address regulatory risks and concerns.

The proposed Payment Services Bill would adopt an activity-based approach and govern activities that: (i) face either customers or merchants; or (ii) process funds or acquire transactions. The proposed regulated activities include: (a) account issuance services which would cover issuing or operating an e-wallet or a non-bank credit card; (b) e-money issuance allowing the user to pay merchants or transfer e-money to another individual; and (c) virtual currency services including buying or selling virtual currency or providing a platform to allow persons to exchange virtual currency.

AML/CTF obligations would be imposed on virtual currency intermediaries which:

- i. deal in virtual currencies – i.e. buy and sell virtual currencies which involves exchanging virtual currency for fiat currency or another virtual currency; and/or
- ii. facilitate the exchange of virtual currency. This would include establishing or operating a virtual currency exchange allowing participants to use the platform to exchange or trade virtual currencies.

The new requirements would apply to virtual currency service providers that process funds or virtual currency. The AML/CTF requirements would include identifying and verifying customer and beneficial owner identity, screening for AML and CTF

concerns, suspicious transaction reporting, ongoing monitoring and record keeping.

The new ordinance would not however apply to regulated financial service providers, in-game assets and loyalty-points that are not denominated in fiat currency.

Gibraltar

Gibraltar is one of the jurisdictions at the forefront of ICO regulation and aims to develop Gibraltar as an ICO hub.

Gibraltar's DLT principles-based regulation

Regulations governing businesses operating in or from Gibraltar which use distributed ledger technology for storing or transmitting value belonging to others (DLT Activities) took effect on 1 January 2018. Firms carrying on a business in DLT Activities, including crypto trading exchanges, need to be authorised as DLT Providers by Gibraltar's Financial Services Commission (the **GFSC**).

Gibraltar's regulatory approach to DLT is outcome-focused, not prescriptive. The GFSC requires DLT Providers to comply with nine principles designed to ensure achievement of desired regulatory outcomes, including investor protection.

The nine principles require a DLT firm to:

- i. conduct its business with honesty and integrity;

- ii. pay due regard to the interests and needs of each and all its customers and communicate with its customers in a way which is fair, clear and not misleading;
- iii. maintain adequate financial and non-financial resources;
- iv. manage and control its business effectively, and conduct its business with due skill, care and diligence; including having proper regard to risks to its business and customers;
- v. have effective arrangements in place for the protection of client assets and money when it is responsible for them;
- vi. have effective corporate governance arrangements;
- vii. ensure that all systems and security access protocols are maintained to appropriate high standards;
- viii. have systems in place to prevent, detect and disclose financial crime risks such as anti-money laundering and countering terrorist financing (**AML/CFT**); and
- ix. be resilient and develop contingency plans for the orderly and solvent wind down of its business.

Proposed ICO regulation

ICOs are not however specifically regulated in Gibraltar, although they may fall within the scope of existing regulation of securities. However, Gibraltar's Government (**HMGOG**) and the GFSC issued proposals for the regulation of ICOs in March 2018. The proposals would introduce a requirement for an "authorised sponsor" of all publicly offered ICOs and would regulate the conduct of authorised sponsors, secondary token market operators and token investment and ancillary service providers.

The “Proposals for the regulation of token sales, secondary market platforms and investment services relating to tokens”⁴² propose new legislation to regulate the following activities conducted in or from Gibraltar:

- the promotion, sale and distribution of tokens;
- operating secondary market platforms trading in tokens; and
- providing investment and ancillary services relating to tokens.

The regulations will impose obligations on:

- authorised sponsors of public ICOs;
- secondary token market operators (i.e. crypto exchanges); and
- token investment and ancillary service providers.

They will not however regulate token issuers or promoters, nor the tokens or technology underlying them. Instead, regulation will be effected by requiring authorised sponsors, crypto exchanges and service providers to comply with new regulations.

The aim of the proposed regulatory regime would be to mitigate the risks associated with token-based crowd financing by requiring full and accurate disclosure of information, imposing rules for the orderly and proper conduct of secondary market platforms and requiring competent professional investment services. GFSC will be the relevant supervisory authority for AML/CFT regulation, and the provisions of DLT regulations will apply to firms covered by the new token regulations.

Public offering of tokens

The first limb of the regulations will regulate the primary market promotion, sale and distribution of tokens that are not securities (which are already covered under existing securities legislation), outright gifts or donations which are conducted in or from Gibraltar. These tokens typically offer commercial products or services (which may not exist at the time of the token sale) and are sometimes referred to as utility or access tokens. Tokens that function solely as decentralised virtual currency⁴³ (e.g. Bitcoin) or as central bank-issued digital currency will be excluded from this limb of the regulations. However, hybrid tokens (which have an underlying economic function that is both virtual currency and something else) will be caught.

The activities to be regulated under the first limb are proposed to include activities:

- which purport to be or imply that they are made from Gibraltar;
- are intended to come to the attention of or be accessed by any person in Gibraltar;
- are conducted by overseas subsidiaries of Gibraltar-registered legal persons (in such cases, the Gibraltar person will be liable); or
- are conducted by overseas agents and proxies acting on behalf of Gibraltar-registered legal persons, or on behalf of natural persons ordinarily resident in Gibraltar (in such cases, the Gibraltar person will be liable).

Disclosure rules

The proposed regulations on the promotion, sale and distribution of tokens will require adequate, accurate and balanced disclosure of information to enable anyone considering purchasing tokens in the primary market to make an informed decision. The regulations may prescribe what, as a minimum, constitutes adequate disclosure, and in what form disclosures are made (e.g. in a key facts document not exceeding 2 pages). The GFSC may publish guidance on the disclosure rules from time to time.

Financial crime provisions

Undertakings that receive, whether on their own account or that of another person, proceeds in any form from the sale of tokens were brought within the scope of the Proceeds of Crimes Act 2015 (**POCA**) by an amendment that took effect in March 2018. Token issuers are thus already under an obligation to perform AML and CFT checks on token purchasers.

Authorised sponsors

The proposed regulations will establish a regime for the authorisation and supervision of token sale sponsors (**authorised sponsors**) who will be responsible for compliance with this limb of the regulations. An authorised sponsor will need to be appointed in respect of every public token offering promoted, sold or distributed in or from Gibraltar. Authorised sponsors may be appointed by the Gibraltar promoter or by organisers of the offering, wherever located.

Authorised sponsors will be required to have knowledge and experience of ICOs and mind and management in Gibraltar. They will be allowed to delegate some of their work to others,

including offshore parties, but will remain directly accountable to GFSC for the actions of their delegates.

Codes of practice

Authorised sponsors will be required to have in place one or more codes of practice relating to offerings they sponsor. Authorised sponsors are considered to be in the best position to determine best practice for the offerings they sponsor and will be free to apply different codes to different categories of tokens and offerings. Codes of practice may cover matters such as methods for applying and distributing sale proceeds.

A code of practice will have to be incorporated in authorised sponsors' agreements with their ICO clients. Submission of codes of practice will form part of the application process for an authorised sponsor licence. Prior reporting of amendments to codes of practice will be required and will be treated in the same way as other major business changes.

It is proposed that regulations would specify principles governing the content of codes of practice. Authorised sponsors will be free, subject to approval, to set their own methodologies for implementing the principles.

Registers of authorised sponsors, codes of practice, sponsors' clients and tokens

GFSC will establish and maintain a public register of authorised sponsors and their codes of practice (past and present).

GFSC will add to the public register the following details of public offerings provided by authorised sponsors of public offerings they are engaged in:

- the client(s) for whom they act;
- the token(s) included in the offering;
- the code of practice applicable to the offering; and
- any interest they, and connected persons, have in the tokens offered.

New Controlled Activity and Offence

A new controlled activity of being an authorised sponsor will be created and it will be an offence to promote, sell or distribute tokens in or from Gibraltar without compliance with:

- the requirement for an authorised sponsor;
- the requirement for a current entry on the public register;
- specified disclosure obligations; and
- relevant provisions of POCA, where applicable.

The promotion, sale and distribution of a public token offering may only be conducted once, and while the offering appears on the register.

Secondary market activities

The proposals include regulation of secondary market platforms operated in or from Gibraltar that are used for trading tokens and, to the extent not covered by other regulations, their derivatives. The regulations aim to ensure that the activities of such markets are fair, transparent and efficient and that organised trading occurs only on regulated platforms.

The proposed regulations will set out requirements for:

- disclosure to the public of data on trading activity;
- disclosure of transaction data to GFSC; and
- specific supervisory actions concerning tokens and positions on token derivatives.

These regulations will cover secondary market trading of all tokenised digital assets including virtual currencies and will be modelled, to the extent appropriate, on market platform provisions under MiFID 2 and MiFIR. GFSC may issue guidance as appropriate.

Authorised secondary token markets

The proposals include adding a new controlled activity of operating a secondary market platform used for trading tokens and their derivatives. GFSC will authorise and supervise secondary token market operators and maintain a public register of such operators.

Investment and ancillary services relating to tokens

The proposed legislation would include a new controlled activity of providing investment and ancillary services relating to tokens in or from Gibraltar and, to the extent not covered by other regulations, their derivatives.

This limb of the regulations is intended to cover advice on investments in tokens, virtual currencies and central bank-issued digital currencies, including:

- generic advice (setting out fairly and in a neutral manner the facts relating to token investments and services);
- product-related advice (setting out in a selective and judgemental manner the advantages and disadvantages of a particular token investment and service);
- and personal recommendation (based on the particular needs and circumstances of the individual investor).

This limb of the regulations will be modelled on similar provisions under MiFID.

Russia

Bills “On Digital Rights”, “On Digital Financial Assets” and “On Attracting Investments Using Investment Platforms” passed their first reading in the State Duma of the Russian Federation on 22 May 2018. The second reading of the bills is currently scheduled to occur in autumn 2018.⁴⁴

The law “On Digital Financial Assets” will introduce a number of new concepts into Russian law. Cryptocurrencies and tokens will be defined as “digital financial assets”, which means “property in electronic form created using cryptographic means”. Rights of ownership to digital assets will be certified by entries in a “registry of digital transactions”, although no details of the registry are provided in the draft law.

The law states that digital financial assets are not a legal means of payment in the territory of the Russian Federation. Thus while they can be bought, they cannot be used as a means of payment. Tokens will only be exchangeable for fiat currencies through “operators of exchange of digital financial assets”. This will

require investors to undergo identity verification procedures in accordance with the anti-money laundering law and to open an electronic wallet (“software and hardware that allows you to store information about digital records”) with the operator. As regards cryptocurrencies, the law is not clear as to whether they will be exchangeable for fiat.

The new law creates an official definition of “smart contracts” (“contracts in electronic form, under which the performance of rights and obligations is effected by the automatic transfer of digital transactions”) and allows them to be used to enter into contracts with investors when conducting an ICO. The signing of paper contracts will still be possible.

The law will impose restrictions on ICOs. Only registered businesses and officially registered entrepreneurs will be allowed to conduct an ICO. A maximum limit will be imposed by the Bank of Russia on the amount unqualified investors are permitted to invest in digital coins/tokens. The draft law does not however implement a previously proposed ceiling of 1 billion rubles on the amount a company can raise through an ICO.

The procedure for issuing tokens will consist of the following steps:

- i. publication via the Internet of an investment memorandum, a public offer containing the conditions for the purchase of the tokens (“public offer”), and other documents as determined by the issuer; and
- ii. the entering into of contracts (which may be in the form of smart contracts) between the issuer and each purchaser for the sale and purchase of the tokens. There must be at least three days between the publication of the public offer and the entering of contracts for the sale of the tokens.

The draft law imposes requirements as to the contents of the investment memorandum and public offer. The investment memorandum will need to disclose information about the beneficiaries of the project, the rights of coin/token holders, and the proposed use of proceeds. Coin issuers will need to be transparent about the token price and how it is determined and will be required to provide information on the process for issuing and storing tokens. The name of the token issuer (the new law provides that tokens have a single issuer), the location of its permanently operating executive body and its website address will also need to be made public.

The law “On Digital Rights” consists of amendments to the Civil Code and introduces new concepts of “digital rights” and “digital money” to define tokens and cryptocurrencies, respectively. Digital rights are defined as a set of digital data (a digital code or symbol) in a decentralised information system that: (i) certifies that a person having sole access to the digital code or symbol has rights to certain assets (“objects of civil rights”) other than intangible assets; and (ii) enables such person to obtain information about those assets. Digital money is defined as a set of digital data (a digital code or symbol) in a decentralised information system that does not certify rights to any assets but is used for making payments. The law provides that digital rights may be transferred by making an entry in the relevant information system. The rules on digital rights will also apply to transfers of digital money.

B e l a r u s

On 21 December 2017, a decree on the development of the digital economy (**Decree 8**) designed to establish a regulatory regime for cryptocurrencies, ICOs and smart contracts was issued by the

government of Belarus.⁴⁵ Its provisions came into force on 28 March 2018.⁴⁶

Decree 8 legalised ICOs in Belarus, as well as cryptocurrency mining and other transactions.

Residents of Belarus' High Technology Park (**HTP**) can now legally launch ICOs, deal in tokens and hold them in virtual wallets. No tax will apply to cryptocurrencies, tokens and profit from cryptocurrency operations in the subsequent five years. Decree 8 also introduces regulations to simplify the visa regime for HTP residents, freeing them of the obligation to apply for work permits by way of waiver and by granting them temporary residency status in Belarus.

It has been reported⁴⁷ that amendments to Decree 8 are being prepared, according to which crypto exchanges operating in the HTP will be required to disclose their data and identify customers. In addition, crypto exchanges wishing to open in the HTP will have to provide information on their management structure and beneficial owners. Operators will be required to identify the clients of the exchange, and record and store all communications with them. In certain cases, exchanges in the HTP will be required to conduct customer verification procedures. Information about customers and their transactions should be stored at the crypto exchange for at least five years.

The Ministry of Finance of Belarus adopted accounting standards for cryptocurrencies in March 2018.⁴⁸ Tokens are required to be entered into a company's accounting records at initial cost, and they will be classified according to their method of acquisition and intended use.

- Tokens purchased through ICOs are classified as investments, and will therefore need to be debited as "Long-term financial

investments” if their circulation period is greater than 12 months, or otherwise as “Short-term financial investments”, and credited under “Settlements with different debtors and creditors” and “Other income and expenses”.

- Tokens purchased by a trader or an exchange for subsequent trading should be debited under the “Goods” account and credited under “Settlements with suppliers and contractors” and “Income and expenses for current activities”.
- Tokens acquired from mining should be debited under the “Finished goods” account and credited under the “Main activities” account.

A u s t r a l i a

ICOs

In October 2017, Australia’s Securities and Investments Commission (**ASIC**) released an information sheet⁴⁹ which provides information on, among other things, when ICOs will be considered an offer of a financial product and subject to the provisions of Australia's Corporations Act. The statement stresses that the legal status of any ICO token will depend upon the nature of the ICO and the circumstances of the offer. An ICO will constitute an offer of a financial product if it is a managed investment scheme, offer of shares or a derivative. An arrangement will be considered a managed investment scheme when:

- people contribute money or assets (such as digital currency) to obtain an interest in the scheme ('interests' in a scheme are a type of 'financial product', regulated by the Corporations Act);

- any of the contributions are pooled or used in a common enterprise to produce financial benefits or interests in property; and
- contributors do not have day-to-day control over the operation of the scheme but, at times, may have voting rights or similar rights.

The rights attached to the tokens issued in an ICO will need to be analysed to determine the legal status of an ICO. Rights include future or contingent rights and rights which are not legally enforceable.

Following amendments to the Anti-Money Laundering and Counter-Terrorism Financing Act which took effect on 3 April 2018, digital currency exchanges (**DCEs**) are required to comply with AML/CTF requirements in respect of transactions involving fiat to cryptocurrency trading. DCEs' obligations in respect of such transactions include:

- adopting and maintaining an AML/CTF program to identify, mitigate and manage money laundering and terrorism financing risks;
- identifying and verifying the identities of their customers;
- reporting to the Australian Transaction Reports and Analysis Centre (**AUSTRAC**), the anti-money laundering and counter-terrorism financing regulator in Australia, suspicious matters and transactions involving physical currency of \$10,000 or more; and
- To keep certain records for seven years.

A 'policy principles' grace period will be in place until October 2018, where AUSTRAC will only have a right to take an enforcement action if a DCE fails to take reasonable steps to comply.⁵⁰ Transitional registration arrangements are in place for the period during consideration of the businesses' registration applications. After the policy principles period concludes, provision of DCE services without registration will be considered a criminal offence.

United Kingdom

ICOs

On 12 September 2017, the UK Financial Conduct Authority (the **FCA**) released a statement on ICOs, warning consumers that ICOs are very high-risk, speculative investments. The FCA cautioned that persons should only invest in an ICO if they are experienced investors, confident in the quality of the ICO project and are prepared to lose their entire stake.

The FCA warned of risks associated with ICOs, including that most ICOs are not regulated by the FCA, the lack of investor protection, price volatility, the potential for fraud, and that most are in a very early stage of development. Further, ICOs are not subject to regulated prospectus requirements, but rather typically issue a 'white paper', which may be unbalanced, incomplete or misleading.

Whether ICOs are regulated by the FCA is determined on a case-by-case basis, and depends on how the ICO is structured. While noting that many ICOs fall outside the regulated space, the FCA has stated that some involve regulated investments and pointed to the parallels between some ICOs and initial public offerings, private placements of securities, crowdfunding or collective

investment schemes. The FCA has warned businesses that they should carefully consider if their activities could constitute arranging, dealing or advising on regulated financial investments.

The Financial Services and Markets Act 2000 (**FSMA**) generally prohibits carrying on a regulated activity in the UK unless the relevant person is authorised to do so or is exempted from the authorisation requirement. Activities are regulated if they relate to “specified investments”. ICO tokens may constitute “specified investments” if they create rights which are akin to those provided by shares, debentures or collective investment schemes.

The FSMA also prohibits communicating in the course of a business an invitation or inducement to engage in investment activity unless the person is authorised. “Investment activity” includes (among others) activities in relation to “specified investments”.

Where tokens constitute “transferable securities”⁵¹, an approved prospectus will be required if the tokens will be offered to the public in the UK or admitted to trading on a regulated market in an EU Member State, unless an exemption is available.

Transferable securities are “classes of securities negotiable on the capital markets but excluding instruments of payment”. There is uncertainty as to the circumstances in which the market for tokens might constitute a “capital market”. In any event, the prospectus requirement will apply only if the tokens in question are regarded as “transferable securities”.

Crypto Exchanges

Operating an exchange in the UK which provides for the trading of tokens which are financial instruments under the Markets in Financial Instruments Directive II (MiFID II) (which would include

most specified investments) may be a regulated activity which would require the exchange to be authorised by the FCA.

Otherwise, however, crypto exchanges are not currently regulated in the UK. CryptoUK, the self-regulatory body established to represent the UK cryptocurrency industry, has however responded to the Treasury Select Committee's inquiry into cryptocurrencies with proposals for crypto exchanges to be licensed by the FCA. CryptoUK has apparently suggested that regulation should focus on the platforms facilitating the interaction between digital and fiat currencies.

THE WAY FORWARD

The difficulty in classifying digital tokens or coins is the fact that even if coins' primary purpose is to provide access to goods or services via a platform, once they are listed on a trading exchange, they may also be traded by speculators for the purpose of profit taking. Whether that alone should bring a coin within the definition of "securities" is arguable.

There are clearly risks associated with ICOs. Quite apart from the risks of fraud and theft, the project may never be completed and coin holders stand to lose their investment. Coins would not in most cases give holders any contractual rights against the coin issuer or any rights on its insolvency. Offers are not generally restricted to professionals deemed sufficiently sophisticated to assess the risks of investment. The disclosure made in white papers is not subject to any particular standards or scrutiny. Whether regulators choose to clamp down on coin offers will probably depend on the perceived risk to retail investors in particular jurisdictions.

There are clearly arguments both for and against regulation of ICOs. While greater legal certainty would be welcome, there have been calls to ensure that any regulation imposed should not be overly onerous. Many, although not all, ICOs are involved in the development of blockchain-based technology and applications which will offer substantial improvements in efficiency. The danger of over-regulation is that technological innovation may be stifled and there have already been criticisms of China's clampdown on cryptocurrencies as stifling their development and diminishing China's once dominant position in the cryptocurrency revolution.⁵²

Other concerns relate to money laundering and terrorist financing. Since most exchange operators in Hong Kong are currently unlicensed, one possibility would be to impose AML and CTF obligations on exchange operators since this is the point at which the worlds of fiat currencies and cryptocurrencies intersect.

Many ICO issuers and crypto exchanges are adopting best practices which are both in the best interests of potential coin purchasers and also serve to distinguish legitimate players from the Ponzi schemes and fraudulent exchanges which have dogged the industry in some jurisdictions. Self-regulation is all well and good, but it fails to provide sanctions for those who do not comply. Many in the crypto market, both exchanges and issuers, would welcome balanced regulation as a means of giving cryptocurrencies legitimacy. Investment in cryptocurrencies remains dominated by individual investors. If cryptocurrencies are to attract institutional investors, they probably require the legitimacy that regulation would provide.

Note: The above represents Charltons' current understanding of the regulation of ICOs in different jurisdictions. Charltons advises only on Hong Kong law and while the above represents our understanding of the legal position in certain other jurisdictions, legal advice from qualified lawyers in the relevant jurisdictions should be sought in relation to any particular transaction or situation. Further, this note is intended for educational purposes and it does not constitute Hong Kong legal advice. Specific advice must be sought in relation to any particular situation.

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