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# SECURITY TOKENS IN HONG KONG



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# Background to **STOs**

- Instead of being stored on a single company's database, a securities token is a digital or virtual asset issued on distributed ledger technology (**DLT**) in the form of a regulated security
- Representation of traditional forms of investment products such as shares, bonds, interests in a collective investment scheme, loans and structured products
- "Utility" or "network" tokens which regulators decide should be regulated as securities

# Impact of US SEC decision on **DAO**

- STOs evolved from and have come to replace initial coin offerings (ICOs)
- US SEC's regulatory determination - DAO tokens offered and sold by a "virtual" organisation called "The DAO" were an "investment contract" under the Howey test, and thus "securities"
- Unregistered public offering of tokens breached US securities laws



- The proceeds of sale were invested in projects on the understanding that investors would receive a share of profits from the investments
- A tokenised investment fund which, if publicly offered in Hong Kong, would have breached Hong Kong's Securities and Futures Ordinance (SFO) - as an unauthorised public offer of interests in a collective investment scheme under section 103(1) SFO
- Offering by unlicensed entities would breach the SFO's licensing requirements

# DAO tokens

# Initial coin offerings

- A form of crowdfunding
- The developer of a blockchain-based project would issue tokens to raise funds to finance the development of a blockchain-based project
- On completion of the project, token holders gain access to a product or service available on the platform and the tokens are often used as a means of payment for the product or service provided
- "Utility tokens" — intended to fall outside the scope of regulation, akin to a pre-paid voucher

# US "securities" definition — the **Howey test**

1

An investment  
of money

3

An investment in  
a common enterprise

2

An expectation  
of profit from  
the investment

4

Profit must result from the effort  
of a promoter or third party  
beyond the investors' control

# SEC v Ripple

- Filed an enforcement action against Ripple and 2 senior executives for allegedly conducting an unregistered securities offering of XRP tokens
- Alleges that XRP is an "investment contract" within the Howey Test and a security subject to the registration requirements of the US Securities Act of 1933

## Ripple:

- XRP is a currency, like Bitcoin and Ether, which the SEC has said are not securities
- XRP has a fully functional ecosystem and a real use case as a bridge currency that does not rely on Ripple's efforts for its functionality or price

# SEC Statement on Framework for "Investment Contract" Analysis of Digital Asset (April 2019)

## Reliance on the efforts of others

- Do purchasers rely on the efforts of others?
- Are those efforts "significant... , that is... essential managerial efforts which affect the failure or success of the enterprise"
- Is the network or virtual asset still in development or not fully functional at the time of the token offering?

- Where token holders have the right to share in the enterprise's income or profit or to realise a gain from the token's capital appreciation which results, at least in part, from the development or improvement of the platform
- Where they are offered broadly to potential purchasers rather than being offered to the expected users of the goods or services or those with a need for the network's functionality
- If the tokens are currently or will in future be tradable on a secondary market, this will make it more likely that they are securities

## Reasonable expectation of profits

# Other relevant considerations

- Whether the tokens are sold for use by the purchaser

## Unlikely to be securities where:

- The distributed ledger network is fully developed and operational
- The tokens can be used immediately (e.g. as a means of payment) on the network

# When ICOs are STOs under US law

Whereas ICOs tried to operate outside regulation, STOs sought to bring themselves within the scope of US regulation, so that they could rely on various exemptions from the securities laws' registration requirements:

- Reg D (for offers only to "accredited investors" or not exceeding US\$5 million)
- Reg A (for companies with 2 years' financial statements raising no more than US\$50 million)
- Reg S (available only to firms outside the US)
- JOBS Act Crowdfunding Regulations (which allow firms to raise up to US\$5 million but prevent resale for 12 months)

# The tokenised securities market

- The US is the leading jurisdiction for tokenised stock issuance, followed by Switzerland
- Mostly used for financial services, particularly bond issues, and tokenised real estate
- Ethereum as the most popular STO platform
- Can never be transferred to an ineligible individual in the primary or secondary market
- Digitisation improves transferability while reducing settlement and reconciliation costs

# Tokenised shares in the US

- Security token trading volume increased over 1,000% in 2020
- The US has witnessed an increasing number of security tokens offered to professional investors in the US and overseas retail investors based on exemptions such as Reg A, Reg D and Reg S
- STOs are seen in the US as a way of enabling companies to raise funds fairly quickly at a lower cost than a traditional IPO



# Tokenised shares in **Europe and Asia**

## Switzerland

- The DLT Act allows uncertified securities to be issued and managed on DLT
- Emergence of regulated entities on which tokenised securities can be traded

## Germany

- German Federal Financial Supervisory Authority (BaFin) — tokenised financial instruments are securities under German securities law
- After prospectus approval, the securities tokens can be offered throughout the EU under the passporting system

## Malaysia

- Fusang Corp (FSC) has secured Labuan Financial Services Authority approval for an IPO of its equity tokens

# Hong Kong regulation of securities tokens

The definition of "securities" in Schedule 1 to the SFO is wide and includes:

- Shares, debentures, bonds or notes any body (incorporated or unincorporated), government or municipal government authority or any rights, options or interests therein;
- Interests in a collective investment scheme;
- Interests, rights or property (whether in the form of an instrument or not) that are commonly known as securities; and
- Structured products



- The tokens were exchangeable for shares in the ICO issuer - making the offering equivalent to a share offering in Hong Kong in breach of section 103 SFO

- The SFC however referred to the ICO potentially amounting to a collective investment scheme and to the potential breach of SFO licensing requirements

## **SFC's** **action** **against** **Black Cell**

# SFC statement re. ICOs

- Warned seven ICO issuers and seven crypto exchanges of the regulatory consequences of offering or trading tokens that are securities under Hong Kong law
- Entities contacted either confirmed their activities complied with Hong Kong's securities laws or ceased their activities in Hong Kong
- No details of the characteristics of the tokens offered or traded were provided by the SFC

# Regulatory and licensing requirements for intermediaries

- Where a token is a tokenised share or a tokenised debenture, it will be a security

**A public offering of a securities token that is a share and debenture in Hong Kong will require compliance with:**

- The prospectus regime under the Companies (Winding Up and Miscellaneous Provisions) Ordinance; and
- The restrictions on public offering without SFC authorisation under section 103(1) SFO
- Offers by a decentralised autonomous organisation (DAO) not covered by C(WUMP)O prospectus regime

**Intermediaries offering securities tokens will be required to be licensed for the relevant regulated activities:**

- **Type 1** — marketing or trading securities tokens
- **Type 4** — advises on buying and selling tokens
- **Type 9** — fund manager investing in securities tokens



# Collective investment scheme **definition**

1

An arrangement in respect of property;

2

CIS participants should 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);

3

Property should be managed as a whole by or on behalf of the person operating the arrangements, and/or the participants' contributions and the profits or income should be pooled; and

4

Arrangement should be intended to provide participants with profits, income or other returns from the acquisition or management of the property

# CIS definition vs **Howey test**

- The definition bears similarities to the US Howey test
- Would a token's proposed listing on a crypto exchange and the potential for token holders to earn a return if the tokens appreciate in value bring it within the definition of a CIS?
- Applying the reasoning used by the US courts, purchasers of tokens which have no immediate use would appear to be buying the tokens as investments rather than their use case on the platform
- The categorisation of a token as a security can change over time
- Lack of case law and SFC guidance



# SFC Statement on Security Token Offerings (March 2019)

- STOs - structured to have features of traditional securities offerings
- Security tokens - digital representations of ownership of assets (e.g. gold or real estate) or economic rights (e.g. a share of profits or revenue) using blockchain technology
- Securities tokens encompass digital versions of traditional securities such as shares, debentures and interests in investment funds
- No elaboration on why digital representations of assets such as gold or real estate should fall within the definition of securities

# Structured products & Regulated investment agreements

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:

- Changes in the price, value or level of securities, commodities, indices, property, interest rates, currency exchange rates or futures contracts, or any combination or basket of any of these; or
- The occurrence or non-occurrence of any specific events other than an event relating only to the issuer and/or the guarantor of the product

- An agreement intended to provide any party to the agreement with a profit, income or other return calculated by reference to changes in the value of any property, such as equity-linked deposits

- The definition excludes collective investment schemes

A background image of a financial candlestick chart with a dark blue color scheme and a white trend line.

# Regulated investment agreements

# SFC regulation of fund managers managing funds investing in digital assets

## De minimis threshold

- The November 2018 regulatory framework extended SFC regulation of licensed fund managers to cover their fund management activities in virtual assets

## Will regulate a Type 9 licensed fund manager in relation to its management of virtual assets where:

- It has a stated investment objective of investing in virtual assets; or
- It invests more than 10% of its gross asset value (GAV) in virtual assets



# Licensing requirement for managers of funds investing in digital assets that are securities or futures contracts

- A fund manager which only manages funds which invest only in virtual assets which are not securities or futures contracts does not require a Type 9 licence
- It will need to be licensed for Type 1 if it intends to distribute the fund in Hong Kong
- Any marketing or offering of interests in a CIS will be "dealing in securities" which requires a Type 1 licence under the SFO

# SFC notification requirement

- A fund manager intending to invest in virtual assets is required to notify the SFC even if it intends to invest less than 10% of its GAV in virtual assets

## Professional investor protection

- As defined in the SFO (which include the categories of high net worth investors under the Securities and Futures (Professional Investor) Rules)

## Custody requirements

To assess and select the most appropriate custodial arrangement taking into account:

- As defined in the SFO (which include the categories of high net worth investors under the Securities and Futures (Professional Investor) Rules)
- Ease of accessibility to the virtual assets
- Security of the custodial facility

Where the licensed fund manager opts for self-custody:

- To document the reasons for self-custody and disclose the risks of self-custody to investors
- To implement measures to protect the fund's assets and effectively segregate the virtual assets from the fund manager's own assets in the event of its insolvency
- To use best endeavours to acquire and maintain insurance cover over the virtual assets

# Licensing conditions

# Licensing conditions for fund managers (Cont'd)

## Valuation and liquidity

- To select valuation principles, methodologies, models and policies which are reasonably appropriate in the circumstances and in the best interests of investors
- To consider setting a cap on a fund's investment in illiquid virtual assets and newly-launched ICO Tokens and their exposure to counterparties

## Audit requirement

- To appoint an independent auditor to audit the financial statements of managed funds

## Liquid capital

- Where a licensed fund manager holds virtual assets on behalf of the funds it manages, to maintain liquid capital equal to the higher HK\$3 million or the amount of its variable required liquid capital

# Venture Smart **Asia**

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First fund manager to obtain  
a Type 9 asset management  
licence to manage funds  
investing in virtual assets



# SFC regulation of crypto exchanges under the SFO

## SFC's November 2019 Position Paper on Virtual Asset Trading Platforms

- Will only license centralised trading platforms that trade at least one virtual asset that is a security under the SFO
- To be licensed for Type 1 (dealing in securities) and Type 7 (providing automated trading services)

# Licensing conditions for **crypto exchanges**

- Restrict provision of trading services to professional investors
- Virtual assets to be held by a Hong Kong subsidiary of the platform operator which holds a licence as a trust or company service provider under the AMLO
- An insurance policy covering the risks of custody of virtual assets and strict controls on the generation and storage of private keys

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# Problems with the existing regulatory framework for **crypto exchanges**

Virtual assets which are securities that are traded on the platform have to:

- Be asset-backed;
- Be approved or registered with regulators in comparable jurisdictions (as determined by the SFC); and
- Have been issued more than 12 months previously

# Problems with the existing regulatory framework for **crypto exchanges**

- No SFC guidance on which virtual assets will be regarded as "asset-backed"
- Presumably this would include physically backed stable tokens such as Tether
- Whether synthetic stablecoins would be considered asset-backed is unclear
- The requirement for virtual assets to have been issued more than 12 months prior to their listing on the trading platform rules out most ICO tokens
- Absence of a list of jurisdictions the SFC regards as comparable

- There have not been any STOs in Hong Kong to date

- The SFC has not spelt out that ICO tokens would be securities, nor the circumstances in which that would be the case

**Difficulty for  
crypto exchanges  
in satisfying  
regulatory  
requirements**

# Regulatory implications of STOs being "securities" under the **SFO**

- Intermediaries which market and distribute security tokens are required to satisfy the Code of Conduct including under para 5.2 to ensure that customer recommendations and solicitations in relation to security tokens are reasonably suitable for customers based on the information about customers of which intermediaries should be aware through the exercise of due diligence



# Due diligence obligations

- Where licensed intermediaries distribute security tokens, they need to conduct due diligence to develop an in-depth understanding of the tokens
- Due diligence on the background and financial soundness of the management of the token issuer and of the rights attaching to the assets backing the securities tokens
- Intermediaries are required to review all materials published in relation to the STO

# STOs as "complex products"

- Securities tokens are complex products under para 5.5 of the Code of Conduct and under the Guidelines on Distribution and Advisory Platforms, both of which set out additional KYC obligations for complex products

## A licensed intermediary providing services to a client in complex products:

- To ensure that the product is suitable for the client in the circumstances; and
- To provide the client with information on the key nature, features and risks of the complex product

# SFC Statement on Security Token Offerings

The SFC's Guidelines on Distribution and Advisory Platforms apply to licensed intermediaries providing online distribution and advisory platforms for investment products:

- Para 6.3 — to ensure that transactions in complex products are suitable for particular clients
- Paras 6.7 and 6.8 — to provide information and warnings similar to the requirements of the Code of Conduct

Exemptions from all these requirements apply to clients who are:

- Institutional professional investors; or
- Corporate professional investors as defined in the Code of Conduct

# SFC Statement on Security Token Offerings

## Provision of information to clients:

- To provide clients with information relating to STOs, including warnings of the risks of investing in virtual assets
- To consult with the SFC before engaging in activities relating to STOs

## Provision of information to clients:

- To provide clients with information relating to STOs, including warnings of the risks of investing in virtual assets



# Shortcomings of SFC regulatory approach

## Provision of information to clients:

- The investor protection requirements in the Code of Conduct only apply where a traditional intermediary is involved
- Issuers thus have no obligation to ensure the suitability of their tokens for prospective investors or to disclose the risks of investing in them
- As token issuers, their designers and developers are typically based offshore, the SFC has no regulatory jurisdiction over these foreign actors

# Shortcomings of SFC regulatory approach

- If securities tokens are offered from outside Hong Kong, there will be only a breach of section 115 of the SFO if the offshore entity markets services to the Hong Kong public which would require it to be licensed in Hong Kong
- There is no breach of the SFO if there is no active marketing of services to the Hong Kong public
- There is no protection for Hong Kong investors who acquire tokens on an offshore platform



# Julia Leung at HK FinTech Week November 2021

- Financial institutions are increasingly looking to offer virtual assets to professional investors and their private bank clients

- Some licensed firms want to provide virtual asset trading services to clients by acting as an introducing agent or through an omnibus account opened with a virtual asset trading platform

#### Questions to be addressed by the SFC:

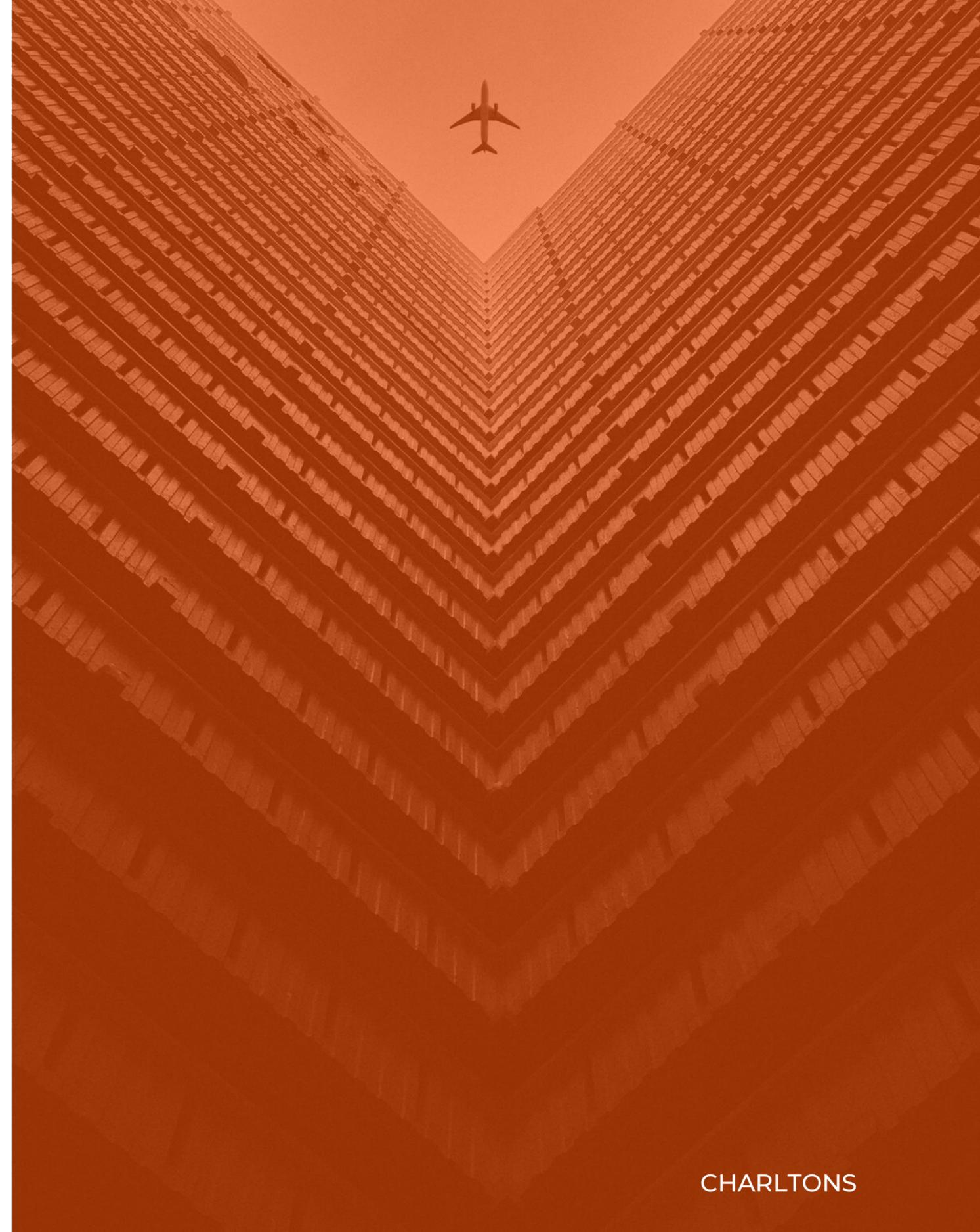
- Whether these firms expose their clients to undue risks if the virtual asset trading platforms are unregulated or only regulated for limited purposes?

**Can licensed firms  
provide trading  
services to clients?**

# **SFC** regulatory concerns where licensed firms trade via omnibus accounts with crypto exchanges?

## Questions to be addressed by the SFC:

- Whether some of the regulatory obligations typically applied to licensed virtual asset trading platforms should be extended to licensed firms trading virtual assets on their clients' behalf?
- Whether firms should be required to conduct a knowledge assessment before providing virtual asset trading services to clients?



# The future of STOs in **Hong Kong**

- More appealing than an IPO for small and medium-sized enterprises and seed to Series A rounds rather than unicorn startups and billion-dollar publicly traded companies

## Advantages over IPOs

- No need to rely on central third parties
- 24/7 trading possible
- Still subject to AML obligations



# MCQs

# Question 1

Which of the following statements about security tokens is incorrect?

- (A) They are digital representations of traditional, regulated securities
- (B) They are issued on distributed ledger technology
- ✓ (C) They are distributed by third party intermediaries such as tokens
- (D) Controls such as transfer restrictions can be built in

## Question 2

Which of the following is NOT a key characteristic of a "security" under the US Howey test?

- A) An expectation of profit resulting from the efforts of a third party beyond the investors' control
- ✓ (B) The ability to trade the instrument on a regulated stock exchange
- (C) An investment of money
- (D) An investment in a common enterprise

# Question 3

Which of the following is a "security" under the Hong Kong definition in Schedule 1 to the Securities and Futures Ordinance:

- (A) An interest in real estate
- ✓ (B) An interests in a fund which invests in real estate
- (C) Gold
- (D) Air miles

# Question 4

Which of the following statements about Hong Kong's current licensing regime for crypto exchanges is false?

- (A) Only centralised trading platforms need to be licensed
- (B) Exchanges should trade at least one virtual asset that is a security under SFO
- (C) Licensed exchanges can only provide trading services to professional investors
- (D) Licensed exchanges must comply with Hong Kong's anti-money laundering legislation
- ✓ (E) Securities tokens can only be traded if they were issued more than 6 months previously

# Question 5

Which of the following statements about Hong Kong's proposed new regime for the licensing of virtual assets exchanges under the AMLO is incorrect?

- (A) The SFC will be the licensing authority
- (B) Exchanges licensed under the SFO will be exempt from licensing under the new regime
- ✓ (C) Retail investors will be able to trade in crypto traded on licensed platforms
- (D) Platforms trading digital assets which are not securities will need to be licensed under the new regime

# Q&A

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