

## SFC Warns of Potential Action Against Cryptocurrency Exchanges and Issuers of ICOs

February 13, 2018

On February 9, 2018, the Hong Kong Securities and Futures Commission (“**SFC**”) published an alert to investors in cryptocurrency trading and initial coin offerings (“**ICOs**”), warning of the risks of extreme price volatility, hacking and fraud. The SFC warned cryptocurrency exchanges and ICO issuers to refrain from conducting regulated activities by dealing in cryptocurrencies or offering tokens which are considered “securities” under the Securities and Futures Ordinance (Cap. 571, “**SFO**”). The SFC alert indicates that it has been closely monitoring the activities of cryptocurrency exchanges and issuers of ICOs and is prepared to enforce securities laws of Hong Kong against any violator.

### Background

Since the launch of Bitcoin, the first application of decentralized ledger technology in peer-to-peer payment, in 2009, the global market has seen the birth of more than 1500 cryptocurrencies. While initially introduced as a disruptive payment tool, cryptocurrencies gained popularity over the years as a digital asset class. Cryptocurrency trading really took off in 2017, when institutional investors started to show interest. According to Coinmarketcap.com, the market capitalization of all cryptocurrencies combined reached USD 413 billion as of February 12, 2018. As a result of the growing demand, online exchanges, brokers, investment vehicles and venture capital funds flourished. On the other hand, widely publicized security issues, such as hacking suffered by cryptocurrency exchanges and e-wallet providers and misappropriation of customer funds, continue to cause investors significant losses. In addition, the pseudonymous nature of cryptocurrencies has drawn criminals engaged in illicit trading, money laundering and terrorism funding.

ICOs, also known as token sales, gained popularity in early 2017 as a decentralized way for blockchain startups to finance new projects without having to go through the traditional funding routes, such as borrowing loans or initial public offering of equity shares. By issuing digital tokens to supporters of the project in exchange for fiat money or cryptocurrencies in circulation, a startup links the usefulness or value of the tokens to the performance of its blockchain project while amassing sufficient funds to develop the project. Many tokens issued at such ICOs can be traded at exchanges. While applauded by many as an innovative and efficient way to raise capital for technology firms, the downsides are obvious. Scams and frauds are commonplace and investors in many cases found themselves left without legal remedy.

The Hong Kong government does not recognize Bitcoin or other cryptocurrencies as a form of money, consistently holding the view that cryptocurrencies are not widely accepted as a medium of payment in Hong Kong and have limited impact in business transactions and people’s daily life. Rather, cryptocurrencies are treated as virtual commodities. The Hong Kong government has not adopted any legislation specifically addressing the regulation of cryptocurrencies in addition to the existing legal framework concerning money laundering, drug dealing, organized and serious crimes, fraud, cyber-crimes and securities laws.

### The February 2018 SFC Alert and Previous SFC Warnings in the Cryptocurrency Space

Since 2014, the SFC has issued several general warnings to investors, licensed corporations and associated entities about price volatility, fraud and security incidents, anti-money laundering and counter-

terrorist financing risks in the cryptocurrency space. The February 2018 alert is the third time the SFC voiced its view concerning cryptocurrency trading and ICO activities in the context of securities laws.

### **September 2017 Alert on ICOs**

On September 5, 2017, one day after the Chinese regulators announced a ban on all ICO activities, the SFC issued a notice stating that, depending on the “facts and circumstances of an ICO,” digital tokens offered or sold may be captured by the securities law as shares, debentures or interests in a collective investment scheme (“**CIS**”) in the following ways:

- A. Share. Digital tokens offered in an ICO may represent equity or ownership interests in a corporation. Investors receive dividends as part of their shareholder rights.
- B. Debenture. Digital tokens are sometimes offered as a liability or debt owed by the issuer. Investors in this scenario may receive fixed income return as creditors.
- C. CIS.<sup>1</sup> Participants receive return from the ICO scheme operator’s investment in projects with proceeds from the token sale.

Dealing in or advising on ICOs, or managing or marketing a fund investing in such ICOs may therefore constitute regulated activity which cannot be conducted by an unlicensed person. An SFC license is required for any person, whether or not located in Hong Kong, engaged in regulated activities targeting the Hong Kong public. ICOs which fall under the prospectus regime under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) must be registered. All CISs made to the general public are subject to the authorization by the SFC. Additionally, for cryptocurrency exchanges dealing with trading of tokens sold in ICOs, the SFC notice states that “certain requirements relating to automated trading services and recognized exchange companies may be applicable to the business activities of cryptocurrency exchanges.”

Given the broad scope of CIS, tokens issued at an ICO which do not fall under the definition of equity share or debt may well be captured under the realm of a CIS. The offering of securities to the Hong Kong public is subject to the listing rules, with specific requirements concerning, among others, the suitability of the listing applicant, the fair and orderly manner in which the issuing and marketing exercise is conducted, and the public disclosure of information. The September 2017 SFC alert thus in effect put a halt to sales of tokens which would fall under the definition of securities.

### **December 2017 Alert on Bitcoin Futures Contracts and Cryptocurrency-Related Investment Products**

On December 11, 2017, the SFC issued a circular to licensed corporations and registered institutions concerning Bitcoin futures contracts and cryptocurrency-related investment products. This alert was sent when CBOE and CME, leading U.S. commodity exchanges and automated trading service providers authorized by the SFC, began to launch bitcoin futures contracts which enabled Hong Kong investors to trade in Bitcoin futures.

In this notice, the SFC made clear that Bitcoin futures are regarded as futures contracts for the purpose of the SFO, such that businesses dealing in Bitcoin futures, marketing a fund investing in Bitcoin futures, or

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<sup>1</sup> CIS is broadly defined under Hong Kong law. Under Schedule 1 of the SFO, the key features of a CIS are: an arrangement in respect of the property; no day-to-day control over the management of the property by the CIS participants; a pool for contributions by participants and profits for distribution or the property is managed as a whole by or on behalf of the person operating the arrangements; the purpose of receiving return from the collective management or acquisition of the property.

advising on Bitcoin futures must have the requisite licenses. Additionally, the SFC warned that as cryptocurrency-related investment products such as options, swaps and contracts for differences, depending on their terms and features, may constitute securities under the SFO, parties dealing in, advising on, or managing such products in Hong Kong, or targeting such services to investors in Hong Kong, may be subject to the SFC's licensing, conduct and authorization requirements.

## **February 2018 Alert concerning Exchanges and ICO Issuers**

In the February 2018 alert, the SFC indicated that it had received complaints from investors regarding problems with withdrawing from customer accounts opened at certain exchanges, security failures of exchanges causing losses, misappropriation of customer funds, and fraudulent or unlicensed activities by ICO issuers.

The SFC stated that it had sent letters to seven cryptocurrency exchanges in Hong Kong or with connections to Hong Kong and seven ICO issuers, warning them to comply with securities laws in Hong Kong and not to engage in regulated activities without proper license. While most of the exchanges and ICO issuers confirmed compliance or immediately took rectification measures, the SFC emphasized its zero tolerance to securities law violations and indicated its readiness to bring further actions against any offender. It also urged market professionals, such as lawyers, accountants and consultants, to join efforts in warding off frauds or dubious fundraising in ICOs and ensuring compliance with the law.

This alert came a few days after the Chinese government further tightened its control over the cryptocurrency trading activities in mainland China by prohibiting Chinese cryptocurrency investors from trading on foreign exchanges. The SFC made it unequivocally clear that it would continue to closely monitor the cryptocurrency market and will not shy away from bringing enforcement actions against breaches of Hong Kong securities laws.

## **Recent Regulatory Trend in Asia**

Globally, cryptocurrencies are increasingly scrutinized by regulators. In Asia, while China and South Korea took active measures to place restrictions on cryptocurrency trading by its nationals and imposed a ban on all domestic ICO activities, other key jurisdictions such as Singapore and Japan are formulating new rules or revisiting existing regulations in relation to cryptocurrencies.

### **China**

Following China's ban on all ICO activities and shut-down of major domestic cryptocurrency exchanges in September 2017, Chinese investors and entrepreneurs have largely turned to overseas exchanges and ICO platforms to continue engaging in cryptocurrency activities. To further achieve its regulatory objectives, the Chinese government recently toughened its stance by implementing measures to restrict cryptocurrency mining activities in January 2018 and indicating in early February 2018 that it would tighten regulations on Chinese investors' participation in overseas ICOs and foreign cryptocurrency exchanges.

### **South Korea**

In November 2017, several South Korean regulators issued proposals, guidance and directives in an attempt to formulate a regulatory response to the growing virtual currency market in Korea. On January 30, 2018, a new regulation came into effect in South Korea, requiring identity verification for all trading accounts on domestic cryptocurrency exchanges and prohibited foreigners and minors from trading on South Korean exchanges.

## Japan

Japan passed an amendment to its payment law to recognize cryptocurrencies as payment tools and place exchanges under a licensing regime since April 2017. More than a dozen exchanges have been licensed to carry out cryptocurrency trading business. On January 29, 2018, the Financial Services Agency announced that it would inspect all cryptocurrency exchanges following Japanese exchange Coincheck's report on January 26 of its loss of USD 530 million as a result of a hacking incident, the world's biggest cryptocurrency theft.

## Singapore

The Monetary Authority of Singapore (“**MAS**”) announced in November 2017 that the exchange of virtual currencies into national currencies or other virtual currencies will be regulated. Entities carrying out virtual currency services will be required to hold a MAS-issued license. This move seeks to address money laundering and terrorism financing risks. The new rules, which are expected to take effect in 2018, will be included with a broader set of new rules governing payment services. These will include requirements to conduct customer due diligence, monitor transactions, perform screening, report suspicious transactions and keep adequate records.

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