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LCQ15: Regulation of offering and trading of digital tokens

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Following is a question by the Hon Chan Chun-ying and a written reply by the Secretary for Financial Services and the Treasury, Mr James Lau, in the Legislative Council today (November 8):

Question:

In recent years, there has been an increase in activities in Hong Kong and elsewhere of raising funds in the name of initial coin offerings (ICOs). Earlier on, a relevant platform even advertised extensively in Hong Kong its ICO fundraising activities. On September 4 this year, the People's Bank of China, in collaboration with six other regulatory bodies, promulgated the Announcement on Guarding against the Risks of Financing by Initial Coin Offerings, under which financing by ICOs is regarded as "a form of unapproved and illegal public fund-raising", and such financing activities will be eradicated on the Mainland. On the following day, the Securities and Futures Commission of Hong Kong published a statement on ICOs, elucidating that digital tokens offered or sold by individual ICOs may be regarded as the "securities" defined in the Securities and Futures Ordinance (Cap. 571) and, therefore, the conduct of the ICOs concerned in Hong Kong is subject to the regulation of the securities laws of Hong Kong. On the other hand, in September this year, the Chief Executive Officer of JPMorgan Chase & Co. publicly slammed Bitcoin, a virtual currency, as a fraud. In this connection, will the Government inform this Council:

(1) whether it has studied the legality and risks of various kinds of digital token financing activities; if so, of the details; if not, the reasons for that;

(2) of the policy bureau or statutory body responsible for monitoring ICOs that are conducted in Hong Kong and do not fall within the ambit of securities offerings; and

(3) given that the price of Bitcoin has risen by over five times since early this year, whether it has evaluated the impact of trading activities of virtual currencies becoming increasingly vigorous on the financial market in Hong Kong; if so, of the details; if not, the reasons for that?

Reply:

President,

Firstly, we would like to point out that digital tokens are not currencies. They are a type of virtual commodities. In addition, we note an increase in the use of Initial Coin Offerings (ICOs) to raise funds in the market. Depending on the development of individual markets, the regulatory approaches over ICOs vary across jurisdictions. Some regulators impose a ban on ICOs, while other regulators leverage on existing regimes to regulate such activities. Our consolidated reply to the three parts of the question is as follows:

In the light of the development of ICOs in the Hong Kong market, the Securities and Futures Commission (SFC) published a statement on September 5 this year. The statement points out that 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, and accordingly subject to the securities laws of Hong Kong. Where digital tokens offered in an ICO represent equity or ownership interests in a corporation, these tokens may be regarded as "shares". For example, token holders may be 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. Where digital tokens are used to create or to acknowledge a debt or liability owed by the issuer, they may be considered as a "debenture". For example, an issuer may repay token holders the principal of their investment on a fixed date or upon redemption, with interest paid to token holders. If token proceeds are managed collectively by the ICO scheme operator to invest in projects with an aim to enable token holders to participate in a share of the returns provided by the project, the digital tokens may be regarded as an interest in a "collective investment scheme" (CIS). "Shares", "debentures" and interests in a "CIS" are all regarded as "securities". Where the digital tokens involved in an ICO fall under the definition of "securities", dealing in or advising on the digital tokens, or managing or marketing a fund investing in such digital tokens, may constitute a "regulated activity". Parties engaging in a "regulated activity" are required to be licensed by or registered with the SFC irrespective of whether the parties involved are located in Hong Kong, so long as such business activities target the Hong Kong public.

In addition, we also note that the anonymous nature of virtual commodities poses potential money laundering or terrorist financing risks in their transactions. Financial regulators have required financial institutions to assess carefully the money laundering and terrorist financing risks associated with virtual commodities and comply continuously with the statutory customer due diligence and record keeping requirements under the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance when establishing or maintaining business relationships with customers who are operators of any schemes or businesses relating to virtual commodities.

Under the Organised and Serious Crimes Ordinance, the Drug Trafficking (Recovery of Proceeds) Ordinance or the United Nations (Anti-Terrorism Measures) Ordinance, any individuals (including financial institutions, virtual commodity dealers or operators), shall, on any occasion, 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 Customs and Excise Department. A failure to disclose such suspicious transactions to the JFIU may amount to an offence.

The Government and financial regulators have, for years, been reminding the public that virtual commodities do not have any backing whether in physical form or from the issuer. Such virtual commodities are highly volatile in price and do not qualify as a medium of payment or electronic currencies. The SFC also urges investors to be mindful of potential scams as well as the investment risks associated with ICOs. As ICOs operate online and may not have a physical presence in Hong Kong, investors may be exposed to heightened risks of fraud.

Apart from those digital tokens falling within the definition of "securities" under the Securities and Futures Ordinance, Hong Kong does not have any targeted regulatory measures on virtual commodities in respect of their safety or soundness, as well as the trading platforms or operators of such commodities. That said, our existing laws provide sanctions against money laundering, terrorist financing, fraud and cyber-crimes, whether or not virtual commodities are involved. We will keep a close watch on the development of ICOs and virtual commodities in Hong Kong, and maintain contacts with regulators in other jurisdictions through active participation in meetings of relevant international organisations (such as the Financial Action Task Force).

According to our understanding, virtual commodities have yet to be widely accepted as a medium of payment in Hong Kong as compared with other places, and their circulation as a medium of exchange in daily life or business transactions is insignificant. There are only very few vendors claiming that they would accept virtual commodities as a medium of payment. Having regard to their nature and the current circulation in Hong Kong, as well as the fact that regulators have already required financial institutions to assess stringently and continuously when maintaining business relationships with virtual commodities operators, it is unlikely that virtual commodities will have a systemic impact on Hong Kong's financial system at this moment. That said, the Government and regulators will continue to closely monitor the market development.

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