



FINTECH ASSOCIATION
OF HONG KONG

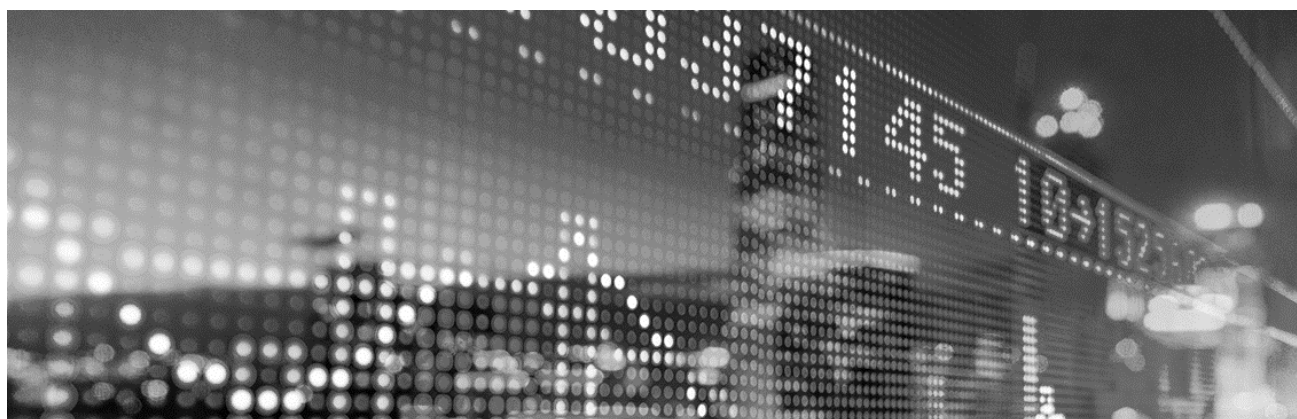
Best Practices for Token Sales

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Overview

1 Introduction

Digital assets can play an important role in an innovative digital economy. They facilitate the creation, recording and transfer of rights in ways that propel financial technology, commerce and interaction in new directions.

Digital or “cryptographic” tokens are a type of digital asset based on blockchain technology, often (but not always) utilising platforms such as Ethereum.

1.1 About this document

This document provides insights and suggested general practices from the Hong Kong fintech community on issuing digital tokens as part of a token sale carried out in or from Hong Kong. It focuses on initial token sales used as part of the development of new projects, but it is not limited to them.

It is not law, nor is it legal or commercial advice. It is not issued or endorsed by any regulatory authority, and the considerations are Hong Kong-focussed. However, in creating this document, the FinTech Association of Hong Kong has sought contributions from a cross-section of the community, including leading experts, issuers, sponsors and advisors. You must consult your professional advisors and obtain the advice you need before a token sale.

**We may update this document from time to time.
Please keep an eye out on our website at <http://hkfintech.org>.**

1.2 A note about terminology

This document refers to “**tokens**” generically to refer to a record on a blockchain that represents a bundle of rights.

There are many different types of tokens. For example, a token might:

- (a) operate as a digital pre-paid voucher for a software licence;
- (b) provide rewards based on the activities of the holder or some other metric;
- (c) represent a loyalty point or other incentive; and/or
- (d) be backed by, or represent an interest in, certain assets.

Certain tokens may even reflect an existing financial product such as a share, fund interest or debt security. Other types of tokens exist and more will undoubtedly emerge, but many of the core principles in this document should still apply. The nature and features of each token will influence the regulatory impact, tax and accounting analysis, marketing strategy and other factors.

A “**token sale**” is sometimes also referred to as a “token generating event” or (loosely) an “initial coin offering” or “ICO”. Terminology matters for various reasons, but not to this particular document. This is general guidance only.

2 Before you begin

Make sure a token sale is right for you.

Token sales can deliver opportunities for the right projects. However, running a token sale involves significant time, effort, expenditure and risk. It is not right for every project or for every person. Even great ideas may fail in execution or because the market environment is not right. If you are relying on a token sale as critical source of funding, a sudden regulatory change can have a severe impact on your project.

There are numerous funding routes for good projects. Don't pursue a token sale unless it's the best fit for your project and you have the right people around you to make it happen. While it may seem easy in principle, execution can be much more challenging in practice.

Best practices at a glance

3 What does a good token sale look like?

3.1 Guiding principles

In crafting a token sale, you should seek to make it comply with the following overarching principles:

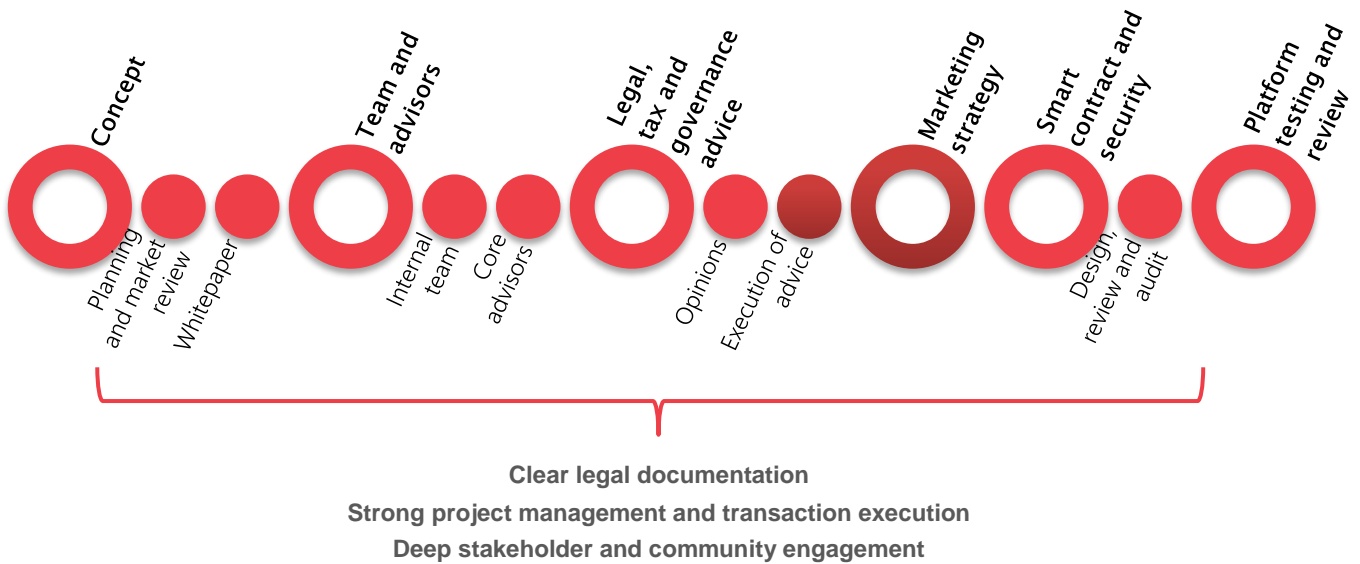
- Core Principle 1** Legally compliant in all key relevant markets
- Core Principle 2** Strong business model to launch and sustain the token
- Core Principle 3** Secure
- Core Principle 4** Transparent by disclosing the material features and risks of the token and the token sale, including with regards to pricing, structure, allocation, utility and risks
- Core Principle 5** Project-focussed, in seeking to deliver a real outcome and provide a solution to a real need, based on strong research and technical development
- Core Principle 6** Fair to your participants and in the interests of a safe digital asset market. Do not encourage interest based solely on greed and fear of missing out
- Core Principle 7** Long term-oriented

Certain jurisdictions may require tokens to have a **minimum viable utility** at the time of sale. If this applies to you, then this should also be a core principle for your token sale.

3.2 Strong roadmap and stakeholder engagement

Common to all good token sales is a proper roadmap that hits the important issues relating to legal and regulatory compliance, tax / accounting, marketing expertise, security, execution, governance and where relevant, community-building.

The following graphic provides a snapshot of some of the key factors for success.



3.3 Planning

Plan the project, budget, token utility and campaign structure. Assemble your technical and advisory team, and have them look over the plan.

3.4 Set a realistic timetable

Token sales typically require approximately 2 to 6 months for proper execution. Some take a lot more; some less. If you are running a token sale for the right reasons, you won't rush just because of hype or because the price of a particular cryptocurrency is rising or falling on a given day. Be ambitious, sure – but not foolhardy.

3.5 Set realistic funding goals

You need to know both how much funding your project needs, and how much the token sale will itself cost. Ask yourself: do you need a pre-sale to fund token sale expenses? Or will the entire project be funded in one phase? Are you capping the token sale? Have you disclosed the possibility of future sales down the road?

Run your sale as if your reputation depends on it (because it does).

3.6 Consider allocations early

Most token sales allocate a certain proportion of tokens to the public, while others are allocated to advisors, founders, service providers, bounty programs, future sales or otherwise. Certain tokens are locked for a certain period of time. Consider this issue early and disclose your approach. See further, paragraph 7.7.

Key considerations for token sales

4 Develop your idea

A token sale is only as good as the concept behind it.

Before embarking on a token sale, think long and hard about whether this is the right approach for you.

About your project	<ul style="list-style-type: none">• What are you trying to create?• What problems does it solve?• Is there a market for that?• Does the project already exist (and if so, is your solution significantly different)?
About the token	<ul style="list-style-type: none">• Do you actually need a digital token? Why?• What is the token utility model?• How will your token contribute to the success of your application in ways that a non-tokenised solution would lack?• Why would people buy your token, now or later?• What would the success of the project mean for the token (and token holders)?• What are the token economics?
About you	<ul style="list-style-type: none">• Do you have the necessary expertise for this? If not, are you willing and able to source it? At what cost?• How will you finance your token sale?
About strategy	<ul style="list-style-type: none">• How will you execute the plan, in practice?• How will you handle any conversion between tokens and fiat currencies?• Is there a better way of executing your vision? For example, private investments and loans may be much better suited for your project, or they may complement it

If you decide to proceed, the usual approach is to develop a conceptual document typically called a Whitepaper. Key messages for a Whitepaper:



Disclosure principles

- **Be transparent:** Opportunities, challenges and conditions for success
- **Be fair:** If you don't know something, say so
- **What would you want to know?** Put yourself in participant's shoes and consider what someone needs to know to make a fair assessment before buying your tokens

The Whitepaper should:

- (a) set out a **persuasive rationale** for your project and the token, including the relevant market context;
- (b) include the **specific steps** you propose to take and map out the **milestones** you intend to achieve;
- (c) provide a sufficient **technical explanation** of the key features;
- (d) identify the key **contingencies**, including risks and dependencies, and how you plan to mitigate them;
- (e) be **reviewed** by professional advisors, including your lawyers and experts in the field of your project;
- (f) identify the **key team members** involved; and
- (g) use **appropriate language** that makes it clear that certain aspects of the project are conceptual only and adopt appropriate disclaimers and warnings.

Some service providers offer to write Whitepapers. This is fine, but make sure it is always your project. Compensation should also be considered.

Some projects also have a technical paper. Consider if this approach is appropriate for your project, keeping in mind that each project is different and potential participants will have a different focus areas and expectations.

Your goal should always be **transparent and fair disclosure**.

5 Establish a strong project team

5.1 Cover your bases

You need expertise that covers all the bases for the token sale.

Your project team may comprise both internal and external people. It may also include people who can deliver on the ultimate project. Key team members often involved in a token sale include:

- (a) Core project developers
- (b) Business and corporate development team members
- (c) Token sale advisors
- (d) Website developers
- (e) Smart contract authors and reviewers
- (f) Strategy, marketing and public relations team members, which may cover one or more target market segments
- (g) Legal advisors in relevant markets
- (h) Tax and accounting advisors

A number of other service providers may assist, such as advisors on governance arrangements for both for-profit and not-for-profit issuers. However, focus on **quality over quantity**. In this new area, there are many individuals claiming expertise.

Decide from the outset whether you are relying on advisors for expertise or for execution. Ask yourself: are they really going to deliver value? Ask for their specific experience and (ideally) references.

5.2 Managing the project

Token sales require strong project management and execution skills. Appoint a project lead. Make sure relevant team members are talking to one another. Meet regularly. Encourage people to raise issues early. To drive your token sale forward, you should:

- (a) develop a time and responsibility schedule;
- (b) agree key milestones with all key stakeholders;
- (c) plan for slippage – things rarely go 100% to plan; and
- (d) if Plan A doesn't work, have a Plan B (and a Plan C) ready to go.

6 Design well

6.1 What rights do your tokens give? How do they function in the project?

This is the crux. Your tokens may do many different things and this is an essential part of the commercial and utility design and regulatory status of your token.

Often tokens confer purchasers with one or more of the following rights. The precise rights will impact their characterisation and regulatory status. You must decide what your token does – whether:

- (a) **share / proprietary right** – granting a share or other proprietary right in a company or in particular property;
- (b) **membership/access right** – providing its holders the ability to access a product or service, tangible or intangible;
- (c) **profit right** – entitling its holders to profits or revenues from the product, service or some other business;
- (d) **derivative interest** – granting entitlements or embedding other features determined by reference to something that is unknown and/or fluctuating;
- (e) **contribution rights** – enabling its holders to play some role in developing and/or maintaining the product or service;
- (f) **governance rights** – enabling its holders to influence the governance of the product, service or other matters;
- (g) **payment / medium of exchange right** – enabling its holders to use it to make payments – for example, as transaction or other fee; and/or
- (h) **other rights** – there are many other potential rights and opportunities that could be created, including things like repayment rights, block creation rights and staking mechanisms.

Spend time to study token economics to understand how your token economy can achieve sustainability in the short, medium and long term. Consider engaging a professional advisor who can help analyse and model out your proposed economic model to ensure the economy you are designing for your users is viable.

6.2 Are these tokens transferable?

You need to decide whether the rights attributable to the tokens (if any) will be transferable (usually yes) and on what conditions (if any). If so, your documentation needs to say so.

However, **do not encourage speculation** – whether through what you say on social media, in your documents or in connection with any listing of your tokens on an exchange. This can impact the regulatory analysis in certain markets and also create risk for you from a contractual standpoint. Ensure you get the legal advice you need.

6.3 Avoiding a scam

Most people believe in their project, care about their reputation and are keen to do the right thing by their purchasers. However, that does not mean you will be protected from scams.

Key things to look out for are:

- (a) **large promises and/or below-market costs** from advisors, other service providers and certain prospective purchasers – if it sounds too good to be true, it probably is. While a token sale may cost less than the alternatives, they do not come cheap;
- (b) **less qualified service providers**, without the expertise and track record in relevant areas to deliver. While expertise is still developing in the digital asset space, due diligence is important, and is especially critical for technology procurement;
- (c) **your cybersecurity controls**, to address multiple attack vectors;
- (d) **over-stating** what you can actually deliver; and
- (e) **reneging** on commitments you have already made or implied – for example, by materially varying terms of your token and/or the sale, to the detriment of purchasers. Sometimes, variations are permitted in documentation, but it does not eliminate risk.

Many of these could expose you to allegations of fraud, misrepresentation, negligence and breach of contract. Purchasers could also have other causes of action against you.

6.4 The “anti-FOMO principle”: Distance yourself from opportunism

Don't encourage the “fear of missing out” in your prospective purchasers. Stirring a frenzy in the market and in your token holders may hurt the long term prospects of success for your project.

7 Think about the long game

7.1 What is the best legal structure?

You have to live with the structures you create, so design them well.

Many token issuers are keen to raise funds swiftly. However, restructures are costly, time-consuming and sometimes impracticable. Disputes easily arise if handshake agreements are not formalised into a legally binding agreement.

Seek professional advice early. It's a lot cheaper to whiteboard ideas and then settle on an agreed approach than it is to remedy a bad project.

Lots of factors go into designing a good structure. You should take into account at least the following factors when you establish the legal structure for your token sale and project.



You also need to consider what will happen the day after the token sale closes – is your structure also set up for executing on your project?

7.2 Tax and accounting

In planning the project, token utility and a token sale, there are many tax and accounting considerations that need to be seriously reviewed. These include the following:

- (a) **Issuing entity tax footprint** – not only in terms of the optimal jurisdiction for the issuing entity but also the most appropriate legal structure. Where senior management are based or where the intellectual property resides could be important.
- (b) **Tax and accounting treatment of token issue proceeds** – whether the proceeds are taxable and if so the timing of it. The tax treatment may also depend heavily on the accounting treatment (eg whether the proceeds are revenue receipts and if so the timing of recognition).
- (c) **Potential tax relief** – availability of permissible software or research and development deductions that will help reduce the taxable margins.
- (d) **Transfer pricing** – especially when part of the research and development (R&D) or software spend will be done by other related entities in different countries. Requirement that associated related party transactions are conducted at arm's length with proper policies and support in place.
- (e) **Founders and staff tax impact** – remuneration received other than in cash may also be taxable.
- (f) **Tax compliance obligations** – whether there are any tax reporting, filing and compliance obligations for the issuing entity and/or other related entities in Hong Kong and in different countries.

Tax and accounting are complex matters, and these are for general consideration only. Professional advice is essential. This also applies to any digital asset activities, such as trading and funds.

7.3 How much do you want to raise? Why?

Adopt a logical fundraising strategy. Some, but not all, token sales are capped. You may consider imposing a hard cap and or soft cap on token sales. Essentially:

- (a) a **hard cap** represents the maximum number of tokens available for purchasing between the opening and closing date; and
- (b) a **soft cap** is set below the hard cap to provide flexibility to an issuer if it wants to close a sale in advance of the proposed closing date. Any unsold tokens as a result of activating the soft cap may be made available for future token sales, or they may be destroyed. In either case, this must be disclosed.

The key questions you should ask yourself include:

- (i) How much do I actually need for my project?
- (ii) Do I need to do a pre-sale (and if so, why)?
- (iii) If I raise less than expected, what will the impact on my project be?
- (iv) Do my caps carry any legal, regulatory or tax implications?
- (v) How will I implement the caps in practice?
- (vi) Are the caps for the initial sale only, or will there be a finite supply as well?
- (vii) Do I need any flexibility to change the approach if needed? If so, how is that disclosed?
- (viii) Will I need to do multiple sales (and if so, on what terms)?

Consider adopting a hard cap for token sales that are being undertaken as part of fundraising for a project, to reflect what you actually realistically need within disclosed timeframes. This does not mean that you have to have a finite number of tokens available forever, although you should disclose your plans.

7.4 What is your target market?

First and foremost, focus on **who has a genuine need for your token**. This should tie into your broader project.

Other things you should think about include:

- (a) **legal and regulatory requirements.** These relate to:
 - (i) **capacity** – for example, individual purchasers being at least 18 years old and corporate purchasers having been properly established;
 - (ii) **prohibited or higher risk transactions** – for example, with persons associated with sanctioned countries, terrorism and/or politically exposed persons;
 - (iii) **regulatory requirements** – for example, avoiding sales to residents (and in some cases even citizens) of certain jurisdictions, to comply with financial services or other regulatory restrictions; and
 - (iv) **specific exemptions** – for example, it may be possible to sell certain security tokens to certain professional / accredited purchasers; and
- (b) **practical and strategic considerations.** For example, you may have an existing customer base / market that makes sense to pursue.

Private sales and pre-sales require close inspection

Many sales involve a combination of private sales and public sales. Private sales often involve discounts or bonuses. They may also involve the provision of services in exchange for tokens. The target market for private sales is generally limited to larger purchasers, who might warrant additional incentives. Sometimes, there may also be public pre-sales.

However, carefully consider whether or not those incentives are lawful, correctly priced and in the project's best interests. **Do not undertake private / pre-sales that are likely to result in perverse incentives and inappropriate behaviour (such as post-sale dumping) or which do not reflect genuine need.**

Carefully consider offers from large purchasers and seek advice. Consider appropriate lock-ups and setting a cap on the amount allocated to such sales. Ensure you obtain advice, particularly where there are complicating factors such as convertible or derivative features. Validate through professional advice if they constitute securities. If so, then you need to comply with securities law – see paragraph 8.

7.5 Pricing and payments

Pricing and payment methodologies should be absolutely clear and logical.

Key points:

- (a) **Pricing must be clear.** As a general rule, it should be fixed unless you get legal advice. Discounts, bonuses and premiums should clearly disclosed as necessary. Don't confuse your purchasers.
- (b) **Price must be known at the time of sale.** If you accept multiple payment options, make sure the pricing is known when the person purchases the token. Any methodology used to calculate exchange rates should be disclosed.
- (c) **Consider the practical aspects** of accepting particular payment methods. The more complicated your sale, the more work needs to be done to make sure it is safe. If you plan to accept fiat currency, do you have the bank accounts or other channels required to do that?

7.6 How are you going to use the proceeds from token sales?

An issuer needs to consider how to use the proceeds from token sales. Token purchasers would want to know that too.

Commonly, proceeds from token sales may be used for:

- (a) **project development** – development, promotion, marketing, and maintenance of the project and other related purposes. An issuer may also formulate a development roadmap, dividing projects into stages for which there is an allocated budget; and
- (b) **operational expenses** – such as fees and expenses attribute to the trading platform, advisor fees, outsourcing fees, employee compensation, IT costs, etc. This includes all the expenses associated with the token sale itself.

Consider how this is documented, governed and executed. It is one of the most closely examined aspects of token sales from a purchaser standpoint. Consider your minimum require disclosure – but implement as much as is practical.

7.7 Allocations

Token allocations should be given serious thought. For example, from the perspective of purchasers, they impact the perceived supply (and therefore arguably any value derived from scarcity), as well as any future supply overhang. Accordingly, consider the interaction of tokens allocated amongst private sales, public pre-sales, general public sales and future sales.

It is also important to consider the allocation objectives for tokens granted to service providers, community bounties, advisors, project team members and sponsors, either at no charge or at a discount. For example, is the intent of the allocation primarily to serve as compensation in lieu of cash consideration (where cash budget is limited)? Or is it to align interests to be consistent with those of purchasers and/or the project (that is, are you trying to encourage certain behaviour)? Or is it a combination?

No matter the objective, lock-up considerations for any “free” or discounted tokens will be a key area of interest for purchasers. Care is required as to the recipients, the rationale and any locking/unlocking mechanisms you adopt.

Be very clear about how you are allocating tokens. If you need flexibility, say so.

8 Address legal and regulatory issues early

Even though tokens and even blockchain technology are reasonably new, a significant body of law already applies to token sales. The legal and regulatory impact will be driven by the token utility design, so these issues need to be considered at the beginning of your project and dynamically as it unfolds.

This paragraph provides a synopsis of legal and regulatory issues common to many token sales, but it is not legal advice, nor does it cover everything you need to know. You must obtain legal advice for any token sale and this should be done as early as possible in your planning process. You should also make sure that your documentation and marketing materials are consistent.

8.1 What laws are likely to apply?

The question of which laws apply links to **jurisdictional nexus** – that is, whether there are any connecting factors to a particular jurisdiction that trigger its laws.

You should consider the laws and regulations *at least* of the following:

- (a) **Domicile of the issuer** – the place in which the token issuer is established. This usually occurs by incorporating a company. This impacts a range of important issues including business and company registrations, taxation and employment law, plus visas for any staff coming from overseas.
- (b) **Marketing of the token** – any jurisdiction in which you market your token, even if no one ends up buying from there. Marketing can occur in person, online, over the phone or even passively. Make sure you understand what is caught and adopt appropriate controls.
- (c) **Sale of the token** – linked to marketing, each jurisdiction from which you will accept purchasers for the sale. This may be different to the places in which you marketed. Know-your-customer (“**KYC**”) checks and anti-money laundering and counter-terrorist financing (“**AML/CTF**”) laws and regulations are also relevant here, as is the method of sale, which may be available in many different jurisdictions around the world, in many different forms.
- (d) **Platform / business location** – the location of your platform and any related businesses. This can be challenging to determine for certain platforms, particularly where they are online and decentralised. However, do not assume that no laws apply – in fact, it’s likely that multiple overlapping laws apply.
- (e) **Exchange location** – any jurisdiction in which you expect (or wish) to have your tokens traded, which may be different from the above. Many exchanges will ask you for a

confirmation that your token can be sold in that place. They may even ask you to provide a legal opinion or similar form of confirmation.

Other jurisdictions may also be relevant – for example, certain citizens are prohibited from participating in certain activities, or are subject to additional obligations, such as taxation and sanctions compliance.

8.2 Are your tokens regulated in Hong Kong?



Every token sale is unique. This means that every token sale must be examined on the facts. There are key themes and particularly laws that merit special attention.

When considering whether your token is regulated, you will generally need to think about:

- (a) what your token represents;
- (b) who your purchasers are;
- (c) what rights your purchasers receive;
- (d) how the token can be used;
- (e) how the token is priced;
- (f) how it is marketed;
- (g) what you have told purchasers during the token sale;
- (h) how the token is traded (if at all); and
- (i) what any underlying platform or business does.

The following chart identifies some of the key laws that you should consider when assessing a token sale, with the assistance of counsel. **It is not exhaustive.**

Regulated product	Key features	Key triggers to think about
“Money” <i>Generally interpreted as being limited to fiat for now, but should be monitored.</i>	Generally accepted medium of exchange for goods, services and the payment of debts	<ul style="list-style-type: none"> • Banking Ordinance (Cap. 155) - deposit-taking business and money brokerage • Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (Cap. 615) (“AMLO”): remittance services and money changing • Payment Systems and Stored Value Facilities Ordinance (Cap. 584): stored value facilities
“Currency” <i>As above.</i>	Money in circulation in an economy by which sales and purchases are effected.	
“Share”	A representation of ownership in a company, entitling the holder to participate in the distribution of the company’s profits and, when the company is wound up, its surplus assets.	<ul style="list-style-type: none"> • Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32): share offerings • Securities and Futures Ordinance (Cap. 571) (“SFO”): various regulated activities requiring a licence in respect of certain “shares” and “stocks” as “securities”, plus approval

Regulated product	Key features	Key triggers to think about
		requirements in some cases. Other interests may also be caught
“Debenture”	Another type of security that generally represents a <i>debt</i> obligation.	As above – but may trigger other types of regulation because of their particular features
“Collective investment scheme”	Complex and broad definition, but typically involves the pooling of funds for the acquisition of certain property which is centrally managed. Investors receive profits, income or other returns derived from that property.	SFO: various regulated activities requiring a licence as a class of “securities”, plus potential approval requirements in some cases  This classification should be reviewed closely, particularly for any token issued in connection with a specific project
“Structured product”	At a high level, an instrument under which the return or amount due (or mode of settlement) is determined by reference to changes in the value of securities, commodities, indices, property, interest rates, currency exchange rates or futures contracts, or any combination of it, amongst other possible things such as certain events.	SFO: various regulated activities requiring a licence as a class of “securities” (if offered to the public and not exempt), plus potential approval requirements in some cases  Pay particular attention to the pricing of your token when considering this issue
“Futures contract”	A contract or option on a contract made under the rules or conventions of a futures market.	SFO: various regulated activities requiring a licence, where dealing and/or advice are involved
“Leveraged foreign exchange trading”	Complex and broad definition, but can include, for example: <ul style="list-style-type: none"> • financing for spot FX contracts; • deliverable and non-deliverable FX forwards (or financing them); and • deliverable commodity forwards with pricing referable to FX fluctuations (or financing them). 	SFO: regulated activity requiring a licence, plus possible approval requirement in some cases

Derivatives and commodities regulations may also be relevant to your token, depending on the facts.

Regulatory statements

You should also take into account the Securities and Futures Commission’s “Statement on initial coin offerings” dated 5 September 2017, and the “Notice on Potential Regulations Applicable to, and Risks of, Crowd-funding Activities” dated 7 May 2014, which provides a useful synopsis of its position.

For those dealing with banks, make yourself aware of the Hong Kong Monetary Authority’s (“**HKMA**”) position as well, as it will help you understand where those banks are coming from.

Many other laws apply

Compliance is not just about financial services regulation.

Hong Kong has a rich fabric of laws that protect purchasers from improper conduct, even for otherwise unregulated sales. For example:



8.3or anywhere else?

Make sure you make yourself aware of the laws that apply and take the advice you need in other jurisdictions relevant to your project.

Where you choose **not** to sell in a particular jurisdiction, consider adopting geo-blocking on your website, appropriate KYC checks, contractual restrictions, self-declarations and/or other steps to prevent unwanted marketing and sales.

8.4 Staying on top of developments

The legal and regulatory landscape for token sales is continually evolving. You must keep yourself informed of developments, particularly while you are preparing for a token sale.

9 Create strong and complete documentation

9.1 Why this matters

You need legal documentation to spell out the terms of your token and the contract you have with token holders. In most cases, the law will imply a contract between you and token holders – so you may as well write one and have control over what it says.

The documentation needs to cover the token sale as well as your arrangements with third parties. Your project may also need separate terms.

9.2 What is in your document suite?

Token sales that do not involve regulated product or entity do not require a specific set of documentation with prescribed content.

However, a strong token sale usually includes the following documents.



9.3 Other key documentation

Token sales may require particular filings and documentation in certain jurisdictions. Running a business also requires a range of other documentation, such as employment contracts, visas, customer terms etc.

For projects involving cross-border and/or decentralised activities, the legal and documentation issues become especially important to consider early and thoroughly.

9.4 Electronic transactions

Hong Kong supports the provision of information and execution of documents electronically. However, there are certain requirements and restrictions in the Electronic Transactions Ordinance (Cap. 553). Your legal advisor should cover these off, but make sure you make them aware if you plan to sign documents or give notices electronically.

9.5 Make a call on governing law and dispute resolution

Digital assets don't just exist in cyberspace. All contracts should have appropriate governing law and dispute resolution clauses. Consider also if arbitration may be appropriate.

10 Adopt appropriate KYC controls

Digital tokens and cryptocurrencies are vulnerable to misuse and abuse for various reasons, including their anonymous / pseudonymous nature. As a token issuer, you are exposed to risk when issuing and accepting such assets, as well as when accepting fiat currency.

10.1 Why should I bother about KYC?

KYC controls serve lots of really useful purposes. For example, they can assist with:

- (a) **avoiding financial crime** – complying with AML/CTF, sanctions and weapons of mass destruction (“WMD”) non-proliferation requirements, which can carry significant criminal penalties – see paragraph 10.2;
- (b) **preventing regulatory breach** – allowing you to screen out purchasers to whom you do not wish to sell, to avoid breaching regulatory restrictions in particular jurisdictions. For example, this could mean avoiding whole jurisdictions altogether, or it might mean that you only sell to a more narrow pool of “professional”, “sophisticated” or “accredited” (or similar) purchasers who meet certain tests; and
- (c) **strengthening reputation** – enhancing your reputation with purchasers, advisors, regulators and ancillary service providers (including banks).

The Financial Action Task Force on Money Laundering issued a report on “Virtual Currencies Key Definitions and Potential AML/CFT Risks” in June 2014. Amongst other things, it highlights how virtual currencies are potentially vulnerable to money laundering and terrorist financing (“ML/TF”). Further guidance was provided in its “Virtual Currencies Guidance for a Risk-based Approach” in June 2015. Various regulators have highlighted these risks, including the HKMA.

KYC is critical to mitigate these risks, as is appropriate ongoing monitoring.

10.2 Financial crime laws you need to know

In Hong Kong, various legislation, rules and regulations restrict or prohibit payments, transactions, services and dealings with assets having a proscribed connection with certain countries, individuals, groups or entities subject to international sanctions or associated with terrorism, money laundering, weapons of mass destruction or other criminal activity.

These apply even if you are not handling fiat currency.

The key laws include the following:

- (a) Organized and Serious Crimes Ordinance (Cap. 455);
- (b) Drug Trafficking (Recovery of Proceeds) Ordinance (Cap. 405);
- (c) United Nations (Anti-Terrorism Measures) Ordinance (Cap. 575);
- (d) United Nations Sanctions Ordinance (Cap. 537); and
- (e) Weapons of Mass Destruction (Control of Provision of Services) Ordinance (Cap. 526),

together with subsidiary rules, regulations and gazetted persons etc.

Some institutions are also subject to additional detailed due diligence requirements in the AMLO. Certain authorities, industry associations and transnational bodies also publish guidance for certain sectors. This document does not describe these documents and you should obtain advice about them as needed.

The rules are broad and carry significant penalties, including criminal liability, fines and imprisonment. Importantly, they do not require knowledge of the actual underlying crime – suspicion can be enough.

10.3 Key prohibitions

You are prohibited from dealing with property (including cash, crypto or other assets) where you either know or have reasonable grounds to believe:

- (a) that the property in whole or in part, directly or indirectly, represents proceeds of:
 - (i) drug trafficking;
 - (ii) organised and serious crimes (which would include a range of serious offences, including fraud, bribery and tax evasion); and
 - (iii) terrorism; and
- (b) your services might assist the proliferation of WMDs.

These prohibitions apply **irrespective of value, form or context**. They can also apply even if you are not sure of the exact underlying crime involved.

You must also report relevant knowledge or suspicion to the Joint Financial Intelligence Unit (“**JFIU**”) before dealing with that person and must avoid prejudicing any potential investigation by “tipping off”. It is also possible to seek JFIU consent to proceed with transactions, even if they would otherwise be in violation of applicable laws. Reportable suspicious transactions may even arise if the token proceeds are not in your custody (for example if paid to a designated bank account, wallet or escrow account).

Sanctions controls are complex, as they usually target certain persons, goods, services and/or industries. Ensure you have a policies and procedures to deal with the risk. Seek advice when you need it.

10.4 You may also be subject to offshore laws

In certain cases, the AML/CTF and sanctions rules of other jurisdictions may apply because of your domicile or other relevant connections. You should obtain appropriate advice to protect against breaching those rules.

Offshore sanctions can also provide grounds for a relevant suspicion under Hong Kong law. For example, an offshore sanction could describe a particular entity being involved in developing nuclear or chemical weapons, which could trigger Hong Kong WMD non-proliferation rules *even if* they are not specifically sanctioned under Hong Kong’s sanctions regime.

10.5 Sample KYC procedure

There is no “one size fits all” approach. It’s important to think about what is right for your project and your token sale.

Schedule 1 sets out a sample KYC procedure that may be adapted to your sale. You should take into account the nature and steps of your sale plus any additional steps and restrictions that you wish to apply. By all means, use appropriate technology solutions if they are available – often they save time and cost, and enhance user experience. Just do your due diligence first to make sure they achieve what you want and address your legal exposure.

10.6 Further KYC controls

You should also consider what further AML/CTF and other KYC controls you conduct after a token sale. For example, it may be appropriate to conduct further checks and/or update information before accepting tokens for use on your platform.

10.7 And when you are collecting so much information...

Comply with your privacy and confidentiality requirements. In Hong Kong, the Personal Data (Privacy) Ordinance (Cap. 486) is the key legislation that applies to the collection and use of personal data. However, it is not the only law that applies. Depending on your operations, you may be subject to other requirements, including offshore rules. Obtain advice early. Implement a good privacy policy and robust procedures and controls.

11 Market fairly and transparently

Play fair.

- (a) Choose an appropriate target audience and marketing channels.
- (b) Take the time to understand your privacy and confidentiality obligations, and provide easy ways for people to opt-out of your communications. An annoyed person is not going to buy your token.
- (c) Do not mislead or deceive anyone and actively manage expectations.
- (d) Disclose anything material, including conflicts. Put yourself in the shoes of potential purchasers and ask what you would expect to know. If you don't, it's arguably misleading.
- (e) Ads should not be dressed up as genuine endorsements. **#ad** (or similar) – it's that easy. Don't fake it.
- (f) Create marketing guidelines and model answers to frequently asked questions, to ensure everyone is on the same page. Some projects are complex – a one-page summary and overview deck may help prospective purchasers as well as your project team.

12 Sell securely and meticulously

Funds and sales collection processes will differ depending on the nature of the token sale.

However, in all cases, **security is essential to the success of the project**. Many tokens sales have failed due to inadequate security. Security is a critical success factor for a token sale. It is imperative that you and relevant advisors evaluate all possible attack vectors and mitigate accordingly.

Systems	All systems concerned with the token sale should be deployed and safeguarded by experienced IT security personnel, and a responsible security officer should be employed for the duration of the project.
Handcrafted HTML	Important/ visible web sites should avoid using commonly attacked marketing tools. Instead, HTML should be handcrafted and delivered as static content
White glove administration	All access to key systems should be accessible only from clean "white glove" administrative systems
Communication channels	Coordination among communication channels should be in place, with contingency plans if one or more are compromised
Two factor authentication	All staff access to all systems (including social media services and email) should have two factor authentication enabled. A similar approach should be considered for other users
	Mobile phone / SMS should not be used, as a two factor authentication services as mobile phone numbers are easily of often hijacked through fraudulent number porting requests

Multiple DDoS protection	Multiple levels of distributed denial of service (DDoS) protection should be in place for all web facing aspects of the project
Legal review	Legal counsel should be taken through all steps and processes related to the collection of funds and issuance of tokens, from language through to mechanics - as seemingly innocuous technology decisions may have material legal implications
Escrow	Where possible, third party escrow services may be employed for collecting fiat and digital assets
Smart contract protocols	<p>If smart contracts are used for the collection of funds:</p> <ul style="list-style-type: none"> • timing - smart contract code should be finalised as soon as possible to allow adequate testing and external review • review - all relevant smart contract code should be reviewed by third party security specialists • audit - third party security audit specialists should be engaged early in the project life-cycle as they may not be available on short notice
Cold storage and other digital asset security mechanisms	All digital assets collected should be stored in cold storage or using hardware devices, and where possible multi signature employed to reduce key person risk
Secure name service solutions	Where possible, secure name service solutions should be used for sharing contract addresses with the public to prevent phishing and other attacks that attempt to redirect users to fake smart contract addresses. Also be aware of fake website names, URLs etc, and have a plan to secure key names and URLs
Social media	All social media channels should be locked down or monitored heavily for attacks throughout the entire campaign as this is the most common attack vector
Internal controls	Internal controls and segregation of duties should be imposed, and access to significant funds should be tightly controlled, with no single person having access or control
Employee, supplier and technology diligence	<p>All staff and suppliers should be subject to background checks before employment in any sensitive roles within the project team.</p> <p>Ensure you do appropriate due diligence on all technology products and services. Appoint someone to stay on top of any developments ahead of sale</p>

13 Adopt a strong governance framework

13.1 Risk management for the sale

Robust risk management and governance are essential for token sales. Token sales are particularly prone to the following risks:

- (a) **Legal and regulatory risks** – the legal and regulatory landscape applicable to token sales is developing rapidly. Your exposure to the risk of that landscape changing increases with each jurisdiction to which you sell. It is important to stay abreast of changes and speak to legal advisors experienced in financial regulatory issues.
- (b) **IT risks** – smart contracts have potential vulnerabilities that should be addressed as part of pre-sale audits. Your token sale platform is also vulnerable to cybersecurity threats, including third party hacking. The security of digital wallets and issuance platforms must be managed. Relevant and appropriate business continuity plans should be in place.
- (c) **Operational risks** – you must have an experienced team to help you manage technology, IT infrastructure, daily operations, marketing, etc. Trust your team, but make sure you hire the right team, source third party support where you need it and manage key person risk. For example, token sales require highly specialised technology expertise. Also consider adopting internal controls and segregation of duties to mitigate internal risks.
- (d) **Fraud risks** – Linked with IT risks, you should adopt appropriate measures to prevent attempts (from within or outside your organisation) to misappropriating your assets, tokens or proceeds from token sales.

A number of security-related suggestions are set out in paragraph 12.

13.2 Governance for the project itself

The public wouldn't trust a multi-million dollar business or foundation in the normal world unless it has a proper governance frameworks in place. The same applies in the token sale and cryptocurrency space. Certain basic governance and control items need to be carefully thought through and established:

Key considerations include the following:

- (a) **Rights and obligations** of token holders vs shareholders / controlling interests of the issuer. This includes determining who has the power to appoint and remove people in decision-making roles at the issuer or project level
- (b) **Board and committee structure**, composition, operations and effectiveness
- (c) **Strategy, planning and monitoring** of the issuer and the project that relates to the token sale, including who has power to change the project and how
- (d) **Robust risk management and compliance** processes, including:
 - (i) written policies and procedures, approved by the Board; and
 - (ii) appropriate checks and balances, as well as senior management oversight and engagement
- (e) **Transparency and disclosure** to all stakeholders, including token holders, members, customers, the community at large and regulators where needed
- (f) **Corporate citizenship** – for example, codes of conduct, business ethics, employee relations and social responsibilities.

13.3 DAOs need care

If you are creating a decentralised autonomous organisation (or similar), make sure you consider what you are creating legally and what ongoing governance and/or intervention rights you wish to retain. For example, they could amount to a collective investment scheme, partnership or other structure that carries legal and regulatory implications.

Like tokens, the facts matter. If participants are located in multiple jurisdictions, it is also likely that many laws will apply (and could conflict). Seek advice about the pre-requisites for participation, locations, logistics, regulatory implications, intervention mechanisms, data protection and cybersecurity issues early.

14 Final word

A legally compliant, secure and fair digital asset economy is in the interests of the entire Hong Kong fintech (and broader) community. If for no other reason, take a best practice approach because it boosts *your* reputation and helps protect *your* own downside risk.

Token sales tend to be relatively high profile and will attract attention (both wanted and unwanted) from media, the public, and regulators. It is important that you have a plan to provide a consistent message externally – with appropriate supporting documents as needed.

This is not an exhaustive document. The digital asset space is constantly evolving and you must stay on top of it.

This is not legal or other professional advice. Make sure you obtain it.

Schedule 1 – Sample KYC procedure

1 Sample KYC procedure

1.1 Minimum requirements

There is no “one size fits all” approach to KYC procedures. Ultimately the approach taken depends on the nature of the token sale, the participants and your risk tolerance. Further, KYC can be done internally or it can be outsourced. If you choose the latter, your obligation and exposure will not necessarily be fully mitigated.

Overall, you should implement a risk-based KYC framework for your sale. This will involve deciding the parameters of your KYC framework, and any threshold levels you may use.

Please consider this carefully and seek additional advice if you need it. You should adopt the KYC procedure that is right for your sale. There are many technology solutions that may add to or replace the procedures here – do your due diligence and use them if they help you mitigate risk better. In any event, you will need to have evidence of the policies and procedures that you adopt, should your token sale come under scrutiny.

(a) Step 1 – Initial pre-screening

Each person is required to select their jurisdiction of residence and/or nationality from a drop-down menu before gaining access to the token sale purchase steps.

This will help make clear that you have restricted persons from certain jurisdictions from participating in the Token Sale for regulatory, sanctions or other lawful reasons. To assist with this, you should devise a list of blacklisted jurisdictions.

An IP address check may be implemented to help verify that the person is not from a blacklisted jurisdiction.

(b) Step 2 – Registration and collection of information

Each person registers for the Token Sale. The registration window should close with enough time to properly verify and perform necessary checks.

As part of registration, interested participants should provide some (or ideally all) of the following details. Blank fields should not be permitted.

Individuals

- Full name
- Date of birth
- Nationality and place of residence if different
- Government-issued photo identity document type
- A copy of that identity document and (ideally) proof of address
- Email address
- Digital wallet information and any other details required to effect the purchase

Companies

- Full company name
- Company number
- Date and place of incorporation
- Registered company address and business address if different
- Full name of authorised person
- A copy of the document authorising the person to bind the company, such as a board resolution or power of attorney
- Full name of each ultimate beneficial owner of the company
- Authorised email address
- Digital wallet information and any other details required for the purchase

See also paragraphs 1.2, 1.3 and 2 of this schedule.

(c) Step 3 – Verification and screening of registered users

Having great information is not enough. The next step is to:

- (i) verify the data provided as part of registration against the documents provided and information that is publicly available;
- (ii) conduct screening using a trusted source of information containing designated person lists and sanctions. There are numerous compliance databases provided by third party vendors; and
- (iii) report any relevant knowledge or suspicion to the JFIU.

You may also wish to **outsource** these procedures if you do not have sufficient in-house bandwidth. If so, make sure all parties understand who is responsible for what.

(d) Step 4 – Dealing with special situations

Situations may arise that require special attention. These may include, for example:

- (i) positive sanctions hits, which should be rejected;
- (ii) other negative screening results, which should be considered from both a legal and reputational standpoint;
- (iii) incomplete, obviously inaccurate or poor quality information, which should be queried and/or rejected;
- (iv) mismatches between the information provided and what is in the identification document, which should also be queried and/or rejected; and
- (v) information that suggests a person is from another blacklisted jurisdiction, which should be rejected.

Ideally, you should have a documented policy and procedure to assist relevant staff members and/or service providers to understand AML/CTF obligations, assess KYC information and deal with these situations.

These should include internal escalation and reporting procedures in the event that any information gives rise to a suspicion or knowledge of improper activity. Legal advice should be sought as required.

(e) Step 5 – Pre-sale confirmation

There should be a final set of pre-sale “tick-box” confirmations, which include a specific acknowledgement of the terms and conditions.

1.2 What about other sales, such as pre-sales?

Substantially the same KYC procedures should apply.

However, such purchasers may be subject to different factual circumstances in the sense that sales may occur in a different context (eg offline), there may be additional restrictions (eg financial status) and purchasers may include other structures (eg trusts).

You should adopt a risk-based approach to the type and level of information and documentation you collect from such purchasers. What this means in practice is that you should look at their domicile, regulatory status, reputation and structure. For example, you may not need to ask for as much information from a licensed corporation or listed company, where relevant information is available on a government registry.

1.3 Asking for additional information

You should consider whether it may be appropriate to obtain further information to provide more protection from a KYC standpoint.

For example, regulated financial institutions in Hong Kong would usually also obtain certificates of incorporation, lists of directors, additional beneficial ownership information and documents, a detailed corporate chart etc. Any other structures, such as partnerships and trust arrangements, should be considered on a case-by-case basis.

All information collected should be subject to screening and verification as suggested above.

2 Additional steps to consider

2.1 Calibrating the measures to address risk

You may also want to tailor your KYC measures further – for example, based on:

- (a) **jurisdiction risk** – for example, through blocking or adopting enhanced measures for persons from countries with known AML/CTF vulnerabilities;
- (b) **customer risk** – for example, taking into account that a particular purchase is a large, well-known financial institution of good standing and reputation, based on publicly available records (or on the flipside, not known at all); and
- (c) **channel risk / purchase amount** – for example, adopting a system whereby above certain purchase amounts or having regard to the online purchase environment, additional documents and information are needed. For example, a purchaser may be required to provide a selfie of themselves, showing them holding their identity document and a piece of paper showing the current date.

On the other hand, very low-value purchases could be subject to simplified requirements.

2.2 After the sale

Consider implementing risk-based AML/CTF controls *after* tokens are sold – for example, periodically updating information you hold to ensure it remains relevant and up-to-date and undertaking KYC on any new token holder when accepting tokens to access your platform.

Take a look at the technology, other tools and information available to help address the potential misuse of your tokens. These are rapidly evolving and can help mitigate risk and strengthen reputation.

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