



FINTECH ASSOCIATION
OF HONG KONG

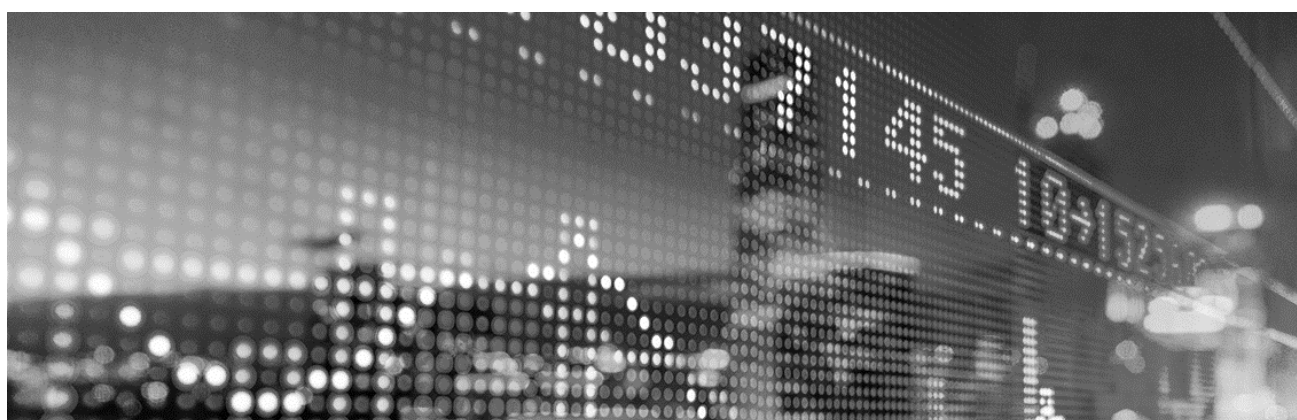
Best Practices for Token Sales

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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,¹ often (but not always) utilising platforms such as Ethereum, the largest token sale platform to date. A token typically represents certain rights and prerogatives granted to its holder. Tokens can be distributed in multiple ways, including through public token sales, private sales, exchange offerings, airdrops, in return for services and as grants.

Tokens themselves can play multiple roles. For example, they can just serve as the ‘contribution vehicle’ for a project. In that case, once contributors receive their tokens, they must exchange them for other tokens, coins, points or otherwise according to some stated formula to access the relevant utility (for example: one acquired Ethereum token grants me the right to redeem 10 points on the new platform, or in an alternative scenario, one token on a newly developed blockchain protocol). Alternatively, and depending on the architecture of the project, the tokens operate as the sole vehicle for both the token sale and its utility.

The sheer number and variety of possible structures makes prescriptive rules about token sales impossible. However, there are numerous common threads to a token sale that has integrity and helps protect relevant stakeholders.

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 intended to help you ask the right questions.

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 focused. 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.

In an effort to make this document more accessible for individuals and entities preparing for a token sale, we have added these Guide Points, provided in blue sections such as this one. If you are considering a token sale, these sections may be particularly useful.

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

¹ This term is used in a broad and generic sense and is intended to include other types of distributed ledger (and similar) technologies.

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;
- (d) be used as a medium of exchange, store of value or unit of account; and/or
- (e) 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, which might be called a “security token” offering (or “**STO**”). 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. Further details are set out in paragraph 6.1.

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

Labels are not determinative. If you are concerned about the legal and regulatory ramifications of conducting a project labelled as an “ICO” or “STO”, re-terming it as a “token sale” or a “token generating event” and not changing other details of the project will not change how it is viewed by regulators. Even distributions via an exchange or for free (including via “airdrop”) may be problematic.

1.3 Global principles and developments

This document should not be your only resource - the laws and regulations of many different jurisdictions may apply.

Numerous bodies and industry groups are formulating best practice principles and guidance that may be useful for you. For example, Global Digital Finance, an industry body, has released its “Code of Conduct for Cryptoassets” (“**GDF Code**”).² Parts 1 and 2 of the GDF Code are useful adjuncts to this document. Cross-references to the GDF Code are provided throughout.

Token sales do not occur in a legal vacuum. You must be prepared to grapple with laws and regulations across the globe, or limit your sale appropriately. The landscape for token sales is also rapidly changing. Stay at the cutting edge of international principles and use best practice to your advantage.

² Available at: <https://www.gdf.io/>. In addition, the Asia Securities Industry & Financial Markets Association (ASIFMA) has also issued “Best Practices for Digital Asset Exchanges”, which contains guidance on issues such as custody and exchange listing requirements. The Financial Action Task Force also issues various documents relevant to anti-money laundering and counter-terrorist financing.

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.

What are some questions that you should ask to determine if a token sale is right for you?

- Does your project require blockchain technology / decentralisation?
- Is there a need to create a new token?
- Is there a need to sell it through a token sale, or are there better channels?
- Do you have an online community interested in your project more than just the potential financial gain associated to it?

Despite the hype, token sales should only be pursued if they are an appropriate fit for the project. If you have access to other forms of funding that are a better fit for your project, don't twist your project into a new shape in order to justify a token sale.

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
- Core Principle 8** Strong governance

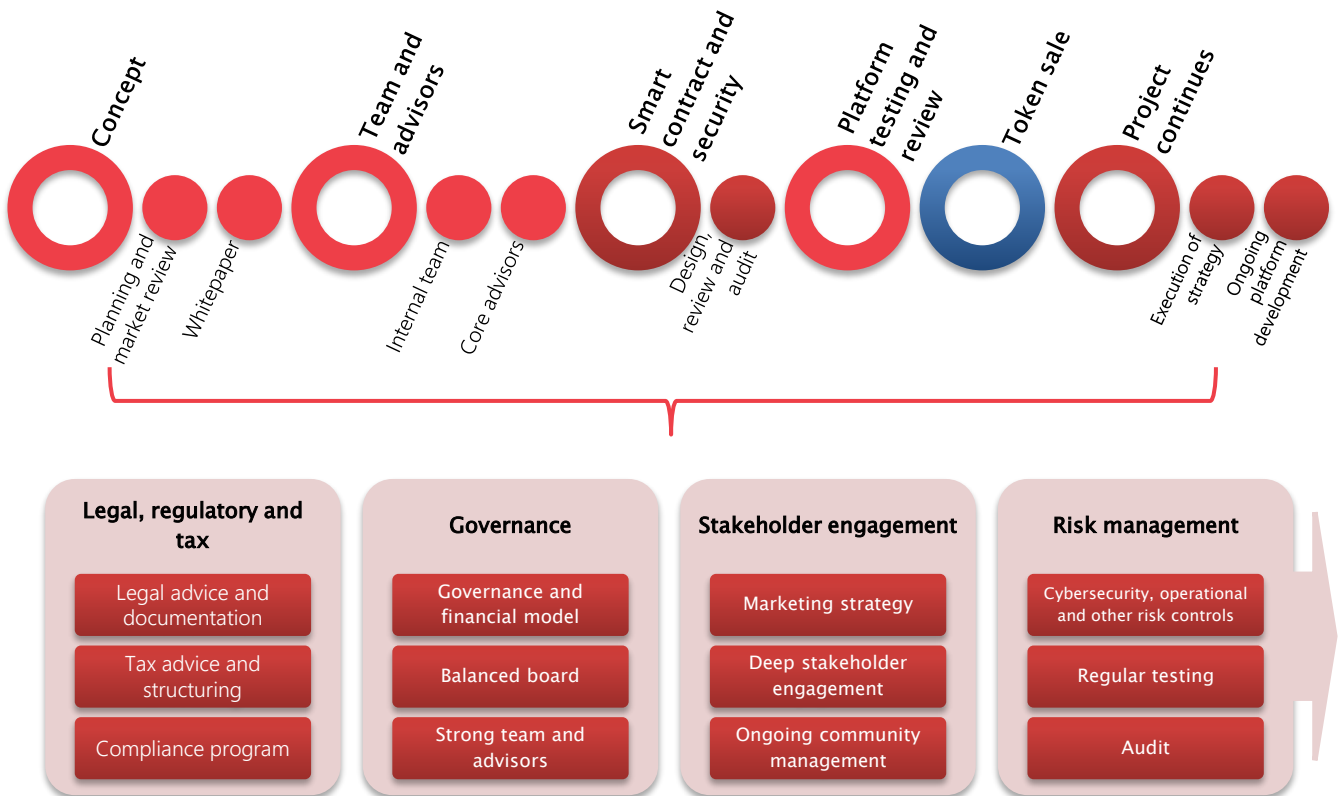
Certain jurisdictions may require tokens to have a **minimum viable utility** at the time of sale. If this applies to you, then this should also be a core principle for your token sale.

▣ **Not all jurisdictions require a minimum viable utility before a token sale. If your jurisdiction requires one, you may need to put together a working product by the time of the token sale, so that tokens have an immediate use. In some jurisdictions, a working 'beta' of your product with an intent to provide later value additions may be sufficient.**

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.

▣ **Consider hiring an independent third-party auditor to audit your project's technology, including the smart contracts used during the token sale and the project's blockchain and its script, and application layers. Keep in mind that there are costs related to these types of audits.**

3.4 Set a realistic timetable

Token sales typically require approximately 3 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.

▣ **Depending on the specific details of your project, some alternative token sale models may be worth exploring. For example, tiered or extended-length token sale models may better suit your project.**

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?

When considering your fundraising goals, you should also consider custody solutions. How will you hold and spend the funds you are raising? Different token sales consider different options: some use a combination of hot and cold storage wallets, some use air-gapped solutions, and others use multi-signature solutions to guard against fraudulent use of the funds. Consider your needs and explore your options. Also consider conducting due diligence on potential custody providers.

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

▣ **Pick a reasonable number when deciding how much money you need to raise to fund your project. Though there can be issues with raising more than a project may need, there are also issues with not raising enough to cover your project's costs. A good project is well-planned out and well budgeted. At its core, a token sale is a fundraising exercise with a commitment to deliver. Consequently, the funds raised should be commensurate with your technical and commercial needs. You should include a development schedule that includes regular upgrades, improvements, and security enhancements to the core codebase. The detailed roadmap should be communicated to relevant stakeholders.**

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.

▣ **Although some service providers may charge high fees, the work will need to be done one way or another. The more aspects of a token sale that you handle in-house, the higher your fixed costs will be. On the other hand, the more work you outsource to service providers, the more tokens/funds that you give away. Consider the size of your team and determine what its internal capabilities are. Token sale services are typically paid for with a combination of tokens and cash. As of August 2018, a properly run token sale can cost approximately USD 500,000 to USD 1 million in fiat currency.**

3.7 Bounty programs and airdrops

These concepts are reasonably common. Although they have similarities, they are not identical and differ in their usage and their objectives.

The intention of airdrops is usually to distribute free tokens to certain people for the sake of promotion. They may be undertaken by issuers, exchanges and others. In general, recipients are granted airdrops as an incentive to participate in the platform or perhaps even to promote the project on social media platforms or to attract members from other communities. They can also be used as a reward for past participation. Recipients might decide to hold these tokens, use them or perhaps sell them on exchanges, depending on their nature and terms.

Bounty programs (or “earndrops”) are different: they usually correspond to specific tasks complementary to the core activities of the technical teams or to reward individuals or communities for their help – for example, a person might receive a certain number of tokens for designing a logo, finding a bug, completing whitelisting for your token sale, promoting the project or performing some technical tests.

The key things to consider before implementing an airdrops or bounty are as follows:

- (a) **Can the token itself be legally distributed?** Just because it is free or distributed as payment for something, does not necessarily change its legal nature or regulatory implications. Check with your legal team.
- (b) **Is what you are trying to incentivise legal?** Even if your token can freely be distributed, there may be limitations on the action or behaviour you are trying to encourage. For example, if the token is being given to people who play a game, this could be gambling, which is highly restricted in Hong Kong and other markets.
- (c) **Are you increasing the risk for yourself?** For example, if you have a bounty program that asks people to comment about your project on social media, they may well be making claims about your project that are incorrect. If your token is a security, they may also be exposing themselves (and you) to liability.
- (d) **Terms and conditions matter.** These can be short, but you must be specific about how your bounty program or airdrop works and what terms and conditions apply.
- (e) **What about AML/KYC?** Giving tokens to a terrorist for free is still terrorist financing. Consider how your AML/KYC program fits in – see paragraph 10 and Schedule 1.

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) **clearly identify the issuer** – full legal name, jurisdictions of incorporation and operation (if different) and contact details;
- (b) only contain material that is **verifiably accurate** and opinions / projections that are based on **reasonable due diligence**;
- (c) set out a **persuasive rationale** for your project and the token, including the relevant market context and why blockchain technology is essential to your project;
- (d) include your project's **current status**, the **specific steps** you propose to take and map out the **milestones** you intend to achieve;
- (e) provide a sufficient **technical explanation** of the key features, including the technical specifications of the token and the underlying consensus protocol that the tokens relies on;
- (f) identify the key **contingencies**, including risks and dependencies, and how you plan to mitigate them;
- (g) be **reviewed** by professional advisors, including your lawyers and experts in the field of your project;
- (h) identify the **key team members** and any **third parties** involved;
- (i) disclose any **conflicts of interest** that may arise between to your project, the key team members and the identifiable third parties; and
- (j) use **appropriate language** that makes it clear that certain aspects of the project are conceptual only and adopt appropriate disclaimers and warnings.

Section 2 of Part 2 of the GDF Code provides further guidance on the content of the Whitepaper, but keep in mind that not all these recommendation may be appropriate to your project or may not be known at time of publication. You may consider either updating the Whitepaper as the project progresses, or alternatively providing updates through your project's website or other public channel.

Some service providers offer to write Whitepapers. This is fine, but make sure it is always your project. Compensation should also be considered. Think about requiring your service provider to comply with Section 3 of Part 2 of the GDF Code.

▣ **Keep in mind that a large portion of the information that is included in your Whitepaper is closely related to the goals of your project or your business model. Therefore, there is no one that knows it better than you. We recommend writing the first draft of your Whitepaper yourself. External parties can help you to review, re-write, and edit your Whitepaper to improve it but the project's core tenets should be decided by you.**

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**.

▣ **When considering what information to disclose, lean towards over-sharing rather than under-sharing.**

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
- (i) Auditors

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. You may also refer to Section 2 of Part 1 of the GDF Code, which provides further guidance on organisational matters.

▣ **Some of these roles may be covered by the same person/company, however, having one person cover too many of these roles may reduce their efficacy in delivering any of them successfully.**

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.

▣ **Projects bring on advisors for different reasons. Some advisors can provide access to a certain key sector, jurisdiction, or technology while other advisors can connect your project with other important investors, advisors, or service providers. Generally, we recommend bringing on advisors only when they can offer something specific and valuable to a project.**

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.

▣ **Encourage project members to raise issues early. This may result in delays to your planned timeline but delaying your token sale is better than having it fail. In the same vein, don't rush to release your Whitepaper. It's OK to have a tiered marketing approach – you may want to start with a tiered release of your website.**

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.

You must be especially careful about share, proprietary, profit, derivative and governance rights, as they are often the hallmarks of regulated products. Of course, the facts always matter to a legal analysis – even seemingly simple “payment” tokens could be regulated depending on their structure, the way they are sold and other factors.

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.

▣ You should be able to walk through a token’s ‘life cycle’ and have an understanding of how you expect tokens to move among different types of token holders. Thinking through this can help you determine the importance of certain accessibility factors, including community access to the token, tokens being tradable on exchanges, or early purchasers holding or selling the token.

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.

▣ Encouraging speculation is not simply limited to explicitly encouraging investors to purchase tokens because their value might rise. Other practices may be construed as encouraging speculation as well. For example, avoid using terms such as “HODL” and “moon”, which intimate that the value of the token will rise in the long term. Additionally, if you are not selling your tokens to purchasers from certain jurisdictions, be sure not to have your project’s core team members approach exchanges in those jurisdictions regarding listing your tokens because regulators may believe that you are encouraging speculation or attempting to get your tokens into the hands of purchasers in that jurisdiction, despite the wording of your terms and conditions

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;

▣ In order to understand what above- and below-market costs are, source quotes from multiple providers. Don’t necessarily go forward with the first provider you meet. Though the blockchain and token sale spaces are burgeoning, there are numerous service providers for each type of work you may want assistance with.

(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;

▣ **Keep in mind that malicious parties may attack your project on a variety of fronts, including your website, social media accounts, and physical servers.**

(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.

▣ **We know that there are a variety of different structures for token sales. Token sales vary widely and different structures may work better than others in different scenarios – we purposefully avoided recommending a certain structure because it is important that you assess what structure works best for your individual project.**

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). Indirect tax considerations may also be relevant.
- (c) **Potential tax relief** – availability of permissible software or research and development deductions that will help reduce the taxable margins.
- (d) **Transfer pricing** – when you have an international business it will be important to understand what transactions you have between related persons / entities and how value is created, as the pricing of these will have a material impact on which jurisdictions your profits will be taxed. Common inter-company arrangements might include software development services, licenses of technology or other intangible assets, related party lending, or marketing and community building services, amongst others. Transfer pricing rules in Hong Kong and other jurisdictions require tax payers to set these prices at arm's length.
- (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. In some cases, the success of an ICO would be conditional on reaching a soft cap. In case this minimal amount is not reached, the entire project would shut down and the funds collected returned to their contributors.

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) If I meet my soft cap but do not meet my hard cap, how will I spend the 'additional funds' in surplus of the soft cap?
- (v) What is the smallest amount of funding I need to proceed with my project? Detail your course of action if funds are raised below this point.
- (vi) Do my caps carry any legal, regulatory or tax implications?
- (vii) How will I implement the caps in practice?
- (viii) Are the caps for the initial sale only, or will there be a finite supply as well?
- (ix) Do I need any flexibility to change the approach if needed? If so, how is that disclosed?
- (x) 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.

Be sure to disclose explicitly and specifically how you plan to spend the funds that you will raise. Token sale participants need to be able to hold you accountable for your promises.

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.

Consider how your token holders will use your token. Will all of them use the token in the same way? Recognize that different people may have different needs for the token in different stages of its life cycle. For example, maybe individual token holders are incentivized to spend their tokens while companies are incentivized to hold their tokens or vice versa. You may need to restructure your token economy multiple times to ensure it flows as intended.

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. Additionally, consider setting caps on individual participants as well, to encourage wider adoption of the token. Ensure you obtain advice, particularly where there are complicating factors such as convertible or derivative features. Validate through professional advice if they constitute securities or other regulated products. If so, then you need to comply with applicable law – see paragraph 8.

▣ **Some token sales raise most of their funds during a private sale or pre-sale and only use the public portion of the token sale to promote widespread adoption. Other token sales are completely private or completely public. Consider different structures and determine which is best for your project. Keep in mind that, depending on the size of the pool of funds and other factors, your project could be considered a collective investment fund or another regulated product.**

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?

▣ **Be sure to plan for how you will manage funds after they are raised. When opening a bank account, you may face some hurdles if you announce that you are inputting funds from a token sale. Despite this, do not lie to your bank. It can be difficult to open a bank account in some jurisdictions and certain jurisdictions are more crypto-friendly than others. Some private services exist to assist with opening bank accounts.**

Additionally, if you raise funds in cryptocurrencies, you may need to turn some or all of your funds into a different 'more spendable' currency. If you trade funds using over-the-counter services, there can be volatility risks and exchange costs. Make sure to consider these aspects early in your token sale process.

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 attributed 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 required 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 novel, 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.

Most regulators do not provide opinions on token sales. They will also expect that you will have done your homework and sought advice. As a result, carefully consider whether or not there is a need to, or other value in, approaching a regulator. Some jurisdictions have regulators that offer proactive support for token sales, such as fintech sandboxes or other programs. Speak to your advisors about whether consultation or presentation to relevant regulators is worthwhile.

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 activities are regulated 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
<p>“Money”</p> <p><i>Generally interpreted as being limited to fiat for now, but should be monitored.</i></p>	<p>Generally accepted medium of exchange for goods, services and the payment of debts</p>	<ul style="list-style-type: none"> • Banking Ordinance (Cap. 155) - deposit-taking business and money brokerage
<p>“Currency”</p> <p><i>As above.</i></p>	<p>Money in circulation in an economy by which sales and purchases are effected.</p>	<ul style="list-style-type: none"> • Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) (“AMLO”): remittance services and money changing • Payment Systems and Stored Value Facilities Ordinance (Cap. 584): stored value facilities
<p>“Share”</p>	<p>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.</p>	<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 requirements in some cases. Other interests may also be caught. There are also restrictions on how these types of instrument may lawfully be marketed
<p>“Debenture”</p>	<p>Another type of security that generally represents a <i>debt</i> obligation.</p>	<p>As above – but may trigger other types of regulation because of their particular features. There are also restrictions on how these types of instrument may lawfully be marketed</p>
<p>“Collective investment scheme”</p>	<p>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.</p>	<p>SFO: various regulated activities requiring a licence as a class of “securities”, plus potential approval requirements in some cases</p> <p> This classification should be reviewed closely, particularly for any token issued in connection with a specific project</p> <p>There are also restrictions on how these types of instrument may lawfully be marketed</p>

Regulated product	Key features	Key triggers to think about
“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.	<p>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</p> <p> Pay particular attention to the pricing of your token when considering this issue</p> <p>There are also restrictions on how these types of instrument may lawfully be marketed</p>
“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
“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, commodities and trust and company service regulations may also be relevant to your token, depending on the facts.

Regulatory statements and intervention

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.

Since then, the SFC has made several other statements on tokens. On 9 February 2018, the SFC alerted investors to the potential risks of dealing with cryptocurrency exchanges and investing in token offerings. The SFC also noted that it had taken regulatory action against a number of cryptocurrency exchanges and token issuers. In particular, the SFC issued a statement on 19 March 2018 noting that, following regulatory action, Black Cell Technology Limited had halted its token issuance to the Hong Kong public and had agreed to unwind transaction for Hong Kong investors.

If you receive any inquiries from a regulator on your token offering, you must take them extremely seriously, and be prepared to respond to the questions in an open and transparent way. You should always consider obtaining legal advice if faced with these sorts of query.

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:

Fraud	Contract	Estoppel	Ponzi schemes
Unconscionable dealing	Implied terms	Theft	Privacy and confidentiality
Competition	Anti-bribery and corruption	AML/CTF and sanctions	Gambling

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.

- ▣ Sales in many jurisdictions mean laws in many jurisdictions. Consider “whitelisting” each target jurisdiction (not just blacklisting a few), with a legal opinion to back you up.
- ▣ Be especially careful about adopting labels that suit one jurisdiction, but could cause you difficulties in others. For example, not all “security tokens” are actually securities in all jurisdictions, but labelling them as such could result in unnecessary regulatory action.

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 sets of terms and conditions for your token sale and for use of the product, software, or platform that you are developing.

9.2 What is in your document suite?

Token sales that do not involve a 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, 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, with more expected during the course of the next year.³ 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 publications.

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

³ On 19 October 2018, the Financial Action Task Force also released updates to its Recommendations and Glossary. This included introducing new recommendations and definitions for “virtual asset” and “virtual asset provider”, to encourage member jurisdictions to implement licensing / registration and AML/CTF compliance frameworks for the sector. Whilst the focus is on market participants such as exchanges, this is likely to have at least downstream impacts for token issuers.

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. You may also refer to Section 1 of Part 1 of the GDF Code, which provides additional guidance on compliance.

10.3 Key AML/CTF 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) an indictable criminal offence (which would include a range of offences, including fraud, bribery, tax evasion, theft and handling of stolen goods, gambling offences, drug dealing, import/export offences, immigration offences); 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 Sanctions

Hong Kong sanctions may prohibit transactions, services and dealings that have a direct, or indirect, connection with certain countries, persons or legal entities that have been designated under the United Nations (Anti-Terrorism Measures) Ordinance or United Nations Sanctions Ordinance. You may have additional obligations depending on your regulatory status and the jurisdictions with which you and other relevant persons are connected (see paragraph 10.5).

Close attention to the scope of each specific sanction regime is needed. This is to ascertain the precise scope of the prohibited activity and the target of the sanctions.

The Hong Kong Commerce, Industry and Tourism Branch of the Commerce and Economic Development Bureau maintains a variety of lists, to facilitate searching for specific sanctions.⁴ However, ensure that you obtain all necessary advice and only select reputable service providers.

10.5 You may also be subject to offshore laws

In certain cases, the AML/CTF and sanctions rules of other jurisdictions may apply to a firm or individual employee (or other relevant person) because of their domicile or other relevant connections. You should obtain appropriate advice to protect against breaching those rules. By way of example only, the United States sanctions regime has very broad application.

⁴ Available at: http://www.cedb.gov.hk/citb/en/Policy_Responsibilities/united_nations_sanctions.html

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.

10.6 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.

10.7 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.


10.8 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 and comply with the law.

- (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.
- (g) Know your consumer protection laws and what amounts to unfair trade practices – you won’t always be able to rely on disclaimers. The Trade Descriptions Ordinance (Cap. 363) and the Unconscionable Contracts Ordinance (Cap. 458) are just two examples in Hong Kong.

 **Be mindful and specific when determining what terminology you use, especially when it comes to marketing purposes. The way that your token is marketed may affect whether or not it is considered a security by regulators.**

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	<p>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</p> <p>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</p>
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, exchange and technology diligence	All staff and suppliers should be subject to background checks before employment in any sensitive roles within the project team. Ensure you do appropriate due diligence on all technology products and services. Appoint someone to stay on top of any developments ahead of sale

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 robust 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 token 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 Post-sale transparency

Transparency between a token issuer and its token sale participants, service providers, and business partners shouldn't end when the sale closes.

Set a strong base of transparency in the time leading up to the token sale and build upon that base afterwards. Generally speaking, trust in a project and the value of a token are determined, at least in part, by the decisions that the issuer makes and the information that it publishes. This information is important to token holders as they decide how to buy and sell a token or interact with a token ecosystem.

Although token issuers don't need to make every decision public, it is crucial that token holders have a clear understanding of key decisions that an issuer makes and how it opts to spend relevant funds, to enable token holders to make their own decisions going forward.

15 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

Please consider this carefully and seek additional advice if you need it. You should adopt the KYC procedure that is right for your sale and business, and which addresses any specific legal and regulatory requirements to which you are subject. 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.

1 Introduction

A robust KYC procedure should mitigate and manage ML/FT risk and also help you to screen out persons who are not eligible to participate in your sale for other legal and regulatory reasons. It should also document the approved procedures relating to AML/CTF compliance and sanctions and politically exposed person (“PEP”) screening.

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.

2 Risk-based procedures

2.1 Adopting risk-based procedures

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.

Internationally-recognised standards relating to KYC typically adjust the level of checks to be conducted on a customer based on the assessed level of risk:

- (a) **Customer Due Diligence** (or “CDD”) for standard risk customers.
- (b) **Enhanced Due Diligence** (or “EDD”) for higher risk customers. We have identified at Step 4 below certain high risk factors that could lead to EDD, although these are not exhaustive.
- (c) **Simplified Due Diligence** (or “SDD”) for low risk customers such as large well-known corporations, listed companies and regulated financial institutions.

You must also take into account any additional legal and regulatory requirements to which you are subject (eg if you are a regulated entity), which may be much higher than those set out in this schedule.

2.2 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, but be mindful of anti-discrimination principles.

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

2.3 Step 2 – Registration and collection of information

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

As part of registration, interested participants should provide some (or ideally all) of the following details. Blank fields should not be permitted, unless a particular piece of information or document is not required because you are following an SDD approach. Ensure you have your privacy policy and related procedures in place.

Individuals

- Full name
- Date of birth
- Nationality
- 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

Corporate entities

- Full company name
- Company identification number
- Date and place of incorporation
- Registered company address and business address if different
- Confirmation of the entity type and any listing/regulatory status
- Jurisdiction(s) of operation
- Full name and date of birth of each authorised person
- A copy of a government-issued photo identity document for each authorised person
- A copy of the document authorising the person to bind the company, such as a board resolution or power of attorney
- An ownership chart, showing the chain of ownership right through to the ultimate beneficial owner(s)
- Full name of each ultimate beneficial owner of the company⁵

You should take reasonable measures to verify the identity of each ultimate beneficial owner. This could be from publically available information if there are no high risk factors relating to the customer or, alternatively, government issued photo identity.

- Authorised email address
- Digital wallet information and any other details required for the purchase

⁵ This generally refers to any individual who owns or controls more than 25% of the share capital and/or voting rights of a company, or who otherwise exercises ultimate control over the management of the company. See Part 1 of Schedule 2 to the AMLO.

Other scenarios

If you are dealing with a partnership, trust arrangement, syndicate or other scenario, ensure you obtain appropriate legal advice about what to do.

See also paragraphs 3, 4 and 5 of this schedule.

2.4 Step 4 – Verification and screening of registered users

Having great information is not enough. The next steps are to:

- (a) verify the data provided as part of registration against the documents provided and information that is publicly available;
- (b) conduct screening to check whether the participant or any ultimate beneficial owner is a PEP, subject to international sanctions or otherwise proscribed.. Screening can be completed using a trusted source of information such as the United Nations consolidated list of sanctioned persons. Alternatively, there are numerous compliance databases provided by third party vendors. All records of potential hits generated through screening and or clear results should be recorded within the relevant due diligence file for each participant. Where there is a potential hit which can be discounted as false, the rationale for the discount should also be recorded; and
- (c) 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.

Screening incoming payments

You should also consider screening incoming payments, whether in fiat or digital asset form. This generally involves asking participants about the source of their payment, and can also extend to analysing the chain of ownership of digital assets by examining the relevant blockchain. A number of service providers can assist with this.

2.5 Step 5 – Dealing with special situations

Situations may arise that require special attention and/or EDD. These may include, for example:

- (a) positive sanctions hits, which should be rejected;
- (b) identifying a PEP's involvement;
- (c) other negative screening results (eg negative news), which should be considered from both a legal and reputational standpoint;
- (d) incomplete, obviously inaccurate or poor quality information, which should be queried and/or rejected;
- (e) mismatches between the information provided and what is in the identification document, which should also be queried and/or rejected;
- (f) information that suggests a person is from another blacklisted jurisdiction, which should be rejected; and
- (g) high value purchase amounts.

EDD should include obtaining additional information on the customer (eg identifying and verifying the identities of directors), obtaining additional information in relation to the customer's source of wealth and source of funds / payment or requiring a proposed customer to provide a photograph of themselves, showing them holding their identity document and a piece of paper showing the current date.

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.

2.6 Step 6 – 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 and privacy policy, as well as other points recommended by your legal counsel.

3 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.

4 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.

5 Additional steps to consider

5.1 Calibrating the measures to address risk

As flagged in paragraph 2.1, your KYC measures should be based on the risks you have assessed in relation to your institution and the participant in question. For example, KYC measures can be calibrated based on:

- (a) **jurisdiction risk** – for example, through blocking or adopting enhanced measures for persons from countries with known AML/CTF vulnerabilities;
- (b) **participant risk** – for example, taking into account that a particular participant 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, provided that there are no other elevated risk factors.

6 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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