

# When DeFi Meets Securities Laws - A Regulatory Deep Dive

April 2022

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## What is DeFi?

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Decentralised finance (“**DeFi**”) is an umbrella term that encompasses a range of financial services provided on public blockchains. This emerging ecosystem of financial technology products claims to be more open, inclusive and transparent in relation to its accessibility, service offering, and transactions/ operations (including fees charged).

Through decentralised apps, users can lend out “virtual assets” (“**VA**”)<sup>[1]</sup> to earn interest, stake their crypto holding in return for staking rewards, participate in liquidity mining, purchase synthetic assets or even participate as stakeholders of these decentralised platforms (by being members of decentralised autonomous organisations (“**DAOs**”).

In the early days of the VA fund industry in Hong Kong, VA fund strategies were predominantly restricted to “buy and hold” (or “tracker”) funds that invested in VA such as Bitcoin (“**BTC**”) or Ethereum (“**ETH**”) on a long-only basis. Within the course of the last year or so, however, VA funds have increasingly expanded into the DeFi space in the following two ways:

- First, private equity (“**PE**”) or venture capital (“**VC**”) funds that would invest in the equity securities of companies that themselves are active in the DeFi or blockchain space. These funds are often structured as traditional closed-ended PE/VC style funds that would invest on a longer-term basis, with the manager taking board seats on portfolio companies and helping them grow to a listing or trade sale. Unlike traditional closed-ended funds, however, these types of funds would not only hold the equity securities or debt of the portfolio companies, but may also invest in the native coins or tokens of the portfolio companies or DAOs, or the platforms which they operate (including, for example, by participating in Liquidity Bootstrapping Pools); and
- Second, open-ended and liquid VA funds that would directly operate yield farming strategies (including lending, staking and liquidity mining) and dealing in synthetic assets (through a combination of trading, lending or liquidity mining of synthetic assets).

With DeFi strategies becoming increasingly popular and with DeFi assets comprising a growing proportion of many VA fund portfolios, the question of regulations has come back into focus. In particular, the assumption that “crypto is not a security” bears further scrutiny, given the more complex characteristics of DeFi assets and activities (and the fact that they are fundamentally set up to mimic/replicate traditional financial functions and instruments). In this paper, we will examine some of these DeFi assets/strategies in greater detail from the viewpoint of regulations, and whether, in particular, managing, dealing in, or advising on, a portfolio of such assets would amount to regulated activity in Hong Kong (thereby requiring a licence from the Securities and Futures Commission (“**SFC**”).

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## Regulatory framework

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Trading, managing or advising on DeFi assets, like any other type of assets, falls within the local regulatory perimeter, if such DeFi assets constitute “securities” or “futures contracts” as defined in Schedule 1 of the Securities and Futures Ordinance (“SFO”).

Specifically, section 114(1) of the SFO provides that no person is allowed to “carry on a business in a regulated activity” without being licensed by the SFC. The various categories of “regulated activities” are listed in Schedule 5 to the SFO and relevantly (for the purpose of this discussion), those that would trigger a licensing requirement would be:

- Type 1 – Dealing in securities (that is buying, selling, or inducing third parties to buy or sell securities);
- Type 4 – Advising on securities (that is, providing advice as to price, timing, terms and conditions for the purchase or sale of securities); and
- Type 9 – Managing a portfolio of securities or futures contracts (that is, managing an investment fund or a managed account, where the portfolio comprises securities).

As can be seen, central to all three activities is the concept of a “security” (we will set aside the discussion of “futures contracts” for the moment). And, under Schedule 1 of the SFO, the term “securities” is defined in the widest sense to include all types of products that would ordinarily be considered as securities, including, for example:

*“shares, stocks, debentures, loan stocks, funds, bonds or notes, rights, options or interests in respect of shares, certificates of interests, interests in any collective investment schemes...interests, rights of property, whether in the form of an instrument or otherwise, commonly known as securities”.*

As for VA and whether they would fall into any of the above categories (or be commonly known as securities), the position is not black and white.

In a statement issued in September 2017<sup>[2]</sup> (the “**September 2017 Statement**”), the SFC stipulated that the question of whether “digital tokens” constitute “securities” is answered by assessing whether they carry rights equivalent to traditional securities.

The SFC’s starting point is that “digital tokens”<sup>[3]</sup> that amount to “virtual commodities” are not securities under the SFO. Features of such “virtual commodities” would include situations:

- where the tokens are strictly “utilitarian” in nature – such that they only provide access or use rights on digital platforms or related software developed by the issuers of the tokens (using proceeds raised from the token sales); or
- where token holders expect to make a return on their investment by reselling on cryptocurrency exchanges.

However, in the September 2017 Statement, the SFC did go on to stipulate that certain tokens may have terms and features that may render them “securities”. For example, if:

- holders are given rights similar to holding “shares”, i.e., to receive dividend and the right to participate in the distribution of the corporation’s surplus assets upon winding up;
- holders are given rights similar to holding “debentures”, i.e., right to repayment of principal on a fixed date with interest payment upon redemption; or
- the project or platform is managed collectively by the token issuer to invest in projects with an aim to enable token holders to participate in a share of the returns provided by the project (such that it becomes a “collective investment scheme” (“CIS”), then the tokens may represent interests in such schemes,

and in all of those cases, such tokens or VA could conceivably fall under the definition of a “security” under the SFO.

In a later Circular dated 11 December 2017<sup>[4]</sup>, the SFC specifically identified BTC as not being regulated under the SFO (and we can take from this, therefore, that similar “utility tokens” such as ETH, SOL, ADA and LUNA/ANC would also not be regulated as “securities”).

In some cases, a VA may also be caught by the definition of a “structured product”, which is also considered a “security” if certain conditions are met (we will discuss this in greater detail).<sup>[5]</sup>

With these concepts in mind, we will attempt to examine in closer detail, the more common types of DeFi assets / activities. The “universe” of DeFi assets / activities is, of course, very broad, and constantly evolving. New types of instruments and activities are constantly being innovated, and we cannot hope to cover all of these comprehensively. Instead, we will restrict our treatment to the DeFi assets and activities that are currently the most relevant to VA Funds, namely:

- VA lending;
- Staking;
- Liquidity mining; and
- DAOs.

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### VA lending

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Similar to traditional finance, lending in the realm of DeFi allows VA holders to earn interest on their holdings. A lender is usually paid an attractive annual percentage yield (“**APY**”) in return for providing a loan. The interest earned helps off-set some of the short-term price volatility that the VA holder may experience.

A DeFi lending arrangement usually involves three parties including the lender, the borrower and a DeFi lending platform. The borrowers deposit VA as collateral while the lenders pool their assets and distribute the loan to borrowers on the DeFi platform using smart contracts.

Although lenders pool their VA on DeFi platforms for lending purposes, the DeFi arrangement differentiates VA lending from a typical CIS because the pooled assets are not managed as a whole by a centralised body. Instead, lending on DeFi platforms is performed on a peer-to-peer basis, where lending and borrowing are matched by smart contracts with open-source codes.

While VA lending resembles closely loans in traditional financial markets (except in the absence of a centralised financial system or intermediaries), it is unlikely that participating in VA lending will be caught by any definition of regulated activities involving “securities”. Indeed, even when it comes to the traditional space, pure loan arrangements are themselves not regarded as “securities”. It is only if the loan obligations are unitised (say under a participation arrangement), or are represented by “notes” that become freely transferable between holders, that they then start looking and behaving like “securities” (and likely to be caught as “debentures” under the SFO).

In the same way, VA loans themselves should not amount to “securities” (nor should dealing in them, advising on them, or managing a portfolio of such loans including in a fund) unless:

- The loans become centrally managed and administered with a view to providing returns or profits to participants; or
- The loans become unitised or “minted” into other assets that are also freely transferable for value.

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### Staking

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VA holders earn a percentage-rate reward by staking – locking up a VA for a certain period of time to support a blockchain network and validating cryptocurrency transactions. The rewards are usually paid in native tokens and governance tokens of DAOs by participating in a proof-of-stake (“**PoS**”) consensus mechanism without a centralised body.

Unlike ordinary financial intermediaries, stakers simply communicate to the network that valid entries have occurred, and they do not redirect transactions they put in the blocks. PoS changes the way blocks are verified by using the machines of coin owners. The owners offer their coins as collateral for the chance to validate blocks (coin owners that stake their coins become “validators”). Validators are then selected randomly to “mine” or validate the block. This system randomises who gets to validate the block (as opposed to the competition-based “proof-of-work” mechanism).

Third parties can participate in the “staking” process by providing their tokens to validators, and sharing in the proceeds the validators earn from their “mining” activities.

From the point of view of the party providing its tokens for staking, this would appear to draw similarities with a term deposit arrangement at a bank, where the principal amount being “staked” does not change, and a regular “interest” component is paid. The only difference would be that in the usual course, tokens being staked may be withdrawn immediately, although in some cases, an unstaking period may be imposed during which time, tokens being “unstaked” also earn no interest (in the case of Luna staking, for example).

If we approached staking in this manner, it would seem unlikely that staking itself gives rise to any security implications (in the same way that depositing moneys at a bank in a fixed term deposit would not give rise to those considerations) – especially where the token being staked is, itself, not considered a security.

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## Liquidity mining

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With the emergence of DeFi, the investment and trading of crypto assets has gradually migrated from centralised exchanges (“**CEX**”) to decentralised exchanges (“**DEX**”). A majority of DEXs operate using an automated market maker protocol (“**AMM**”). Unlike CEXs (e.g. Binance, Kraken, CEX.io) which match buyers and sellers via a centralised order book, AMM-based DEXs link traders with liquidity pools and execute trades through smart contracts. The price of assets traded on AMM-based DEXs is determined by AMMs using a constant product formula and in the absence of counterparties.

Without involving intermediaries such as professional market makers, AMM-based DEXs resolve liquidity issue by incentivising liquidity providers to channel funds into liquidity pools. In this process, liquidity providers deposit their VA assets into liquidity pools and the type of token(s) deposited depends on the protocol design of the relevant DEX. In return, liquidity providers are rewarded newly “minted” LP tokens (“**LP Tokens**”). LP Tokens typically represent the liquidity provider’s share in the liquidity pool. When the liquidity pool facilitates a transaction, LP token holders will be entitled to receive a fractional trading fee in respect of that transaction. To retrieve the underlying liquidity, liquidity providers will need to “burn” their LP tokens in exchange for the proportion of liquidity they contributed and the proportional fee allocation.

LP Tokens allow AMMs to be non-custodial and represent a key feature of the DeFi ecosystem. On AMM platforms, the liquidity providers remain in control of their assets through their custody and control of their LP Tokens, while the AMM pools are themselves managed by code and not by human operation. Holding the LP Tokens allows the liquidity provider to have total control over when to withdraw their share of the pool. Unlike staking, where contributed tokens are “locked up” and cannot be applied to other uses, LP Tokens can, themselves, be used multiple times in other DeFi products, or staked in a platform governance mechanism. This, therefore, helps solve the problem of limited liquidity by opening up an indirect form of staking.

As the way liquidity mining arrangements work and their features vary from platform to platform, the analysis as to whether these activities trespass into the realm of “securities” will also vary among different platforms. The analysis can be approached over increasing levels of complexity as follows:

1. At a fundamental level, the act of providing VA tokens in pairs to liquidity pools is a mere contractual arrangement, similar to a loan. The provider of the VA tokens is paid returns akin to interest, and the provider may “recall” or “redeem” the “loan” at any time (although in some cases, the mining contracts may be locked for a certain period). In a situation where the tokens are not returned on redemption of the loan, it is conceivable that the liquidity provider would have contractual rights similar to a lender to return of capital (the tokens provided) and (perhaps) interest (fees earned from participating in the mining). At this level, there is little to suggest that this is a mere loan arrangement, and so there would be no “securities” involved.
2. On another level, however, liquidity mining differs from a loan in that the principal investment may go up or down, depending on the price of the underlying tokens that have been contributed to the pool. Where prices go up or down while the pair is locked into liquidity mining, “impermanent loss” may be incurred. In this sense, the liquidity mining process shares some common features with a CIS. For example, liquidity providers contribute token pairs into liquidity pools in return for profits distributed to them on a pro-rata basis, and there is the prospect of capital gains as well as losses. However, the fact that liquidity protocols act as AMMs and that liquidity contributed is not managed by any centralised entity (whether as a whole or on behalf of the liquidity providers) distinguishes the liquidity mining arrangement from a typical CIS. And so, this also does not give rise to the prospect of the transaction being one that involves a “security”.
3. When LP Tokens are brought into the picture, however, the analysis becomes more complicated. Looking at the nature of these instruments, it is arguable that they provide rights that are akin to the payment of “interest” or “dividends”. As they also represent mathematical proof that a party has provided assets to a pool, and hold the key to claiming those assets back, the similarities between shares/debentures and LP Tokens become difficult to ignore.

As alluded to earlier, it also appears that LP Tokens may arguably be “structured products”, given that they are instruments under which some or all of the return, or amount due, or method of settlement (whether in relation to the LP Token itself or the underlying contributed tokens which the LP Token represents) is determined by reference to:

- Changes in the price, value or level of any type or combination, or any basket of securities, commodity, index, property, interest rate, currency exchange rate or futures contract (in this case, the underlying price of the tokens that have been contributed to the liquidity pool); or
- The occurrence or non-occurrence of any specified event(s) (excluding any event relating only to the issuer or guarantor of the instrument or both) – specifically, events affecting the price of the underlying contributed tokens.

And, importantly, as LP Tokens are generally available to retail investors and are not restricted to non-HK resident investors, they would be “structured products” that are also considered “securities” under Schedule 1 of the SFO.<sup>[6]</sup>

Finally, where LP Tokens are also capable of being freely transferred, exchanged, or staked on other protocols (for example, if they are ERC-20 tokens such as those on platforms like Uniswap, Curve, and Balancer, the argument for these being “securities” becomes even more compelling).

### Governance Tokens

Some protocols (such as SushiSwap and Uniswap) also distribute governance tokens to liquidity providers in addition to LP Tokens. Governance tokens are usually limited in supply and they allow holders to vote on change proposals or new initiatives on such crypto platforms. On other platforms such as Anchor or Mirror protocol, LP Tokens and/or governance tokens can also be staked to not only earn staking rewards (akin to “interest” payments) in the form of more of the same governance tokens – the act of staking itself also gives rise to voting rights.

Governance tokens distributed to liquidity providers, depending on the rights attached to them, may share some common features with “shares”. Governance tokens confer voting rights to holders and sometimes a right to share a portion of trading fees and airdropped tokens when they are staked. The right to receive fractional fees and future tokens on DeFi platforms is similar to the right to receive dividends attached to “shares” in companies. Where these governance tokens themselves become freely transferable on an exchange (e.g., ANC or MIR tokens), and where their intrinsic value begins to rise not purely because of demand and supply but because the underlying organisation issuing them (for example Terra protocol in relation to ANC and Luna tokens) becomes more profitable or grows in size, there is little doubt that they start looking like securities, akin to “shares” in a corporation.

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### Synthetic assets

Synthetic assets in DeFi, (also known as “**synths**”), are conceived as “tokenised” versions of securities in the traditional financial world. These blockchain-based VA derivatives generate their value from the underlying assets which they are simulating, such as stocks, bonds, commodities, indexes, currencies, or interest rates, and are represented by digital tokens.

Investors in the crypto market earn a profit from the price fluctuations of various tokens without holding these actual tokens in their wallets, (instead, they are catalogued, sold and transferred online).

Synths closely track the price movements of the real-world asset by using price data feeds generated by oracles. Oracles are software that act as intermediaries, collecting information from a data source in the real world and translating it into the smart contracts on a blockchain, which will execute certain transactions under specific conditions as written in the code. Among oracles available in the market, Chainlink is a widely used platform because of its secured and reliable price feeds framework, which helps secure the minting, swapping, redeeming, and liquidation functions of the synthetic asset protocol.

Like their real-world counterparts (and unlike tokens on VA exchanges), any form of dealing with synths also depends on market opening and closing times.

Synthetic versions of large cap stocks such as Tesla Inc., Amazon.com Inc. and indices such as the SPY and VIX are readily available for trading on synthetic asset exchanges such as Synthetix, Cake DeFi, and Mirror Protocol. On exchanges such as Mirror Protocol and Cake DeFi, synths can also be “minted” (through borrowing and collateralising a native token such as DFI or aUST) and either subsequently traded like normal securities, or contributed to a liquidity pool for liquidity mining (paired with either a Stablecoin, or the platform’s native token).

One way of looking at synths is that fundamentally, an individual is merely trading a digital token measured in a different format - the issuer of the token is choosing a different reference for the token price (for synthetic stocks, the prices will be determined by oracle feeds). Hence, the holders of synths do not have any rights or obligations which are assigned to the underlying listed equity. Trading in synths does not affect the price of real-world counterpart either, as there is no actual buy or sale of the real securities involved.

On the other hand, there is no doubt that because synths base their prices on oracles (which, themselves, are conduits/channels for real world data), the pricing and dynamics of synth assets, and the behaviour of the participants on synthetic exchanges, will largely mirror those of the real world. In this way, there is little to distinguish synths from real life securities.

Financial regulators in different jurisdictions seem to have taken different approaches to the way synths are conceived and regulated.

In Singapore, for example, the financial regulators take the view that synthetic shares are not capital markets products (possibly because the intervention of oracles breaks the chain of causation between the real world asset and their synthetic versions).

On the other hand, in 2021, the Italian Securities and Exchange Commission (“**Consob**”), the U.K. Financial Conduct Authority (“**FCA**”), the German Federal Financial Supervisory Authority (“**BaFin**”), and the Hong Kong SFC have issued warnings <sup>[7]</sup> to Binance regarding its offering of “tokenised shares” such as Tesla.

According to the SFC, synthetic shares are likely to be “securities” under Hong Kong rules, and dealing in securities and offering them to the Hong Kong public without being appropriately licensed to do so may be an offence.

We would agree with the SFC’s approach. Even if synths do not have features that are akin to traditional securities (in that they do not provide for voting rights, and do not pay “dividends”), and even if they approximate utility tokens such as BTC and ETH (in that they are traded purely for profit based on their demand and supply on exchanges), there is little doubt that they are “structured products” as defined under the SFO.

Specifically, they appear to be instruments under which some or all of the return, or amount due, or method of settlement (namely price) is determined by reference to either:

- changes in the price of the underlying securities which they mirror; or
- the occurrence or non-occurrence of any specified event(s) (for example, macroeconomic, industry or sector specific, or company specific),

depending on the type of oracle being used, and the way that oracle functions. At least under the SFO definition, we do not take the view that the interjection of oracles between the synth and the underlying “real” world security which they mirror removes the derivative nature of the synth asset.

Further, as these “structured products” are not restricted to “professional investors”, are intended for access by the retail public, and do not prohibit access by the Hong Kong public, this would make them fall squarely within the definition of a “security” under the SFO.

Technicalities aside, it would also be good policy making to have these assets regulated as securities, given that, like traditional securities, they (and the exchanges on which they are traded) are vulnerable to manipulation and market misconduct.

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## DAOs

DAOs are an emerging type of organisation particularly prevalent on the Ethereum blockchain ecosystem. DAOs are collectively owned and managed by their members. Unlike traditional corporations, DAOs do not have centralised authority—no CEO, no CFO, no board of directors, nor are there shareholders whose interests need to be served/protected. While shareholders and articles of association are the backbones of a traditional corporation, the foundations of a DAO are its tokenholders and smart contracts.

The smart-contract between tokenholders defines the rules of the DAO and governs the organisation’s treasury. Once the smart-contract is live on the Ethereum blockchain, the rules can only be changed by vote. Those proposals supported by the majority (or other prescribed portion) of the tokenholders are adopted and enforced by the rules encoded into the smart-contract. Any attempted actions which are not covered by the rules and logic in the code will fail. Similarly, as the treasury is also defined and governed by the smart-contract, no party can deal with the organisation’s funds or capital without approval of other tokenholders.

There are currently over 200 DAOs (tracked by [deepdao.io](https://deepdao.io)) with approximately US\$12 billion in assets under management and more than 1.8 million tokenholders. <sup>[9]</sup> Each DAO will have its specific purpose - from buying music-based NFTs (BeetsDAO), to investing in a broad range of DeFi projects (BitDAO), to single purpose DAOs such as the headline-making ConstitutionDAO formed solely to bid on an original-print of the US constitution, etc.

Given their rather novel constitutional framework and operations, there has been ambiguity as to whether DAOs fall under the ambit of global financial and securities regulatory bodies. As is true with any emerging trend, there is limited regulation or oversight surrounding DAOs across most jurisdictions. This makes a DAO much simpler to set up than a traditional corporate business model.

In July 2021, the state of Wyoming in the US became the world’s first jurisdiction to codify rules for DAOs domiciled in that state so that a DAO can be organised as such under the laws of Wyoming. <sup>[9]</sup> In Australia, the Australian Senate Select Committee published a report in October 2021 detailing its recommendations to establish a new DAO company structure, which would place a DAO within the definition of a “body” under the Australian Corporations Act. <sup>[10]</sup>

In Hong Kong, there seems to be little development on this front. However, the existing regulatory regime does appear to be adequately equipped to deal with many of the issues that may arise in relation to the nature of DAOs.

To the extent DAOs are created for profit making or income generation purposes, and have elements of a “pooling” of funds or property for the purpose of deployment to achieve these objectives, they share some common features with a CIS. However, it is also clear that there is no management of this property or funds by a third party for or on behalf of the participants in the DAO, and that the participants in a DAO do have day-to-day control over management decisions (through a voting mechanism). As such, it would be difficult to characterise a DAO as a CIS under the SFO. <sup>[11]</sup>

Nevertheless, it would still be open to classify the tokens of a DAO as “securities”, particularly if:

- they provided for regular payments which are akin to payments of “dividend”;
- they provided for voting rights; and

- their value (or price) depends on, or fluctuates with, the commercial success of the DAO, or the primary purpose or underlying enterprise for which it was formed.<sup>[12]</sup>

As each DAO may be formed for different purposes, and organised differently, one would need to “drill down” into their specific characteristics on a case-by-case basis to understand the nature of the tokens they are issuing. What is clear is that merely because a DAO may “look” and “feel” radically different from a traditional corporation or other body, does not then take it out of the realms of securities regulations.

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## Conclusion

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DeFi is a vibrant and rapidly evolving space that has seen increasing attention from managers and investors alike, including from institutional backgrounds. With increasing participation, however, has come an uptick in regulatory scrutiny – yet many managers still approach DeFi assets with the attitude that they are too far removed from any notion of “securities” to warrant serious regulatory attention. As we have seen in this paper, however, that notion does not hold up well under scrutiny.

While activities such as lending and staking would be more akin to traditional loans (that therefore do not involve “securities”), other activities such as liquidity mining begin to take on hybrid characteristics (between equity and debt investments) – and the accompanying LP Tokens that arise from such activities clearly have attributes that are similar to both debt and equity instruments as well. Synths, at least in Hong Kong, would be caught under the definition of “structured products”, and because they are readily accessed by the retail public, would also be “securities”. The fact that their relationship to the underlying real assets from which they are derived is “interrupted” by the imposition of an “oracle” does not, at least under the Hong Kong regime, make a material difference to the analysis. Finally, while DAOs themselves may not be “companies” or “collective investment schemes”, their associated tokens may be “securities” depending on the nature of the DAO’s underlying activities, and whether those tokens provide the holders with a share of the economic participation in those activities.

Where the instruments themselves are caught by the definition of a “security” under the SFO, activities such as advising on them (Type 4), dealing or marketing them (Type 1) or managing a portfolio of them (Type 9) would attract the need for a licence from the SFC.

While the lacuna of not being a security, and therefore not needing to be regulated, still remains in Hong Kong for the moment, we wonder how long that will remain the status quo. Given the recent moves by the SFC and HKMA (in their joint announcement issued on 28 January 2022)<sup>[13]</sup> to close the loop on VA advisory and VA dealing activities (by intermediaries), and the upcoming VA Service Provider exchange regime (to regulate all VA exchanging and dealing activities whether by intermediaries or non-intermediaries)<sup>[14]</sup>, our view is that there is a clear trend towards the establishment of a comprehensive regime that will capture all VA related activities, regardless of whether they are “securities” or not.

Perhaps by then, the above analysis will no longer be needed. But until we cross that bridge, managers and participants in the VA space would be well advised to pay more attention to the particular instruments that make up their DeFi portfolios, and whether those already put them well within the sights of the regulators in Hong Kong.

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## Appendix

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[1] For the purpose of this discussion, the article will use the definition of “virtual assets” adopted by the SFC, being “digital representations of value which may be in the form of digital tokens (such as utility tokens, stablecoins or security- or asset-backed tokens) or any other virtual commodities, crypto assets or other assets of essentially the same nature, irrespective of whether or not they amount to “securities” or “futures contracts” as defined under the Securities and Futures Ordinance (SFO), but excludes digital representations of fiat currencies issued by central banks.” For details, please see [“Joint circular on intermediaries’ virtual asset-related activities”](#), 28 Jan 2022

[2] [“Statement on Initial coin offerings”](#), 5 September 2017

[3] In this paper, we will assume that the concept of “digital tokens” is covered under the definition of “Virtual Assets” and we will use the two terms interchangeably.

[4] [“Circular to Licensed Corporations and Registered Institutions on Bitcoin futures contracts and cryptocurrency-related investment products”](#), 11 December 2017

[5] See generally Section 1A, Schedule 1 of the SFO under “structured product” and the definition of “securities” para (g).

[6] Para (g) of the definition of “Securities” includes a “structured product that does not come within the definition of any of the preceding paras (a) to (f), but in respect of which the issue of any advertisement, invitation, or document that is or contains an invitation to the public to do any act referred to in section 103(1)(a) of this Ordinance is authorized, or required to be authorized, under section 105(1) of this Ordinance”. Effectively, this means that a “structured product” would be a “security” if it is being publicly offered (as opposed to a private placement; if it is intended to be disposed of only to persons outside of Hong Kong (s 103(3)(j) SFO); or if it is intended to be disposed of only to professional investors (s103(3)(k) SFO).

[7] [“Warning statement on unregulated virtual asset platforms”](#), 16 July 2021.

[8] [DeepDAO organisations](#), 31 March 2022.

[9] [Decentralised Autonomous Organisation Supplement Bill No. SF0038 of the State of Wyoming](#).

[10] [Select Committee on Australia as a Technology and Financial Centre](#), October 2021.

[11] Schedule 1 of the SFO defines a CIS as follows:

(a) It must involve arrangements in respect of an property (widely defined to include, for example, money, goods, choses in action and real estate, whether located in Hong Kong or elsewhere;

(b) Participants in such arrangements do not have day-to-day control over the management of the property (whether or not they have the right to be consulted or to give directions about the management of the property);

(c) The arrangement is one under which

(i) the contributions of the participating persons and the profits or income from which payments are made to them are pooled; and/or

(ii) the property is managed as a whole by or on behalf of the person operating the arrangements;

(d) The purpose or effect of the arrangement is for the participants to participate in or receive profits, income or other returns from the acquisition, holding, management or disposal of the property, or the same in respect of any acquisition, holding, disposal, redemption or expiry of any interest in the property.

[12] The SEC also came to the same conclusion in relation to tokens issued by The DAO in July 2017, when it found that the DAO was a for-profit organisation, created to hold a corpus of assets which would then be used to fund “projects”. The holders of DAO Tokens stood to share in the anticipated earnings from these projects as a return on their investment in DAO Tokens by re-selling them on secondary exchanges – see the report issued by the SEC at the [link](#).

[13] [The SFC's and HKMA's updated guidelines on VA – A significant tightening of permissible VA related activities for licensed intermediaries](#), February 2022.

[14] [Public Consultation on Legislative Proposals to Enhance Anti-Money Laundering and Counter-Terrorist Financing Regulation in Hong Kong](#), May 2021.

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The materials contained in this document were assembled in April 2022 and were based on the law enforceable and information available at that time.