

LEGAL CONSIDERATIONS FOR CRYPTO BANKING

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SEMINAR OUTLINE

- ≡ Capital Formation in the Crypto Economy
- ≡ Navigating the Local Regulatory Landscape
- ≡ Real Life Case Study: Country Heights ICO (Interactive Session)



If companies can issue currencies, what will it look like?



ten

BOWIE BONDS

■ ■ ■	Year:	1997
■ ■ ■	Underwriter:	Pullman Group (Fahnestock)
■ ■ ■	Issue:	US\$55 million
■ ■ ■	Assets:	Rights to David Bowie's master tapes and publishing catalog
■ ■ ■	Yield:	7.9%
■ ■ ■	Maturity:	10 years
■ ■ ■	Credit Rating:	AAA (Moody)
■ ■ ■	Purpose:	To buyback publishing rights in some songs owned by former manager, and invest in internet companies
■ ■ ■	Buyer(s):	Prudential Insurance Co
■ ■ ■	Source:	Kretschmer (2001)

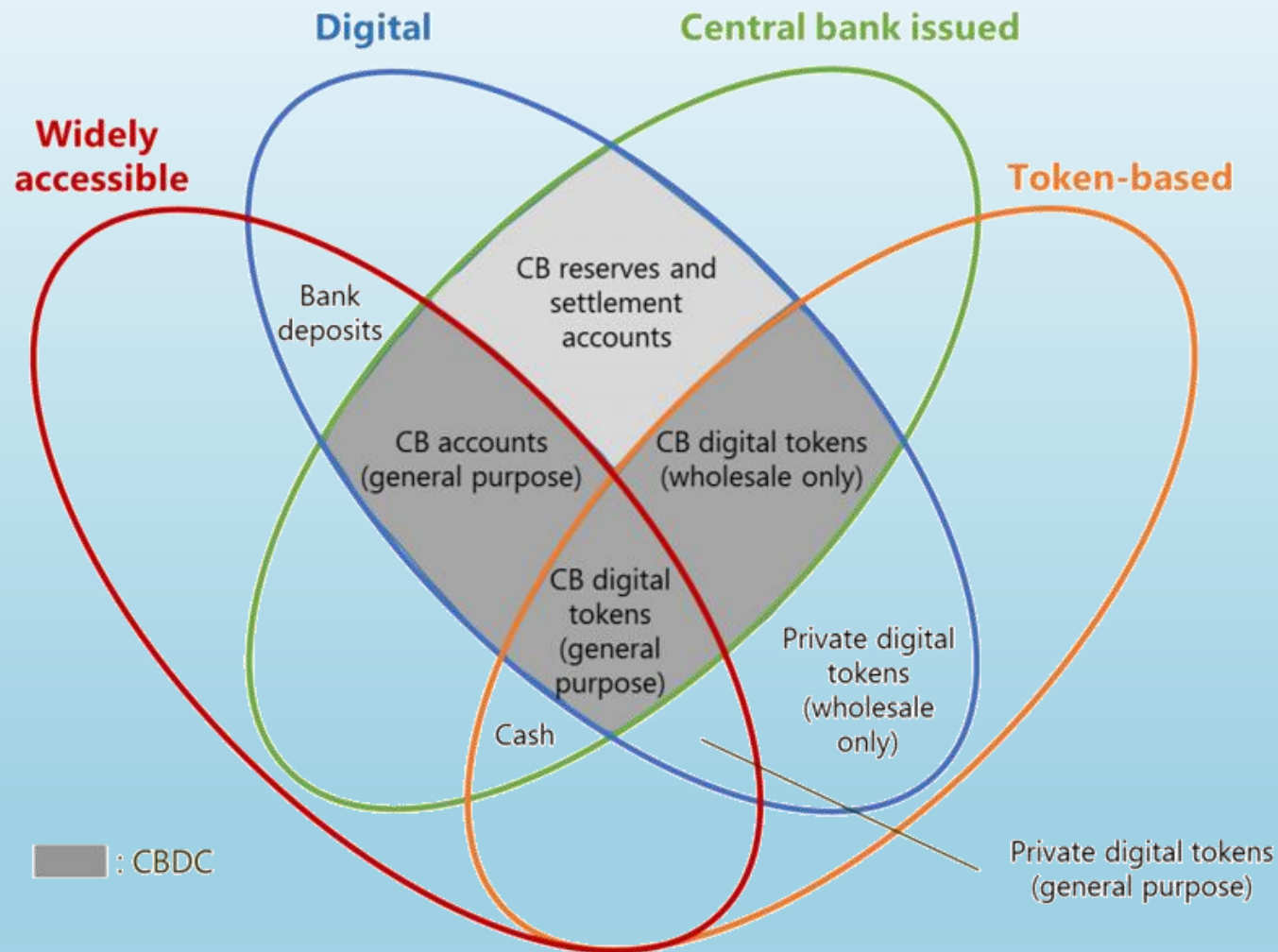




What are Digital Tokens?

- ≡ Evolved from video games like World of Warcraft, Second Life, Runescape etc.
- ≡ You plan to open a carnival/fun fair in the near future.
- ≡ You sell coupons in advance for customers to play the rides and consume food/drinks.
- ≡ These coupons are tradeable or transferrable from one another at market price.
- ≡ Similar to casino chips, public transport reloads, laundromat coins, reward points etc.

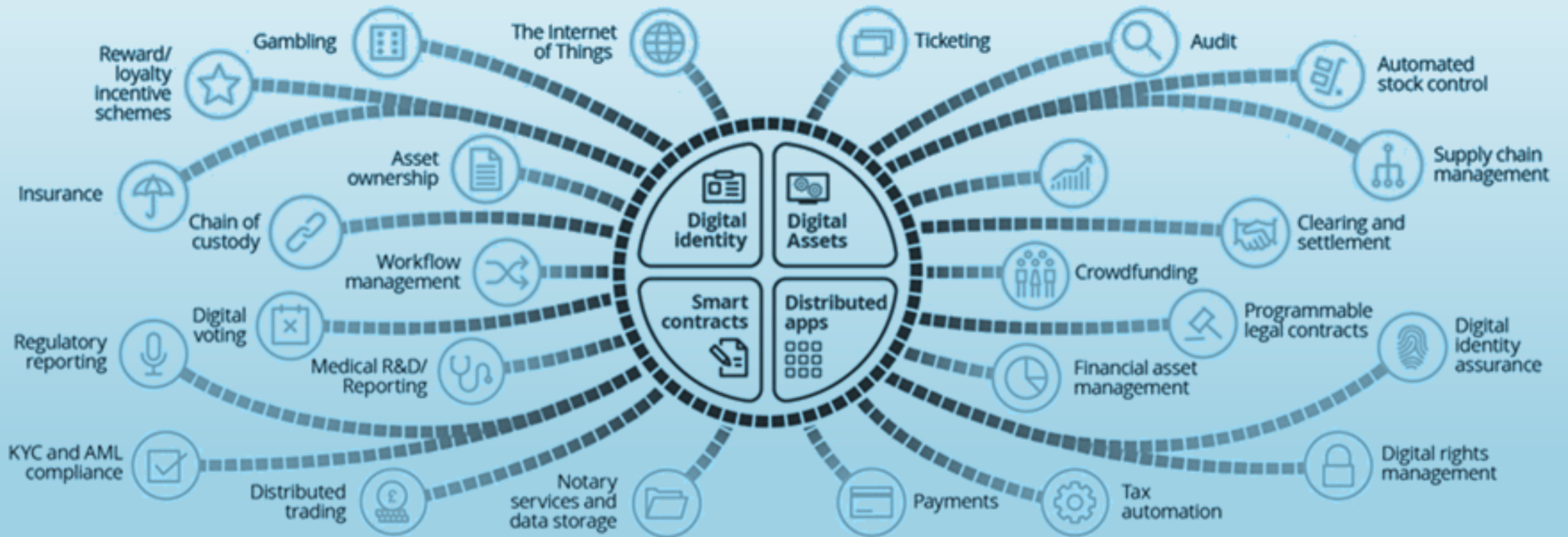
What are Digital Tokens?



- ≡ Token-based money are already used widely. In fact, only 8% of all the world's currencies exists as physical cash.
- ≡ Some are even issued by central banks themselves.
- ≡ Key properties are being digital and widely accessible.
- ≡ Tokens are the currency of the internet. They are private (not sovereign) like barter units.
- ≡ Diagram – Money Flower, Bank of International Settlements.

Shifting from 'internet of information' to 'internet of value'

While the internet currently creates free flow of information – blockchain enables open and global access, exchange and transfer of **digital assets**.



'Blocktopus' Diagram by Deloitte UK

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Key findings from the PwC Strategy report in June 2018

- ≡ 537 ICOs with a total volume of **more than \$13.7 billion** have been registered since the beginning of 2018. In comparison, in 2017 there were 552 ICOs with a volume of **just over \$7.0 billion**.
- ≡ Average size of an ICO has almost doubled **from \$12.8 million to over \$25.5 million** since 2017 – notable raises: Telegram \$1.7B, EOS \$4.1B (era of ICO unicorns).
- ≡ **The USA, Singapore and Switzerland** are still the most important ICO hubs globally, largely due to progress in regulation. City states such as **Hong Kong, Gibraltar, Malta and Liechtenstein** are fast catching up.
- ≡ “Strategically, ICOs continue to crowd out traditional VC funding... **the show must go on!**”

YEAR	DURATION (D)	TOTAL ICO (#)	FUNDING (\$)	AVERAGE (\$)
2013	41	2	0.8	0.4
2014	68	8	30.5	3.8
2015	32	10	9.9	1.0
2016	39	40	252.0	5.1
2017	29	552	7,043.3	12.8
2018 H1	48	537	13,712.8	25.5
ALL	38	1158	21,049.4	18.2

Key findings from the KPMG report in Nov 2018

- ≡ “**Cryptoassets are a big deal**... The staying power will be defined by their ability to reduce friction and inefficiencies that currently exist within the global economy.”
- ≡ “In 2018, we are seeing a wave of new entrants in the market such as security token platforms, stablecoins, and established financial services institutions... **Cryptoassets are now impossible to ignore.**”
- ≡ “While volatility is certainly a problem... these assets are still **fairly immature and will become less volatile as they mature.**”
- ≡ “Regulatory agencies are beginning to seriously discuss cryptoassets (to) help drive **institutional participation.**”

KPMG Accounting Firm Releases 'Institutionalization Of Crypto Assets' Report, Talking About Bitcoin's Arrival

By Bitcoin Exchange Guide News Team - November 15, 2018



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CRYPTO

KPMG Report Lays Out Incredibly Bullish Case for Crypto Assets

COLE PETERSEN | NOVEMBER 15, 2018 | 10:00 PM

REGULATION!

INNOVATION!



IPO

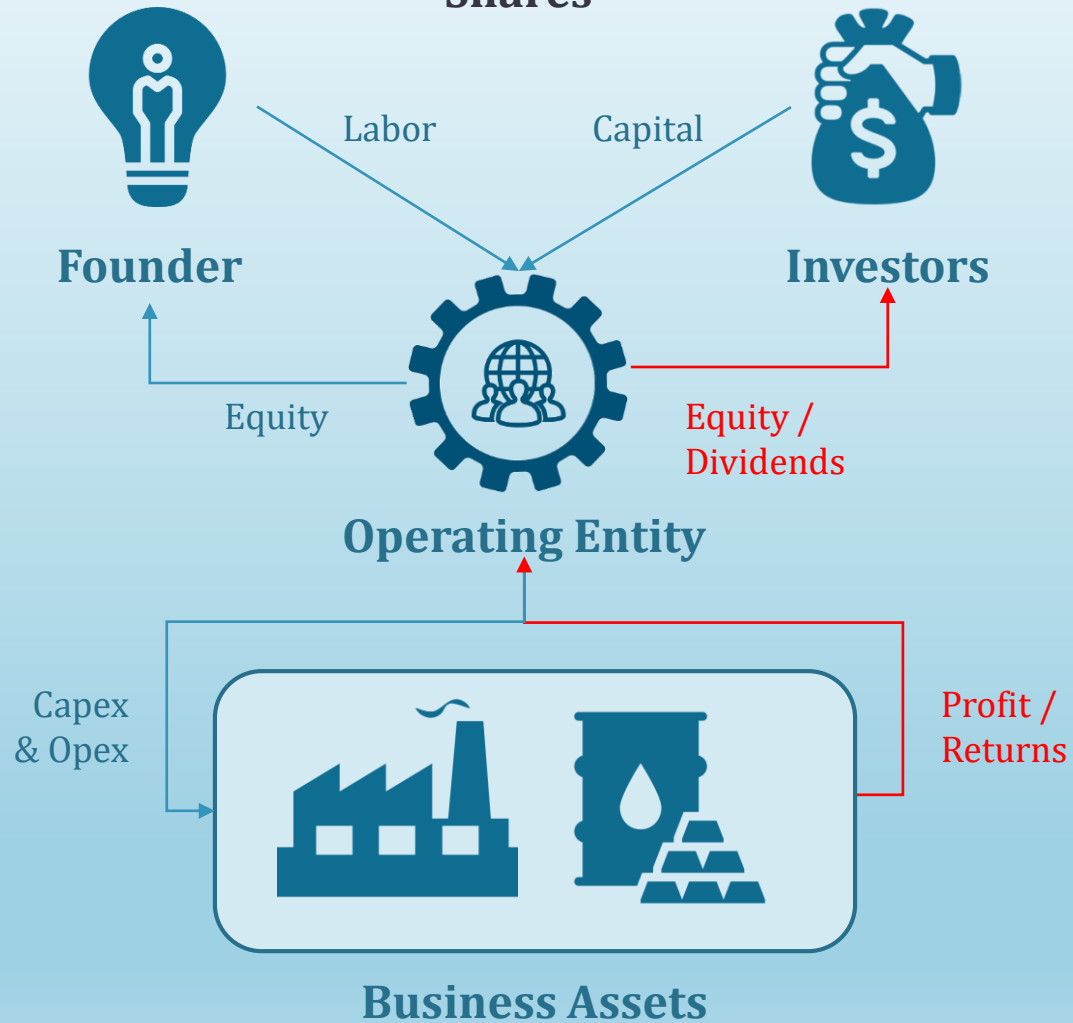
- ≡ Need **product prototype** to determine stage and amount of funding.
- ≡ Need **continuous business results** and track record to be eligible for listing.
- ≡ Need a **bloated team** of investment bankers, lawyers, lead arrangers, underwriters et.al.
- ≡ Need **high cost commitment** though amount potentially raised is limited in local bourses.
- ≡ Need to **cede voting rights** (dilutive equity), board seats, and management control.
- ≡ Need to **deliver on profits** and dividends on quarterly or regular basis.
- ≡ Need to **strictly comply** with SC regulations before you can proceed.

ICO

- ≡ Need **whitepaper** with/out any product (newer gen of ICOs are more exacting).
- ≡ Need **token**, **smart contract** and **website**; the latter is discretionary.

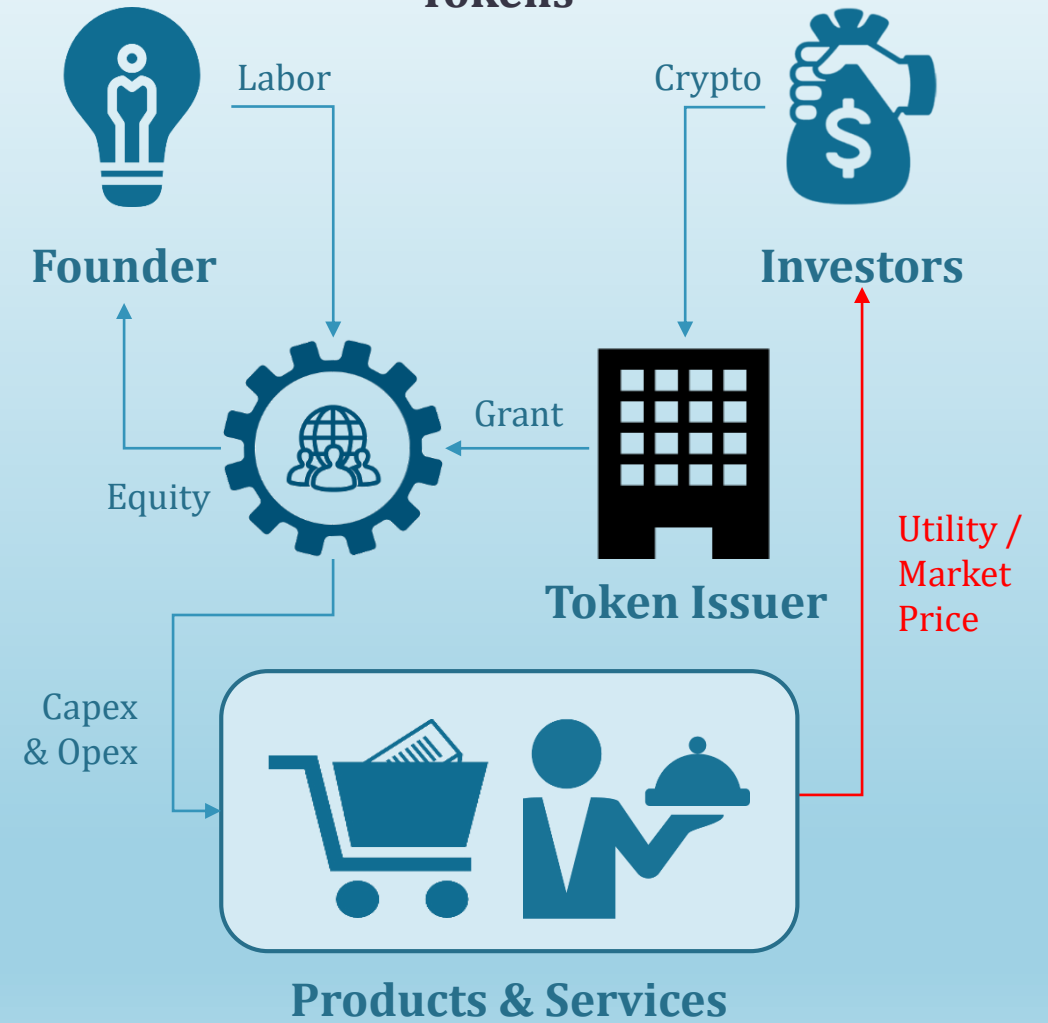
IPO

Shares

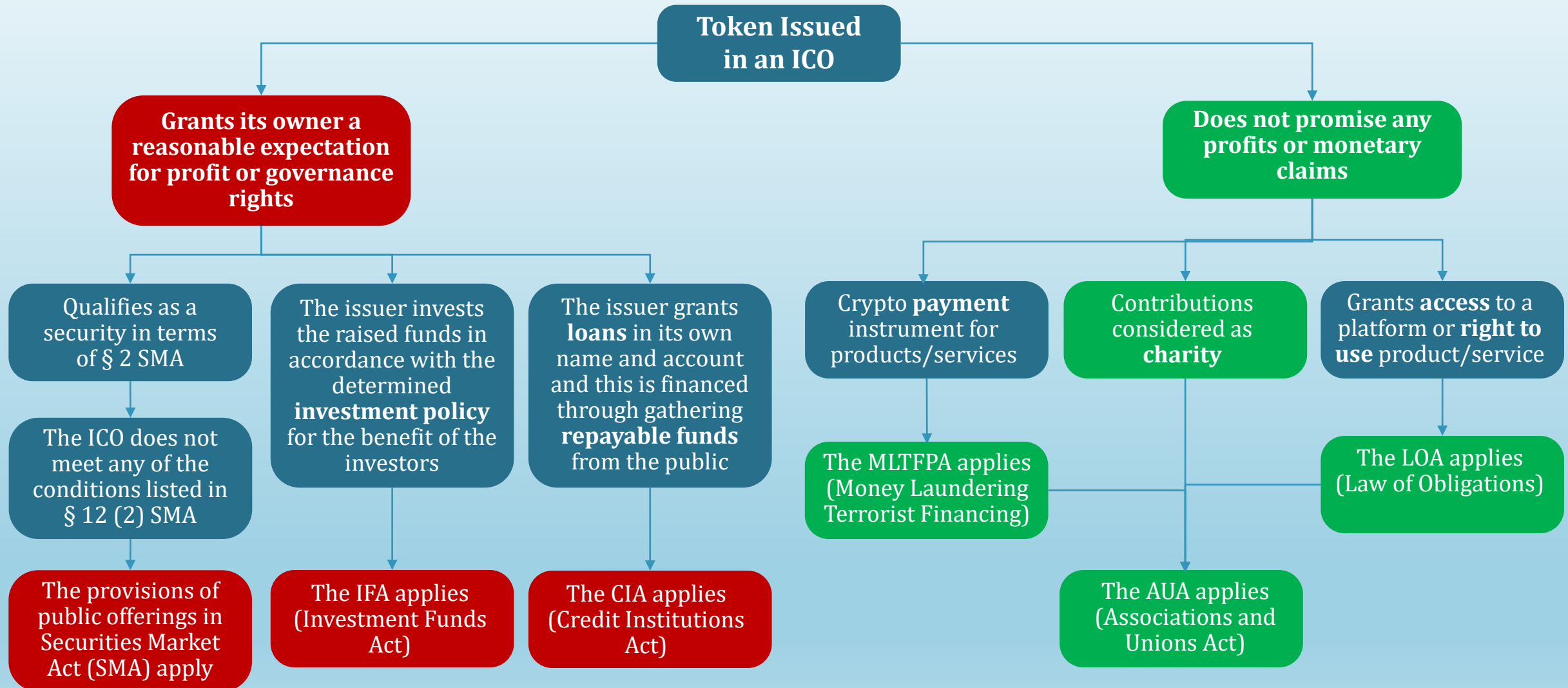



ICO

Tokens



Legal applicability of ICOs in Estonia (popular destination)





The most popular question which
you will come across in the course
of ICOs:

Is it a Utility or Security Token?

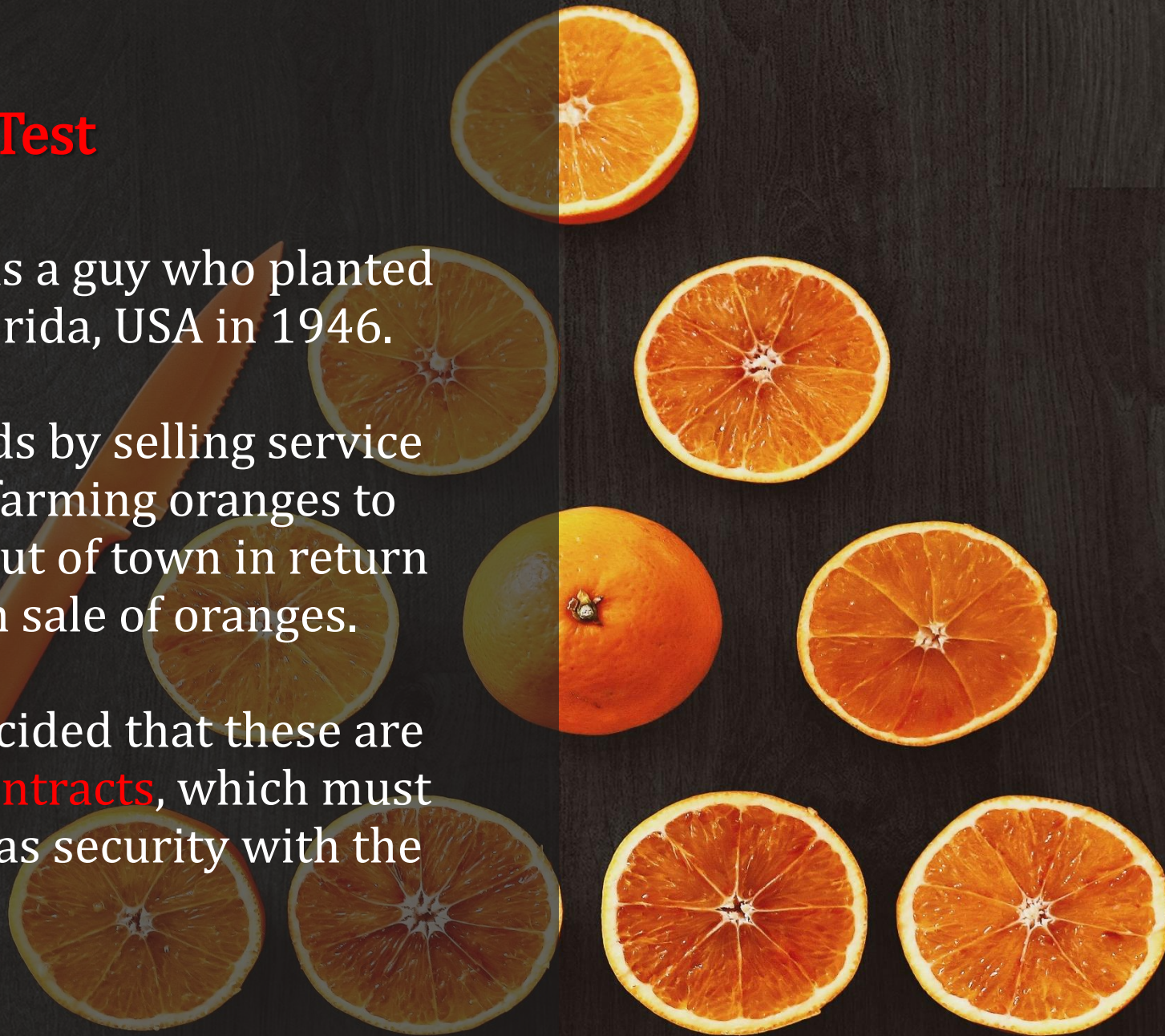
In the absence of any specific laws
on crypto, regulators will fall back
to existing securities laws – CMSA
2007 and Bursa rules.

The Howey Test

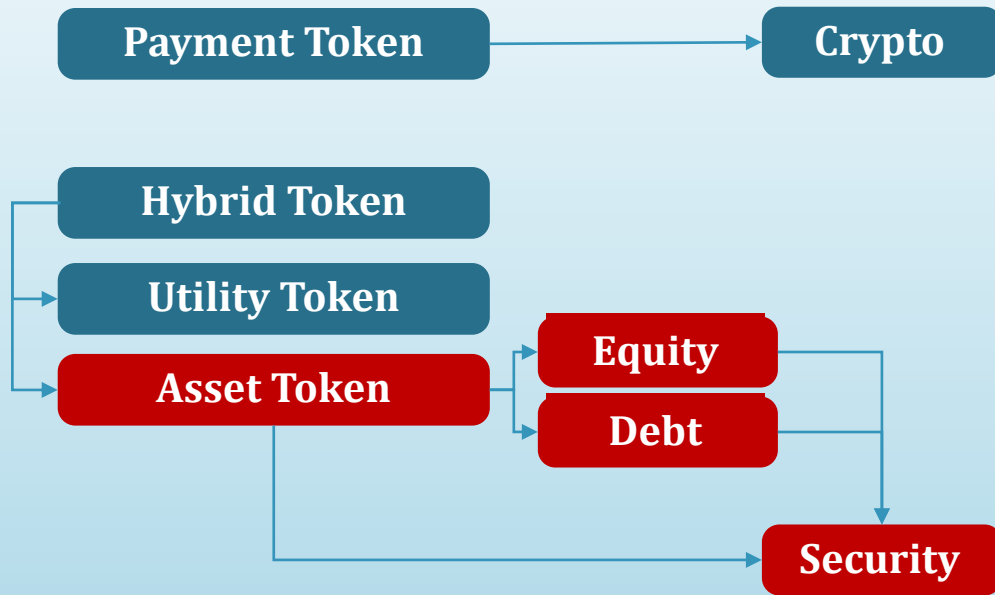
Mr. Howey was a guy who planted oranges in Florida, USA in 1946.

He raised funds by selling service contracts for farming oranges to buyers from out of town in return for profit from sale of oranges.

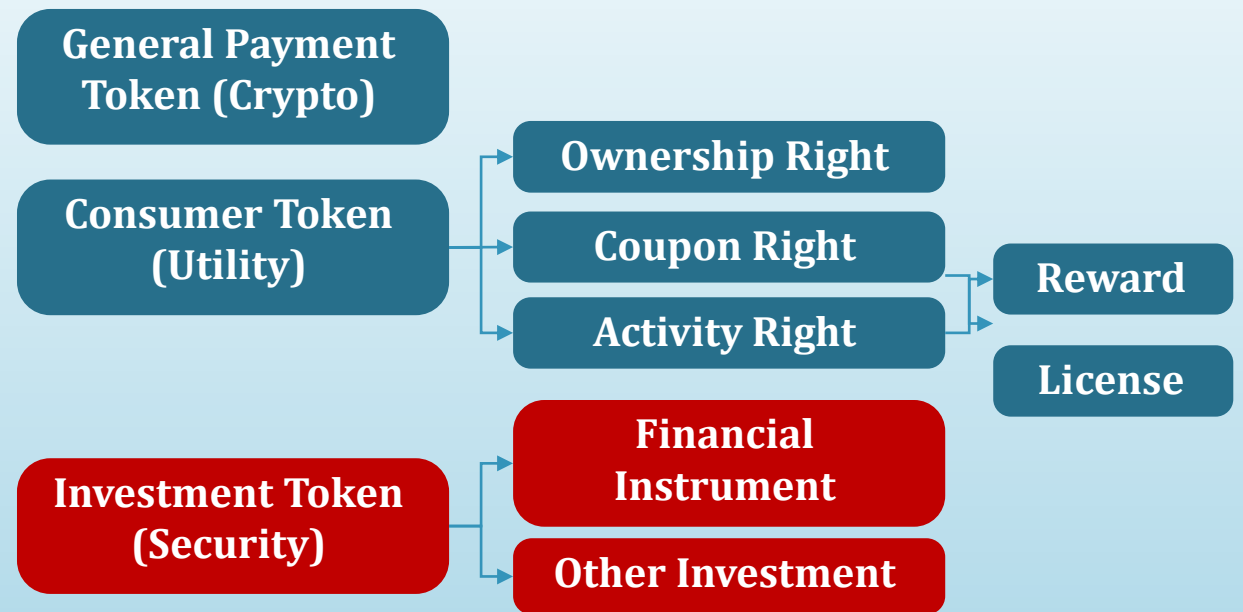
The courts decided that these are **investment contracts**, which must be registered as security with the authorities.



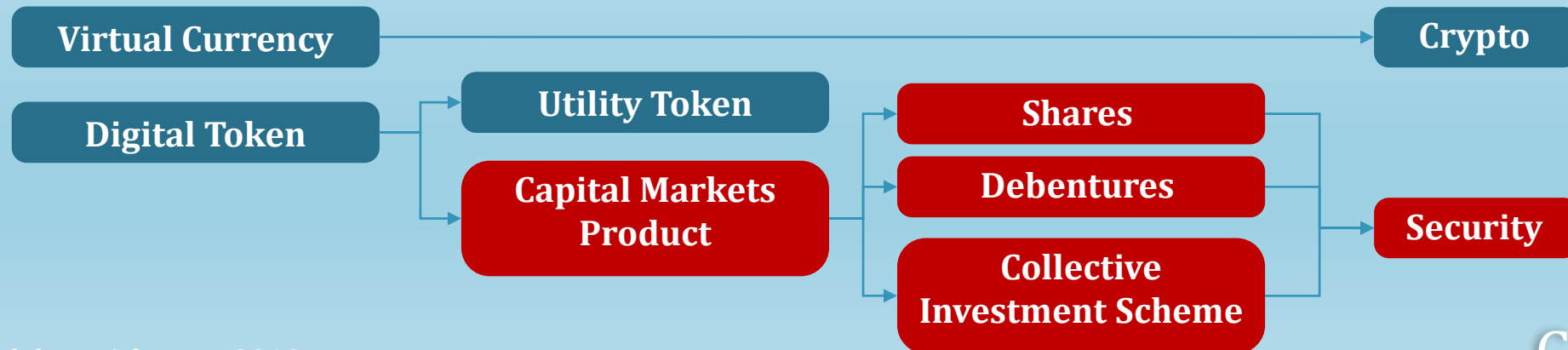
Financial Market Supervisory Authority of Switzerland



The Brooklyn Project (Consensys) New York



Monetary Authority of Singapore



Under CMSA (2013), “capital market products” include:

“**securities**” means:

- (a) debentures, stocks or bonds issued or proposed to be issued by any government;
- (b) shares in or debentures of, a body corporate or an unincorporated body; or
- (c) units in a unit trust scheme or prescribed investments

“**derivatives**” means:

any contract, either for the purposes of **creating an obligation or a right or any combination of both**, of which its market value, delivery or payment obligations are derived from, referenced to or based on, but not limited to –

underlying securities or **commodities, assets, rates, indices or any of its combination**, whether or not a standardized derivative or an over-the counter derivative

a **private retirement scheme**;

a **unit trust scheme**;

any product or arrangement which is **based on securities or derivatives, or any combination thereof**; and

any other product which the **Minister may prescribe** as a capital market product

The background of the entire slide is a dense, repeating pattern of colorful teddy bears. The bears are arranged in vertical columns of different colors: orange, teal, purple, yellow, and blue. Each bear has a white belly and a smiling face.

If you are selling to Malaysians,
the most important thing to
watch out for in Malaysia is **not**
the Howey Test, but rather:

Is it a
**Collective Investment
Scheme?**

Per Interest Schemes Act 2016

CIS

Statutory definition of Collective Investment Scheme under Section 2 of *Capital Markets & Services Act (Malaysia) 2007*

- ≡ **Expectation** – There is an arrangement to expect or receive profits arising from asset or business that is funded by the tokens.
- ≡ **Pooling** – The contributions from investors are “pooled” which can mean that they are sent to a common account (wallet address).
- ≡ **Reliance** – The expectation of profits based on the reliance of the efforts of a third party, which in this case is the ICO issuer.
- ≡ **Control** – There is no day-to-day control of the management and operations of the ICO by investors or token holders.

ICO

In many cases out there, ICOs will tend to create what is known as “utility tokens” to circumvent the “security” definition.

- ≡ **Expectation** – Depends, though realistically speaking most token buyers seek the return (of investment) and not the usage of it.
- ≡ **Pooling** – Definition met
- ≡ **Reliance** – Depends, if the network and use cases are sufficiently decentralized. Even if there is network, actual users would be few.
- ≡ **Control** – Definition met

We foresee an inevitable evolution to **security tokens**. Instead of avoiding the law, we should engage it.

ECF

- ≡ Four types of digital contribution: **rewards, donation** (both unregulated), **peer lending, and equity crowdfunding** (regulated).
- ≡ Issuer needs to go through **registered ECF and P2P operators**. SC issued 6 licences for ECF in 2015 and another 6 for P2P in 2016. Circa **RM118 mil raised for 1000 deals** as of June 2018. More applications are invited.
- ≡ Issuer can **raise up to RM3 mil within a 12-month period**, irrespective of the number of projects and a total of RM5 million through the ECF platform.
- ≡ Typically an **“all-or-nothing” model** i.e. if the issuer fails to raise the targeted investment amount by the deadline, the fund raised will be **returned to investors** and the issuer will get nothing.

ICO

- ≡ Issuers operate in the **unregulated** utility or donation space.
- ≡ Generally **no registration** unless required by law where applicable.
- ≡ **No limit** to amount raised unless issuer self-imposes hard cap.
- ≡ **No refund**; issuer can place soft cap trigger but this is optional.

ECF

- ≡ **Angel investor** (i.e. accredited by Malaysian Business Angels Network) can invest up to **RM500,000** within a 12-month period.
- ≡ **Retail investor** can invest up to **RM5,000** per issuer with a total not exceeding RM50,000 within a 12-month period.
- ≡ **Sophisticated investor** (i.e. high-net worth entity or individual, or accredited): **no limit** to investment amount.
- ≡ ECF operator is required to ensure that any fund raised must be **kept and maintained in a trust account** until the targeted amount sought to be raised has been met.
- ≡ Investors are given a **six (6) day cooling off period** within which they may withdraw the full amount of their investment.

ICO

- ≡ **No subscription limit**, but minimum entry may be stipulated for private placement.
- ≡ **No subscription limit.**
- ≡ **No subscription limit.**
- ≡ **No trustee** or management company. More prudent issuers deploy multi-sig wallets.
- ≡ **No investor protection**, but restrictions are imposed on distribution and advertising by some countries.

Look out for the eventual convergence of ECF rules with ICO

This is already evident in the Thailand and Philippines model.
Even US-based **Indiegogo**, one of the largest ECF platforms in the world, launched an ICO / STO.



Pursuant to BNM Sector 6 AML CFT guidelines, one needs to determine:

Is it an Exchange of Digital Currency?

Will it come under Money Services Business Act 2013 now that crypto has legal recognition as currency in some foreign countries?

If the token is used for payment of goods and services, then:

Is it a Designated Payment Instrument?

Even though digital currencies are not classified as 'electronic money' per definition in FSA 2013.

This is important as capital gains are not taxable in Malaysia except for real property. So:

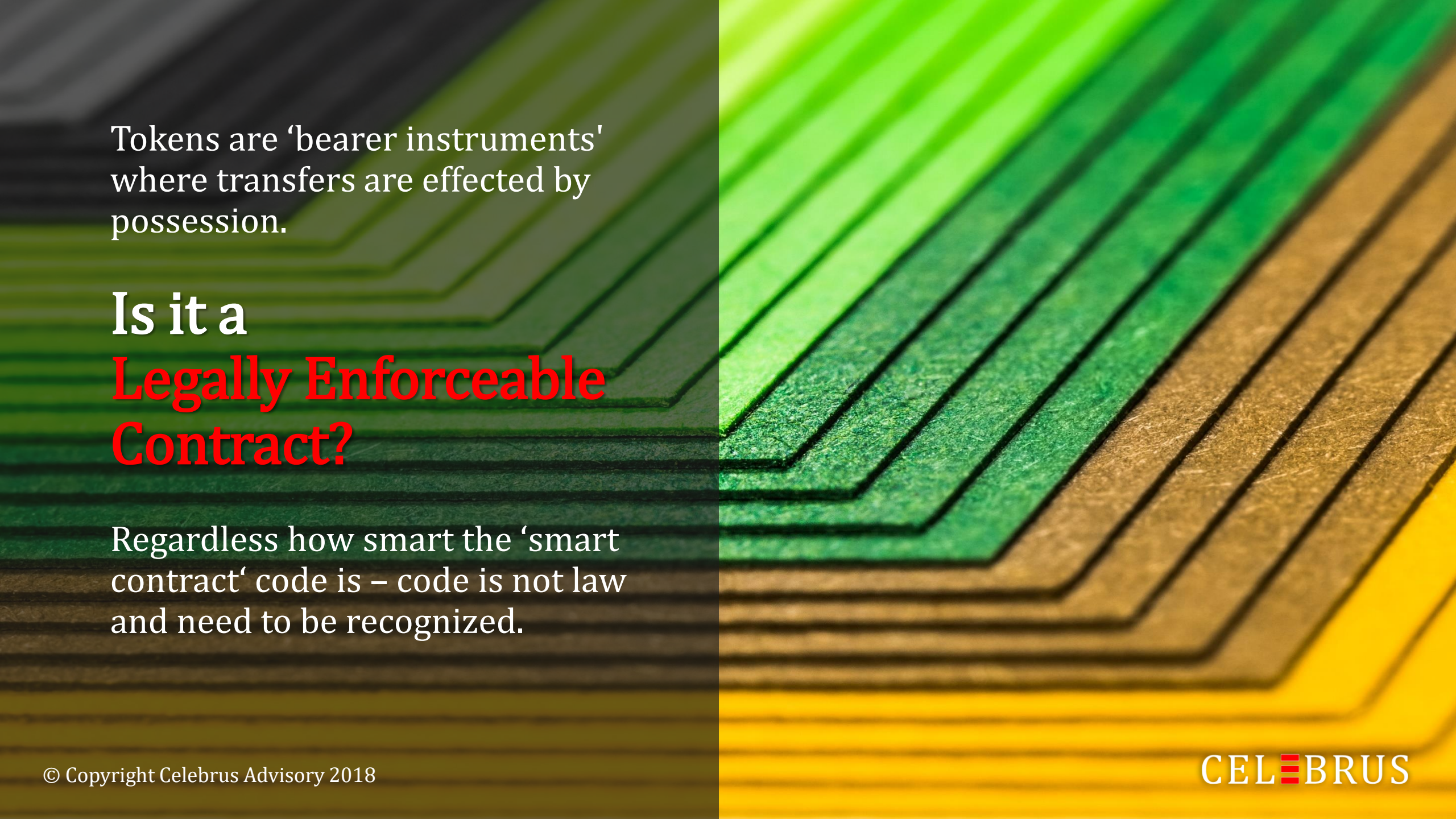
Is it an **Asset or Currency (for Taxation)?**

Issues arise for mining industry if is a currency unless seigniorage is made taxable...

Financial fraud is broadly defined as an intentional act of deception for personal gain:

Is it a **Prohibited or Fraudulent Activity?**

Failure to deliver on whitepaper may constitute “cheating” as per Penal Code s415, 417.






Tokens are 'bearer instruments' where transfers are effected by possession.




Is it a **Legally Enforceable Contract?**

Regardless how smart the 'smart contract' code is – code is not law and need to be recognized.

Comparative analysis of ICO guidelines in SEA – Part 1

	Singapore 	Thailand 	Philippines 
Initial Coin Offerings			
Reference	<ul style="list-style-type: none"> November 2017 Guidelines from Monetary Authority of Singapore (MAS) 	<ul style="list-style-type: none"> July 2018 Digital Asset Businesses Decree by SEC (enacted) 	<ul style="list-style-type: none"> August 2018 Consultation paper by SEC for public feedback (ended 31 Aug)
Legal Status	<ul style="list-style-type: none"> Virtual currencies (or cryptocurrencies) are not regulated by MAS as they are neither considered securities nor legal tender. But transactions are still subject to AML-CFT compliance. 	<ul style="list-style-type: none"> Cryptocurrencies differ from digital tokens. SEC designated some crypto as approved medium of exchange based on the liquidity, demand and extent of decentralization. 	<ul style="list-style-type: none"> Virtual currencies (or cryptocurrencies) are neither endorsed nor prohibited by Bangko Sentral Ng Pilipinas (BNP) but will be regulated for its delivery and is subject to AML-CFT compliance.
Token Taxonomy	<ul style="list-style-type: none"> Utility Token Security Token 	<ul style="list-style-type: none"> Digital Token: Utility Investment 	<ul style="list-style-type: none"> Asset Token Payment Token Utility Token Security Token
Litmus Test	<ul style="list-style-type: none"> Tokens are regulated if they fall within definition of capital markets products, namely: shares, debentures or units in a collective investment scheme. These are referred to as security tokens. 	<ul style="list-style-type: none"> Tokens can give participative rights to an business (investment), or to receive specific goods or services (utility). Tokens that can be used immediately are utility. Tokens with an objective of public fund raising is investment. 	<ul style="list-style-type: none"> Tokens can be asset, payment or utility tokens that satisfy the definition of a security, which are shares, participation or interests in a commercial enterprise or profit making venture.
Assessment	<ul style="list-style-type: none"> Self-assessment based on six case studies / fact scenarios, which are indicative only and non-exhaustive. Prevailing securities laws apply. 	<ul style="list-style-type: none"> Assessment done by licensed ICO portals on token attributes, issuer qualification, and due diligence on prospectus and registration statement. 	<ul style="list-style-type: none"> Initial assessment request (IAR) shall be submitted by the ICO issuer to SEC for determination of token status at least 90 days before start of presale period,

Comparative analysis of ICO guidelines in SEA – Part 2

	Singapore 	Thailand 	Philippines 
Initial Coin Offerings			
Documentary Requirements	<ul style="list-style-type: none"> Prospectus is exempted for security tokens if it is a small or private raise made to institutional or accredited parties. 	<ul style="list-style-type: none"> Prospectus and registration statement, which includes detailed business plan, audited financial statements, published smart contract codes, etc. 	<ul style="list-style-type: none"> Application form which requires team CVs, background checks, legal opinion and whitepaper, which SEC states is not interchangeable with a prospectus.
Subscription Limits	<ul style="list-style-type: none"> Prospectus must be registered for any offer above SGD5 million (or foreign currency equivalent); or For private placements to over 50 persons within 12 month period, for institutional or accredited investors, subject to certain conditions. 	<ul style="list-style-type: none"> No limit for ultra high net worth, VC, PE and institutional investors. THB300K for retail investor per person per offering. Retail portion must be <70% of total value of token offering, or ≤ 4 times the shareholders' equity of the issuer. 	<ul style="list-style-type: none"> Exempted from security registration if sale to less than 20 persons within 12 month period; or Qualified buyers such as institutional investors and banks; or For judicial sale, to liquidate bona fide debt, or is a isolated transaction.
Approval Timeframe	<ul style="list-style-type: none"> Not applicable 	<ul style="list-style-type: none"> Up to 60 days by SEC 	<ul style="list-style-type: none"> 20 days + extendable 20 days for IAR Plus SEC registration process if security
Permitted Currencies	<ul style="list-style-type: none"> Not specified 	<ul style="list-style-type: none"> Thai Baht and SEC approved crypto (BTC, ETH, BCH, XRP, LTC, XLM) 	<ul style="list-style-type: none"> Not specified
Extra-Territoriality	<ul style="list-style-type: none"> Singapore laws apply if the person operates a primary platform; or a trading platform partly in or partly outside of Singapore; or as an ICO promoter to induce the local public. 	<ul style="list-style-type: none"> ICOs and any token offers to local Thai public can only be done by a company (either private or public) established in Thailand. No international ICOs will be accepted by ICO portals. 	<ul style="list-style-type: none"> Foreign ICOs must have branch office in Philippines, subject to site audit or ocular inspection The ICO business must also show how it is relevant for the Filipino market.

What comes next? The industry will fiercely adapt!

- ≡ Once regulations kick in, they will **drastically reduce the total number of ICOs**, not just the influx of unscrupulous ICOs.
- ≡ This a good thing for investor protection but will it turn off the valve for SME funding? Or **will they just move elsewhere**? Case in point – South Korea.
- ≡ Is the utility-security token **dichotomy even useful anymore**? CFTC in US has jurisdiction over crypto as 'commodities', and Indonesia may be following suit.
- ≡ How will these ICO regulations reconcile or **interact with ASEAN CIS Code**? What will be the fate of ECF and P2P?
- ≡ Regulating through licensed ICO portals is a novel idea. They can supplement SEC on the tech part where it does not have expertise – but is it vulnerable to corruption? Too early at this inchoate stage of industry **not to have direct line of sight**?
- ≡ A **whole new coterie** of trustee corporations, custody and escrow services, security / code auditors will emerge.
- ≡ STOs (security token offerings) will become the new normal. They could be **mainstream with crypto investment banking**. Y Ventures (Singapore), J Fin / J Mart (Thailand), Elmer Francisco (Philippines) are merely the start of an avalanche of reverse ICOs.

What is stopping ICOs from going private or offshore?

To take advantage of exemptions (Reg D), safe harbors (Reg S), or crypto friendly jurisdictions.

NOTHING



REAL LIFE CASE STUDY

Lessons from the
Malaysian Experience





A BLANK CHEQUE FOR COUNTRY HEIGHTS?



theedgemarkets.com

ts shareholders give nod to

Lee Kim Yew gets Country Heights shareholders' nod for ICO issue

/ theedgemarkets.com

14:45 pm +08



SC says yet to receive details of Country Heights' cryptocurrency plans

Posted on 17 October 2018 - 10:53pm


Last updated on 18 October 2018 - 11:09am

V. Ragananthini

sunbiz@thesundaily.com



Sep 28, 2018	Country Heights (CHHB) announces plans for an ICO that will be an Asset-Backed Cryptocurrency (ABC) .	Nov 9, 2018	Horse Currency will be mainly used as a utility token, a reward token, and loyalty programme with businesses, and in exchange for CHHB's products and services, at the Palace of Golden Horses, health screenings/treatments at Grand Wellness Centre, dining at its restaurants and private jet trips. It can be "legal tender" to buy properties by the group.
Oct 3, 2018	CHHB files Company Announcement to Bursa Malaysia . Says it will keep regulators "well-informed".	Nov 9, 2018 Source: The Edge	Annual Report: CHHB's total assets amounted to RM1.27 billion as at Dec 31, 2017. The group's property, plant and equipment, investment properties and land held for property were valued at RM684.91 million. CHHB chairman, said that the group intends to revalue some of its assets in order to achieve the value of RM2 billion .
Oct 27, 2018 Source: The Sun	Securities Commission: "We have engaged the company and they have yet to provide us with details of the proposed ICO."		
Nov 8, 2018	CHHB convenes Extraordinary General Meeting with its shareholders on the ICO and obtains approval from them.		
Nov 9, 2018 Source: The Edge	No circular issued to shareholders to understand the risks of the ICO and the implications for the group before casting their votes at the EGM.		



CHHB proposed to issue **1 billion Horse Coins**, backed by RM2 billion worth of the group's assets, with initial 300 million of Horse Currencies open for circulation to the public.

Though not reflected in its balance sheet, Lee assured that the CHHB "definitely has RM2 billion of assets" after the revaluation of some of its investments and properties.

DISCUSS THE LEGAL MERITS OF THIS ICO

VISIT OUR WEBSITE
CELEBRUSADVISORY.COM
FOR RECOMMENDED READINGS

WE ARE LOOKING FOR A
PART-TIME RESEARCH ASSISTANT

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