

Cryptocurrencies and other virtual assets: Hong Kong's new approach

November 2018

On 1 November 2018, the Hong Kong Securities and Futures Commission (SFC) issued two publications setting out a new regulatory approach for virtual assets.

Overview of changes

Two publications issued by the SFC

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| 1 | Circular to Intermediaries on Distribution of virtual asset funds (the Circular) |
| 2 | Statement on regulatory framework for virtual asset portfolios managers, fund distributors and trading platform operators (the Statement) |

ACTIVITY	EXISTING POSITION	ANY NEW LICENSING REQUIREMENTS?	ANY OTHER NEW REQUIREMENTS?
Distributing (including fund manager who distributes) funds holding any virtual assets (regardless of whether they are securities or futures contracts)	Type 1 licence required unless exemption applies	No	If (i) the fund is not SFC authorised and (ii) de minimis threshold is not satisfied, then new requirements in the Circular apply in relation to enhanced selling restrictions, due diligence and information to be provided to clients De minimis applies if the fund does not intend to and has not invested more than 10% of GAV in virtual assets and has no stated investment objective to invest in virtual assets
Management of funds that only hold virtual assets that are not securities or futures contracts	Not regulated	No	If fund manager (i) is Type 9 licensed or (ii) Type 1 licensed and (iii) does not satisfy the de minimis threshold, then additional licensing conditions will be imposed by the SFC - see Appendix 1 of the Statement
Management of funds of funds holding virtual assets	Type 9 licence required unless exemption applies	No	No additional licensing conditions if fund manager only manages portfolios that invest in virtual asset funds

SFC Keynote Speech: Hong Kong FinTech Week 2018

The impending publication of the Circular and Statement had been announced earlier that day by Ashley Alder, Chief Executive Officer of the SFC, during his keynote speech at Hong Kong FinTech Week 2018.

Themes discussed in Mr Alder’s speech included the unprecedented rate of innovation and change in businesses across a wide variety of sectors, and the attendant customer experience and financial inclusion benefits.

Some of the key takeaways from the speech are summarised below.

- The SFC reiterated its support for Fintech and innovation, although being cognisant of the need for caution in certain areas.
- The SFC regards virtual assets, including cryptocurrencies, to be different to other innovations. Virtual assets have been identified as a dominant risk at IOSCO meetings. Whilst the virtual asset market is currently too small to pose a threat to global economic or financial stability, they pose a significant risk to investors. Current regulatory focus is therefore mainly on investor protection.
- Virtual asset markets are young; with trading rules that may not have the same standards of fairness as other markets, including in respect of agent/principal trades. Outages are not infrequent and there are concerns about market manipulations and fraud.
- The anonymous trading of cryptocurrency raises concerns of money laundering and terrorist financing.
- The SFC acknowledges the investment demand for virtual assets and the fact that they may not fall within the usual regulatory

ambit of the SFC (if neither securities nor futures contracts).

- The SFC regards it as too early to seek to change legislation to deal with virtual assets, noting there to be no international consensus on legal standards in this space.
- The SFC considered an approach of stating that virtual assets are unregulated and then informing the public of the attendant risks. However, because such an approach would provide little investor protection, the SFC has instead decided to adopt new measures within its existing regulatory remit to protect those who invest in virtual asset portfolios or funds.
- The SFC’s new approach is set out in the Circular and Statement referred to above and described in further detail below.

Existing regulatory position

Many virtual assets do not (and are often deliberately structured so as not to) constitute “securities” or “futures contracts” as defined in the Securities and Futures Ordinance (**Non-SF Virtual Assets**). Accordingly, managing funds solely investing in, and operating platforms which only provide trading services for, Non-SF Virtual Assets were not subject to SFC oversight. However, firms which distribute funds or manage funds of funds holding virtual assets (irrespective of whether they are “securities” or “futures contracts”) must be licensed or registered with the SFC and, as highlighted in a Circular to Intermediaries dated 1 June 2018, notification requirements apply if a licensed corporation or registered institution intends to provide trading and asset management services involving crypto-assets.

The new measures aim to regulate the management and distribution of virtual asset funds so that investors’ interests are protected at either the fund management or distribution level or both. The measures do not amend the law or

the definitions of “securities” or “futures contracts” - they clarify existing requirements and impose new requirements primarily in the form of licensing conditions on intermediaries. The SFC has also released details of a conceptual framework to explore the regulation of virtual asset trading platforms.

Circular to Intermediaries on Distribution of virtual asset funds

The Circular notes that the SFC has observed investors’ growing interest in funds which invest in “virtual assets” and that the purpose of the Circular is to: (i) remind intermediaries licensed or registered for Type 1 regulated activity (dealing in securities) or Type 9 regulated activity (asset management), to the extent that these intermediaries are engaged in distributing virtual asset funds under their management, about the existing regulatory requirements; and (ii) provide guidance on the expected standards and practices in relation to the distribution of virtual asset funds. The key takeaways from the Circular are summarised below.

Distributors of collective investment schemes (**Funds**), typically being mutual funds or unit trusts) are required to be licensed by the SFC for Type 1 (dealing in securities) regulated activity, unless an exemption applies.

The distribution of Funds that invest in virtual assets, including cryptocurrencies, is therefore regulated (regardless of whether or not the virtual assets constitute ‘securities’ or ‘futures contracts’).

Distributors (including asset managers distributing under the incidental exemption) are already required under paragraph 5.2 of the SFC Code of Conduct (the **Code**) to ensure the suitability of any recommendation or solicitation to a client is reasonable. This is subject to certain exemptions, in particular institutional professional investors (as defined in the Code).

In addition, where a Fund:

- is not authorised by the SFC for distribution to retail clients (**non-authorised**); and
- has a stated investment objective to invest in virtual assets, or intends to or has invested more than 10% of gross asset value in virtual assets (directly or indirectly e.g. derivatives with virtual assets as underlying),

then:

Selling restrictions / concentration assessments

- (i) SFC licensed distributors should target professional investors only
- (ii) SFC licensed distributors should assess whether the clients (other than institutional professional investors) have sufficient knowledge of investing in virtual assets. If they do not, then distributors may only proceed if they would be acting in the best interest of the clients or after taking into account a client’s prior investment experience in private equity or venture capital or start-up capital in the last two years
- (iii) SFC licensed distributors should ensure that the amount invested by a client into non-authorised virtual asset Fund is reasonable, considering the client’s net worth

Due diligence on non-authorised virtual asset Funds

- (iv) SFC licensed distributors should conduct proper due diligence on non-authorised virtual asset Funds. A number of due diligence steps are referred to in the Circular, including:

- Review of the Fund’s constitutive documents and due diligence questionnaire
- *Fund manager*: in-depth understanding of the Fund manager (amongst other relevant considerations, the circular refers to track record, regulatory status, compliance, internal controls and systems, IT infrastructure, risk management and disaster recovery)
- *Fund*: in-depth understanding of the Fund (amongst other relevant considerations, the Circular refers to the targeted investors, instruments intended to be traded and limitations on holding sizes, valuation policy (noting ICO tokens may be both illiquid and hard-to-value), custody, leverage, targeted risk and return, key risks and auditors)
- *Fund counterparties*: in-depth understanding of the Fund counterparties, including status, experience, track record, IT system robustness, financial soundness and insurance coverage

Information for Clients

- (v) SFC licensed distributors should provide information on the Fund and its underlying virtual asset investments in a clear and easily comprehensible manner. A number of warning statements should be included, which are listed in the Circular.

Next steps: Relevant SFC licensed distributors (including fund managers who distribute) should implement adequate systems and controls to ensure compliance with the above requirements.

Statement on regulatory framework for virtual asset portfolios managers, fund distributors and trading platform operators

The Statement notes the SFC’s concern with the growing investor interest in gaining exposure to virtual assets via funds and unlicensed trading platform operators in Hong Kong and that the purpose of the Statement is to provide guidance on the regulatory standards expected of virtual asset portfolio managers and fund distributors, in order to address the significant risks associated with investing in virtual assets. The Statement notes that the SFC is also exploring a conceptual framework for the potential regulation of virtual asset trading platform operators.

The key takeaways from the Statement are summarised below.

1. Regulatory approach for virtual asset portfolio managers and fund distributors

Virtual asset portfolio managers

The SFC supervises the following types of virtual asset portfolio managers:

- Managers who manage and distribute a Fund that invests in virtual assets

This includes managers who do not require a Type 9 (asset management) licence because the Fund does not invest in ‘securities’ or ‘futures contracts’. Such a manager would however distribute the Fund and hence require a Type 1 (dealing in securities) licence, unless an exemption applies.

- Managers who are asset managers of a Fund that holds securities or futures contracts

Such managers require a Type 9 (asset management) licence to manage such securities.

Where such managers falling within (i) or (ii) above also manage portfolios which invest solely or partly in Non-SF Virtual Assets, this will be subject to SFC oversight through the imposition of licensing conditions.

This oversight is subject to a *de minimis* threshold that the Fund has a stated investment objective to invest in virtual assets, or there is an intention to invest 10% or more of the gross asset value of the Fund portfolio in virtual assets.

The managers falling within (i) or (ii) above should observe essentially the same regulatory requirements, regardless of whether or not the Fund invests in virtual assets. With this in mind, the SFC has developed a set of ‘**Terms and Conditions**’ for licensed corporations, capturing the essence of the existing requirements, adapted as needed in the context of virtual assets. They will likely be imposed as licensing conditions, subject to minor variations depending upon the particular asset manager.

As well as the *de minimis* threshold exemption, the Terms and Conditions will also not apply to licensed corporations which only manage fund of funds that have portfolios investing in virtual asset funds.

Some of the key Terms and Conditions are attached to the Statement. They include the following:

- Only professional investors should be permitted to invest in any virtual asset portfolio. Risks should be clearly disclosed
- Appropriate custodial arrangements are selected by the licensed corporation, including consideration of advantages and disadvantages of “hot wallets”, “cold wallets” and “deep cold wallets”
- Due skill, care and diligence in selecting, appointing and monitoring custodians. A number of custodian factors to consider are listed in Appendix 1 to the Statement

- Portfolio valuation principles, noting there are no generally accepted valuation principles for virtual assets
- Risk management limits and periodic stress testing. A particular focus is on the cybersecurity of virtual asset exchanges given the incidences where such exchanges have been hacked. A number of assessment procedures for the reliability and integrity of virtual asset exchanges are listed in Appendix 1 to the Statement
- Auditor independence, due diligence in selecting auditor
- Liquid capital requirements, where the licensed corporation holds virtual assets

Licensed corporations are required to inform the SFC if they are presently managing or intend to manage portfolios that invest in virtual assets. The SFC will then seek to understand the manager’s business activities and discuss the Terms and Conditions with the manager before imposing them as licensing conditions. If the manager does not agree to the Terms and Conditions, the portfolio should be unwound within a reasonable period of time.

Virtual asset Fund distributors

Fund distributors of virtual assets (irrespective of whether they constitute securities or futures contracts) are regulated as described in the *Circular to Intermediaries on Distribution of virtual asset funds*, referred to above. Thus under the new approach, every virtual asset Fund available in Hong Kong will be subject to SFC requirements at the distribution or fund management level (or both) - whether through the fund being managed by portfolio managers that are subject to the Terms and Conditions and/or being distributed by firms subject to existing SFC requirements and those set out in the Circular.

2. Voluntary regulation of platform operators

The Statement notes that the SFC is setting out a conceptual framework to potentially regulate, on a voluntary basis, virtual asset trading platform operators. Those platforms that become regulated and thereby adhere to a high level of standards and practices would be set aside from unlicensed operators.

Such interested platforms would first be placed in the SFC Regulatory Sandbox for observance by the SFC (which would include assessing whether the platform is indeed appropriate to be regulated by the SFC, and whether inherent risks can be appropriately dealt with).

An 11-page conceptual framework for potential regulation of virtual asset trading platform operators is attached to the Statement.



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