

SFC Announces Regulatory Framework for Virtual Asset Trading Platform Operators, Portfolio Managers and Fund Distributors

November 8, 2018

The Hong Kong Securities and Futures Commission (“**SFC**”) last week took a significant step in its regulation of virtual asset¹ activities by establishing a new, opt-in regulatory sandbox framework for virtual asset trading platform operators, proposing new licensing requirements for portfolio managers and imposing new requirements on fund distributors engaged in virtual asset activities. These actions were issued through several documents, including a “Circular to intermediaries – Distribution of virtual assets funds” (the “**Circular**”) and a “Statement on regulatory framework for virtual asset portfolios managers, fund distributors and trading platform operators” (the “**Statement**”, and together with the Circular, the “**November 2018 Updates**”), and discussed in a speech by Mr. Ashley Alder, CEO of the SFC.²

Notification requirement

All licensed corporations are already required to notify the SFC if they intend to provide trading and asset management services involving crypto-assets.³ This remains the same after the November 2018 Updates.

Virtual asset trading platform operators

Prior to the November 2018 Updates

Operators of a trading platform for virtual assets (e.g. a cryptocurrency exchange or a broker for virtual assets) are not regulated by the SFC if none of those virtual assets is classified as “securities” or “futures contracts”.⁴

However, if any of those virtual assets fall under the definition of “securities”, the trading platform operator may be subject to the SFC’s licensing and conduct requirements.⁵ For example, depending on the business model of the platform, a Type 1 (dealing in securities) or Type 7 (providing automated trading services) licence may be needed. In addition, requirements relating to recognised exchange companies may also be applicable.⁶

¹ “**Virtual assets**” is defined in the Circular to include digital tokens, such as digital currencies, utility tokens or security or asset-backed tokens, and any other virtual commodities, crypto assets and other assets of essentially the same nature.

² See Ashley Alder, “Fintech: Meeting the regulatory challenges – Keynote speech at Hong Kong FinTech Week 2018”, 1 November 2018.

³ “Crypto-assets” include cryptocurrencies, funds investing in cryptocurrencies and related products, cryptocurrency futures contracts and structured products. See SFC, “Circular to intermediaries on compliance with notification requirements”, 1 June 2018.

⁴ There may however be other requirements. For example, the trading platform operator may need a money service operator licence and may be subject to AML/CFT requirements.

⁵ See SFC, “Statement on initial coin offerings”, 5 September 2017.

⁶ Ibid.

The November 2018 Updates

The Statement sets out a conceptual framework for the SFC to regulate virtual (cryptocurrency) asset trading platforms in order to enhance investor protection, especially with respect to corporate governance, internal controls, anti-money laundering / counter-financing of terrorism (“**AML/CFT**”) and product suitability, while at the same time fostering innovation. Under the framework, a licence is not compulsory; thus, a trading platform not providing for the trading of securities may choose to remain unlicensed. The licensing regime is designed to set apart those trading platform operators willing to adhere to the standards set by the SFC.

The framework applies to any online trading platform in Hong Kong⁷ that (i) provides trading, clearing and settlement services for virtual assets; and (ii) has control over investors’ assets. The licensing regime does not cover platforms for direct peer-to-peer marketplace where investors typically retain control over their own assets, or firms that trade virtual assets for clients (including order routing) without providing automated trading services.⁸

A trading platform operator wishing to obtain a licence may notify the SFC. The SFC will then place the trading platform operator in the SFC Regulatory Sandbox (the “**Sandbox**”)⁹ and the SFC will work with the operator to determine whether the operator is suitable to be licensed and regulated. If the SFC makes a positive determination, it will then consider granting a licence subject to licensing conditions.

The licensing conditions will be based on the following principles and may be varied according to the business model of the trading platform after discussion between the SFC and the trading platform operator.

Core principles

- All Relevant Activities¹⁰ shall be conducted under a single legal entity holding the licence.
- All Relevant Activities shall comply with regulatory requirements, including licensing conditions, even if certain activities may not relate to virtual assets classified as “securities”.
- Services shall be offered to professional investors¹¹ only.
- Tokens issued by way of initial coin offering (the “**ICO**”) may only be traded at least 12 months after the completion of the ICO or when the ICO project has started to generate profit, whichever is earlier.

⁷ At this stage, the threshold for the jurisdictional nexus with Hong Kong is unclear. The traditional approach focuses primarily on the question of whether the platform is operating in Hong Kong, but this may be factually more challenging in the context of an online platform. A secondary approach would be to look at the platform’s active marketing to Hong Kong investors. This is in line with the SFC’s indication in 2003 that the SFC will not seek to regulate activities that are conducted from outside Hong Kong and over the Internet, provided that such activities are not targeted at persons residing in Hong Kong and are not detrimental to the interests of the Hong Kong investing public or to the market integrity of Hong Kong. See SFC, “Guidance Note for Persons Advertising or Offering Collective Investment Schemes on the Internet”, April 2003.

⁸ As defined under Part 2 of Schedule 5 to the SFO.

⁹ See SFC, “Launch of the SFC Regulatory Sandbox”, 29 September 2017.

¹⁰ Under paragraph (1), Part I of Appendix 2 to the Statement, “**Relevant Activities**” is defined as any virtual asset (irrespective of the nature of any token) trading activities on and off the platform, and any activities wholly incidental to the provision of such trading services, but excluding the distribution of virtual asset funds or management of virtual asset portfolios which are regulated separately.

¹¹ As defined under Part 1 of Schedule 1 to the SFO.

- No financial accommodation or margin financing shall be provided by the platform operator, and trades shall only be executed if there are sufficient assets (fiat or virtual) in the client's account to cover the trade.
- No derivatives (including futures contracts) based on virtual assets may be traded.

Sample licensing conditions

- Comply with the Securities and Futures Ordinance (the “SFO”) and its subsidiary legislation, the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission, and guidelines, circulars and frequently asked questions published by the SFC from time to time.
- Financial soundness.
- Insure against risks specific to custody of virtual assets, including theft and hacking. Full coverage is required for hot storage, and substantial coverage (e.g. 95%) is required for cold stage.
- Assess clients' knowledge with respect to virtual asset trading as part of KYC except for institutional professional investors.
- Adequate AML/CFT measures.¹²
- Adequate disclosure of risks and fees.¹³
- Disclose the criteria for admitting a virtual asset for trading on the platform and perform reasonable due diligence on virtual assets before admitting them. A committee should be responsible for deciding whether to admit the virtual asset, and the fee structure for admitting a virtual asset should be designed to avoid any potential, perceived or actual conflicts of interest.
- Publish comprehensive trading rules online.¹⁴
- Prevent manipulative and abusive activities, such as fictitious or artificial transactions or the disclosure of misleading information.¹⁵
- Maintain written policies governing employees' trading to avoid actual or potential conflicts of interest, and require employees to report their virtual asset holdings to senior management.
- Prioritise client orders over proprietary orders, including those of employees or agents.
- Segregate client assets from proprietary assets, and store a sizable amount (e.g. 98%) of those assets not required to be immediately available in cold storage.
- Comply with ongoing reporting obligations regarding aspects specified by the SFC, which may include changes in scope of service, details of new virtual assets, monthly trading volume, client identities and locations, and trading / clearing / settlement statistics in Hong Kong.

¹² See Paragraph 4, Part II of Appendix 2 to the Statement for detailed requirements.

¹³ See Paragraph 5, Part II of Appendix 2 to the Statement for detailed requirements.

¹⁴ See Paragraph 7, Part II of Appendix 2 to the Statement for detailed requirements.

¹⁵ See Paragraph 8, Part II of Appendix 2 to the Statement for detailed requirements.

Management of virtual asset portfolios

Prior to the November 2018 Updates

The manager of a portfolio investing in any virtual asset falling under the definition of “securities”¹⁶ will need a Type 9 licence (asset management). Further, a manager of a portfolio which invests in virtual asset funds, i.e. a manager of a fund of funds, also needs a Type 9 licence (asset management) as the underlying virtual asset *funds* are collective investment schemes (and hence classified as “securities”) regardless of whether the underlying virtual *assets* are “securities”.

A manager of a portfolio investing solely in virtual assets not classified as “securities” is not regulated by the SFC and the portfolio manager does not need a licence. Moreover, where a licensed corporation not only conducts regulated activities (for example, dealing in securities under a Type 1 licence or managing assets involving securities under a Type 9 licence) but also manages portfolio(s) investing solely in virtual assets not classified as “securities”, the management of the latter portfolio(s) is not regulated.

The November 2018 Updates

In the November 2018 Updates, the SFC proposes additional requirements, to be imposed by way of licensing conditions, on licensed corporations (such as fund distributors with a Type 1 licence or fund managers with a Type 9 licence) which also manage or plan to manage portfolios with either a stated investment objective to invest in virtual assets or an intention to invest 10% or more of the gross asset value of the portfolio in virtual assets, regardless of whether those virtual assets are classified as “securities” (“**Specified Virtual Asset Portfolios**”). On the other hand, licensed corporations which only manage portfolios that invest in virtual asset funds (i.e. a fund of funds) need the Type 1 licence (dealing in securities) but will not be subject to these additional requirements. These additional requirements also do not apply to corporations that do not need a licence, such as a fund manager that only manages a fund investing in virtual assets not classified as “securities”.

The additional requirements are as follows.

- Only professional investors should be allowed to invest in Specified Virtual Asset Portfolios.
- Proper risk disclosure to potential investors.
- Proper custodial arrangements.
- Proper portfolio valuation with adequate disclosure to investors.
- Adequate risk management measures.
- Audit of financial statements of the portfolios by independent auditors.
- Minimum liquid capital requirement of HK\$3 million (or the licensed corporation’s variable required liquid capital, whichever is higher).

Upon being notified that a firm manages or intends to manage Specified Virtual Asset Portfolios, the SFC will seek to understand the firm’s business activities. If the firm appears capable of meeting the expected regulatory standards, the SFC will allow the firm to manage the Specified Virtual Asset Portfolios subject to the firm’s acceptance of the above requirements (which may be modified by the SFC after discussing with the firm to suit the latter’s business model) to be imposed by way of licensing conditions.

¹⁶ As defined under Part 1 of Schedule 1 to the SFO. See *also* SFC, “Statement on initial coin offerings”, 5 September 2017. In this statement, the SFC clarified that depending on the facts and circumstances of an initial coin offering, digital tokens offered or sold may be regarded as (i) shares, (ii) debentures, or (iii) interests in a collective investment scheme depending on the features.

Type of firm	Consequence of refusal to comply with the licensing conditions
<i>Licence applicant</i>	The licensing application will be rejected.
<i>Existing licensed corporation planning to manage virtual asset portfolios</i>	The licensed corporation shall not manage any virtual asset portfolios.
<i>Existing licensed corporation already managing virtual asset portfolios</i>	The licensed corporation shall unwind the virtual asset positions in its portfolios within a reasonable period of time, taking due account of the interests of the portfolios' investors.

Distribution of virtual asset funds

Prior to the November 2018 Updates

All distributors of virtual asset funds need a Type 1 licence (dealing in securities) regardless of whether the underlying virtual assets are classified as “securities”, as a fund is considered as a collective investment scheme such that the distribution of a fund constitutes dealing in securities.

The November 2018 Updates

The Circular imposes additional requirements on fund distributors for funds that (i) are not authorised by the SFC and (ii) fall under the definition of Specified Virtual Asset Portfolios (see above). The additional requirements are as follows.

- These funds should only be distributed to professional investors.
- Where non-institutional professional investors are involved, the distributor should assess whether the investor has sufficient knowledge and experience in the relevant areas, and if not, whether it is in the best interests of the clients to effect the transaction.¹⁷
- Proper due diligence should be conducted with respect to the fund, the fund manager and counterparties of the fund.¹⁸
- Prominent warning statements should be provided regarding investment risks (continuous evolution of virtual assets and global regulatory requirements; exchanges being unregulated and potential price manipulation; price volatility and the lack of secondary markets; counterparty risk; and cybersecurity and technology-related risks).

The Circular also specifically reminds fund distributors of the general obligation to ensure that any recommendation or solicitation made is suitable for clients.

As mentioned above, if a fund distributor also manages funds, the SFC may regulate the management aspect by imposing licensing conditions on the fund distributor's existing licence.¹⁹

¹⁷ See section (A) of the Circular for detailed requirements.

¹⁸ See section (B) of the Circular for detailed requirements.

¹⁹ See “Management of virtual asset funds”, *supra*.

Comparison Jurisdictions

Singapore

In Singapore, if virtual assets represent ownership or a security interest over an issuer's assets or any property, or a debt owed by the issuer, they may be regarded as securities and hence regulated under the Securities and Futures Act (the "SFA"). Similar to the Hong Kong regulatory regime, in Singapore, (i) there is a general obligation on the public to report suspicious transactions (ii) intermediaries dealing in tokens classified as securities shall be licensed, (iii) platforms facilitating secondary trading of such tokens shall be approved by the Monetary Authority of Singapore (**MAS**), and (iv) these intermediaries and platforms are subject to AML/CFT requirements. Moreover, on 21 November 2017, the MAS issued a consultation paper on the Proposed Payment Services Bill, which requires intermediaries that buy, sell or exchange virtual currencies to comply with AML/CFT regulations.

As of May 2018, the MAS has warned eight digital token exchanges in Singapore not to facilitate trading in digital tokens that are securities or futures contracts unless and until they are authorised by the MAS. In addition, the MAS also required an ICO issuer to stop offering digital tokens and return funds to Singapore-based investors, as those tokens fall under the definition of securities under the SFA and the ICO issuer failed to comply with relevant regulations.

The MAS and the Singapore government has also published a number of articles or statements aimed at strengthening investor education, and indicated that it has been studying (i) market risks that arise from the direct exposure of financial institutions to crypto tokens; (ii) AML/CFT concerns relating to crypto tokens; (iii) concerns regarding cyber theft and attacks; and (iv) market manipulation and other fraudulent activities.

United States

In the United States, the U.S. Congress, as well as many federal and state agencies, have been examining digital assets, and the networks on which they operate, with particular focus on investor protection and the safety and soundness of exchanges or other service providers that take custody of users' digital assets. As in Hong Kong, the regulatory regimes to which exchanges and fund managers may be subject, will depend on whether virtual assets are securities under U.S. law or not.

Trading platforms and fund managers that engage in activities involving virtual assets that are securities under U.S. law generally are subject to licensing requirements under the U.S. federal securities laws. These licensing requirements are administered by the U.S. Securities and Exchange Commission and could include, in the case of a virtual asset exchange, licensing as a national securities exchange or a broker-dealer, and, in the case of a fund manager, as an investment adviser, each with the U.S. Securities and Exchange Commission. These licensing regimes impose comprehensive regulatory, disclosure, risk management, and compliance requirements on licensed firms.

In addition, virtual asset trading platforms that facilitate trading in non-security digital assets may be subject to licensing with the Financial Crimes Enforcement Network as a money services business (“MSB”) and various U.S. state money transmission licensing requirements. These regimes generally impose anti-money laundering and suspicious transaction reporting requirements on MSBs and money transmitters. And firms that engage in “virtual currency business activities” and that are located or operate in New York may be subject to licensing with the New York Department of Financial Services under its so-called bitlicense regime.

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