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Virtual assets – SFC imposes new rules on licensed fund managers and distributors and considers the regulation of virtual asset trading platform operators

On 1 November 2018, the Securities and Futures Commission (the “SFC”) issued a **policy statement and two appendices** (the “**Policy Statement**”) on the Hong Kong regulatory framework for virtual asset portfolio managers, fund distributors and trading platform operators alongside a **circular** to intermediaries on the distribution of virtual asset funds (the “**Circular**”).

“Virtual assets” 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.

The Policy Statement:

- identifies the risks associated with investing in virtual assets;
- clarifies that (i) the SFC considers that all licensed portfolio managers intending to invest in virtual assets should observe essentially the same regulatory requirements, irrespective of whether these virtual assets amount to “securities” or “futures contracts” and (ii) firms which distribute funds that invest in virtual assets in Hong Kong will require a licence or registration for Type 1 regulated activity (dealing in securities);
- imposes additional licensing conditions on virtual asset portfolio managers which intend to invest 10% or more of the gross asset value (“GAV”) of the portfolios under their management in virtual assets (the “**De Minimis Threshold**”); and
- sets out a conceptual framework for the potential regulation of virtual asset trading platforms.

The Circular provides guidance on the SFC’s expected standards and practices to firms that are licenced or registered for Type 1 regulated activity (dealing in securities) or Type 9 regulated activity (asset management) which distribute funds that invest in virtual assets in Hong Kong.

There is no specific timeframe for affected managers and distributors to implement the new proposals. Fund managers should review their portfolios to determine if they should inform the SFC that they presently manage or are planning to manage one or more portfolios that invest in virtual assets. Affected fund distributors should take steps to ensure their compliance with existing regulatory requirements, including the suitability obligations, before engaging in the distribution of virtual asset funds.

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Background

The Policy Statement and Circular are aimed at addressing certain risks associated with investing in virtual assets perceived by the SFC, such as a lack of valuation principles, volatile pricing, illiquidity, a lack of agreed standards for accounting and auditing, cybersecurity risks and money laundering and terrorist financing concerns. The new rules demonstrate a desire by the SFC to try to bring some formal regulation to the virtual asset industry.

The SFC acknowledges that some crypto markets are not legally capable of being regulated by the SFC if the virtual assets involved are not “securities” or “futures contracts” (as defined in the Securities and Futures Ordinance (“SFO”). The Policy Statement and Circular accordingly introduce new measures applicable to firms within the SFC’s regulatory permits – they impose additional regulatory requirements on fund managers (to the extent that they are considered to manage portfolios which invest in virtual assets) and fund distributors (which distribute funds that invest in virtual assets). The new regulatory requirements apply regardless of whether the virtual assets fall within the scope of “securities” and “futures contracts”. In this way, the SFC is able to regulate virtual asset funds at the fund management level, at the distribution level or both.

The SFC is also considering the potential regulation of virtual asset trading platforms that have operations in Hong Kong, none of which are currently licensed by the SFC.

Virtual asset portfolio managers

The SFC seeks to impose additional licensing conditions on the following types of firms, to the extent that they are considered to manage portfolios which invest in virtual assets:

- firms which are licensed or are to be licensed for Type 1 regulated activity (dealing in securities) which manage and distribute funds in Hong Kong; and
- firms which are licensed or are to be licensed for Type 9 regulated activity (asset management) for managing portfolios in “securities”, “futures contracts” or both.

Notification requirement

With immediate effect, licence applicants and licensed corporations must inform the SFC if they are presently managing or planning to manage one or more portfolios that invest in virtual assets.

A portfolio manager will be considered as managing one or more portfolios that invest in virtual assets if (i) its stated objective is to invest in virtual assets; or (ii) the portfolio exceeds the De Minimis Threshold.

Terms and conditions

After receiving notification that a licence applicant or licensed corporation will invest in virtual assets, the SFC may propose terms and conditions (“**Terms and Conditions**”), which, if accepted, will be imposed as licensing conditions.

Although Terms and Conditions will be modified for each firm's particular business model, the SFC has indicated that certain Terms and Conditions are standard and will usually apply. For example:

- *types of investors*: only professional investors (as defined under the SFO) are permitted to invest in any virtual asset portfolio;
- *investor disclosure*: the licensed corporation must disclose all associated risks to potential investors and distributors of their virtual asset funds; and
- *safeguarding of assets*: the licensed corporation must (i) assess, select and adopt the most appropriate custodial arrangement (with due regard of specified criteria), (ii) exercise due skill, care and diligence in the selection, appointment and ongoing monitoring of custodians, and (iii) if assets are held in self-custody, document any reasons for self-custody, implement measures to safeguard assets, acquire and maintain adequate insurance and disclose to investors the risks associated with such arrangements.

If a licence applicant does not agree to comply with the Terms and Conditions, its licensing application will be rejected. If an existing licensed corporation does not agree to comply with the Terms and Conditions, it will be prohibited from managing any virtual asset portfolios and required to unwind the virtual asset positions in its virtual asset portfolios within a reasonable period of time.

Details on the Terms and Conditions are contained in [Appendix 1](#) to the Policy Statement.

For the avoidance of doubt, the SFC will not impose such Terms and Conditions on licensed corporations which only manage portfolios that themselves invest in virtual asset funds (e.g. funds of funds), as the SFC is of the view that existing regulatory requirements (in particular, the Fund Manager Code of Conduct) adequately govern the management of funds of funds, including where underlying funds invest in virtual assets.

Virtual asset fund distributors

The Circular is relevant for intermediaries licensed or registered for (i) Type 1 regulated activity (dealing in securities)¹ or (ii) Type 9 regulated activity (asset management) to the extent that these intermediaries are engaged in distributing virtual asset funds, meaning funds which have a stated investment objective to invest in virtual assets or will exceed or have exceeded the De Minimis Threshold.

In particular, the Circular reminds such intermediaries that they must comply with the suitability obligations in paragraph 5.2 of the Code of Conduct for

¹ The SFC reiterates that, under the SFO, any person who carries on a business in the distribution of interests in a collective investment scheme in Hong Kong or to the Hong Kong public must be licensed or registered for Type 1 regulated activity (dealing in securities) unless an exemption applies and, accordingly, the distribution of a fund which invests in virtual assets will also trigger this licensing or registration requirement, regardless of whether or not the underlying virtual assets constitute "securities" or a "futures contract".

Persons Licensed by or Registered with the Securities and Futures Commission (the “**Code of Conduct**”) when making a recommendation or solicitation in respect of virtual asset funds (whether or not authorised by the SFC) and that they will be required to comply with the Guidelines on Online Distribution and Advisory Platforms and paragraph 5.5 of the Code of Conduct (which come into effect in April 2019).

The Circular also provides guidance on the expected standards and practices in relation to the distribution of virtual asset funds which are not authorised by the SFC. For example:

- intermediaries should only target clients who are professional investors as defined under the SFO;
- intermediaries should assess whether clients who are not “institutional professional investors” have knowledge of investing in virtual assets or related products prior to effecting the transaction on their behalf, and, if the clients do not possess such knowledge, intermediaries may only proceed to effect the transaction if in so doing they would be acting in the best interests of the clients;
- intermediaries should manage concentration risks with due regard to a client’s net worth;
- intermediaries should conduct proper due diligence on unauthorised virtual asset funds, their fund managers and parties which provide trading and custodian services to the funds; and
- intermediaries should provide clear and easily comprehensible information and prominent risk warning statements in relation to the fund as well as the underlying virtual asset investments.

The SFC clarifies that failure to ensure compliance with such requirements will affect an intermediary’s fitness and properness and may result in disciplinary action.

Virtual asset platform operators

The SFC is exploring the regulation of virtual asset trading platforms which provide trading, clearing and settlement services for virtual assets and have control over investors’ assets.

- The **initial exploratory stage** will involve the participation of interested virtual asset trading platform operators in the SFC Regulatory Sandbox (the “**Sandbox**”). During this stage, the SFC will discuss its expected regulatory standards with Sandbox participants and observe the live operations of Sandbox participants in light of these standards.

The Sandbox will be restricted to virtual asset trading platform operators which operate an online trading platform in Hong Kong and offer trading of at least one or more virtual assets which fall under the definition of “securities” on its platform (i.e. platform operators that would fall within the jurisdiction of the SFC and require a licence for Type 1 (dealing in securities) and Type 7 (providing automated trading

services) regulated activities). The identity of the Sandbox participants and any discussions will be kept confidential.

- In the **second exploratory stage**, the SFC may decide to grant a licence to a Sandbox participant, after which the platform operator will be expected to comply with the SFO and its subsidiary legislation and all relevant regulatory requirements (e.g. the Code of Conduct).

The SFC will also impose licensing conditions on the platform operator, which will first be discussed between the SFC and the platform operator. For example, the SFC may require the platform operator to comply with all applicable regulatory requirements for all its virtual asset trading business activities, even where virtual assets are not “securities”, or require the platform operator to only provide its services to “professional investors”. Other terms and conditions may include the requirement to maintain financial reserves equivalent to 12 months of operating expenses and requirements to take out an insurance policy meeting specified requirements.

A Sandbox participant in the second exploratory stage will only be able to apply to the SFC for removal or variation of some licensing conditions or to exit the Sandbox after a minimum 12-month period.

- After the exploratory stages, if the SFC concludes that the related risks cannot be adequately addressed and investor protection still cannot be ensured, it may decide that it should not regulate virtual asset platform operators. In particular, the SFC indicates that it is not certain whether virtual asset platform operators will be able to satisfy the expected anti-money laundering standards, given that anonymity is the core feature of blockchain.

The conceptual framework is explained in [Appendix 2](#) to the Policy Statement.

Next steps

Affected fund managers and fund distributors should consider immediately the impact of the new rules on their businesses.

The SFC has indicated that it will continue to monitor developments in the virtual assets market and international regulatory developments, and it may decide to provide further guidance and implement other measures where appropriate. Firms dealing in virtual assets should continue to keep the development of regulation of these assets and activities in view.

The SFC’s announcement on the new regulatory approach for virtual assets is [here](#). The SFC Policy Statement is available [here \(including Appendix 1 and Appendix 2\)](#). The SFC Circular is available [here](#).

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