



## Hong Kong takes the first step in regulating managers and distributors of virtual asset funds

By Kenneth Choy, James Griffiths and Paul Lau

The Hong Kong Securities and Futures Commission (SFC) has been following the development of cryptocurrencies and other virtual assets in the marketplace. Periodically, the SFC has issued statements, notices and circulars to intermediaries cautioning about the risks associated with investment and dealings in virtual assets. Because its authority derives from the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong), which gives it a regulatory supervisory role over securities, such as equity and debt instruments and futures contracts, hitherto the SFC has not exercised its regulatory powers in matters relating to virtual assets except where it felt that a virtual asset marketed to the Hong Kong investment public possesses the characteristics of a security or is a collective investment scheme.

That changed on November 1, 2018, when the SFC issued a public statement and a circular to intermediaries stating a change in its approach to regulating virtual assets. The SFC stated that it would bring within its regulatory net a significant portion of virtual asset portfolio management activities, even if the underlying virtual assets are not defined as securities or futures contracts and thereby are outside the scope of the SFC's direct authority.

The new approach will, subject to certain exemptions, impose additional obligations on both existing licensed corporations and new applicants for licensing where the funds managed or distributed by them invest in virtual assets.

The following types of firms managing funds which invest in virtual assets will be subject to SFC oversight:

- Firms managing funds which invest solely in virtual assets that do not amount to securities or futures contracts and which distribute such funds in Hong Kong. These firms would not require a Type 9 licence, but will typically require a Type 1 licence under existing law because distribution of a fund usually involves dealing in securities; and
- Firms which manage portfolios of securities or futures contracts and which also manage or intend to manage portfolios which have (i) a stated investment objective to invest in virtual assets, or (ii) an intention to invest 10% or more of the gross asset value of the portfolio in

virtual assets. The 10% test provides a de minimis exemption for portfolios that will have only a small proportion of their gross assets invested in virtual assets. These firms require a Type 9 licence (for managing portfolios of securities or futures contracts) and are thereby also already caught by the regulatory net.

In each case, SFC oversight of the management and distribution of funds which invest in virtual assets will be implemented by the imposition of licensing conditions. If the firm does not agree to comply with the conditions, then it will be required to unwind existing virtual asset portfolios or, if it is a new applicant for licensing, its licence application will be rejected. Given that oversight will apply to both managers and (if different) distributors of funds investing in virtual assets, most of such funds will become subject to regulation by the SFC.

The licensing conditions will impose a set of “terms and conditions” developed by the SFC based on the existing regulatory framework, but adapted to the risks associated with virtual assets. The terms and conditions will require applicable licensed corporations to observe the following requirements:

- **Restrictions on investors:** Only professional investors should be permitted to invest in portfolios of virtual assets (unless the portfolio is a collective investment scheme authorized by the SFC);
- **Risks:** All associated risks should be disclosed to potential investors and distributors.
- **Custody:** The most appropriate custodial arrangements should be selected, following an assessment of the pros and cons of holding virtual assets at the available different host locations, and licensed corporations should exercise due skill, care and diligence in the selection, appointment and ongoing monitoring of custodians (taking into account factors specific to virtual assets). Special requirements will apply where virtual assets have to be held in self-custody.
- **Portfolio valuation:** Due care should be taken in selecting valuation principles, methodologies, models and policies and these should be disclosed to investors.
- **Risk management:** Limits should be set on each product and market in which a portfolio invests and each counterparty to which a portfolio is exposed, and stress testing should be undertaken. Assessments of the reliability and integrity of virtual asset exchanges should be made taking into account their track record, legal or regulatory status, governance and management, operational capabilities, mechanisms to guard against fraud, cybersecurity risk management measures and financial resources.
- **Audit:** Funds should be audited by an independent auditor with appropriate experience in relation to virtual assets.
- **Liquid capital:** If a licensed corporation holds virtual assets for portfolios under its management, it will need to maintain a required liquid capital of not less than HK\$3 million (or its variable liquid capital, whichever is higher).

The SFC expects that both existing licensed corporations and applicants for licensing will inform the SFC if they are managing or intend to manage any portfolio that invests or intends to invest in virtual assets (even if the de minimis exemption applies). The SFC will then discuss with the firm whether and how the standard terms and conditions (tailored as appropriate) will apply.

The SFC is also imposing additional requirements on any intermediaries that distribute virtual asset funds, whether or not they are also managers of those funds. In addition to existing obligations

regarding suitability (where applicable), intermediaries will need to observe the following requirements (among others):

- **Target Investors:** Only professional investors or persons with prior investment experience in private equity or venture capital or who have provided capital for a start-up business in the past two years can be targeted.
- **Due Diligence:** Intermediaries will be required to conduct proper due diligence on the virtual asset funds they distribute covering (i) the funds themselves (targeted investors, type of instruments for investment, valuation policy, custody arrangements, use of leverage and derivatives, targeted risk and annual returns, key risks of the funds, auditors and audited financial statements); (ii) the managers of the funds (operations, IT systems, risk management arrangements); and (iii) those counterparties providing trading and custodian services for the funds (legal and regulatory status, experience and track record, IT systems, financial soundness and insurance coverage).
- **Risk warnings:** Intermediaries must issue prominent warnings to potential investors of their funds covering the evolution of virtual assets and potential impact of global regulatory developments, price volatility, potential price manipulation on exchanges and trading platforms, lack of secondary markets, essential lack of regulation of most exchanges and trading platforms, counterparty risks, risk of loss of virtual assets (particularly those held in hot wallets) and cybersecurity and technology-related risks.

The new approach targets intermediaries and does not cover virtual asset transactions directly between buyers and sellers. It also does not directly cover initial coin offerings or token generation events managed by issuers directly.

Apart from these new requirements, the SFC also announced that it will use a regulatory sandbox to explore potential regulation of virtual asset trading platforms to determine if such platforms are suitable for regulation. If so, the SFC will develop standards of conduct regulation for virtual asset trading platform operators which may be comparable to those governing licensed automated trading services operators. A trading platform can enroll in the sandbox and, if deemed appropriate by the SFC, the trading platform may eventually receive an operating licence for its platform.

The new approach by the SFC signals to the crypto industry and the investing public that it now has a workable handle on dealing with risks associated with virtual assets. Since the new approach relies on superimposing new obligations on licensed corporations, it can be seen as a flexible and speedy response to some of the challenges presented by the virtual asset industry. It remains to be seen if the extended requirements may be challenged as exceeding the authority of the SFC or if the SFC plans to bring in formal legislation to cover virtual assets in due course. In any case, the cryptocurrency and virtual asset industry is attracting the interest of institutional professional investors and small investors alike. As the industry develops virtual assets as an alternative investment class, participants should welcome a regulatory framework that will help improve the legitimacy and credibility of the industry. This may also be the first step towards the SFC allowing securities token offerings in Hong Kong.

Licensed corporations and persons intending to manage or distribute virtual asset funds will need to take the new regime into account, and should consider whether disclosures to the SFC are required concerning their existing and planned activities, whether they need to apply for licenses and how best to negotiate the new license conditions that may be imposed on them.

In addition to advising on cryptocurrency and digital asset matters, our Hong Kong office is also experienced in advising on SFC licensing matters, including Type 1 and 9 licensing and registrations.

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