

## New virtual assets regulatory framework and market update

The Securities and Futures Commission (the “SFC”) has a profound concern of investor interest in funds and unlicensed trading platform operators for virtual assets (“VA”) (i.e. a digital representation of value (e.g. Bitcoin or Ethereum)) in Hong Kong. VA poses significant investor protection risks. Under the existing regulatory regime in Hong Kong, where VA involved falls outside the legal definition of "securities" or "futures contracts" (“Non-SF VA”) under the Securities and Futures Ordinance (the “SFO”), the trade thereunder may not fall within the regulatory net in Hong Kong. Hence, investors, who trade VA through unregulated trading platforms or invest in such portfolios which are managed by unregulated portfolio managers, do not enjoy the protections under the SFO.

The SFC had therefore issued a paper dated 1 November 2018<sup>1</sup> (the “2018 Paper”) to explicitly list out the regulatory standards for (i) VA’s portfolio managers, (ii) fund distributors and (iii) trading platform operators. The framework is briefly set out hereinafter.

### 1. Regulatory approach for VA portfolio managers

#### (a) Regulatory landscape prior to the 2018 Paper

Firms managing portfolio which solely invest in Non-SF VA is not required to be licensed for Type 9 regulated activity (i.e. asset management) (“RA9”), but a firm which distributes VA funds in Hong Kong will be required to be licensed under Type 1 regulated activity (i.e. dealing in securities) (“RA1”).

Where the firm licensed to carry out RA9 manages another portfolio that solely or partially invests in Non-SF VA in addition to managing a portfolio of securities, futures contracts or both, it is not required to be licensed insofar as its management of the portfolio or portion of portfolio relates to Non-SF VA.

#### (b) Regulatory standards following the 2018 Paper

Prior to the 2018 Paper, some VA portfolio managers do not fall within the regulatory stretch. The SFC considered that all portfolio managers should observe essentially the same regulatory requirements even if the portfolios (or portion of portfolios) under their management invest in VA irrespective of whether these are Non-SF VA. That is to say, all licensed portfolio managers invest in VA, irrespective of whether they invest solely or partially in VA, and whether these are Non-SF VA, should comply with the same legal and regulatory requirements.

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<sup>1</sup> “Statement on regulatory framework for virtual asset portfolios managers, fund distributors and trading platform operators” issued by the SFC dated 1 November 2018 (<https://www.sfc.hk/en/News-and-announcements/Policy-statements-and-announcements/Statement-on-regulatory-framework-for-virtual-asset-portfolios-managers>)

In addition, the SFC has developed a set of standard terms and conditions<sup>2</sup> (the “**Terms and Conditions**”) which captures the essence of the Existing Requirements<sup>3</sup>. The SFC has announced in a circular dated 4 Oct 2019<sup>4</sup> that the Terms and Conditions will be imposed on all licensed corporations which manage or plan to manage portfolios with:

- (i) a stated investment objective to invest in VA; or
- (ii) an intention to invest 10% or more of the gross asset value of the portfolio in VA as licensing conditions (subject to minor variations and elaborations depending on the business model and circumstances).

(c) Licensing process

Licence applicants and licensed corporations are required to inform the SFC if they are presently managing or planning to manage one or more portfolios that invest in VA. The SFC will then seek to understand the firms’ business activities. Where they appear to be capable of meeting the expected regulatory standards, the proposed Terms and Conditions will be provided to them (where applicable) and the SFC will discuss the Terms and Conditions with them and, where appropriate, vary the Terms and Conditions so as to ensure that they are reasonable and appropriate.

If the proposed Terms and Conditions are agreed, they will be imposed as licensing conditions. Where a licence applicant does not agree to comply with the Terms and Conditions, its licensing application will be rejected. In case an existing licensed corporation with a VA portfolio does not agree to comply with the Terms and Conditions, it will be required to unwind that portfolio within a reasonable period.

## 2. Regulatory approach for fund distributors

(a) Regulatory landscape

A firm which distributes VA funds under its management that solely invest in non-SF VA in Hong Kong will be required to be licensed to carry out RA1.

(b) Regulatory standards

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<sup>2</sup> The proforma set of terms and conditions dated October 2019 is available on the SFC’s website ([https://www.sfc.hk/web/EN/files/IS/publications/VA Portfolio Managers Terms and Conditions \(EN\).pdf](https://www.sfc.hk/web/EN/files/IS/publications/VA_Portfolio_Managers_Terms_and_Conditions_(EN).pdf)).

<sup>3</sup> “**Existing Requirements**” refers to existing legal and regulatory requirements set out under the legislation, the Code of Conduct for Persons Licensed by or Registered with the SFC, the Fund Manager Code of Conduct and guidelines, circulars and frequently asked questions issued by the SFC from time to time.

<sup>4</sup> “Terms and Conditions for Licensed Corporations which Manage Portfolios that Invest in Virtual Assets” issued by the SFC dated 4 October 2019

(<https://apps.sfc.hk/edistributionWeb/api/circular/openFile?lang=EN&refNo=19EC62>)

VA fund distributor is required to comply with the Existing Requirements. Further guidance on the expected standards and practices when distributing VA funds is provided in “Circular to intermediaries on the distribution of virtual asset funds” issued by the SFC on 1 November 2018<sup>5</sup>.

Further, the Terms and Conditions will also apply to VA fund distributor who is licensed to carry out RA1.

### 3. Regulatory approach and updates for trading platform operators

The SFC adopts a new approach to VA trading platforms in a position paper dated 6 November 2019 (the “**2019 Paper**”)<sup>6</sup>. It is also announced on 16 December 2020<sup>7</sup> that the SFC has granted the first licence to a VA trading platform in Hong Kong.

#### (a) Regulatory landscape

VA trading platforms typically provide trading in non-security tokens (i.e. Non-SF VA). The activities of the operator of a centralized trading platform<sup>8</sup> which only provides trading services in Non-SF VA will fall outside the SFC’s jurisdiction.

Platforms which operate in Hong Kong and offer trading of at least one or more VA that falls within the definition of “securities” under the SFO, are required to be licensed to carry out RA1 and Type 7 (i.e. providing automated trading services) regulated activities (“**RA7**”). The SFC’s regulatory remit will be engaged once a platform involves trading activities in security tokens, even if these are a small part of its business.

#### (b) Regulatory standards

If the SFC decides to grant a licence to a qualified platform operator, it may impose licensing conditions as set out in the 2019 Paper to address the specific risks associated with its operations.

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<sup>5</sup> “Circular to intermediaries - Distribution of virtual asset funds” issued by the SFC on 1 November 2018 (<https://apps.sfc.hk/edistributionWeb/api/circular/openFile?lang=EN&refNo=18EC77>)

<sup>6</sup> “Position paper - Regulation of virtual asset trading platforms” published by the SFC dated 6 November 2019 (<https://www.sfc.hk/-/media/EN/files/ER/PDF/20191106-Position-Paper-and-Appendix-1-to-Position-Paper-Eng.pdf>)

<sup>7</sup> News “SFC licenses first virtual asset trading platform” announced by the SFC on 16 December 2020 (<https://apps.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=20PR127>)

<sup>8</sup> Centralized trading platforms are platforms which provide trading, clearing and settlement services for VA, and have control over investors’ assets.

Also, the Terms and Conditions will apply to VA trading platform operator who is licensed to carry out RA1 and RA7.<sup>9</sup>

(c) Going forward

The Financial Services and the Treasury Bureau (the “FSTB”) launched a consultation on 3 November 2020 on legislative proposals to enhance anti-money laundering and counter-terrorist financing (“AML/CFT”) regulation in Hong Kong through the introduction of a licensing regime for VA services providers<sup>10</sup> (“VASPs”).

The FSTB proposes amending the Anti-Money Laundering Ordinance (Cap. 615) (“AMLO”) to introduce a new licensing regime for VASPs. Any person (e.g. VA trading platform operator) seeking to conduct regulated business in Hong Kong will be required to apply for a licence from the SFC subject to meeting the fit-and-proper test, with licensed VASPs being subject to the AML/CFT requirements under Schedule 2 of AMLO. Platforms solely trading Non-SF VA are not covered.

#### 4. Market Update

The first licensed and regulated VA fund in Hong Kong was launched on 20 April 2020 which purchases, holds and tracks the price of Bitcoin. The second licensed corporation approved by the SFC to manage and distribute pure VA funds in March 2021, launched four VA funds on 22 April 2021, including an actively managed fund that invests in cryptocurrencies and a private equity fund that invests in VA mining-related projects.

Should you have any question, please contact our Mr Lawrence Yeung on (852) 2854 3070 or by email at [lawrence.yeung@ycylawyers.com.hk](mailto:lawrence.yeung@ycylawyers.com.hk).

*This explanatory note is not, and should not be regarded as, legal advice. Should you have any enquiries, please seek specific advice from legal advisers.*

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<sup>9</sup> See the Terms and Conditions for VA Trading Platform Operators: [https://apps.sfc.hk/publicreg/Terms-and-Conditions-for-VATP\\_10Dec20.pdf](https://apps.sfc.hk/publicreg/Terms-and-Conditions-for-VATP_10Dec20.pdf)

<sup>10</sup> The proposed definition of VASPs includes any person engages in activities such as exchanging between VA and fiat currencies, transferring, safekeeping and/or administration of VA, and provision of financial services related to an issuer’s offer and/or sale of a VA.