

SFC Sets Standards for Virtual Asset Portfolio Managers and Fund Distributors

On 1 November 2018, the Securities and Futures Commission (**SFC**) published a [Statement on Regulatory Framework for Virtual Assets Portfolios Managers, Fund Distributors and Trading Platform Operators](#)^[1] (the **Regulatory Framework Statement**) setting out the regulatory standards applicable to virtual asset portfolio managers and distributors of virtual funds. The SFC has already issued a number of warnings of the risks associated with virtual assets. Its ability to regulate activities relating to virtual assets is however limited by the fact that its regulatory jurisdiction does not extend to the many virtual assets that are not “securities” or “futures contracts” within the definitions under the Securities and Futures Ordinance (the **SFO**).

However, given the investor protection concerns associated with virtual assets, and increased demand for funds investing in virtual assets, the latest regulatory approach seeks to extend the SFC’s regulatory remit as far as possible within the scope of the existing law.

The new regulatory approach is set out in the following documents:

- The [Statement on Regulatory Framework for Virtual Assets Portfolios Managers, Fund Distributors and Trading Platform Operators](#);
- The [Regulatory standards for licensed persons managing virtual asset portfolios](#);^[2] and
- The [Circular to intermediaries: Distribution of virtual asset funds](#).^[3]

I. VIRTUAL ASSET PORTFOLIO MANAGERS

Pre-November 2018 Regulation

- “Asset management”, which requires a Type 9 licence, is defined as managing a portfolio of securities or futures contracts. Firms which only manage portfolios^[4] which invest solely in virtual assets which are not “securities” or “futures contracts” (**Non-SF virtual assets**), such as Bitcoin and Ethereum, did not require a Type 9



“securities” and its distribution thus constituted dealing in securities regardless of whether the fund’s underlying assets were securities or not.

- Firms managing a fund of funds required a Type 9 licence, irrespective of whether the underlying funds invested solely in non-SF virtual assets. The underlying funds are collective investment schemes, which are securities, and their management constitutes asset management.
- Firms with a Type 9 licence for the management of portfolios of securities and/or futures contracts which additionally managed portfolios investing solely or partially in non-SF virtual assets, were not subject to regulatory requirements in their management of a portfolio, or part of a portfolio, relating to non-SF virtual assets.
- Licensed corporations were already required to notify the SFC before providing any trading or asset management services involving virtual assets by the [SFC’s circular of 1 June 2018](#) on the basis that this constitutes a significant change in business or service type which must be notified under the Securities and Futures (Licensing and Registration) (Information) Rules.

Post November 2018 Regulatory Requirements

The rationale behind the SFC’s latest position is that licensed portfolio managers which invest in virtual assets should comply with the same standards of regulation even if the portfolios or parts of portfolios under their management invest solely or partially in virtual assets, and irrespective of whether or not the virtual assets are securities or futures contracts.

The Scope of Regulation

The SFC will impose new terms and conditions in the form of licensing conditions on:

1. Type 9 licensed fund managers which:
 - a. in addition to managing portfolios of securities and/or futures contracts also manage portfolios which invest solely or partly in non-SF virtual assets; and
 - b. intend to invest 10% or more of the gross asset value (**GAV**) of the portfolios under their management in virtual assets; and
2. Type 1 licensed fund distributors which manage or plan to manage funds investing solely in non-SF virtual assets.

The licensing conditions will not however apply to:

1. Licensed corporations which only manage funds investing in virtual asset funds (i.e. funds of funds); or
2. Licensed corporations which manage portfolios whose mandate is to invest mainly



steps to reduce the portfolio's investment in virtual assets below the 10% of GAV threshold. If, however, the position is expected to continue (i.e. virtual assets will continue to exceed 10% of GAV), the licensed corporation must alert the SFC which will consider imposing licensing conditions. Failure to notify the SFC may result in disciplinary action.

As previously, a fund manager which only manages funds investing solely in non-SF virtual assets is not required to be licensed for Type 9. Such a fund manager will however require a Type 1 licence to distribute such a fund and will be subject to the licensing conditions because it is managing the fund.

The Licensing Conditions

The standard terms and conditions to be imposed as licensing conditions are set out in the [Regulatory standards for licensed corporations managing virtual asset portfolios](#) (at Appendix 1 to the Regulatory Framework Statement) and are summarised below.

1. Investor type

Only *professional investors* as defined under the SFO are allowed to invest in a portfolio with:

- a. a stated investment objective of investing in virtual assets; or
- b. an intent to invest 10% or more of the portfolio's GAV in virtual assets.

This restriction does not apply to funds authorised by the SFC for retail distribution under s.104 SFO.

2. Disclosure to investors

All associated risks must be clearly disclosed to potential investors and distributors appointed for the distribution of virtual asset funds.

3. Safeguarding of assets

Licensed corporations will be required to:

- a. assess and select the most appropriate custodial arrangement (e.g. whether to hold the assets itself or with a third-party custodian or an exchange) taking into consideration the advantages and disadvantages of holding virtual assets at different host locations by way of "hot wallets", "cold wallets" and "deep cold wallets") with regard to (among others):
 - i. the ease of accessibility to virtual assets, i.e. time required to transfer virtual assets to the trading venue; and
 - ii. the security of the custodial facility, i.e. whether appropriate safeguards are in place to protect against external threats such as cyberattacks; and
- b. exercise due skill, care and diligence in selecting, appointing and conducting on-going monitoring of custodians by reference to factors such as the custodian's:



- iii. corporate governance structure and the background of its senior management;
- iv. financial resources and insurance cover for compensating customers for loss of customer assets; and
- v. operational capabilities and arrangements, for example, its “wallet” arrangements and cybersecurity risk management measures.

Where virtual assets are held by the licensed corporation itself, the licensed corporation is additionally required to:

- a. document the reasons for self-custody;
- b. implement appropriate measures to protect the assets;
- c. ensure the effective segregation of the virtual assets from the licensed corporation’s own assets on its insolvency;
- d. use best endeavours to acquire and maintain insurance cover over the virtual assets; and
- e. disclose the risks of self-custody to investors.

4. *Portfolio valuation*

There are currently no generally accepted valuation principles for virtual assets, particularly ICO tokens. The licensing conditions will however require licensed corporations to exercise due care in selecting valuation principles, methodologies, models and policies which are reasonably appropriate in the circumstances and in the best interests of the investors. These will also need to be disclosed to investors.

5. *Risk management*

Licensed corporations will be required to set appropriate limits for each product and market the portfolios invest in and each counterparty to which the portfolios have exposure. They should, for example, consider setting a cap on portfolios’ investment in illiquid virtual assets and newly-launched ICO Tokens. Periodic stress testing should be carried out to assess the effect of abnormal and significant changes in market conditions on portfolios.

Before transacting with virtual asset exchanges, licensed corporations will be required to assess the reliability and integrity of the virtual asset exchange taking into account matters such as the virtual asset exchange’s:

- a. experience and track record;
- b. legal or regulatory status, if any;
- c. corporate governance structure and background of its senior management;
- d. operational capabilities;



g. financial resources and insurance cover.

Exposure to individual virtual asset exchanges should be limited by setting appropriate caps.

6. *Auditors*

An independent auditor will need to be appointed to audit the financial statements of managed funds. In selecting the auditor, a licensed corporation will need to consider the auditor's experience and capability in checking the existence and ownership of virtual assets, and ascertaining the reasonableness of their valuation.

7. *Liquid Capital*

A licensed corporation which holds non-SF virtual assets for portfolios under its management will need to maintain a required liquid capital of not less than HK\$3 million (or its variable required liquid capital, whichever is higher).

Notification Requirement

The Regulatory Framework Statement requires licence applicants and licensed corporations to inform the SFC if they:

1. currently manage or plan to manage one or more portfolios that invest in virtual assets; or
2. intend to hold non-SF virtual assets on behalf of the portfolios under their management.

The notification requirement under paragraph 1 above applies even if: (a) the intention is to invest less than 10% of the portfolio's GA in virtual assets; or (b) the virtual assets involved are "securities" or "futures contracts". Failure to inform the SFC may constitute a breach of the Securities and Futures (Licensing and Registration) (Information) Rules.

The Licensing Process

On being informed that a firm is managing or plans to manage virtual asset portfolios, the SFC will seek to understand the firm's business activities. If it considers that the firm is capable of meeting the required regulatory standards, it will send the standard licensing conditions to the firm and these may be varied following discussions with the firm according to its particular business model. Existing licensed corporations which do not agree to comply with the licensing conditions will be prohibited from managing virtual asset portfolios and must unwind their virtual asset positions.

A new licence applicant will have to agree to the licensing conditions proposed and



Firms which distribute funds that invest (wholly or partially) in virtual assets in Hong Kong were required to be registered for Type 1 regulated activity (dealing in securities) irrespective of whether or not the virtual assets are securities or futures contracts.

Post-November 2018 Regulatory Requirements

As previously, distributors of funds investing in virtual assets are required to hold a Type 1 licence. Type 9 licensed asset managers which also distribute funds under their management which invest in virtual assets are able to rely on the incidental exemption from the requirement to be Type 1 licensed.

The SFC's "Circular to intermediaries on the distribution of virtual asset funds" (the **Circular**) reminds licensed corporations which distribute virtual asset funds that they are required to comply with the SFC's Code of Conduct for Persons Licensed by or Registered with the SFC, including the requirement to ensure the reasonable suitability of any recommendation or solicitation made to a client under paragraph 5.2 of that Code (as supplemented by the SFC's [Frequently Asked Questions on Compliance with the Suitability Obligations by Licensed or Registered Persons](#)^[5] and the [Frequently Asked Questions on Triggering of Suitability Obligations](#)^[6]).

The Circular also sets out additional requirements which apply to distributors of virtual asset funds which:

1. are not authorised by the SFC for retail distribution under section 104 SFO; and
2. have a stated investment objective of investing in virtual assets or intend to invest or have invested more than 10% of their GAV in virtual assets (i.e. funds which the licensed corporation knows, or should reasonably have known, to be investing more than 10% of their GAV in virtual assets at the time it distributes the fund, unless it has been advised that the fund manager intends to reduce the fund's investment in virtual assets to below 10% of the fund's GAV in the near future). The investment in virtual assets may be direct or indirect (i.e. through fund of funds and funds which invest in derivatives, for example, total return swaps, with virtual assets as the underlying).

Additional Requirements

The additional requirements that apply to licensed corporations distributing these funds are as follows:

1. *Selling restrictions*

- Only professional investors as defined under the Securities and Futures Ordinance should be targeted.
- Except in the case of institutional professional investors, licensed corporations should assess whether clients have knowledge of investing in



knowledge, if this would be in the best interest of the client. For the purposes of the knowledge assessment, a licensed corporation may take into account a client's prior investment experience in private equity or venture capital or whether they have provided capital for a start-up business in the previous two years.

2. Concentration assessments

- Licensed corporations must consider the aggregate amount to be invested by a client in virtual asset funds not authorised by the SFC to be reasonable given the client's net worth.

3. Due diligence on virtual asset funds not authorised by the SFC

Licensed corporations will need to conduct extensive due diligence on non-SFC authorised funds, their fund managers and parties providing trading and custodian services to the funds. The due diligence should include (without limitation) an examination of the fund's constitutive documents and completion of a due diligence questionnaire, in addition to making enquiries of the fund manager to obtain an in-depth understanding of the following:

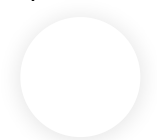
a. In relation to the fund manager

i. General

- its background, relevant experience and, where applicable, the track record of its senior management, including its chief investment, operation, risk and technology officers;
- its regulatory status, e.g., whether the fund manager is subject to any regulatory oversight and its robustness; and
- its compliance history, e.g., whether any disciplinary or regulatory actions have been taken against it by any regulatory authorities.

ii. Operations/ Internal controls and systems for example:

- whether there is proper segregation of key functions, such as portfolio management, risk management, valuation and custody of assets and, if not, whether there are any adequate compensating controls to prevent abuse;
- the persons who can transfer assets from the fund or custodians and what safeguards are in place;
- the persons responsible for, and the procedures for, reconciling transactions and positions, including the frequency of reconciliations; and
- the methodology and the persons responsible for determining the



- its IT infrastructure (e.g. in terms of security and access management).
- iv. Risk management
- its risk management procedures, including concentration limits, counterparty risk management procedures, stop-loss arrangements and stress testing;
 - its liquidity risk management policy; and
 - disaster recovery plan.
- b. In relation to the fund
- i. The fund's targeted investors;
 - ii. List of instruments the fund intends to trade or invest in and any limitations on the size of its holding of ICO tokens, pre-ICO Tokens or other illiquid or hard-to-value instruments;
 - iii. Its valuation policy (especially for ICO Tokens, pre-ICO Tokens or other illiquid or hard-to-value instruments);
 - iv. The custody arrangement for the fund assets, including the policy on the allocation of assets to be kept at different host locations, such as exchanges, custodians, hot storage, cold storage;
 - v. Its use of leverage and derivatives;
 - vi. The fund's targeted risk and return per annum;
 - vii. Key risks (as described in "Information for clients" below); and
 - viii. The fund's auditors and audited financial statements, including whether the fund has received a qualified audit opinion in the past, and whether the audited statements are up-to-date.
- c. In relation to the fund's counterparties
- i. Legal and regulatory status (whether they are regulated by any authorities to, among other things, undertake custody business or trade in virtual assets);
 - ii. Their experience and track record in dealing with virtual assets;
 - iii. The robustness of their IT systems (including cybersecurity risk management measures) and contingency plans; and
 - iv. Their financial soundness and insurance coverage, e.g., insurance to cover losses of customer assets.

4. *Provision of information to clients*

Licensed corporations will need to provide clients with the following information in relation to the fund and its underlying virtual asset investments. They must also provide prominent warning statements covering, among others:

- a. The continuing evolution of virtual assets and how this may be affected by global regulatory developments:



- d. Lack of secondary markets for certain virtual assets;
- e. That most exchanges, trading platforms and custodians of virtual assets are currently unregulated;
- f. Counterparty risk when effecting transactions with issuers, private buyers/sellers or through exchanges or trading platforms;
- g. The Risk of loss of virtual assets, especially if held in “hot wallets”;^[7] and
- h. Cybersecurity and technology-related risks.

Summary of pre and post November 2018 Position

Activity	Position Pre-November 2018	Position Post-November 2018
Firms only managing portfolios investing solely in non-SF virtual assets	No Type 9 licence requirement, but Type 1 licence required for distribution	No Type 9 licence requirement, but Type 1 licence required for distribution. Additional licensing conditions will be imposed on the Type 1 licence of firms managing or planning to manage non-SF virtual assets
Firms only managing fund of funds where any underlying fund holds non-SF virtual assets	Type 9 licence required	Type 9 licence required. No additional licensing conditions
Firms managing portfolios investing wholly or partially in non-SF virtual assets and portfolios investing in securities or futures contracts which intend to invest 10% or more of the GAV of portfolios under their management in virtual assets	Type 9 licence required	Additional licensing conditions apply
Firms distributing funds investing in virtual assets	Type 1 licence required Compliance with the Code of Conduct required	Type 1 licence required



		<p>ensure the suitability of recommendations and solicitations to clients</p> <p>If the fund is not authorised by the SFC under s.104 SFO and has a stated investment objective of investing in virtual assets or intends to invest or has invested more than 10% of its GAV in virtual assets, additional requirements apply under the Circular including:</p> <ul style="list-style-type: none"> • Restriction on sales to professional investors; • Extensive due diligence obligations in relation to the fund, its fund manager and counterparties; and • Requirements for information and warnings to be given to clients
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[1] SFC. "Statement on regulatory framework for virtual asset portfolio managers, fund distributors and trading platform operators". 1 November 2018 at <https://www.sfc.hk/web/EN/news-and-announcements/policy-statements-and-announcements/reg-framework-virtual-asset-portfolios-managers-fund-distributors-trading-platform-operators.html>

[2] SFC. "Regulatory standards for licensed corporations managing virtual asset portfolios". 1 November 2018 at https://www.sfc.hk/web/EN/files/ER/PDF/App%201%20-%20Reg%20standards%20for%20VA%20portfolio%20mgrs_eng.pdf

[3] SFC. "Circular to intermediaries: Distribution of virtual asset funds". 1 November 2018 at <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=18EC77>



[5] SFC. Frequently Asked Questions on Compliance with Suitability Obligations by Licensed or Registered Persons. 23 December 2016 at <https://www.sfc.hk/web/EN/faqs/intermediaries/supervision/suitability-obligations-of-investment-advisers/compliance-with-suitability-obligations.html>

[6] SFC. Frequently Asked Questions on Triggering of Suitability Obligations. 23 December 2016 at <https://www.sfc.hk/web/EN/faqs/intermediaries/supervision/triggering-of-suitability-obligations/triggering-of-suitability-obligations.html>

[7] A “hot wallet” refers to a wallet used for holding virtual assets in an online environment which provides an interface with the internet, which is more susceptible to cyber-attacks.

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