

HONG KONG CRYPTO REGULATION

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C H A R L T O N S

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The regulatory position in Hong Kong regarding “virtual assets” – that is digital tokens - including cryptocurrencies (such as Bitcoin) and ICO tokens – is that these are unregulated, except to the extent they constitute securities within the definition under Hong Kong’s Securities and Futures Ordinance (**SFO**).

On 1 November 2018, Hong Kong’s Securities and Futures Commission (**SFC**) published new regulatory standards which apply to virtual asset portfolio managers and distributors of virtual asset funds that are already required to be licensed. Separately, the SFC is inviting virtual asset trading platforms and exchanges which are interested in becoming licensed to join the SFC’s Regulatory Sandbox with a view to potentially becoming licensed, if the SFC determines that they are appropriate for licensing following its assessment of their performance in the Sandbox.

The initiative is an important step forward as it demonstrates the SFC’s willingness to engage with participants in the crypto industry. There have been calls from the industry to introduce regulation in order to create legitimacy for players willing to comply with regulatory standards. The latest guidance on virtual asset portfolio managers and distributors of virtual asset funds will be particularly welcome to fund managers which manage and distribute virtual asset funds in addition to traditional securities funds as it clarifies the applicable regulatory standards. The requirements for fund distributors of third party virtual asset funds are less likely to be welcomed given the extensive due diligence they will have to perform on funds, their fund managers and counterparties. As regards the proposed licensing of trading platforms and exchanges, the proposed regulatory requirements are likely to be seen as excessively burdensome. It will be interesting to see whether

exchanges' desire for the credibility which comes with licensing will make them willing to submit to the additional regulatory burden.

REGULATING AROUND THE EDGES

Essentially, the SFC is trying to impose regulation where it can. As it has previously spelled out ¹, where a virtual asset constitutes a security (i.e. it carries rights equivalent to traditional securities such as shares, debentures or interests in a collective investment scheme) or a futures contract, it is already regulated by the SFC. Accordingly, licensing requirements apply to firms carrying on “regulated activities” in relation to such virtual assets. Licensing requirements thus apply to an exchange providing trading services for virtual assets which are securities or futures or a firm managing funds investing in them.

However, the SFC's regulatory jurisdiction does not extend to the many virtual assets which are not securities or futures contracts – which the SFC refers to as “non-SF virtual assets”. Thus an exchange which only trades non-SF virtual assets or a firm which only manages funds investing in non-SF virtual assets is completely unregulated.

Primary market issues and offers of virtual assets (such as ICOs) which are not securities also remain unregulated.

Virtual asset exchanges

The proposals for potentially regulating virtual asset exchanges essentially involve an entirely voluntary process whereby exchanges wanting to be licensed would operate within the SFC's Regulatory Sandbox. If the SFC decides to proceed with licensing with virtual asset exchanges, which is by no means a given, it would be a licensing condition

1 SFC. [Statement on initial coin offerings](#). 5 September 2018.

that the exchange trades at least one virtual asset which is a security in order to bring the exchange within the SFC's regulatory jurisdiction. Once it is, the SFC would apply its regulatory framework to all activities of the exchange irrespective of whether they involve virtual assets which are securities or not.

Virtual asset portfolio managers and virtual asset fund distributors

The SFC is imposing regulation on virtual asset portfolio managers and virtual asset fund distributors which are already required to be licensed either because:

- they additionally manage portfolios of traditional securities or futures contracts which requires an asset management licence; or
- they distribute funds investing solely in non-SF virtual assets. Fund distribution requires a securities dealer licence because a fund constitutes a security irrespective of whether the fund invests in virtual assets which are securities or not.

The SFC has applied additional licensing conditions to both types of firm to the extent that they manage portfolios (or portions of portfolios) that invest in virtual assets. Portfolio management includes both fund management and management of discretionary accounts (in the form of an investment mandate or a pre-defined model portfolio).

Firms distributing virtual asset funds (whether as fund managers under an asset management licence or as fund distributors under a securities dealer licence) are required to comply with:

- a.** the SFC's regulatory framework for licensed corporations including its Code of Conduct for Persons Licensed by or Registered

with the SFC (**Code of Conduct**), including (among others) Know-your-Client (**KYC**) and AML and CTF obligations as well as the obligation to ensure the suitability of recommendations and solicitations to clients; and

b. additional requirements including extensive due diligence in relation to the virtual asset funds they distribute ², their fund managers and counterparties.

The impetus for regulation

FATF – the setter of international standards on Anti-money Laundering (**AML**) and Counter-terrorist financing (**CTF**) – revised its recommendations in October 2018 to require member countries (which include Hong Kong) to regulate “virtual asset service providers” - which include crypto exchanges ³ - for AML and CTF purposes and impose licensing or registration obligations on them so that their compliance with AML/CTF standards can be monitored. FATF is due to issue further guidance on a risk-based approach to regulating virtual asset service providers in June 2019.

As a result, a number of jurisdictions are in the process of bringing crypto exchanges within the scope of their AML/CTF and licensing regimes. In Singapore, for example, a Payment Services Bill is currently going through the legislative process and will require cryptocurrency exchanges to be licensed and subject to AML/CTF obligations.

2 The additional requirements will not apply to funds authorised by the SFC for retail distribution.

3 Certain types of wallet providers and providers of financial services for ICOs are also covered.

POTENTIAL FRAMEWORK FOR REGULATION OF VIRTUAL ASSET PLATFORM OPERATORS

Currently, none of the cryptocurrency exchanges operating in Hong Kong are licensed by the SFC. The SFC has written to exchanges warning them not to trade virtual assets which are securities but has not named the relevant virtual assets or clarified why it considered them to be securities. Generally cryptocurrencies are regarded as “virtual commodities” and thus outside the scope of the regulatory ambit of:

- The Hong Kong Monetary Authority which supervises banks;
- The SFC which regulates the securities and futures industry;
- The Hong Kong Customs & Excise Department which regulates Money Service Operators (i.e. a currency exchange or money remittance service provider).

Recognizing its lack of jurisdiction over exchanges which solely trade non-SF virtual assets, the SFC is offering exchanges the chance to become licensed – in order to be able to set themselves apart from unlicensed exchanges – if they trade at least one virtual asset which is a security. The SFC is proposing to regulate all activities of a crypto exchange – including those relating to virtual assets that are not securities, on the basis that the trading of one (or more) security virtual assets brings the exchange within its regulatory jurisdiction. The SFC refers to this as an “opt-in” regime.

The SFC is envisaging a staged approach comprising:

- An initial exploratory phase – platform operators would not be

licensed at this stage. The SFC would discuss with Platform Operators its expected standards of regulation, observe their live operations, and assess whether Platform operators are appropriate for regulation by the SFC based on the performance of those trading in the Sandbox. To avoid public confusion about Platform Operators' regulatory status, the SFC will keep Sandbox applicants' identity confidential.

- At the end of the exploratory stage, the SFC may decide not to regulate Platform Operators. If, however, it determines that they are appropriate to be regulated, it will consider granting licences for Type 1 (dealing in securities) and Type 7 (providing automated trading services) to Platform Operators subject to stipulated licensing conditions.
- The Platform Operator will then move to the second stage of the Sandbox when it will need to put in place robust internal controls and will be subject to closer SFC supervision. After 12 months, the Platform Operator will be able to apply for removal of some of the licensing conditions, e.g. on ongoing reporting obligations, and exit the Sandbox.

According to the "[Conceptual framework for the potential regulation of virtual asset trading platform operators](#)" (**Conceptual Framework**), if a Platform Operator is interested in becoming licensed, it must:

- operate an online trading platform in Hong Kong;
- offer trading of at least one virtual asset that constitutes a "security" under the SFO; and
- provide trading, clearing and settlement services for virtual assets

and have control of investors' assets.

These basic requirements raise a number of issues:

i. It is not clear at what stage the Platform Operator needs to offer trading in a virtual asset which is a security – is this a requirement for entering the Sandbox and starting the “Exploratory stage”; or only for the grant of a licence? The latter interpretation makes more sense given that the licensing obligation would be triggered once a platform provides trading for a virtual asset which is a security.

ii. It is unclear which virtual assets will qualify as “securities”. The SFC has said that most virtual assets fall outside the scope of the definition, but has not provided any explanation for that view. To be a security, a virtual asset would need to have the features of shares, debentures, a collective investment scheme, structured product or regulated investment agreement. In some cases, it may be fairly obvious – e.g. where a virtual asset entitles the holder to a share of the issuer’s profit making it similar to a share, or where the issuer will invest the token proceeds and distribute a share of the return on investment to holders, making it a collective investment scheme. Yet there will be many virtual assets where the position is uncertain. In the UK, a report of the Cryptoassets Taskforce (October 2018) noted that the complexity and opacity of many virtual assets make it difficult to determine whether they qualify as security tokens. ⁴

iii. given that many platforms are available online, the scope of the requirement that the exchange “operates” in Hong Kong needs clarification.

Given that the framework proposed is entirely voluntary, and the SFC may decide at the end of the “exploratory phase” not to licence crypto exchanges, it is difficult to see how Hong Kong is intending to comply with the FATF’s latest recommendation. Possibly the intention is to indicate to FATF that Hong Kong is doing something. Moreover, the licensing conditions and regulatory standards the SFC is proposing may prove unattractive for exchanges.

Proposed Licensing Conditions

If the SFC grants a licence to a qualified Platform Operator, it will impose licensing conditions which are likely to include the following “core principles”:

1. Services must be provided only to “professional investors”

The SFC will require platforms to limit trading activities to professional investors only. For individuals, this will require them to have a portfolio of cash and securities of at least HK\$8 million. The restriction on retail customers may put off platforms which currently cater for retail clients. The move could also be criticised for disenfranchising retail investors.

2. All virtual asset trading activities must be conducted under a single legal entity

All virtual asset trading activities conducted by the Platform Operator’s group which are: (a) conducted in Hong Kong; or (b) actively marketed to Hong Kong investors, will need to be carried out by a single SFC-licensed entity. Virtual asset trading activities include all virtual asset trading activities on and off the platform, and any

activities that are wholly incidental to the provision of trading services.

The SFC notes in the Conceptual Framework that it will not license virtual asset trading platforms that only provide a direct peer-to-peer market place for investors who retain control over their own assets (whether fiat currencies or virtual assets). It is not clear therefore whether the SFC would allow operations to be split between those which the SFC is prepared to license and those it is not.

3. Transactions must be pre-funded and no leverage or virtual asset-related futures contracts or other derivatives are allowed

Platform Operators will only be allowed to execute a trade for a client if there are sufficient fiat currencies or virtual assets in the client's account with the platform to cover the trade. Platform Operators will be prohibited from providing financial accommodation for clients to acquire virtual assets. No trading of virtual assets which are futures contracts or other derivatives is allowed. The limitation on providing margin financing could act as a deterrent.

4. Prohibition on trading ICO tokens in initial 12 months

A virtual asset issued by way of an initial coin offering (ICO) will only be acceptable for trading at least 12 months after completion of the ICO, or when the ICO project has begun to generate profit, whichever is earlier.

Ongoing Regulatory Standards

If a Platform Operator is granted a licence, it will be required to comply

with the SFO and its subsidiary legislation as well as the Code of Conduct for Persons Licensed by or Registered with the SFC (Code of Conduct) and other codes and guidelines issued by the SFC.

In particular, licensed Platform Operators would need to comply with know-your-client procedures under paragraph 5.1 and the suitability requirement under paragraph 5.2 of the Code of Conduct, as well as the Guideline on Anti-Money Laundering and Counter-Financing of Terrorism.

The SFC has also set out terms and conditions that would generally apply to licensed Platform Operators, although these will be subject to variation depending on a Platform Operator's particular business nature, size and model and the outcome of discussions with the SFC.

1. Financial Resources

Platform Operators will need to assess whether they are able to meet the financial qualification requirements.

To be licensed as a securities dealer and provider of automated trading services, a Platform Operator will need minimum paid-up share capital of HK\$5 million and minimum liquid capital of HK\$3 million under the Securities and Futures (Financial Resources) Rules.

The SFC may additionally require (on a case-by-case basis) Platform Operators to maintain a reserve equivalent to 12-months of operating expenses to cushion them against risks of theft and hacking.

2. KYC, AML and CTF Obligations

As licensed entities, platform operators would be required to per-

form know-your-client, AML and CTF procedures. They will also have to comply with the suitability requirement – i.e. ensure that any recommendation or solicitation made to clients with regard to virtual assets is “suitable” having regard to the information about the client of which they are or should be aware through due diligence (exemptions from this requirement are available for institutional professional investors and, subject to performing certain procedures, corporate professional investors).

With regard to AML and CTF, the SFC highlights in its Regulatory Statement that Platform Operators’ inability to comply with requirements on AML and CTF due to the anonymity of blockchain transactions may be a reason why the SFC ultimately determines that Platform Operators are not suitable for licensing. It states “the SFC is not certain at this stage whether platform operators would satisfy the expected anti-money laundering standards, given that anonymity is the core feature of blockchain, ... the underlying technology of virtual assets”.

Many exchanges are already voluntarily adopting KYC and AML procedures. However, the Conceptual Framework would impose additional detailed obligations in relation to KYC/AML including requirements to:

- a.** conduct all deposits and withdrawals of fiat currencies for a client’s account through a designated bank account opened in the client’s name with an authorised financial institution in Hong Kong or other jurisdictions agreed by the SFC;
- b.** apply enhanced due diligence and ongoing monitoring in specified circumstances including transactions involving virtual assets with higher risk or greater anonymity (such as virtual assets

which mask users' identities or transaction details) and transactions with tainted wallet addresses such as "darknet" marketplace transactions; and

c. have systems in place that are able to:

i. identify and prohibit transactions with virtual asset addresses where there is a reasonable suspicion that it is used for the purposes of conducting fraud or any other criminal activity; and

ii. track virtual assets through multiple transactions to allow accurate identification of the source and destination of virtual assets.

3. Knowledge Requirement

Except in the case of institutional professional investors, Platform Operators will be required to assess a client's knowledge of virtual assets (including risks associated with virtual assets) prior to provision of service. If a client does not have the required knowledge, a Platform Operator would only be able to provide services to the client if it would be acting in the client's best interests.

This requirement is likely to be problematic for Platform Operators since the SFC does not provide guidance as to what will be considered to be sufficient knowledge or the circumstances in which a trade could be considered to be in a client's best interests. Sufficient knowledge will be particularly difficult to assess given that virtual assets are a recent phenomenon and they vary widely. Would experience of trading Bitcoin, for example, be regarded as providing sufficient knowledge for the trading of ICO tokens? The Circular to intermediaries distributing virtual asset

funds, which also imposes a knowledge assessment obligation on distributors, provides that licensed corporations 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. The SFC should confirm whether this would also apply to Platform Operators assessment of client knowledge.

4. Due Diligence on Virtual Assets Admitted to Trading

One of the most onerous obligations to be imposed is the requirement that Platform Operators perform all reasonable due diligence on virtual assets before listing them. Despite the broad scope of the obligation, the specified areas that Platform Operators may consider for these purposes are broad and imprecise and Platform Operators are likely to experience considerable difficulty in conducting due diligence for example in relation to:

- the security infrastructure of the blockchain protocol underlying the virtual asset and whether it may be susceptible to attack by miners controlling more than 50% of the network's mining hash rate or computing power;
- the accuracy of the marketing materials and the requirement that they are not misleading;
- the demand, supply, maturity and liquidity of the virtual asset.

Platform Operators will need to establish and disclose their criteria for admitting virtual assets for trading. If a Platform Operator receives payments for admitting virtual assets to trade, its fee structure must avoid any actual, potential or perceived conflict of

interest (e.g. by imposing a flat rate for all virtual asset issuers).

5. Insurance

Another potential difficulty for Platform Operators may be fulfilling the requirement to take out insurance against theft or hacking.

6. Market Manipulation and Abuse

Platform Operators will be made responsible for preventing market manipulation and abuse.

7. Public Disclosure

Licensed Platform Operators would be required to make public information as to their fees and charges; the trading rules governing their platform operations and their criteria for admitting virtual assets to trading.

8. Ongoing Reporting Obligations

Potential ongoing reporting obligations will include requirements to report to the SFC details of new virtual assets to be admitted to trading on the platform and the identities and locations of its clients at month-end.

9. Other Requirements

Other, less onerous obligations include:

- Implementing written policies and procedures governing employees' dealings in virtual assets;
- Prioritizing clients' orders over orders for the Platform Opera-

tor's account, accounts in which it is interested or the accounts of its employees or agents; and

- Holding clients' money and virtual assets in a segregated account.

While **Platform Operators** are operating in the Sandbox, the SFC may further consider or refine its regulatory and supervisory approach through discussions with them. Licensing conditions (and terms and conditions) imposed will be made public. The SFC may also issue further guidance depending on developments in virtual asset-related activities.

REGULATION OF VIRTUAL ASSET PORTFOLIO MANAGERS

Firms managing virtual asset portfolios, whether as licensed asset managers or as licensed securities dealers will be subject to additional licensing conditions. These apply to firstly to firms which are or are to be licensed as asset managers because they manage portfolios of traditional securities or futures contracts and which also manage or plan to manage portfolios investing solely or partially in virtual assets. This is subject to a *de minimis* provision although the Regulatory Framework Statement and the Regulatory Standards for Licensed Corporations Managing Virtual Asset Portfolios (**Regulatory Standards**) (at Appendix 2 of the Regulatory Framework Statement) are inconsistent as to how the *de minimis* provision will apply:

- According to the Regulatory Framework Statement, a virtual asset portfolio manager will only be subject to the licensing conditions if it intends to invest 10% or more of the gross asset value (**GAV**) of the portfolios under its management in virtual assets (i.e. irrespective of the make-up of individual portfolios);

- According to the Regulatory Standards, however, the licensing conditions will be imposed on licensed corporations which manage or plan to manage portfolios with:
 - i.** a stated investment objective to invest in virtual assets; or
 - ii.** an intention to invest 10% or more of the GAV of the portfolio in virtual assets.

This suggests that a single managed portfolio investing more than 10% of GAV in virtual assets would subject the portfolio manager to the additional licensing conditions, even if the portfolio manager's investment in virtual assets amounts to less than 10% of the GAV of all portfolios under its management.

The new licensing conditions will also apply to firms which only manage funds which invest solely in non-SF virtual assets. These firms are not required to be licensed as asset managers (since the management of a fund which does not invest in securities or real estate is outside the definition of asset management). However, a firm that distributes such a fund in Hong Kong is required to be licensed as a securities dealer and the SFC will impose the new licensing conditions for virtual asset fund management on its securities dealer licence.

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 in securities and/or futures contracts, where the investment in virtual assets exceeds 10% of NAV as a

result of an increase in the prices of the virtual assets held in one or more of the portfolios. The licensed corporation is required to take all reasonable 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.

Bringing Virtual Asset Portfolio Managers within the Regulatory Net

All existing licensed corporations and licence applicants are required to notify the SFC if they currently manage or plan to manage one or more portfolios that invest in virtual assets, or intend to hold non-SF virtual assets on behalf of the portfolios under their management. The notification requirement 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 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, or its licensing application will be rejected.

The Licensing Conditions

1. Restriction to professional investors and disclosure requirements

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.

As discussed in relation to licensing trading platforms, portfolio managers may not wish to be restricted to dealing only with professional investors.

Despite the restriction to professional investors, firms will be required to disclose all associated risks to potential investors and distributors appointed for the distribution of virtual asset funds.

2. Safeguarding of assets

Licensed corporations will be subject to requirements to ensure the safe custody of virtual assets, although the SFC acknowledges that virtual asset funds face “a unique challenge due to the limited availability of qualified custodian solutions”. The SFC is imposing onerous obligations on licensed corporations with regard to their selection of appropriate custodians. Their ability to comply

with these requirements will depend on the willingness of custodians to disclose information on their financial resources, corporate governance and risk management etc.

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:

i. experience and track record in providing custodial services for virtual assets;

ii. regulatory status, particularly whether its virtual asset custodial business is subject to regulatory oversight;

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.

3. Portfolio valuation

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

4. 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;
- e.** mechanisms (e.g., surveillance systems) implemented to guard against fraud and manipulation with respect to products traded on the exchange;
- f.** cybersecurity risk management measures; and
- g.** financial resources and insurance cover.

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

5. Auditors

The SFC notes that the accounting profession has no agreed standards and practices for how an auditor can perform assurance procedures to obtain sufficient audit evidence for the existence and ownership of virtual assets, and ascertain the reasonableness of the valuations. Despite this, the SFC will require the appointment of an independent auditor to audit the financial statements of managed funds. Despite the difficulties acknowledged by the SFC, it will require licensed corporations to consider auditors' experience and capability in checking the existence and ownership of virtual assets, and ascertaining the reasonableness of their valuation, in their selection of an auditor.

6. 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 at least HK\$3 million (or its variable required liquid capital, whichever is higher).

VIRTUAL ASSET FUND DISTRIBUTORS

Firms which distribute funds that invest (wholly or partially) in virtual assets in Hong Kong are 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. Type 9 licensed asset managers which also distribute funds under their management which invest in virtual assets can rely on the incidental exemption from the Type 1 licensing requirement.

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

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>

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 virtual assets or related products before effecting the transaction on their behalf. They may only effect a transaction for a client without such 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

- A particularly difficult obligation on licensed corporations is a requirement that they must consider the aggregate amount to be

invested by a client in virtual asset funds 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. Where licensed corporations distribute third party funds, their compliance with these obligations will depend on the willingness of the various parties to disclose the required information. The assessments licensed corporations will be required to make are difficult given the lack of developed standards in the industry. The due diligence is required to 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 pricing and assessment of the reasonableness of the determined price of each virtual asset.

iii. IT system

- 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 prominent warning statements covering, among others:

- a.** The continuing evolution of virtual assets and how this may be affected by global regulatory developments;
- b.** Price volatility;
- c.** Potential price manipulation on exchanges or trading platforms;
- 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.

For licensed fund managers which manage funds investing in virtual assets and distribute those funds, the new requirements should not prove problematic, particularly where they provide custody for the virtual assets. The requirements are likely to be much more problematic for Type 1-licensed fund distributors where the extent of due diligence they will be required to perform on third party funds, their fund managers and custody arrangements may not be practical.

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.