

## Hong Kong's SFC Issues Significant Announcements on the Regulation of Virtual Assets

*The SFC has outlined its regulatory approach to the management and distribution of virtual asset funds and virtual asset exchanges.*

### Key Points:

- Investor protection is paramount and the SFC is taking steps to tighten its supervision of funds that invest in virtual assets and distributors of such funds.
- SFC-licensed asset managers and fund distributors should only sell virtual asset funds to “professional investors” (which include high net-worth individuals) and not to the retail market.
- SFC-licensed asset managers who manage funds that invest in virtual assets will be subject to enhanced regulatory requirements that relate to disclosure, custody, risk management, and regulatory capital.
- Distributors of virtual asset funds must be licensed for Type 1 regulated activity (dealing in securities) and will be subject to enhanced regulatory requirements that relate to diligence and disclosure to investors.
- The SFC has also set out a conceptual framework to explore a pathway for compliance for virtual asset trading platform operators who are willing to be supervised by the SFC.

### Background

On 1 November 2018, the Hong Kong Securities and Futures Commission (SFC) announced a series of measures aimed at providing an enhanced layer of regulatory oversight to the management and distribution of virtual asset funds in Hong Kong. The purpose of the new measures is to provide a greater level of protection to Hong Kong investors while also creating additional regulatory certainty around the regulation of these virtual asset products. This additional regulatory certainty could allow licensed fund managers and distributors of fund products to initiate compliance and internal control models that better enable virtual asset products to be managed and distributed alongside traditional securities and futures products.

The SFC is also currently exploring whether virtual asset trading platforms (VA Trading Platforms) are appropriate for regulation under the SFC's existing powers, and has set out a conceptual framework for their potential regulation.

## Regulatory standards for licensed firms that manage or distribute virtual asset portfolios

In Hong Kong, as in many other jurisdictions, the regulation of virtual assets<sup>1</sup> has been hotly debated in recent years, partly due to the popularity of so-called initial coin offerings (ICOs) or token sales, which enable companies to raise funds through the sale of virtual assets rather than through traditional fundraising activities, such as the sale of equity or debt instruments.

One of the principal regulatory challenges associated with virtual assets is their characterization under applicable laws and regulations. In Hong Kong, virtual assets that fall outside the legal definitions of “securities” or “futures contracts” (non-SF virtual assets) cannot be regulated by the SFC. Accordingly, investors who trade in virtual assets through unregulated virtual asset trading platforms or who invest in virtual asset portfolios that are managed by unregulated fund managers do not enjoy the regulatory protections and safeguards set out in Hong Kong’s primary source of securities law, the Securities and Futures Ordinance (SFO).

Such protections include requirements to ensure safe custody of assets, and fair and open markets. In addition, if VA Trading Platform operators (Platform Operators) and virtual asset fund managers are not regulated by the SFC, their fitness and properness, including their financial soundness and competence, have not been assessed, and their operations are not subject to any regulatory supervision.

The SFC has now decided to adopt a new approach that will bring a significant portion of virtual asset portfolio management activities and the distribution of virtual asset funds into its regulatory net within its existing powers.

The overarching principles and regulatory standards of the SFC’s new regulatory framework are set out in the SFC’s “*Statement on regulatory framework for virtual asset portfolios managers, fund distributors and trading platform operators*”,<sup>2</sup> the “*Regulatory standards for licensed corporations managing virtual asset portfolios*”,<sup>3</sup> and the “*Circular to intermediaries: Distribution of virtual asset funds*”,<sup>4</sup> all of which were issued on 1 November 2018 and which are summarised below.

## A. Overarching regulatory principles and framework

The SFC has proposed that the management and distribution of virtual asset funds be regulated and supervised based on the following framework:

Firms managing funds that solely invest in non-SF virtual assets and distribute the same in Hong Kong:	Firms that are licensed or wish to apply to be licensed by the SFC for Type 9 regulated activity (asset management) for managing portfolios in “securities”, “futures contracts”, or both:
<ul style="list-style-type: none"> <li>• These firms will typically require a licence for Type 1 regulated activity (dealing in securities) because they market and distribute these funds in Hong Kong.<sup>5</sup></li> <li>• If the manager does not market and distribute the fund, the SFC has acknowledged that it has no direct power to supervise that manager (because the underlying assets under management are non-SF virtual assets).</li> <li>• However, under its new proposals, the SFC intends to supervise such management activity indirectly by imposing licensing conditions on the fund distributor (described in part C below).</li> </ul>	<ul style="list-style-type: none"> <li>• The new requirements (described in part B below) would apply to licensed asset managers that manage funds investing in traditional securities products (equity, debt) and who also invest in non-SF virtual assets or wish to add non-SF virtual assets to their portfolios under management (subject to a <i>de minimis</i> requirement).<sup>6</sup></li> <li>• Under the SFC’s proposals, the management of the non-SF virtual asset portfolio(s) will become subject to the SFC’s oversight through the imposition of specific licensing conditions.</li> </ul>

## B. Regulatory standards for virtual asset fund managers

In order to afford better protection to investors, the SFC considers that all licensed asset managers intending to invest solely or partially in virtual assets should observe essentially the same regulatory requirements that apply to the management of funds that invest in ‘traditional’ investment products,<sup>7</sup> irrespective of whether these virtual assets amount to “securities” or “futures contracts”.

For this purpose, the SFC has developed a set of standard terms and conditions (Terms and Conditions) that specifically aim to address the risks associated with virtual assets. These Terms and Conditions are principles-based and the SFC’s view is that they should generally be appropriate to be imposed on virtual asset portfolio managers as licensing conditions, subject to minor variations and elaborations depending on the individual virtual asset portfolio manager’s business model. Some of the key items from the Terms and Conditions are set out in the table below:

Issue	Conditions imposed upon the licensed corporation	Outcome / possible outcome
<b>Investor category and disclosure</b>	<ul style="list-style-type: none"> <li>• Only “professional investors”<sup>8</sup> should be permitted to invest into any portfolio with (i) a stated investment objective to invest in virtual assets; or (ii) an intention to invest 10% or more of the gross asset value (GAV) of the portfolio in virtual assets.</li> </ul>	<ul style="list-style-type: none"> <li>• The SFC’s view is that virtual asset funds generally are not suitable for the general public and should only be targeted at “professional investors”.</li> </ul>

Issue	Conditions imposed upon the licensed corporation	Outcome / possible outcome
	<ul style="list-style-type: none"> <li>• All associated risks must be clearly disclosed to potential investors and to distributors they have appointed for distribution of their virtual asset funds.</li> </ul>	<ul style="list-style-type: none"> <li>• While this requirement is clearly aimed at increasing retail investor protection, it also means that retail investors will not be able to access virtual asset fund products that seek to provide exposure to virtual assets but are designed to spread the risk of investing in these assets. For example, retail investors would not be able to access a fund that invests in a basket of large-cap virtual assets (similar to an index fund). Those retail customers may instead end up trading directly on unregulated virtual assets trading platforms where they are potentially exposed to a greater level of risk.</li> </ul>
<b>Custody</b>	<ul style="list-style-type: none"> <li>• The licensed corporation must select the most appropriate custodial arrangement (e.g., third-party custodian, exchange, self-custody).</li> <li>• The licensed corporation must exercise due skill, care, and diligence in the selection, appointment, and ongoing monitoring of custodians, taking into account the following factors: <ul style="list-style-type: none"> <li>– The experience and track record of the custodian in providing custodial services for virtual assets</li> <li>– The regulatory status of the custodian, including, in particular, whether the custodian is subject to any regulatory oversight over its virtual asset custodial business</li> <li>– The corporate governance structure and background of the senior management of the custodian</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Custodians of non-SF virtual assets are not directly subject to the SFC's regulatory purview but, by imposing on fund managers a quasi-diligence checklist for custodians, the SFC is effectively imposing a baseline minimum level of standards for virtual asset custodians.</li> <li>• Fund managers now have some certainty regarding the SFC's bottom-line requirements for assessing and monitoring third-party virtual asset custodians. This should be advantageous for legal, risk, and compliance teams within licensed fund managers to create appropriate compliance procedures that are consistent with the SFC's</li> </ul>

Issue	Conditions imposed upon the licensed corporation	Outcome / possible outcome
	<ul style="list-style-type: none"> <li>– The financial resources and insurance cover of the custodian for the purpose of compensating its customers in the event of loss of customers’ assets</li> <li>– The operational capabilities and arrangements of the custodian; for example, the “wallet” arrangements and cybersecurity risk management measures</li> <li>• If virtual assets are held in self-custody (e.g., the licensed corporation holds the private key of the wallet for maintaining these virtual assets), the licensed corporation should document the reasons for self-custody, implement appropriate measures to safeguard these assets, and maintain proper records and arrangements to ensure that these assets can be effectively segregated from the licensed corporations’ own assets upon the licensed corporations’ insolvency. In order to protect against the loss of clients’ assets kept in self-custody, licensed corporations should use their best endeavours to acquire and maintain adequate insurance cover over these assets. Licensed corporations should also make proper disclosures to investors of the risks associated with such arrangements.</li> </ul>	<p>expectations. Knowing the expected “rules of the road” should enable licensed fund managers to develop virtual asset fund offerings with a greater degree of regulatory certainty.</p> <ul style="list-style-type: none"> <li>• If a licensed fund manager holds non-SF virtual assets in self-custody, there may be a consequential impact on the fund manager’s liquid capital requirements (see “Liquid capital” below).</li> </ul>
<b>Portfolio valuation</b>	<ul style="list-style-type: none"> <li>• The licensed corporation must exercise due care in selecting valuation principles, methodologies, models, and policies that are reasonably appropriate in light of the circumstances and in the best interests of the investors of the portfolios under the licensed corporations’ management.</li> <li>• The same should also be properly disclosed to investors.</li> </ul>	<ul style="list-style-type: none"> <li>• This requirement may cause fund managers to pay special attention to valuations of new virtual assets that are launched by way of an ICO.</li> <li>• ICOs and offerings of non-SF virtual assets are not subject to the SFC’s regulatory purview, but this requirement will cause fund managers to examine the</li> </ul>

Issue	Conditions imposed upon the licensed corporation	Outcome / possible outcome
		token economics of these types of transactions closely.
<b>Risk management</b>	<ul style="list-style-type: none"> <li>• Set appropriate limits in respect of (i) each product and market in which the portfolios invest; and (ii) each counterparty to which the portfolios have exposure. For example, setting a cap on the portfolios' investment in illiquid virtual assets and newly launched ICO tokens.</li> <li>• Conduct periodic stress testing to determine the effect of abnormal and significant changes in market conditions on these portfolios.</li> <li>• Implement additional procedures to assess the reliability and integrity of virtual asset exchanges before transacting with them. For example, taking into account: <ul style="list-style-type: none"> <li>– The experience and track record of the virtual asset exchange</li> <li>– The legal or regulatory status of the virtual asset exchange, if any</li> <li>– The corporate governance structure and background of the senior management of the virtual asset exchange</li> <li>– The operational capabilities of the virtual asset exchange</li> <li>– The mechanisms (e.g., surveillance systems) implemented by the virtual asset exchange to guard against fraud and manipulation with respect to the products traded on the exchange</li> <li>– The cybersecurity risk management measures of the virtual asset exchange</li> <li>– The financial resources and insurance cover of the virtual asset exchange</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Under current Hong Kong laws and regulations, non-SF virtual asset exchanges are not subject to the SFC's regulatory purview. However, the new requirements for assessing the reliability and integrity of exchanges may consequentially impact the quality and practices of virtual asset exchanges (<i>i.e.</i>, licensed fund managers will not be able to transact with exchanges unless they satisfy the assessment criteria proposed by the SFC).</li> <li>• However, it will remain to be seen whether or not exchanges will be willing or able to (i) provide the necessary information to fund managers in order for them to make the relevant risk determinations; and/or (ii) satisfy the risk management requirements.</li> <li>• Exchanges that are based in jurisdictions where they are subject to a specific licensing/regulatory regime (e.g., Japan) are likely to be more suitable for fund managers to use rather than exchanges that are completely unregulated.</li> </ul>

Issue	Conditions imposed upon the licensed corporation	Outcome / possible outcome
	<ul style="list-style-type: none"> <li>Appropriate caps should also be set to limit the exposure to individual virtual asset exchanges.</li> </ul>	
<b>Auditors</b>	<ul style="list-style-type: none"> <li>The licensed corporation should ensure that an independent auditor is appointed to perform an audit of the financial statements of the funds under their management.</li> <li>When selecting the auditor, licensed corporations should take into account, among other factors, the auditor's experience and capability in checking the existence and ownership of virtual assets, and ascertaining the reasonableness of the valuation of virtual assets.</li> </ul>	<ul style="list-style-type: none"> <li>The SFC does not regulate auditors, but this requirement may indirectly serve to improve the quality of auditors in the virtual assets space. Fund managers will be held to account for their selection of auditors and may therefore be more cautious about engaging new or untested audit firms.</li> </ul>
<b>Liquid capital</b>	<ul style="list-style-type: none"> <li>A licensed fund manager that holds non-SF virtual assets for portfolios under its management shall be required to maintain a required liquid capital of not less than HK\$3,000,000 (approx. US\$380,000) (or its variable required liquid capital, whichever is higher).</li> <li>This condition contrasts with existing laws that permit a licensed fund manager to maintain a minimum liquid capital amount of HK\$100,000 (approx. US\$13,000) on the condition that the manager does not hold client assets (e.g., client securities and client money).</li> </ul>	<ul style="list-style-type: none"> <li>This condition may dissuade asset managers who currently rely on the lowest liquid capital requirement of HK\$100,000 because they do not hold client assets, as they would be required to hold a significantly larger amount of liquid capital if they are "holding" non-SF virtual assets.</li> </ul>

### C. Regulatory standards for virtual asset fund managers

SFC-licensed intermediaries that distribute virtual asset funds to Hong Kong clients are required to ensure that any recommendations or solicitations made in respect of such funds are suitable for clients in all circumstances.<sup>9</sup>

In addition, the SFC will now require intermediaries to observe the following requirements if both of the following apply:

- They distribute virtual asset funds that are not authorised by the SFC.
- Such funds have a stated investment objective to invest in virtual assets, or intend to invest or have invested more than 10% of their GAV in virtual assets<sup>10</sup> directly or indirectly.<sup>11</sup>

In addition, the SFC will now require licensed intermediaries to observe the following requirements if they act as distributors of virtual asset funds:

Additional requirements for intermediary acting as distributor	
<b>Selling restrictions</b>	<ul style="list-style-type: none"> <li>• Intermediaries may only target clients who are “professional investors”.</li> <li>• Intermediaries should assess whether clients have knowledge of investing in virtual assets or related products prior to effecting the transaction on their behalf.</li> <li>• If the clients do not possess such knowledge, intermediaries may only proceed to effect the transaction if, by so doing, they would be acting in the best interests of the clients.</li> <li>• Intermediaries may take into account whether the clients have prior investment experience in private equity or venture capital, or have provided capital for a start-up business in the past two years.</li> </ul>
<b>Concentration assessments</b>	<ul style="list-style-type: none"> <li>• To avoid concentrated exposure to virtual assets, intermediaries should ensure that the aggregate amount to be invested by a client in virtual asset funds that are not authorised by the SFC is reasonable, as determined by the intermediaries, considering the client’s net worth.</li> </ul>
<b>Fund manager diligence</b>	<ul style="list-style-type: none"> <li>• Intermediaries should take into account the following when conducting due diligence on the underlying fund manager:               <ul style="list-style-type: none"> <li>– Background, relevant experience, and track record of senior management</li> <li>– Regulatory status (<i>i.e.</i>, is the manager licensed or not)</li> <li>– Compliance history</li> <li>– Internal controls (<i>e.g.</i>, segregation of key functions, persons authorized to transfer assets, and associated safeguards)</li> <li>– IT infrastructure and robustness of systems (including cybersecurity risk management measures)</li> <li>– Risk management (<i>e.g.</i>, disaster recovery plan, concentration limits, stress testing, liquidity risk management).</li> </ul> </li> </ul>
<b>Fund diligence</b>	<ul style="list-style-type: none"> <li>• Intermediaries should take into account the following when conducting due diligence on the underlying fund itself:               <ul style="list-style-type: none"> <li>– Investments the fund intends to trade (including the size of its holding / intended holding of illiquid virtual assets, such as ICO tokens)</li> </ul> </li> </ul>



Additional requirements for intermediary acting as distributor	
	<ul style="list-style-type: none"> <li>– Custody arrangements, including any policies regarding allocation of assets to be kept at different host locations (e.g., such as exchanges, custodians, hot storage, cold storage)</li> <li>– Any use of leverage and derivatives by the fund</li> <li>– The identity of the fund's auditors and details of the fund's audited financial statements (including whether the fund received a qualified audit opinion in the past and whether the audited statements are up to date).</li> </ul>
<b>Disclosure to clients</b>	<ul style="list-style-type: none"> <li>• Intermediaries should provide prominent warning statements covering, among other issues:               <ul style="list-style-type: none"> <li>– Continuing evolution of virtual assets and how this may be affected by global regulatory developments</li> <li>– Price volatility</li> <li>– Potential price manipulation on exchanges or trading platforms</li> <li>– Lack of secondary markets for certain virtual assets</li> <li>– Currently unregulated nature of most exchanges, trading platforms, and custodians of virtual assets</li> <li>– Counterparty risk when effecting transactions with issuers or private buyers/sellers, or through exchanges or trading platforms</li> <li>– Risk of loss of virtual assets, especially if held in "hot wallets"</li> <li>– Cybersecurity and technology-related risks</li> </ul> </li> </ul>

These enhanced regulatory requirements for intermediaries should not have any impact on the retail investor market in Hong Kong because only professional investors are within the scope of distribution for such products. However, the enhanced requirements will provide intermediaries that deal with professional investors (e.g., private banking and private wealth businesses with clients who will include high net-worth individuals) with greater clarity on the steps they need to follow if they wish to include virtual asset funds in the suite of products that they offer to their clients.

Intermediaries are reminded to implement adequate systems and controls to ensure compliance with the abovementioned requirements before they engage in the distribution of virtual asset funds. Failure to do so may affect their fitness and properness to remain licensed or registered and may result in disciplinary action by the SFC.<sup>12</sup>

## Conceptual framework for potential regulation of Platform Operators

### D. Potential regulation of Platform Operators

The SFC is also currently exploring whether VA Trading Platforms are appropriate for regulation under the SFC's existing powers, and has set out a conceptual framework for their potential regulation.<sup>13</sup>

To conduct a study of the conceptual framework, the SFC has announced that it will work with interested Platform Operators by placing them in the SFC's regulatory sandbox. Under the initial exploratory stage, the SFC will not be granting licences to participants; instead, it will be discussing its expected regulatory standards with participants and considering whether VA Trading Platforms are appropriate to be regulated.

If, at the end of its study, the SFC determines that VA Trading Platforms are suitable for regulation, it will consider granting licences to qualified Platform Operators and imposing licensing conditions on such Platform Operators. The SFC, however, also noted that it could reach the conclusion that Platform Operators, as a whole, are not suitable for regulation by the SFC under the SFC's existing powers.

Participation in the regulatory sandbox is voluntary. However, the SFC has expressed its view that Platform Operators who opt in to the regulatory sandbox have demonstrated a commitment to adhering to the SFC's high standards, as opposed to those who are unwilling or unable to meet the conduct standards set by the SFC.

### E. Summary of conceptual framework

Under the existing regulatory regime, the SFC is empowered to grant licences for the carrying on of "regulated activities" as defined under the SFO. Accordingly, if a Platform Operator is interested in being licensed by the SFC, the Platform Operator will need to operate its VA Trading Platform in Hong Kong and offer trading of at least one or more virtual assets that fall under the definition of "securities".

Such Platform Operator can then fall within the regulatory jurisdiction of the SFC and receive licences for the regulated activities of Type 1 (dealing in securities) and Type 7 (providing automated trading services).<sup>14</sup>

If the SFC's conceptual framework is implemented, the SFC will likely impose certain core licensing conditions on a Platform Operator, including the ones below:

SFC's proposed core licensing conditions for Platform Operators	
<b>Single entity</b>	All virtual asset trading activities, which are actively marketed to Hong Kong investors or are conducted in Hong Kong, will need to be carried out under a single legal entity licensed by the SFC.
<b>Professional investors</b>	The Platform Operator should only provide services to professional investors. <sup>15</sup>
<b>Admission of ICO tokens to trading</b>	The Platform Operator should only admit a virtual asset issued by way of an ICO for trading on its VA Trading Platform at least 12 months after the completion of the ICO or when the ICO project has started to generate a profit, whichever is earlier.

SFC's proposed core licensing conditions for Platform Operators	
<b>No financial facilities</b>	A Platform Operator should only execute a trade for a client if the client's account has sufficient fiat currencies or virtual assets with the VA Trading Platform to cover that trade. A Platform Operator should not conduct relevant activities in relation to virtual assets that are futures contracts or other derivatives.

The SFC may also impose a number of further conditions depending on the Platform Operator's operational model, its size, the nature of its business and the outcome of the SFC's discussions with the relevant Platform Operator. Some of these additional conditions contemplated by the SFC are set out below:<sup>16</sup>

SFC's proposed additional licensing conditions for Platform Operators	
<b>Additional financial resources</b>	The Platform Operator will need to maintain financial resources commensurate with the role and functions it performs and the level of risk it undertakes. For example, the SFC may require the Platform Operator to maintain a reserve that is equivalent to 12 months of the VA Trading Platform's operating expenses.
<b>Insurance policy</b>	The Platform Operator will need to maintain an insurance policy that would provide full coverage for virtual assets held in cold storage and a substantial coverage for virtual assets held in hot storage.
<b>Admission rules</b>	The Platform Operator needs to have (i) performed all reasonable due diligence on virtual assets before listing them on the VA Trading Platform; and (ii) established and disclosed the criteria for admitting a virtual asset to be traded.
<b>Trading rules</b>	The Platform Operator must publish on its website comprehensive trading rules governing its VA Trading Platform operation including, but not limited to, types of orders available, order execution methodology, and custodial arrangements.
<b>Knowledge assessment</b>	The Platform Operator should, as part of its know-your-client procedures, assess a client's knowledge of virtual assets (including the relevant risks associated with virtual assets) before providing any services to the client, except if the client is an institutional professional investor. <sup>17</sup> If a client does not possess such knowledge, a Platform Operator may only proceed to provide any service to the client if it would be acting in the best interests of the client.

## F. Potential considerations for Platform Operators

The conceptual framework set out by the SFC is a welcome development as it demonstrates the SFC's commitment to investor protection. However, Platform Operators that wish to participate in the SFC's regulatory sandbox and potentially obtain a SFC licence face a number of practical considerations.

- Some VA Trading Platforms may not currently be trading in securities or conducting any regulated activities. As the SFC itself has also acknowledged, such a VA Trading Platform is, strictly speaking, not subject to the purview of the SFC. Therefore, its Platform Operator does not require a licence from the SFC. If such a Platform Operator wishes to obtain a SFC licence, the Platform Operator will need to identify and consider whether it can admit a virtual asset or other instrument that is a “security” for trading on its VA Trading Platform.
- A Platform Operator interested in participating in the regulatory sandbox should conduct a preliminary assessment on whether it is able to comply with the licensing conditions set out in the conceptual framework. In particular, a Platform Operator will need to consider whether restricting its services to professional investors only is feasible, whether it can comply with the financial resources requirements, and whether it can obtain insurance for its business.
- A Platform Operator will also need to be aware of the other rules and regulations that apply to licensed corporations more generally. These include, among other provisions, the ongoing regulatory notification requirements under the Securities and Futures (Licensing and Registration)(Information) Rules.

## Conclusion

Overall, the SFC’s enhanced regulatory requirements for the management and distribution of virtual asset funds provide clarity on the SFC’s regulatory expectations for these products and demonstrate that the SFC has conducted a careful study of the virtual asset market.

While the SFC recognises that there are clear limitations on the scope of its supervisory authority over non-SF virtual assets, the enhanced regulatory requirements aim to cast a wide net by imposing strict diligence obligations on licensed firms that rely upon third parties within the virtual assets sector who may not be subject to financial regulatory oversight, such as custodians and exchanges.

Importantly, the enhanced regulatory requirements provide a pathway for virtual assets to be incorporated into existing regulated financial services products and businesses, and this may be welcomed by participants in the virtual assets and financial institutions sectors.

The proposals in relation to Platform Operators and VA Trading Platforms are conceptual but the direction of travel seems clear; if possible, the SFC would like to bring VA Trading Platforms under its supervisory umbrella to better protect investors and prevent market abuse. Many market participants will welcome this level of regulation as blockchain-based securities (e.g., security tokens or other tokenised financial products) are developed and require a regulated platform on which they can be issued and traded.

Latham lawyers are available to consult with Platform Operators who wish to know more about the conceptual framework for Platform Operators and VA Trading Platforms or who wish to participate in the SFC’s regulatory sandbox.

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**Endnotes**

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- <sup>1</sup> This *Client Alert* has adopted the SFC's definition of virtual assets, which includes "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."
  - <sup>2</sup> See <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>.
  - <sup>3</sup> See [https://www.sfc.hk/web/EN/files/ER/PDF/App%201%20-%20Reg%20standards%20for%20VA%20portfolio%20mgrs\\_eng.pdf](https://www.sfc.hk/web/EN/files/ER/PDF/App%201%20-%20Reg%20standards%20for%20VA%20portfolio%20mgrs_eng.pdf).
  - <sup>4</sup> See <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/openFile?refNo=18EC77>.
  - <sup>5</sup> Units in funds typically constitute units in a "collective investment scheme" under the SFO. A "collective investment scheme" falls within the definition of a "security" under the SFO and accordingly the offering and distribution of units in a collective investment scheme (even if the underlying assets are non-SF virtual assets) would constitute the offering and distribution of a "security" and would need to be conducted by a Type 1 licensed intermediary.

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- <sup>6</sup> That is, only virtual asset portfolio managers which intend to invest 10% or more of the gross asset value (GAV) of the portfolios under its management in virtual assets will be subject to the SFC's oversight in this way.
- <sup>7</sup> Namely the requirements set out in the SFO and its subsidiary legislation, the SFC's Code of Conduct for Persons Licensed by or Registered with the SFC, the SFC's Fund Manager Code of Conduct, and guidelines, circulars and "frequently asked questions" issued from time to time by the SFC.
- <sup>8</sup> For individuals, being a "professional investor" generally means having a portfolio of not less than HK\$8 million (approx. US\$1 million) and for corporations, a portfolio of not less than HK\$8 million or total assets of not less than HK\$40 million (approx. US\$5 million).
- <sup>9</sup> Intermediaries are also subject to regulatory requirements pursuant to paragraph 5.2 of the Code of Conduct as supplemented by the SFC's "*Frequently Asked Questions on Compliance with Suitability Obligations by Licensed or Registered Persons*" and the "*Frequently Asked Questions on Triggering of Suitability Obligations*".
- <sup>10</sup> This refers to funds which the intermediary knows, or should reasonably have known, to be investing more than 10% of its GAV in virtual assets at the time of distributing the fund, unless the intermediary has been advised that the fund manager intends to shortly reduce the fund's investment in virtual assets to below 10% of the fund's GAV.
- <sup>11</sup> This includes funds of funds and funds which invest in derivatives, for example, total return swaps, with virtual assets as underlying.
- <sup>12</sup> The SFC has also reminded intermediaries in a circular dated 1 June 2018 about the notification requirements under the Securities and Futures (Licensing and Registration)(Information) Rules if they intend to provide trading services involving virtual assets.
- <sup>13</sup> The SFC has clarified that, at this stage, it is only focusing its efforts on exploring the regulation of VA Trading Platforms that provide trading, clearing, and settlement services for virtual assets, and have control over investors' assets. The current proposals, therefore, do not apply to decentralized platforms in which investors typically retain control over their own assets.
- <sup>14</sup> The SFC has noted that it will not consider licensing Platforms Operators that trade virtual assets that are "futures contracts" or "structured products" at this stage.
- <sup>15</sup> Please see endnote 8 above.
- <sup>16</sup> In addition to those listed out, there are a number conditions mentioned by the SFC that mirror the regulatory framework applicable to the regulated activities of licensed corporations. These include, for example, the conditions to: (i) have appropriate anti-money laundering and counter-financing of terrorism system; (ii) disclose fees and risks of trading on the platform; (iii) establish policies and procedures to address market manipulative or abusive activities; (iv) have appropriate employee dealing policies and procedures; (v) have client orders have priority over house orders; (vi) segregate client money and virtual assets; and (vii) notify the SFC of certain events on an ongoing basis.
- <sup>17</sup> Institutional professional investors are those set out in paragraphs (a) to (i) of the definition of "professional investor" in section 1 of Part 1 of Schedule 1 to the SFO.