

CLIENT ALERT ON 19 NOVEMBER 2018

**RE: SFC STATEMENT ON REGULATORY STANDARDS FOR LICENSED CORPORATIONS MANAGING VIRTUAL ASSET PORTFOLIOS**

On 1 November 2018, the Hong Kong Securities and Futures Commission (“**SFC**”) issued a Statement on Regulatory Framework for Virtual Asset Portfolios Managers, Fund Distributors and Trading Platform Operators<sup>1</sup> (the “**Statement**”), and along with the Statement, an appendix titled “Regulatory Standards for Licensed Corporations Managing Virtual Asset Portfolios”<sup>2</sup> (the “**Regulatory Standards**”) and a Circular to intermediaries: Distribution of virtual asset funds<sup>3</sup> (the “**Circular**”). This Client Alert focuses on the SFC’s stance and the regulatory standards to be imposed on (i) Type 9 licensed intermediaries which presently manages or intends to manage portfolios that invest in “Virtual Assets”; and (ii) Type 1 licensed intermediaries which distribute Virtual Assets funds in Hong Kong.

**(A) CONFIRMATION OF CERTAIN EXISTING POSITIONS**

Interestingly, the SFC has confirmed the following positions in the Statement and the Regulatory Standards:

- (i) The Hong Kong Monetary Authority (the “**HKMA**”) has stated that Bitcoin is not a legal tender but a virtual “commodity” and therefore Bitcoin and other similar virtual commodities are not regulated by the HKMA.<sup>4</sup> The SFC has also stated that digital tokens offered in a typical initial coin offering (“**ICO**”) are usually characterized as a “virtual commodity”, which is not a “security” itself, provided that the tokens do not exhibit terms and features that render them to be qualified as “securities” as defined under the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) (“**SFO**”).<sup>5</sup> The SFC has now (in the Regulatory Standards adopted a wider concept of “virtual assets”, which include 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 (“**Virtual Assets**”).<sup>6</sup> To the extent that such Virtual Assets do not constitute “securities” or “futures contracts” (which the SFC has now specifically confirmed Bitcoins and Ether as examples), they may be referred to as “**Non-SF Virtual Assets**”.
- (ii) Where a firm only manages a “portfolio” (which covers collective investment schemes<sup>7</sup> and discretionary accounts in the form of an investment mandate or a pre-defined model

<sup>1</sup> Statement on regulatory framework for virtual asset portfolios managers, fund distributors and trading platform operators - <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>2</sup> Regulatory standards for licensed corporations managing virtual asset portfolios – [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>3</sup> Circular to intermediaries, Distribution of virtual asset funds – <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=18EC77>

<sup>4</sup> The HKMA reminds the public to be aware of the risks associated with Bitcoin on 11 February 2015 - <https://www.hkma.gov.hk/eng/key-information/press-releases/2015/20150211-3.shtml>

<sup>5</sup> Statement on initial coin offerings – <https://www.sfc.hk/web/EN/news-and-announcements/policy-statements-and-announcements/statement-on-initial-coin-offerings.html>

<sup>6</sup> A new asset class as created by the SFC in the Statement. For further details, please be referred to our article on 5 November 2018 titled “Re: Statement from SFC on conceptual framework for regulating crypto-exchanges” as available on our website at <http://www.lylawoffice.com/hk/publication/>.

<sup>7</sup> The SFC has specifically confirmed in the Regulatory Standards that “the management of collective investment schemes solely investing in non-SF virtual assets does not amount to a regulated activity”

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portfolio) which invests solely in Non-SF Virtual Assets, it is not required to be licensed or registered for Type 9 regulated activities (asset management) (the “**Type 9 Licence**”).

- (iii) Where a firm manages a fund of funds (even with the underlying fund investing solely in the Non-SF Virtual Assets), the firm is required to be registered for Type 9 Licence.

### (B) REGULATORY STANDARDS FOR TYPE 9 INTERMEDIARIES

The Statement and the Regulatory Standards have the most impact on the prospective and existing Type 9 licensed intermediaries which manage both a portfolio of “securities”, “futures contracts” and also another portfolio that solely or partially invests in Non-SF Virtual Assets. Prior to the issuance of the Statement and the Regulatory Standards, the legal and regulatory requirements under the SFO and the subsidiary legislation do not apply to the Type 9 licensed intermediary insofar as its management of the portfolio or portion of portfolio relates to Non-SF Virtual Assets. In order to rectify this issue and to give better protection to Hong Kong investors, the SFC has developed a set of principles-based standard terms and conditions which would be imposed as licensing conditions<sup>8</sup> (the “**VA Licensing Conditions**”) on the Type 9 licensed intermediaries (the “**Type 9 VA Intermediaries**”) 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 gross asset value (the “**GAV**”) of the portfolio (the “**De Minimus Threshold**”) in Virtual Assets (collectively, the “**Virtual Asset Portfolio(s)**”).

The key VA Licensing Conditions to be imposed are summarised as follows:

- a. **Only professional investors allowed with proper risk disclosure.** Type 9 VA Intermediaries should only allow “professional investors”<sup>9</sup> to invest into a Virtual Asset Portfolio and should clearly disclose all the associated risks and the appointed distributors, so that the potential professional investors could make an informed investment decision.
- b. **No less than HK\$3 million liquid capital.** A Type 9 VA Intermediary which holds Non-SF Virtual Assets (which, strictly speaking, does not constitute “client assets” under the SFO<sup>10</sup>) for portfolios under its management shall be required to maintain a required liquid capital of not less than HK\$3 million<sup>11</sup> (or its variable required liquid capital, whichever is higher).
- c. **Appropriate portfolio valuation principles to be adopted.** Type 9 VA Intermediaries are required to exercise due care in selecting reasonably appropriate valuation principles, methodologies, models and policies in light of the circumstances and in the best interests of the investors of the Virtual Asset Portfolios. Nevertheless, the SFC acknowledges that there are currently no generally accepted valuation principles for Virtual Assets, especially

<sup>8</sup> It is meant to capture the essence of the existing requirements being adopted by licensed corporations, including The Code of Conduct for Person Licensed by or Registered with the Securities and Futures Commission, the Fund Manager Code of Conduct (FMCC), guidelines, circulars and frequently asked questions issued by the SFC from time to time.

<sup>9</sup> As defined under the Securities and Futures (Professional Investor) Rules - <https://www.elegislation.gov.hk/hk/cap571D>

<sup>10</sup> This is being defined under the SFO as (a) client securities and collateral; and (b) client money.

<sup>11</sup> Otherwise if the Type 9 VA Intermediary does not hold any “client assets”, it is only required to maintain a liquid capital of not less than HK\$100,000 (or its variable required liquid capital, whichever is higher). This is a similar standard as those imposed under the Securities and Futures (Financial Resources) Rules.

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for ICO tokens, and has not provided any further guidance so far.

- d. **Independent, experienced and capable auditor must be appointed.** Type 9 VA Intermediaries are required to appoint an independent auditor with experience and capability in checking the existence and ownership of the Virtual Assets and in ascertaining the valuation to perform an audit of the financial statements of the funds under their management. Due to the novelty and complexity of the blockchain technology behind the Virtual Assets, it is believed that only a very limited number of auditors would have the necessary expertise.
- e. **Management of product risk and counterparty risk.** Type 9 VA Intermediaries are required to conduct periodic stress testing and to set appropriate limits to the exposure for each product, for example setting a cap on the portfolio's investment in illiquid Virtual Assets and newly-launched ICO tokens. If they have to enter into transactions with Virtual Assets exchanges, they will have to conduct due diligence to assess the level of "reliability and integrity" of the Virtual Asset exchanges prior to such transactions, including but not limited to considering the experience, the track record, the background of senior management, the operational capabilities, the cyber risk management measures, the insurance cover etc.<sup>12</sup>
- f. **Appropriate custodial arrangement.** The Type 9 VA Intermediary should assess the advantages and disadvantages of different custodial arrangements (i.e. self-custody vs a third-party custodian or an exchange) and select the most appropriate custodial arrangement. If self-custody is chosen, the Type 9 VA Intermediary shall document the reasons for doing so and shall implement appropriate measures to safeguard the Virtual Assets with proper records and segregation of assets from the Type 9 VA Intermediary's own assets; if a third-party custodian or an exchange is chosen, the Type 9 VA Intermediary should exercise due skill, care and diligence in selecting, appointing and monitoring on an ongoing basis the custodians taking into account their experience, track record, regulatory status, financial resources, operation capabilities and insurance cover etc. Currently, there are limited options for custodians and insurance products for the protection of Virtual Assets, such requirement is likely to have an impact on the management of Virtual Asset portfolios.

### (C) DISTRIBUTION OF VIRTUAL ASSETS PORTFOLIOS AND FUNDS

In addition, the SFC has also confirmed in the Regulatory Standards and the Circular that:

- (i) If a firm distributes a fund under its management that solely invests in Non-SF Virtual Assets in Hong Kong, it is required to be licensed or registered for Type 1 regulated activities (dealing in securities) ("**Type 1 VA Licensed Intermediary**"). In such case:
  - (a) in respect of distribution of Virtual Asset funds, whether or not they are authorized

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<sup>12</sup> It is also interesting to note that SFC's appendix on "conceptual framework on potential regulating Virtual Assets Trading Platform Operators" and how the SFC intends to implement this requirement should the SFC has a negative determination after the sandbox. For further details, please be referred to our article on 5 November 2018 titled "Re: Statement from SFC on conceptual framework for regulating crypto-exchanges" as available on our website at <http://www.lylawoffice.com/hk/publication/>.

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by the SFC, the Type 1 VA Licensed Intermediary is required to ensure compliance with, inter alia, paragraph 5.2 of the Code of Conduct<sup>13</sup> as supplemented by the Suitability FAQ<sup>14</sup>. The Type 1 VA Licensed Intermediary should ensure that the recommendation or solicitation made is suitable for clients in all circumstances, including knowing their clients, understanding the investment products they recommend to clients, providing reasonably suitable recommendation by matching the risk return profile, providing all relevant material information, employing competent staffs and document and retaining the reasons for each investment recommendation; and

- (b) in respect of distribution of Virtual Asset funds which are not authorized by the SFC, the Type 1 VA Licensed Intermediary (1) should only target clients who are “professional investors”<sup>15</sup>; (2) should assess whether such clients<sup>16</sup> have knowledge of investing in Virtual Assets or related products<sup>17</sup> prior to effecting the transaction on their behalf<sup>18</sup>; (3) should provide the clients certain information and prominent warning statements in relation to the Virtual Asset fund and the underlying Virtual Asset investments for the purpose of assisting clients to make informed investment decisions; and (4) should conduct proper due diligence on the Virtual Asset funds, the fund manager, the custodian and other counterparties.
- (ii) the proposed VA Licensing Conditions will be applied to Type 1 VA Licensed Intermediary which manage or plan to manage collective investment schemes sole investing in non-SF Virtual Assets and distribute or plan to distribute the same in Hong Kong.

### (D) DUTY OF NOTIFICATION

It should be reminded that licence applicants and licensed corporations including but not limited to those licensed for Type 1 and/or Type 9 if they are presently managing or planning to manage one or more portfolios in Virtual Assets, they are required to notify the SFC even if their Virtual Asset Portfolio falls below the De Minimis Threshold.<sup>19</sup>

### (E) WAY FORWARD

The Statement, Circular and Regulated Standards signify the SFC’s intention to be involved in

<sup>13</sup> Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission – Paragraph 5.2 requires licensed or registered person to ensure the suitability of the recommendation or solicitation for a client is reasonable in all circumstances when making such recommendation or solicitation.

<sup>14</sup> The Frequently Asked Questions on Compliance with Suitability Obligations by Licensed or Registered Persons and the Frequently Asked Questions on Triggering of Suitability Obligations.

<sup>15</sup> As defined under the Securities and Futures (Professional Investor) Rules - <https://www.elegislation.gov.hk/hk/cap571D>

<sup>16</sup> Save for the ‘institutional professional investors’, which is referred to as the specified entities as set out in paragraphs (a) to (i) of the definition of “professional investor” under Section 1 of Part 1 of Schedule 1 to the SFO.

<sup>17</sup> It 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.

<sup>18</sup> The Type 1 VA Licensed Intermediary should also ensure the aggregate amount to be invested by a client in Virtual Assets funds which are not authorized by the SFC is reasonable, as determined by the Type 1 VA Licensed Intermediary, considering the client’s net worth.

<sup>19</sup> See footnote 9 of the Statement. Please also refer to SFC’s Circular to intermediaries on compliance with notification requirements <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=18EC38>

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the very dynamic world of Virtual Assets. This also implies that Virtual Assets are to be given significance and recognition that they have long deserved. Perhaps in the very near future, it may well be of existence two types of firms managing portfolios that invest in the Non-SF Virtual Assets in Hong Kong: one with Type 9 Licence (i.e. those with existing asset management business investing in Non-SF Virtual Assets) and one without (i.e. those investing solely in Non-SF Virtual Assets). The Type 9 VA Intermediaries which invest or intend to invest at the De Minimus Threshold or above will be burdened with the VA Licensing Conditions - they could only accept professional investors with additional compliance overheads on the liquid capital requirement, the auditor appointment, the product risk and counterparty risk assessment, and also the custodial arrangement. Nevertheless such requirements will no doubt offer better protection to the investors and those Type 9 VA Intermediaries who are able to and have complied with such requirements will be rewarded by enjoying a better reputation in the market.

We have already received enquiries from existing and potential Type 9 VA Licensed Intermediaries to review their positions in light of the Statement and the Regulatory Standards. Should you have any similar requests or wish to understand more about the securities licensing regime in Hong Kong, please do not hesitate to reach out to a member of us to discuss further at [hyu@lylawoffice.com](mailto:hyu@lylawoffice.com) or +852 2115 9525.

### HENRY YU & ASSOCIATES



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