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## RE: STATEMENT FROM SFC ON CONCEPTUAL FRAMEWORK FOR REGULATING CRYPTO-EXCHANGES

On 1 November 2018, the Hong Kong Securities and Futures Commission (“**SFC**”) issued the Statement on Regulatory Framework for Virtual Asset Portfolios Managers, Fund Distributors and Trading Platform Operators<sup>1</sup> (the “**Statement**”), with an appendix titled “Conceptual Framework for the Potential Regulation of Virtual Asset Trading Platform Operators”<sup>2</sup> (the “**Conceptual Framework**”), which sets out the potential regulations over “virtual asset trading platform operators” (commonly known as the “cryptocurrency exchanges”) (the “**Platform Operators**”) with a view to implement safeguards for investors’ protection.

Interestingly, the SFC has in the Statement introduced the concept of a new asset class called “virtual assets” (the “**Virtual Assets**”), which refers to “a digital representation of value. Examples include ‘cryptocurrencies’, ‘crypto-assets’ and ‘digital tokens’”<sup>3</sup> and “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>4</sup>. SFC has not made clear which tokens or coins would fall under this new asset class but has admitted that many<sup>5</sup> virtual assets do not necessarily constitute “securities” or “futures contracts” for the purpose of the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) (“**SFO**”).

At the initial stage, the SFC may place Platform Operators in the SFC Regulatory Sandbox (the “**Sandbox**”) if the SFC considers it is demonstrating its commitment to adhering to the high standards of SFC, whereby the Platform Operators will work closely with SFC for the exploration of any prospect in SFC granting licences to the Platform Operators, subject to licensing conditions (as further explained below). The SFC is currently targeting the cryptocurrency exchanges which provide trading, clearing and settlement services for Virtual Assets, and have control over investors’ assets (commonly known as the “centralized cryptocurrency exchanges”), but not those platforms that only provide direct peer-to-peer marketplace for transactions by investors who typically retain control over their own assets and those that trade or intend to trade Virtual Assets for customers but do not provide automated trading services.

It is interesting to note that the Sandbox is an “opt-in approach” designed to set those Platform Operators who are committed to adhering to the SFC’s high standards apart from

<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> Conceptual framework for the potential regulation of virtual asset trading platform operators – [https://www.sfc.hk/web/EN/files/ER/PDF/App%20-%20Conceptual%20framework%20for%20VA%20trading%20platform\\_eng.pdf](https://www.sfc.hk/web/EN/files/ER/PDF/App%20-%20Conceptual%20framework%20for%20VA%20trading%20platform_eng.pdf)

<sup>3</sup> SFC sets out new regulatory approach for virtual assets – <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=18PR126>

<sup>4</sup> As defined under footnote 1 of appendix 1 of the Statement, Regulatory standards for licensed corporations managing virtual asset portfolios – [https://www.sfc.hk/web/EN/files/ER/PDF/App%20-%20Reg%20standards%20for%20VA%20portfolio%20mgrs\\_eng.pdf](https://www.sfc.hk/web/EN/files/ER/PDF/App%20-%20Reg%20standards%20for%20VA%20portfolio%20mgrs_eng.pdf)

<sup>5</sup> It is interesting to note the SFC’s sharp contrast with the view of Chairman of the Securities and Exchange Commission of the United States that most ICO tokens are “securities” – <https://www.sec.gov/news/testimony/testimony-virtual-currencies-oversight-role-us-securities-and-exchange-commission>

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those who are unwilling or unable to meet the conduct standards set by SFC. Therefore, any Platform Operator that is interested in obtaining the SFC licences<sup>6</sup> should operate an online platform in Hong Kong offering trading of at least one or more Virtual Assets, which fall under the definition of “securities” under SFO - it is still subject to clarification as to whether this means any Platform Operator who shows its capabilities in adhering to the high standard as required by SFC and subsequently obtains the SFC licence would be able to offer the trading of “securities tokens”.

If, at the end of the initial stage of the Sandbox, the SFC concludes that it may grant a licence to a qualified Platform Operator, it has indicated that it will impose certain licensing conditions as set out in the Conceptual Framework. We set out below some key observations on such proposed licensing conditions:

- a. **Services to be offered to “professional investors” only who have passed the suitability test.** Only customers who are professional investors<sup>7</sup> and, save for the institutional professional investors, have shown sufficient knowledge in Virtual Assets (including the relevant associated risks)<sup>8</sup> should be offered the trading services of Virtual Assets. The level of knowledge in Virtual Assets required is still subject to clarification.<sup>9</sup> The cryptocurrency exchanges should make an internal assessment as to whether their existing customers would be able to meet such standard before opting-in the Sandbox.
- b. **AML/CFT requirements on customers.** The Platform Operators are required to conduct due diligence on customers and have an adequate anti-money laundering/counter-financing of terrorism (“**AML/CFT**”) system, which should include specific measures such as obtaining sufficient contact information of the customers (and suspend/terminate those who provides incomplete information), conducting all deposits and withdrawals of fiat currencies for customers who have designated bank accounts in their names as held with an authorised financial institution in Hong Kong (or other jurisdictions as agreed by SFC) and to apply enhanced customer due diligence and ongoing monitoring under certain circumstances e.g. transactions involving tainted wallet addresses or Virtual Assets with a higher risk or greater anonymity. It remains to be seen whether the Platform Operators could satisfy the expected AML/CFT standard and, if so, how, in particular some of the cryptocurrencies offer a high degree of anonymity.
- c. **Limitations on trading of ICO tokens within the initial 12 months.** One of the core principles to the licensing conditions is that only Virtual Assets that were issued by way of an initial coin offering (“**ICO**”) should be admitted to the platform if the ICO of such Virtual Assets have been completed for at least 12 months or if such ICO project has started to generate profit, whichever is earlier. Platform Operators may also be subject to licensing principles where it must establish and disclose its Virtual Assets admission criteria (the “**Listing Conditions**”), set up a committee responsible for making decision to admitting Virtual Assets and also adopt a fee structure to avoid any potential, perceived

<sup>6</sup> More likely to be Type 1 (dealing in securities) and Type 7 (providing automated trading services) licences

<sup>7</sup> As defined under Part 1 of Schedule 1 of the SFO

<sup>8</sup> Unless the Platform Operator could justify that the provision of the trading services would be acting in the best interests of such customers.

<sup>9</sup> In the Circular to Intermediaries – Distribution of Virtual Asset Funds dated 1 November 2018 at <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=18EC77>, the SFC has suggested that intermediaries who are distributing Virtual Asset funds 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.

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or actual conflict of interest when receiving payment for admitting Virtual Assets. Whilst there are many rooms of uncertainty (for example on the definition of “generate profit”, whether this expands to Virtual Assets not issued by way of an ICO, and what constitutes a conflict of interest), this is a high burden whereby even some of the most successful ICO tokens (e.g. EOS) may not be able to satisfy the requirement at the moment and it is uncertain whether such tokens, if currently being listed on the Platform Operators, would need to be delisted for the time being.

- d. **Prevention of market manipulative and abusive activities.** The Platform Operator is required to establish and implement written policies and procedures to identify, prevent and report market manipulative and abusive activities, which include taking any actions with the effect of creating a false or misleading appearance of active trading or price of a Virtual Asset, carrying out one or more transactions with the effect of creating or maintaining an artificial price of Virtual Asset, carrying out any transactions that do not involve a change in the beneficial ownership of a Virtual Asset with the effect of manipulating the price, disclosing information about the manipulation of the price, and information that is false or misleading, of a Virtual Asset and carrying out two or more transactions which are likely to manipulate the price with the intention to induce another person to trade a Virtual Asset. As liquidity is one of the most critical issues for Virtual Assets, in particular ICO tokens, it remains to be seen as to whether the SFC allows certain degree of legitimate liquidity provision or price stabilisation with appropriate measures in place would be allowed.
- e. **Ongoing reporting obligations.** Platform Operators will be under closer supervision by the SFC and may be required to submit information (as specified by the SFC) on a regular basis, including: changes in the scope and details of services of the Platform Operators, details of any new Virtual Assets that it intends to admit, monthly volume of Virtual Asset transactions conducted through the Platform Operators (both on- or off-platform), identities and locations of its customers as at the end of the relevant month and other statistics on trading, clearing and settlement activities, as applicable in Hong Kong. The last requirement may have a significant impact and discourage the international investors in trading on the Hong Kong cryptocurrency exchanges as they may be reluctant for their identities and locations to be regularly reported to the regulator. It may also add substantial burden on the Platform Operators in gathering such information.
- f. **Insurance requirements.** The Platform Operators may be required to take out an insurance policy for risks associated with the custody of Virtual Assets, such as theft or hacking. SFC indicates that the policy would be expected to provide full coverage for Virtual Assets held by a Platform Operator in hot storage and a substantial coverage (for instance, 95%) for those held in cold storage. There are currently very limited insurance options on the market and, even if available, given the relatively short history and the significant value fluctuation of Virtual Assets, it is possible that the insurance product would require a higher premium and thus increase the operation costs of the Platform Operators.
- g. **Segregation and custody of customers’ money and Virtual Assets.** SFC is likely to require the Platform Operators to establish and maintain in Hong Kong one or more

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segregated accounts for customers' money and Virtual Assets in a designated trust account or client account. It appears that SFC heavily focuses on the protection of customers' assets and may require there to be certain custodial arrangements in place but there are currently limited options available on the market.

Based on the Statement and the Conceptual Framework, SFC seems to be getting prepared in regulating Virtual Assets with a similar standard as regulating the "securities" and "futures contracts". Nevertheless, SFC has also made clear that they may conclude, at the end of the initial stage, that risks involved cannot be properly dealt with under the standards the SFC would expect and further decide that no licences would be granted to any Platform Operators. Even if the SFC concludes that Platform Operators can be regulated by the SFC, it is possible that the standard of the licensing conditions would be high which is likely to result in increased overheads and limited options available to Platform Operators. Such high level of regulation may have an impact on discouraging international exchanges in viewing Hong Kong as a suitable place to participate in the Virtual Assets industry and raises concerns as to the feasibility of operating as a licensed Platform Operator in Hong Kong. It is also unclear at this stage how some of the items could be unwound as a result of the Licensing Conditions, e.g. whether existing cryptocurrency exchange would be required to delist Virtual Assets which do not satisfy the Listing Conditions or to reject existing customers who do not meet the "professional investor" status or do not pass the suitability test. This, again, is likely to have an impact on the existing business of the Platform Operators. The good news is that there is a possibility that the SFC may permit the trading of securities tokens should they form the view that Platform Operators can be licensed under the SFO. It remains to be seen as to whether such licensing model would be sustainable for any Platform Operators and the impact this will bring to the cryptocurrency industry.

Since the publication of the Statement, we have been noticed that there are a lot of interests in relation to the above. Should you have any queries or wish to understand more about the Sandbox, 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.

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