

1 November 2018

Statement on regulatory framework for virtual asset portfolios managers, fund distributors and trading platform operators

The Securities and Futures Commission (SFC) notes with concern the growing investor interest in gaining exposure to virtual assets via funds and unlicensed trading platform operators in Hong Kong. The SFC has identified significant risks associated with investing in virtual assets and these are set out below. In order to address these risks, the SFC is issuing guidance on the regulatory standards expected of virtual asset portfolio managers and fund distributors. The SFC is also exploring a conceptual framework for the potential regulation of virtual asset trading platform operators.

Background

Technology is transforming the landscape of the financial industry. Distributed ledger technology offers an anonymous way to digitally record ownership of virtual assets and facilitates peer-to-peer trading. A virtual asset is a digital representation of value, which is also known as “cryptocurrency”, “crypto-asset” or “digital token”. The polymorphous and evolving features of virtual assets mean that they may be, or claim to be, a means of payment, may confer a right to present or future earnings or enable a token holder to access a product or service, or a combination of any of these functions.

Public interest in virtual assets has grown exponentially around the world since the creation of the most widely-known digital token, Bitcoin, in 2008. At its peak in early January 2018, the market capitalisation of Bitcoin and other digital tokens was estimated at more than US\$800 billion¹. Over 2,000 different digital tokens are currently traded around the world with an estimated total market capitalisation of over US\$200 billion. Although the aggregated market capitalisation of digital tokens has fallen substantially from its peak, trading volumes remain substantial. There is also a growing demand for funds which invest in virtual assets.

While virtual assets have not posed a material risk to financial stability², there is a broad consensus among securities regulators that they pose significant investor protection risks. The regulatory response to these risks varies in different jurisdictions, depending on the regulatory remit, the scale of the activities and their impact on investor interests and whether virtual assets are deemed financial products suitable for regulation.

Under existing regulatory remits in Hong Kong, markets for virtual assets may not be subject to the oversight of the SFC if the virtual assets involved fall outside the legal definition of “securities” or “futures contracts” (or equivalent financial instruments). Therefore, investors who trade in virtual assets through unregulated trading platforms or invest in virtual asset portfolios which are managed by unregulated portfolio managers do not enjoy the protections afforded under the Securities and Futures Ordinance (SFO), such as requirements which ensure safe custody of assets and fair and open markets. If platform operators and portfolio managers are not regulated, their fitness and properness, including their financial soundness

¹ Website of CoinMarketCap: <https://coinmarketcap.com/charts/>.

² Report entitled “*Crypto-asset markets - potential channels for future financial stability implications*” published by the Financial Stability Board on 10 October 2018: <http://www.fsb.org/wp-content/uploads/P101018.pdf>.

and competence, have not been assessed, and their operations are not subject to any supervision.

Risks associated with investing in virtual assets

Virtual assets pose significant risks to investors. Some of these risks are inherent in the nature and characteristics of the virtual assets themselves and others stem from the operations of platforms or portfolio managers.

Valuation, volatility and liquidity

Virtual assets are generally not backed by physical assets or guaranteed by the government. They have no intrinsic value. There are currently no generally accepted valuation principles governing certain types of virtual assets. Prices on the secondary market are driven by supply and demand and are short-term and volatile by nature. The volatility faced by investors may be further magnified where liquidity pools for virtual assets are small and fragmented.

Accounting and auditing

Among the accounting profession, there are 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.

Cybersecurity and safe custody of assets

Trading platform operators and portfolio managers may store clients' assets in hot wallets (ie, online environments which provide an interface with the internet). These can be prone to hacking. Cyber-attacks resulting in the hacking of virtual asset trading platforms and thefts of virtual assets are common. Victims may have difficulty recovering losses from hackers or trading platforms, which can run to hundreds of millions of US dollars.

Virtual asset funds face a unique challenge due to the limited availability of qualified custodian solutions. Available solutions may not be totally effective.

Market integrity

Unlike regulated stock exchanges, the market for virtual assets is nascent and does not operate under a set of recognised and transparent rules. Outages are not uncommon, as are market manipulative and abusive activities, and these all result in investor losses.

Risk of money laundering and terrorist financing

Virtual assets are generally transacted or held on an anonymous basis. In particular, platforms which allow conversions between fiat currencies and virtual assets are inherently susceptible to higher risks of money laundering and terrorist financing. Where criminal activities are involved, investors may not be able to get back their investments as a result of law enforcement action.

Conflicts of interest

Virtual asset trading platform operators may act as agents for clients as well as principals. Virtual asset trading platforms may facilitate the initial distribution of virtual assets (eg, initial coin offerings), facilitate secondary market trading, or both, as in a traditional exchange, alternative trading system or securities broker. If these operators are not under the purview of any regulator, it would be difficult to detect, monitor and manage conflicts of interest.

Fraud

Virtual assets may be used as a means to defraud investors. Virtual asset trading platform operators or portfolio managers may not have conducted sufficient product due diligence before allowing a virtual asset to be traded on their platforms or investing in a virtual asset for their portfolios. As a result, investors may become victims of fraud and lose their investments.

Existing regulatory regime

The SFC has issued a number of circulars clarifying its regulatory stance on virtual assets³. Where virtual assets fall under the definition of “securities” or “futures contracts”, these products and related activities may fall within the SFC’s ambit. The SFC also reminded intermediaries in a circular dated 1 June 2018⁴ about the notification requirements under the Securities and Futures (Licensing and Registration)(Information) Rules if they intend to provide trading and asset management services involving crypto-assets.

The SFC has undertaken a series of actions against those who may have breached its rules and regulations when carrying out activities related to virtual assets. These include providing regulatory guidance, issuing warning and compliance letters and taking regulatory action⁵.

However, many virtual assets do not amount to “securities” or “futures contracts”. Moreover, managing funds solely investing in virtual assets which do not constitute “securities” or “futures contracts” does not amount to a “regulated activity” as specified under the SFO. Similarly, the operators of platforms which only provide trading services for virtual assets not falling within the definition of “securities” do not fall within the jurisdiction of the SFC. Notwithstanding the above, if firms are engaged in the distribution of funds which invest in virtual assets, irrespective of whether these assets constitute “securities” or “futures contracts”, these firms are required to be licensed by or registered with the SFC.

I. Regulatory approach for virtual asset portfolio managers and fund distributors

In the application of the SFC’s regulatory powers, many investors in virtual assets are left unprotected by the conventional approach where financial products are classified as “securities” or “futures contracts”. The SFC has decided to adopt a way forward which will bring a significant portion of virtual asset portfolio management activities into its regulatory

³ These include the Statement on initial coin offerings dated 5 September 2017, Circular to Licensed Corporations and Registered Institutions on Bitcoin futures contracts and cryptocurrency-related investment products dated 11 December 2017, and the press release, “SFC warns of cryptocurrency risks”, dated 9 February 2018.

⁴ Please refer to the Circular to intermediaries on compliance with notification requirements dated 1 June 2018 for details.

⁵ For details, please refer to the press release, “SFC’s regulatory action halts ICO to Hong Kong public”, dated 19 March 2018.

net. The overarching principles and regulatory standards of the regulatory framework are summarised below.

(a) Virtual asset portfolio managers

(i) Scope of supervision

The following types of virtual asset portfolio managers will be subject to the SFC's supervision:

- Firms managing funds which solely invest in virtual assets that do not constitute "securities" or "futures contracts" and distribute the same in Hong Kong

These firms will typically require a licence for Type 1 regulated activity (dealing in securities) because they distribute these funds in Hong Kong. The management of these funds will also be subject to the SFC's oversight through the imposition of licensing conditions; and

- Firms which are licensed or are to be licensed for Type 9 regulated activity (asset management) for managing portfolios in "securities", "futures contracts" or both

To the extent that these firms also manage portfolios which invest solely or partially (subject to a de minimis requirement⁶) in virtual assets that do not constitute "securities" or "futures contracts", such management will also be subject to the SFC's oversight through the imposition of licensing conditions.

(ii) Regulatory standards

In order to afford better protection to investors, the SFC considers that all licensed portfolio managers intending to invest in virtual assets should observe essentially the same regulatory requirements⁷ even if the portfolios (or portions of portfolios) under their management invest solely or partially in virtual assets, irrespective of whether these virtual assets amount to "securities" or "futures contracts"⁸.

For this purpose, the SFC has developed a set of standard terms and conditions (Terms and Conditions) which captures the essence of the Existing Requirements, adapted as needed to better address the risks associated with virtual assets. For example, only professional investors as defined under the SFO should be allowed to invest in any virtual asset

⁶ 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.

⁷ This refers to existing legal and regulatory requirements set out under the subsidiary legislation, the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission, the Fund Manager Code of Conduct and guidelines, circulars and frequently asked questions issued by the SFC from time to time (collectively referred to as "Existing Requirements").

⁸ This is on the premise that virtual assets, as an asset class, have similar features and risk characteristics, whether or not they amount to "securities" or "futures contracts".

portfolios (subject to the de minimis requirement). These Terms and Conditions are principles-based and should generally be appropriate to be imposed on virtual asset portfolio managers as licensing conditions, subject to minor variations and elaborations depending on the business model of the individual virtual asset portfolio manager. Some of the key terms and conditions are set out in **Appendix 1**, “Regulatory standards for licensed corporations managing virtual asset portfolios”.

(iii) Licensing process

Licence applicants and licensed corporations are required to inform the SFC if they are presently managing or planning to manage one or more portfolios that invest in virtual assets⁹. Upon being so informed, the SFC will first seek to understand the firm’s business activities. If the firm appears to be capable of meeting the expected regulatory standards, the proposed Terms and Conditions will be provided to the firm (where applicable) and the SFC will discuss them with the firm and vary them in light of its particular business model so as to ensure that they are reasonable and appropriate.

If a licence applicant does not agree to comply with the proposed Terms and Conditions, its licensing application will be rejected. Similarly, if an existing licensed corporation with a VA portfolio does not agree to comply with the proposed Terms and Conditions, it will be required to unwind that portfolio within a reasonable period of time.

After the licence applicant or licensed corporation has agreed with the proposed Terms and Conditions, they will be imposed as licensing conditions.

Failure to comply with any licensing condition is likely to be considered as misconduct under the SFO. This will reflect adversely on its fitness and properness and may result in the SFC taking regulatory action.

(b) Virtual asset fund distributors

Firms which distribute funds that invest (solely or partially) in virtual assets in Hong Kong will require a licence or registration for Type 1 regulated activity (dealing in securities). As such, these firms are required to comply with the Existing Requirements, including the suitability obligations, when distributing these funds. Given the significant risks posed to investors, further guidance on the expected standards and practices when distributing virtual asset funds is provided in the “Circular to intermediaries on the distribution of virtual asset funds” issued by the SFC on 1 November 2018.

Under this arrangement, if a virtual asset fund available in Hong Kong is not already managed by those firms mentioned under section I(a)(i), these funds will still be distributed by firms mentioned under section I(b), all of which are subject to the SFC’s oversight. As such, the management or distribution of these funds would be regulated in one way or another by the SFC.

⁹ For the avoidance of doubt, this notification requirement applies even if (i) the licence applicant or licensed corporation manages or plans to manage virtual asset portfolios with an intention to invest less than 10% of the GAV of the portfolio in virtual assets; or (ii) the virtual assets involved have features of “securities” or “futures contracts” as defined under the SFO.

II. Exploring regulation of platform operators

Separately, the SFC is also setting out a conceptual framework for the potential regulation of virtual asset trading platforms in this statement, with a view to exploring (and forming a view after the exploratory stage) whether virtual asset trading platforms are suitable for regulation. If the SFC is minded to license any virtual asset trading platforms, it is proposed that the standards of conduct regulation for virtual asset trading platform operators should be comparable to those applicable to existing licensed providers of automated trading services.

The SFC considers that the regulatory approach under the conceptual framework (if implemented) could provide a path for compliance for those platform operators capable and willing to adhere to a high level of standards and practices, and set licensed operators apart from those which do not seek a licence.

Some of the world's largest virtual asset trading platforms have been seen operating in Hong Kong but they fall outside the regulatory remit of the SFC¹⁰ and any other regulators. Owing to the serious investor protection issues identified and having regard to international developments, the SFC considers it necessary to explore in earnest whether and if so, how it could regulate virtual asset trading platforms under its existing powers.

To conduct a meaningful study of the framework, the SFC will work with interested virtual asset trading platform operators that have demonstrated a commitment to adhering to the high expected standards by placing them in the SFC Regulatory Sandbox¹¹.

In the initial exploratory stage, the SFC would not grant a licence to platform operators. Instead, it would discuss its expected regulatory standards with platform operators and observe the live operations of the virtual asset trading platforms in light of these standards. It will also consider the effectiveness of the proposed regulatory requirements in addressing risks and providing adequate investor protection. The SFC will critically consider whether the virtual asset trading platforms are, in fact, appropriate to be regulated by the SFC in light of the performance of these trading platforms in the Sandbox. Factors to be considered include the adequacy and effectiveness of the proposed conceptual framework; ability to comply with the terms and conditions; investors' interests; as well as local market and international regulatory developments.

It may be a possibility that due to the inherent characteristics of the underlying technology or business models of platform operators, the SFC will conclude that risks involved cannot be properly dealt with under the standards it would expect, and that investor protection still cannot be ensured. In that case, the SFC may decide that platform operators should not be regulated by the SFC. For instance, 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, which is the underlying technology for virtual assets. The SFC also has to take into account the rapid evolution of the whole virtual asset industry as well as development in the international regulatory community, including the work being done in International Organization of Securities Commissions (IOSCO).

¹⁰ Platforms which offer trading of virtual assets that are not "securities" or "futures contracts" are not subject to the purview of the SFC.

¹¹ Please refer to the press release, "Launch of the SFC Regulatory Sandbox", dated 29 September 2017 for details.

The exploratory stage is crucial for the SFC to understand the actual operations of platform operators to determine whether these platforms are suitable for regulation. If the SFC makes a positive determination at the end of this stage, it would then consider granting a licence to a qualified platform operator. In order not to confuse the public about the regulatory status of platform operators, the identity of the Sandbox applicants in this stage and the discussions will be kept confidential.

If the SFC grants a licence to a qualified platform operator, it will impose appropriate licensing conditions and the operator will proceed to the next stage of the Sandbox. This would typically mean more frequent reporting, monitoring and reviews so that through close supervision by the SFC, operators could put in place robust internal controls and address any of the SFC's concerns arising from the conduct of their business. The SFC may also further consider or refine its regulatory and supervisory approach through intensive dialogue with operators when they are operating in the Sandbox. After a minimum 12-month period, the virtual asset trading platform operator may apply to the SFC for removal¹² or variation of some licensing conditions and exit the Sandbox. Licensing conditions (and terms and conditions) imposed in this stage would be made public in the usual way.

Details of the conceptual framework are set out in **Appendix 2**, "Conceptual framework for the potential regulation of virtual asset trading platform operators".

The SFC will keep the development of activities related to virtual assets in view and may issue further guidance where appropriate.

Market participants are welcome to contact the Fintech Contact Point at fintech@sfc.hk if they have any questions.

Intermediaries Division
Securities and Futures Commission

¹² For example, the licensing condition on ongoing reporting obligations.

1 November 2018

Regulatory standards for licensed corporations managing virtual asset portfolios

This paper sets out the regulatory standards imposed by the Securities and Futures Commission (SFC) on licensed corporations which manage portfolios that invest in virtual assets¹.

The SFC's *Statement on regulatory framework for virtual asset portfolios managers, fund distributors and trading platform operators* describes the unique features and characteristics of virtual assets and outlines some of the risks associated with investing in them. For licensed corporations, the risks faced and factors to be considered when managing portfolios which invest in virtual assets are very different from those faced and considered when managing portfolios investing in securities or futures contracts.

Scope of supervision

Under the current regulatory landscape, management of portfolios² (or portions of portfolios) that invest in virtual assets (virtual asset portfolios) may or may not be subject to the SFC's regulatory oversight, depending on whether these assets amount to "securities" or "futures contracts" as defined under the Securities and Futures Ordinance (SFO)³. In particular:

- (a) where a firm only manages a portfolio which invests solely in virtual assets which do not amount to "securities" or "futures contracts" (hereafter referred to as "non-SF virtual assets"), for example, Bitcoin and Ethereum, it is not required to be licensed or registered for Type 9 regulated activity (asset management), ie, to be a Type 9 intermediary. Notwithstanding the above, the firm will be required to be licensed or registered for Type 1 regulated activity (dealing in securities) if it distributes a fund under its management that solely invests in non-SF virtual assets in Hong Kong⁴;
- (b) where a firm manages a fund of funds, regardless of whether each underlying fund invests solely or partially in non-SF virtual assets, the firm is required to be a Type 9 intermediary; and
- (c) where a Type 9 intermediary, besides managing a portfolio of securities, futures contracts or both (which would amount to a regulated activity), also manages another portfolio that solely or partially invests in non-SF virtual assets, the current legal and regulatory requirements do not apply to the intermediary insofar as its management of the portfolio or portion of portfolio relates to non-SF virtual assets.

The regulatory regime for the management of portfolios investing in non-SF virtual assets is not straightforward. In particular, it may not be apparent to investors that certain asset

¹ These 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.

² These cover collective investment schemes and discretionary accounts in the form of an investment mandate or a pre-defined model portfolio.

³ As defined in Part 1 of Schedule 1 to the SFO.

⁴ This includes the distribution of these funds to the Hong Kong public.

management activities conducted by a Type 9 intermediary may not be subject to regulatory oversight, and investors may invest in a portfolio managed by that intermediary investing in non-SF virtual assets thinking they will be protected under the existing legal and regulatory framework. Furthermore, given the significant risks associated with virtual assets, the SFC is also concerned that problems arising from an intermediary's involvement in the management of a portfolio investing in non-SF virtual assets could potentially affect the intermediary's fitness or properness to remain licensed or registered for its regulated activities.

To afford better protection to investors in Hong Kong, the SFC considers that licensed corporations should observe essentially the same regulatory requirements⁵ even if the portfolios (or portions of portfolios) under their management invest in virtual assets, irrespective of whether these assets amount to "securities" or "futures contracts"⁶.

In order to achieve the above, the SFC has developed a set of standard terms and conditions which capture the essence of the Existing Requirements adapted as needed in order to better address the risks associated with virtual assets. These will be imposed, by way of licensing conditions, on licensed corporations in relation to:

- (a) their management of portfolios (or portions of portfolios) that invest in virtual assets (subject to the de minimis threshold referred to below); and
- (b) their financial resources if they plan to hold non-SF virtual assets on behalf of portfolios under their management.

As the standard terms and conditions are by and large principles-based, they should generally be appropriate as licensing conditions for all licensed corporations managing virtual asset portfolios, subject to minor variations and elaborations depending on the licensed corporations' business models.

Licensing conditions

The terms and 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 gross asset value (GAV) of the portfolio in virtual assets (10% GAV de minimis threshold). These specifically refer to:

- (a) Licensed corporations licensed for Type 9 regulated activity which, in addition to managing portfolios which solely invest in securities, futures contracts or both, manage or plan to manage:
 - Portfolios that invest solely in virtual assets; or
 - Portfolios that invest partially in securities, futures contracts or both and partially in virtual assets; and

⁵ This refers to existing legal and regulatory requirements set out under the subsidiary legislation, the Code of Conduct for Persons 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 (collectively referred to as "Existing Requirements").

⁶ This is on the premise that virtual assets, as an asset class, have similar features and risk characteristics, whether or not they amount to "securities" or "futures contracts".

- (b) Licensed corporations licensed for Type 1 regulated activity which manage or plan to manage collective investment schemes solely investing in non-SF virtual assets and distribute or plan to distribute the same in Hong Kong. While the management of collective investment schemes solely investing in non-SF virtual assets does not amount to a regulated activity, it is of paramount importance that all licensed corporations are subject to comparable regulatory requirements should they manage these schemes. To this end, the SFC requires these licensed corporations to comply with these terms and conditions through licensing conditions.

For the avoidance of doubt, these terms and conditions will not apply to:

- (a) licensed corporations which only manage portfolios that invest in virtual asset funds (ie, funds of funds)⁷; or
- (b) licensed corporations which manage portfolios whose mandate is to mainly invest in securities, futures contracts or both but the investment in virtual assets exceeds the 10% GAV de minimis threshold due to the increase in the prices of the virtual assets held in one or more of these portfolios. However, all reasonable steps should be taken to reduce the portfolio's investment in virtual assets in a timely manner so as to reduce the proportion to below the 10% GAV de minimis threshold. However, if this situation (in which the de minimis threshold is exceeded) is anticipated to persist, the SFC should be duly alerted so it could consider imposing terms and conditions on the licensed corporation. Failure to notify the SFC may result in disciplinary action.

The standard terms and conditions are summarised below in broad terms.

Type of investors and disclosure to investors

Licensed corporations should only allow professional investors as defined under the SFO to invest into any portfolio⁸ under their management 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.

To ensure that potential investors can make an informed decision, licensed corporations should also clearly disclose all the associated risks to potential investors and distributors they have appointed for distribution of their virtual asset funds.

Safeguarding of assets

Licensed corporations should select the most appropriate custodial arrangement, for example, whether the assets should be held by the licensed corporation itself (ie, self-custody of assets), with a third-party custodian or an exchange. In assessing which custodial arrangement (or combination of custodial arrangements) to adopt, licensed corporations should assess the advantages and disadvantages of holding virtual assets at these different

⁷ The Existing Requirements, especially the FMCC, are considered adequate for governing the management of funds of funds, including the situation where the underlying funds invest in virtual assets.

⁸ For the avoidance of doubt, this does not apply to those collective investment schemes authorized by the SFC under section 104 of the SFO.

host locations by way of “hot wallets”, “cold wallets” and “deep cold wallets” with reference to, among other things:

- (a) The ease with which the virtual assets are accessible, ie, the time required to transfer the virtual assets to the trading venue; and
- (b) The security of the custodial facility, ie, whether there are adequate safeguards in place to protect the facility from external threats, including cyberattacks.

Licensed corporations should exercise due skill, care and diligence in the selection, appointment and ongoing monitoring of custodians. Licensed corporations should, among other things, consider the following factors:

- (a) the experience and track record of the custodian in providing custodial services for virtual assets;
- (b) the regulatory status of the custodian, in particular, whether it is subject to any regulatory oversight over its virtual asset custodial business;
- (c) the corporate governance structure and background of the senior management of the custodian;
- (d) the financial resources and insurance cover of the custodian for the purpose of compensating its customers in the event of loss of customers’ assets; and
- (e) the operational capabilities and arrangements of the custodian, for example, the “wallet” arrangements and cybersecurity risk management measures.

Some virtual assets may not be kept with a third-party custodian for various reasons, for example, limited scope of service provided, security reasons or technological incompatibility. As such, these virtual assets may have to be held in self-custody, for example, by holding the private key of the wallet for maintaining these virtual assets. Licensed corporations should document the reasons for self-custody, implement appropriate measures to safeguard these assets, and maintain proper records and arrangement to ensure that these assets can be effectively segregated from the licensed corporations’ own assets upon the licensed corporations’ insolvency. Furthermore, 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 disclosure to investors of the risks associated with such arrangements.

Portfolio valuation

There are currently no generally accepted valuation principles for virtual assets, especially for virtual assets issued by way of an initial coin offering (ICO Tokens). As such, licensed corporations should exercise due care in selecting valuation principles, methodologies, models and policies which are reasonably appropriate in light of the circumstances and in the best interests of the investors of the portfolios under the licensed corporations’ management. The same should also be properly disclosed to investors.

Risk management

Licensed corporations should set appropriate limits in respect of each product and market the portfolios invest in and each counterparty to which the portfolios have exposure. For example, they should consider setting a cap on the portfolios' investment in illiquid virtual assets and newly-launched ICO Tokens⁹. They should also conduct periodic stress testing to determine the effect of abnormal and significant changes in market conditions on these portfolios.

In relation to the management of counterparty risk, hacking of virtual asset exchanges is not uncommon and investors have suffered enormous losses due to hacking incidents. As such, licensed corporations should implement additional procedures to assess the reliability and integrity of virtual asset exchanges before transacting with them, for example, taking into account:

- (a) the experience and track record of the virtual asset exchange;
- (b) the legal or regulatory status of the virtual asset exchange, if any;
- (c) the corporate governance structure and background of the senior management of the virtual asset exchange;
- (d) the operational capabilities of the virtual asset exchange;
- (e) the mechanisms (for example, surveillance systems) implemented by the virtual asset exchange to guard against fraud and manipulation with respect to the products traded on the exchange;
- (f) the cybersecurity risk management measures of the virtual asset exchange; and
- (g) the financial resources and insurance cover of the virtual asset exchange.

Appropriate caps should also be set to limit the exposure to individual virtual asset exchanges.

Auditors

Licensed corporations should ensure that an independent auditor is appointed to perform an audit of the financial statements of the funds under their management. When selecting the auditor, licensed corporations should take into account, among other things, the experience and capability of the auditor in checking the existence and ownership and ascertaining the reasonableness of the valuation of virtual assets.

⁹ In 2017, almost half of the ICO projects reportedly failed, either at the fundraising stage or within eight months after the initial launch. There were also cases where the management team of an ICO project simply stopped communicating on social media and the project never materialised.



Liquid capital

Under the Securities and Futures (Financial Resources) Rules, if a corporation is licensed for Type 9 regulated activity and holds “client assets”¹⁰, it must maintain a required liquid capital of not less than \$3 million (or its variable required liquid capital, whichever is higher). On the other hand, if it does not hold any “client assets”, it must maintain a required liquid capital of not less than \$100,000 (or its variable required liquid capital, whichever is higher).

Although non-SF virtual assets do not fall under the definition of “client assets”, the SFC considers the risks associated with a licensed corporation holding these assets on behalf of portfolios it manages (for example, in wallets in its own name or capacity) to be similar to the risks associated with holding “client money” or “client securities”¹¹.

In order to secure a higher chance of recovery for clients and the orderly return of non-SF virtual assets in the case of liquidation, a licensed corporation which holds non-SF virtual assets for portfolios under its management shall be required to maintain a required liquid capital of not less than \$3 million (or its variable required liquid capital, whichever is higher).

Future guidance

Licensed corporations should also follow future guidance as may be provided by the SFC regarding the management of virtual asset portfolios from time to time.

Way forward

Licence applicants and licensed corporations are required to inform the SFC if they are presently managing, or planning to manage, one or more portfolios that invest in virtual assets¹², or if they intend to hold non-SF virtual assets on behalf of the portfolios under their management. Failure to do so may amount to a breach of the Securities and Futures (Licensing and Registration) (Information) Rules.

Upon being aware of any firm managing or planning to manage virtual asset portfolios, the SFC will first seek to understand the firm’s business activities. If the firm appears to be capable of meeting the expected regulatory standards, the standard terms and conditions will be provided to the firm (where applicable) and the SFC will discuss and vary them with the firm in light of its business model so as to ensure that the terms and conditions proposed by the SFC are reasonable and appropriate.

If a licence applicant does not agree to comply with the proposed terms and conditions, its licensing application will be rejected. Similarly, if an existing licensed corporation does not agree to comply with the proposed terms and conditions, it shall not manage any virtual asset portfolios. If any such licensed corporation is presently managing virtual asset portfolios, it will be required to unwind the virtual asset positions in these portfolios within a reasonable period of time, taking due account of the interests of the portfolios’ investors.

¹⁰ As defined under Part 1 of Schedule 1 to the SFO.

¹¹ As defined under Part 1 of Schedule 1 to the SFO.

¹² For the avoidance of doubt, this notification requirement applies even if (i) the licence applicant or licensed corporation plans to manage or is managing any portfolio with an intention to invest less than 10% of the GAV of the portfolio in virtual assets; or (ii) the virtual assets involved amount to “securities” or “futures contracts” as defined under the SFO.



After the licence applicant or licensed corporation has agreed with the proposed terms and conditions, these will be imposed through licensing conditions. Failure to comply with licensing conditions is likely to be considered as misconduct under the SFO. This will reflect adversely on a licensed corporation's fitness and properness and may result in the SFC taking regulatory action.

Separately, the SFC will continue to monitor developments in the market as well as international regulatory developments and may provide further guidance and implement other measures (including amending the imposed terms and conditions) where appropriate.

For enquiries, please contact the SFC Fintech Contact Point at fintech@sfc.hk or the Licensing case officer of your firm.

Intermediaries Division
Securities and Futures Commission

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Conceptual framework for the potential regulation of virtual asset trading platform operators

This paper sets out a conceptual framework for the Securities and Futures Commission (SFC) to license and regulate virtual asset trading platforms (commonly known as cryptocurrency exchanges). The SFC intends to, in a sandbox environment, explore (and form a view after the exploratory stage) whether it is appropriate to grant a licence to and regulate any of these platforms under its existing powers. Trading platforms may approach the SFC if they are interested in being licensed and to demonstrate their commitment to adhering to the SFC's requirements and the high standards expected of them.

The SFC considers that clear regulatory standards for virtual asset trading platforms would enhance investor protection as well as foster innovation and market development as a number of the more active virtual asset trading platforms have operations in Hong Kong. None of them are currently licensed by the SFC.

Background

The SFC's *Statement on regulatory framework for virtual asset portfolios managers, fund distributors and trading platform operators* (Policy Statement) describes the unique features and characteristics of virtual assets and outlines some of the risks associated with investing in them.

In brief, virtual asset trading platforms are online platforms which match buyers' and sellers' orders for trading in virtual assets, and they perform functions similar to traditional securities brokers, stock exchanges and private trading venues (eg, alternative liquidity pools). Investors usually buy, sell or trade virtual assets on these platforms and they play an important role in providing market liquidity and price transparency for these assets.

However, some virtual asset trading platforms may not be subject to any regulatory standards, and protection for investors trading on unregulated platforms is manifestly insufficient. These platforms may not have a sound corporate governance framework or sufficient internal controls. It is not uncommon for these platforms to be hacked. There have also been reports of platforms suspected to be involved in market manipulation and treating investors unfairly¹.

An additional regulatory challenge is posed by the direct, online access to virtual assets offered by unregulated trading platforms to retail investors. Traditional securities trading venues are typically accessed by regulated brokers which perform know-your-client procedures and anti-money laundering and counter-terrorist financing checks, and ensure product suitability for investors (where applicable). The ease of retail access to unregulated virtual asset trading platforms combined with aggressive online advertising raise important investor protection issues.

¹ An online article entitled "Cryptocurrency Trader Says The Market Is Manipulated" published on Forbes on 1 June 2018: <https://www.forbes.com/sites/francescoppola/2018/06/01/cryptocurrency-trader-says-the-market-is-manipulated/#48882b0225cd>

Scope of supervision

If the SFC considers that a virtual asset trading platform operator (Platform Operator) can demonstrate its commitment to adhering to the high standards expected of it, such an operator may be placed in the SFC Regulatory Sandbox² (Sandbox). In the initial exploratory stage, the SFC will explore with Platform Operators to determine whether they are appropriate to be regulated. If the SFC makes a positive determination, it would then consider granting a licence to a qualified Platform Operator, subject to licensing conditions.

Under the Securities and Futures Ordinance (Cap. 571)(SFO), the SFC is empowered to grant licences for the carrying on of “regulated activities”³ as defined under the SFO. If a Platform Operator is interested in being licensed by the SFC, it should operate an online trading platform in Hong Kong and offer trading of at least one or more virtual assets which fall under the definition of “securities”⁴ on its platform. Such a Platform Operator would then fall within the jurisdiction of the SFC and require a licence for Type 1 (dealing in securities) and Type 7 (providing automated trading services) regulated activities⁵.

This is an opt-in approach designed to set those Platform Operators who are committed to adhering to the SFC’s high standards apart from those who are unwilling or unable to meet the conduct standards set by the SFC. Details of the Sandbox process are further explained in the Policy Statement.

The SFC notes that some virtual asset trading platforms only provide a direct peer-to-peer marketplace for transactions by investors who typically retain control over their own assets (be they fiat currencies or virtual assets). Others may also trade or intend to trade virtual assets for clients (including order routing) but do not provide automated trading services themselves. At this stage, the SFC does not consider that it is appropriate for existing licensed corporations to conduct such activities⁶ under the same regulated entity or for any new licensing applications in this regard to be approved. The SFC will focus its efforts on exploring the regulation of virtual asset trading platforms which provide trading, clearing and settlement services for virtual assets, and have control over investors’ assets.

The SFC will keep the development of activities related to virtual assets in view and may issue further guidance where appropriate.

² Please refer to the press release, “Launch of the SFC Regulatory Sandbox”, dated 29 September 2017 for details.

³ “Regulated activities” are specified in Part 1 of Schedule 5 to the SFO. Parties engaging in regulated activities in Hong Kong or targeting Hong Kong investors are required to be licensed by the SFC.

⁴ The SFC will not consider licensing Platform Operators which trade virtual assets that are “futures contracts” or “structured products” at this stage.

⁵ As provided under the Guidelines for the Regulation of Automated Trading Services, parties providing automated trading services (ATS) under the existing regulatory framework should either be authorised under Part III of the SFO, or be licensed or registered for Type 7 regulated activity under Part V of the SFO. In general, an ATS licence or registration under Part V is more appropriate when the provision of ATS is incidental to the performance of a dealing function, such as dealing in securities. Such ATS providers are typically intermediaries providing dealing services, and offer ATS as an added facility. Where the provision of ATS is a core function, an ATS authorisation under Part III is more appropriate.

⁶ Licensed corporations are reminded of the notification requirements set out in the Circular to intermediaries on compliance with notification requirements dated 1 June 2018.

I. Core principles – Proposed licensing conditions

If the SFC concludes that it may grant a licence to a qualified Platform Operator, the SFC will impose certain licensing conditions under section 116(6) of the SFO to address the specific risks associated with a Platform Operator’s operations. These conditions are likely to include the core principles (set out below) and other specific terms and conditions (set out in Section II below), subject to modifications and discussion between the SFC and the Platform Operator in the Sandbox.

The SFC expects a licensed Platform Operator (if any) to comply strictly with all licensing conditions imposed on it when conducting its entire virtual asset trading business. Failure to comply with any licensing condition is likely to be considered as misconduct under the SFO. This will reflect adversely on the fitness and properness of a Platform Operator to remain licensed and may result in disciplinary action by the SFC.

Core principles

(1) All virtual asset trading activities under a single legal entity

A Platform Operator should ensure that all virtual asset trading business activities (Relevant Activities) conducted by its group of companies⁷ (which are actively marketed to Hong Kong investors or are conducted in Hong Kong) are carried out under a single legal entity licensed by the SFC. Relevant Activities mean any virtual asset (irrespective of the nature of any token) trading activities on and off the platform, and any activities wholly incidental to the provision of such trading services. For the avoidance of doubt, Relevant Activities do not include the distribution of virtual asset funds or management of virtual asset portfolios discussed in the “Circular to intermediaries – Distribution of virtual asset funds” and Appendix 1 to the Policy Statement, “Regulatory standards for licensed corporations managing virtual asset portfolios” dated 1 November 2018.

Placing all Relevant Activities within a single legal corporate entity to be licensed allows the SFC to have comprehensive and holistic oversight of the licensed entity and avoids public confusion about which part of its business is licensed and supervised by the SFC.

(2) Compliance with applicable requirements by entire virtual asset trading business

A Platform Operator should comply with all applicable regulatory requirements (including any licensing conditions imposed by the SFC) for all Relevant Activities. Notwithstanding that the activities may not relate to virtual assets which are “*securities*”, they may affect the overall fitness and properness of the Platform Operator.

⁷ “Group of companies” means any two or more corporations one of which is the holding company of the other or others (as defined under Part 1 of Schedule 1 to the SFO).

(3) Services to be offered to “professional investors”⁸ only

Given the significant risks associated with the trading of virtual assets, a Platform Operator should provide its services only to “professional investors”.

Where a Platform Operator offers its trading systems to other companies as a technology solution, it should also ensure that its participants and all end users who are able to access its systems are “professional investors”.

(4) Limitations on trading of ICO tokens within the initial 12 months

A Platform Operator should only admit a virtual asset issued by way of an initial coin offering (ICO Tokens) for trading on its platform at least 12 months after the completion of the ICO or when the ICO project has started to generate profit, whichever is earlier.

This ensures that there is sufficient market information and a performance track record for investors to consider whether an ICO Token is backed by a genuine and viable project. This also allows the Platform Operator to have more information to perform proper due diligence on any tokens that it permits to trade on its platform.

(5) Transactions be pre-funded, and no leverage or virtual asset-related futures contracts or other derivative products

A Platform Operator should only execute a trade for a client if there are sufficient fiat currencies or virtual assets in his account with the platform to cover that trade. Further, a Platform Operator should not provide any financial accommodation for investors to acquire virtual assets. It also should not conduct Relevant Activities in relation to virtual assets which are futures contracts or other derivatives.

Virtual assets inherently pose substantial risks for investors due to their volatility. Where a Platform Operator offers margin financing services or allows investors to trade futures contracts or other derivatives of underlying virtual assets, these risks may be magnified by the leverage inherent in the services or products.

II. Proposed terms and conditions

A licensed Platform Operator (if any) is expected to comply with the SFO and its subsidiary legislation⁹. When conducting Relevant Activities, it is also required¹⁰ to comply with all relevant regulatory requirements set out in the Code of Conduct¹¹ and guidelines, circulars and frequently asked questions published by the SFC from time to time.

In particular, the SFC highlights that a licensed Platform Operator (if any) will be required to comply with the 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-

⁸ As defined under Part 1 of Schedule 1 to the SFO.

⁹ Including but not limited to the Securities and Futures (Financial Resources Requirements) Rules (Cap.571N) and the Securities and Futures (Licensing and Registration)(Information) Rules (Cap.571S).

¹⁰ To be imposed by way of a licensing condition.

¹¹ The Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.

Money Laundering and Counter-Financing of Terrorism (For Licensed Corporations) when conducting its Relevant Activities.

In addition to the core principles, where the existing requirements may not directly apply to them (but the SFC considers similar requirements should be observed) or where the virtual assets' unique features or technologies may give rise to new risks for which the SFC considers that enhanced investor protection measures are necessary, the SFC has set out, in the terms and conditions (Terms and Conditions), the regulatory standards which are considered to be generally appropriate for imposition on licensed Platform Operators (if any) as licensing conditions. These terms and conditions can vary according to the operational model, size and nature of business of each Platform Operator, and pursuant to discussions with the SFC in the Sandbox.

Examples of key terms and conditions which may be imposed are set out as follows:

(1) Financial soundness

Depending on its role and functions, a Platform Operator may typically assume multiple responsibilities (for instance, as a custodian of clients' virtual assets). In the event of theft or the hacking of a virtual asset trading platform, a Platform Operator and its clients may suffer from substantial losses. It is therefore of paramount importance that the Platform Operator maintains sufficient financial resources to provide a higher chance of recovery or ensure an orderly wind-down of its critical operations and services for business contingency purposes.

In light of the above, a Platform Operator should maintain financial resources which are commensurate with the role and functions it performs and the level of risk it undertakes. The SFC may require, on a case-by-case basis, a Platform Operator to maintain a reserve equivalent to 12 months of operating expenses as a financial buffer. In determining the level of financial resources required, the SFC may consider factors including:

- (a) the role and functions to be performed by a Platform Operator;
- (b) actual or estimated trading volume on its platform;
- (c) types of virtual assets to be traded on its platform;
- (d) types of "professional investors" to be served by the Platform Operator;
- (e) projected operating expenses in the first 12 months after being licensed;
and
- (f) financial position of the Platform Operator.

(2) Insurance requirement

A Platform Operator should take out an insurance policy for risks associated with the custody of virtual assets, such as theft or hacking.

The SFC generally expects that the insurance policy would provide full coverage for virtual assets held by a Platform Operator in hot storage and a substantial coverage for those held in cold storage (for instance, 95%)¹².

(3) Knowledge assessment

Except for institutional professional investors¹³, a Platform Operator should, as part of the 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. Where 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.

(4) Anti-money laundering and counter-financing of terrorism (AML/CFT)

A Platform Operator should ensure that its AML/CFT systems can adequately manage the money laundering and terrorist financing risks relating to Relevant Activities. Specific measures to be taken by a Platform Operator should include but are not limited to the following:

- (a) to obtain sufficient contact information of the client, and to suspend or terminate the account of any client who provides incomplete or suspicious contact information;
- (b) to conduct all deposits and withdrawals of fiat currencies for a client's account only through a designated bank account opened in the name of the client with an authorised financial institution in Hong Kong or other jurisdictions as agreed by the SFC from time to time;
- (c) to apply enhanced customer due diligence and ongoing monitoring regarding:
 - (i) the use of proxies, any unverifiable or high risk geographical locations, any disposable email addresses or mobile numbers, or use of a constantly changing device to conduct transactions;
 - (ii) transactions involving tainted wallet addresses such as "darknet" marketplace transactions and tumblers; and
 - (iii) transactions involving virtual assets with a higher risk or greater anonymity (eg, virtual assets which mask users' identities or transaction details);
- (d) to establish and maintain adequate and effective systems and processes to monitor transactions involving virtual assets and to conduct appropriate

¹² A Platform Operator typically holds clients' virtual assets in cold or hot storage. Cold storage describes the practice where the private keys to virtual assets are kept off-line, ie, air-gapped. In contrast, hot storage is connected to the internet and is therefore highly vulnerable to hacking.

¹³ This refers to the specified entities 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.

enquiries and evaluate potentially suspicious transactions. In particular, a Platform Operator should:

- (i) identify and prohibit transactions with virtual asset addresses or its equivalent which are compromised or tainted¹⁴; and
 - (ii) employ technology solutions which enable the tracking of virtual assets through multiple transactions to more accurately identify the source and destination of these virtual assets;
- (e) to regularly review the effectiveness of its AML/CFT systems and introduce enhancement measures where necessary, taking into account any new guidance issued by the SFC and latest updates of the Financial Action Task Force (FATF)¹⁵ Recommendations applicable to virtual assets-related activities; and
- (f) where a Platform Operator engages a third-party service provider to assist with its AML/CFT compliance, to conduct adequate due diligence in selecting the service provider and monitor its ongoing performance.

(5) Disclosure requirements

A Platform Operator should fully disclose and ensure investors fully understand the nature and risks that they may be exposed to in trading virtual assets and using their virtual asset trading services. The disclosed risks should, among other things, include:

- (a) the protection offered by the Investor Compensation Fund does not apply to transactions involving virtual assets;
- (b) virtual assets are not legal tender;
- (c) transactions in virtual assets may be irreversible, and, accordingly, losses due to fraudulent or accidental transactions may not be recoverable;
- (d) the value of a virtual asset may be derived from the continued willingness of market participants to exchange fiat currency for a virtual asset, which means that the value of a particular virtual asset may be completely and permanently lost should the market for that virtual asset disappear; and
- (e) the volatility and unpredictability of the price of a virtual asset relative to fiat currencies may result in significant losses over a short period of time.

Further, virtual asset trading platforms may have different compositions and descriptions of fees. A Platform Operator should disclose its related fees and

¹⁴ A digital token address is considered compromised or tainted where there is reasonable suspicion that it is used for the purposes of conducting fraud, identity theft, extorting ransom or any other criminal activity.

¹⁵ For instance, FATF issued a "Guidance for a Risk-based approach to virtual currency" in June 2015: <http://www.fatf-gafi.org/media/fatf/documents/reports/Guidance-RBA-Virtual-Currencies.pdf>

charges to enhance transparency, the comparability of fees and charges and ease of understanding by clients.

All information provided to clients should be presented in a clear and fair manner which is not misleading.

(6) Virtual assets to be admitted for trading

A Platform Operator should have performed all reasonable due diligence on the virtual assets before listing them on its platform. It should also establish and disclose the criteria for admitting a virtual asset to be traded. Below is a list of non-exhaustive factors which a Platform Operator may consider:

- (a) the regulatory status of a virtual asset in relevant jurisdictions;
- (b) the demand and supply, maturity and liquidity of a virtual asset;
- (c) technical aspects of a virtual asset, including:
 - (1) security infrastructure of the blockchain protocol underlying a virtual asset;
 - (2) size of the blockchain and network, in particular, whether it may be susceptible to a 51% attack¹⁶;
 - (3) type of consensus algorithm; and
- (d) accuracy of the marketing materials of a virtual asset which should be non-misleading.

Further, a Platform Operator should set up a committee responsible for making decisions about whether a certain virtual asset should be admitted for trading on its platform in accordance with the admission criteria.

Where a Platform Operator receives payments for admitting a virtual asset to trade on its platform, it should adopt a fee structure which avoids any potential, perceived or actual conflicts of interest (eg, charge a flat rate for all virtual asset issuers).

(7) Trading rules

Unlike traditional exchange platforms, investors can directly access virtual asset trading platforms without engaging any licensed intermediaries through whom securities trades are typically conducted on behalf of the end clients.

As an additional safeguard to ensure that investors are fully informed about how a virtual asset trading platform operates, a Platform Operator should prepare and

¹⁶ This refers to an attack on a blockchain by a group of miners controlling more than 50% of the network's mining hash rate or computing power.

publish on its website comprehensive trading rules governing its platform operations which should, at the minimum, cover the following areas:

- (a) trading and operational matters;
- (b) different types of orders;
- (c) order execution methodology;
- (d) rules preventing market manipulative and abusive activities;
- (e) custodial arrangements;
- (f) deposit and withdrawal procedures, including the procedures for transferring virtual assets from the platform account to a user's private wallet and withdrawing fiat currencies to a user's bank account;
- (g) arrangements during trading suspensions and outages; and
- (h) a dispute resolution mechanism, including complaint procedures.

(8) Prevention of market manipulative and abusive activities

These activities include but are not limited to:

- (a) taking any action with the effect of creating a false or misleading appearance of: (i) active trading in, or (ii) with respect to the market for, or the price of, a virtual asset;
- (b) carrying out (or offering to carry out) one or more transactions with the effect of creating or maintaining an artificial price of a virtual asset;
- (c) carrying out (or offering to carry out) any transactions that do not involve a change in the beneficial ownership of a virtual asset with the effect of maintaining, increasing, reducing, stabilising or causing fluctuations in (ie, manipulating) the price of a virtual asset;
- (d) carrying out (or offering to carry out) any fictitious or artificial transaction or device with the effect of manipulating the price of a virtual asset;
- (e) disclosing information about the manipulation of the price of a virtual asset;
- (f) disclosing false or misleading information inducing transactions in a virtual asset; and
- (g) carrying out (or offering to carry out) two or more transactions which are likely to manipulate the price of a virtual asset with the intention to induce another person to trade, or refrain from trading in, the virtual asset.

To safeguard the fairness and integrity of the market, a Platform Operator should establish and implement written policies and procedures to identify, prevent and report malicious actors behind any market manipulative or abusive activities.

The SFC may further require a Platform Operator to adopt an effective market surveillance programme provided by a reputable and independent consultant to identify, monitor, detect and prevent any market manipulative or abusive activities on its platform.

(9) Employee dealings

A Platform Operator should establish and maintain written policies and procedures governing employees' dealings in virtual assets to eliminate, avoid, manage or disclose actual or potential conflicts of interest which may arise from such dealings.

Where employees of a Platform Operator are permitted to deal in virtual assets for their own accounts, the written policy should specify the conditions under which employees may deal for their own account (in particular, those who possess inside information should be prohibited from dealing in the relevant virtual asset). Employees should also be required to identify virtual asset holdings in their own accounts and related or associates' accounts, and report the same to senior management.

(10) Proprietary trading

Orders of clients in virtual assets should have priority over orders for the account of the Platform Operator, or any accounts in which the Platform Operator has an interest or the accounts of any employees or agents of the Platform Operator.

(11) Segregation and custody of clients' money and virtual assets

As an intermediary, a Platform Operator is required to comply with the Securities and Futures (Client Money) Rules (Cap.571I), including the requirement to establish and maintain in Hong Kong one or more segregated accounts for client money in a designated trust account or client account.

Where a Platform Operator holds virtual assets on behalf of its clients, it should ensure that clients' virtual assets, whether they are "*securities*" or not, are held in a segregated account which is designated as a client account and established by the Platform Operator for the purpose of holding virtual assets on behalf of clients only.

A Platform Operator is expected to store a sizable amount (for example, 98%) of clients' virtual assets which are not required to be immediately available in cold storage to minimise exposure to losses arising from a system compromise or hacking.

(12) Ongoing reporting obligations

A Platform Operator will be under closer supervision by the SFC and may be required to submit certain information on a regular basis (as specified by the SFC), for example:

- (a) any changes in the scope and details of its services, eg, the provision of token underwriting services in addition to trading services;
- (b) details of any new virtual assets that it intends to admit to trading on its platform;
- (c) the monthly volume of virtual asset transactions conducted through the Platform Operator (whether on- or off-platform), with a breakdown by types of virtual asset (as specified by the SFC) traded by investors;
- (d) identities and locations of its clients as at the end of the relevant month; and
- (e) other statistics on trading, clearing and settlement activities, as applicable, in Hong Kong.

Interested parties should contact the Fintech Contact Point at fintech@sfc.hk for discussion.

Intermediaries Division
Securities and Futures Commission