

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

End