

Fintech: Meeting the regulatory challenges

Keynote speech at Hong Kong FinTech Week 2018

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Good morning. I want to thank InvestHK for arranging this event once again and inviting me to speak.

I am a markets regulator, and so it will not surprise you to learn that today I want to talk about the regulatory response to the growing importance of financial technology (Fintech).

I am fully aware that many in the Fintech world see regulation as an unnecessary or unwelcome brake on innovation. But what I hope to do today is to calm some of these concerns. I will describe how we take a facilitative approach to innovation in the many instances where this is justified, but also how we adopt a far more cautious stance where we see serious risk. I will also preview some important announcements we will make about crypto assets.

It is obvious that the pace of change and innovation in financial services is unprecedented. We spend a lot of time and effort at the Securities and Futures Commission (SFC) tracking these developments to make sure regulation remains effective as new technologies are more widely adopted.

Among other things, we have set up channels to encourage communication with the market, including our Fintech Contact Point and a Fintech Advisory Group.

There is clearly an excellent case for adapting our rules so that technology can be used to provide a better customer experience, to increase financial inclusion or to make markets far more efficient and reliable. So we have worked hard to make sure that regulation keeps up with new business models.

This year, we implemented guidelines to help firms reduce hacking risks.¹ Some of these requirements were already implicit in our regulations, but the industry agreed that it would be helpful to consolidate and expand them into a set of specific, targeted rules.

Note: This is the text of the speech as drafted, which may differ from the delivered version.

¹ See [press release](#) dated 27 October 2017.

We also issued guidance on methods to verify client identities when opening accounts online², and on how firms can use instant messaging to take client orders³.

We also realised that firms which use new technologies may need to hire people with specialised tech expertise to oversee their operations. So we announced that we would consider this expertise as relevant industry experience for leaders at a Fintech firm to qualify as SFC regulated personnel.⁴

Other reforms are explicitly aimed at promoting the growth of online platforms to give investors more choice, convenience and flexibility. We now have specific guidance on automated or robo-advice and how suitability assessments can be applied in the online environment. This framework will take effect next April.⁵ In a sense, this is the securities market equivalent of the virtual banking initiative from the HKMA.

In fact, robo-advice is a great example of how Fintech simply requires regulators to adapt so it can thrive in a conventional regulated environment. With artificial intelligence or machine learning, we look at governance structures and risk management. Of course, we must hold management responsible should algorithms go awry. With firms now outsourcing a fair amount to unregulated technology and other service providers, we are already thinking hard about where responsibility should lie. This ranges from cloud computing through to post-trade services in the derivatives world.

Our rules are meant to be principles-based and technologically neutral. The challenge is how to apply consistent principles of investor protection and provide useful, detailed guidance on the use of innovative technology in this new, fast-moving environment. We, and other securities regulators around the globe, want Fintech to flourish in a way that promotes a high level of confidence for all who participate.

Virtual assets, or crypto-assets

However, one area in particular poses a very different set of issues: the emergence of crypto assets. I recently returned from a meeting of the IOSCO⁶ Board, which I chair. IOSCO is the association of securities regulators which acts as the global standard-setter.

You may not be surprised to hear that Fintech was at the very top of our meeting agenda. The single dominant risk identified by all of us concerned cryptocurrencies or crypto-assets, which I will also call virtual assets, for want of a better term. In fact, the potential conduct and market integrity risks of these assets is now one of IOSCO's top priorities.

A report by the Financial Stability Board (FSB) this summer concluded that, despite some concerns, virtual assets and platforms used to trade them did not - as yet - pose a threat to global economic or financial stability⁷. This was mainly because the size of the crypto market was still too small to have an impact on a global scale.

² See circular: [Online client onboarding](#), 12 Jul 2018.

³ See circular: [Receiving client orders through instant messaging](#), 4 May 2018.

⁴ See [Circular to clarify the "relevant industry experience" requirement for Responsible Officers under the Guidelines on Competence](#), 29 September 2017.

⁵ See [press release](#) dated 28 March 2018.

⁶ International Organization of Securities Commissions.

⁷ [Crypto-assets: Report to the G20 on the work of the FSB and standard-setting bodies](#), 16 July 2018.

However, the FSB also found that crypto-assets do give rise to significant investor or consumer protection concerns. This reflected an already emerging consensus among securities regulators that virtual assets require significant regulatory attention.

Some of the risks are inherent in the nature of the virtual assets themselves.

They have no intrinsic value and are generally not backed by physical assets. Not being guaranteed by any government, they are not currencies.

Nevertheless, over the past few years, some investors have taken an intense interest in this asset class. There are now hundreds of crypto assets and tokens and the total amount involved is reportedly in the hundreds of billions of US dollars.

One of many big questions is how to assess the value of virtual assets under current accounting frameworks. There are no agreed standards on how to obtain audit evidence for virtual assets or judge the reasonableness of valuations.

There are other particular risks which relate to the operations of crypto exchanges or trading platforms, as well as funds investing in crypto assets. These are activities of special interest to securities regulators as, superficially, these platforms seem to mimic conventional funds and stock exchanges.

For example, crypto exchanges may act both as agents for customers as well as principal dealers trading their own book. If they are not regulated, it would be difficult to detect and monitor the major conflicts of interest which then arise. Safe custody of virtual assets by trading platforms is another key concern, especially with the need to ensure that investors are protected from cybersecurity breaches, which have occurred with alarming frequency.

The market for virtual assets is still very young and trading rules may not be transparent and fair. Outages are not uncommon, as is market manipulation and abuse. There are also outright scams or frauds, as seen in many failed Initial Coin Offerings (ICOs).

Another challenge is that many virtual assets are traded anonymously, which immediately raises issues around money laundering and terrorist financing. Bitcoins have been used in illegal and fraudulent schemes. And unlike conventional exchanges, the public does not access these platforms through regulated brokers. Direct access implies additional vulnerabilities for consumers.

Anti-money laundering and counter-terrorist financing concerns were recognised at a recent meeting of the G20 Finance Ministers and Central Bank Governors, which called for the Financial Action Task Force (FATF) to clarify how its anti-money laundering standards apply to virtual assets. FATF has now announced the next steps.

Nonetheless, we must recognise that many people around the world do have an appetite for these assets. We do not know whether this interest will be sustained in the long term. But financial market regulators have to acknowledge that virtual assets, and the challenges they present, are now part of the landscape and are probably not going away any time soon. We therefore have an obvious interest in seeing the development of fair and efficient markets for these assets.

Responsible players in this industry also recognise that clear and effective regulation will be essential for them to establish the trust and legitimacy they need to make their businesses credible.

So far, individual regulators have responded to these risks in different ways depending largely on their different regulatory remits, the scale of crypto activities in their territories and whether virtual assets should be seen as financial products actually suitable for regulation.

One core issue for regulators is very simple. This is whether they actually have legal jurisdiction over crypto firms and activities. Some have decided that their current regulations already apply to those virtual assets which can be classified as securities, and have been active in this space. Others have found that they need to develop new legal frameworks. Others are adopting a wait and see approach.

The regulatory regime for virtual assets

In Hong Kong we now have a sizeable population of investors who have an interest in trading virtual assets through unregulated trading platforms. At the same time, there is a growing demand for funds which invest in virtual assets.

We do not have a lot of options here. We could rely on an interpretation of our remit as a narrow one, view the whole crypto world as unregulated and rely on investor education to warn the public of the risks. But maintaining the status quo may not be an option if in reality investors are left unprotected as crypto activities thrive.

As such, we recently decided to step up as much as we are able to protect investors who trade virtual assets. To that end, as I mentioned at the start, we will be making some significant regulatory announcements about crypto assets later today.

I will now explain our thinking.

First of all, it is important to understand that some crypto markets are not legally capable of being regulated by the SFC if the virtual assets involved fall outside the legal definition in Hong Kong of “securities” or “futures contracts”⁸.

Even within this constraint, we have already set out our regulatory stance in a number of statements and circulars. We made it clear that where a virtual asset clearly falls under the definition of “securities” or “futures contracts”, it can still be subject to our rules. And we have told our licensees that they must notify us if they intend to provide services involving virtual assets.

We have also intervened in several cases – mainly ICOs – where the activities of firms or individuals may have breached our rules. We provided regulatory guidance or issued a warning and in some cases took formal regulatory action.

However, if a fund solely invests in virtual assets which themselves are not currently subject to SFC regulation, not being securities, then the management of that fund will be outside the SFC’s regulatory perimeter too.

⁸ As defined in Part 1 to Schedule 1 of the Securities and Futures Ordinance.

Similarly, operators of platforms which only provide trading services for virtual assets not falling within the definition of “securities” are not regulated.

Recognising all of these limitations, we have been working hard to come up with a creative framework which should bring a significant number of these activities into our regulatory net for the first time.

Virtual asset portfolio managers and distributors

For funds, our starting point was the recognition that many Hong Kong investors gain exposure to virtual asset portfolios through fund managers or their distributors.

Later today, the SFC will issue a statement setting out the exact regulatory standards expected of virtual asset fund managers.⁹ In essence, all those supervised by the SFC intending to invest more than 10% of a mixed portfolio in virtual assets will need to observe new requirements targeting crypto assets, irrespective of whether they amount to “securities” or “futures contracts”. To afford better protection, only professional investors should be allowed to participate for the time being. However, I should be clear that our reach will still not extend to managers of “pure” crypto funds.

We can fill this gap by looking at fund distribution. Today, we will also issue a circular on the expected standards when firms distribute virtual asset funds.¹⁰

These firms are required to be registered with or licensed by the SFC as brokers. As such, they already have to comply with our distribution requirements for all collective investment schemes, including suitability obligations. But today’s circular will, for the first time, provide specific guidance on the regulatory standards for the distribution of all funds with crypto-exposures.

The combined effect of these measures is that the management or distribution of crypto funds will be regulated in one way or another, so that investor interests will be protected either at the fund management level, at the distribution level, or both.

Exploring regulation of platform operators

Another section of the statement we are putting out today describes a new, exploratory approach to see how we might regulate virtual asset trading platforms or “crypto-exchanges”.

We have seen some of the world’s largest platforms set up in Hong Kong. However, unlike crypto asset funds, a significant part of their activities do not yet fall within the regulatory perimeter of the SFC or any other local regulator.

Nevertheless, given the serious investor protection issues at stake, we see a real need to examine how the SFC might regulate these platforms under our existing legal powers, but without resorting to new legislation. This is the part that requires us to be creative.

We are not yet sure that virtual asset trading platforms are in fact suitable for regulation. They are technically, structurally and qualitatively different from traditional stock and futures

⁹ The statement will be available on the [SFC website](#) on 1 November 2018.

¹⁰ The circular will be available on the [SFC website](#) on 1 November 2018.



exchanges. Our aim here is to explore how they *might* be regulated and then form a more definitive view after this exploratory stage.

One basic principle is that, to be regulated by the SFC, the standards of conduct, operational resilience and financial soundness expected of a platform operator should be the same as, if not higher, than those which apply to the automated trading platforms which we already supervise – such as dark pools. We also think that for the time being, they should only provide their services to professional investors, which is the same as what we will expect of virtual asset fund managers.

Today's statement sets out a conceptual framework for potential regulation which we hope may provide a pathway to compliance for those operators who have the willingness and the ability to stick to high standards.

Clearly, investors will benefit if those platforms who want to be supervised by us are set apart from the others.

This is essentially an opt-in approach for platform operators. Interested operators would first explore the conceptual framework with us in a strict, Sandbox environment. How the opt-in mechanism works as a technical matter will be explained in our release later today.

In the Sandbox stage, no formal regulatory approval will be given to an operator. We will discuss our expected standards and closely monitor the live operations of the platform in light of those standards.

It may be that, because of the characteristics of the underlying technology or platform business models, we ultimately conclude that the risks involved cannot be dealt with under the standards we would normally expect. In other words, that investor protection still cannot be ensured through conventional regulation.

For example, we are unsure at this stage whether platforms can satisfy our expected anti-money laundering standards. This is because anonymity is a core feature of blockchain, which is the underlying technology for virtual assets. We also need to be alive to the rapid evolution of the whole crypto industry as well as developments in the international regulatory community, including the work being done in IOSCO.

The exploration we will do in the SFC Regulatory Sandbox will be crucial to our understanding of the live operations of platform operators. In this way we can discover, with a high level of confidence, if it would be appropriate for them to be regulated by the SFC. If, and only if, we decide at the Sandbox stage that we should regulate, we would consider granting a licence. The platform would then be subject to intensive reporting and monitoring to ensure that strict internal controls operate as expected and investor interests are protected.

New financial technologies are already having a tremendous impact on our markets and the businesses we regulate. We need to be open to the benefits of innovation but we also need to stay vigilant about potential risks.



The jury is still out on whether virtual assets serve a useful social function and should be considered in the same bracket as more familiar financial assets. But it is clear that if we do regulate operators in the virtual asset space, we should hold them to the same standards as the rest of the financial system.

In my view it is far too early to attempt to change our laws to specifically cover the crypto world. This world moves too fast to be pinned down by a bespoke legal framework, an international consensus on standards is yet to emerge and there is still much to learn. In fact, our Sandbox approach to crypto exchanges will be part of the learning process.

As I said earlier, the type of Fintech which promotes financial inclusion and efficiency needs to be distinguished from emerging technologies whose value to society is yet to be proven. This is particularly so when these technologies raise potential financial stability concerns and pose immediate investor and consumer protection risks.

We hope the measures to be announced today in Hong Kong will encourage the responsible use of new technologies, influence the international debate and also provide investors with more choices and better outcomes.

Thank you.