SECURITIES AND FUTURES COMMISSION TO REGULATE VIRTUAL ASSET FUNDS

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Asia Investment Management Alert

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On November 1, 2018, the Securities and Futures Commission ("SFC") announced that, to improve investor protections, it will bring virtual asset funds under its regulatory purview.

In a statement on regulatory framework and the accompanying circular, the SFC provided additional clarity and guidance around virtual asset management, distribution of fund interests, and trading platforms, with the most notable announcements being:

1. **Investment in, distribution and management of virtual assets constitute regulated activities:** The SFC confirmed that funds that invest in and distribute virtual assets will trigger the licensing and registration requirements under the Securities and Futures Ordinance (Cap. 571) ("SFO") as a Type 1 regulated activity (dealing in securities), regardless of whether the underlying virtual assets constitute a "security" or a "futures contract" as defined under the SFO. Similarly, to the extent that firms that are licensed for Type 9 regulated activity (asset management) also manage portfolios that invest solely or partially (subject to a de minimis requirement) in virtual assets that do not constitute a "security" or a "futures contract" as defined under the SFO, such firms will also fall under the SFC's oversight. Hence, investment in, distribution of, and dealing in virtual assets may constitute a Type 9 and/or Type 1 regulated activity and will be held to a set of standards that the SFC has developed based on the existing regulatory requirements applicable to Type 9/Type 1 licensees.
2. **Additional requirements will be imposed on managers and distributors of virtual asset funds not authorized by the SFC:** Portfolio managers who manage virtual asset funds (subject to a de minimis requirement) should allow only professional investors as defined under the SFO to invest in those funds. Similarly, intermediaries who distribute virtual asset funds are required to target only professional investors. For managers who manage funds that are not authorized by the SFC, additional requirements that will be imposed by the SFC include maintaining a liquid capital of not less than HK$3million. For intermediaries who distribute such unauthorized funds, other additional requirements under the heightened standards include: concentration assessments (namely, the client's aggregate investment should be "reasonable" considering its net worth), heightened due diligence requirements, additional client disclosure requirements, and compliance and risk-management-related requirements.
3. **The SFC intends to launch an exploratory regulation program for virtual asset trading platforms:** The SFC stated that it intends to allow virtual asset trading platforms to opt in to a new regulatory exploratory program, under which the interested platform operators will be put into a SFC Regulatory Sandbox for a minimum period of 12 months. During the exploratory stage, the SFC will consider, among other things, the adequacy and effectiveness of the proposed regulatory framework, the operators' ability

to comply with the SFC regulatory standards, investors' interests, and international regulatory developments. At the end of the exploratory stage, the SFC stated that it may consider granting licenses to adequate operators with conditions that are likely to be based on those applicable to existing licensed providers of automated trading services. At the present stage, it is clear that licensed operators would be able to offer trading in virtual assets that fall under the SFO definition of "securities", but it is uncertain as to non-securities virtual assets.

The SFC has delivered a clear message that virtual asset funds are welcome in Hong Kong and that the SFC is willing to support the growth of this industry in a transparent, safe, and sustainable way. In addressing the media on this development, the CEO of the SFC indicated that the SFC hopes to encourage the responsible use of new technologies while also providing investors with more choices and better outcomes.

Compared to the blanket ban of digital currencies and initial coin offerings in China, the regulatory framework in Hong Kong offers a balanced approach taken by the SFC and renders Hong Kong an attractive regional alternative, especially to high-net-worth investors and more established virtual asset funds who are looking for further growth and expansion.

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