

HONG KONG CRYPTO REGULATION

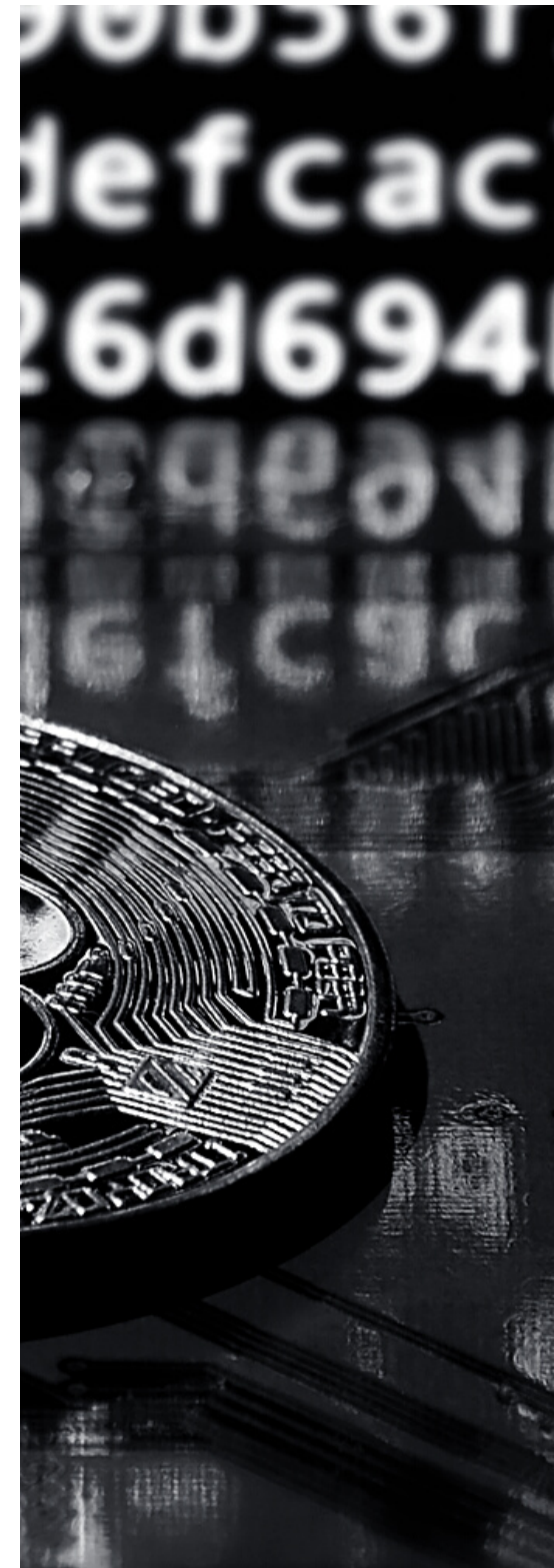
Webinar 2 - 15 January 2021

IMPLEMENTATION OF REVISED RECOMMENDATIONS

35 implemented regimes for VASPs

19 no regimes for VASPs

13 intend to regulate VASPs



TRAVEL RULE IMPLEMENTATION

- development of technological standards for use by different travel rule solutions
- several different travel rule solutions are being developed
- lower implementation / adoption of the travel rule when compared to other AML/CTF requirements



A GLOBAL VASP LIST?

PEER-TO-PEER TRANSACTIONS VIA PRIVATE/UNHOSTED WALLETS

- peer-to-peer transactions of virtual assets, without the use or involvement of a VASP or financial institution, are not explicitly subject to AML/CTF obligations under the revised FATF Recommendations



BATCH AND POST FACTO SUBMISSION AND PAST TRANSFERS

01

extent to which the batched data submission of transfers of originator and beneficiary data is permissible

02

whether the originator and beneficiary data could be submitted on a post facto basis

03

the extent to which beneficiary and originator data should be collected on past virtual asset transfers



INTER-OPERABILITY OF SYSTEMS

- development of global messaging standards is necessary
- inter-operability of different travel rule solutions may be impacted unless (i) sufficient flexibility is built into the messaging standards or (ii) solutions are being developed to accommodate the requirements of particular jurisdictions



SUNRISE ISSUE

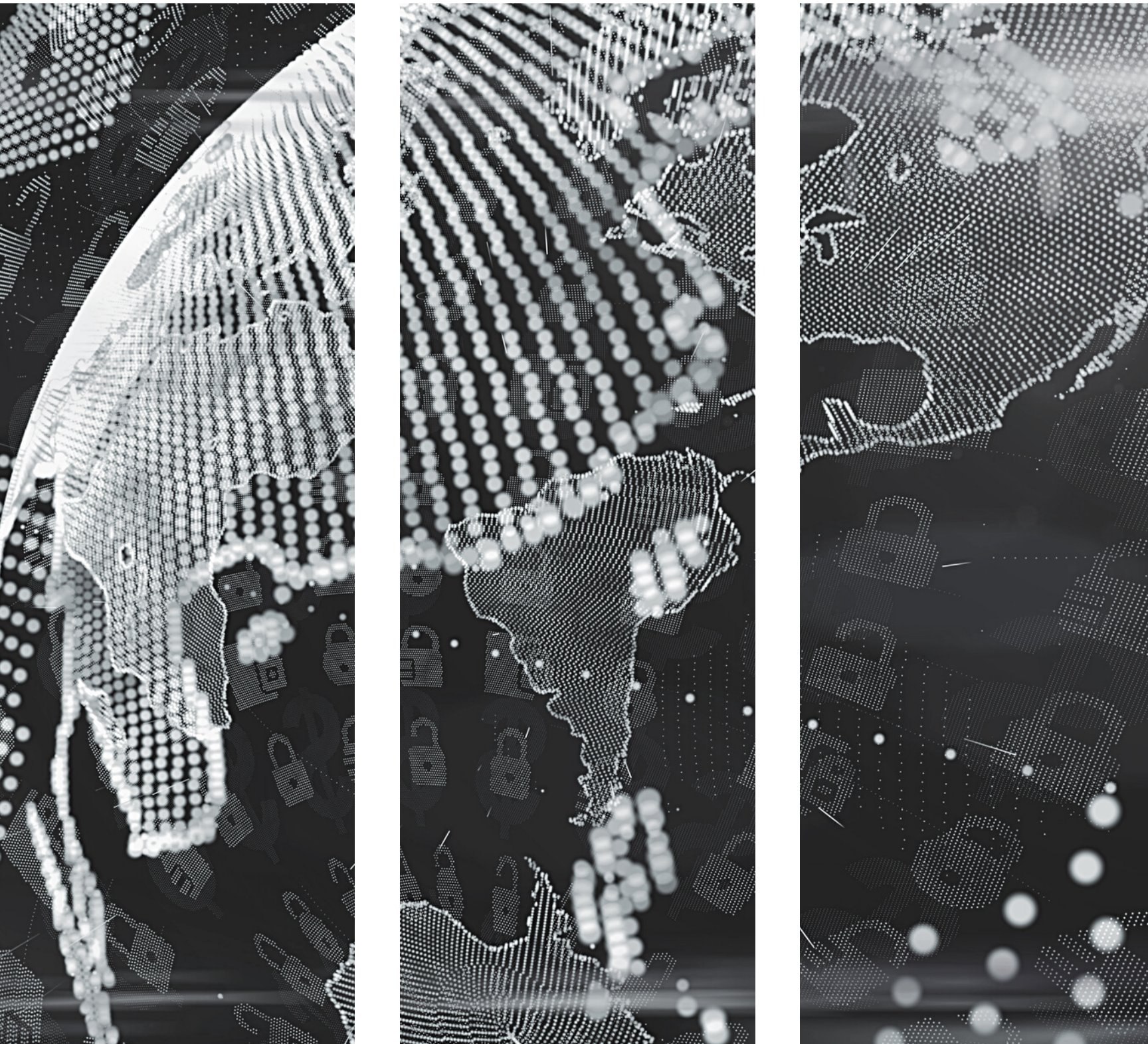
Lack of a global framework for travel rule compliance poses a challenge to VASPs

SPECIFIC WORDING ISSUES

"Legal Entity Identifier"

"Account number"

"Address of an originator"



IMPLEMENTATION OF OTHER AML/CFT OBLIGATIONS

- implementation of AML/CFT obligations globally is at an early stage
- many VASPs may be unfamiliar with the fundamentals of AML/CFT
- jurisdictions which have developed and imposed AML/CFT regimes on VASPs have reported improved overall compliance



HK CRYPTO REGULATION

- regulates entities conducting activities in cryptocurrencies where the relevant cryptocurrencies are "securities" or "futures contracts" as defined in the SFO
- intermediaries conducting regulated activities in relation to cryptocurrencies that are securities or futures contracts must be licensed or registered by the SFC and must comply with its AML/CFT requirements
- cryptocurrencies are not regulated by Hong Kong's other financial regulators

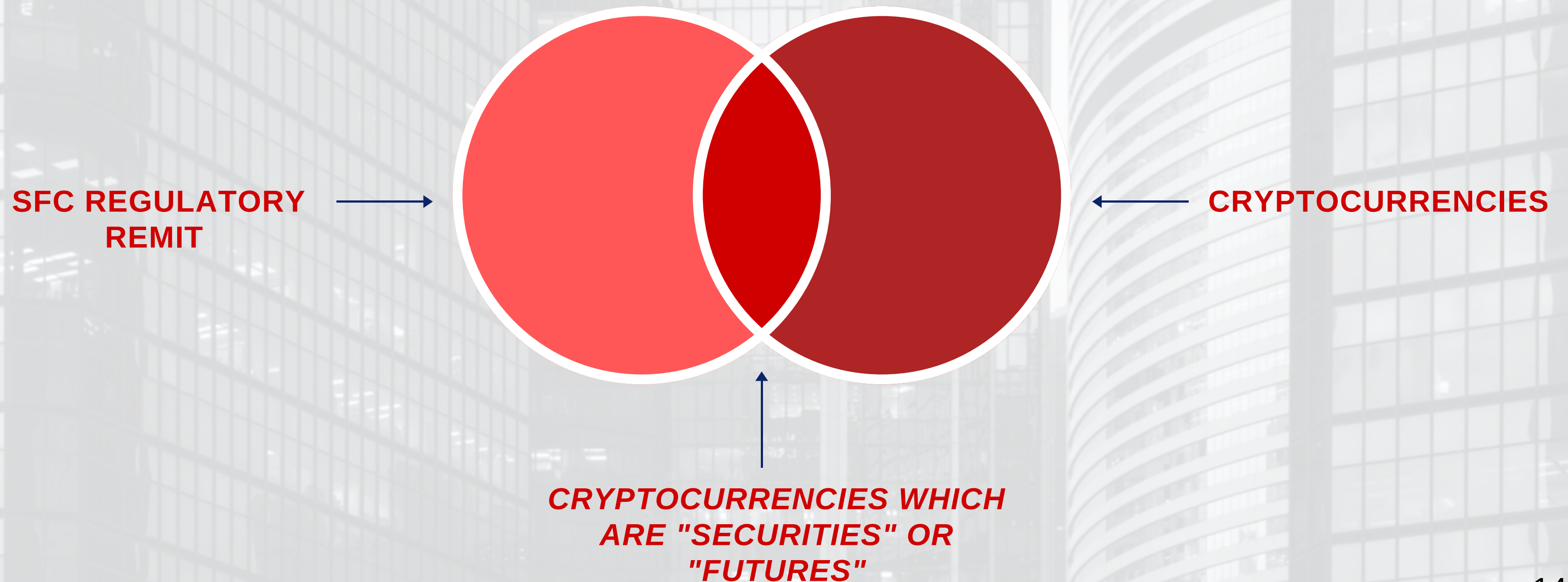
FSTB CONSULTATION

- 3 NOV 2020 - proposal to introduce a new licensing regime under the AMLO for virtual asset exchanges that are not required to be licensed under the SFO
- licensed exchanges will be required to comply with the AML and CTF obligations in Sch.2 to the AMLO
- the new regime would fulfil FATF's requirements for virtual asset exchanges

SFC REGULATORY STANDARDS

- NOV 2018 - SFC published new regulatory standards which apply to virtual asset portfolio managers and distributors of virtual asset funds that are already required to be licensed
- SFC invited virtual asset trading platforms and exchanges interested in becoming licensed to join the SFC Regulatory Sandbox

REGULATING AROUND THE EDGES





MANAGING ML/TF RISKS ASSOCIATED WITH VIRTUAL ASSETS AND VASPs

- HKMA Dec 2019 notice:
 - carry out appropriate risk assessments to differentiate the risks of each VASP
 - undertake additional customer due diligence
 - before introducing new banking or investment products, undertake ML/TF risk assessments and take appropriate measures to manage and mitigate the identified risks in accordance with the applicable legal and regulatory requirements

VA PORTFOLIO MANAGERS AND VA FUND DISTRIBUTORS

SFC imposes licensing on those already required to be licensed either because:

01 |

they also manage portfolios of traditional securities or futures contracts which requires an asset management licence; or

02 |

they distribute funds investing solely in non-SF virtual assets

firms distributing VA funds are required to comply with:

01 |

SFC regulatory framework for licensed corporations; and

02 |

additional requirements including extensive due diligence in relation to the virtual asset funds they distribute, their fund managers and counterparties



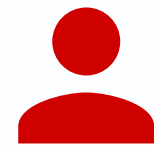
REGULATION OF MANAGERS OF FUNDS INVESTING IN CRYPTOCURRENCIES

- SFCs Regulatory Standards for Licensed Corporations Managing Virtual Asset Portfolios impose licensing conditions on Type 9 licensed fund managers which manage funds whose stated investment objective is to invest in crypto or which intend to invest 10%+ of their gross asset value in crypto
- conditions do not apply to:
 - (1) licensed corporations which only manage funds that invest in crypto funds (i.e. FoF); or
 - (2) licensed corporations managing portfolios whose mandate is to invest mainly in securities and/or futures contracts and investment in crypto exceeds 10% of their gross asset value only because of an increase in the prices of crypto held

(1) RESTRICTION TO PROFESSIONAL INVESTORS

- restricted to professional investors as defined in the SFO (including HNWs)
- must implement measures to ensure that the fund is only distributed to professional investors

(2) CUSTODIAN REQUIREMENT



must assess and select the most appropriate custodial arrangement, considering:

- ease of accessibility to crypto; and
- security of the custodial facility



must exercise due skill, care and diligence in selecting, appointing and conducting on-going monitoring of custodians by reference to:

- experience and track record
- regulatory status
- corporate governance structure and background of senior management
- financial resources and insurance coverage
- operational capabilities and arrangements

CUSTODIAN REQUIREMENT (CONT.)

where held by licensed fund manager itself, must:

- (a) document reasons for self-custody and disclose risks to investors
- (b) implement appropriate measures to protect fund assets and segregate crypto from own assets in event of its insolvency
- (c) use best endeavours to acquire and maintain insurance cover over the crypto



(3) PORTFOLIO VALUATION

- must select valuation principles, methodologies, models and policies which are reasonably appropriate in the circumstances and in the best interests of investors
- these must be disclosed to investors

(4) RISK MANAGEMENT

- must set appropriate limits for each product or market the fund invests in
- should consider using more than one custodian to hold the fund's assets
- periodic stress testing is required

(4) RISK MANAGEMENT (cont.)

before transacting with a crypto exchange, a licensed virtual fund manager must assess the reliability and integrity of the virtual asset exchange taking into account:

- experience and track record
- legal / regulatory status
- corporate governance structure
- operational capabilities
- mechanisms to guard against fraud and manipulation with respect to products traded on the exchange
- cybersecurity risk management measures
- financial resources and insurance cover

exposure to individual crypto exchanges must be capped





(5) AUDITORS

01 |

an independent auditor must be appointed to audit the financial statements of managed funds

02 |

must consider auditors' experience and capability in checking the existence and ownership of cryptocurrencies, and ascertaining the reasonableness of their valuation, in their selection of an auditor



(6) LIQUID CAPITAL

- licensed fund manager which holds crypto on behalf of the funds it manages must maintain liquid capital equal to the higher of HK\$3m or the amount of its variable required liquid capital

SFC LICENSED FIRMS



火币科技
Huobi Tech

REGULATION OF CRYPTO FUND DISTRIBUTORS

- a fund manager which only manages funds investing in cryptocurrencies that are not securities does not need to be licensed for Type 9
- the distribution of a fund will require the distributor to be licensed for Type 1
- a Type 9 licensed asset manager which also distributes the funds it manages may rely on the incidental exemption from the Type 1 licensing requirement



CIRCULAR TO INTERMEDIARIES ON THE DISTRIBUTION OF VIRTUAL ASSET FUNDS

01 | Licensed Corporations must:

ensure the reasonable suitability of any recommendation or solicitation made to a client under para. 5.2 of the Code

02 | Additional requirements for distributors of VA funds apply if:

the distributor knows, or should reasonably know, at the time it distributes the fund that the fund has invested 10%+ of its GAV in crypto, unless the fund manager informed it that it intends to reduce the fund's investment in crypto to below 10% in the near future

(1) SELLING RESTRICTIONS

- a distributor can only target professional investors as defined under the SFO
- distributor must assess whether its clients have knowledge of investing in cryptocurrencies or related products before effecting a transaction on their behalf
- transaction can only be executed for a client without such knowledge if it would be in the best interests of the client



(2) CONCENTRATION ASSESSMENTS

licensed corporations must consider the aggregate amount to be invested by a client in VA funds to be reasonable given the client's net worth

(3) DUE DILIGENCE ON CRYPTO FUNDS

must conduct extensive DD on crypto funds, fund managers and parties providing trading and custodian services to the funds



DUE DILIGENCE: FUND MANAGER

01

background and relevant
experience and track record of
senior management

02

regulatory status, compliance
history and internal controls and
systems

03

IT infrastructure, risk management
procedures, liquidity risk
management policy and disaster
recovery plan

DUE DILIGENCE: THE FUND

- 01 | fund's targeted investors
- 02 | instruments fund intends to trade / invest in and any limitations on the size of its holding of ICO tokens, pre-ICO tokens or other illiquid or hard-to-value instruments
- 03 | valuation policy
- 04 | custody arrangement for the fund assets, including policy on allocation of assets to be kept at different host locations



DUE DILIGENCE: THE FUND

05 | use of leverage and derivatives

06 | targeted risk and return per annum

07 | key risks

08 | auditors and audited financial statements



DUE DILIGENCE: FUND'S COUNTERPARTIES

- 01** legal and regulatory status
- 02** experience and track record in dealing in crypto
- 03** robustness of IT systems and contingency plans
- 04** financial soundness and insurance coverage

(4) PROVISION OF INFORMATION TO CLIENTS

- continuing evolution of cryptocurrencies and how this may be affected by global regulatory developments
- price volatility
- potential for price manipulation on crypto exchanges or trading platforms
- lack of secondary markets for certain cryptocurrencies
- that most exchanges, trading platforms and custodians of cryptocurrencies are currently unregulated
- counterparty risk when effecting transactions with issuers, private buyers/sellers or through exchanges or trading platforms
- risk of loss

A hand holds a physical Bitcoin coin in the foreground. The coin features the Bitcoin symbol and the text 'BITCOIN: A PEER-TO-PEER ELECTRONIC CASH SYSTEM'. In the background, a laptop screen displays a blurred image of a website with numbers like '48,815.00' and '132,338'. The entire image is overlaid with a semi-transparent red filter.

MCQs

QUESTION 1

FATFs Travel Rule requires that VASPs must -



- A. Be able to identify when they are transacting with another VASP.
- B. Use a particular technology software to comply with the Travel Rule requirements.
- C. Work together to create a global VASP list.
- D. Not transact with VASPs located in jurisdictions without the travel rule.



QUESTION 2

The SFCs licensing requirements do not apply to which of the following?

- A. A firm which distributes funds which invest in virtual assets (whether or not they are securities).
- B. A firm which manages funds that invest in virtual assets which are securities or futures.
- C. An exchange which offers trading in at least one security token.
-  D. An exchange which provides trading services in virtual assets such as Bitcoin.



QUESTION 3

Which of the following is false with respect to the regulation of firms distributing virtual asset funds in Hong Kong?

A. Firms distributing virtual asset funds must comply with the SFC Code of Conduct.




B. A firm which distributes funds investing solely in virtual assets which are not securities, does not require a securities dealer licence (Type 1).

C. A Type 9-licensed asset manager which also distributes the funds it manages can rely on the incidental exemption from the Type 1 licensing requirement.

D. A firm which only distributes funds which invest solely in virtual assets which are not securities is not required to be licensed as an asset manager (Type 4).

QUESTION 4

Which of the following is not an obligation on licensed corporations with respect to safeguarding assets?

- A. Assess and select the most appropriate custodial arrangement.
- B. Exercise due skill, care and diligence in selecting, appointing and conducting on-going monitoring of custodians.
-  C. Ensure that virtual assets are entrusted to a third-party custodian.
- D. In the case of self-custody, use best endeavours to acquire and maintain insurance cover over the virtual assets.

QUESTION 5

Which of the following is false?



- A. Licensed corporations must conduct extensive due diligence on non-SFC authorised virtual asset funds, their fund managers and counterparties.
- B. Type 9 asset managers which also distribute funds under their management which invest in virtual assets must also be licensed/registered for Type 1.
- C. Intermediaries must consider whether the aggregate amount to be invested by a client in virtual assets funds is reasonable given the client's net worth.
- D. Virtual asset fund distributors may only target professional investors as defined under the SFO.



Q&A