

# HONG KONG CRYPTO REGULATION

Webinar 3 - 22 January 2021



The SFC will determine the regulatory status of ICO tokens on a case-by-case basis depending on whether they carry rights equivalent to traditional securities, for example:

- 01 |** they carry rights similar to those provided by shares, such as a right to a portion of the issuing company's profits or surplus assets on winding up;
- 02 |** they have rights similar to debentures such as a right to repayment of the purchase price;
- 03 |** they are similar in nature to an interest in a CIS where the purchase price will be invested in assets or projects and any return will be distributed to the holders.

An aerial photograph of the Hong Kong skyline, featuring numerous skyscrapers and the Victoria Harbour. The word "ICOs" is overlaid in large, white, sans-serif font on the right side of the image.

# ICOs



# DEFINITION OF A CIS

- 01 it must involve an arrangement in respect of property;
- 02 the participants do not have day-to-day control over the management of the property;
- 03 the property must be managed as a whole by or on behalf of the persons operating the arrangements, and/or the participants' contributions and the profits/income are pooled; and
- 04 the purpose of the arrangement should be to provide participants with profits, income or other returns from the acquisition or management of the property.





# ICOs IN HONG KONG

FEB 2018

SFC statement suggesting that "utility tokens" are outside the scope of HK securities legislation

MAR 2018

SFC prevented Black Cell Tech Ltd's ICO being offered to the HK public on the basis that it may have been a CIS



# SECURITY TOKEN OFFERINGS

2017 - US\$22m raised

2018 - US\$442m raised

2019 - US\$452m raised

value of STO market expected to grow from  
US\$983m to US\$2.6bn by 2023





# SECURITY TOKEN OFFERINGS (CONT.)

- SFC March 2019 statement does not adapt or explain the concept of intermediary in the context of STOs
- FCA Jan 2019 Consultation Paper: employs the term "issuers of tokens" to cover entities including developers, designers, firms who issue tokens and certain intermediaries



- digital assets which have the features of traditional securities, including tokens which represent economic rights such as a share of profits or revenue and tokens with features of a debt
- SFC Mar 2019 statement: a token representing ownership of assets, such as gold or real estate, would amount to a security token
- depending on how the tokens are structured, tokens representing an underlying asset could constitute regulated investment agreements or structured products subject to HK securities law

## WHAT DOES THE SFC CONSIDER TO BE A SECURITY TOKEN?





# STRUCTURED PRODUCTS

any product where all or part of the return or amount due (or both) or the settlement method, is determined by reference to:

- changes in the price, value or level of securities, commodities, indices, property, interest rates, currency exchange rates or futures contracts, or any combination or basket of any of these; or
- the occurrence or non-occurrence of any specified event(s) other than an event relating only to the issuer and/or guarantor of the product



# REGULATED INVESTMENT AGREEMENTS

agreements whose purpose or effect is to provide to any party to the agreement a profit, income or other return calculated by reference to changes in the value of any property



# REGULATORY IMPLICATIONS OF STOs BEING SECURITIES

an offer of securities tokens  
only to professional investors

exempt from the requirement for SFC authorisation of any advertisement or invitation issued in relation to an offer of securities (under s.103 SFO) where the security tokens are offered to the Hong Kong public

where STO tokens are interests in a CIS, restricting the offer to professionals will mean that the requirements of SFC's Code on Unit trusts and Mutual Funds do not apply.





# LICENSING REQUIREMENTS FOR INTERMEDIARIES

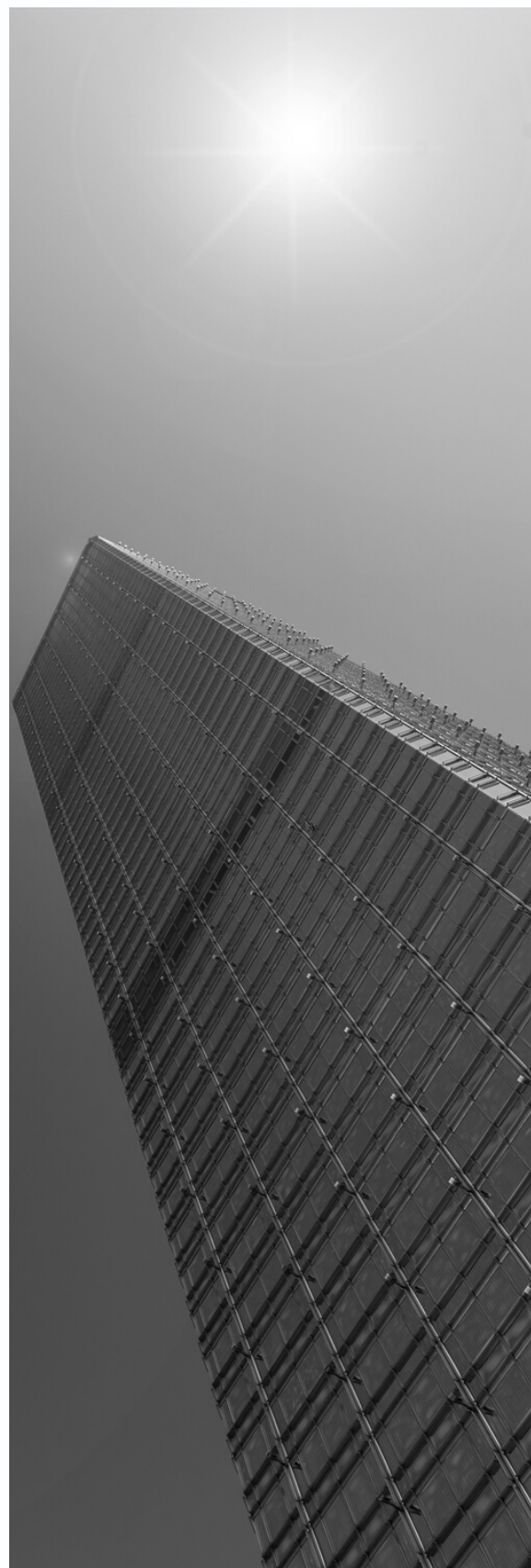
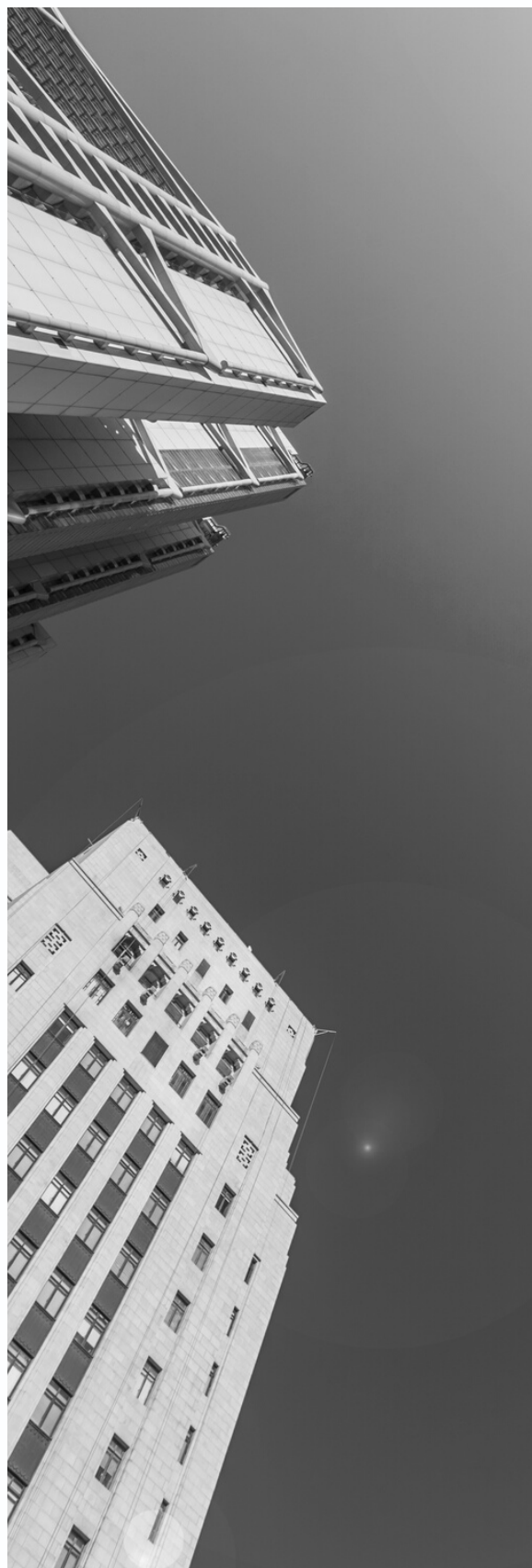
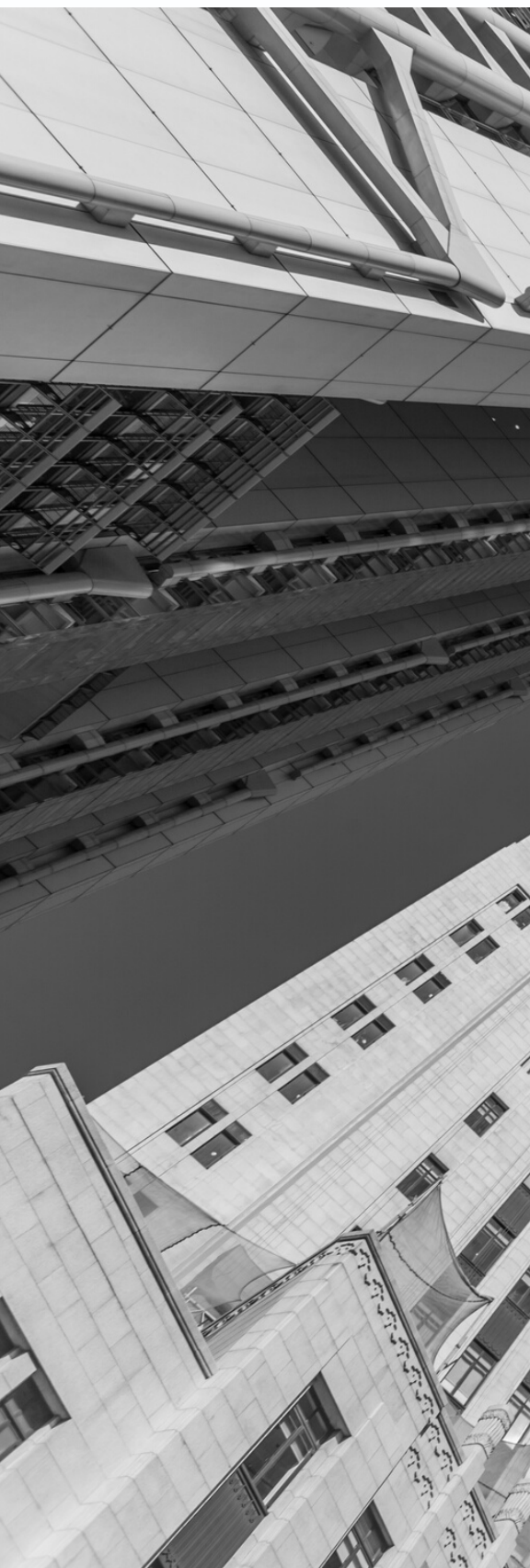
- any intermediary which markets and distributes security tokens must be licensed or registered by the SFC for Type 1 (dealing in securities) regulated activity
- each of its staff members involved in their marketing must be a Type 1 licensed representative accredited to the Type 1 licensed entity



# CONDUCT REQUIREMENTS FOR LICENSED INTERMEDIARIES

- must comply with the conduct provisions of the SFC's Code of Conduct
  - para. 5.2 - ensure that customer recommendations and solicitations with respect to security tokens are reasonably suitable for the particular customer, given the information about the particular customer of which the intermediary is or should be aware of through the conduct of due diligence
- must refer to the SFC's Suitability FAQs and FAQs on Triggering the Suitability Obligations
- under an obligation to conduct customer DD and AML checks





# COMPLEX PRODUCTS

STOs are "complex products" under para. 5.5 of the SFC Code of Conduct

(1) security token must be suitable for the client in all the circumstances;

(2) client must be provided with sufficient information on the key nature, features and risks of the security token to understand it before making an investment decision; and

(3) the client must be provided with clear warning statements about the security token's distribution



**01** background and financial soundness of the management, development team and issuer of the security token; and

**02** existence of and rights attached to any assets backing the security token

**03** study whitepapers and all relevant marketing materials and other published information

**04** ensure information provided to customers is accurate and not misleading

## **INTERMEDIARIES' DD OBLIGATIONS**





## **Information to be provided to customers**

must provide customers with clear and comprehensible information on STOs

## **Requirement to notify the SFC before dealing in security tokens**

intermediaries must notify the SFC prior to conducting any business in security tokens



# SHORTCOMINGS OF SFC REGULATORY APPROACH

**01** investor protection measures of the Code of Conduct only apply where a traditional intermediary is involved

**02** Code of Conduct does not apply to issuers of securities

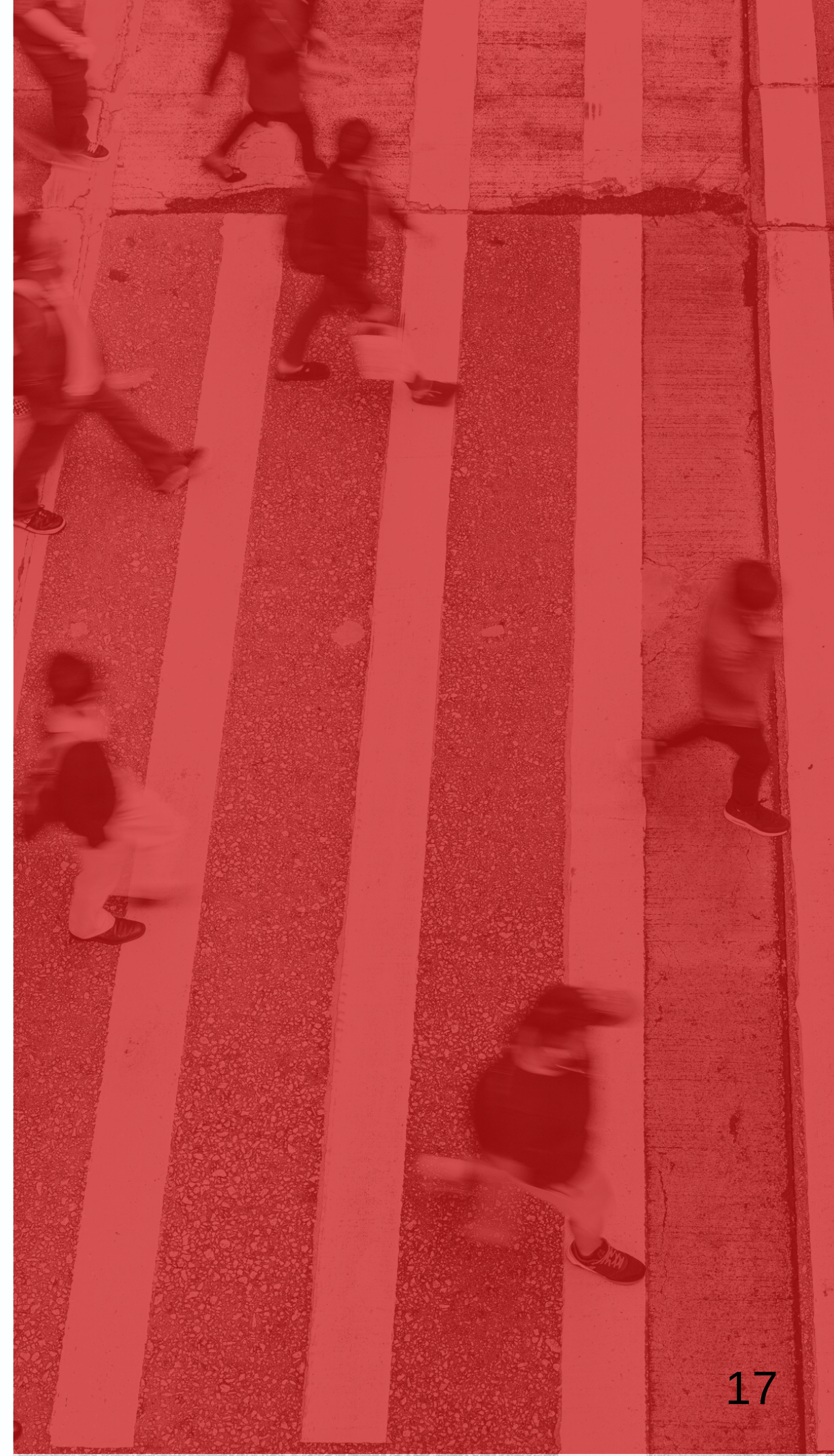
**03** token issuers / designers / developers based offshore are not caught by the SFC's regulatory remit

**04** Code of Conduct requirements only apply where a HK SFC-licensed/registered intermediary is engaged to market tokens to HK investors



# FRAMEWORK FOR REGULATION OF VA PLATFORM OPERATORS

- SFC will regulate trading platforms operating in Hong Kong only if they trade at least one cryptocurrency which is a security
- AMLO only applies to financial institutions, SFC-licensed corporations, licensed insurance companies, SVF issuers and money service operators and DBFBPs
- Crypto exchanges which trade at least one cryptocurrency which is a security are required to be licensed by the SFC and are subject to the AMLO's requirements
- Financial Secretary's 2020-2021 budget speech - Hong Kong to consider extending the AML/CFT requirements to cover crypto currency service providers
- FSTB Nov 2020 - consultation on proposed licensing regime for virtual asset exchanges under the AMLO







OSL





# LICENSING CONDITIONS

- restricted to providing services only to professional investors as defined in the SFO
- prior SFC approval required for offering a new service, changing an existing service or adding a product
- must provide the SFC with monthly reports on their business activities
- must engage an independent professional firm to conduct an annual review of their activities and prepare a report confirming compliance
- platform operator must comply with Terms and Conditions for Virtual Asset Trading Platform Operators



## TRUST STRUCTURE

- must hold client assets on trust and ensure that they are properly segregated from those of the platform operator
- any material legal uncertainties must be disclosed in full to clients
- the client assets must be held through a company which is incorporated in Hong Kong which is a wholly owned subsidiary of the licensed platform operator and holds a trust or company service provider licence



- must hold 98% of client cryptocurrencies in "cold wallets"
- must limit holdings of client virtual assets in "hot wallets" to no more than 2%
- must minimise transactions out of the cold wallet in which a majority of client cryptocurrencies are held
- must have adequate processes in place for handling requests for deposits and withdrawals of client cryptocurrencies to guard against loss arising from theft, fraud and other dishonest acts, professional misconduct or omissions

# HOT AND COLD WALLET STORAGE



# TERMS AND CONDITIONS (cont.)

## Insurance

- must have an insurance policy in place at all times covering risks associated with custody of cryptocurrencies held in both hot storage and cold storage

## Private Key Management

- must set up and implement strong internal controls and governance procedures for private key management





# KYC REQUIREMENTS FOR CRYPTO EXCHANGES

- licensed platform operators must take all reasonable steps to establish the true and full identity of each of their clients, client's financial situation, investment experience and investment objectives
- must ensure client has sufficient knowledge of cryptocurrencies (and risks) before providing any services to the client
- concentration risks are required to be assessed by setting a trading limit, position limit or both by reference to client's financial situation



- licensed platform operators must establish and implement adequate and appropriate AML/CFT policies, procedures and controls
- must regularly review the effectiveness of AML/CFT systems and effect appropriate enhancements
- should adjust AML/CFT policies and procedures to reflect requirements of FATF Recommendations applicable to crypto-related activities
- crypto tracking tools can also be used to trace transaction histories against a database of known addresses connected to criminal activities

# AML / CFT REQUIREMENTS



# PREVENTION OF MARKET MANIPULATION AND ABUSIVE ACTIVITIES

- must establish and implement written policies and controls for proper surveillance of activities on platforms to identify, prevent and report any market manipulation / abusive trading activities
- must adopt an effective market surveillance system and provide SFC access to perform its own surveillance





# ACCOUNTING AND AUDITING REQUIREMENTS

- must exercise due skill, care and diligence in selecting and appointing auditors



# RISK MANAGEMENT AND CONFLICT OF INTEREST IDENTIFICATION

- must have risk management framework which enables them to identify, measure, monitor and manage full range of risks arising from businesses / operations
- clients must pre-fund their own accounts
- licensed platforms cannot engage in proprietary trading or market-making activities on a proprietary basis
- must have policy governing employees' dealings in crypto to eliminate, avoid, manage or disclose actual or potential conflicts of interest



# CRYPTOCURRENCIES FOR TRADING

- Platform operator cannot offer or trade crypto futures contracts or crypto derivatives

**01** background of management / development team of issuer of the cryptocurrency

**02** whether the crypto can be traded under the SFO

**03** supply, demand, maturity and liquidity, market cap, average daily trading volumes, whether other platforms trade it, trading pairs, jurisdictions offered

**04** marketing materials must not be misleading

**05** development / outcomes of any associated projects and major incidents

**06** platforms can only trade crypto that are "securities" if they are asset-backed, approved or registered with regulators in comparable jurisdictions and have a track record of 12months+ since issue



# VIRTUAL ASSET FUTURES AND CME AND CBOE BITCOIN FUTURES

- trading platforms or persons which offer and/or provide trading services in virtual asset futures contracts without being licensed under the SFO may be in breach of the SFO
- virtual asset futures contracts may also constitute “contracts for differences” under the Gambling Ordinance which may be illegal unless authorised
- a Hong Kong entity which enables Hong Kong investors to trade Bitcoin futures contracts which are traded on the Chicago Mercantile Exchange (CME) or Chicago Board Options Exchange (CBOE), including by relaying or routing orders for these Bitcoin futures contracts, will need to be licensed by the SFC for Regulated Activity Type 2





# FSTB PROPOSALS

- Nov 2020 -FSTB proposal for new licensing regime for virtual asset exchanges under the AMLO
- will require any person seeking to conduct the regulated VA activity of operating a virtual asset exchange in Hong Kong to obtain a VASP licence
- proposed regime aims to implement the FATF requirement for jurisdictions to regulate VASPs for AML/CFT purposes and supervise their compliance



# SCOPE OF REGULATED ACTIVITY OF OPERATING A VIRTUAL ASSET EXCHANGE

## DEFINITION OF VA EXCHANGE

any trading platform which is operated for the purpose of allowing an offer or invitation to be made to buy or sell any virtual asset in exchange for any money or any virtual asset (whether of the same or a different type) and which comes into custody, control, power or possession of, or over, any money or any virtual asset at any point in time during its course of business.

## DEFINITION OF VIRTUAL ASSETS

a digital representation of value that: is expressed as a unit of account or a store of economic value; functions (or is intended to function) as a medium of exchange accepted by the public as payment for goods or services or for the discharge of a debt, or for investment purposes; and can be transferred, stored or traded electronically.



# VIRTUAL ASSET EXCHANGE - LICENSING REQUIREMENTS

- 01** must be a Hong Kong-incorporated company with a permanent place of business in Hong Kong
- 02** active marketing of a regulated VA activity or similar whether in Hong Kong or elsewhere to the public in Hong Kong without a VASP licence will be prohibited
- 03** must appoint at least 2 responsible officers
- 04** the licensing applicant, its responsible officers and the ultimate owners of the corporate entity must satisfy a fit-and-proper test



- 01 |** restrictions on providing trading services to professional investors only
- 02 |** minimum paid-up share capital requirement and, depending on the nature of the business, liquid asset requirement
- 03 |** proper governance structure
- 04 |** operate business in prudent and sound manner and ensure client and public interests are not adversely affected
- 05 |** appropriate risk management policies and procedures in place to manage ML/TF risks, cybersecurity and other risks



# OBLIGATIONS OF LICENSED VA EXCHANGES



# OBLIGATIONS OF LICENSED VA EXCHANGES (CONT.)

- 06** | ensure proper segregation of client assets and ensure policies and procedures are in place to ensure proper management and custody
- 07** | robust rules for the listing and trading of virtual assets on their platforms
- 08** | follow specific auditing and disclosure requirements and publish audited accounts
- 09** | proper surveillance of activities on the exchange
- 10** | prohibited from engaging in proprietary or market-making activities on a proprietary basis





# PROPOSED SFC POWERS

empowered to supervise the AML/CFT conduct of licensed VA exchanges

monitor, investigate and enforce their other obligations under the AMLO licensing regime

certain powers in relation to entering and inspecting premises and documents

empowered to impose administrative sanctions

intervention powers to impose restrictions and prohibitions on operations



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 interface with numbers like "8,815.00" and "132.33". The entire image is overlaid with a semi-transparent red filter.

**MCQs**



# QUESTION 1

Token proceeds of an ICO are managed collectively by the ICO scheme operator to invest in projects with the aim of enabling token holders to receive a share of the returns provided by the profits. In this case, the tokens may constitute



- A. Interests in a Collective Investment Scheme.
- B. Debentures.
- C. Utility tokens.
- D. Structured products.








## QUESTION 2

**Which of the following is FALSE with respect to security tokens and STOs in Hong Kong?**

- A. Security tokens are considered “complex products”.
- B. Security tokens are typically offered to professional investors.
-  C. There is an obligation on issuers of security tokens to ensure the accuracy of information in its marketing documents.
- D. Intermediaries marketing and distributing security tokens must be licensed or registered with the SFC for Type 1 (dealing in securities).



# QUESTION 3

**In which of the following scenarios would a crypto exchange be eligible to be licensed by the SFC under the existing framework?**

A. A trading platform which operates in Hong Kong and trades virtual assets for clients, including order routing, but does not provide automated trading services themselves.



B. A centralised trading platform which operates in Hong Kong and offers trading of security tokens, however its main business comprises trading of non-security tokens.

C. A centralised trading platform which operates in Hong Kong and only provides trading services in non-security tokens.

D. A. A platform which operates in Hong Kong provides a direct peer-to-peer marketplace for transactions by investors who typically retain control over their own assets.



# QUESTION 4

**Which of the following measures is a licensed crypto exchange expected to have in place to ensure the safe custody of crypto assets held on behalf of its clients?**



- A. Client assets must be held on trust.
- B. A majority of client virtual assets must be stored online.
- C. An insurance policy must be in effect at all times covering the risks associated with the custody of virtual assets held in hot storage only.
- D. All of the above.



# QUESTION 5

Which of the following statements about the FSTB's proposed licensing regime for Virtual Asset Service Providers is false?



- A. Hong Kong businesses which provide crypto wallets will be required to be licensed
- B. A crypto exchange which trades security tokens will not need to be licensed under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance
- C. The new licensing regime will require a crypto exchange to be licensed even if it only trades cryptocurrencies which are not “securities” under the SFO
- D. Crypto exchanges licensed under the new regime will be subject to the Anti-Money Laundering obligations of the Anti-Money Laundering and Counter-Terrorist Financing Ordinance





**Q&A**