Interpretation of Hong Kong's “Regulatory Exchange Position Paper”: Comprehensive Legislation Urgently Needed in the Field of Virtual Assets

At 5 pm on November 6, SFC issued the "Warnings on Virtual Asset Futures Contracts" (hereinafter referred to as "Warnings") and "Position Letters: Supervising Virtual Asset Trading Platforms" (hereinafter referred to as "Position Letters").

In the "Warning", SFC directly warns of the risks of virtual currency futures. SFC said that the prices of virtual assets under virtual asset futures contracts are extremely volatile, and the highly leveraged nature of virtual asset futures contracts has also doubled the risks faced by investors. The platform for selling or buying or selling virtual asset futures contracts involves market manipulation and illegal activities.

So far, no one in Hong Kong has been licensed by the SFC or authorized to sell or trade virtual asset futures contracts in Hong Kong.

In the Position Paper, SFC elaborated on their supervisory measures on virtual asset trading platforms. Among them are detailed rules such as asset custody, KYC certification, market manipulation, compliance supervision, accounting and auditing, professional investor thresholds, and anti-money laundering.

In this document, the regulatory experience of traditional transactions is borrowed to the new rules, which clarifies the direction about licensed institutions can only provide services to professional investors.

Hong Kong’s Ta Kung Pao columnist, “Chaineng Lecture Hall” column host, and senior researcher of Hong Kong International New Economic Research Institute, Tony Fu , said in an interview of ChainDD App“SFC has clearly seen that there are dozens of virtual asset trading platforms, and they may think that the regulatory requirements of the SFC are too onerous, and they would rather run a business that is completely unregulated. However, the SFC still issued this document from the perspective of protecting investors.”

At the Hong Kong FinTech Week meeting on the same day (November 6), the chief executive officer of SFC， Alder, said in a keynote speech that he would conduct comprehensive supervision of the virtual asset industry. In addition, he also emphasized that "our rules are neutral, and the challenge we face is how to implement investor protection provisions in a rapidly changing environment and provide useful and detailed guidance on innovative technologies."

Who is regulated?

The new rules apply to central virtual asset trading platforms where virtual assets operating and trading in Hong Kong include at least one security token. SFC stated that it does not supervise bitcoin, and only supervises trading securities token platform; Bitcoin and other common cryptocurrencies are not securities.

SFC has stated that they do not have the authority to license or regulate platforms that only trade non-secure virtual assets or tokens. Because such assets are not part of a "securities" or "futures contract" under the Securities and Futures Ordinance. In other words, only platforms that provide securities-type virtual assets or token transaction services to customers are under the supervision of the SFC. Even if only one type of token belongs to securities, they are also under the supervision of the SFC.

How to manage?

A year ago, on 1 November 2018. SFC has issued a "Conceptual Framework for the Supervision of Digital Currency Exchanges", which plans to distinguish between license holders and operators who do not intend to apply for a license.

During the year, SFC met with the exchange several times to discuss their business and regulatory requirements, and finally came up with a set of strict regulatory standards similar to those applicable to licensed securities dealers and automated trading venues.

This involves properly maintaining assets, knowing your customers (KYC), combating money laundering and terrorist financing, market manipulation, accounting and auditing, risk management, and more. And decided to issue licenses only to platforms that meet expected standards.

In the view of SFC, once a platform that chooses to include securities-type virtual assets or tokens in the trading scope is licensed, investors can easily distinguish between regulated and unregulated platforms. This is also a major feature of the new regulatory framework.

In addition, SFC also stated that even if the virtual asset trading platform is licensed and regulated by the SFC. Virtual assets bought and sold on the platform are not subject to any recognition or prospectus registration provisions applicable to the traditional sale of Securities or collective investment schemes. SFC has no other mandatory disclosure requirements applicable to non-security virtual asset offers.

SFC points out that even if the virtual assets bought and sold on a licensed platform are securities tokens, as long as the tokens are only sold to professional investors. They are not subject to Hong Kong's investment offer recognition process and prospectus registration system

It is worth noting that **once the operator of the virtual asset trading platform is licensed, it will be placed in the regulatory sandbox of the SFC. This means more frequent reporting, monitoring and inspection.** Through strict supervision, SFC will be able to highlight areas where operators should improve their internal controls and risk management.

Licensing and regulatory details

If you operate a virtual asset exchange in Hong Kong and provide at least one security token transaction on its platform, it will fall within the jurisdiction of the SFC and **must have Type 1 (Securities Trading) and Type 7 (Providing automated trading services) licenses for regulated activities** .

SFC requires that platform operators can **only provide their services to professional investors** and ensure that their clients fully understand virtual assets. They must also formulate strict inclusion criteria to screen virtual assets traded on their platforms.

Specifically, individuals: portfolios of $ 8 million or more; corporations and partnerships: portfolios of $ 8 million or more, or total assets of $ 40 million or more; trust corporations: total assets of $ 40 million or more.

For exchanges, SFC will require platform operators to **ensure that they store 98% of their customer's virtual assets in their offline wallets and limit their virtual assets held by customers to no more than 2%.** Exchanges should minimize the allocation of assets from offline wallets that hold most of their customers' virtual assets for trading.

In terms of the insurance coverage of the exchange, SFC will require platform operators to ensure that the insurance they purchase is valid at all times, and its protection scope should cover the risks involved in holding the customer's virtual assets through online storage (full protection), and custody of the risks involved in holding customers' virtual assets by offline storage (most protections, such as 95%).

In addition, SFC also listed a number of compliance requirements in the licensing conditions. For example: when adding related services and products, you must obtain the prior written approval of the SFC; submit a monthly report to the SFC; engage an independent professional company acceptable to the SFC to prepare reports on relevant laws and regulatory requirements. (For details, please refer to: speed reading of the "Highlights" of SFC)

Expert interpretation: Hong Kong's supervision of digital currencies and virtual assets has always been at the forefront of the world

Although it is only a position paper, this document can be described as insignificant, and even the hard fork or airdrop specific to virtual assets has also been supervised. It can be said that although the new regulatory regulations were born out of the traditional transaction supervision experience. However, it has adapted and updated the "virtual assets" as a new asset form, and has detailed requirements on funds custody, platform transactions, insurance, anti-money laundering, and KYC. Eventually, this regulatory document looked more stringent and comprehensive.

Hong Kong's "Ta Kung Pao" columnist, "Chaineng Lecture Hall" column host, and senior researcher of Hong Kong International New Economic Research Institute Tony Fu analyze the reasons to ChainDD App.

1. Protect investors. Hong Kong is a market dominated by institutional investors. It will ensure that the platform operators only provide services to professional investors and only to those who can prove that they have sufficient investment knowledge in this field. All licensed platforms must insure against the loss or theft of virtual assets. The related premiums can be very high.

2. Be open to innovation benefits. Virtual assets have already begun to enter traditional financial markets, and most have also been included in the existing securities regulatory scope. One typical example is Bitcoin futures, which are now offered by some well-known US exchanges.

3. The current situation is worrying. Cryptocurrency exchanges have proliferated to dozens in Hong Kong, and so far these platforms have largely not been regulated in any way. Because most virtual assets go beyond the legal definition of "securities" or "futures contracts."
He pointed out that the SFC already knew that even without the introduction of supervision, some exchanges had large-scale funds for investment. For existing large exchanges, this is a rare opportunity to legalize.

ChainDD App: What signals are passed?

Tony Fu: Hong Kong has indirectly recognized the way of securities token financing, and encourages the development of digital asset exchanges and STOs (security-based virtual asset tokens) with a trillion-dollar market size.

Major regulatory concerns related to safekeeping of assets, knowing your customers, combating money laundering and terrorist financing, market manipulation, accounting and auditing, risk management, conflicts of interest, and acceptance of virtual assets for trading. The SFC will only grant licenses to platforms that meet expected standards.

A licensed exchange must engage an independent professional company accepted by SFC to conduct an annual review of the licensee's exchange activities and operations, and compile a report confirming that it has complied with the licensing conditions and all relevant legal and regulatory requirements and Submit it to the Hong Kong Securities Regulatory Commission within the prescribed time limit.

The above draws heavily on the standards of Hong Kong's traditional securities brokers and automated trading systems. At the same time, there are some provisions specifically applicable to the technology on which the cryptocurrency industry is based, such as "airdrops" and "forks."

ChainDD App: For exchanges, it seems easier to avoid supervision than to make adjustments?

Tony Fu: Can't be lucky. As another thing announced today (November 6) that operating virtual asset trading platforms may be illegal. So far, no one has been licensed or authorized by the SFC to sell or trade virtual asset futures contracts in Hong Kong. Taking into account the risks currently involved in these contracts, in order to protect the majority of investors, it is unlikely that the SFC will grant licenses or approvals for the operations of the relevant contracts.

In Hong Kong, any trading platform or person who sells virtual asset futures contracts or provides trading services for virtual asset futures contracts without proper licenses or approvals may violate the Securities and Futures Ordinance (Cap.571) or the " Gambling Ordinance (Cap. 148). Anyone who violates the relevant provisions of the Securities and Futures Ordinance or the Gambling Ordinance may be prosecuted and, once convicted, criminal sanctions will apply.

Currently, there are many leveraged digital currency contract exchanges around the world. Licensed physical delivery, such as Bakkt, and licensed speculation, such as CME. And more are unlicensed (unregulated) digital currency contract exchanges. Among them, there are physical delivery, such as Coinflex, and speculation index, such as bitMex. People of insight, such as BitMex, have withdrawn from the Hong Kong market in April this year (announcing that they do not accept investors from Hong Kong).

ChainDD App: Does this framework provide a reference for regulatory programs in most countries? How do virtual assets develop?

Tony Fu: Hong Kong's capital market ranks among the top in the world in terms of the number of financial institutions, the size of financial professionals, the total value of assets under management, the number of IPOs, the issuance of other financial products, and the total number of private equity hedge funds registered. The supervision of Hong Kong's capital market is also at the forefront of the world.

According to the information disclosed in the position paper, this can only be a temporary measure. The rapid development of the field of virtual assets urgently requires new and comprehensive legislation. In other words, the status quo should force the relevant laws to adjust. As Hong Kong is a mature capital market, the amendments to its laws and regulations are also of reference significance to Mainland China.

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