

1 November 2018

Circular to intermediaries

Distribution of virtual asset funds

The Securities and Futures Commission (SFC) has observed investors' growing interest in funds which invest in "virtual assets"¹. This circular reminds intermediaries licensed or registered for (i) Type 1 regulated activity (dealing in securities) or (ii) Type 9 regulated activity (asset management) to the extent that these intermediaries are engaged in distributing virtual asset funds under their management about the existing regulatory requirements and provides guidance on the expected standards and practices in relation to the distribution of virtual asset funds.

Background

In recent years, the rise in the prices of some virtual assets has led to an increased demand for related investment products. The SFC's *Statement on regulatory framework for virtual asset portfolios managers, fund distributors and trading platform operators* describes the unique features and characteristics of virtual assets and outlines some of the risks associated with investing in them.

Under the Securities and Futures Ordinance (SFO), any person who carries on a business in the distribution of interests in a collective investment scheme in Hong Kong or to the Hong Kong public is required to be licensed or registered for Type 1 regulated activity (dealing in securities) unless an exemption applies². In this respect, the SFC would like to emphasise that the distribution of a fund which invests in virtual assets will also trigger this licensing or registration requirement, regardless of whether or not the underlying virtual assets constitute "securities" or a "futures contract" as defined in the SFO.

Distribution

Virtual asset funds

Intermediaries which distribute virtual asset funds, whether or not they are authorised³ by the SFC, are required to ensure compliance with, among other things, paragraph 5.2 of the Code of Conduct⁴ as supplemented by the Suitability FAQs⁵. Specifically, intermediaries should ensure that the recommendation or solicitation made is suitable for clients in all circumstances⁶.

¹ These include digital tokens (such as digital currencies, utility tokens or security or asset-backed tokens) and any other virtual commodities, crypto assets and other assets of essentially the same nature.

² For example, where a fund manager, which is licensed or registered for Type 9 regulated activity, also engages in marketing activities relating to those funds under its management, it may generally rely on the incidental exemption provided in paragraph (xiv) of the definition of "dealing in securities" under the SFO to be exempted from the requirement of being licensed or registered for Type 1 regulated activity.

³ This refers to funds authorised by the SFC under section 104 of the SFO.

⁴ The Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.

⁵ The Frequently Asked Questions on Compliance with Suitability Obligations by Licensed or Registered Persons and the Frequently Asked Questions on Triggering of Suitability Obligations.

⁶ In addition, intermediaries would also be required to comply with the Guidelines on Online Distribution and Advisory Platforms and paragraph 5.5 of the Code of Conduct which would come into effect in April 2019.

Virtual asset funds not authorised by the SFC

Intermediaries should observe the following additional requirements if they distribute virtual asset funds which are not authorised by the SFC and which have a stated investment objective to invest in virtual assets or intend to invest or have invested more than 10% of their gross asset value (GAV) in virtual assets⁷ directly or indirectly⁸.

(A) Selling restrictions and concentration assessments

1. Intermediaries should only target clients who are professional investors as defined under the SFO. Except for institutional professional investors⁹, intermediaries should assess whether clients have knowledge of investing in virtual assets or related products prior to effecting the transaction on their behalf. If the clients do not possess such knowledge, intermediaries may only proceed to effect the transaction if, by so doing, they would be acting in the best interests of the clients. Alternatively, intermediaries may take into account whether the clients have prior investment experience in private equity or venture capital or have provided capital for a start-up business in the past two years.
2. To avoid concentrated exposure to this nascent asset class, intermediaries should ensure that the aggregate amount to be invested by a client in virtual asset funds which are not authorised by the SFC is reasonable, as determined by the intermediaries, considering the client's net worth.

(B) Due diligence on virtual asset funds not authorised by the SFC

3. Intermediaries distributing these funds should conduct proper due diligence on virtual asset funds which are not authorised by the SFC as well as their fund managers and the parties which provide trading and custodian services to the funds. This should include, but is not limited to, scrutinising the fund's constitutive documents and due diligence questionnaire, as well as making enquiries with the fund manager, in order to develop an in-depth understanding of the following matters where applicable:

(a) About the fund manager

(i) General

- Its background, relevant experience and, where applicable, the track record of its senior management, including its chief investment, operation, risk and technology officers;
- Its regulatory status, for example, whether the fund manager is subject to any regulatory oversight and its robustness; and

⁷ This refers to funds which the intermediary knows, or should reasonably have known, to be investing more than 10% of its GAV in virtual assets at the time of distributing the fund, unless the intermediary has been advised that the fund manager intends to shortly reduce the fund's investment in virtual assets to below 10% of the fund's GAV.

⁸ This includes funds of funds and funds which invest in derivatives, for example, total return swaps, with virtual assets as underlying.

⁹ This refers to the specified entities set out in paragraphs (a) to (i) of the definition of "professional investor" in section 1 of Part 1 of Schedule 1 to the SFO.

- Its compliance history, for example, whether any disciplinary or regulatory actions have been taken against it by any regulatory authorities.

(ii) Operations

- Its internal controls and systems, for example:
 - whether there is proper segregation of key functions, such as portfolio management, risk management, valuation and custody of assets and, if not, whether there are any adequate compensating controls to prevent abuse;
 - the persons who can transfer assets from the fund or custodians and what safeguards are in place;
 - the persons responsible for, and the procedures for, reconciling transactions and positions, including the frequency at which such reconciliations are performed; and
 - the methodology and the persons responsible for determining the pricing and assessment of the reasonableness of the determined price of each virtual asset.

(iii) IT system

- Its IT infrastructure (for example, in terms of security and access management).

(iv) Risk management

- Its risk management procedures, including concentration limits, counterparty risk management procedures, stop-loss arrangements and stress testing;
- Its liquidity risk management policy; and
- Its disaster recovery plan.

(b) *About the fund*

- (i) The fund's targeted investors;
- (ii) The list of instruments the fund intends to trade or invest in and any limitations on the size of its holding in virtual assets issued by way of an initial coin offering (ICO Tokens), pre-ICO Tokens or other illiquid or hard-to-value instruments;

- (iii) The valuation policy (especially for ICO Tokens or pre-ICO Tokens or other illiquid or hard-to-value instruments) of the fund;
- (iv) The custody arrangement of the fund assets, including the policy on the allocation of assets to be kept at different host locations, such as exchanges, custodians, hot storage, cold storage;
- (v) The use of leverage and derivatives by the fund;
- (vi) The targeted risk and return per annum of the fund;
- (vii) The key risks of the fund (please refer to the "Information for clients" section for details); and
- (viii) The auditors and audited financial statements of the fund, including whether the fund received a qualified audit opinion in the past, and whether the audited statements are up-to-date.

(c) *About counterparties of the fund*

- (i) Their legal and regulatory status (ie, whether they are regulated by any authorities to, among other things, undertake custody business or trade in virtual assets);
- (ii) Their experience and track record in dealing with virtual assets;
- (iii) The robustness of their IT systems (including cybersecurity risk management measures) and contingency plans; and
- (iv) Their financial soundness and insurance coverage, for example, insurance to cover losses of customer assets.

(C) Information for clients

4. To help clients make informed investment decisions, intermediaries should provide the following information in relation to the fund as well as the underlying virtual asset investments in a clear and easily comprehensible manner. Intermediaries should also provide prominent warning statements covering, among other things:

- (a) Continuing evolution of virtual assets and how this may be affected by global regulatory developments;
- (b) Price volatility;
- (c) Potential price manipulation on exchanges or trading platforms;
- (d) Lack of secondary markets for certain virtual assets;
- (e) Most exchanges, trading platforms and custodians of virtual assets are presently unregulated;



- (f) Counterparty risk when effecting transactions with issuers, private buyers/sellers or through exchanges or trading platforms;
- (g) Risk of loss of virtual assets, especially if held in “hot wallets”¹⁰; and
- (h) Cybersecurity and technology-related risks.

Intermediaries are reminded to implement adequate systems and controls to ensure compliance with the abovementioned requirements before they engage in the distribution of virtual asset funds. Failure to do so may affect their fitness and properness to remain licensed or registered and may result in disciplinary action by the SFC.

Should you have any queries regarding this circular, please contact Ms Seine Luk at 2231 1696.

Intermediaries Supervision Department
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End

SFO/IS/061/2018

¹⁰ A “hot wallet” refers to the wallet used for holding virtual assets in an online environment which provides an interface with the internet, which is more susceptible to cyber-attacks.