

Client Alert

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Hong Kong unveils licensing conditions for managers of virtual assets portfolios

On 4 October 2019, Hong Kong's Securities and Futures Commission (SFC) published the *Proforma Terms and Conditions for Licensed Corporations which Manage Portfolios that Invest in Virtual Assets* ("**VA Terms and Conditions**"). These VA Terms and Conditions set out the principles and requirements to be observed by SFC licensed corporations when managing portfolios (or portions of portfolios) that invest in "virtual assets"¹ and meet a *de minimis* threshold (as described below).

Background

A broad outline of the VA Terms and Conditions was introduced on 1 November 2018 in the SFC's *Regulatory Standards for Licensed Corporations Managing Virtual Asset Portfolios*, which formed part of the measures developed by the SFC to protect the interests of investors in virtual asset portfolios or funds. An overview of this framework is set out in our client alert [The Dawn of Virtual Assets Regulations: New measures for crypto funds activities, Sandbox plans for crypto-exchanges](#).

The VA Terms and Conditions are largely principles-based. They substantially replicate the existing regulatory requirements applicable to licensed/registered intermediaries (asset managers) under the *Fund Manager Code of Conduct* (FMCC), with variations to address the specific business models of virtual assets portfolio managers and the unique features and risks associated with virtual assets. The VA Terms and Conditions will be imposed on applicable managers in the form of a licensing condition.

Scope of Application

Applicable Fund Managers

The VA Terms and Conditions are imposed on licensed corporations ("**VA Fund Managers**") which manage a fund (or portion of a fund) that invests in virtual assets, where the fund has (i) a stated investment objective to invest in virtual assets or (ii) an intention to invest 10% or more of the gross asset value (GAV) of the portfolio in virtual assets ("**de minimis threshold**").

The VA Terms and Conditions do not specify the type of regulated activity for which a VA Fund Manager should be licensed/registered - they may be imposed on any licensed corporation managing virtual assets funds which meet the preconditions above. Notably, their application is not confined to Type 9 asset managers (who, generally speaking, are already subject to the requirements under the FMCC). Please also be reminded that intermediaries which intend to provide trading and asset management services involving crypto-assets are expected to notify the SFC under the *Securities and*

¹ The SFC describes "virtual assets" as digital representations of value which may be in the form of 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, regardless of whether they amount to "securities" or "futures contracts" as defined under the SFO.



Futures (Licensing and Registration) (Information) Rules, as this will be regarded as a significant change to their business or service.

Excluded Fund Manager

The VA Terms and Conditions do *not* apply to licensed corporations which manage portfolios whose mandate is to mainly invest in securities, futures contracts or both with no intention to invest 10% or more of its GVA in virtual assets, but the investment in virtual assets exceeds the de minimis threshold of 10% GAV due to the increase in the prices of the virtual assets held in the fund (provided that reasonably practical steps are taken to reduce the proportion to below the de minimis threshold in a timely manner).

Failure to Comply with VA Terms and Conditions

If a licence applicant does not agree to comply with the VA Terms and Conditions, its licensing application will be rejected. Similarly, if an existing licensed corporation with a virtual assets portfolio that meets the de minimis threshold does not agree to comply with the VA Terms and Conditions, it will be required to unwind that portfolio within a reasonable period of time.

A breach of the VA Terms and Conditions is likely to be considered as misconduct under the *Securities and Futures Ordinance* (SFO) and may call into question a VA Fund Manager's fitness and properness to remain licensed/registered, which may result in disciplinary action by the SFC. Notwithstanding, the SFC has specified that it will adopt a pragmatic approach, taking into account all relevant circumstances, including the size of the VA Fund Manager, and any compensatory measures implemented by its senior management.

VA Terms and Conditions

A summary of the key conditions that may apply to a VA Fund Manager (depending on its role and the operation/strategy of the fund) is set out below.

Fund manager responsible for the overall operation of the fund

The concept of a "fund manager responsible for the overall operation of the fund" was first introduced in the revised FMCC, and has been replicated in the VA Terms and Conditions. Essentially, the SFC's intention is to capture fund managers who, in substance, are responsible for the day-to-day operation and management of the fund. The SFC has issued guidance in the form of FAQs to illustrate whether a fund manager may be considered to be responsible for the overall operation of a fund, and it can be assumed that such guidance will apply equally to VA Fund Managers under the VA Terms and Conditions. Please refer to our previous client alert "[Fund Managers: Are You Prepared for Hong Kong's New Fund Management Regulations?](#)" for a more detailed discussion on this matter.

Organisation and Management Structure

The VA Terms and Conditions set out similar requirements relating to the VA Fund Manager's organisation and structure as the FMCC, including those dealing with its segregation of duties, conflicts of interest, senior management responsibilities, risk management policies and procedures, anti-money laundering measures, audit function and delegation principles.



Notably, VA Fund Managers are required to maintain at all times liquid capital of HK\$3 million, or its variable required capital (whichever is higher) if the VA Fund Managers hold virtual assets on behalf of the funds it manages, even if the virtual assets do not constitute “securities” or “futures contracts” under the SFO (“**non-SFC virtual assets**”). This requirement is based on the current requirements in the *Securities and Futures (Financial Resources) Rules* in relation to the holding of client assets.

A VA Fund Manager should take all reasonable measures to ensure that proper safeguards exist to mitigate the risks of money laundering and terrorist financing, especially in respect of subscriptions made by fund investors using virtual assets. In particular, a VA Fund Manager should comply with the *Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (For Licensed Corporations)* as if it were conducting a regulated activity, even if the funds under its management invest in non-SF virtual assets.

Virtual Asset Fund Management

Similar to the FMCC, the VA Terms and Conditions contain a number of requirements relating to the management of the funds, including best execution policies, procedures to prohibit and prevent market misconduct, order allocation, fund portfolio turnover, underwriting activities, participation in initial coin offerings, transactions with Connected Persons, sale and purchase transactions between fund accounts (cross trades) and policies dealing with house accounts, day-to-day business operations, leverage and termination.

Of particular relevance to virtual assets are the requirements relating to the expected risk management control techniques and procedures to address market, liquidity, counterparty and operational and cybersecurity risks. In relation to the management of counterparty risk, the SFC notes that the hacking of virtual asset exchanges is not uncommon, and licensed corporations are therefore expected to implement additional procedures to assess the reliability and integrity of virtual asset exchanges before transacting with them. The VA Fund Manager must also set appropriate limits in respect of (i) the product and market in which the portfolios invest; (ii) the counterparty to which the portfolios have exposure; and (iii) exposure to individual virtual asset exchanges.

Custody

A VA Fund Manager must ensure that any fund assets entrusted to it are accounted for properly and promptly and adequately safeguarded. While many of the basic requirements relating to the custodial arrangements are based on those in the FMCC, including the selection and appointment of a custodian, self-custody arrangements, custody agreement terms, investor disclosures and continuous monitoring requirements, the VA Terms and Conditions also contain a number of new requirements specific to virtual assets. These include:

- implementing adequate processes and controls when creating new accounts with trading platforms and custodians; whitelisting new IP and wallet addresses at trading platforms and custodians; and effecting transfer of assets between trading platforms, custodians and wallets held by the VA Fund Manager



- in assessing which custodial arrangement (such as independent custodian or self-custody, host locations, use of hot or cold wallets) is the most appropriate to adopt, having regard to the features and characteristics of the different custodial arrangements, such as (a) the hardware and software infrastructure; (b) the virtual assets which are supported; (c) the security controls over key generation, storage, management and transaction signing; (d) the documented process of handling software upgrades to the storage devices used by the custodians and the VA Fund Manager; and (e) the process of handling blockchain forks
- where the Virtual Asset Fund Manager intends to hold fund assets in self-custody, it should use reasonable endeavours to acquire and maintain adequate insurance cover over the virtual assets, as well as specifically disclosing the existence and risks of self-custody, the additional safeguards that have been put in place and the details of insurance coverage over the assets

Operations

A number of operational requirements under the VA Terms and Conditions are based on those in the FMCC, including record keeping policies, side pocket arrangements, auditors and audited accounts (including the experience and capability of the auditor in checking the existence and ownership, and ascertaining the reasonableness of the valuation of virtual assets), net asset value calculation and pricing and reconciliations..

In the case of portfolio valuations, the SFC has noted that there are currently no generally accepted valuation principles for virtual assets, especially for virtual assets issued by way of an initial coin offering. Accordingly, VA Fund Managers should exercise due care in selecting valuation principles, methodologies, models and policies which are reasonably appropriate in light of the circumstances and in the best interests of the investors of the portfolios under the licensed corporations' management.

Marketing Activities

VA Fund Manager must only allow professional investors (as defined under section 1 of Part 1 of Schedule 1 to the SFO) ("**Professional Investors**") to invest in virtual asset funds. Where the virtual asset fund is distributed through distributors, a VA Fund Manager should establish and implement measures to ensure that the fund is only distributed to Professional Investors.

Discretionary Account Managers

By way of background, the scope of the FMCC was expanded in November 2018 to include discretionary account managers "to the extent relevant to [their] functions and powers". The same requirement has carried through to the VA Terms and Conditions.

Appendix 1 of the VA Terms and Conditions specifies that the following requirements will *not* apply to discretionary account managers: (i) liquidity management; (ii) the termination of funds; (iii) side pockets; (iv) audit of financial statements of funds and accounting information in funds' annual report; (v) frequency of valuation of fund assets; and (vi) net asset value calculation and pricing of different share classes.



In addition, a Virtual Asset discretionary account manager is required to:

- only provide its services to Professional Investors
- assess whether clients have knowledge of investing in virtual assets or related products before providing discretionary account management services to them or alternatively take into account a client's prior investment experience in private equity or venture capital or prior provision of capital for a start-up business
- ensure suitability of the mandate or predefined model investment portfolio for that client based on information about the client's personal circumstances of which it is or should be aware through the exercise of due diligence
- enter into a written discretionary client agreement with minimum content requirements
- undertake performance review at least biannually (unless otherwise agreed)
- provide valuation reports to clients monthly basis or as prescribed in the client agreement

Implications

Type 9 asset managers who are already subject to the FMCC should be well positioned to understand their enhanced regulatory roles and responsibilities, whether as a fund manager responsible for the "overall operation of a fund" or otherwise. As such, we expect that compliance with the substantially similar obligations imposed on their virtual asset activities by the VA Terms and Conditions should, to a large extent, be relatively straightforward. They should of course pay attention to certain new requirements, such as procuring acceptable insurance over the virtual assets and appointing a duly qualified custodian.

Other types of licensed corporations which are not currently subject to the requirements under the FMCC framework (in light of the nature of their business and the types of service they provide) will now be subject to comparable regulatory requirements under the VA Terms & Conditions. This will require putting in place detailed systems and controls to comply with the new licensing conditions and ascertaining whether they are a "fund manager responsible for the overall operation of the fund", as this will impact the level of obligations to which they are subject under the VA Terms and Conditions.

Actions to Consider

VA Fund Managers who are subject to the VA Terms and Conditions should consider the following:

- perform gap analysis to identify gaps specific to virtual funds activities, and make revisions to ensure gaps are addressed
- review marketing materials to ensure virtual asset funds are only offered to/ distributed to Professional Investors



- review disclosure documents to identify if updates are required, and make revisions to comply with requirements
- review third party relationships (eg, delegates, custodian) to determine if contractual provisions are sufficient, and if policies and procedures, and internal controls are adequate, and put in place additional measures
- in the case of discretionary account managers, review the existing discretionary client agreement to identify gaps, and amend the client agreement where appropriate
- consider contingency plans (such as unwinding plans) in the event they cannot accept or are not capable of meeting the VA Terms and Conditions

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