

First SFC Licensed Cryptocurrency Fund launched in Hong Kong

DENTONS

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On 20 April 2020, Venture Smart Asia launched its cryptocurrency fund in Hong Kong that purchases, holds and tracks the price of Bitcoin. This is the first time a pure cryptocurrency fund is licensed to trade virtual assets in Hong Kong since the introduction of the regulatory framework for management and distribution of virtual assets by the Securities and Futures Commission (SFC) on 1 November 2018¹.

The fund launch is certainly a welcome development in the Hong Kong financial industry and is expected to spur interest from industry players to join the market. Those who wish to follow in the footsteps of Venture Smart Asia will have to meet the SFC's licensing conditions, which are designed to mitigate the inherent risks associated with investing in virtual assets at both the fund management and distribution levels.

The SFC's current approach is that all virtual asset portfolio managers² will be required to observe essentially the same existing requirements that are applicable to licensed institutions dealing in "securities" or "futures contracts" as defined under the Securities and Futures Ordinance (Cap. 571) (SFO) (such as the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission and the Fund Manager Code of Conduct), subject to elaborations and amendments catering for the virtual asset portfolio managers' particular business models.

Below is a summary of the key conditions in broad terms³:

1. **Type of investors:** Only professional investors (as defined under the SFO) should be allowed to invest in virtual assets funds.
2. **Disclosure to investors:** Licensed virtual asset portfolio managers are required to disclose all associated risks to potential investors and distributors they have appointed for distribution of their virtual asset funds.
3. **Safeguarding of assets:** Licensed virtual asset portfolio managers are required to exercise due skill, care and diligence in the selection, appointment and ongoing monitoring of custodians.
4. **Risk management:** Appropriate limits are required to be set in respect of each product and market the portfolios invest in and each counterparty to which the portfolios have exposure. Suggested practices include setting a cap on the portfolios' investment in illiquid virtual assets, conducting periodic stress testing to determine the effect of abnormal and significant changes in market conditions on these portfolios, and implementing procedures to assess reliability of virtual asset exchanges before transacting.
5. **Liquid capital:** Licensed virtual asset portfolio managers should maintain a required liquid capital of not less than HK\$3 million (or its variable required liquid capital).

As for distributors of virtual asset funds, apart from complying with their existing requirements for Type 1 regulated activities (dealing in securities), they are expected to put in place measures and controls to ensure proper due diligence, suitable recommendation and solicitation, and adequate risk disclosure when they are engaged in distributing virtual asset funds under their management⁴.

The SFC made it clear that contravention of these conditions is likely to be considered as misconduct under the SFO

which will reflect adversely on the fitness and properness of a virtual asset fund manager/distributor to remain licensed and may result in disciplinary action by the SFC. As such, a licensed firm should regularly review the status of its regulatory compliance and adequacy of internal control. Ultimately, for virtual assets to be widely accepted, there needs to be proper oversight and risk management.

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1. The SFC's statement on the regulatory framework for virtual asset portfolio managers, fund distributors and trading platform operators on 1 November 2018 is available here: <https://www.sfc.hk/>
 2. Specifically, the following types of virtual asset portfolio managers are subject to the SFC's supervision:
 - a. firms managing funds which solely invest in virtual assets that do not constitute "securities" or "futures contracts" and distribute the same in Hong Kong; and
 - b. firms which are licensed or are to be licensed for Type 9 regulated activities (asset management) and also manage portfolios which invest solely or partially (subject to a de minimis requirement, i.e. 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 of the portfolio in virtual assets) in virtual assets that do not constitute "securities" or "futures contracts".
 3. Following the statement on 1 November 2018, the SFC published "Proforma Terms and Conditions for Licensed Corporations which Manage Portfolios that Invest in Virtual Assets" on 4 October 2019 to elaborate on the principles and requirements with which licensed corporations should comply when managing portfolios investing in virtual assets and meet the de minimis threshold. A copy of the document is available here: <https://www.sfc.hk/>
 4. The SFC released a circular to intermediaries on 1 November 2018 to provide guidance on the expected standards and practices when distributing virtual asset funds. A copy of the document is available here: <https://www.sfc.hk/>

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