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SFC Addresses Regulation of Managers of Virtual Asset Funds and Virtual Asset Discretionary Accounts

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In light of an increasing demand for virtual asset investment products, the Hong Kong Securities and Futures Commission (SFC) has been taking steps to clarify the legal and regulatory requirements for this market.¹ In this regard, on October 4, 2019 the SFC issued “Proforma Terms and Conditions for Licensed Corporations which Manage Portfolios that Invest in Virtual Assets (T&Cs). The T&Cs set forth terms and conditions that are imposed on all in-scope virtual asset fund managers in the form of licensing conditions, subject to minor variations and elaborations concerning certain business models. This OnPoint provides an overview of the T&Cs.

Scope of Application

The T&Cs apply to licensed corporations that manage funds (or portions of funds) that invest in “virtual assets”, and which have: (a) a stated investment objective to invest in virtual assets; or (b) an intention to invest 10% or more of the gross asset value of their portfolio in virtual assets (Virtual Asset Fund Managers). “Virtual assets” are digital representations of value, which may be in the form of: digital tokens (e.g., digital currencies, utility tokens or asset-backed tokens); any other virtual commodities; and crypto assets or other assets of essentially the same nature, irrespective of whether they may be deemed “securities” or “futures contracts” as defined in the Securities and Futures Ordinance (SFO).²

Virtual Asset Fund Managers responsible, or to which responsibility has been delegated, for the overall operation of a fund are subject only to certain T&Cs.³

Virtual Asset Fund Managers that (i) conduct discretionary account management (in the form of an investment mandate or a pre-defined model investment portfolio) and (ii) receive management fees and/or performance fees as remuneration for managing the discretionary accounts of their clients (Virtual Asset Discretionary Account Managers) are subject to additional requirements in Appendix 1 of the T&Cs.

Summary of the T&Cs

The responsibilities of Virtual Asset Fund Managers are set forth in the T&Cs summarized below.

¹ On November 1, 2018, the SFC issued circulars setting out regulatory standards relating to virtual asset portfolio managers and fund distributors, as well as the conceptual framework for the potential regulation of virtual asset trading platform operators. For further information, please refer to [Hong Kong Regulation of Crypto-Related Investments](#).

² Chapter 571 of the Laws of Hong Kong.

³ Such managers are subject to paragraphs 3.16, 3.17 (except for 3.17(b) and 3.17(c)), 3.18, 3.19, 3.20, 3.21, 4.2, 4.6 to 4.11, 5.4, 5.8 to 5.12, 5.13, 5.16 to 5.17, and 6.2 of the T&Cs.

	A Virtual Asset Fund Manager must:
General Principles	<ul style="list-style-type: none"> Comply with general principles comparable to the Hong Kong Code of Conduct⁴ (in particular, the senior management⁵ of a Virtual Asset Fund Manager will be primarily responsible for ensuring the maintenance of appropriate standards of conduct and adherence to procedures by such manager).
Organisation and Management Structure	<ul style="list-style-type: none"> Maintain an effective organization and management structure to: handle conflicts of interest; and ensure sufficient human and technical resources, risk management⁶ and compliance policies. Maintain a minimum liquid capital of the greater of: (a) HK\$ 3 million (US\$382,000) or (b) the variable required liquid capital (5% of adjusted liabilities as calculated in accordance with the Securities and Futures (Financial Resources) Rules). Appoint an independent compliance officer and draft detailed compliance procedures. Comply with requirements relating to segregation of duties and senior management responsibilities.
Virtual Asset Fund Management	<ul style="list-style-type: none"> Carry out investment transactions within each fund's mandate and execute fund orders on the best available terms. Only participate in underwriting activities on behalf of a fund if specifically permitted in the fund's mandate, and credit all commissions and fees received under such contract to the fund's account. When participating in an initial offering, ensure that the allocation received in the offering provides for a fair allocation among the funds that it manages and that preferential allocations are prohibited. Comply with requirements relating to: order allocation; connected person transactions; house accounts; disclosure of leverage; and liquidity management.
Custody	<ul style="list-style-type: none"> Segregate fund assets from the manager's proprietary assets. Select and adopt the most appropriate custodial arrangement, taking into account the characteristics of different arrangements. Appoint independent custodians and take steps to ensure that the custodians are capable of performing their functions. Where self-custody is adopted, ensure that: the reasons for adopting self-custody are properly documented; appropriate safeguards are implemented; records are properly maintained; the licensed corporation's own assets can be effectively segregated from virtual assets in the event of insolvency of the licensed corporation; adequate insurance is maintained to cover the crypto-assets; and proper disclosure is made to investors regarding the risks associated with such arrangements.

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

⁵ "Senior management" is defined as "the Managing Director of a Virtual Asset Fund Manager or its Board of Directors, CEO or other senior operating management personnel in a position of authority over the Virtual Asset Fund Manager's business decisions".

⁶ Appendix 2 of the T&Cs sets out the detailed risk management control techniques and procedures.

<p>Operations</p>	<ul style="list-style-type: none"> • Appoint an independent auditor to perform audits of financial statements, taking into account (among other matters) the auditor's experience and capability to check the existence and ownership, and ascertain the reasonableness of the valuation, of the relevant virtual assets. • Exercise due care in selecting valuation principles, methodologies, models and policies, which are reasonably appropriate in the circumstances and in the best interests of the investors, and make proper disclosures to such investors. • Comply with requirements relating to: recordkeeping; disclosure and management of side pockets; net asset value calculation; and pricing and reconciliations.
<p>Dealing with the Fund and Fund Investors</p>	<ul style="list-style-type: none"> • Provide investors with adequate information and updates regarding any material changes to enable them to make an informed decision about their investments (including the trading platforms and custodians used by the fund, as well as key risks associated with the fund's investment in virtual assets). • Maintain proper procedures to ensure confidentiality of information and handling of complaints.
<p>Marketing Activities</p>	<ul style="list-style-type: none"> • Offer virtual asset funds only to "professional investors" as defined under the SFO. • Ensure representations made to investors and all marketing materials are accurate and not misleading.
<p>Fees and Expenses</p>	<ul style="list-style-type: none"> • Disclose the basis and amount of their fees and charges (which should be fair and reasonable). • Receive soft dollars and cash rebates only under prescribed circumstances.
<p>Reporting to the SFC</p>	<ul style="list-style-type: none"> • Report to the SFC as soon as practicable upon any actual or suspected non-compliance with the T&Cs or any other applicable legal and regulatory requirements. • Notify the SFC of any significant change in its business activities at least seven business days before the change takes place. • Provide such other information as may be requested by the SFC promptly and in an open and cooperative manner. • Ensure that all information provided to the SFC is accurate and not misleading.

Additional Requirements Applicable to Virtual Asset Discretionary Account Managers

Virtual Asset Discretionary Account Managers are subject only to certain of the above T&Cs, as set out in Appendix 1. Appendix 1 also sets out the following additional requirements applicable to Virtual Asset Discretionary Account Managers: (i) minimum content requirements of discretionary client agreements;⁷ and (ii) the responsibilities summarized below.

⁷ The minimum content requirements do not apply to Institutional Professional Investors (*i.e.*, persons within the scope of paragraphs (a) through (i) of the definition of "professional investor" set out in Schedule 1, Part 1, section 1 of the SFO).

	A Virtual Asset Discretionary Account Manager must:
Target Clients	<ul style="list-style-type: none"> • Prior to providing discretionary account management to clients, assess whether they have: knowledge regarding investment in virtual assets; prior investment experience in private equity or venture capital; or provided capital for a start-up business.
Suitability	<ul style="list-style-type: none"> • Conduct due diligence to ensure the mandate or pre-defined model investment portfolio is suitable for each client. • Review the mandate or pre-defined model investment portfolio on a regular basis and recommend revisions where suitable for client's current circumstances. • Document the relevant assessment and provide the assessment rationale to the client in writing.
Client Agreements	<ul style="list-style-type: none"> • Set out in discretionary client agreements the precise terms and conditions under which discretion will be exercised. • Meet the minimum content requirement of discretionary client agreements, as set out in Appendix 1.
Performance Review and Valuation Reports	<ul style="list-style-type: none"> • Review the performance of discretionary accounts against agreed benchmarks at least twice a year, unless otherwise agreed with the client. • Provide valuation reports to clients within 10 business days after the monthly accounting period, unless otherwise agreed with the client.

Compliance with the T&Cs

Contravention of the T&Cs' licensing conditions is likely to reflect adversely on the fitness and propriety of a Virtual Asset Fund Manager or Virtual Asset Discretionary Account Manager to remain licensed, and may result in disciplinary action by the SFC. The SFC will adopt a pragmatic approach in implementing the T&Cs, taking into account all relevant circumstances, including the size of the Virtual Asset Fund Manager or Virtual Asset Discretionary Account Manager, as the case may be, as well as any compensatory measures implemented by their senior management.

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