Overview of Hong Kong's New Crypto Exchange Framework

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The Hong Kong Securities and Futures Commission ("SFC") issued a conceptual framework for licensing and regulating virtual asset trading platforms ("Platform Operators") on 1 November 2018 ("Exchange Framework"). In this report, we wish to highlight some of the key features of this Exchange Framework and provide our thoughts on certain aspects which have not been covered (although few in number) and the potential challenges Platform Operators may face within the sandbox environment.

Scope of Supervision

If a Platform Operator runs an online trading platform in Hong Kong and offers trading of at least one or more virtual assets which fall under the definition of "securities", and is interested in being licensed by the SFC, it would fall under the SFC's jurisdiction and require a Type 1 (dealing in securities) and Type 7 (providing automated trading services) license. Platform Operators are encouraged to adhere to the high standards set by the SFC and to utilise the SFC Regulatory Sandbox ("Sandbox"), which can help facilitate the future determination of licensing conditions. The SFC will focus on regulation of cryptocurrency exchanges that provide trading, clearing and settlement services for virtual assets, and those that have control over investors' assets. This means that only centralised exchange platforms would be regulated. Decentralised exchanges that provide a peer-to-peer marketplace for transactions and which do not hold investors' assets would not fall under the Exchange Framework, and are thus not permitted within the Sandbox.

Moreover, the Exchange Framework primarily focuses on Platform Operators trading virtual assets that fall under the definition of "securities" pursuant to the Securities and Futures Ordinance (Cap. 571) ("SFO"), because the SFC only has the power to regulate "regulated activities" including the issuing and trading of securities. In other words, the SFC's actions are limited to governing such "regulated activities" and they are not able to regulate exchanges that deal with utility tokens only for example.

Overview of the Exchange Framework

The SFC has taken the first step towards providing a framework to licence and set standards for Platform Operators in respect of issuing and trading virtual assets defined as securities. The background of virtual assets and Platform Operators has been well-researched. However, the SFC has clearly stated that it is still in an exploratory stage with regards to setting standards for these operators. For example, if a Platform Operator utilises the Sandbox, the Conceptual Framework is not mandatory immediately, meaning that Platform Operators can first evaluate their own corporate governance framework and internal controls, before committing to the Framework and being involved in discussions with the SFC on the business and trading environment. This set-up allows Platform Operators to showcase their own cryptocurrency exchange among their peers and demonstrate how they are meeting the high standards set by the regulator.

The SFC will consider any new risks relating to virtual assets which come to light during the Sandbox stage and determine if enhanced investor protection measures are required. The Exchange Framework leaves it open for the SFC to explore additional terms and conditions and regulatory standards that it may impose upon Platform Operators as it observes them during the Sandbox.

Mandatory Know Your Customer (“KYC”) / Anti Money Laundering (“AML”)

The Exchange Framework requires licensed Platform Operators (if any) to comply with KYC procedures (specifically the procedures under paragraph 5.1 of the Code of Conduct for Persons Licensed by or Registered with the SFC), suitability requirements under the Code of Conduct and Guidelines on AML and Counter-Financing of Terrorism.

Mandatory Reserve Lock-up / Capital Requirements

On a case-by-case basis, the SFC may require a Platform Operator to maintain a reserve equivalent to 12 months’ operating expenses, or back up, as a financial buffer to ensure financial soundness of the cryptocurrency exchange. This ensures that sufficient reserves are kept by the Platform Operator in the event of theft or hacking, which may result in substantial losses. In determining the buffer, the SFC may consider the following factors:

- the role and functions to be performed by a Platform Operator;
- actual or estimated trading volume on its platform;
- types of virtual assets to be traded on its platform;
- types of “professional investors” to be served by the Platform Operator;
- projected operating expenses in the first 12 months after being licensed; and
- financial position of the Platform Operator.

Disclosure Requirements

Platform Operators should disclose the nature of risks that investors may be exposed to in trading virtual assets. The disclosed risks should (among other things) include any associated fees and charges (e.g. exchange listing fees), clarification that the Investor Compensation Fund does not apply to virtual assets, that virtual assets are not legal tender, etc. These risks should be clearly disclosed to promote transparency so that clients can better compare and understand the fee structure and the risks associated with acquiring virtual assets via a Platform Operator.

Segregation and Custody of Clients’ Money and Virtual Assets

Similar to traditional intermediaries, Platform Operators are also required to comply with the SFC (Client Money) Rules (Cap.571I), including the requirement to establish and maintain in Hong Kong one or more segregated accounts for client money in a designated trust account or client account. This includes all virtual assets and not only those defined as “securities”. Furthermore, the majority of clients’ virtual assets should be placed in cold storage to minimise exposure to security incidents.

Ongoing Reporting and Monitoring

The SFC intends to closely monitor Platform Operators and establish requirements with respect to regular reporting including any changes in scope and details of services, new virtual assets for trading, monthly volume, identities and locations of clients, and other statistics on trading, clearing and settlement activities, as applicable.

Challenges / What is yet to be covered?

Scope and Protection for Retail Investors

For a broad range of reasons, the scope of this Conceptual Framework does not immediately impact the majority of the existing cryptocurrency exchanges in Hong Kong. For example, under this Framework, a decentralised exchange would not be able to enter the Sandbox despite its willingness to comply with all the SFC's requirements. The Framework also does not cover exchanges that do not handle security tokens.

Furthermore, Platform Operators under this Conceptual Framework can only provide services to "professional investors". Today, there are many exchanges that execute trades for retail investors, which are not covered under the scope. As there is no protection for retail investors in any form, this may result in retail investors exploring offshore exchange options (if they wish to trade security tokens) and/or forcing them to use unregulated exchanges which are not supervised by the SFC (if they are trading in non-security / utility tokens). Whilst it is understandable that the SFC has restricted Platform Operators to only accept professional investors as clients, the consequence of this is that retail investors in Hong Kong (and there are many), are not afforded similar protections. Nevertheless, it is still a step in the right direction.

12-month Maturation Period to List Virtual Assets

Pursuant to the Exchange Framework, a Platform Operator should only admit a virtual asset issued by way of an initial coin offering ("ICO") for trading on its platform at least 12 months after the completion of the ICO or when the ICO project has started to generate profit (whichever occurs first). Although the 12 month timeframe is sufficiently clear, questions will likely arise as to how the SFC will determine the profitability of the ICO project. Platform Operators will certainly be keen to list virtual assets that are securities as part of their operations in the Sandbox sooner rather than later.

Cyber Security

The SFC has acknowledged the weaknesses in corporate governance and lack of internal controls for some cryptocurrency exchanges. However, the guidance provided on cyber risks associated with such exchanges is reasonably high level and there is scope for more detail to be provided on how the SFC plans to implement cyber requirements in the future.

Insurance

Platform Operators will be required to take out an insurance policy relating to the custody of virtual assets, providing full coverage for virtual assets in hot storage and the majority of virtual assets in cold storage (e.g. 95%) to protect both the Platform Operator and its clients.

Arguably, whilst cryptocurrency exchanges have moved forwards, the insurance industry has lagged behind somewhat and as a result, obtaining insurance to the levels mentioned by the SFC may be challenging as well as costly for Platform Operators.

Bank Accounts

The Exchange Framework requires that bank wires come from a Hong Kong bank. However, opening a bank account in Hong Kong for cryptocurrency exchanges is extremely difficult. Imposing this as a requirement may make it an impractical task for many exchanges.

Capital requirements

The SFC may require a Platform Operator to maintain a reserve equivalent to 12 months of operating expenses as a financial buffer to ensure financial soundness of the cryptocurrency exchange. However, questions may arise as to what expenses are regarded as being operating in nature and in what form the reserves will need to be maintained i.e. only cash or would some other liquid investments be permissible.

Suitability assessment

The SFC has highlighted in the Exchange Framework that Platform Operators may be required to comply with the "suitability requirement under paragraph 5.2 of the Code of Conduct". It is currently unclear the extent of suitability requirements that would apply to Platform Operators, and whether the majority of virtual assets would be considered to be a "complex product", which would trigger more stringent suitability requirements. Cryptocurrency exchanges entering the Sandbox may need to work together with the SFC to agree on what suitability measures would be reasonable and provide a balance between customer experience and investor protection.

Conclusion

Cryptocurrency exchanges must voluntarily enter the Sandbox if they wish to be eligible to obtain a Type 1 or Type 7 license in Hong Kong. Although the SFC has laid out strict licensing conditions and requires that Platform Operators in the Sandbox meet high regulatory standards, this is nevertheless an encouraging initiative and demonstrates the SFC's formal recognition of the cryptocurrency industry.

While the Sandbox will potentially provide an avenue for Platform Operators to be licenced in Hong Kong, the SFC will only make a final decision on its cryptocurrency exchange licencing regime once the exploratory stage ends. Hence, it remains to be seen how exchanges will perform within a highly regulated environment. We also do not know yet what the demand will be for entry to the Sandbox and whether the majority of exchanges will instead prefer to move to a jurisdiction which operates a less stringent regulatory environment.

However, despite the challenges highlighted in this report, the SFC has helped to provide clarity in what was before a rather opaque and unclear environment. We also view this as a golden opportunity for cryptocurrency exchanges to 'institutionalise' themselves and their offering further and believe that it is an important step towards the maturation of the virtual assets industry as a whole.

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