

Fintech: Meeting the regulatory challenges

Keynote speech at Hong Kong FinTech Week 2018

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Good morning. I want to thank InvestHK for arranging this event once again and inviting me to speak.

I am a markets regulator, and so it will not surprise you to learn that today I want to talk about the regulatory response to the growing importance of financial technology (Fintech).

I am fully aware that many in the Fintech world see regulation as an unnecessary or unwelcome brake on innovation. But what I hope to do today is to calm some of these concerns. I will describe how we take a facilitative approach to innovation in the many instances where this is justified, but also how we adopt a far more cautious stance where we see serious risk. I will also preview some important announcements we will make about crypto assets.

It is obvious that the pace of change and innovation in financial services is unprecedented. We spend a lot of time and effort at the Securities and Futures Commission (SFC) tracking these developments to make sure regulation remains effective as new technologies are more widely adopted.

Among other things, we have set up channels to encourage communication with the market, including our Fintech Contact Point and a Fintech Advisory Group.

There is clearly an excellent case for adapting our rules so that technology can be used to provide a better customer experience, to increase financial inclusion or to make markets far more efficient and reliable. So we have worked hard to make sure that regulation keeps up with new business models.

This year, we implemented guidelines to help firms reduce hacking risks.¹ Some of these requirements were already implicit in our regulations, but the industry agreed that it would be helpful to consolidate and expand them into a set of specific, targeted rules.

Note: This is the text of the speech as drafted, which may differ from the delivered version.

¹ See [press release](#) dated 27 October 2017.

However, the FSB also found that crypto-assets do give rise to significant investor or consumer protection concerns. This reflected an already emerging consensus among securities regulators that virtual assets require significant regulatory attention.

Some of the risks are inherent in the nature of the virtual assets themselves.

They have no intrinsic value and are generally not backed by physical assets. Not being guaranteed by any government, they are not currencies.

Nevertheless, over the past few years, some investors have taken an intense interest in this asset class. There are now hundreds of crypto assets and tokens and the total amount involved is reportedly in the hundreds of billions of US dollars.

One of many big questions is how to assess the value of virtual assets under current accounting frameworks. There are no agreed standards on how to obtain audit evidence for virtual assets or judge the reasonableness of valuations.

There are other particular risks which relate to the operations of crypto exchanges or trading platforms, as well as funds investing in crypto assets. These are activities of special interest to securities regulators as, superficially, these platforms seem to mimic conventional funds and stock exchanges.

For example, crypto exchanges may act both as agents for customers as well as principal dealers trading their own book. If they are not regulated, it would be difficult to detect and monitor the major conflicts of interest which then arise. Safe custody of virtual assets by trading platforms is another key concern, especially with the need to ensure that

Responsible players in this industry also recognise that clear and effective regulation will be essential for them to establish the trust and legitimacy they need to make their businesses credible.

So far, individual regulators have responded to these risks in different ways depending largely on their different regulatory remits, the scale of crypto activities in their territories and whether virtual assets should be seen as financial products actually suitable for regulation.

One core issue for regulators is very simple. This is whether they actually have legal jurisdiction over crypto firms and activities. Some have decided that their current regulations already apply to those virtual assets which can be classified as securities, and have been active in this space. Others have found that they need to develop new legal frameworks. Others are adopting a wait and see approach.

The regulatory regime for virtual assets

In Hong Kong we now have a sizeable population of investors who have an interest in trading virtual assets through unregulated trading platforms. At the same time, there is a growing demand for funds which invest in virtual assets.

We do not have a lot of options here. We could rely on an interpretation of our remit as a narrow one, view the whole crypto world as unregulated and rely on investor education to warn the public of the risks. But maintaining the status quo may not be an option if in reality investors are left unprotected as crypto activities thrive.

As such, we recently decided to step up as much as we are able to protect investors who trade virtual assets. To that end, as I mentioned at the start, we will be making some significant regulatory announcements about crypto assets later today.

I will now explain our thinking.

First of all, it is important to understand that some crypto markets are not legally capable of being regulated by the SFC if the virtual assets involved fall outside the legal definition in Hong Kong of “securities” or “futures contracts”⁸.

Even within this constraint, we have already set out our regulatory stance in a number of statements and circulars. We made it clear that where a virtual asset clearly falls under the definition of “securities” or “futures contracts”, it can still be subject to our rules. And we have told our licensees that they must notify us if they intend to provide services involving virtual assets.

We have also intervened in several cases – mainly ICOs – where the activities of firms or individuals may have breached our rules. We provided regulatory guidance or issued a warning and in some cases took formal regulatory action.

However, if a fund solely invests in virtual assets which themselves are not currently subject to SFC regulation, not being securities, then the management of that fund will be outside the SFC’s regulatory perimeter too.

Similarly, operators of platforms which only provide trading services for virtual assets not falling within the definition of “securities” are not regulated.

Recognising all of these limitations, we have been working hard to come up with a creative framework which should bring a significant number of these activities into our regulatory net for the first time.

Virtual asset portfolio managers and distributors

For funds, our starting point was the recognition that many Hong Kong investors gain exposure to virtual asset portfolios through fund managers or their distributors.

Later today, the SFC will issue a statement setting out the exact regulatory standards expected of virtual asset fund managers.⁹ In essence, all those supervised by the SFC intending to invest more than 10% of a mixed portfolio in virtual assets will need to observe new requirements targeting crypto assets, irrespective of whether they amount to “securities” or “futures contracts”. To afford better protection, only professional investors should be allowed to participate for the time being. However, I should be clear that our reach will still not extend to managers of “pure” crypto funds.

We can fill this gap by looking at fund distribution. Today, we will also issue a circular on the expected standards when firms distribute virtual asset funds.¹⁰

These firms are required to be registered with or licensed by the SFC as brokers. As such, they already have to comply with our distribution requirements for all collective investment schemes, including suitability obligations. But today’s circular will, for the first time, provide specific guidance on the regulatory standards for the distribution of all funds with crypto-exposures.

The combined effect of these measures is that the management or distribution of crypto funds will be regulated in one way or another, so that investor interests will be protected either at the fund management level, at the distribution level, or both.

Exploring regulation of platform operators

Another section of the statement we are putting out today describes a new, exploratory approach to see how we might regulate virtual asset trading platforms or “crypto-exchanges”.

We have seen some of the world’s largest platforms set up in Hong Kong. However, unlike crypto asset funds, a significant part of their activities do not yet fall within the regulatory perimeter of the SFC or any other local regulator.

Nevertheless, given the serious investor protection issues at stake, we see a real need to examine how the SFC might regulate these platforms under our existing legal powers, but without resorting to new legislation. This is the part that requires us to be creative.

We are not yet sure that virtual asset trading platforms are in fact suitable for regulation. They are technically, structurally and qualitatively different from traditional stock and futures

⁹ The statement will be available on the [SFC website](#) on 1 November 2018.

¹⁰ The circular will be available on the [SFC website](#) on 1 November 2018.

