



香港信託人公會
Hong Kong Trustees' Association

HONG KONG TRUSTEES' ASSOCIATION

WEBINAR ON

Virtual Assets – Becoming Mainstream?

7 October 2024

HKTA Seminar

Virtual Assets – Becoming Mainstream?

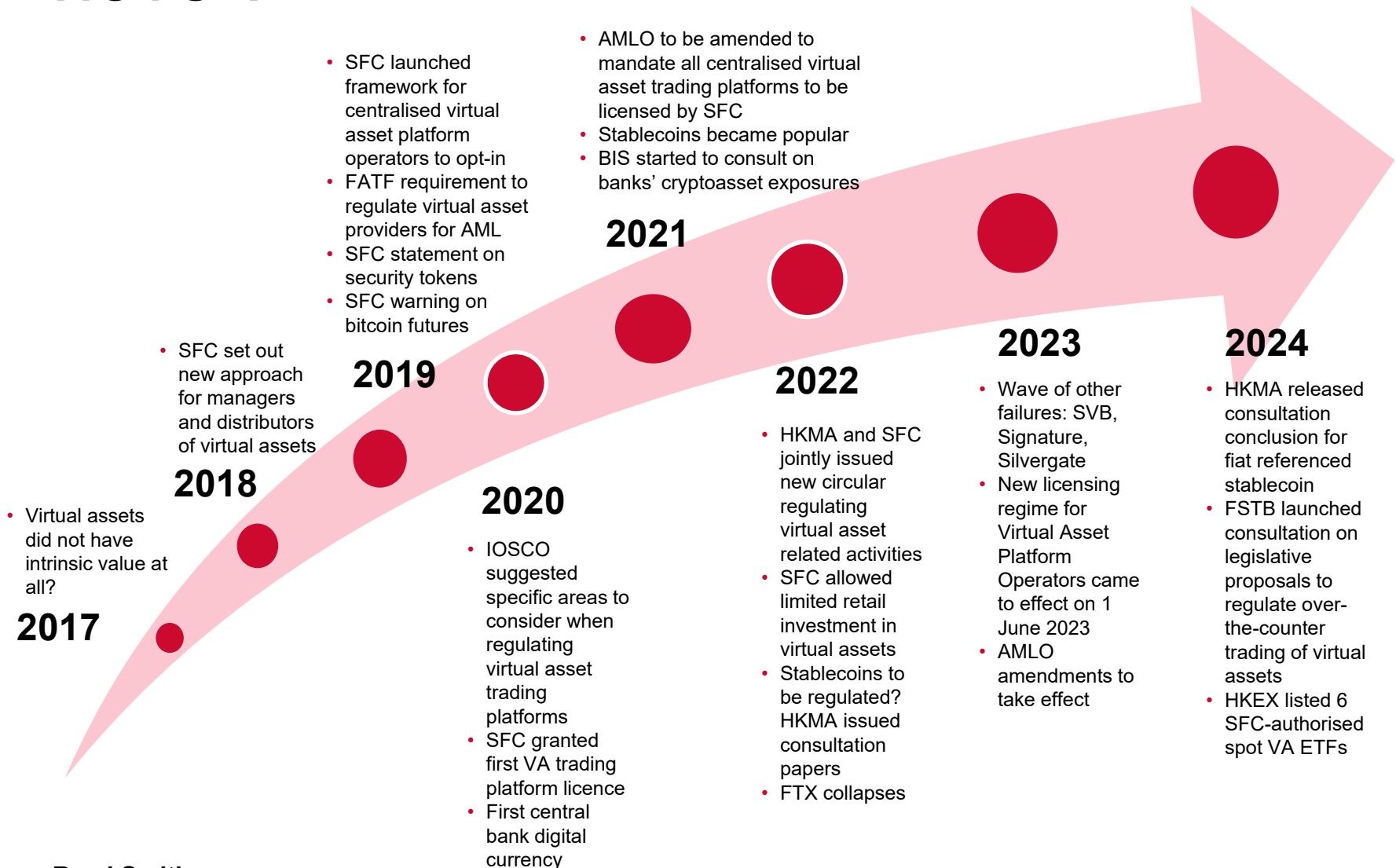
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October 2024

Topics Covered

- **The overall regulatory framework**
- **Recent failures such as FTX, JPEX and the SFC's crackdown on various cryptoexchanges**
- **Proposal for stablecoins and OTC virtual asset trading**
- **VA custody services**

Evolution of Virtual Assets – no longer novel?



Who are the regulators and who do they regulate?

- SVFs
- Banks that carry out virtual asset-related business
- Stablecoins (in future)

**Hong Kong
Monetary Authority
(HKMA)**



- Virtual asset trading platform operators
- Virtual asset fund managers
- Intermediaries dealing in or advising on virtual assets
- Intermediaries distributing virtual asset-related products

**Securities and
Futures
Commission (SFC)**



The regulatory regimes



Virtual asset trading platform operators

Regulated by the HKMA and SFC under the Dual Licensing Regime as per Securities and Futures Ordinance (Cap. 571) (SFO) and the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) (AMLO)



Fund manager & intermediaries dealing in or advising on virtual assets

Regulated by the SFC through the imposition VAFM Terms and Conditions (for fund manager), and /or VA Dealing or Advisory Terms and Conditions (for relevant intermediaries) - on their SFC licences.

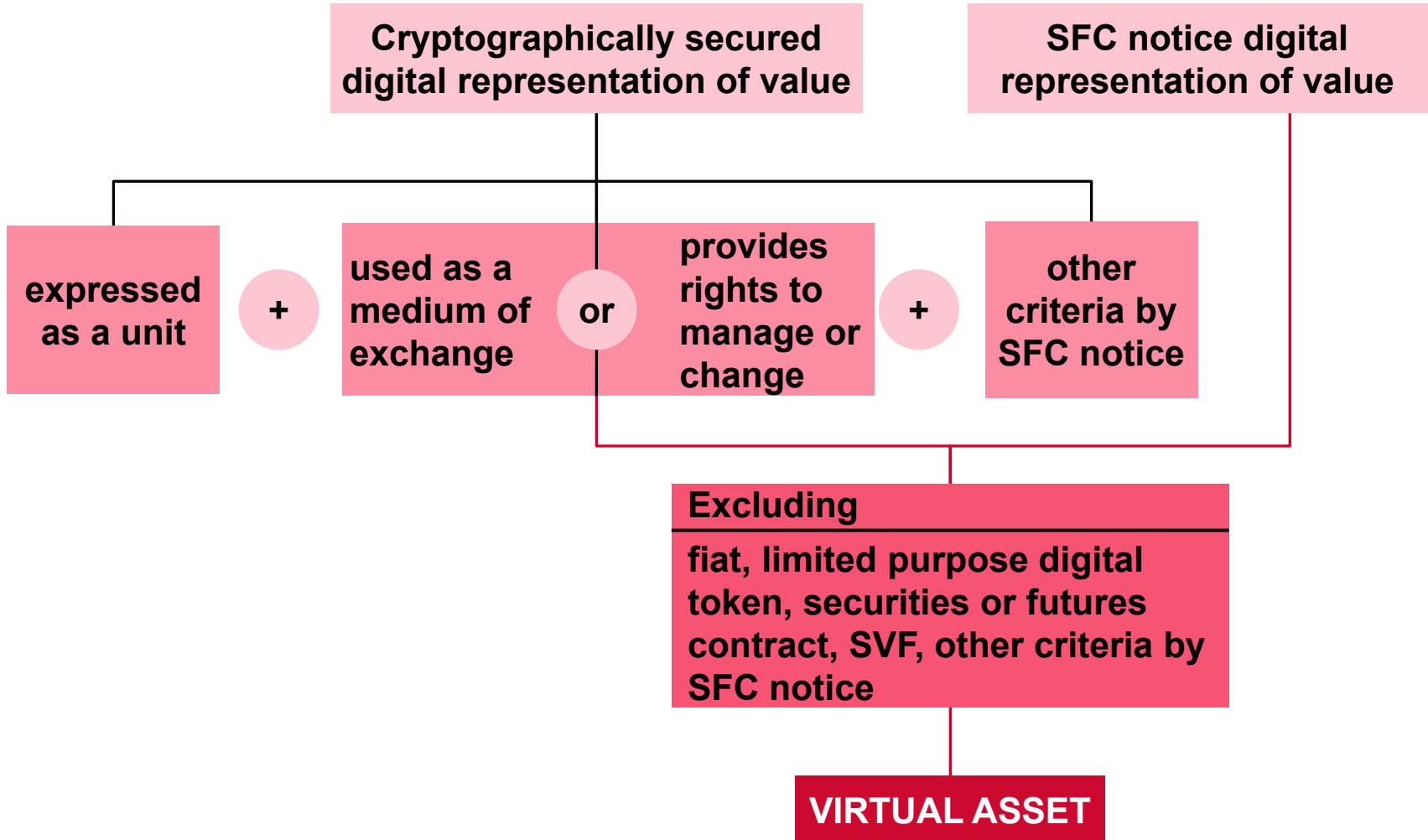


Intermediaries distributing virtual asset-related products

Regulated by the SFC under existing existing SFO regime, in particular, the Joint circular on intermediaries' virtual asset-related activities dated 22 December 2023

Anti-Money Laundering and Counter- Terrorist Financing (Amendment) Bill 2022

AMLO definition of VA



AMLO – Regulated Activity

A person must not carry on or hold out as carrying on a business of providing any VA service without a licence.

VA Service: operating a VA exchange

Providing services through means of electronic facilities:

- (a) whereby—
 - (i) offers to sell or purchase virtual assets are regularly made or accepted in a way that forms or results in a binding transaction; or
 - (ii) persons are regularly introduced, or identified to other persons in order that they may negotiate or conclude, or with the reasonable expectation that they will negotiate or conclude sales or purchases of virtual assets in a way that forms or results in a binding transaction; and
- (b) where client money or client virtual assets comes into direct or indirect possession of the person providing such service.

AMLO – Offence

Section 53ZRD **Carrying on a VA service business without a licence**

- (1) A person must not (a) carry on a business of providing any VA service; or (b) hold itself, himself or herself out as carrying on a business of providing any VA service ...
- (5) A person who, without reasonable excuse, contravenes subsection (1)(a) or (b) commits an offence and is liable (a) on conviction on indictment to a fine of \$5,000,000 and to imprisonment for 7 years ... or (b) on summary conviction to a fine of \$500,000 and to imprisonment for 2 years ...

Section 53ZRE **Offence to issue advertisements relating to unlicensed person's provision of VA service**

- A person (*subject person*) commits an offence If he or she, being an unlicensed person, issue or possess for the purpose of issue, an advertisement which holds the person out as prepared to provide a VA service.

AMLO – Offence

Section 53ZRF

Offence involving fraudulent or deceptive devices etc. in transactions in virtual assets

- A person commits an offence if the person, directly or indirectly, in a transaction involving any virtual assets –
 - a) Employs any device, scheme or artifice with intent to defraud or deceive; or
 - b) Engages in any act, practice or course of business that is fraudulent or deceptive, or would operate as a fraud or deception.

Section 53ZRG

Offence to fraudulently or recklessly induce others to invest in virtual assets

- A person commits an offence if the person makes any fraudulent misrepresentation or reckless misrepresentation for the purpose of inducing another person to enter into, or offer to enter into, an agreement to acquire, dispose of, subscribe for or underwrite any virtual assets.

Guidelines for VATP Operators

Retail Investors Protection

Token due
diligence &
admission

VA is an eligible
large cap VA
included in min of 2
acceptable indices

Restricted
activities

Offering, trading or
dealing in VA futures
contracts, derivatives;
staking/earning
activities

Dealing with
Clients

KYC; Knowledge
assessment test

Client Assets

98% of client VA in cold
storage; stored in HK;
segregated account
held on trust; insurance
arrangement

Guidelines for VATP Operators

Fitness and Properness Requirements

Competence Requirements (Corporation and Individual)

Continuous Professional Training Requirements

Financial Soundness

Management, Supervision and Internal Control

Cybersecurity

Record Keeping

Ongoing Report / Notification Obligations

New AML and CTF Guideline for Licensed Corporation and VASPs

Implementation

Dual-licence Application:

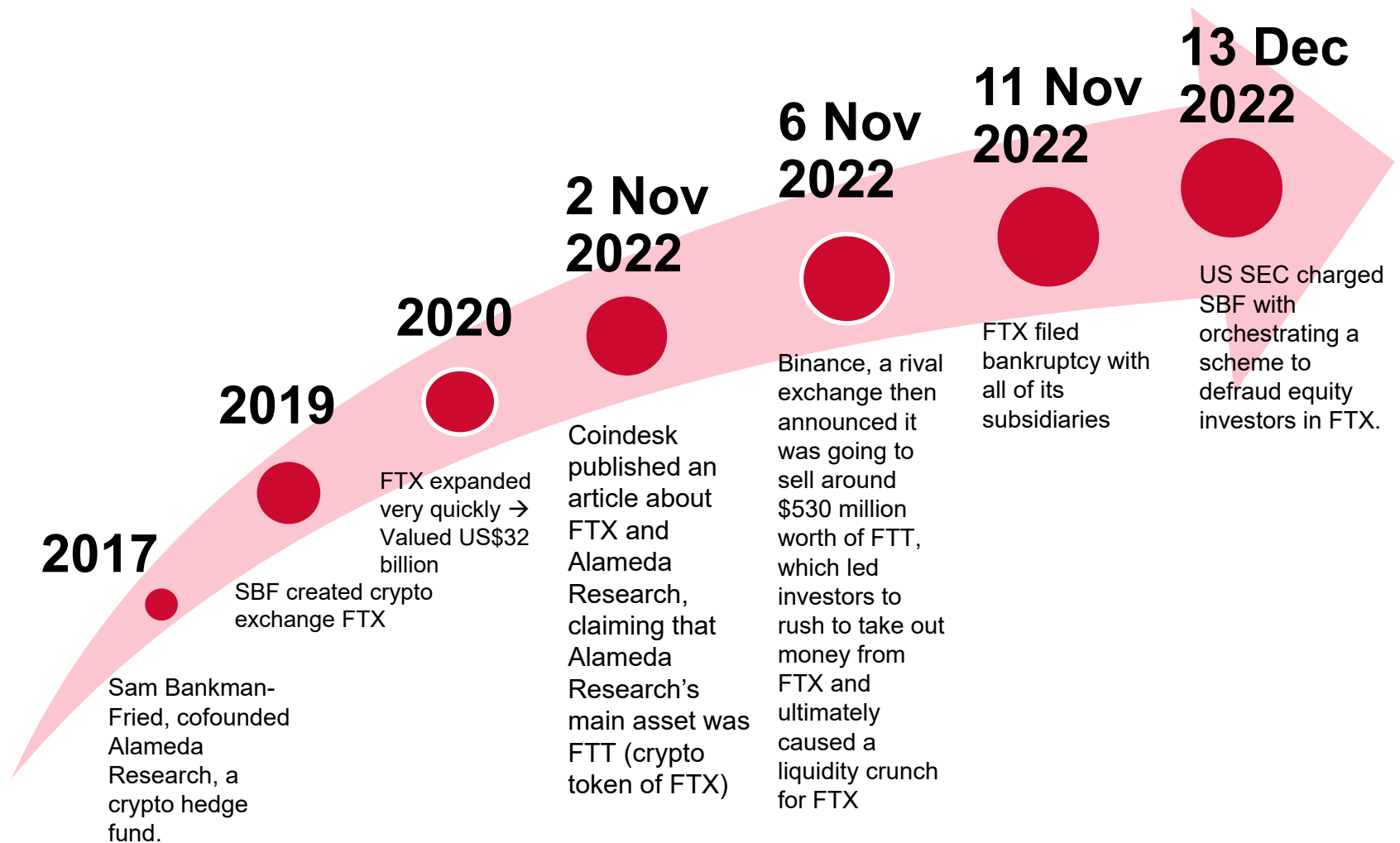
- SFO Type 1 (dealing in securities) and Type 7 (automated trading service (ATS))
- Virtual asset trading platform licence

Latest statistics:

- 16 ongoing VATP applications (including 3 existing applicants under the SFC's previous opt-in regime; latest submission on 27 August 2024)
- 12 withdrawals and 1 returned application
- 3 entities received approval through having participated in previous opt-in regime (OSL, Hashkey, HKVAX – licensed only as of 3 October 2024)

FTX – What happened

FTX



FTX

Some interesting (and very relevant) facts:

- Alameda Research CEO Caroline Ellison is Sam Bankman-Fried's ex girlfriend
- FTX co-founder Gary Wang first met Sam Bankman-Fried at a math camp in high school and later became his college roommate
- FTX's engineering chief Nishad Singh was close friends with Sam Bankman-Fried's brother

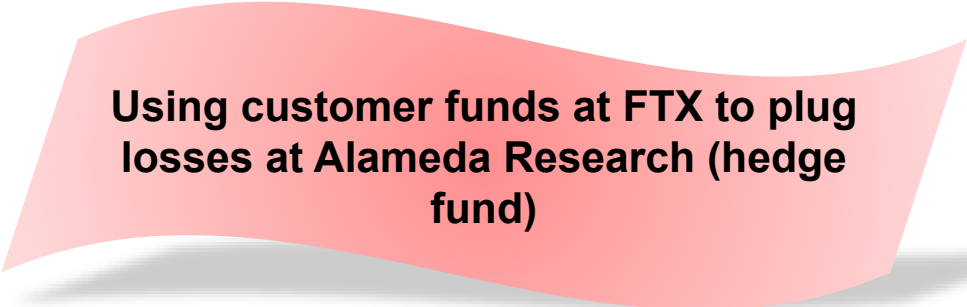
FTX

- **SBF**

- Found guilty for all 7 charges – wire fraud, conspiracy to commit wire fraud and securities fraud, and money laundering.
- Sentenced to 25 years in prison and ordered to pay US\$11 billion in forfeiture in March 2024.
- Appeal recently filed in September 2024

- **Caroline Ellison**

- Pleaded guilty to charges all 7 charges of fraud and conspiracy
- Sentenced to 2 years in prison and ordered to forfeit US\$11 billion also



Using customer funds at FTX to plug losses at Alameda Research (hedge fund)

What went wrong?

Never in my career have I seen such a complete failure of corporate controls and such a complete absence of trustworthy financial information as occurred here. From compromised systems of integrity and faulty regulatory oversight abroad, to the concentration of control in the hands of a very small group of inexperienced, unsophisticated and potentially compromised individuals, this situation is unprecedented.



**John J Ray III
CEO of FTX appointed
Nov 2022**

FTX

Corporate Culture and Integrity

- President of FTX.US resigned following a protracted disagreement with Bankman-Fried and Singh over the lack of appropriate delegation of authority, formal management structure, and key hires at FTX.US.
- A lawyer within the FTX Group was summarily terminated after expressing concerns about Alameda's lack of corporate controls, capable leadership, and risk management.

Did FTX foster an environment that encouraged open communication?

FTX

Board Effectiveness : checks and balances?

- The management and governance of FTX seemed largely limited to Bankman Fried, Wang and Nishad Singh (FTX senior executives)
- FTX group did not have any independent board advisers
- Meeting minutes and decisions were not documented
- Insufficient record keeping
- FTX allegedly used an instant messenger system that would instantly erase messages, for informal and formal communication
- Approval of expenses by emoji

FTX

Risk Management and Controls

Lack of internal control / proper record keeping

- Some employees at FTX were given corporate funds to purchase homes and other personal items in the Bahamas
- Inadequate accounting system
- Assets and liabilities of FTX moved through the enterprise fluidly with no adequate documentation and no corporate boundary

FTX

Shareholder Engagement

- Lack of transparency (regarding ownership and control)
 - No one entity held majority ownership or control over the platform
 - His ownership structure also confused users who had difficulty determining where their funds were deposited and who was responsible for resolving disputes when things went wrong
- Lack of communication with shareholders/ customers
- Users often found themselves unable to access their accounts and had no recourse for assistance when asking questions or reporting problems

JPEX

- **Corporate culture and integrity**
 - No accountability?
 - False or misleading statements?
- **Crisis management? Risk management/ internal control**
 - No/ ineffective internal control system governing the use/ withdrawal of investment funds
 - Repeatedly making public statements arguing with SFC and disclosed SFC's correspondence

SFC crack down on crypto exchanges

SFC crack down on crypto exchanges

The usual complaints:

- carrying out fraudulent activities
- conducting unlicensed activities
- used suspicious money laundering activities, “risky transactions activity” as reasons to suspend the investors’ accounts and required investors to pay exorbitant “verifications fees”/ “security deposits” to withdraw assets from the website, or to unfreeze investor’s account

Proposed Licensing Regime for Stablecoin Issuers (Jul 2024)

HKMA Stablecoin Consultation Conclusion

Stablecoin: a cryptographically secured digital representation of value that can be:

1. Expressed as a unit of account or store of economic value
2. Used, or is to be used as a medium of exchange accepted by the public for the payment of goods or services; discharge of a debt; and/or investment;
3. Can be transferred, stored, or traded electronically
4. Uses a distributed ledger or similar technology that is not controlled solely by the issuer
5. Purports to maintain a stable value with reference to a specified asset, or a pool or basket of assets.

The regime targets fiat-referenced stablecoins (“FRS”) – maintains a stable value with reference to one or more fiat currencies

Consultation Conclusion: Stablecoins Regulatory Regime – Published by HKMA and FSTB in July 2024

- The licensing regime will provide that no person shall, unless it holds a fiat-referenced stablecoin (FRS) issuer licence from the HKMA:
 - issue, or hold oneself as issuing, an FRS in Hong Kong;
 - issue, or hold oneself out as issuing, a stablecoin that purports to maintain a stable value with reference to the value of the Hong Kong dollar; or
 - actively market its issuance of FRS to the public in Hong Kong.

Consultation Conclusion: Stablecoins Regulatory Regime – Published by HKMA and FSTB in July 2024

- Key requirements:

Governance

- Appropriate risk management processes and governance
- Senior management need to be fit and proper and based in HK

Licence

- Minimum paid-up share capital of HKD25 million or 1% of the par value of FRS in circulation, whichever is higher
- Local incorporation in HK

Stabilisation

- FRS issued must always be fully backed by reserve assets at any point in time
- Investment policies for reserve assets of a quality and liquidity commensurate with business
- Reserve assets in segregated accounts with effective trust arrangement

Operation

- FRS issuers shall fulfil redemption requests within one business day
- No lending or financial intermediation activities, no interest shall be paid to FRS users
- Issuers to conduct annual risk assessment and audit

Stablecoins Sandbox

On 18 July 2024, the HKMA announced the list of participants of the stablecoin issuer sandbox

- JINGDONG Coinlink Technology Hong Kong Limited;
- RD InnoTech Limited; and
- Standard Chartered Bank (Hong Kong) Limited, Animoca Brands Limited, Hong Kong Telecommunications (HKT) Limited.

HKMA launched the sandbox in March 2024. The sandbox program allows prospective issuers to test their proposed business models under relaxed regulatory settings and facilitates the dialogue between the issuers and regulators.

Proposed Regulation for Over-the-Counter (OTC) Trading of Virtual Assets (VAOTC)

Financial Services and Treasury Bureau Consultation – Feb 2024

- **Regulator** - Customs and Excise Department
- **Any person operating VAOTC businesses or actively marketing provision VAOTC services to the Hong Kong public will be licensed**
- **VAOTC Businesses:** by way of business, provide services of spot trade of any VA for any money, or vice versa, through physical outlets (inc. ATM) or digital platforms.
- **Prohibit licensees** from carrying out VA advisory or referral services, offering of VA derivatives or other financial products (*i.e. staking, lending and margin trading*)
- **Does not cover** VA-to-VA trading as it is covered by VATP licence

Financial Services and Treasury Bureau Consultation – Feb 2024

Proposed Key Requirements:

- Hong Kong-incorporated company with a permanent place of business in HK or foreign company incorporated elsewhere but registered in Hong Kong
- Must have a **suitable premise** (brick-and-mortar shop) or a **local management office** (for digital operations) – correspondence address
- Satisfy the “**fit and proper**” requirement (*i.e. no past convictions, not subject to bankruptcy proceedings, no contravention of AML/CTF or other applicable rules*)

VA custody services

Lack of dedicated framework for VA custody – relies on regulatory guidance and framework under various authorities such as SFC, HKMA, and Companies Registry

Virtual Assets Trading Platform

VATP should hold all client assets on trust through an “associated entity” (ie, a licensed trust or company service provider incorporated in Hong Kong, which is a wholly-owned subsidiary of the platform operator.)

VATP Guidelines set out the custodial requirements as follows:

- client virtual assets should be segregated from the assets of the platform operator and its associated entity;
- at least 98% of client virtual assets should be stored in cold wallets (ie, offline environment) and transactions out of cold storage should be minimised;
- strong internal controls should be established to ensure all cryptographic seeds and keys are securely generated, stored and backed up;
- Require a combination of third-party insurance, funds or virtual assets set aside on trust and/or bank guarantees provided by Hong Kong banks to cover the potential loss of 50% of client virtual assets in cold storage and 100% of client virtual assets in hot and other storages.

Virtual Assets Fund Manager

VA Fund manager can choose to manage its VA a) by an independent custodian, or (b) by way of self-custody, or (c) a combination of both

Proforma Terms and Conditions for Licensed Corporations which Manage Portfolios that Invest in Virtual Assets set out the custodial requirements as follows: fund manager should

- segregate fund assets from their manager's assets and assets of their clients;
- ensure that the custodian that is to be entrusted with a fund's assets is functionally independent from the fund manager and enter into a formal custody agreement with such custodian; and
- implement proper controls when creating new accounts with trading platforms and custodians, effecting transfer of virtual assets etc.

Virtual Assets Fund Manager

Selection and Appointment of an Independent Custodian

In considering whether a custodian is capable of properly performing its functions, the VA fund manager should consider the following as part of the selection process for custodians, among others:

- the experience and track record of the custodian in providing VA custodial services;
- the corporate governance structure and background of the senior management;
- whether the custodian has appropriate segregation arrangements in place;
- the financial resources and insurance cover of the custodian;
- the custodian's operational capabilities and arrangements, for example, the “wallet” arrangements and cybersecurity risk management measures;
- the physical setup and processes of the custodian, especially in dealing with transfer of assets, blockchain forks and software upgrades of devices; and
- where the appointment of sub-custodians is allowed, the custodian would use due skill, care and diligence in the selection, appointment and monitoring of its sub-custodians.

HKMA Custody Circular (Feb 2024)

- **Guidance for Authorised Institutions (“Als”) regulated under Banking Ordinance when engaging with digital asset-related custodial activities**
- Applies to Als and subsidiaries of locally incorporated Als holding client digital assets
- **Covers 8 Principles:**

Governance and Risk Management	Segregation of Client Digital Assets
Safeguarding of Client Digital Assets	Delegation and Outsourcing
Disclosure	Record Keeping & Reconciliation of Digital Assets
AML/CTF	Ongoing Monitoring

HKMA Custody Circular (Feb 2024)

- **Can AI Outsource or delegate the custodian service?**
- For VAs (as defined in section 53ZRA of the AMLO) → can delegate or outsource the custody function to (i) another AI (or a subsidiary of a locally incorporated AI); or (ii) a VA trading platform licensed by the SFC.
- For digital assets other than VAs (i.e. tokenized securities and other tokenized assets, AI should exercise care and assess whether it is appropriate to delegate or outsource based on the risk involved.
- Where an AI enters into a delegation or outsourcing arrangement for digital asset custodial services, the AI should perform appropriate due diligence of the service provider, documented in writing. The AI should assess and be satisfied with:
 - service provider's financial soundness, reputation
 - managerial skills, technical and operational capability
 - capacity to ensure compliance with applicable legal and regulatory requirements,
 - the ability and capacity to keep pace with the technological developments

Re Gatecoin – VA is property

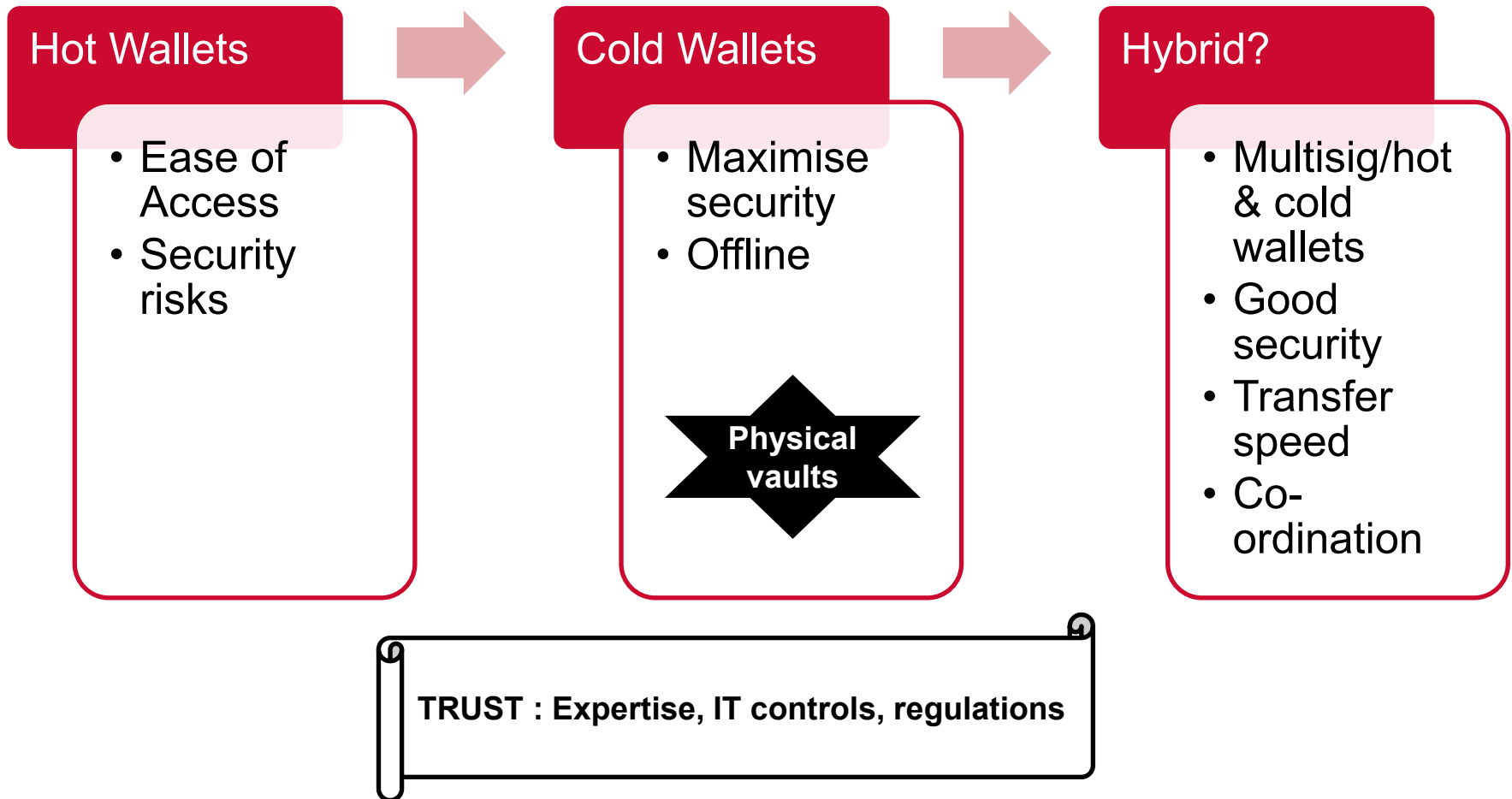
Re Gatecoin Limited [2023] HKCFI 914

- Gatecoin was wound up by Hong Kong court. Liquidators take into custody all “property” upon a winding-up order.
- Question: Are crypto-assets “property”?
- Test: (a) definable; (b) identifiable; (c) capable of assumption by third parties; (d) some degree of permanence and stability
- Court: Checked all boxes → crypto-assets are “property” capable of being held on trust → beneficiaries have a proprietary claim against the trustee

Intermediaries providing custodian services – some points to consider

- Whether there is a trustee/beneficiary relationship – depends on contractual arrangement
- If there is trust, is the duty breached? → depends on the scope of duty under the trust, for example, the risk allocation for loss of client assets resulted from cybersecurity failures or fraud

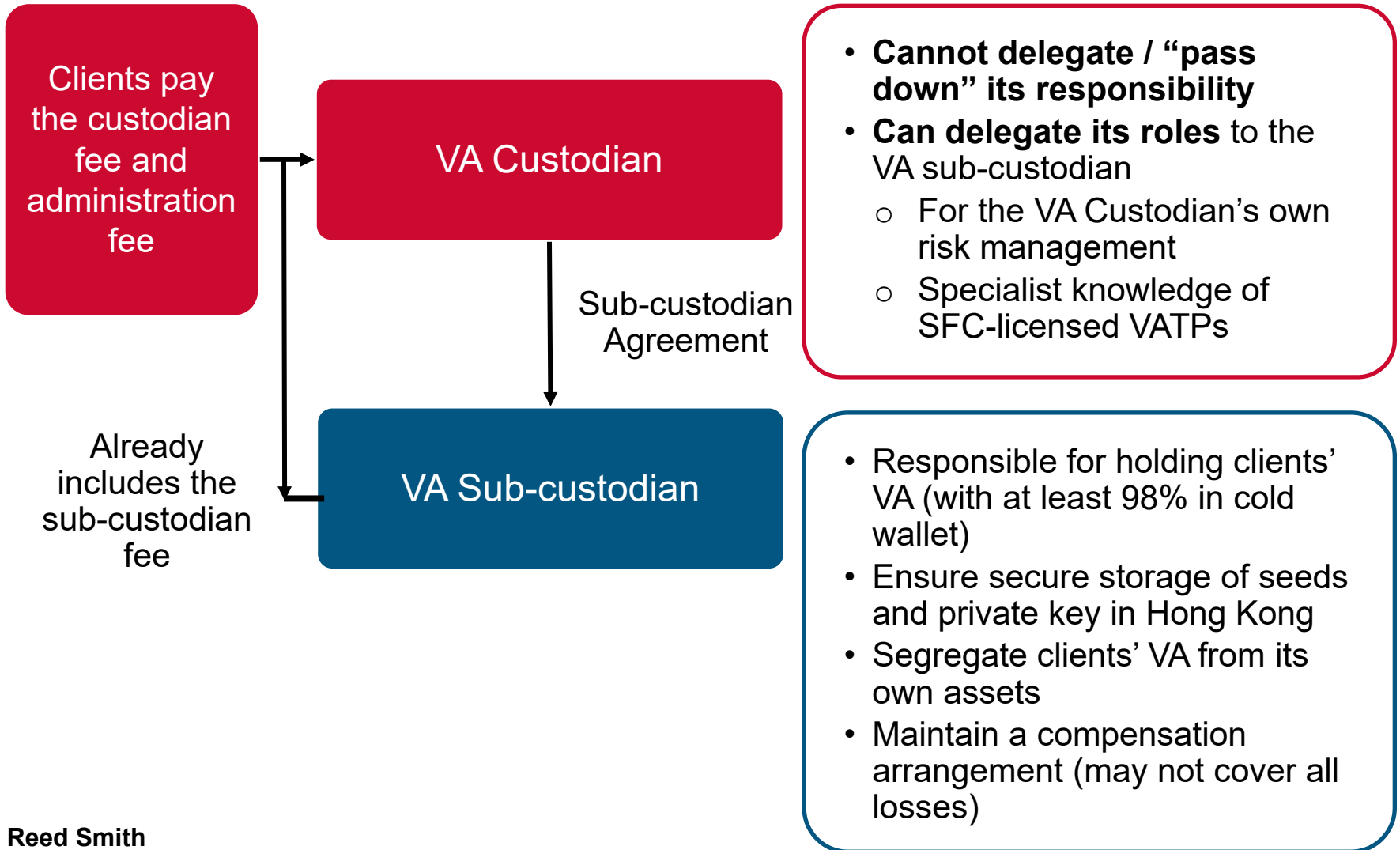
Practical Challenges



VA custody services - more players to join

- Partnered with sub-custodians OSL Digital Securities Limited and Hash Blockchain Limited, BOCI-Prudential is the custodian for the six spot Bitcoin and Ether ETFs listed on the Stock Exchange of Hong Kong earlier this year.
- Hex Trust is an established digital asset custodian that provides services to financial institutions, Web3 and Metaverse players.
- Bank of New York Mellon launched its Digital Asset Custody platform in Oct 2022, offering cryptocurrency custodian service to selected clients.

Exchange traded ETFs



Questions?



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Jill's areas of practice are financial services and corporate regulatory and compliance issues. She is regularly identified as a leading lawyer in legal directories.

She was previously Deputy General Counsel at the Hong Kong Monetary Authority and was in-house counsel as Head of the Asia-Pacific Regulatory Advisory Group, Legal and Compliance at Credit Suisse. In addition, Jill has also worked in leading international law firms in Hong Kong. Her experience with a regulatory and as in-house counsel, combined with many years of advising financial institutions and corporates during times of great regulatory changes, allows her to provide in-depth and constructive insights into the regulatory issues and challenges facing financial institutions and corporations.

Thank You

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