

LCQ16: Regulation of financial technology applications

Following is a question by the Hon Dennis Kwok and a written reply by the Secretary for Financial Services and the Treasury, Mr James Lau, in the Legislative Council today (April 3):

Question:

In November last year, the Securities and Futures Commission (SFC) announced a new regulatory approach for virtual assets aiming to bring virtual asset portfolio managers and distributors of virtual asset funds within the scope of SFC's regulation, which includes imposing licensing conditions on such managers and exploring regulation of virtual asset trading platform operators. In addition, the SFC launched in September 2017 the SFC Regulatory Sandbox to provide a confined regulatory environment for qualified firms to conduct regulated activities utilising financial technologies (Fintech). Regarding the regulation of Fintech applications, will the Government inform this Council:

(1) whether it has plans to amend the legislation to bring the trading activities of virtual currencies within the scope of regulation by the SFC; if so, of the details; if not, the reasons for that;

(2) of the measures in place to prevent lawbreakers from conducting money laundering activities and other illegal activities through the trading of virtual currencies, which are currently not regulated by the law;

(3) whether it knows the regulatory actions which the SFC has taken against relevant managers and distributors since the new regulatory approach was announced;

(4) whether it knows if the SFC Regulatory Sandbox has conducted trials on activities on crowdfunding platforms; if the Sandbox has, of the results and operation; whether it will amend the existing legislation to facilitate the launch in Hong Kong of new types of crowdfunding activities conducted by utilising Fintech; if so, of the details and timetable; if not, the reasons for that;

(5) whether it knows if the SFC Regulatory Sandbox has currently included, in its scope of regulation and study, the securities dealing activities conducted through artificial intelligence; if the Sandbox has, of the results; if not, the reasons for that; and

(6) of the following details of the trials which the SFC Regulatory Sandbox has conducted or is conducting (set out by product in the table below):

(i) the commencement date of the trial,

- (ii) the end date of the trial,
- (iii) the reasons for ending the trial,
- (iv) whether legislative amendments were/are involved,
- (v) (if legislative amendments were/are involved) the details of the amendments, and
- (vi) (if legislative amendments were/are not involved) the reasons for amendments not being involved?

Product on trial	(i)	(ii)	(iii)	(iv)	(v)	(vi)

Reply:

President,

(1) The financial regulators in Hong Kong have been keeping a close watch on the development of virtual assets activities in order to prevent the potential risks involved. If the structure, facts and circumstances of individual virtual asset fall under the definition of "securities" or "future contracts" in the Securities and Futures Ordinance (Cap 571), they are subject to the regulation of Hong Kong securities laws. For individuals or institutions that are dealing in or advising on such virtual assets, or managing or marketing a fund investing in such virtual assets, they are required to be licensed by or registered with the Securities and Futures Commission (SFC).

As far as Initial Coin Offerings are concerned, if the digital tokens that are offered or sold are "securities", including shares, debentures and collective investment schemes, as defined in the Securities and Futures Ordinance, such activities will be regulated under the Ordinance. The SFC published a statement in September 2017 to reiterate and clarify the relevant regulatory regime.

As regards virtual assets trading platforms, pursuant to the power under the existing law, the SFC announced in November 2018 an exploratory regulatory approach under the sandbox environment to observe the operations of platform operators who are willing to be supervised by the SFC on a voluntary basis. Such arrangement enables the SFC to explore whether it is suitable to regulate and grant license to virtual assets trading platforms. The new regulatory approach announced in November 2018 also brings firms which manage or intend to manage portfolios investing in virtual assets and distributors of virtual assets under its regulatory net, so as to regulate the funds at the fund management level and/or fund distribution level.

We will continue to maintain contact with overseas regulators through

active participation in meetings of relevant international organisations, such as the International Organization of Securities Commissions and the Financial Stability Board, to ensure that we could devise a suitable mechanism in good time to address the potential risks arising from virtual assets activities.

(2) Virtual assets activities are potentially vulnerable to crimes such as money laundering and frauds. Such offences are already regulated by existing legislation regardless of whether they involve virtual assets activities.

In terms of the risks of money laundering and terrorist financing, the Organized and Serious Crimes Ordinance (Cap 455), the Drug Trafficking (Recovery of Proceeds) Ordinance (Cap 405) and the United Nations (Anti-Terrorism Measures) Ordinance (Cap 575) stipulate that any individuals shall, on any occasion, report any suspicious activities in relation to money laundering or terrorist financing to the Joint Financial Intelligence Unit set up by the Hong Kong Police Force and the Customs and Excise Department. The Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap 615) imposes that financial institutions and designated non-financial businesses and professions should, when establishing or continuing business relationships with customers, strictly comply with the relevant statutory requirements relating to customer due diligence and record-keeping to prevent money laundering and terrorist financing.

As regards frauds and deceptions under the name of virtual assets investments, they are regulated under the Theft Ordinance (Cap 210) with a maximum sentence of 14-year imprisonment.

The Government, relevant regulators and the Investor and Financial Education Council have rolled out a series of initiatives to remind investors of the risks associated with virtual assets activities.

(3) The SFC has not initiated any regulatory or enforcement actions since its announcement of the new regulatory approach for virtual assets in November 2018. In the event of taking any regulatory or enforcement action, the SFC will, following the established practice, suitably disclose its actions through a press release or a statement, subject to its secrecy obligations.

(4) At present, there is no dedicated piece of legislation governing crowd-funding activities in Hong Kong. Depending on the structures and features of relevant crowd-funding activities, some (such as equity crowd-funding and peer-to-peer lending) may be subject to the provisions of the Securities and Futures Ordinance and/or the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap 32). The SFC has been adopting a "technology-neutral" regulatory approach. If crowd-funding platforms which apply innovative technologies and business model that requires testing, they may be placed in the SFC Regulatory Sandbox and subject to the SFC's close supervision. The SFC has placed two crowd-funding platforms involving the application of innovative technologies in the Regulatory Sandbox at the moment and has been, on a trial basis, monitoring their operation through granting of licences, with the condition that they can provide services to professional investors only.

(5) Many licensed corporations have been making use of algorithms and artificial intelligence in dealing in securities. While dealing in securities is, as always, regulated by the SFC under the Securities and Futures Ordinance, the SFC is open to testing the application of artificial intelligence and other innovative technologies in such regulated activities under the Regulatory Sandbox. To-date, the SFC has not received any application to include this type of operational model into the Regulatory Sandbox for study.

(6) The specific arrangements for including qualified firms involving the application of innovative technologies in the Regulatory Sandbox would depend on the circumstances of an individual case. Depending on the actual circumstances of the trial (e.g. once a qualified firm has demonstrated that its services are reliable and its internal control procedures have adequately addressed any risks identified), it may apply to exit the Regulatory Sandbox and end the study at a suitable time. Unless relevant statutory exemptions apply, the SFC cannot disclose specific information about individual licensed corporation, including its testing arrangements and performance in the Regulatory Sandbox due to secrecy obligations. Overall speaking, since the relevant trials and testings are still in progress, we have yet to come to a final conclusion on the outcome, including whether there is a need to make legislative amendments.