

## **Fintech: Metamorphosis of the financial industry Keynote address at Hong Kong FinTech Week 2021**

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I am delighted to have this opportunity to update you on the progress of the Securities and Futures Commission's (SFC) approach to Fintech regulation in Hong Kong and share some views on the dramatic changes in the global regulatory landscape over the past few years.

### **The process of metamorphosis**

I want to begin by talking about dramatic changes. Many of you would have learnt about metamorphosis when you were in school. The most well-known example of this is the life cycle of butterflies. To start the process, a caterpillar's body releases hormones which trigger drastic changes to its cells, and even some behavioural changes such as spinning the cocoon that protects it during its transformation.

When metamorphosis is complete, the caterpillar—which once was an unsightly crawling worm—transforms into a beautiful flying insect.

### **Fintech and virtual assets**

The financial industry is also undergoing a kind of metamorphosis. Just like the hormones that trigger the metamorphosis of the caterpillar, technology has triggered the transformation of the financial industry. It has allowed firms to introduce a wide variety of innovative products and services which have enhanced the customer experience and helped achieve better investor outcomes.

For instance, if you want to open an account with a securities broker, you can now do it remotely, from Hong Kong or overseas. You can now use instant messaging apps to place orders with your stock broker or buy an investment fund from a mobile app on your smart phone. Our latest survey on the sale of investment products in Hong Kong found that about 54% of clients had bought funds from online platforms, and online sales accounted for about one-fifth of all funds sold. The number of SFC-licensed corporations selling funds online more than doubled last year. In fact, the distribution of investment products is one area where the pandemic and work-from-home really accelerated the use of technology.

The use of technology can also lower costs for consumers. In the past, investors needed to pay substantial fees for financial advice. With the advent of technology, these services can now be automated and be provided at a lower cost.

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

In Hong Kong, we license several digital wealth management advisory platforms, or what we call “robo-advisors”, and are now considering a few new applications. These services can help retail investors diversify their portfolios more efficiently and more affordably.

Here I want to stress that for all of the examples I just mentioned, the SFC has provided clear guidance on how our regulatory principles will apply in a digital environment.

### **A paradigm shift**

This brings me to virtual assets. Amongst all the changes in the financial industry, virtual assets are the one innovation which has brought about a paradigm shift and what we might even call a metamorphosis.

To start with, it might be useful to recap how we got here in the first place. The virtual asset space has evolved dramatically over the span of just a few years. In metamorphic terms, there have been many butterfly cycles already.

Virtual assets first appeared on the regulatory radar in 2017, when initial coin offerings were prevalent. Many so-called offerings were actually scams which posed serious consumer protection issues.

At that time, international regulatory bodies such as the Financial Stability Board declared that virtual assets did not have any intrinsic value at all. The crypto world was seen to be of marginal importance to the global financial system—a fad that would eventually fade away.

Those were the early days. Financial regulators were reluctant to put this under their regulatory net, as that may provide virtual assets with legitimacy. Another challenge was where the line was drawn around the regulatory perimeter. Bitcoins do not fit into the definition of securities or funds and therefore fall outside the perimeter in most jurisdictions.

But it was clear that the anonymity common in trading these assets raises serious issues around money laundering and terrorist financing. Not only that, but trading on unregulated virtual asset platforms raises serious market integrity and consumer protection issues related to cybersecurity, market manipulation and the safe custody of assets.

Financial regulators were struggling with these issues. How do virtual assets and their activities fit into the regulatory regime? Should they be regulated or not?

At the time, the responses from regulators were diverse. At one end of the spectrum, a few opted for a total ban. At the other end, some jurisdictions fully embraced crypto assets. Thinking that regulation might stymie innovation, they opted for an extremely light touch.

Most jurisdictions fell in between, adopting a wait and see attitude.

### **The SFC’s approach to virtual assets**

The SFC was one of the early pioneers in coming up with a comprehensive policy response. We decided that we could not rely on a narrow interpretation of our remit, taking the view that the whole crypto world was unregulated and the most we could do was warn the public of the risks. If, in reality, investors are left unprotected as crypto activities thrive, then maintaining the status quo may not be an option.

This led us to announce a regulatory regime for virtual assets at FinTech Week in 2018. It included new requirements for funds supervised by the SFC which intend to invest more than 10% of a mixed portfolio in virtual assets. This is irrespective of whether the virtual assets amount to “securities” or “futures contracts”, which already fell within our regulatory perimeter.

Another requirement was that only professional investors should be allowed to participate, and we provided specific guidance on the distribution of funds with crypto exposures.

We also announced that we would explore a conceptual framework for centralised virtual asset platform operators to opt-in for our regulation. A year later, we formally launched this framework, publishing regulatory requirements which applied the principle of “same business, same risks, and same rules”.

What this means is that the regulatory requirements for virtual asset platform operators draw heavily on the standards we expect of conventional securities brokers and automated trading systems, although they have been adapted somewhat to deal specifically with crypto technology. In addition, we required that licensed platforms should only provide services to professional investors for the time being.

The framework covers all the key investor protection concerns, including the safe custody of assets, know-your-client requirements, anti-money laundering, market manipulation, risk management and cybersecurity. The requirements are the same as for the automated trading platforms and dark pools we already supervise.

Why an opt-in approach? Our view back then was that it was far too early to change our laws to specifically cover the crypto world, which moves too fast to be pinned down by a bespoke legal framework. This approach has allowed us to protect investors, watch the space evolve and gain supervisory experience to help us decide how the wider virtual asset universe should be regulated in future.

### **The changing regulatory landscape**

Three years have gone by since the inception of the idea, and we have put in place a regulatory framework for virtual assets, licensed one virtual asset trading platform and applications from several others are under our consideration. We also approved a number of virtual asset fund managers and are considering several more of those too. Of course, some in the crypto world would say three years is an eternity. But there is no denying that the regulatory landscape has gone through a dramatic change in a short period of time.

First, in recognition of the fact that virtual assets are going to stay, most regulators around the world have brought them under some form of regulation—at the very least, some kind of anti-money laundering regime.

The Financial Action Task Force made a strong global push toward greater regulation of the virtual asset space. It enhanced its standards to require jurisdictions to license or register virtual asset service providers and subject them to the same range of anti-money laundering obligations which apply to financial institutions.

To comply with these standards, the Hong Kong Government concluded earlier this year that the local anti-money laundering law should be amended to mandate all centralised virtual asset trading platforms to be licensed by SFC.

Second, regulators are paying more attention to market integrity and investor protection concerns. The International Organization of Securities Commissions (IOSCO) has suggested specific areas to consider when regulating virtual asset trading platforms<sup>1</sup>. You may not be surprised to hear that these are the same areas the SFC looks at under our existing regulatory framework for virtual asset trading platforms. Just recently, Gary Gensler from the US Securities and Exchange Commission said publicly that he has made it a priority to focus on regulating crypto trading platforms.

The third area of regulatory attention is stablecoins. This follows an explosion of interest in Diem, previously known as Libra. In contrast to virtual assets like Bitcoin, which has no intrinsic value and is extremely volatile, stablecoins are relatively stable and this is a key feature of the pitch that they can make cross-border payments far less expensive.

The Bank for International Settlements' Committee on Payments and Market Infrastructures and IOSCO recently published a joint report which advocated for regulating stablecoin arrangements as a financial market infrastructure similar to traditional payment, clearing and settlement systems. The report also urged regulators to consider the systemic importance of stablecoin arrangements.

These developments in the international regulatory scene underscore that the “same business, same risks, same rules” approach we adopted in 2018 is the right way to go.

### **New market developments**

Of course, there have also been significant changes in the market landscape over the past three years. Virtual assets are edging towards mainstream finance.

More different types of virtual asset investment products are available and conventional exchanges overseas now offer crypto exchange-traded funds (ETFs). Financial institutions are moving towards offering these products and services. In recent months, we have received a number of enquiries from financial institutions eager to offer virtual assets to their private bank clients or professional investors.

These questions involve complicated issues because the regulatory landscape is still very uneven. For instance, some licensed firms wish to provide cryptocurrency trading services to clients either by acting as an introducing agent or through an omnibus account arrangement opened at a virtual asset platform.

The question under consideration is: do these firms expose their clients to undue risks if the virtual asset platforms are unregulated or regulated for limited purposes? Also, under an omnibus account arrangement, the firm will directly onboard the clients and trade for them. Would some of the regulatory obligations typically imposed on a licensed virtual asset trading platform apply to licensed firms too? Do we expect the firm to conduct a knowledge assessment before providing virtual asset trading services to clients?

Distribution of virtual asset-related investment products is another growing area of interest. We already have guidance on the distribution of investment funds with crypto exposures. But what about other products, such as crypto-related ETFs traded on conventional exchanges?

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<sup>1</sup> IOSCO Final Report, [Issues, Risks and Regulatory Considerations Relating to Crypto-Asset Trading Platforms](#), February 2020.



Should we allow retail investors to access these products through online brokers? If so, would there be additional knowledge requirements or risk disclosures?

This is just a glimpse of the regulatory issues involved. We are now reviewing the regulatory regime for virtual assets we introduced three years ago to see if it is still fit for purpose, and whether any modifications are required. We are in close contact with the Hong Kong Monetary Authority with a view to issuing a joint circular after the review. One can expect that it would incorporate the “same business, same risks and same rules” principle in a proportionate manner.

Here in Hong Kong, we see our job as providing regulatory clarity to support the healthy development of this space. A clear regulatory environment is just as important as the cocoon in metamorphosis. Some may say the cocoon is limiting innovation and development, but like all good regulation, it will help Fintech firms and their services to incubate. They can operate within a secure environment for sufficient trust to be gained from investors for the business to be scaled and provided to the wider public.

To conclude, I want to emphasise that we will maintain our practical approach to provide a well-defined regulatory environment which fosters innovation, market development and investor protection. We look forward to continuing this journey with all of you, and to seeing more beautiful butterflies from the Fintech sector complete their transformation and move from the fringe to the financial industry mainstream.

Thank you very much.