

Fintech: a regulatory strategy for a dynamic industry Keynote speech at Hong Kong FinTech Week 2019

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6 November 2019

At last year's FinTech Week, I talked about some emerging regulatory views on technology in financial services, especially in relation to blockchain-based crypto assets.

What a difference a year makes!

In 2018, the crypto world was seen to be of marginal importance to the global financial system. The Financial Stability Board, which is basically the G20's financial regulatory arm, concluded last year that, although blockchain "currencies" such as Bitcoin were problematic from an investor protection angle, they did not yet pose any significant financial stability risks.

But then came Facebook's Libra, and the international regulatory community had to get its act together very rapidly.

So, today I want to run through some of what has happened over the past twelve months from a regulatory perspective. And, as I did last year, I will outline some important announcements we will be making later today about the regulation of crypto assets in Hong Kong.

First, there is no doubt that we have had to contend with a growing list of issues raised by technology in financial services.

These include how to apply existing regulations in the context of increased automation and the adoption of artificial intelligence and machine learning. Or whether we need to introduce entirely new rule sets to manage activities based on new technology.

Many regulators are also concerned about financial services that are outsourced to a small number of "big tech" companies. In fact, only last month the SFC issued a statement on how we expect records to be accessible when firms use cloud computing. And, on top of this, data privacy issues are looming ever larger. As are fundamental questions about how to regulate conduct in financial services when machines, not humans, make decisions.

We recognise that we must be open to the benefits of innovation, but our bottom line is that we need to stay vigilant about the risks of new technology. The basic approach is technology-neutral. Same business, same risks, same rules.

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

Recent trends in crypto assets

But the sector which has seen more regulatory activity than most is, as I have said, that involving crypto assets.

These go by many different names: including “cryptocurrencies” – although the official sector has studiously avoided this term because it implies that crypto-coins, digital tokens, initial coin offerings and the like are equivalent to money, which they are not. At the SFC we have been using “virtual assets” as a relatively neutral label.

And there is no doubt that these virtual assets have been moving further into conventional financial markets, with more falling within the existing scope of securities regulation. One example is Bitcoin futures, which are now offered by established exchanges in the US.

And in other areas, firms which traditionally offer safe custody of familiar financial assets – stocks, bonds and their derivatives – are now looking to provide similar services for virtual assets. Insurers are more open to providing coverage, and demand from virtual asset businesses has prompted the “Big Four” accounting firms to expand into this area.

Separately, some large, well-established financial institutions are seeking to develop their own crypto-tokens on private blockchains to enable cheap, instantaneous cross-border payments for their institutional clients.

And this brings me to the explosion of interest in so-called stablecoins, and Libra in particular.

These typically claim to have a mechanism to stabilise their value by backing a virtual token – or coin – with fiat currencies, commodities or a basket of other crypto assets. That’s not to say that these are 100% stable. But in contrast to a crypto asset such as Bitcoin – which has no intrinsic value whatsoever and is, as a result, extremely volatile – their relative stability, or claim of stability, is a key attribute. As is the pitch that they might accelerate financial inclusion in unbanked markets and make cross border payments far less expensive.

But you can’t fail to have noticed from media coverage that stablecoin proposals have led to serious concerns among a range of politicians, central bankers and financial regulators. They are especially concerned about proposals which are capable of being adopted extremely rapidly on a global scale.

You will have also read that Facebook’s Libra project has faced headwinds since it was announced in June, with some participants leaving in recent weeks.

But, regardless of its future prospects, the Libra project has galvanised regulators across the world to look far harder at the opportunities and risks inherent in virtual assets. This is a significant change from the more relaxed attitude only last year. We now fully recognise that any convincing official sector response will need, for the first time ever, to coordinate properly across two important dimensions.

The first involves the need for the full range of domestic data privacy, financial stability, competition, anti-money laundering, and consumer and investor protection authorities to work together on an unprecedented scale. That’s because stablecoin initiatives, especially



those proposed by technology businesses with large ecosystems, involve risks in all of these areas.

And to add to the challenge for regulators, the second dimension is that all these authorities must also coordinate globally to tackle a real risk of regulatory arbitrage.

The concern is that if a retail stablecoin is approved in one jurisdiction, whether as a security, payment system, fund, trading platform or another category (or a combination of these), it could easily go global very quickly if it rides on the back of the huge user-base of a Big Tech platform. There are even fears that a global stablecoin could result in countries – especially in developing markets – losing control over their own currencies and monetary policy.

In fact, stablecoins have raised such fundamental issues about the digitalisation and the potential privatisation of money that they have already inspired the beginning of a new global, multilateral approach amongst central banks, regulators and governments, in which the SFC is also closely involved.

So watch this space – there will be much more to come.

Update on the SFC's Fintech initiatives

But today I want to concentrate on what the SFC has been doing in Hong Kong in response to the use of new technologies.

Over at the Hong Kong Monetary Authority, the big story has been virtual banks.

For the SFC the key focus of our work has been whether to regulate platforms – commonly known as “crypto exchanges” – through which the public can trade a whole range of virtual assets.

We saw this as a priority because this type of platform has proliferated in Hong Kong and up to now has largely escaped any form of regulation.

Why is this the case? It's because most virtual assets fall outside the legal definition of “securities” or “futures contracts”. So if a platform only offers these “non-securities” types of crypto-assets for trading, the operation of the platform itself escapes the prospect of being subject to any investor protection regulation.

Notwithstanding this, we haven't been inactive in this area.

For instance, we intervened in several cases – mainly involving initial coin offerings – where we provided regulatory guidance, issued warnings or in some cases took formal regulatory action.

But our policy work has mainly concentrated on businesses where the virtual asset world most closely interacts with financial services and the wider public. These are, first, investment funds with exposures to virtual assets. And secondly, as I've mentioned, those platforms across which the public can trade virtual assets.



As to funds, we started with announcements made at last year's FinTech Week, shortly followed by detailed conduct standards for brokers who distribute virtual asset funds as well as the standards expected of fund managers themselves.

These measures meant that investor interests are now protected either at the fund management level, at the distribution level, or both.

But this left the crucial area of virtual asset platforms to be dealt with. Crucial because it is through these platforms where the public mainly gets access to virtual assets. And crucial because Hong Kong is home to a large number of these platforms.

So later today, we will publish a new regulatory framework which enables virtual asset trading platforms to be regulated by the SFC.

Regulatory framework for virtual asset trading platforms

This is a major development, and builds on a potential way forward I outlined at FinTech Week last year.

At that time, we were very alive to the special risks posed by virtual asset trading platforms.

The safe custody of a user's crypto-assets and cybersecurity are major concerns. There have been many instances of platforms being hacked, with investors suffering substantial losses. Trading rules may not be transparent and fair, and crypto markets are vulnerable to manipulation.

Members of the public usually trade through these platforms directly over the internet, rather than through SFC-regulated brokers or advisers, who would otherwise provide a valuable layer of protection. And the anonymity and other technical features of blockchain-based crypto assets are a major worry from an anti-money laundering and counter-financing of terrorism perspective.

So, bearing all of these risks in mind, we met with a number of crypto-platform operators to see whether we could design a credible regulatory response and whether some platforms were in fact capable of operating in a regulated environment. After an in-depth examination of the unique technical and operational features of these platforms, we finally concluded that some could be regulated by us.

So what we will announce today is a detailed scheme for the regulation of crypto-platforms. It draws heavily on the standards which we expect of conventional securities brokers and automated trading systems. But it also adapts those standards to deal specifically with the technology on which the industry is based¹.

Our new regulatory framework covers all of the key investor protection concerns, including the safe custody of assets, know-your-client requirements, anti-money laundering and

¹ The International Organization of Securities Commissions published a [consultation report](#) in May 2019 setting out key considerations and toolkits for jurisdictions which have legal authority to regulate trading activities on virtual asset trading platforms.

market manipulation. And it also zeros in on many of the new concepts we are getting used to, such as hot and cold wallets, forks, airdrops and the like. We will also set out the criteria for platforms to decide on the inclusion of a new virtual asset for trading.

And we will make sure that platform operators can only provide services to professional investors, and then only to those who can demonstrate that they already have sufficient knowledge of investing in this area.

Finally, all licensed platforms must have insurance covering the risk of virtual assets being lost or stolen.

Now, a very important point. I have mentioned that the SFC only has power to regulate a platform that trades virtual assets or tokens which are legally “securities” or “futures contracts”. Bitcoin and the other, more familiar crypto assets are not securities.

And nothing in our new framework alters this position. It can only apply to those platforms which decide to include at least one security crypto asset or token for trading. But once this happens our new rules will apply to all platform operations, even if the vast majority of other virtual assets traded on the platform are not securities.

So this, essentially, is a framework allowing a platform operator to opt-in to regulation. The benefit is that it would then be able to say to all its clients that it is a supervised business. Once licences are granted to those platforms which choose to opt-in, investors will then be able to distinguish easily between properly regulated platforms, and all the rest.

New licensing applications

The upshot is that the SFC will, from today, invite licensing applications from platform operators which are committed to and are capable of complying with our licensing criteria and continuing conduct requirements.

Now although we have come up with a comprehensive regime for those platforms which choose to be regulated, the fact is that we are doing this under existing legislation which was not designed with the crypto world in mind. This leaves us with inevitable gaps and limitations.

First, most virtual assets traded on an SFC-licensed platform will not be subject to the same kind of regulation which applies to traditional offerings of securities or investment funds.

For example, there are no disclosure requirements for an offer of virtual assets which are not legally securities – which will still account for the majority of products traded on licensed platforms.

Further, the SFC’s usual authority to take legal action against market participants for misconduct will not apply to licensed virtual asset trading platforms. That’s because these platforms are not recognised stock exchanges or futures markets.

We also recognise that Hong Kong hosts dozens of virtual asset trading platforms which, while posing serious investor protection concerns, may decide not to seek an SFC licence under the new regulatory framework.

As I've said, they can do this simply by ensuring that no virtual asset traded on their platforms is a "security". They may well take the view that the SFC's regulatory expectations are too difficult or too costly, and that they would much rather continue as an entirely unregulated business.

We recognise that this remains the most significant limitation, and explains why the maximum we can do at the moment is to offer an opt-in solution.

It was of course open to us to delay any regulatory response altogether, notwithstanding the growth of virtual asset trading platforms in Hong Kong. We could have waited until any new legislation covers the entire virtual assets sector.

But we decided that it would be wrong to bury our heads in the sand just because we could not provide a comprehensive answer. Legislation is usually a fairly long process. And it was clearly in the public interest to act now, allowing investors to choose to participate only in those crypto-platforms or "exchanges" which agree to be regulated and supervised.

But I should also emphasise that this can only be an interim measure. The rapid evolution of the virtual asset sector cries out for new, comprehensive legislation which enables innovation benefiting investors and economies to flourish in an environment where new risks are addressed properly.

And as I mentioned at the beginning, the game-changing proposals around stablecoins are likely to be a catalyst for accelerated thinking about an overarching, globally consistent set of regulatory expectations.

One further thing. We have been extremely concerned about platforms which offer virtual asset futures contracts to the public, especially contracts which are highly leveraged. They are volatile and extremely risky, and valuation is extremely difficult. Platforms offering these contracts have also been criticised for changing their trading rules during the life of a futures contract, including halting trades or rolling back transactions.

So we will issue a second statement today which alerts investors to these risks. It also makes clear that those who offer virtual asset futures for trading may well be conducting an illegal activity, either under the Securities and Futures Ordinance or the Gambling Ordinance.

Conclusion

To conclude, I want to emphasise once again that our rules are meant to be principles-based and technologically neutral. The challenge is how to apply consistent principles of investor protection and provide useful, detailed guidance on the use of innovative technology in such a fast-moving environment. We, and other regulators around the globe, want Fintech to flourish in a way that promotes a high level of confidence in all who participate.

The jury is still out on whether some virtual assets – especially those that have no intrinsic value – have a useful social function or can be considered as equivalent to conventional financial assets. But it is clear that if we do regulate operators in the virtual asset space, we should hold them to the same standards as the rest of the financial system.



So we hope the measures we will announce today will encourage the responsible development of new technologies, influence the international debate and also provide investors with more choices and better outcomes.

Thank you and enjoy the rest of FinTech Week.