

Hong Kong Regulator's Views on Decentralised Finance

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Keith Choy, Interim Head of Intermediaries, Securities and Futures Commission (SFC), delivered a keynote speech¹ at the Hong Kong Web3 festival on 12 April 2023. He shared the commission's regulatory stance and policy initiatives on Decentralised Finance (DeFi) and Virtual Asset Trading Platforms (VATPs) as well as the SFC's views on potential regulations under the current regime. Below are some of the key points from his speech.

“The challenges associated with identifying the persons who should be held accountable in DeFi may not actually be insurmountable.”

Keith Choy, Interim Head, Intermediaries, SFC.



Decentralised Finance

Regulatory Issues

- **Financial stability implications** were highlighted arising from:
 - **Interconnectedness** within DeFi and virtual asset (VA) ecosystems as well as DeFi traditional financial worlds; and
 - **Leverage** obtained by posting VA borrowed from one DeFi (borrowing and lending protocols) as collateral to obtain further loans.
- **Limited transparency** on the interconnections and linkages within the market due to the limited availability of data, as many firms and activities are not currently regulated;
- **Market integrity issues identified** such as price oracle manipulation, front running transactions and other types of abusive behavior; and
- **Investor protection and cybersecurity concerns** arising from the increasing number and scale of cyber attacks, smart contract code exploits, frauds and scams involving DeFi protocols.

Challenges with Regulating DeFi

- 1. Who should be held accountable when things go wrong?**
 - The governance of a DeFi product or service may be decentralised to varying degrees and may involve the use of governance tokens or decentralised autonomous organisations. Therefore, it is **difficult to identify the individual(s) responsible for a DeFi product or service from an accountability perspective**
- 2. Difficulty in identification of developers and operators of a DeFi protocol**
 - **Pseudonymous nature of DeFi** renders identification of developers and operators of a DeFi protocol challenging; and
 - **Cross-border nature of DeFi** products and services, whose developers and operators may be based in multiple jurisdictions, further compounds the identification challenges



Regulator's Views on DeFi

1. The **same existing regulatory framework** applies to all financial activities. Providing DeFi activity falls within the scope of the Securities and Futures Ordinance (SFO), it would be subject to the same regulatory requirements applicable to a traditional finance activity, under the **“same business, same risk, same rule” approach**.
2. **Identifying accountable individual(s):**
 - Regulators will first assess each DeFi service or activity on a case-by-case basis after understanding the inner workings and arrangements of a DeFi protocol; and
 - Once a review of the DeFi arrangements is completed, regulators will identify the individual(s) who should be held accountable for any misconduct or breach of regulatory requirements.

Key Impacts on DeFi Platforms

Decentralised platforms that provide services **falling within the regulation of the SFO** may be required to be **licensed** in order to continue such activities.

Marketing of a **DeFi liquidity pooling protocol in Hong Kong** which falls within the definition of a collective investment scheme may be subject to the **authorisation requirements** under SFO.

The **individual(s) who hold the vast majority of governance tokens, or who have the power to vet governance proposals put forward by others**, may be held accountable for any misconduct and breach of regulatory requirements.



Areas Where We Can Support You:



Licensing support for DeFi firms, and assistance with SFO authorisation requirements (where applicable).



Review DeFi service or activity protocols, arrangements and internal processes to help identify accountable individual(s) to the SFC.



Licensing support for VATPs, including transitional support for existing SFO-licensed platforms, and new licensing support for non-licensed VA platform operators.



Perform a gap analysis and readiness assessment of VATPs structure, governance, operations, systems and controls, staffing, token admission, custody of virtual assets, KYC, AML/CFT, market surveillance, risk management and cybersecurity.



Cybersecurity and technology assessment through vulnerability scans and penetration tests for both DeFi firms and VATPs.

References

¹Securities Regulation in the Web3 Era Keynote Speech at Hong Kong Web3 Festival 2023, April 2023

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²SFC Consultation Paper on Proposed Licensing Regime for VATP Operators, February 2023

<https://kpmg.com/cn/en/home/insights/2023/03/sfc-consultation-paper-on-proposed-licensing-regime-for-vatp-operators.html>

³Hong Kong Government, Anti-Money Laundering and Counter-Terrorist Financing (Amendment) Bill 2022, June 2022

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