

HONG KONG IMPLEMENTS A COMPREHENSIVE REGIME ON THE REGULATION OF VIRTUAL ASSETS

Executive summary

Licensed intermediaries are permitted to provide a range of services related to virtual assets (VAs) to professional investors, subject to complying with a suite of investor safeguards. The safeguards include partnering only with SFC-licensed VA trading platforms when providing VA dealing services and conducting client knowledge assessments before distributing any VA-related products. Retail investors are excluded from the regime except in relation to the distribution of a limited category of exchange-traded VA derivative products and funds.

This bulletin focuses on the new SFC requirements.

Introduction

On 28 January 2022 Hong Kong financial regulators issued the following guidance to regulate the VA space:

1. SFC and HKMA - [Joint Circular on Intermediaries' Virtual Asset-related Activities \(Joint Circular\)](#);
2. HKMA - [Regulatory Approaches to Authorized Institutions' Interface with Virtual Assets and Virtual Asset Service Providers](#); and
3. Insurance Authority - [Regulatory Approaches of the Insurance Authority in Relation to Virtual Assets and Virtual Asset Service Providers](#).

This represents a comprehensive policy update to regulating VAs and VA-related activities and builds upon the following guidance issued in recent years:

- November 2018 statement on the [regulatory framework for VA portfolio managers, fund distributors and trading platform operators](#) (see our previous [briefing](#) for more detail):
 - Licensed VA portfolio managers are to ensure only professional investors invest in their VA funds. 'Recommendation/ solicitation' suitability requirements and 'complex product' suitability requirements will likely apply other than to a category of professional investors (being institutional

professional investors and qualified corporate professional investors (**Exempt PIs**));

- on 4 October 2019 the SFC published the [Pro Forma Terms and Conditions for VA portfolio managers \(RA9 T&Cs\)](#);
- the SFC [position paper](#) dated 6 November 2019 on the regulation of VA trading platforms. Platforms which offer trading of at least one VA that constitutes a 'security' may opt-in to a licensing regime. They should only offer services to professional investors and assess the client's VA knowledge (other than Exempt PIs); and
- the Financial Services and the Treasury Bureau's May 2021 [consultation conclusions](#) to introduce a new compulsory licensing regime for VA exchanges (largely covering exchange function crypto-assets such as Bitcoin as well as stablecoins). The regime will be housed in the anti-money laundering legislation and will require VA exchanges to offer services to professional investors only. See our previous [briefing](#) for more detail.

The November 2018 [circular on distribution of VA funds](#) has been superseded by the new guidance.

This briefing focuses on the Joint Circular issued in January 2022, which contains (among other things) the investor protection measures that intermediaries (i.e. licensed corporations and registered institutions) are expected to follow when providing VA-related services.

What VA and VA-related products are covered?

What is meant by a 'crypto-asset' or a 'virtual asset' can be confusing. The Bank for International Settlements has issued the following [crypto-asset classification](#) which was recently followed by the HKMA:

Function	Type of Crypto-Asset
Means of exchange	Stablecoins (which can be divided into algorithmic stablecoins, asset-linked tokens and e-money tokens)
	Non-stablecoins (the most well-known being Bitcoin)
Investment (similar to financial instruments)	Security tokens
Utility (granting access to a product/service)	Utility tokens

This classification of crypto-assets excludes digital representations of fiat currencies issued by central banks (commonly known as **CBDCs**).

The new regime relates to all crypto-assets in the above classification (albeit only peripherally to utility tokens).

Joint Circular

'VA' is defined broadly under the Joint Circular to catch any digital representation of value (except CBDCs) which may be in the form of digital tokens (e.g. utility tokens, stablecoins or security- or asset-backed tokens), crypto assets or other assets of the same nature, irrespective of whether they amount to 'securities' or 'futures contracts' under the Securities and Futures Ordinance. VA therefore covers a wider range of crypto assets than security tokens, and includes crypto-coins such as Bitcoin.

'VA-related products' refer to investment products which have a principal investment objective to invest in VAs, derive their value principally from the value and characteristics of VAs, or track / replicate the investment results or returns which closely match or correspond to VAs.

The Joint Circular's requirements broadly can be categorised as follows:

1. Where the intermediary provides VA dealing services

An intermediary may provide **VA dealing services** if:

- a. the intermediary is licensed for Type 1 regulated activity;
- b. it partners only with SFC-licensed VA trading platforms for the dealing, either by way of introducing clients to the platforms for the client's direct trading or the intermediary

establishing an omnibus account with the platforms and trading for the clients. As at today, there is only one such platform although more are expected to be licensed;

- c. the client is a professional investor. This tracks the professional investor requirement which applies to SFC-licensed VA trading platforms;
- d. it complies with certain conduct requirements such as only allowing clients to withdraw or deposit fiat currencies - see paragraphs 19 to 21 of the Joint Circular; and
- e. in particular, under an omnibus arrangement, the licensing conditions in [Appendix 6](#) will apply, similar to those that apply to SFC-licensed VA trading platforms. Save for Exempt PIs, suitability requirements will apply where there is a recommendation or solicitation, and the client's knowledge of VAs and related risks should be prior assessed and training given if there is insufficient knowledge.

Accordingly, retail investors wishing to invest in VAs cannot do so via SFC-licensed trading platforms and intermediaries.

2. Where the intermediary distributes investment products which are VA-related products

The Joint Circular imposes various requirements on intermediaries **distributing investment products which are VA-related products** depending on the nature of the product. [Appendix 3](#) to the Joint Circular contains an illustrative flow chart.

For **non-derivative VA-related products**, these are 'very likely' complex products and the following investor safeguards would apply to their distribution *irrespective* of any solicitation or recommendation by the intermediary:

- a. only be offered to professional investors;
- b. intermediaries must conduct a VA knowledge test on the client (unless it is an Exempt PI). If assessed to have insufficient knowledge, the intermediary should only proceed if it's in the client's best interest and provide client training; and
- c. existing requirements under the complex products regime i.e. ensuring suitability, minimum information and warning

statements (unless the client is an Exempt PI).

For **derivative VA-related products**, the starting point is that the same requirements as for non-derivative products apply. Accordingly, they can only be offered to professional investors and the full scope of complex product requirements apply as described above. In addition, the derivative product KYC requirements under paragraphs 5.1A (knowledge assessment) and 5.3 (e.g. ensure sufficient net worth) of the [Code of Conduct](#) apply, with unauthorised VA funds having additional due diligence requirements under [Appendix 4](#) to the Joint Circular.

Less onerous investor protection measures apply to a limited suite of **derivative VA-related products which are traded on a specified exchange** (being one of the 64 exchanges listed in Schedule 3 to the Securities and Futures (Financial Resources) Rules) **and, additionally in the case of funds, are authorised / approved in a designated jurisdiction** (being one of 12 jurisdictions listed in [Appendix 2](#) to the Joint Circular). These products are considered complex exchange-traded derivatives under the existing complex products regime. This means that for this limited category of products:

- a. the VA knowledge test and the derivative product KYC requirements apply (with certain exceptions for Exempt PIs);
- b. the products may be distributed to *retail investors*, subject to the usual selling restrictions / offer of investments to the public regime in Hong Kong or other applicable jurisdiction; and
- c. where there has been *no solicitation or recommendation*, intermediaries do not need to comply with the suitability requirement under the complex products regime (this operates in a similar fashion to the existing paragraph 5.5(b) Code of Conduct carve-out from the complex products suitability requirement for paragraph 5.1A(a) exchange traded derivatives).

Any distribution of a fund which is a VA-related product that is not authorised for retail distribution by the SFC is subject to product due diligence to be carried out by the intermediary over the fund manager, the fund and the fund's counterparties. The specific product due diligence requirements are contained in [Appendix 4](#) to the Joint Circular.

The above means that certain derivative VA-related products traded on a specified exchange may, in certain circumstances, be available to retail investors.

3. Providing VA asset management services

A Type 9-licensed intermediary can provide **VA-related fund asset management services and VA-related discretionary account management services**. Those providing such services which meet the de minimis threshold (10% or more of the gross asset value of a portfolio in VAs) must comply with the existing requirements (including suitability requirements) set out in the [RA9 T&Cs](#). Type 9 intermediaries would not be subject to these requirements if operating below the threshold. The Joint Circular clarifies that where a Type 1 (dealing in securities) intermediary is authorised by its clients to provide VA dealing services on a discretionary basis as an ancillary (i.e. wholly incidental) service, that Type 1 intermediary should invest less than 10% of the gross asset value of the client's portfolio in VAs.

In each case, the intermediary should allow only professional investors to invest in the fund/account.

4. Providing VA advisory services

To provide **VA advisory services**, intermediaries must:

- a. be licensed in Type 4 (advising on securities) regulated activity (or Type 1 (dealing in securities) regulated activity where presumably the advice will be wholly incidental to the dealing);
- b. offer such services only to professional investors who are existing clients;
- c. comply with the conduct requirements for VA advisory services set out in [Appendix 6](#) to the Joint Circular, such as conducting a VA knowledge test (unless the client is an Exempt PI). Where - as there usually will be - a recommendation or solicitation is made to a client, suitability requirements will apply (except where made to an Exempt PI); and
- d. where it is providing advisory services in VA-related products, observe the same requirements as for the distribution of VA-related products.

Implementation

Intermediaries which already engage in VA-related activities have a six month transition period (until 28 July 2022) to revise their systems and controls to align with the updated requirements. Intermediaries which do not currently engage in VA-related activities must comply with the requirements before introducing such services.

The SFC (and the HKMA, where applicable) should be **notified in advance** if intermediaries intend to engage in VA-related activities, which include the distribution of VA-related products and the provision of VA dealing services.

Hong Kong Monetary Authority and Hong Kong Insurance Authority circulars

Turning to other Hong Kong regulators, the HKMA circular provides guidance on banks' interaction with VAs and VA Service Providers (VASPs) whether through proprietary investment or provision of banking and investment services to customers. The HKMA adopts a risk-based approach based on the principle of 'same risk, same regulation', with banks expected to identify and understand associated risks before engaging in VA activities. The circular provides more specific guidance on three areas: prudential supervision, AML/CFT and investor protection. It clarifies banks are not currently prohibited from incurring financial exposures to VAs, but

will need to have adequate risk management controls and risk mitigation in place (such as setting prudent limits on the institution's overall exposures to VAs) and conduct appropriate due diligence on VAs and VASPs. Banks planning VA products or services should liaise **in advance** with the HKMA on the adequacy of their risk-management controls.

The Insurance Authority adopts a similar risk-based approach. It requires authorised insurers to comply with existing obligations under the Guideline on Enterprise Risk Management in assessing and addressing risks associated with VA-related activities. Insurers are expected to adopt a conservative approach and deduct the full value of VAs when deriving their solvency positions. Those carrying on general business should not include VAs as local assets under section 25A of the Insurance Ordinance (maintenance of assets in HK). Where VAs form part of the premium payment or coverage is provided in relation to VAs, insurers should capture the circumstances and sophistication of customers in the product design phase, make appropriate risk disclosures and provide training so that intermediaries only target customers for whom a product is designed and can advise on its suitability. Insurers planning VA activities should consult with the IA **before** launching any new products or services (including forming any type of relationship with VASPs).

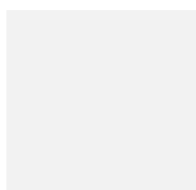
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