

An update on the virtual asset regulatory landscape in Hong Kong



In the past few weeks, the Securities and Futures Commission ("**SFC**") and Hong Kong Monetary Authority ("**HKMA**") issued several publications regarding the regulation of virtual assets in Hong Kong. These publications, listed below, bring about new developments to Hong Kong's virtual asset (and by extension, financial) industry. We explore these developments in this client alert.

- [HKMA's Discussion Paper on Crypto-assets and Stablecoins \(12 Jan 2022\)](#)
- [HKMA's letter re Regulatory approaches to Authorized Institutions' interface with Virtual Assets and Virtual Asset Service Providers \(28 Jan 2022\)](#)
- [SFC and HKMA's Joint circular on intermediaries' virtual asset-related activities \(28 Jan 2022\)](#)

HKMA's Discussion Paper on Crypto-assets and Stablecoins

As its name states, this publication is a discussion paper - it serves to give colour to the city's de-facto central bank's thinking and future policy direction, and to solicit feedback.

We summarize certain of the paper's key discussion points below.

- The HKMA's priorities are to regulate *payment-related* stablecoins (as opposed to non-payment-related stablecoins and other virtual assets). Within the stablecoins ecosystem, the HKMA will be looking to regulate those who undertake activities relating to (amongst other things): the issuance of stablecoins; the stabilization of the value of stablecoins; the validation of transactions; the transmission of funds; and the execution of transactions using stablecoins.
- The HKMA is considering expanding the scope of the Payment Systems and Stored Value Facilities Ordinance (or alternatively, introducing new legislation) to govern stablecoins.
- The virtual asset service provider ("**VASP**") regime, which will be introduced under an amendment to the Anti-Money Laundering and Counter-Terrorist Financing Ordinance, is, at this point, only intended to cover those operating virtual asset ("**VA**") exchanges. The VASP regime will be expanded to cover other types of VA-related activities if and when the regulators feel that there is a need to do so. We previously wrote about the VASP regime [here](#). As at the date of this update, we are not aware of any such amendment bill having been introduced into LegCo.¹
- Authorised institutions that want to provide VA-related investment services are **required** to notify the HKMA and the SFC **in advance**.

Members of the public and the industry are welcome to submit feedback to the HKMA by 31 March 2022.

¹ It is expected to be introduced in Q2 2022, see paragraph 24 of the [Legislative Council Panel on Financial Affairs' paper on Anti-Money Laundering and Counter-Terrorist Financing \(Amendment\) Bill 2022](#).

SFC and HKMA's Joint circular on intermediaries' virtual asset-related activities

This joint circular serves as guidance to, and imposes requirements on, intermediaries who wish to engage in VA-related activities. It expressly supersedes the 1 November 2018 circular to intermediaries on the distribution of VA funds. The requirements will come into effect on **28 July 2022**.

We set out a list of some of the key obligations imposed on intermediaries in respect of different VA-related activities. The list is non-exhaustive, and is subject to various nuances. One of the most welcome changes is that a limited class of exchange-traded VA derivative products may now be offered to retail investors.

| Type of VA-related activity | Our comments and observations (and reference to the relevant part of the joint circular) |
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| <p>Distribution of VA-related products and provision of VA-related services generally</p> | <ul style="list-style-type: none"> • Subject to the exception discussed in the row below, all VA products and services continue to be restricted to professional investors ("PIs") only. • Investors (other than institutional PIs and qualified corporate PIs) must take a VA-knowledge test (para 7.2; appendix 1). • Intermediaries must continue to observe all local and overseas selling restrictions (para 10). • Intermediaries must continue to observe suitability obligations (if triggered) (para 11), and in particular: <ul style="list-style-type: none"> ○ ensure recommendations or solicitations made are suitable for clients in all circumstances; ○ ensure compliance with paragraphs 5.1A and 5.3 of the Code of Conduct where the VA-related product is a derivative product, and this includes providing clients with warning statements specific to virtual asset futures contracts (para 11-12; appendix 5); and ○ conducting proper due diligence on VA products. • Intermediaries must be cautious in providing any financial accommodation to clients for investing in VA products, and assure itself that the client has the financial capacity to meet the obligations (para 13). • Intermediaries must provide information to clients in a clear and easily comprehensible manner (para 14). • Intermediaries must provide clients with warning statements specific to virtual assets (para 15; appendix 5). • Intermediaries must notify the SFC (and the HKMA, where applicable) in advance if they intend to engage in the distribution of VA-related products or the provision of VA dealing services (para 28). • Where the VA-related product is a complex one, which most will be, then, subject to the exception discussed in the row below, intermediaries must also comply with the SFC's complex product regime (para 5). |
| <p>Exception: Distribution of (i) VA-related derivative products that are traded on regulated exchanges specified by the SFC, or (ii) exchange-traded VA derivative funds that are authorised or approved for offering to retail investors by the respective regulator in a designated jurisdiction</p> | <ul style="list-style-type: none"> • The SFC takes the view that in the context of these exchange-traded derivative products, pricing transparency and potential market manipulation may be less of a concern. The examples given are (i) VA futures contracts traded on a specified exchange which is a regulated futures market and (ii) public futures-based VA ETFs authorised or approved in a designated jurisdiction for offering to retail investors, the trading of which would be governed by conventional rules. • Accordingly, these products can be made available to retail investors. • As these products are considered complex exchange-traded derivatives, under the existing complex product regime, where there has been no solicitation or recommendation, intermediaries may distribute them without the need to comply with the suitability requirement, but must comply with the existing requirements for derivative products. • Intermediaries must also conduct a VA-knowledge test as an additional safeguard. |

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| | (para 8) |
| Provision of VA dealing services | <ul style="list-style-type: none"> • VA dealing services include introducing clients to VA trading platforms for direct trading, or establishing an omnibus account with the platforms. These services may only be provided to PIs (para 17). • Intermediaries are only allowed to partner with SFC-licensed VA trading platforms ("SFC-licensed platforms") for the provision of VA dealing services (para 17). • Intermediaries may only provide VA dealing services to their existing clients to which they provide services in Type 1 regulated activity (para 18). <ul style="list-style-type: none"> ○ Where Type 1 intermediaries provide VA dealing services as an introducing agent, they should only introduce clients, and must not relay orders or hold any client assets (para 21). ○ Intermediaries providing VA dealing services under an omnibus account arrangement will have to comply with licensing or registration conditions imposed by the SFC (and in consultation with the HKMA, where applicable), including a prescribed set of terms and conditions (para 19-20, Appendix 6). • The SFC and HKMA are only prepared to allow intermediaries licensed or registered for Type 1 regulated activities to provide VA-dealing services (footnote 19). • Intermediaries are expected to comply with all the regulatory requirements imposed by the SFC and the HKMA when providing VA dealing services, whether or not the virtual assets involved are securities (para 18). • Registered institutions who wish to provide VA discretionary account management services should inform the SFC and the HKMA, and will be required to comply with the additional requirements set out in the Pro Forma Terms and Conditions for Licensed Corporations which Manage Portfolios that Invest in Virtual Assets published by the SFC in October 2019 (para 22). • Where a Type 1 intermediary is authorised by its clients to provide VA dealing services on a discretionary basis as an ancillary service, the intermediary should only invest less than 10% of the gross asset value of the client's portfolio in virtual assets (para 23). |
| Provision of VA advisory services | <ul style="list-style-type: none"> • Intermediaries are expected to comply with all the regulatory requirements imposed by the SFC and the HKMA when providing advisory services, irrespective of the nature of the VA (para 24). • Currently, the SFC and HKMA are only prepared to allow intermediaries licensed or registered for Types 1² or 4 regulated activities to provide VA-advisory services (para 24, footnote 26). • Intermediaries should only provide VA-advisory services to their existing clients to which they provide services in Types 1³ and 4 regulated activities (para 24). • The expected conduct requirements for VA-advisory services are set out in the prescribed terms and conditions (para 25, appendix 6). |

HKMA's letter re Regulatory approaches to Authorized Institutions' interface with Virtual Assets and Virtual Asset Service Providers

This letter compliments the joint circular discussed above.

² Although not expressly stated in the joint circular, we believe that the provision of VA advisory services by type 1 intermediaries can only be done on a 'wholly incidental' exceptions basis (see paragraph (ii) of the definition of "advising on securities" in the Securities and Futures Ordinance for details).

³ See the preceding footnote.

In this letter, the HKMA reiterates that money laundering risks are inherent in VAs and VASPs, and therefore, in light of these heightened risks, authorised institutions must put in place sufficiently effective AML/CFT measures to mitigate these risks. This includes:

- paying extra attention to customers engaging in VA-related activities, and understanding the nature of such activities;
- when establishing and maintaining business relationships with VASPs, collecting sufficient information to understand their business, and assessing their AML/CFT controls; and
- imposing additional investor protection measures when distributing VA-related products.

What you need to do

If you currently distribute VA-related products, or provide VA-related services, you need to consider whether or not you need to become licensed. If you need to be licensed, but do not wish to do so, now would be the time to consider re-structuring your business offerings. Apart from licensing issues, you will also need to get appropriate documents in place to meet the regulatory requirements, such as relevant terms and conditions for your VA-related business, risk disclosure statements, internal procedures, etc..

The joint circular comes into effect on **28 July 2022**. We know from experience that even traditional types 1 and 4 licence applications can take anywhere between 4 and 9 months, and sometimes longer because of COVID interruptions. The joint circular does not say whether a transitory/grace period will be afforded to those who have applied for the relevant licenses by 28 July 2022 but are pending approval.⁴ It is therefore vital that any application be made to, and a dialogue started with, the SFC, as soon as possible.

In any event, intermediaries must notify the SFC (and the HKMA, where applicable) in advance if they intend to engage in the distribution of VA-related products or the provision of VA dealing services.

These are all things that we can help with (see more in the "Where we come in" section below).

Where we come in

We have a range of experience in representing our clients in their discussions with the SFC in connection with VA-related businesses and preparing relevant documentation for their businesses, and are qualified to advise Hong Kong financial institutions on all things VA-related.

Outside of traditional securities/payment-related VAs, we have recently advised a client on the online auction sale of a non-fungible token ("**NFT**") linked to digital artwork. Our work involved settling the agreements between our client and each of the seller and the successful buyer, in which we had to consider how best to protect our client from risks in connection with the sale of the NFT and the transfer of the NFT through the Ethereum blockchain and payment for it in Ethereum cryptocurrency.

What we can expect next

The SFC's opening up of a limited class of exchange-traded VA derivative products to retail investors, is likely to be welcomed by investors and intermediaries alike.

Because the SFC and the HKMA looks primarily at the AML, CTF and investor risks involved when formulating policies for VAs, we hope that there may be further liberalisation in the more transparent parts of the VA industry.

⁴ Similarly, there is uncertainty regarding the transitional arrangements of the to-be-implemented VASP regime. See the closing remarks in our article on the [SFC's consultation conclusions on VASPs and DPMSs \(18 June 2021\)](#).

In the meantime, one thing is certain – the SFC and HKMA have said that they will expand their regulatory net to catch any part of the VA industry that gains significant traction (thereby posing substantial risk concerns). As the HKMA has signalled – stablecoins will likely be the next part of the industry to be regulated.

Please get in touch if you are interested in discussing any of the above.

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