

April 2024

Recent HKMA circulars regarding authorized institutions' services in distribution of tokenised products and custody of virtual assets



Background

On 20 February 2024, the Hong Kong Monetary Authority ("**HKMA**") published two circulars to highlight the supervisory standards expected of authorized institutions ("**AI**") in the [sale and distribution of tokenised products](#) ("**Sale and Distribution Circular**") and the [custodial services for digital assets](#) ("**Custodial Services Circular**"). We hereby summarise the two circulars below.

Sale and Distribution Circular

Coverage and general principle

The Sale and Distribution Circular guides AIs when they deal with tokenised products, which is specified to be "digital presentation of real-world assets using distributed ledger or similar technology but does not include those that are regulated under the Securities and Futures Ordinance (the "**SFO**") and governed by the relevant requirements issued by the Securities and Futures Commission (the "**SFC**"). The HKMA specifically referred to "tokenised non-SFO regulated structured investment products and tokenised spot precious metal" as samples, but confirmed that the definition does not include stablecoins.

The general principle that AI should follow is that when distributing a tokenised product, the AI should adopt the prevailing supervisory requirements and investor protection measures applicable to the underlying product. There should be measures in respect of due diligence, disclosure and risk management. In

summary, many of these measures and requirements follow the existing ones laid down by the SFC in the [Circular on intermediaries engaging in tokenised securities-related activities](#) (the "**Tokenised Securities Circular**") and the [circular on tokenisation of SFC-authorised investment products](#) ("**SFC-authorised product Circular**").

Due diligence

The extent of due diligence that AIs should carry out when assessing a tokenised product largely follows the requirements set out by the SFC in the Tokenised Securities Circular. This includes carrying out due diligence on the experience and track records of the issuers and their third-party vendors, the arrangements regarding technology audits and the safeguards against theft, fraud, errors, hacking and other cybersecurity risks.

Product and risk disclosure

In respect of the disclosure required, AIs are required to make adequate disclosure of the relevant material information about the tokenised product. The HKMA also provided a list of material information that should be disclosed for reference. Such list largely follows the list provided by the SFC in the SFC-authorised product Circular and the Tokenised Securities Circular.

Risk management

Finally, in respect of risk management, AIs are expected to have in place proper policies, procedures, systems and controls to identify and mitigate the risk arising from the tokenised products. AIs should also allocate resources to ensure the management and relevant staff have the necessary expertise to perform their duties.

Custodial Services Circular

The Custodial Services Circular, issued on the same day as the Sale and Distribution Circular, sets out the expectation of AIs in respect of the standard the AIs should observe when safeguarding client digital assets, whether they are virtual assets as defined under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 623) ("**AMLO**"), tokenised securities or other tokenised assets, and whether in the course of conducting virtual asset-related activities (as a SFC intermediary), distributing tokenised products or providing standalone custodial services.

The guidance covers 8 areas of concern, including: (1) governance and risk management, (2) segregation of client digital assets, (3) safeguarding of client digital assets, (4) delegation and outsourcing, (5) disclosure, (6) record keeping and reconciliation of client digital assets, (7) anti-money laundering and counter-financing of terrorism and (8) ongoing monitoring. We set out below the more important points:

1. **Safeguarding of client digital assets:** AIs should put in place adequate systems and controls to safeguard client digital assets, which may be designed with a risk-based approach. The HKMA recommended several measures that the AIs can implement, which mirror the requirements expected of a virtual asset trading platform operator as set out in the [guidelines for virtual asset trading platform operators](#) (except for the recommendation of using key sharding or similar technology to split and distribute a private key, which the SFC did not mention in the guideline).
2. **Delegation and outsourcing:** AIs may only delegate or outsource their custodial function to another AIs or a virtual asset trading platform licensed by the SFC. If the digital assets are not virtual assets (as defined under AMLO), but operate on a public-permissionless DLT network, then the AIs should exercise extra caution before outsourcing. The AIs should ensure that the service provider can satisfy the requirements set out in the Custodial Services Circular, and the service provider's ability should be considered when designing the AI's contingency and disaster recovery arrangement.

3. **Disclosure:** The Custodial Services Circular also set out a list of disclosable matters that the AIs should disclose to the customers in respect of the custodial arrangements. This includes matters that affect the respective rights and obligations of the AIs and their clients, the custodial arrangement, the insurance/compensation arrangement, the circumstances where the AI will take legal and/or beneficial title to the client digital assets, the treatment of the rights and entitlements associated with the client digital assets, and the existence of any potential and/or actual conflicts of interest.

Implementation

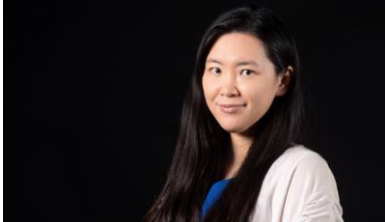
In terms of implementation:

1. For the Sale and Distribution Circular, AIs are required to discuss with the HKMA in advance before they can engage in tokenised product-related activities; and
2. For the Custodial Services Circular, if the AI is already providing digital assets custodial services, then it should check and confirm to the HKMA **within 6 months from the Custodial Services Circular** that it can meet the expected standards. If the AI has yet to start providing this service, it should first discuss it with the HKMA before it starts the relevant business.

How we can help

Many of our clients are AIs and custodians of virtual assets. We regularly advise our clients on virtual assets-related issues. Please get in touch if you are interested in discussing any of the above.

Contact us



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