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SFC and HKMA Introduce Requirements for Hong Kong Licensed Firms and Banks Dealing with Virtual Assets and Virtual Asset Service Providers

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In a further step towards the regulation of virtual assets (including digital tokens, stablecoins, and other crypto assets, "**VAs**") in Hong Kong, on 28 January 2022, the Securities and Futures Commission ("**SFC**") and the Hong Kong Monetary Authority ("**HKMA**", collectively the "**Regulators**") published a joint circular (the "**Joint Circular**") and appendix document (the "**Appendix**") on intermediaries' VA-related activities. "**VA-related activities**" covers:

- Distribution of VA-related products;
- Provision of VA-dealing services; and
- Provision of VA-advisory services.

On the same day, the HKMA published a further circular (the "**HKMA Circular**") to provide regulatory guidance to authorised institutions ("**AIs**") when dealing with VAs and virtual asset service providers.

This client alert provides an overview of the key requirements set out in these two circulars and our views on the regulatory direction of travel in Hong Kong.

I. Scope of the Joint Circular and the HKMA Circular

The Joint Circular refers to "intermediaries", which covers corporations licensed by the SFC to carry on regulated activities and AIs registered with the SFC. The HKMA Circular only applies to AIs. Therefore companies engaged in VA-related activities that are neither intermediaries nor AIs (i.e. "**Unregulated VASPs**") are not directly subject to the requirements and guidance set out in these circulars.

However, these two circulars will significantly affect intermediaries and AIs' ability to deal with Unregulated VASPs, including for their customers. For example, pursuant to the regulatory guidance in the HKMA Circular, AIs may implement systems and controls that could potentially restrict their customers from engaging in certain VA-related activities through their Hong Kong bank accounts. Furthermore, such Unregulated VASPs must ensure that their business activities do not require license, registration and/or authorisation, or else they could be found to be in breach of the Securities and Futures Ordinance (Cap. 571) ("**SFO**") and other laws, and be subject to enforcement action by the Regulators.

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II. Distribution of VA-related products

"**VA-related products**" refers to investment products which:

- Have a principal investment objective or strategy to invest in VAs;
- Derive their value principally from the value and characteristics of VAs; or
- Track or replicate the investment results or returns which closely match or correspond to VAs.

According to the Joint Circular, VA-related products are very likely to be considered "complex products" because, in the Regulators' view, the risks of investing in VAs are not reasonably likely to be understood by a retail investor.

As such, the SFC's investor protection measures for the sale of complex products apply when intermediaries distribute VA-related products. This means that intermediaries must ensure the suitability of transactions in VA-related products, even where there has been no solicitation or recommendation (i.e. execution-only transactions). The regulators also considered it necessary to set out additional investor protection measures for the distribution of VA-related products.

In summary, intermediaries distributing VA-related products must observe the following existing and new requirements:

- **Suitability:** intermediaries must comply with the suitability obligations, taking into consideration the SFC's guidance in the Suitability FAQ.[1] There are many aspects to the suitability obligations, including requiring intermediaries to 'know their clients' (e.g. have knowledge of clients' financial situation, investment experience, knowledge of investment products, purposes of investment, etc.) and to understand the investment product (i.e. by undertaking product due diligence). In respect of product due diligence, the Joint Circular prescribes additional due diligence requirements for unauthorised VA funds (i.e. VA funds not authorised by the SFC).[2]
- **Professional investors only:** VA-related products regarded as complex products should only be offered by intermediaries to professional investors.
- **VA-knowledge test:** except for institutional professional investors and qualified corporate professional investors,[3] intermediaries must assess whether their clients have sufficient knowledge of investing in VAs or VA-related products (with reference to the criteria prescribed by the SFC[4]) before effecting transactions in such products on clients behalf. If a client does not possess the required knowledge, an intermediary may only proceed if, by doing so, it is acting in the client's best interests and the intermediary has provided training to the client on the nature and risks of VAs. Intermediaries must also ensure that their clients have sufficient net worth to be able to assume the risks and to bear the potential losses of trading VA-related products.
- **VA-related derivative products:** before intermediaries offer VA-related derivative products to their clients, they must assess their clients' knowledge of derivatives (including the nature and risks of derivatives), and assure themselves that their clients have sufficient net worth to assume the risks and to bear the potential losses of trading VA-related derivative products.[5] Intermediaries are also required to provide the client a warning statement specific to VA futures contracts (as prescribed by the SFC in Appendix 5), where applicable.
- **Financial accommodation:** intermediaries should be cautious in providing financial accommodation to clients for investing in VA-related products, and should only do so in circumstances where they have assured themselves that their clients have the financial capacity to meet potential obligations arising from leveraged or

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margined positions.

- **Provision of information and warning statements:** intermediaries should ensure that information on VA-related products is provided in a clear and easily comprehensible manner to clients, and intermediaries should also provide VA warning statements to clients.

Note that, while not expressly stated in the Joint Circular, some of the requirements above (e.g. suitability) should not be applicable when intermediaries deal with institutional professional investors and qualified corporate professional investors, which aligns with the regulatory expectations for traditional securities products.

While the Joint Circular prescribes limited exemptions to the above requirements for VA-related derivative products traded on regulated exchanges specified by the SFC,[6] and to exchange-traded VA derivative funds authorised or approved for offering to retail investors by a regulator in a designated jurisdiction specified by the SFC.[7] However, at this time, this exemption will apply to a very small number of VA-related products because many VA-related derivative products are currently traded on unregulated VA trading platforms.

Finally, although not a new requirement, the Joint Circular reminds intermediaries to observe the provisions in Part IV of the SFO which prohibits the offering to the Hong Kong public of investments which have not been authorised by the SFC. Intermediaries are also reminded to strictly adhere to the Hong Kong selling restrictions applicable to VA-related products.

III. Provision of VA-dealing services

According to the Joint Circular, the Regulators' are concerned that the majority of VA trading platforms are either unregulated, or are regulated only for anti-money laundering and counter-financing of terrorism ("**AML/CFT**") purposes. Therefore, these VA trading platforms may not be subject to regulatory standards comparable to the SFC's own regulatory framework for VA trading platforms.[8] As such, the Regulators will require licensed intermediaries that provide VA-dealing services to comply with the following requirements:

- **SFC-licensed platforms only:** intermediaries can only partner with SFC-licensed VA trading platforms to provide VA-dealing services, whether by way of introducing clients to the platform for direct trading or establishing an omnibus account with the platform. Currently, this would cover trading platforms licensed by the SFC under the voluntary opt-in regime for virtual asset trading platforms. In future, this should also expand to cover trading platforms licensed by the SFC under the future virtual asset services providers ("**VASP**") regulatory regime.
- **Professional investors only:** intermediaries can only provide VA-dealing services to professional investors.
- **Compliance with regulatory requirements for securities:** although many VA may not be regarded as "securities" under the SFO, and therefore fall outside the SFC's jurisdiction, intermediaries are expected to comply with the regulatory requirements for dealing in securities, irrespective of whether or not the VAs are securities.
- **Type 1 licence or registration:** the Regulators are only prepared to allow intermediaries licensed or registered for Type 1 regulated activity to provide VA-dealing services (and such services can only be provided to intermediaries' existing clients to whom they currently provide Type 1 dealing services).
- **Terms and conditions:** intermediaries providing VA-dealing services will be required to comply with the SFC's licensing or registration conditions set out in Appendix 6 to the Joint Circular. Intermediaries providing VA-dealing services under an omnibus account arrangement will also be subject to the prescribed

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terms and conditions as set out in Appendix 6 to the Joint Circular (the "**VA T&Cs**"). One of the many conditions set out in the VA T&Cs is that intermediaries providing VA-dealing services under an omnibus account arrangements should only permit their clients to deposit or withdraw fiat currencies (and not VAs) from their accounts.

- **Discretionary account management services:** for intermediaries providing VA discretionary account management services, where the investment objective is to invest 10% or more of gross asset value of a portfolio in VAs, the intermediaries will be required to comply with the requirements set out in the *Proforma Terms and Conditions for Licensed Corporation which Management Portfolios that Invest in Virtual Assets* published by the SFC in October 2019.[9] [10]

IV. Provision of VA-advisory services

According to the Joint Circular, the regulatory requirements for providing VA-advisory services can be summarised as follows:

- **Compliance with regulatory requirements for securities:** similar to the requirements for VA-dealing services, intermediaries are expected to comply with the regulatory requirements for advising on securities, irrespective of whether or not the VAs are securities.
- **Type 1 or Type 4 licence or registration:** the Regulators are only prepared to allow intermediaries licensed or registered for Type 1 or Type 4 regulated activity to provide VA-advisory services (and such services can only be provided to intermediaries' existing clients to whom they provide services in Type 1 or Type 4 regulated activity).
- **SFC's VA T&Cs:** intermediaries providing VA-advisory services will need to comply with the requirements prescribed in the VA T&Cs, including the requirement to comply with the suitability obligations.
- **VA-knowledge test:** intermediaries providing VA-advisory services are subject to the same VA-knowledge test requirements as intermediaries which distribute VA-related products (see above).
- **Professional investors only:** intermediaries can only provide VA-advisory services to professional investors.
- **Advisory services in VA-related products**: intermediaries providing advisory services in VA-related products are required to observe the same requirements applicable to the distribution of VA-related products (see above), including that intermediaries must ensure the suitability of their recommendations.

V. Implementation of requirements in the Joint Circular

For intermediaries that already engage in VA-related activities, there will be a six-month transition period for intermediaries serving existing clients of its VA-related activities to revise their systems and controls to align with the updated requirements in the Joint Circular.

For intermediaries that do not currently engage in VA-related activities, they should ensure that they comply with the requirements in the Joint Circular before providing such services.

Intermediaries are required to notify the SFC (and the HKMA, where applicable) before they engage in VA-related activities.

VI. HKMA Circular

The HKMA Circular provides regulatory guidance for AIs when dealing with VAs and

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VASPs. The guidance can be summarised as follows:

- AIs are expected to keep abreast of ongoing international developments, including those of international forums and standard-setting bodies such as the Financial Stability Board (FSB), the Basel Committee on Banking Supervision (BCBS), the International Organisation of Securities Commissions (IOSCO), etc.
- In addition to Hong Kong laws and regulations, AIs should ensure that their VA activities do not breach applicable laws and regulations in other jurisdictions, and should seek legal advice from competent advisers in relevant jurisdictions outside of Hong Kong as necessary.
- AIs should undertake risk assessments to identify and understand the risks before engaging in VA activities, and should take appropriate measures to manage and mitigate the identified risks, taking into account legal and regulatory requirements. The three risk areas which are in focus are: (a) prudential supervision; (b) AML/CFT and financial crime risk; and (c) investor protection. In particular, the HKMA Circular provides guidance on the regulatory expectations on AIs to establish and implement effective AML/CFT policies, procedures and controls to manage and mitigate money-laundering and terrorist-financing risks that may arise from: (i) customers engaging in VA-related activities through their bank accounts; and (ii) AIs establishing and maintaining business relationships with VASPs. Further guidance is provided in the HKMA Circular.
- AIs intending to engage in VA activities should discuss with the HKMA and obtain the HKMA's feedback on the adequacy of the institution's risk-management controls before launching VA products or services.

VII. Conclusion

The Joint Circular and the HKMA Circular reflect the SFC's and the HKMA's ongoing efforts to regulate the VA sector, particularly from the perspective of investor protection, mitigating AML/CFT risk, and addressing prudential risk in the case of AIs. This is reflected in both existing requirements (e.g. suitability obligations) and new requirements (e.g. VA-knowledge test). For intermediaries already providing or planning to provide VA-related services, there will likely need to be considerable changes to policies and procedures, and systems and controls, to ensure compliance with the latest regulatory requirements and guidance.

While the Joint Circular and the HKMA Circular are not directly applicable to Unregulated VASPs, it can be anticipated that these two circulars will have a commercial impact on these companies, as intermediaries and AIs are likely to implement systems and controls that limit their dealings with such companies (including on behalf of the customers of intermediaries and AIs). In the medium to long-term, these companies which operate VA trading platforms in or from Hong Kong, or provide services marketed to the Hong Kong public, will likely need to be licensed by the SFC under the virtual asset services providers regime and/or under a future regulatory regime to be supervised by the HKMA.

For further information on the future regulatory regimes, please refer to our earlier client alerts:

- Licensing Regime for Virtual Asset Services Providers in Hong Kong (June 7, 2021); and
- Another Step Towards the Regulation of Cryptocurrency in Hong Kong: HKMA Releases Discussion Paper on Stablecoins (January 18, 2022).

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[1] SFC's FAQ on Compliance with Suitability Obligations by Licensed or Registered Persons (last updated 23 December 2020) (the "**Suitability FAQ**").

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[2] See Appendix 4 to the Joint Circular.

[3] "Institutional professional investors" is defined under paragraph 15.2 of the Code of Conduct for Persons Licensed by or Registered with the SFC (the **Code of Conduct**) as persons falling under paragraphs (a) to (i) of the definition of "professional investor" in section 1 of Part 1 of Schedule 1 to the SFO. "Qualified corporate professional investors" refers to corporate professional investors which have passed the assessment requirements under paragraph 15.3A and gone through the procedures under paragraph 15.3B of the Code of Conduct.

[4] See Appendix 1 to the Joint Circular.

[5] These are existing requirements under paragraphs 5.1A and 5.3 of the Code of Conduct.

[6] This refers to the list of specified exchanges set out in Schedule 3 to the Securities and Futures (Financial Resources) Rules (Cap. 571N).

[7] The list of designated jurisdictions is set out in Appendix 2 to the Joint Circular.

[8] This refers to the voluntary opt-in regime set out in the SFC's Position Paper on Regulation of Virtual Asset Trading Platforms (6 November 2019).

[9] Proforma Terms and Conditions for Licensed Corporation which Management Portfolios that Invest in Virtual Assets (4 October 2019).

[10] For completeness, according to the Joint Circular, for intermediaries licensed or registered for Type 1 regulated activity that are authorised by its clients to provide VA-dealing services on a discretionary basis as an ancillary service, these intermediaries should only invest less than 10% of gross asset value of its clients' portfolio in VA.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. If you wish to discuss any of the matters set out above, please contact any member of Gibson Dunn's Crypto Taskforce (cryptotaskforce@gibsondunn.com) or the Global Financial Regulatory team, including the following authors in Hong Kong:

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