

November 2023

Virtual asset regulation November update – the retail market and tokenisation



Background

As Hong Kong continues to build itself into a place that nurtures the growth of fintech businesses, the Securities and Futures Commission ("**SFC**") published three circulars, including one jointly with the Hong Kong Monetary Authority ("**HKMA**"), regarding how intermediaries should carry out virtual asset ("**VA**") related activities. These circulars are: (1) [joint circular on intermediaries' virtual asset-related activities on 20 October 2023](#) (the "**VA Joint Circular**"); (2) [circular on intermediaries engaging in tokenised securities-related activities on 2 November 2023](#) (the "**Tokenisation Circular**"); and (3) [circular on tokenisation of SFC-authorised investment products on 2 November 2023](#) (the "**Tokenised SFC-authorised Investment Products Circular**"). These circulars also conform with the SFC's approach in allowing retail investors to take part in the Hong Kong regulated industry of VA, as seen in the regulations of virtual asset trading platform operators launched earlier this year (which we have covered in another [client alert](#)).

SFC/HKMA VA Joint Circular

The VA Joint Circular supersedes, and expands upon, the previous joint circular on VA-related activities published on 28 January 2022 ("**Old VA Joint Circular**"). Appended to the VA Joint Circular are, amongst other documents, the revised licensing or registration conditions and terms and conditions for licensed corporations or registered institutions providing virtual asset dealing services and virtual asset advisory services ("**VA Dealer/Advisor T&C**"), and the revised terms and conditions for licensed corporations or registered institutions which manage portfolios that invest in virtual assets ("**VA Manager T&C**").

We previously wrote about the Old VA Joint Circular in a [client alert](#) in February 2022.

What is new?

For intermediaries that distribute VA-related products

- Like exchange-traded VA derivative funds, listed public futures-based VA ETFs are now also exempt from the "professional investors only" restriction, as well as the suitability requirements (assuming there was no recommendation or solicitation).
- Intermediaries may now distribute exempted VA-related derivative products without complying with the minimum information and warning statement requirements.
- The requirements to, when distributing VA-related products, provide information and warning statements to clients in relation to VA-related products, information on the underlying VA investments and risk disclosure statements specific to VA (example set out in appendix 5 of the Joint Circular), no longer apply to "institutional professional investors" or "qualified corporate professional investors".

For intermediaries that provide VA dealing services

- The VA Dealer/Advisor T&C, which applies to intermediaries that provide VA dealing services, has been amended such that intermediaries must now also (amongst other things):
 - when making a solicitation or recommendation to a retail investor client on a VA, ensure the recommended VA: (1) is of high liquidity, which includes ensuring the VA is an eligible large-cap VA; and (2) is made available by the SFC-licensed platform for trading by retail investors;
 - not enter into arrangements with its clients using the clients' VA received or held by the intermediaries with the effect of generating returns for the clients or any other parties;
 - assess retail investor clients' knowledge in VA (and provide training if the client lacks such knowledge) and risk tolerance level. It is acceptable to carry out a one-off assessment;
 - set limits for each retail investor client to ensure reasonable exposure to VA, which such limit should be reviewed regularly;
 - ensure that the VA dealing activities are done through an omnibus account maintained with an SFC-licensed VA trading platform (which itself is not subject to a 'professional investors only' licensing condition if the dealing service is being provided to retail investor clients); and
 - ensure retail investor clients can only trade in VA that are permitted for trading by retail investors by SFC-licensed VA trading platforms.
- The previous prohibition that intermediaries could only allow clients to deposit or withdraw fiat currencies from the intermediaries' segregated account is now removed. Going forward, clients are permitted to deposit or withdraw VA from segregated account(s) of the intermediaries maintained with the partnered SFC-licensed VA trading platform or authorised financial institutions.
- Intermediaries that provide execution-only VA dealing services (i.e. where the VA is passed by the clients to the intermediaries for onward passing to the SFC-licensed VA trading platform) no longer need to ensure suitability as long there has not been any recommendation or solicitation, subject to any suitability obligation which already applies to such intermediaries.

- Intermediaries no longer need to provide VA-related risk disclosures for "institutional professional investors" or "qualified corporate professional investors" clients.

For intermediaries that provide VA asset management services

- These services are now no longer limited to professional investors.
- The VA Manager T&C, which applies to intermediaries that provide VA asset management services and replaces the existing Proforma Terms and Conditions for Licensed Corporations which Manage Portfolios that Invest in Virtual Assets published in October 2019, now:
 - exempts intermediaries that are registered institutions from certain requirements on handling client assets;
 - requires intermediaries to assess their clients' knowledge in VA (and provide training if the client lacks such knowledge) before discretionary management services are provided. It is acceptable to carry out a one-off assessment;
 - requires intermediaries to ensure, when providing discretionary asset management services to a retail investor client, that (1) the client will only trade in VA for his/her own account, and (2) the VA is of high liquidity, which includes ensuring the VA is an eligible large-cap VA, and is made available by SFC-licensed VA trading platforms for trading by retail investors;
 - does not require intermediaries to ensure suitability of the investment mandate or portfolio when the client is an "institutional professional investor" or a "qualified corporate professional investor"; and
 - requires intermediaries to enter into a client agreement with their clients (other than "institutional professional investor" and "qualified corporate professional investor" clients).

For intermediaries that provide VA advisory services

- Intermediaries are no longer limited to the "professional investors only" restriction when providing VA advisory services. When recommending any VA to retail investor clients, intermediaries should ensure that its recommended VA is: (1) of high liquidity, which includes ensuring the VA is an eligible large-cap VA, and (2) made available by SFC-licensed VA trading platforms for trading by retail investors.
- Except for "institutional professional investors" and "qualified corporate professional investors" clients, intermediaries must assess the client's risk tolerance level, and determine the client's risk profile and assess whether it is suitable for the client to participate in VA transactions.

Implementation period

Intermediaries that are already providing VA-related dealing services or asset management services are given a three-month period to revise their systems and controls in order to be in compliance with the above requirements. Otherwise, all intermediaries must ensure compliance with the above before they can start providing VA-related services. Intermediaries are expected to consult the SFC in advance before commencing any VA-related businesses or expanding existing ones.

Tokenisation Circular

Tokenised Securities v Digital Securities

The Tokenisation Circular sets out the SFC's expectations of intermediaries that wish to engage in "Tokenised Securities" or "Digital Securities"-related activities. Such activities include issuing, dealing in, advising on, and managing portfolios investing in, Tokenised Securities.

"Tokenised Securities" refers to traditional financial instruments (e.g. bonds or funds) that are securities as defined under the SFO which utilise distributed ledger technology (DLT) or similar technology in their security lifecycle. The SFC considers these instruments to be merely traditional securities with a 'tokenisation wrapper', and therefore ought to continue to be governed by existing laws and regulations applicable to the traditional securities markets.

"Digital Securities" that are not Tokenised Securities may be structured in more bespoke, novel or complicated forms, with some existing exclusively on a DLT-based network with no links to extrinsic rights or underlying assets and having no controls to mitigate the risks that ownership rights may not be accurately recorded.

In other words, Tokenised Securities are a subset of Digital Securities, and therefore all Tokenised Securities are Digital Securities, but not all Digital Securities are Tokenised Securities.

Regulatory Requirements

In addition to all applicable existing laws and regulations governing the traditional securities markets, the SFC has the following general expectations on intermediaries that wish to engage in Tokenised Securities-related activities:

- the intermediary must have the necessary manpower and expertise to understand the nature of such business;
- the intermediary must act with due skill, care and diligence, and perform due diligence on the Tokenised Securities;
- when an intermediary issues or is substantially involved in the issuance of the Tokenised Securities which they intend to deal in or advise on, it remains responsible for the overall operation of the tokenisation arrangement;
- part A of the appendix to the Tokenisation Circular sets out a non-exhaustive list of factors that an intermediary should take into account when assessing the risks related to Tokenisation Securities;
- part B of the appendix to the Tokenisation Circular sets out a non-exhaustive list of factors that an intermediary should take into account when assessing whether the custodial arrangement for Tokenised Securities in bearer form using permissionless tokens on public-permissionless networks is appropriate and robust enough; and
- the intermediary must make adequate disclosure of relevant material information specific to the Tokenised Securities to its clients.

Specifically, intermediaries who are looking to deal in, advise on, or manage portfolios investing in, Tokenised Securities, are expected to:

- conduct due diligence on the issuers and their third-party vendors/service providers involved in the tokenisation arrangement, as well as the features and risks arising from the tokenisation arrangement; and

- understand and be satisfied with the controls implemented by the issuers and their third-party vendors/service providers to manage ownership and technology risks of the Tokenised Securities (as set out in the appendix of the Tokenisation Circular).

Complex Products

In the SFC's view, the 'token wrapper' of a Tokenised Security should not alter the complexity of the underlying security, and therefore whether a Tokenised Security is a complex product requires an assessment to be made on the underlying security. Only Tokenised Securities that are assessed to be complex products need to observe the additional requirements governing the sale of complex products. Digital Securities that are not Tokenised Securities are likely to be complex products.

Professional investors-only restriction

The PI-only distribution and marketing restriction now only applies to Digital Securities that are not Tokenised Securities. No such restriction applies to Tokenised Securities, and for the sake of clarity, the SFC has expressly reversed the position it took in a previous statement dated 28 March 2019 that 'security tokens' (i.e. Digital Securities) could only be offered to PIs.

De minimis threshold for fund managers

For the purpose of considering whether an intermediary managing portfolios investing in virtual assets is subject to the VA Manager T&C by virtue of meeting the "de minimis threshold" set out therein, Tokenised Securities are now excluded.

Virtual Asset Trading Platform operators ("VATPs")

The requirement to arrange compensation arrangements to cover the potential loss of security tokens may, subject to approval from the SFC, exclude certain Tokenised Securities. In assessing such an application, VATPs must demonstrate to the SFC's satisfaction that the risk of financial loss to its clients holding those Tokenised Securities can be effectively mitigated.

Tokenised SFC-authorized Investment Products Circular

The SFC is of the view that tokenised SFC-authorized investment products are appropriate for primary dealing (i.e. subscription and redemption) so long that the underlying product meets all the applicable production authorisation requirements under Part IV of the SFO and the additional safeguards set out in the Tokenised SFC-authorized Investment Products Circular.

Requirements for Product Providers

Providers of tokenised SFC-authorized investment products ("**Product Providers**") must:

- have at least one competent staff with relevant experience and expertise to operate and/or supervise the tokenisation arrangement;
- ensure that the underlying investment products meet the applicable requirements in the relevant rules and regulations, and product codes (including eligibility of Product Providers, product structure, investment and operational requirements, disclosure and ongoing compliance obligations);
- remain ultimately responsible for the management and operational soundness of the tokenisation arrangement;

- ensure that proper records of token holders' ownership interests in the products are maintained and the tokenisation arrangement is operationally compatible with the service providers involved. The SFC also expects Product Providers not to issue tokenised SFC-authorized investment products in bearer form;
- have measures in place to manage cybersecurity risks, data privacy, system outages and recovery, and maintain a robust continuity plan; and
- not use public-permissionless blockchain networks without additional and proper controls.

In addition, Product Providers may be requested by the SFC to:

- demonstrate the management and operational soundness of the tokenisation arrangement, record keeping of ownership and the integrity of the smart contracts;
- obtain third party audit or verification on the management and operational soundness of the tokenisation arrangement; and
- obtain a legal opinion to support its application.

Disclosure

The offering documents of a tokenised SFC-authorized investment products must also set out:

- details of the tokenisation arrangement;
- the ownership representation of the tokens; and
- the associated risks with the tokenisation arrangements.

Authorisation

The SFC requires prior consultation with the SFC before an investment product (whether new or an existing SFC-authorized product) can be tokenised.

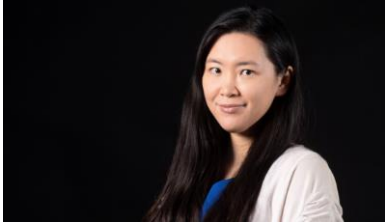
How we can help?

Hong Kong's virtual asset regulatory framework has evolved rapidly over the past several years, culminating in the complex patchwork that it is today. The interplay between various circulars, statements, terms and conditions imposed by way of licensing conditions, and regimes under the SFO and Anti-Money Laundering Terrorist Financing Ordinance, can be difficult to follow.

The above circulars, in particular the Joint Circulars, set out new regulatory requirements that intermediaries should observe when carrying out VA-related activities, whether as an issuer, a dealer, an advisor or an asset manager. Certain previous regulations (or parts thereof) have been superseded. Intermediaries are advised to review and update their internal practice as soon as possible to ensure that they can meet the regulatory expectations, if they wish to engage in VA-related activities.

We advise many clients in the financial sector on matters involving virtual asset regulation. Please get in touch if you are interested in discussing any of the above.

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