

The Regulation of Virtual Assets in Hong Kong – nature, features and risk determine treatment

Regulation of virtual assets (including cryptocurrencies) (“VA”) in the Hong Kong Special Administrative Region (“**Hong Kong**”) has been tightened up in recent years: regulators are moving from regulating VA within the ambit of current legislation to introducing rules that are specific to VA.

There is currently no specific or dedicated digital or VA regulator in Hong Kong. The Securities and Futures Commission (“**SFC**”) regulates VA which fall within the definition of “securities” and “futures contracts” under the *Securities and Futures Ordinance* (Chapter 571 of the laws of Hong Kong) (“**SFO**”). The Hong Kong Monetary Authority (“**HKMA**”) adopts a risk-based approach to supervising bank virtual asset activities, in line with applicable international standards.

What are the main regulatory concerns of the regulators in Hong Kong?

The main regulatory concerns surrounding VA are: (i) that financial institutions may have excessive financial exposure to VA; (ii) the potential use of such assets in illicit and money laundering or terrorist financing activities; and (iii) the risk that purchasers of such assets do not understand what they are investing in and suffer significant losses. Because they may be owned and traded anonymously and are easily transferred electronically and across borders, it is common ground that VA have the potential for abuse by those seeking to engage in financial crime. Regulators are also concerned about whether consumers are adequately informed of the risks when investing in VA and whether product disclosures are sufficient to protect investors. The restriction under the proposed VASP regime (defined below) to professional investors is indicative of these concerns.

There are additional concerns which are specific to payment-related VA, such as stablecoins, with respect to the risks that they may pose to the financial and monetary stability of Hong Kong, which will be explored below. In terms of financial stability, were stablecoins to become widely accepted as a means of payment, any operational

disruption in relation to stablecoins would significantly impact economic activity. If financial institutions were to increase their exposure to stablecoins, the volatility of stablecoins would, in turn, have an impact on their financial health and business model. From the monetary stability perspective, the issuance and redemption of stablecoins that choose the Hong Kong dollar as a backing currency may also affect supply and demand for the currency.

How are virtual assets regulated in Hong Kong?

To the extent they fall within the legal definitions of “securities” or “futures contracts”, VA are regulated by the SFC under the SFO. In other words, whether and how VA are regulated, depends on their nature and features. We discuss below the regulatory status of the most common types of VA.

Token sales or ICOs (Initial Coin Offerings)

There are no specific rules governing token sales or ICOs in Hong Kong. However, stock tokens, which are VA backed by different depository portfolios of underlying overseas listed stocks, with their prices closely tracking the performance of the respective stocks, are likely to be regulated as “securities” as defined under the SFO.

The SFC issued a statement on ICOs on 5 September 2017, stating that digital tokens offered in ICOs are usually characterized as virtual commodities, but certain ICOs have terms and features that may mean that they are treated as securities. The SFC's statement provided the following examples:

- where digital tokens offered in an ICO represent equity or ownership interests in a corporation, for example, token holders are given shareholders' rights such as the right to receive dividends, these tokens may be regarded as shares;
- where digital tokens are used to create, or to acknowledge a debt or liability owed by the issuer, for example, the issuer will repay token holders the principal of their investment on a fixed date or upon redemption and pay an interest, these tokens may be regarded as a debenture; and
- where proceeds of the digital tokens are managed collectively by the ICO scheme operator to invest in

projects which enable token holders to participate in a share of the returns provided by the project, these tokens may be regarded as an interest in a collective investment scheme.

In short, features and functions determine the regulatory approach. Shares, debentures and collective investment schemes are all within the definition of “securities” under the SFO. Accordingly, persons dealing in, or advising on, these digital tokens will need to obtain a licence from the SFC unless an exemption applies.

Stable coins

There are currently no specific rules on stablecoins in Hong Kong. Most stablecoins available in the Hong Kong market are cryptocurrencies, the value of which is pegged to underlying assets, such as commodities, securities or fiat currencies, which means they are i) meant to be less volatile as compared to most popular cryptocurrencies like Bitcoin and Ethereum, because they maintain reserve assets as collateral or use algorithms to control supply (although recent events have shown this is not by any means guaranteed) and ii) are likely to be regarded as “securities” for regulatory purposes and hence regulated under the existing SFO licensing regime.

Some payment-related stablecoins may be regulated under the *Payment Systems and Stored Value Facilities Ordinance* (Chapter 584 of the laws of Hong Kong) (“PSSVFO”) administered by the HKMA, where the stablecoin arrangement constitutes a stored value facility (“SVF”) under the PSSVFO. A stablecoin arrangement constitutes a SVF if the following conditions are fulfilled:

- the facility may be used for storing the value of an amount of money that (i) is paid into the facility from time to time; and (ii) may be stored on the facility under the rules of the facility; and
- the facility may be used as a means of making payments for goods or services or to another person under an undertaking (whether express or implied) given by the issuer of the facility.

If a stablecoin arrangement fulfils the above conditions and constitutes a SVF, the issuer of the stablecoin and any person issuing such stablecoin or facilitating its issuance will need to apply to the HKMA for a licence and comply with the PSSVFO and other requirements issued by the

HKMA. Promoting or assisting another person in issuing such stablecoin or facilitating the issue of such stable coin without a licence is also prohibited under the PSSVFO.

NFTs

The majority of NFTs available in the Hong Kong market are intended to represent a unique copy of an underlying asset, such as an artwork, music, a video and so forth. The SFC has clarified that in general, where an NFT is a genuine digital representation of a collectible, activities relating to it do not fall within the SFC’s regulatory remit. However, where an NFT is structured in a form similar to a security e.g. fractionalized or fungible NFTs, activities relating to it will be regulated under the SFO.

Defi

DeFi strategies have become increasingly popular in recent years.

The Bank of International Settlements Innovation Hub's Hong Kong Centre and the HKMA have recently launched Project Dynamo, which aims to deliver a prototype for the compliant use of DeFi tools, such as blockchain and smart contracts, with the aim of improving access to finance for unfunded or underfunded small and medium enterprises. The purpose of the project is to enable policymakers and the financial services industry to develop a deeper understanding of whether, and if so how, DeFi can reduce transaction and borrowing costs, facilitate productive financing and promote financial inclusion.

Central Bank Digital Currency (“CBDCs”)

Hong Kong does not currently have a CBDC, but unsurprisingly, given the push in China to roll out e-CNY in Mainland China and globally, as well as the number of jurisdictions exploring their options in this region, the HKMA is considering the issuance of a retail CBDC in Hong Kong. On 20 September 2022, the HKMA released a position paper titled “*e-HKD: Charting the Next Steps*” which set out its policy stance on a retail CBDC.

Based on the position paper, the HKMA conducted two rounds of market consultations with key stakeholders to examine the prospect of issuing e-HKD in Hong Kong from a technical and policy perspective. The results of the market consultations suggested to the HKMA that e-HKD

could support the digital economy and facilitate efficient payments, but there are also privacy concerns and legal considerations that need to be addressed. The HKMA will adopt a three-rail approach to address these concerns before launching e-HKD. The first rail will cover the legal and technology aspects. The second rail will address application and design issues and will involve a series of test pilots. The third rail is concerned with the launch of e-HKD.

How are virtual asset-related activities regulated?

Where VA fall within the definition of “securities” or “futures contracts”, the provisions of the SFO, such as restrictions on dealing in, advising on and promotion of, securities and futures contracts, apply to activities relating to such VA.

Conversely, regulatory requirements are imposed on intermediaries (including banks and licensed corporations) which conduct VA-related activities, regardless of whether or not the relevant VA amount to “securities” or “futures contracts” as defined under the SFO. For example, the HKMA explicitly stated in its circular dated 28 January 2022 that it does not prohibit banks from lending against VA as collateral, but banks are expected to conduct proper due diligence and put in place appropriate risk-mitigation measures, such as applying conservative loan-to-value ratios for VA that have been accepted as collateral.

The SFC and the HKMA’s joint circular on intermediaries’ virtual asset-related activities, issued on 28 January 2022, set out the restrictions in relation to the (i) distribution of virtual asset-related products, (ii) provision of virtual asset dealing services and (iii) provision of virtual asset advisory services by intermediaries (including banks). Consistent with the above principle, the circular applies to VA, irrespective of whether or not they amount to “securities” or “futures contracts” as defined under the SFO.

Distribution of virtual asset-related products

Virtual asset-related products (“**VA-related products**”) are very likely to be considered “complex products” for

regulatory purposes, and therefore the usual requirements relating to the distribution of complex products (e.g. ensuring suitability) will apply to VA-related products.

The SFC and the HKMA are of the view that it is necessary to impose the following additional investor protection measures on the distribution of VA-related products:

- **Selling restrictions** – Except for a limited suite of products, VA-related products which are considered complex products should only be offered to professional investors.
- **Virtual asset knowledge test** – Except for institutional professional investors and qualified corporate professional investors, intermediaries must (i) assess whether clients have knowledge of investing in VA or VA-related products prior to effecting a transaction in VA-related products on their behalf; and (ii) ensure that their clients have sufficient net worth to be able to assume the risks and bear any potential losses from trading VA-related products.

In addition to suitability obligations, intermediaries are also required to observe any other selling restrictions in Hong Kong and other jurisdictions which may be applicable to a particular VA-related product.

Where an intermediary provides financial accommodation to a client (e.g. margin loans), it should assure itself that the client has the financial capacity to meet the obligations arising from leveraged or margin trading in VA-related products, including in a worst-case scenario (with the recent “crypto winter” this issue has become a much more immediate concern).

Intermediaries must provide information to clients in a clear and easily understandable manner. They should also provide warning statements to clients (which can be a one-off disclosure) specific to VA.

Provision of virtual asset dealing services

Intermediaries are expected to comply with all the regulatory requirements imposed by the SFC and the HKMA, regardless of whether the VA involved are classified as securities.

VA dealing services can only be provided to intermediaries' existing clients to which they provide Type 1 regulated services.

Intermediaries may only partner with SFC-licensed virtual asset trading platforms (i.e. VA trading platforms licensed under the 2019 voluntary regulatory framework) to provide virtual asset dealing services, for example, introducing clients to the platform for direct trading and establishing an omnibus account with the platform. Furthermore, such services should only be provided to professional investors.

When intermediaries provide dealing services involving VA under an omnibus account arrangement, the SFC will impose the expected conduct requirements as licensing or registration conditions. They will be required to comply with the prescribed terms and conditions.

With respect to virtual asset discretionary account management services, licensed corporations providing services which meet the *de minimis* threshold, i.e., a stated investment objective of a portfolio to invest in VA or an intention to invest 10% or more of the gross asset value of a portfolio in VA, are subject to additional regulatory requirements set out in the *Proforma Terms and Conditions for Licensed Corporations which Manage Portfolios that Invest in Virtual Assets* ("**RA9 Terms and Conditions**") published in October 2019.

Intermediaries with a Type 1 licence that are authorised by their clients to provide VA dealing services on a discretionary basis as an ancillary service should only invest less than 10% of the gross asset value of the client's portfolio in VA.

Provision of virtual asset advisory services

Intermediaries are expected to comply with all the regulatory requirements imposed by the SFC and the HKMA, irrespective of the nature of the VA.

Intermediaries may only provide VA advisory services to their existing clients to which they provide Type 1 (dealing in securities) or Type 4 (advising on securities) regulated activities under the SFO. In other words, no standalone advisory services relating to VA are permitted.

The same requirements for distribution of virtual asset-related products apply and at the same time, intermediaries must ensure the suitability of its recommendations.

Virtual asset portfolio management

Since many VA are not classified as "securities" or "futures contracts", the SFC has decided to adopt a regulatory approach designed to bring a significant portion of VA portfolio management activities within its regulatory net.

Pursuant to a statement by the SFC on 1 November 2018, the following types of VA portfolio managers will be subject to SFC regulation:

- Firms managing funds which solely invest in VA that do not constitute "securities" or "futures contracts" and distribute the same in Hong Kong (these firms typically require a Type 1 licence because they distribute these funds in Hong Kong); and
- Firms which are licensed or are to be licensed for a Type 9 regulated activity (asset management) to the extent that these firms also manage portfolios which invest solely or partially (subject to a *de minimis* threshold) in VA that do not constitute "securities" or "futures contracts".

The regulatory standards for managing these VA portfolios are set out in the RA9 Terms and Conditions and are broadly the same as existing requirements applicable to licensed fund managers, adapted as needed to better address the risks associated with VA.

New licensing regime for virtual asset service providers

There is currently no mandatory licensing requirement for the operation of trading platforms for VA that do not fall within the ambit of the SFO.

Earlier in 2019, the SFC introduced a voluntary regulatory regime which virtual asset trading platforms may opt into, provided that at least one of the VA traded on the platform involves securities features. Platforms solely trading VA which are not classified as securities are not covered. The voluntary regulatory regime sets out regulatory standards which address, for example, safe custody of assets, know-

your-client requirements, anti-money laundering and counter terrorism financing, market manipulation, accounting and auditing, risk management, conflicts of interest and so forth. Under the voluntary regulatory regime, SFC may grant licences to platforms that meet the expected standards.

In June of this year, the Government proposed amendments to the *Anti-Money Laundering and Counter-Terrorist Financing Ordinance* (Chapter 615 of the laws of Hong Kong) ("**AMLO**") to introduce a licensing regime for VA service providers ("**VASPs**"), currently limited to persons operating virtual asset exchanges. Under this new regime, licensed VASPs will only be allowed to provide services to professional investors.

Please click [here](#) to read our article on the VASP licensing regime for further details and watch out for our further update on the development of this licensing regime.

How can we help?

Our Digital Assets and Blockchain Hub brings together our key VA knowledge, helping you take advantage of the technology's huge potential and disruptive impact, while providing insight and guidance on how to avoid falling foul of rapidly evolving legal and regulatory requirements in this space. You can find out more about this toolkit [here](#).

We also offer a range of cutting-edge digital tools that are available by subscription on [Engage Premium](#). Engage is the Hogan Lovells online thought leadership platform available exclusively for our clients. Engage brings together our latest legal, market and regulatory news, industry insights and analysis from across our global network. You can sign up to Engage [here](#).