



Regulatory policy on virtual asset-related activities in Hong Kong of the Securities and Futures Commission (“SFC”) and the Hong Kong Monetary Authority (“HKMA”)

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Background

In January 2022, the Securities and Futures Commission (“SFC”) and the Hong Kong Monetary Authority (“HKMA”) jointly issued a circular on the regulatory policy for virtual asset (“VA”)-related activities conducted by intermediaries (the “Joint Circular”). The Joint Circular sets out the additional investor protection measures that are required for intermediaries (i.e. banks or licensed corporations) on three main VA-related activities, namely (1) distribution of VA-related products; (2) provision of VA dealing services; and (3) offering of VA advisory services. The HKMA also issued a circular (the “HKMA Circular”) reinforcing these investor protection measures, as well as highlighting the AML/CFT and financial crime risks for banks engaging in VA-related activities.

The new regulatory policies under the Joint Circular and the HKMA Circular are immediately applicable to new market entrants upon their engagement in VA-related activities. For market participants providing existing VA-related activities to clients, there is a six-month transition period before the requirements under the Joint Circular are implemented in full.

This publication provides a high-level summary of the key areas highlighted in both circulars, and how our consulting offerings can assist you in complying with these new requirements.



New regulations on intermediaries' VA-related activities

VA and VA-related activities are becoming increasingly popular in Hong Kong, in particular to the retail sector. Nevertheless, the trading platforms or the intermediaries engaging in these activities are currently either unregulated or regulated only for AML/CFT purposes. As such, the SFC and the HKMA are of the view that additional investor protection measures are necessary to cover the specific risks associated to VA and their related activities.

Before any VA or VA-related activities are being regulated under the laws of Hong Kong, the SFC and the HKMA are imposing additional requirements on their regulatees which carry out certain VA-related activities. Any intermediaries (banks or licensed corporations) are required to notify their respective regulator any intention to engage in VA-related activities and which will be supervised under these additional requirements.

The following are the three types of VA-related activities and their respective requirements under the Joint Circular:

I. Virtual asset-related product distribution

Fund distributors which distribute funds that invest (solely or partially) in VAs in Hong Kong are required to be licenced for type 1 (dealing in securities) regulated activity.

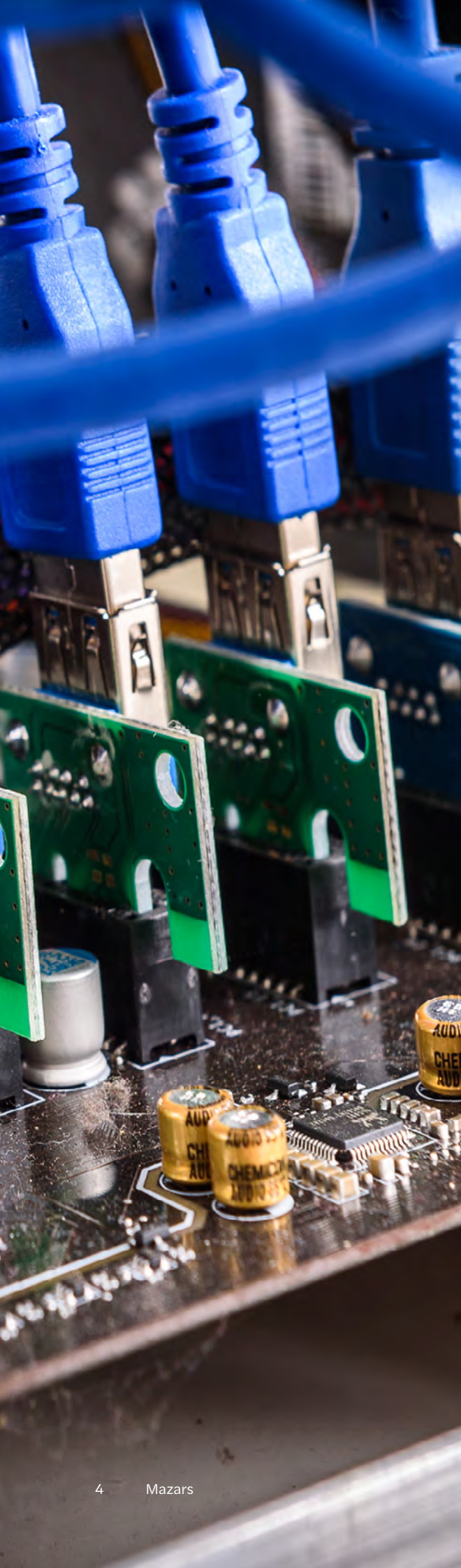
Due to the inherent risks which may not be easily understood by retail investors, VA-related products are likely to be considered “complex products”. Under the SFC’s existing complex products regime, intermediaries should govern the sale of complex products, including ensuring the suitability of VA-related products, providing minimum information and warning statements. Considering the specific risks associated with VA-related products, additional investor protection measures should also be imposed.

Under the Joint Circular, VA-related products are categorized into the three types below based on their nature, and they should comply with the following requirements (i) to (vii) as appropriate:

Type 1: VA-related non-derivative products

Type 2: VA-related derivative products that are traded on specified exchanges

Type 3: Other VA-related derivative products



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(i) “Professional investors only” selling restrictions (applicable to product types 1 and 3)

VA-related products which are considered complex products should only be offered to “professional investors”.

One exception is for a limited suite of VA-related derivative products that are traded on regulated exchanges specified by the SFC and, in the case of exchange-traded VA derivative funds, authorised or approved for offering to retail investors in the designated jurisdiction. Although intermediaries can distribute such products without complying with (iv) suitability obligations, they are still subject to the following know-your-client requirements of (ii) VA knowledge test and (iii) derivative product.

(ii) Know-your-client: VA knowledge test (applicable to all product types 1, 2 and 3)

Other than institutional investors and qualified corporate professional investors, intermediaries should assess whether their clients have knowledge of investing in VAs or VA-related products (e.g. such knowledge can be acquired through training, work experience, or prior trading experience (at least five VA transactions in the preceding three years)). If not, the intermediary should assess whether it is acting in the client's best interest and provide the requisite training.

(iii) Know-your-client: derivative products (applicable to product types 2 and 3)

Where the VA-related product is a derivative product, intermediaries are required to conduct additional know-your-client procedures pursuant to paragraphs 5.1A and 5.3 of the SFC's Code of Conduct, including to assess the client's knowledge of derivatives and characterise the clients based on their knowledge of derivatives, as well as to ensure that the client understands the nature and risks of the products and has sufficient net worth to be able to assume the risks and bear the potential losses.

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(iv) Suitability obligations (applicable to product types 1 and 3)

Irrespective of whether there has been a solicitation or recommendation, intermediaries should ensure suitability obligations are duly fulfilled. In determining suitability, intermediaries should take into account, among others, the clients' risk tolerance and financial situation, to ensure that the products are reasonable for the client and are in the best interests of the client.

(v) Product due diligence (applicable to product types 1 and 3)

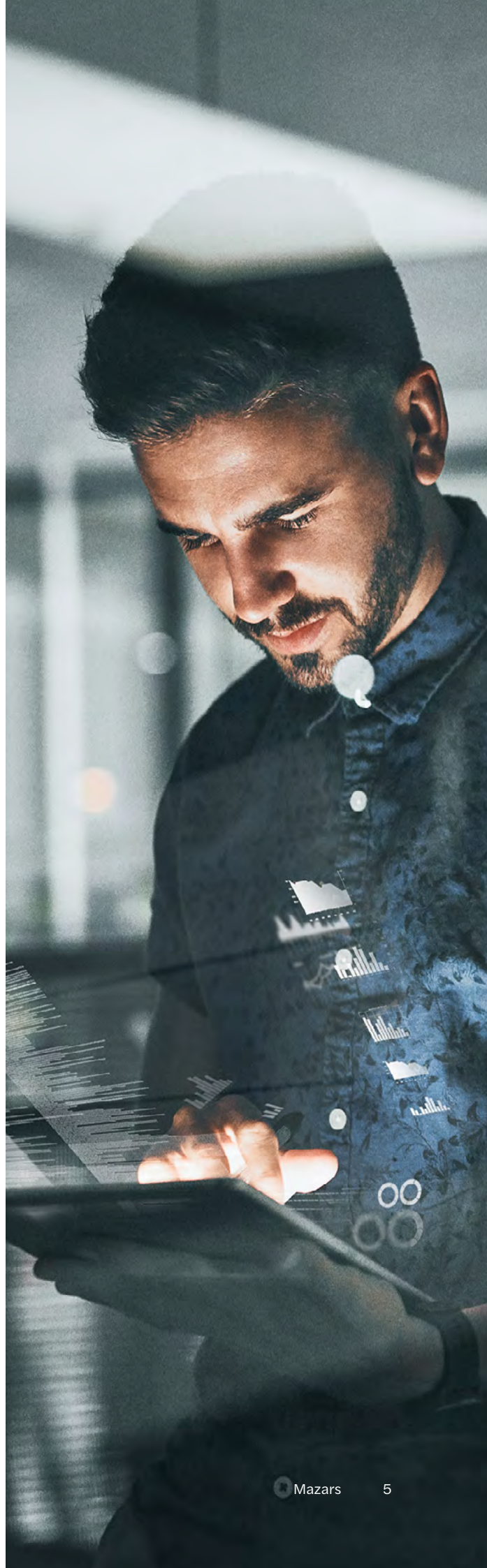
Intermediaries should conduct proper due diligence on VA products to understand their risks and features. Particularly for unauthorised VA funds, additional due diligence should be conducted to assess the funds' constitution, fund managers, operations, IT system, risk management, and the parties providing trading and custodian services.

(vi) Disclosure to clients (applicable to product types 1 and 3)

Intermediaries should provide adequate disclosure to clients in relation to VA-related products and the underlying VA investments in a clear and easily comprehensible manner, together with warning statements specific to VAs.

(vii) Financial accommodation (applicable to product types 1 and 3)

Intermediaries should be cautious in providing any financial accommodation. Instructions should not be accepted unless the intermediary can assure that the client has the financial capacity to meet obligations arising from leveraged or margin trading in VA-related products, including in a worst-case scenario.



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II. Virtual asset dealing services

When providing VA dealing services, irrespective of whether the VA involved are securities, intermediaries should comply with all the regulatory requirements imposed by the SFC and the HKMA. To ensure adequate investor protection, intermediaries wishing to provide VA dealing services are also required to comply with the following:

(i) License required

VA dealing services should only be carried out by type 1 (dealing in securities) intermediaries to their existing clients which they provide services in type 1 regulated activity.

(ii) SFC-licensed VA trading platforms only

Intermediaries are required to partner only with SFC-licensed VA trading platforms for provision of VA dealing services, either by way of acting as introducing agent (i.e., introducing clients to the platforms for direct trading) or establishing an omnibus account with the platform (i.e., acting as agent on behalf of the clients to execute instructions). These services should only be provided to professional investors.



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1. Requirements when acting as introducing agent

For intermediaries which are acting as introducing agents, they should not communicate any offers to effect dealings in VAs or relay any orders on behalf of their clients to the platforms. Also, they should not hold any client assets.

2. Requirements when operating omnibus account

Intermediaries providing VA dealing services through operating an omnibus account should comply with the following conduct requirements imposed by the SFC as licencing or registration conditions, among others:

- Maintain in Hong Kong at all times excess liquid capital equivalent to at least 12 months of its actual operating expenses calculated on a rolling basis, in addition to the requirements under the Securities and Futures (Financial Resources) Rules.
- Only allow clients to deposit or withdraw fiat currencies, instead of VAs, from their accounts.
- A trade should only be executed if there are sufficient fiat currencies or VAs in a client's account to cover the trade. No financial accommodations can be provided.
- Fully disclose the nature and risks that the clients may be exposed to when dealing in VAs in a clear and fair manner which is not misleading.
- Assess a client's knowledge of VAs before providing such service.
- Timely provision of contract notes and statements of accounts.
- Holding of client's assets (i.e., client's VAs and client money) in segregated client accounts.
- Keeping of records for VA related transactions.
- Not engage in VA market making activities on an SFC-licensed platform through which it provides to its clients the VA dealing services.
- Establish and implement policies and controls for identifying any red flags which may arouse reasonable suspicions of market manipulative or abusive trading activities.
- Ensure that its AML/CFT systems can adequately manage the ML/TF risks.

(iii) Additional requirements applicable to discretionary account management services

With respect to VA discretionary account management services, licensed corporations intending to invest 10% or more of the gross asset value of a portfolio in VAs, are subject to the Proforma Terms and Conditions for Licensed Corporations which Manage Portfolios that Invest in Virtual Assets issued by the SFC in 2019. Registered institutions should inform the SFC and the HKMA if they wish to provide such services.

In the case where type 1 intermediaries are authorised by its clients to provide discretionary account management services on an ancillary basis, they should not invest more than 10% of the gross asset value of the client's portfolio in VAs.



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III. Virtual asset advisory services

As the provision of VAs advisory services forms part of an intermediary's advisory business, it may therefore impact its fitness and propriety to conduct regulated activities. Therefore, intermediaries should comply with following regulatory requirements of the SFC and the HKMA when advising on VAs, irrespective of their nature.

(i) License(s) required

VA advisory services should only be carried out by type 1 (dealing in securities) or type 4 (advising on securities) intermediaries.

(ii) Requirements

Where an intermediary provides advisory services in VA-related products, it should observe the same requirements as highlighted in section 1 "Virtual asset-related product distribution" above, which includes the "professional investors only" selling restriction, VA knowledge test and suitability obligation requirements.

Intermediaries should also enter into a written client agreement with each client (other than for institutional investors and certain qualified corporate professional investors) and include a contractual suitability provision in the agreement.

Additional AML/CFT requirements for banks

On top of the requirements for intermediaries conducting VA-related activities set out in the Joint Circular, the HKMA also reinstated its regulatory approach for banks which engage in VA-related activities. In particular, the following policies on AML/CFT and financial crime risk are highlighted in the HKMA Circular:

(i) Banking relationships with customers

Banks should pay extra attention when they become aware of customers engaging in VA-related activities through their bank accounts, for example, to

- understand the nature of the VA-related transactions, and evaluate if there are grounds for suspicion, and
- file any suspicious transaction reports to the Joint Financial Intelligence Unit.

(ii) Banking relationships with virtual asset service providers (“VASPs”)

Banks should conduct appropriate ML/TF risk assessments on VASPs based on risk-based approach. Depending on the nature of the relationship and assessed ML/TF risks level, the following additional customer due diligence measures should be conducted where necessary:

- collect information of the VASP to fully understand its business, whether it is a VA trading platform, a VA wallet provider or an issuer etc.,
- confirm the VASP’s licence or registration, and determine from publicly available information whether it is subject to appropriate regulatory standards, and
- assess the VASP’s AML/CFT controls and evaluate if it has put in place VA-specific risks mitigation controls, such as transactions involving tainted wallet addresses.

Banks are also expected to confirm with the VASP concerned that its operations do not breach any applicable laws and regulations in Hong Kong or any other relevant jurisdiction.



How can Mazars help?

At Mazars, we have extensive experience working with the diversity of financial services players. We assist major financial institutions including brokerage houses, asset managers, investment and corporate banks, retail and private banks, central banks, insurance companies and regulators in dealing with business and regulatory issues with impacts, domestic and international.

Mazars is here to assist you in complying with the regulatory expectations on intermediaries' VA-related activities in Hong Kong. Depending on the scope, coverage and specifics of your needs, our services would typically involve one or more of the following:

How can Mazars help?

A. Regulatory reviews and advice

- I. Review your firm's current practices and needs with respect to virtual assets-related activities, including:
 - distributing VA-related products
 - providing VA dealing services, and/or
 - offering VA advisory services.
- II. Provide guidance regarding the application documents or documents for discussions with regulators regarding the licensing conditions and relevant policies to be implemented, and
- III. Review and comment your firm's relevant policies and procedures for submission to the regulators.

B. Design and implementation of policies and procedures

- I. Review documentation and records with a focus on VA-related activities to ensure compliance, and
- II. Provide advice in designing and implementing enhancements to the risk management / compliance manual, in order to comply with the relevant requirements.

C. Training and insights

- I. Provide training and education for staff, the board and senior management on the regulatory requirements on VA-related activities.
- II. Provide ongoing insights into how peer firms are dealing with the regulatory changes and any common challenges encountered along the way.

We also take on special projects and ad-hoc mandates. We are flexible in our approach and offerings. Please feel free to contact us with any enquiries.

Contacts

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