

## RE: SFC AND HKMA'S UPDATED JOINT CIRCULAR ON INTERMEDIARIES' VIRTUAL ASSET-RELATED ACTIVITIES

On 20 October 2023, the Securities and Futures Commission (the “SFC”) and the Hong Kong Monetary Authority (the “HKMA”) jointly published the “Joint circular on intermediaries’ virtual asset-related activities” (the “**Joint Circular**”), which supersedes the joint circular on the subject previously issued by the SFC and the HKMA dated 28 January 2022 (the “**2022 Circular**”).<sup>1</sup>

We set out in this Client Alert the key changes to the regulatory requirements in relation to virtual asset (“**VA**”)-related activities<sup>2</sup> of intermediaries licensed by or registered with the SFC which have been introduced by the Joint Circular.

### A. Extension of retail access to VA dealing, advisory and asset management services

The most significant development brought by the Joint Circular is that, subject to compliance with the investor protection measures and other requirements prescribed by the SFC, **retail investors** may now be permitted to access the VA dealing, advisory and asset management services provided by licensed intermediaries, which were previously restricted to professional investors only.<sup>3</sup>

#### (a) VA dealing services

Intermediaries licensed or registered for Type 1 regulated activity (dealing in securities) are now permitted to provide VA dealing services to both professional investors and retail clients by either acting as an introducing agent or establishing an omnibus account with a VA trading platform (“**VATP**”) licensed by the SFC. Where a Type 1 intermediary provides VA dealing services under an omnibus account arrangement, it will be required to comply with the terms and conditions<sup>4</sup> prescribed by the SFC (the “**Terms and Conditions**”), which would be imposed as licensing or registration conditions. Key requirements include, without limitation, the following:

- (i) **VA knowledge assessment:** Prior to providing VA dealing services to retail investor clients, intermediaries should assess whether the client possesses sufficient knowledge of VAs, including knowledge of the relevant risks associated with the VAs.<sup>5</sup> Where the client does not possess such knowledge, the intermediary may only provide VA dealing services to the client if it has provided adequate training to the client on the nature and risks of VAs;

<sup>1</sup> Please refer to our previous client alert dated 9 February 2022 for a summary of the 2022 Circular.

<sup>2</sup> It is important to note that, for the purposes of the Joint Circular and this Client Alert, VA has the meaning given in 53ZRA of the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Chapter 615 of the Laws of Hong Kong) and does not include digital representations of value which constitute “securities” or “futures” as defined in Part 1 of Schedule 1 to the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) (the “SFO”).

<sup>3</sup> “Professional investor” is defined in section 1 of Part 1 of Schedule 1 to the SFO.

<sup>4</sup> “Licensing or registration conditions and terms and conditions for licensed corporations or registered institutions providing virtual asset dealing services and virtual asset advisory services” dated October 2023, attached as Appendix 6 to the Joint Circular.

<sup>5</sup> See Appendix 1 of the Joint Circular for the non-exhaustive criteria for assessing whether a client can be regarded as having knowledge of virtual assets.

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- (ii) **Assessment of risk tolerance level:** Similarly, as part of the client onboarding and due diligence process, intermediaries are also required to conduct assessment on the retail client's risk tolerance level and, accordingly, determine the client's risk profile and evaluate whether it is suitable for the client to participate in the trading of VAs;
- (iii) **Limitation of exposure:** Intermediaries should set a limit for each retail client to ensure that the client's exposure to VAs is reasonable, having regard to the client's financial situation (including his or her net worth) and personal circumstances (including his or her overall holdings in VAs);
- (iv) **Permitted types of VAs:** Intermediaries should implement adequate controls to ensure that their retail clients are only permitted to trade in those VAs which are made available by the partnering SFC-licensed VATPs<sup>6</sup> for trading by retail investors; and
- (v) **Transactions through omnibus account only:** All VA dealing activities conducted by intermediaries for or on behalf of retail clients must be conducted through an omnibus account established and maintained with a SFC-licensed VATP, which must not be subject to the licensing condition that it may only serve professional investors.

It should be noted that the requirements in sub-paragraphs (i) to (iii) above apply not only to retail investors but also to professional investors other than institutional professional investors<sup>7</sup> and qualified corporate professional investors.<sup>8</sup>

Where an intermediary merely acts as an introducing agent to refer its clients to SFC-licensed VATPs, it will not be subject to the Terms and Conditions. However, such intermediary should be mindful that it must not relay any orders on behalf of its clients to the VATPs or hold any client assets, including fiat currencies and client VAs, in its capacity as an introducing agent.

#### *(b) VA advisory services*

Subject to compliance with the Terms and Conditions, intermediaries licensed or registered for Type 4 regulated activity (advising on securities) may now provide VA advisory services to both retail and professional investors.

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<sup>6</sup> Currently, only OSL Exchange operated by OSL Digital Securities Limited ("**OSL**"), a wholly-owned subsidiary of BC Technology Group (Stock Code: 863.HK), and HashKey Pro operated by Hash Blockchain Limited ("**HashKey**"), a subsidiary of HashKey Digital Asset Group Limited, possess the full licence granted by the SFC.

<sup>7</sup> "Institutional professional investor" is defined in paragraph 15.2 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (the "**Code of Conduct**") as a person falling under paragraphs (a) to (i) of the definition of "professional investor" in section 1 of Part 1 of Schedule 1 to the SFO. This includes recognised exchanges and clearing houses, licensed corporations and registered institutions (and their wholly-owned subsidiaries and holdings companies), authorised financial institutions (and their wholly-owned subsidiaries and holdings companies), authorised insurers, authorised collective investment schemes, registered provident fund schemes, registered occupational retirement schemes, governments and central banks, as well as the overseas equivalents of such institutions and entities.

<sup>8</sup> "Qualified corporate professional investors" refers to corporate professional investors which have passed the assessment requirements under paragraph 15.3A of the Code of Conduct and gone through the consent and annual confirmation procedures under paragraph 15.3B of the Code of Conduct.

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However, when making a solicitation or recommendation or providing advisory services to retail clients, intermediaries should take all reasonable steps to ensure that any VA being recommended meets the following criteria (the “**Retail VA Criteria**”):

- (i) **High liquidity:** The VA must be of high liquidity. At a minimum, the VA must be included at least two (2) “acceptable indices”<sup>9</sup> issued by two separate and independent index providers, including at least one (1) index provider which complies with the IOSCO Principles for Financial Benchmarks and has experience in publishing indices for the conventional securities market (the “**Large Cap VA Requirement**”); and
- (ii) **Admission on SFC-licensed VATPs:** The VA must be made available for trading by retail investors on SFC-licensed VATPs.

*(c) VA asset management*

Similarly, intermediaries licensed for Type 9 regulated activity (asset management) are now permitted to provide VA advisory service to both retail and professional investor clients, provided that a Type 9 intermediary (the “**VA Fund Manager**”) which manages a fund or portfolio which invests 10% or more of its gross asset value (GAV) in VAs (the “**VA Fund**”) or has a stated investment objective to invest in VAs must comply with the SFC’s prescribed terms and conditions (the “**VA Fund Manager Terms and Conditions**”).<sup>10</sup>

The VA Fund Manager Terms and Conditions require that, amongst other things, the VA Fund Manager should adequately disclose to investors:

- (i) information on the VA Fund which is necessary for investors to be able to make an informed decision about their investment in the VA Fund, including but not limited to the list of VATPs and custodians used by VA Fund; and
- (ii) for investors other than institutional professional investors and qualified professional investors, the key risks associated with the VA Fund’s investment in VAs.

Where a VA Fund Manager provides discretionary account management services to retail clients, it must also observe the Retail VA Criteria.

## **B. Permission of deposit and withdrawal of VAs to and from client accounts**

Another key change introduced by the Joint Circular is that, whereas the 2022 Circular permitted only the deposit and withdrawal of fiat money by clients of licensed intermediaries, both

<sup>9</sup> An “acceptable index” refers to an index which (i) has a clearly defined objective to measure the performance of the largest VAs in the global market; (ii) consists of sufficiently liquid constituent VAs; (iii) is objectively calculated and rules-based; (iv) is issued by an index provider which possess the necessary expertise and technical resources to construct, maintain and review the methodology and rules of the index; and (v) is governed by well-documented, consistent and transparent methodology and rules.

<sup>10</sup> “Terms and conditions for licensed corporations or registered institutions which manage portfolios that invest in virtual assets”, dated October 2023, which is attached as Appendix 7 to the Joint Circular.

professional investor and retail investor clients are now able to deposit and withdraw VAs to and from their accounts. However, intermediaries should only receive or withdraw such client VAs through the segregated account(s) established and maintained with:

- (i) the partnering SFC-licensed VATP; or
- (ii) authorized institutions<sup>11</sup> (or subsidiaries of locally incorporated authorized institutions) which meet the expected standards of VA custody issued by the HKMA from time to time.

### Our Observations

#### *Lifting of “professional investor only” restriction*

The Joint Circular has brought the much-anticipated – and no doubt widely welcomed – lifting of the “professional investor only” restriction long imposed on VA-related activities of Type 1, Type 4 and Type 9 licensed intermediaries, opening up retail access to their VA dealing, advisory and asset management services in a manner which is consistent with the permission for the provision of VA trading services to retail clients by licensed VATPs under the new virtual asset service provider licensing regime, which took effect on 1 June 2023. However, whilst this move is certainly an important development in Hong Kong’s VA regulatory landscape, given the stringent requirements for the admission of VAs for trading by retail investors (in particular the Large Cap VA Requirement, coupled with the ban on trading of security tokens and stablecoins by retail investors), the types of VAs which can be traded by or on behalf of retail investors of licensed intermediaries will likely remain very limited for the time being. Currently, only Bitcoin (BTC) and Ethereum (ETH) are made available for trading by retail investor clients of OSL Exchange and HashKey Pro, the only two SFC-licensed VATPs to date. Although HashKey recently announced the listing of Avalanche (AVAX) on its platform – the third one after BTC and ETH – the token is only made available to professional investors. Such restrictive approach may undermine the appeal of licensed VATPs and other VA service providers in Hong Kong vis-à-vis competitors in other jurisdictions which are able to offer a wider range of products and services.

However, in the SFC’s latest circulars on tokenisation of SFC-authorised investment products and intermediaries’ activities relating to tokenised securities (the “**Tokenisation Circulars**”)<sup>12</sup> (which will be discussed in our next client alert), the SFC has set out a framework for, amongst other things, the issuance and distribution of tokenised SFC-authorised investment products to the Hong Kong public. One day before the publication of the Tokenisation Circulars, OSL announced its submission to the SFC of a proposal for the offer of tokenised retail fund products in Hong Kong jointly with Harvest Global Investments Limited, a holder of Type 1, Type 4 and Type 9 licences granted by the SFC, with which OSL had entered into a memorandum of understanding in relation to a strategic partnership to develop tokenised financial products in September

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<sup>11</sup> The term “authorized institution” is defined in section 2(1) of the Banking Ordinance (Chapter 155 of the Laws of Hong Kong) and means a bank, a restricted licence bank or a deposit-taking company.

<sup>12</sup> “Circular on tokenisation of SFC-authorised investment products” and “Circular on intermediaries engaging in tokenised securities-related activities” issued by the SFC on 2 November 2023.

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2023.<sup>13</sup> It remains to be seen how such tokenised retail fund products would fit into the requirements set out in the Tokenisation Circulars. If the proposal is approved, one can expect to see the entry of similar tokenised financial products (which would likely have traditional forms of securities as their underlying products) into the retail market in Hong Kong in the near term, even if retail access to VAs and VA-related products (which do not include security tokens) may remain relatively restricted for the time being.

*VA custody by authorized institutions?*

Another interesting point of note is that, pursuant to the Joint Circular, Type 1 intermediaries may receive and withdraw client VAs through an authorized institution which meets the standards for VA custody issued by the HKMA from time to time. However, despite strong market demand for VA custody services, none of the licensed banks in Hong Kong – not even those which have been actively venturing into the VA space – has been able to provide such services to date. This is likely attributable at least in part to regulatory uncertainties and compliance-related concerns on the part of the banks. We expect to see further guidance from the HKMA in this regard in the near term and, hopefully, the addition of VA custody to the suite of financial services offered by banks in Hong Kong, which would promote the development of more widely accessible and efficient on / off ramp facilities to support the integration between traditional finance and the burgeoning blockchain economy in the long run.

If you have any questions on the above or would like to further discuss the issues raised in this Client Alert or the Joint Circular generally, please do not hesitate to get in touch with our members at [hyu@lylawoffice.com](mailto:hyu@lylawoffice.com) or at (+852) 2115-9525.

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*Disclaimer: The information provided in this article is not intended to be, nor does it constitute, legal advice and is not a substitute for obtaining proper legal advice in respect of any specific issue.*

<sup>13</sup> See <https://osl.com/press-release/osl-Harvestglobal-tokenisation/> and <https://osl.com/en-HK/press-release/harvest-global-osl-strategic-partnership-security-token-access-hong-kong/>.