Private Wealth Management Association
私人財富管理公會

Virtual Asset Regulation in Hong Kong:
A Private Wealth Management Industry Perspective

PWMA's views and recommendations regarding the January 2022 Joint Circular on Intermediaries' Virtual Asset-Related Activities

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Executive Summary:

The growth of the virtual asset ("**VA**") market has been rapid and volatile and the collapse of FTX has prompted a number of regulatory and enforcement actions in the crypto asset space.

The Financial Services and the Treasury Bureau (the "**FSTB**") published a policy statement entitled "Policy Statement on Development of Virtual Assets" on 31 October 2022 which sets out the Hong Kong Government's policy stance and approach towards developing a vibrant sector and ecosystem for VA in Hong Kong. The Hong Kong Government will adopt the "same activity, same risks, same regulation" principle and put in place timely and necessary guardrails, so that VA innovations can thrive in Hong Kong in a sustainable manner.

The Private Wealth Management Association ("**PWMA**") and its members welcome and support the above principle, as well as the comprehensive framework which the Securities and Futures Commission (the "**SFC**") and the Hong Kong Monetary Authority (the "**HKMA**") have put in place to regulate VA-related activities.

The focus on this position paper is the joint circular which the SFC and the HKMA published on 28 January 2022 entitled "Joint Circular on Intermediaries' Virtual Asset-Related Activities" (the "**Joint Circular**", together with six appendices) which set out new requirements applicable to intermediaries which engage in certain types of VA-related activities. The types of VA-related activities covered by the Joint Circular include: (A) distribution of VA-related products ("**VARPs**"); (B) provision of VA dealing services; and (C) provision of VA advisory services. For example, this position paper will not cover: (i) requirements applicable to investment managers which manage portfolios comprising VA or VARPs, (ii) platform operators; (iii) HKMA's proposed regulatory framework on stablecoins; and (iv) prudential requirements which authorized institutions must comply with when interacting with VA and service providers of VA.

With the aim to defend Hong Kong's position as one of the leading financial centres in the world and a leading private banking hub in the Asia Pacific region – and applying the "same activity, same risks and same regulation" principle – PWMA and its members would like to take this opportunity to make recommendations on the regulatory framework applicable to the types of VA-related activities covered by the Joint Circular.

Set out below is a summary of our key recommendations in regards to the Joint Circular and we will expand on some of the recommendations in this position paper.

Key Recommendations:

1. **The need for better regulations on VA – Definition of VARPs:** We respectfully request the SFC and the HKMA to provide the industry with a bright line test – such as 50% or more exposure to VA - as opposed to the current definition which uses the word "principally" in determining whether or not a product falls within a VARP. We would like to take this opportunity to highlight our proposal to use a "percentage" to determine whether or not a product is, or is not a VARP is not arbitrary. For example, as the SFC and the HKMA is aware, an investment fund will be considered as a derivative fund if its net derivative exposure exceeds 50% of its net asset value. In addition, the definition of VARPs should also explicitly exclude tokenised securities, such as equities, bonds or funds which are registered on a distributed ledger technology infrastructure.

2. **The need for better regulations on VA – the need to revisit the SFC's Guidelines on Online Distribution and Advisory Platforms**: In paragraph 1.2 of the SFC's Guidelines on Online Distribution and Advisory Platforms, the SFC has stated that "these guidelines apply to all licensed or registered persons ***when conducting their regulated activities*** (Counsel emphasis added) in providing order execution, distribution and/or advisory services in respect of investment products via online platforms". The offering of trading facilities and advisory services in respect of VA and VARPs which fall outside the definitions of "securities" and "futures contracts" arguably do not constitute "regulated activities" and it therefore appears

that the SFC's Guidelines on Online Distribution and Advisory Platforms do not apply to these types of trading and/or advisory services.

However, under Section B entitled "provision of VA dealing services" and Schedule 1 to the licensing or registration conditions and terms and conditions for licensed corporations or registered institutions providing virtual asset dealing services and virtual asset advisory services, the SFC states that the SFC's Guidelines on Online Distribution and Advisory Platform will apply to VA dealing services.

Given the focus of this position paper is the Joint Circular, we do not purport to discuss the SFC's Guidelines on Online Distribution and Advisory Platforms in detail. With that said, it is important to bear in mind the guidelines were drafted at a time when VA dealing activities were less prevalent. It is therefore difficult to apply some of the requirements under the SFC's Guidelines on Online Distribution and Advisory Platforms to VA dealing activities. For example, the requirement for a platform operator to "provide clients with material information as soon as reasonably practicable to enable clients to appraise the position of their investments […]. In this connection, a platform operator should put in place proper arrangements to take adequate measures to enable it to access and be informed of up-to-date information concerning all non-exchange-traded investment products available on its online platform". Whilst this requirement sits well with "traditional" asset classes, such as funds, we query how the SFC expect intermediaries to comply with this requirement for VA where there is often a lack of centralised distribution or dissemination of information (e.g. an issuer of a VA may not be required under the applicable laws, rules or regulations to disclose material events). We recommend if the SFC were to apply the SFC Guidelines on Online Distribution and Advisory Platforms to VA dealing activities, this should be done so by way of a separate consultation exercise.

3. **The need for better regulations on VA – risk disclosures**: In relation to the requirement to provide risk disclosures, whilst we agree with this in principle, we query whether standardised risk disclosures – as set out in Appendix 5 and paragraph 6.8 of the terms and conditions for licensed corporations or registered persons providing virtual asset dealing services under an omnibus account arrangement – will actually help investors to understand different risks associated with different types of VA. For example, the risks of trading Bitcoin clearly differs from trading stablecoins. In addition, the Code of Conduct contains robust risk disclosure statements which intermediaries need to provide to clients that trade futures contracts. For example, intermediaries are required to provide investors with risk disclosures to the effect that the risk of loss in trading futures contracts is substantial and, in some circumstances, investors may sustain losses in excess of their initial margin funds. If intermediaries are now required to provide additional risk disclosures for futures contracts with VA as the reference underlying (also with the need to highlight high price volatility), there is a reasonable likelihood that investors will consider the additional risk disclosures as "wallpaper". We therefore recommend the SFC and the HKMA to carry out an independent study on the effectiveness of these risk disclosures, potentially using consumer testing.

   It is also not clear the reason for not addressing, in the Joint Circular, the way in which risk disclosures are presented to investors using digital platforms against investors which use non-digital platforms, with the former being the clear preference for investors to execute VA and VARPs transactions. For example, there may be a possibility that the risk disclosures will exceed character limits, as well as other limitations such as the size of the screen. We respectfully request the SFC and the HKMA to take into account the differences in consumer journey between digital and non-digital platforms and state what the SFC and the HKMA will consider to be acceptable in these two different types of customer journey, rather than applying the requirement to provide risk disclosures without taking into account evolving technology and consumer behaviour.

   Moreover, it is important that the risk disclosures are drafted in plain English. One of the standardised disclosures require intermediaries to notify clients that "a virtual asset may or may not be considered as "property" under the law, and such legal uncertainty may affect the nature and enforceability of a client's interest in such VA". First of all, investors are unlikely to appreciate the differences between property rights and contractual rights, as well as the

concept of "enforceability". We also query whether this statement is actually entirely accurate. A discussion of whether holders of VA could have a property interest under common law is outside the scope of this position paper, but suffice to say there has been series of judgements in common law jurisdictions which suggest that tokens on blockchain-based applications will be property under common law[1]. We therefore recommend the SFC and the HKMA to consider NFA's Interpretative Notice 9073 – Disclosure Requirements for NFA Members Engaging in virtual currency activities and tailor the risk disclosures in light of Hong Kong legal and regulatory landscape. Intermediaries should also have the flexibility in developing their own set of risk disclosures.

4. **The need for better regulations on VA – market surveillance and enforcement power over market manipulation activities**: the Joint Circular imposes – in the terms and conditions for licensed corporations or registered institutions providing virtual asset dealing services under an omnibus account arrangement – that an intermediary must notify the SFC as soon as practical if it suspects a client is engaging in market manipulative or abusive trading activities, such as anomalies in trading patterns and the potential use of abusive trading strategies. First of all, apart from security tokens (which fall within the definition of "securities" under the SFO and are therefore subject to the market misconduct regime), it is not clear what are the laws which prohibit abusive behaviour when dealing in utility tokens and stablecoins. We would therefore be grateful if the SFC and the HKMA could provide more guidance on what will be considered as abnormal trading patterns and what will be considered as abusive trading strategies. Moreover, the novel nature of the VA may create new forms of abusive behaviour, and intermediaries' existing monitoring arrangements may not be able to capture them until and unless the SFC and the HKMA provide guidance in this regard, so that intermediaries can upgrade their trade monitoring systems in line with SFC's and HKMA's guidance.

   In addition, we respectfully submit that the SFC and the HKMA should also disclose to the market how they will monitor trading activities relating to VA and the enforcement power for non-securities-based VA. This point is of paramount importance given the SFC's proposal to significantly expand its enforcement power under Section 213 of the SFO, covering, amongst others, breaches of the Code of Conduct and the Guidelines on Online Distribution and Advisory Guidelines and may substantially increase the fines which intermediaries will be exposed to.

5. **The need for better regulations with regard to VA – restrictions relating to withdrawal or transfer of VA.** The private bank industry is perplexed with the requirement that intermediaries should only permit clients to deposit or withdraw fiat currencies from their accounts, and should not allow the deposit or withdrawal of VA. Article 115 of the Basic Law further provides that Hong Kong shall pursue the policy of free trade ***and safeguard the free movement of*** goods, ***intangible assets*** (Counsel's emphasis added) and capital. Article 115 of the Basic Law form the cornerstone of Hong Kong's success as an international financial centre and lay the foundation for Hong Kong's development into one of the world's leading private wealth management hubs. The importance of Article 115 of Basic Law – as it applies to VA – has been highlighted in Ms. Teresa Cheung's speech. By only permitting clients to deposit and withdrawal fiat currencies, and that ***no withdrawal or transfer*** (Counsel's emphasis added) of VA by clients is permitted at any time, ***even after cessation of clients' accounts maintained with the intermediaries***, (Counsel's emphasis added), this appears at the

[1] In *Armstrong DLW GmbH v. Winnington Networks* [2012] EWCH (Ch) 10, Stephen Morris QC sitting as deputy High Court judge applied the following four-step test to an EU allowance (EUAs). In this case, the defendant, a German company, had purchased EUAs from a third party, which had fraudulently obtained them from the claimant. The claimant, a UK trader in EUAs, brought a claim of proprietary restitution against the defendant. Stephen Morris QC concluded that the EUAs met the four-step test, since it (i) could be defined as the sum total of rights and entitlements conferred on the holder under the Emissions Trading Scheme legislation (ETS); (ii) was identifiable through its unique reference number; (iii) was transferable under ETS; and (iv) had permanence and stability through entries on the registry. Consequently, it was property at common law. Accordingly, it seems likely that many tokens on blockchain-based applications will also satisfy this test. They can be defined as (i) the right to control tokens; (ii) are identifiable through entries on the blockchain; (iii) can be transferred by submitting transactions; and (iv) are registered with a high degree of permanence and stability. This suggests that holders of digital tokens could have a property interest under common law.

very least contradictory to the principle of treating clients fairly. Moreover, even after ceasing a relationship with a private bank, a client may wish to hold its VA. Compulsorily requiring such a client to redeem into cash significantly increases private banks' litigation risk. For example, a client may consider the price of Bitcoin held in his/her account will increase and even if private banks amend their client documentation to allow them to convert clients' VA into fiat currencies upon closure of accounts or in accordance with applicable laws and regulatory requirements, it is not clear whether such a clause will be upheld by the courts under consumer legislation. Moreover, this requirement also needs to be considered in light of Article 115 of the Basic Law.[2]

Turning onto the specific requirements under the Joint Circular:

Regulators' Requirements	**Private Banks' Challenges**	**PWMA's Recommendations**
Definition of "Virtual Assets"[3] ("VA")	The definition of "VA" forms the backbone of the new regulatory requirements applicable to VA distribution, dealing and advisory activities. The Joint Circular defines VA as including utility tokens, asset-tokens, security-tokens and stablecoins or "any other virtual commodities, ***crypto-assets or other assets of essentially the same nature***" (Counsel emphasis added), irrespective of whether or not they also amount to securities or futures contracts under the SFO. We respectfully submit the following: • the meaning of crypto-assets token is not entirely clear. See Annex A entitled "Classification of Crypto-Assets" as set out in the HKMA's Discussion Paper on Crypto-Assets and Stablecoins dated January 2022 where it defines crypto-assets as a mean of exchange, as a means of investment or as a means to gain access to a product/service; and • in light of the ambiguity in interpreting crypto-assets	We recommend the SFC and the HKMA make the following enhancements to the definition of "VA": • adopt the definition of VA under the Anti-Money Laundering and Counter Terrorist Financing Ordinance so that the private banking industry does not need to comply with two different definitions of VA; and • delete the reference to "crypto-assets or other assets of essentially the same nature" from the definition of VA in Joint Circular. In addition, we recommend the SFC and the HKMA confirm that they will not consider any company the primary business of which is dealing in VA (e.g. coin base) as a VA.

[2] Speech by SJ at ADR in Asia Conference: Tomorrow's Disputes Today 27 October 2021. Ms. Teresa Leung considered the arbitrability of crypto-related disputes in Hong Kong during her speech.

[3] The term "VA" is defined in the Joint Circular as referring to digital representations of value which may be in the form of digital tokens (such as utility tokens, stablecoins or security or asset backed tokens) or any other virtual commodities, crypto assets or other assets of essentially the same nature, irrespective of whether or not they amount to "securities" or "futures contracts" as defined under the SFO, but excludes digital representations of fiat currencies issued by central banks (i.e. central bank digital currencies).

Regulators' Requirements	Private Banks' Challenges	PWMA's Recommendations
	in the Joint Circular and the phrase "or other assets of essentially the same nature", this may create uncertainty on whether a particular VA falls within the ambit of the Joint Circular.	
Definition of "VA-Related Products[4] ("VARPs")	The definition of VARPs is equally crucial. However, as opposed to defining VARPs in accordance with the term "principally", it is preferable for the industry to have certainty.	We recommend rather than using the term "principally", the definition of VARPs should include a reference to a specific percentage – for example, VARPs whose exposure to the reference underlying VA exceed 50%. This percentage is in line with the one adopted by the SFC in considering whether a fund needs to be categorised as a derivative fund under the complex product requirement. In addition, the definition of VARPs should also explicitly exclude tokenised securities, such as equities, bonds or funds which are registered on a distributed ledger technology infrastructure. In determining concentration risk, the SFC and the HKMA should also permit intermediaries to exclude tokenised securities from VAs and VARPs. In addition, we recommend the SFC and the HKMA confirm that they will not consider any financial products where the reference underlying are companies the primary business of which is dealing in VA (e.g. coin base) as a VARP.
Distribution of VA-related derivative products and exchange-traded VA derivative funds	In our view, it is not clear the reasons for distinguishing VA-related derivatives and VA-related non-derivative products (listed and non-listed) in Appendix 3 to the Circular. Applying the "same activity, same risk, same regulation" approach, the key focus should be investor protection – for example, in respect of exchange-traded products that are listed on exchanges specified by the SFC, as the Joint Circular has pointed out, pricing transparency and	First of all, we would be grateful if the SFC and the HKMA could confirm for listed exchange-traded products, intermediaries will be able to rely on Chapter 6.5 of the SFC's Guidelines on Online Distribution and Advisory Platform (i.e. the industry acknowledges that these products are complex products but as long as an intermediary has not solicited or recommended these products, it is not necessary for the intermediary to comply with the requirements applicable to complex products).

[4] The term "VARPs" refers to investment products which: (a) have a ***principal*** (Counsel's emphasis added) investment objective or strategy to invest in VA; (b) derive their value ***principally*** (Counsel's emphasis added) from the value and characteristics of VA; or (c) track or replicate the investment results or returns which closely match or correspond to VA.

Regulators' Requirements	Private Banks' Challenges	PWMA's Recommendations
	potential market manipulation should be less of a concern. In addition, it is not practical to require intermediaries to comply with the additional product due diligence requirements for execution-only transactions relating to VARPs. Among the reasons is that these VARPs may not be on the list of products which intermediaries have conducted product due diligence/available for distribution in the first place.	We recommend that for exchange-traded products that are listed on exchanges specified by the SFC, the SFC and the HKMA remove the requirement for intermediaries to comply with the additional product due diligence requirements. We further recommend that the SFC and the HKMA remove the requirement for intermediaries to comply with additional product due diligence requirements for execution-only transactions relating to VARPs.
Distribution of VA: Financial accommodation Intermediaries should be cautious in providing any financial accommodation to investors for investing in VARPs, and must assure themselves that the investors have the financial capacity to meet the obligations arising from leveraged or margin trading in VARPs, including in the worst-case scenario. In the absence of such assurance, intermediaries should not accept instructions from the investor.	Private banks accept that VA and VARPs are complex products. However, the regulators do not prohibit intermediaries from providing financial accommodations to investors to purchase complex products.	We recommend regulators to permit intermediaries to allow investors to use financial accommodation to enter into VA and VARPs transactions, provided all of the relevant Code of Conduct requirements – including Chapter 5.3 – have been complied with. This is also consistent with the "same activity, same risk, same regulation" principle and the regulatory requirement applicable to trading futures contracts – which can be leveraged and which may cause investors to lose more than their initial investments. We also recommend the SFC and the HKMA apply existing principles based on the product types. For example, private banks should assess the overall riskiness (including but not limited to market risk, liquidity, credit risk, regulatory risk, etc.) of a VA-linked structured product, which would include risks of its underlying asset, in order to determine the financial accommodation, loan-to-value ratio, and margining requirements, etc.
Provision of VA Dealing Services ("VA Dealing Services"): SFC-licensed platforms only: Intermediaries can	The amendments to the Anti-Money Laundering and Counter-Terrorist Financing Ordinance, which requires a person operating a VA exchange[5] to be licensed by the SFC.	We anticipate in future, intermediaries should also be permitted to partner with VA trading platforms licensed by the SFC under the new licensing regime. However, at the moment, it is not clear how many VA trading platforms will be licensed by the SFC. In this regard, we

[5] A VA exchange will be defined as any trading platform which is operated for the purpose of allowing an offer or invitation to be made to buy or sell any VA in exchange for any money or any VA, and which comes into custody, control, power or possession of, or over, any money or any VA at any point in time during its course of business. Peer-to-peer trading platforms, to the extent that the actual transaction is conducted outside the platform and the platform is not involved in the underlying transaction by coming into possession of any money or any VA at any point in time, are not covered under the definition of VA exchange.

Regulators' Requirements	Private Banks' Challenges	PWMA's Recommendations
only partner with SFC-licensed VA trading platforms, either by way of: (i) acting as an introducing agent (where the intermediaries only have an introducing role and investors will directly trade on the platform); or (ii) intermediaries establishing an omnibus account with the platforms (so that the intermediary can act as agent on behalf of the investor to execute instructions).		recommend the SFC to create a register of VA trading platforms that are licensed by the SFC, so that this information can be accessed by intermediaries and to provide more transparency. We also recommend that the regulators consider allowing intermediaries the flexibility to partner with VA trading platforms that are licensed outside Hong Kong but in a recognised Financial Action Task Force (FATF) jurisdiction for the provision of VA dealing services, as there are other FATF jurisdictions such as the United States and the United Kingdom that also has adequate investor protection regarding VA. It is not clear why the SFC would permit omnibus accounts only. There are pros and cons for omnibus and segregated accounts. Please refer to Page 23 entitled "VI Custody Issues and Recommendations" of ASIFMA's Best Practices for Digital Asset Exchanges. Where intermediaries act on behalf of investors to execute transactions through an omnibus account, there may be a risk that this arrangement could be abused by investors for escaping targeted surveillance over market manipulative/abusive trading strategies by the VA trading platform. We would be grateful if the regulators can provide more detailed guidance regarding the roles and responsibilities intermediaries in such arrangements and the cooperation protocols (e.g. sharing of information) and control frameworks that should exist, both between intermediaries and VA trading platforms and within intermediaries, that would satisfy the regulators' expectations in Appendix 6 of the Joint Circular – Licensing or registration conditions and terms and conditions for licensed corporations or registered institutions providing virtual asset dealing services and virtual asset advisory services. We also have the following other recommendations: • the SFC should put the obligation for prevention of market manipulative and abusive trading strategies on VA trading platforms and not the intermediaries, given

Regulators' Requirements	Private Banks' Challenges	PWMA's Recommendations
		that intermediaries have very limited visibility over the transactions and limited expertise as compared to the dedicated VA trading platforms; and • it will also be helpful if the regulators could clarify what is the expectation on staff training, given that this is not specifically provided in the Joint Circular but it was brought up by the regulators during one of the dialogues with PWMA's members.
VA Dealing Services: Existing Investors Paragraph 18 of the Joint Circular provides that only a Type 1 regulated intermediary should provide VA Dealing Services to their ***existing clients*** (Counsel's emphasis added).	It is not clear to us the rationale of imposing a requirement that intermediaries should only provide VA dealing services to its existing clients of Type 1 regulated activity.	We recommend for this condition to be removed.
VA Dealing Services: Withdrawal or Transfer of VA Paragraph 20 of the Joint Circular and Section 4.3 of the Terms and Conditions For Licensed Corporations Or Registered Institutions Providing Virtual Asset Dealing Services Under An Omnibus Account Arrangement (i.e. Appendix 6) provides that "a licensed corporation or registered institution should ensure that clients can only deposit fiat currencies and withdraw the same	In our view, the above condition is unduly restrictive. Not only does it prohibit the withdrawal of VA, it also prohibits the transfer of VA from one private bank to another. We would be grateful if the regulators could clarify the rationale.	We recommend for this condition to be removed. Specifically, as long as intermediaries comply with applicable AML/CTF requirements, they will be permitted to allow customers to withdraw or to transfer VA.

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from the licensed corporation or registered institution's segregated account; and that no withdrawal or transfer of VA by clients is permitted at any time, even after cessation of the account maintained with the licensed corporation or registered institution".		
VA Advisory Services: Existing Clients Paragraph 24 of the Joint Circular provides that VA advisory services must only be provided by intermediaries which are licensed by or registered with the SFC to carry out dealing in securities (Type 1) or advising on securities (Type 4) regulated activities to ***existing clients*** (Counsel's emphasis added).	It is not clear to us the rationale of imposing a requirement that intermediaries should only provide VA advisory services to its Types 1 and 4 existing clients.	Applying the "same activity, same risk, same regulation" approach, we recommend removing this requirement.
Product Due Diligence There are two new requirements under Appendix 4 of the Joint Circular: 1. Measures to mitigate risks of AML - "measures adopted by the fund manager to mitigate the risks of money laundering and terrorist financing,	We query whether it is necessary for the SFC and the HKMA to prescribe such prescriptive product due diligence requirements.	We recommend SFC and the HKMA allow intermediaries to leverage their existing product due diligence framework, taking into account specific features or specific risks which are unique to VARPs. PWMA and its members welcome guidance from regulators. We also recommend the SFC and the HKMA allow intermediaries to apply existing product due diligence principles based on product type: • adopt a streamlined/simplified product due diligence process for non-solicited transactions (i.e. execution-only);

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especially in respect of subscriptions made by fund investors in VA (where applicable)" 2. Risk management policy for hacking risks - "its risk management policy for other risks associated with VA fund management, for example, hacking or other technology-related risks"		• full product due diligence on other VARPs; and in either case, the product due diligence process should include assessment of the features and risks of the underlying assets.
Notification Requirement In the circular entitled "Circular to Intermediaries on Compliance with Notification Requirements" dated 1 June 2018, the SFC states, amongst other things, that it considers trading and asset management services involving crypto-assets as significant changes in an intermediary's business which triggers a notification requirement under the Securities and Futures (Licensing and Registration) (Information) Rules		We recommend the requirement to notify the SFC and the HKMA prior to engage in VAs and VARPs activities to be removed. This is because this should not be considered as a material change to an intermediary's business.