Davis Polk

Hong Kong's renewed stance on virtual assets, security tokens and retail investors

November 8, 2022 | Client Update | 12-minute read

On 31 October, the government and regulators of the Hong Kong financial industry signaled a clear intention to embrace digital ledger technology and its various applications such as cryptocurrencies, NFTs and metaverses, while emphasizing the need to create a robust legal and regulatory framework to support the sector. This client update provides an overview of the government and regulators' views on virtual assets outlined in the statements and speeches made during Hong Kong Fintech Week 2022.

Introduction

On 31 October 2022, the government and regulators of the Hong Kong financial industry signaled a clear intention to embrace digital ledger technology (DLT) and its various applications such as cryptocurrencies, NFTs and metaverses, recognizing that they are "here to stay".

At the same time, the government and the regulators have also emphasized the creation of a robust, but hopefully balanced, legal and regulatory framework, to support sustainable and responsible development in the sector in Hong Kong. The overarching principle of "same activity, same risks, same regulation" was also emphasized.

In our view, this represents a change in attitude towards virtual assets (VA), and a gradual opening up to the potential of DLT.

This client update provides an overview of the government and regulators' views on VA as outlined in the various statements and speeches made on 31 October 2022, the first day of Fintech Week 2022. The statements include the following:

- Policy statement issued by the Financial Services and the Treasury Bureau on the development of VA in Hong Kong (the "Policy Statement");
- Circular issued by the SFC on 31 October 2022 on VA futures exchange traded funds;
- Press release by the HKMA on 31 October 2022; and
- Speeches made by Paul Chan, Financial Secretary of Hong Kong, Algernon Yau, Secretary for Commerce and Economic Development, Eddie Yue, Chief Executive of the Hong Kong Monetary Authority (HKMA), Julia Leung, Deputy Chief Executive Officer of the Securities and Futures Commission (SFC), and Clement Cheung, Chief Executive Officer of the Insurance Authority (IA), at the Fintech Week 2022 Conference.

We have included in this client update links to all key circulars, statements and press releases published by the relevant regulators in Hong Kong, with the intention that this client update can be used as a source document to identify all key regulatory publications.

1. Security token offerings (STOs)

The SFC proposes to adopt a modified regime for STOs.

Security tokens, or tokenized securities, refer to tokens that are treated as "securities" under the Securities and Futures Ordinance (Cap. 571), and may include, for example, tokens that represent ownership of assets or economic rights in them. Previously, the SFC indicated in March 2019 that security tokens are treated as "complex products" and can only be offered to professional investors.

The SFC now proposes to remove such default classification. Under the modified regime, tokenized securities may be classified as either non-complex or complex products, depending on their financial characteristics and nature. They would no longer be automatically classified as complex products merely because they are issued or traded on a blockchain.

For example, a tokenized plain-vanilla bond would be classified as a non-complex product. On the other hand, where the token's features are more novel and complicated, such as fractionalized asset-backed tokens or tokens representing an income stream from projects, they may be classified as complex products.

This approach is supported by the SFC's current view that tokenized securities, as digital representations of traditional securities on a blockchain, should be treated in a similar way as the underlying financial instruments. This is also in line with the "same activity, same risks, same regulation" principle expressed by the Hong Kong government and regulators.

Furthermore, the SFC will expect licensed entities to perform reasonable due diligence and conduct smart contract audits before distributing these tokens to its clients. The SFC will also revisit the requirements for listing security tokens on licensed VA exchanges.

The SFC indicated that it is prepared to allow retail access to STOs if proper safeguards are in place.

Details of the modified regime will be announced by the SFC in due course.

2. Retail access to VA exchanges

There is also indication that VA exchanges may open up to retail investors in the future.

By way of background, on 6 July 2022, the government introduced a new licensing regime for VA exchanges to be supervised by the SFC, through the Anti-Money Laundering and Counter-Terrorist Financing (Amendment) Bill 2022. Subject to legislative approval, the licensing regime is expected to come into effect on 1 March 2023. For details of the proposed legislations, please see our previous client update. The FSTB indicated in a Legislative Council Brief dated 22 June 2022 that the government planned to restrict licensed VA exchanges to serving only professional investors, at least in the "initial stage", by imposing that as a licensing condition.

The SFC is now soft consulting the industry on whether the professional investors requirement can be relaxed, and if so, what the governance procedures and listing criteria for VA exchanges should be. The SFC will consult the public on more detailed requirements after the passage of the Bill.

The change in approach is in part due to the changing regulatory environment and the SFC's experience regulating the industry, including VA fund managers, VA exchanges and VA trading brokers, in the past few years.

3. VA futures ETFs

Currently, while the SFC does allow SFC-licensed and registered intermediaries to offer eligible VA futures ETFs to retail customers, this is limited to products traded on conventional exchanges. See the Joint Circular published by the HKMA and SFC on intermediaries' virtual asset-related activities (28 January 2022).

In light of the increasing acceptance of VA as a vehicle for investment allocation by global institutional and individual investors, the SFC is now accepting applications for authorization of VA futures ETFs for retail offering in Hong Kong. At the initial stage, these ETFs are only allowed to invest in Bitcoin and Ether futures traded on the Chicago Mercantile Exchange. The SFC will expand this in the future as appropriate.

In addition, the management company is required to demonstrate a good record of regulatory compliance and at least three years' proven track record in managing ETFs. The management company is expected to adopt an active investment strategy to allow flexibility in portfolio composition, rolling strategy and handling of any market disruptions.

These VA futures ETFs would be treated as derivatives products and VA-related products. Intermediaries are subject to the applicable requirements in the SFC code of conduct and related circulars, including requirements applicable to derivative products and VA, such as the VA-knowledge test requirement.

Relatedly, as a general reminder, licensed intermediaries seeking to provide services in connection with VA are required to notify the SFC of such development. See the SFC Circular to intermediaries on compliance with notification requirements dated 1 June 2018. In addition, licensed corporations providing services with a stated investment objective of investing in VA or an intention to invest 10% or more of the gross asset value of a portfolio in VA are subject to additional licensing conditions. See the Joint Circular published by the HKMA and SFC on intermediaries' virtual asset-related activities on 28 January 2022.

4. Stablecoins

The government drew attention to the HKMA's discussion paper published earlier this year inviting public comment on the regulatory approach towards stablecoins and related activities. The government indicated that the consultation outcome and next steps will be announced in due course.

In the HKMA discussion paper, the HKMA acknowledged that stablecoins may not fall within the definition of existing regulatory regimes, such as the "stored value facilities" regime. As such, the HKMA may not be able to adequately regulate stablecoins. The HKMA recommended an agile regulatory approach by considering the risks of stablecoin activities and acting proportionally.

The HKMA identified key areas of risk for stablecoin-related activities, such as financial stability, monetary stability, settlement, user protection, financial crime and cyber threats, international compliance and regulatory arbitrage. The HKMA proposed to focus on regulating asset-linked stablecoins rather than algorithm-based stablecoins, given the former's prevalence in the market and higher potential for being incorporated into the mainstream financial system. It is unclear if the HKMA's views changed given recent collapses of algorithmic stablecoins.

The HKMA proposed that the following activities be licensed under the new regime:

– Minting and burning of stablecoins;
– Managing reserve assets backing the value of stablecoins and providing custody or trust for such assets;
– Authorizing or verifying the validity of transactions and records;
– Safe-keeping of private keys used to digitally sign transaction instructions on behalf of stablecoin holders;
– Facilitating stablecoin holders to redeem stablecoins for fiat currencies or other assets;
– Ensuring correct and final settlement of transactions to minimize the risk of counterparty default; and
– Conducting transactions in stablecoins on behalf of others.

With regards to timeline, the HKMA aimed to introduce the new stablecoin regime no later than 2023/24. Noting the multiple financial regulatory regimes in Hong Kong administered by different financial regulators, the HKMA will work closely with stakeholders, regulators and other interested parties to identify areas for further collaboration in developing the stablecoin regime.

5. Review of property rights

The government also suggested that there may in the future be a review on property rights for tokenized assets and the legality of smart contracts, to enhance investor protection and provide a strong legal foundation for their development. The government recognizes that the unique characteristics of VA differ from traditional assets and their features may not fit into the current private property law categories or definitions in Hong Kong.

There has been recognition in other common law jurisdictions of the proprietary nature of cryptocurrencies and NFTs and the granting of proprietary remedies like injunctions.

The England and Singapore courts recognizes that digital assets are "properties" and are subject to proprietary remedies. In particular, the courts in both jurisdictions granted proprietary injunctions to freeze digital assets allegedly obtained illegally (whether through fraud, theft or breach of contract). See for example *AA v Persons Unknown* [2019] EWHC 3556 (Comm) on cryptocurrencies and *Osbourne v (1) Persons Unknown and (2) Ozone Networks Inc trading as Opensea*

[2022] EWHC 1021 (Comm) and *Janesh s/o Rajkumar v Unknow Person ("Chefpierre")* [2022] SGHC 264 on NFTs.

While to our knowledge this is an untested area under Hong Kong law, we do not expect the outcome to differ materially from these common law jurisdictions.

It is also worth noting that in the UK, the Law Commission published advice to the UK government on 25 November 2021, concluding that the current legal framework in England and Wales is clearly able to facilitate and support the use of smart legal contracts, without the need for statutory law reform. Given the similarity between Hong Kong and English law, the Hong Kong government, in considering any legislative initiatives relating to smart contracts, will likely take into account the UK assessment.

6. Pilot projects

The government and regulators highlighted three pilot projects being undertaken by the government and the regulators to explore the technological benefits and applications of VA, summarized below.

NFT issuance for HKFTW 2022

The FTSB is issuing NFTs at Fintech Week HK 2022, which will serve as proof of attendance for participants. This is the first time the HK government has issued NFTs, and it considers the issuance as a proof-of-concept project to engage the Fintech and Web3 community.

Tokenizing government green bonds

The government announced in its Policy Statement that the HKMA is working on a pilot project to tokenize government green bonds to streamline issuances. The goal is to test the financial and legal infrastructure for the use of DLT throughout the bond lifecycle, and to serve as a guide for future issuances by market participants.

The project follows successful prototype testing of digital infrastructure for green bond tokenization conducted by the HKMA and the Bank for International Settlements (BIS) Innovation Hub Hong Kong Centre, which concluded in November 2021.

e-HKD

The government and the HKMA are continuing to further their efforts to develop e-HKD as a retail Central Bank Digital Currency (rCBDC). Commenced in June 2021, this is the latest project undertaken by the HKMA in its ongoing research on CBDCs, building on earlier wholesale CBDC (wCBDC) projects conducted in collaboration with other central banks.

The government and the HKMA drew attention to the HKMA's recent report on the next steps in relation to e-HKD, where it proposed a "three-rail" approach to preparing for potential e-HKD implementation.

– The first rail covers setting up the technology and legal foundations for the implementation of e-HKD. As a first step, the HKMA proposed developing the wholesale, interbank use case before moving onto the retail layer. The HKMA expects to formulate a system development plan in around nine months' time, and an additional two to three years to build the wholesale layer.
– The second rail involves deep dives into use cases and implementation and design issues, to be conducted in parallel with the first rail.
– The third rail involves the actual launch of e-HKD, the timing of which depends on the first two rails and the pace of relevant market development, therefore no estimated timeline was given by the HKMA in its report.

In other jurisdictions:

– In the PRC, retail CBDC (rCBDC) development is much further ahead. Public testing of e-CNY, which began in April 2020 in Shenzhen, has now been expanded to cover 23 cities. The PRC also launched an e-CNY app for iOS and Android devices earlier this year, and conducted a trial for overseas visitors at the 2022 Beijing Winter Olympics.
– The US government published a report in September 2022 setting out the policy objectives for a potential US CBDC, but does not make any assessments or recommendations about whether the US should pursue a CBDC.

- The UK government and the Bank of England are also considering whether to introduce CBDC in the UK, with a consultation setting out the government's and BoE's assessment for a UK CBDC, to be launched by the end of 2022.
- The Monetary Authority of Singapore is also undergoing a multi-year, multi-phase exploratory project examining an rCBDC system for Singapore, although the MAS has assessed that there is currently "no urgent need" for rCBDC in Singapore.
- The Reserve Bank of Australia announced in August 2022 that it is looking to explore a limited-scale CBDC pilot test, operating in a ring-fenced environment.

7. Insurtech

In his speech, Mr. Clement Cheung, CEO of IA, emphasized that the IA is progressive and liberal. He noted the wide adoption of technology, Web3 and the internet in the insurance industry, including some insurers' use of NFTs in their marketing efforts and the use of IOT devices to improve underwriting skills and quality, and the increasing popularity of virtual insurers.

He spoke to the IA's goal to build a thriving insurtech ecosystem and to enhance insurability and financial inclusivity. Some of the initiatives include:

- Open API framework – the soft consultation will start soon;
- Cross-sector dialogue with the HKMA;
- Exploring cross-boundary connectivity;
- Developing a cybersecurity assessment framework to assist the market to identify vulnerability and enhance cybersecurity; and
- Welcoming new ideas from the industry.

Conclusion

The government and the regulators' latest indications are to be welcomed. While the VA community has started off being wary of any and all forms of regulations, many now accept that appropriate, well-balanced regulations can move the industry forward and avoid many of the pitfalls made clear by the "crypto winter".

The latest statements represent the first step in providing much-needed regulatory certainty to industry participants, builders, investors, traders and service providers alike. We await further details on the various initiatives.

Resources
Crypto Regulation Hub

Visit our Crypto Regulation Hub for links to congressional proposals related to the regulation of crypto assets and other helpful materials.

Explore our crypto resources

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Martin Rogers
+852 2533 3307
martin.rogers@davispolk.com

Li He
+852 2533 3306
li.he@davispolk.com

James C. Lin
+852 2533 3368
james.lin@davispolk.com

Miranda So
+852 2533 3373
miranda.so@davispolk.com

Yuan Zheng
+852 2533 1007
yuan.zheng@davispolk.com

Xi Shi
+852 2533 3396
xi.shi@davispolk.com

Samuel Kang
+852 2533 1019
samuel.kang@davispolk.com

Lok Cheung
+852 2533 1029
lok.cheung@davispolk.com