Recent Developments on Hong Kong Virtual Assets Regulations

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On 31 October 2022, alongside the commencement of the Hong Kong FinTech Week, the Hong Kong government announced its renewed ambition to make Hong Kong a digital assets hub with the Financial Services and the Treasury Bureau releasing a policy statement on the government’s vision and approach towards the development of virtual assets in Hong Kong. On 13 December 2022, the Securities and Futures Commission of Hong Kong issued a statement highlighting the risks and potential legal requirements associated with virtual asset arrangements.

This alert provides an overview of the Hong Kong government’s and financial regulator’s latest views and positions outlined in those statements, including (1) providing some key observations on virtual asset arrangement services and highlighting certain risks on such virtual assets arrangements to investors and (2) pilot projects such as Central Bank Digital Currency (CBDC or e-HKD) and green bonds tokenisation and other initiatives such as allowing retail investors to access to virtual assets by Exchange Traded Funds (ETFs) and placing certain appropriate regulations on stablecoins.

REGULATOR’S STATEMENT ON VIRTUAL ASSETS DEPOSITS, SAVINGS, EARNINGS, OR STAKING SERVICES

On 13 December 2022, the Securities and Futures Commission (SFC), Hong Kong’s securities regulator, issued a statement on virtual asset (VA), e.g., crypto or digital assets, arrangements which claim to offer returns to investors. In this statement, the SFC identified various risks associated with VA platforms offering VA deposits, savings, earnings, or staking services (VA Arrangements). Some of their key observations about VA Arrangements, which are worthy of investors’ careful attention, include:

- Some platforms offer a high interest rate on VA deposits or a daily generation of additional VA at a guaranteed or fixed rate to investors. The VA deposited by investors with the platforms may then be on-lent by the platform to borrowers on other platforms or decentralised lending protocols or used in investment or other activities.

- Some platforms may offer staking services to investors where investors’ VA may be
The SFC also highlighted potential legal issues, as well as risks of the above arrangements to investors, including:

- Whilst some VA Arrangements are labelled or marketed as deposits or savings products, they are not regulated and are not the same as bank deposits. Investors are not afforded any form of protection.

- VAs are exposed to heightened risks including insufficient liquidity, high price volatility, opaque pricing, potential market manipulation and hacking, and fraud and may lose all value.

- Some VA Arrangements could amount to a collective investment scheme (CIS) as defined under the Securities and Futures Ordinance (SFO) if the participating investors do not have day-to-day control over the management of their VAs and the VAs are pooled or managed as a whole by the operator to generate returns for investors. Such VA Arrangements may be unauthorised CIS and may be highly risky. The product will not have been vetted nor its offer and marketing materials reviewed by the SFC. Investors will have no protection under the SFO.

HONG KONG GOVERNMENT ANNOUNCED RENEWED AMBITION TO MAKE HONG KONG A DIGITAL ASSETS HUB

In late October last year, Hong Kong’s Financial Services and the Treasury Bureau published a Policy Statement on Development of Virtual Assets in Hong Kong (the Policy Statement).

The Policy Statement sets out the Hong Kong government’s vision and next steps to help grow Hong Kong’s VA ecosystem. The Hong Kong government recognises the potential of distributed ledger technology (DLT) and Web 3.0 to become the future of finance and commerce industries. It envisions that, with proper regulation, these technologies will enhance market efficiency and transparency.

The Policy Statement was widely welcomed by market participants, who hope it will attract more talented VA-related businesses to Hong Kong.

As noted in the Policy Statement, Hong Kong is exploring a few pilot projects to assess the technological benefits produced by VAs and their further applications in financial markets. The goal of these initiatives is to fortify and stimulate the VA industry in Hong Kong.

The five key initiatives include:

**Pilot Projects**

- **e-HKD**: The Hong Kong government sees its CBDC or e-HKD as the potential backbone and anchor bridging legal tender and VA, which may help bring price stability and instill confidence in cryptocurrencies and other VA products, and hence, encourage financial innovations.

- **Tokenisation for green bonds**: This initiative seeks to tokenise the Hong Kong government’s green bond issuances for institutional investors.\(^1\)
Other initiatives

- **VA ETFs**: This initiative is focused on exploring ETFs that provide exposure to VAs to be offered to retail investors.

- **Stablecoins**: A consultation is underway to explore the appropriate regime to regulate activities relating to payment-related stablecoins, which will need to be sufficiently agile, while also promoting stable and responsible market innovations.

- **Property rights**: The Hong Kong government is open to future review of the unique characteristics of tokenised assets and how existing private property laws may apply or may need to be revised.

PILOT PROJECTS

e-HKD or Hong Kong CBDC

Currently, cryptocurrencies and other VAs cannot serve as legal tender in Hong Kong. However, the Hong Kong government and the relevant regulators are exploring a launch of the retail CBDC or e-HKD. Many believe that a CBDC or e-HKD could make payments within the special administrative region or even across borders more efficient and quicker. The importance or significance of e-HKD may lie in its potential to serve as the backbone and anchor bridging legal tender and VA. If implemented and used in Hong Kong, it may create price stability and instill greater confidence in cryptocurrencies. This in turn, could facilitate further local VA industry innovations and the development of Hong Kong’s digital economy.

Tokenisation for green bonds

Conventional clearing, settlement, and payment systems have been in place for many decades and have made significant contributions to the development and growth of capital markets globally. However, conventional systems have shown a certain level of time and cost inefficiencies, among other issues.

Tokenisation of bonds and other debt and equity capital market products may reduce these inefficiencies by reducing the number of intermediaries or intermediary systems and simplifying the issuance and settlement processes. The Hong Kong Monetary Authority (HKMA), along with the Bank for International Settlements Innovation Hub Hong Kong Centre, successfully developed two prototypes (utilising permissioned and permissionless blockchain) to concept-test the use of DLT to streamline green bond retail issuance.

Building on from the success of that project, the HKMA is working on a pilot project tokenising Hong Kong government’s green bond issuance for subscription by institutional investors, deploying DLT throughout the lifecycle of a bond, including issuance, settlement, asset servicing, secondary trading, and redemption. This project is aimed at assessing the readiness of the financial, legal, and regulatory infrastructure for tokenised securities, and to serve as a guide for similar future issuances of not just green bonds, but also other conventional bonds and equity capital markets products in tokenised form.
OTHER INITIATIVES

VA ETFs—Giving Access to VAs to Retail Investors

In October 2022, the SFC issued a circular setting out the conditions on which it would authorise ETFs with exposure to VAs through futures contracts (VA Futures ETFs) to be offered to retail investors in Hong Kong. Currently, this is limited to VA Futures ETFs with exposure only to Bitcoin and Ethereum futures traded on the Chicago Mercantile Exchange, although the SFC may consider expanding the scope of eligible VA futures and VA futures markets at a later date.

VA Futures ETFs seeking SFC authorization for public offering in Hong Kong must have a manager that has a good track record of regulatory compliance and at least three years’ experience in managing ETFs. The manager must also adopt an active investment strategy allowing flexibility in portfolio composition, rolling strategy, and handling of market disruptions. The net derivatives exposure of a VA Futures ETF may not exceed 100% of total net asset value.

Launching these products in Hong Kong will provide connectivity between VA players and traditional financial institutions, offering investors access to well-designed and innovative financial products associated with VAs. While the impetus is on promoting growth in this sector of the market, the Hong Kong government and regulators are keenly aware of and concerned about the inherent risks these products may pose to retail investors.

Stablecoins

Another key area of focus is stablecoins. In VAs markets, stablecoins are designed to maintain a stable price over time because their value is pegged, tied to or backed by another currency, commodity or financial instrument. Stablecoins have been used as a means of exchange between fiat currencies and cryptocurrencies. Due to these features, stablecoins have the potential to improve the interconnectedness with conventional financial markets (e.g., in the payment system) and bridge two worlds—VAs and traditional finance. Having observed several stablecoin market crashes and the resulting knock-on effects, governments and regulators are looking to implement better laws and regulations, with a specific focus on governance, stabilisation and redemption mechanisms of stablecoins.

Last year, the HKMA issued a discussion paper on stablecoins, asking for industry feedback on the implementation of a risk-based, proportionate, and agile regime for regulating activities relating to payment-related stablecoins. The outcome from the consultation process, the regulator’s conclusions, and next steps are expected to be announced soon. Stablecoins will remain under scrutiny by all regulators given the rapid growth of the market globally and their potential to impact broader financial systems.

Clarifying property rights of tokenised assets

The Policy Statement indicated that the Hong Kong government is open to future review on property rights for tokenised assets and the legality of smart contracts, which may help set a solid legal foundation for the further development of these assets and stimulate the growth of related markets. VAs have unique characteristics that differentiate them from traditional assets and may therefore require different legal and regulatory regimes. As with other jurisdictions, Hong Kong is considering how best to clarify the laws relating to this rapidly evolving asset class. It is encouraging that Hong Kong is looking to update and adapt its legal regimes, if it is needed, to aid and bolster the future
development of VA and VA-related industries.

For more information on any issues covered in this alert or for assistance with any virtual asset or consumer financial services-related needs, please reach out to the authors or our wider team of payments, banking regulation, and consumer financial services lawyers.

FOOTNOTES

1 A green bond is, generally speaking, a bond or other fixed-income debt securities to support climate-related or environmental projects.

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