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Newsletter

Financial Services

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What's inside?

Changes to the requirements for virtual asset-related activities

Su Cheen Chuah and Joey Lee

On 28 January 2022, the Hong Kong Securities and Futures Commission (**SFC**) and the Hong Kong Monetary Authority (**HKMA**) issued a joint circular on intermediaries' virtual asset-related activities (**Joint Circular**), which supersedes the SFC's circular to intermediaries on the distribution of virtual asset funds dated 1 November 2018 (**2018 Circular**).

The Joint Circular mainly covers the following activities relating to virtual asset-related products (**VA-related products**) and services: (a) distribution of VA-related products; (b) provision of virtual asset dealing services (**VA dealing services**); and (c) provision of virtual asset advisory services (**VA advisory services**). The Joint Circular defines "VA-related products" to mean products which (a) have a principal investment objective or strategy to invest in virtual assets; (b) derive their value principally from the value and characteristics of virtual assets; or (c) track or replicate the investment results or returns which closely match or correspond to virtual assets.

A. Distribution of VA-related products

The following requirements are applicable to the distribution of VA-related products:

(1) **Complex product requirements** – VA-related products are very likely to be considered complex products, and therefore the usual requirements relating to the distribution of complex products (e.g. ensuring suitability, minimum information and warning statements) will apply.

(2) **"Professional investors" only** – Except for a limited suite of products (e.g. VA-related derivative products that are traded on regulated exchanges specified by the SFC, or exchange-traded VA derivative funds that are authorised or approved for offering to retail investors by the respective regulator in a designated jurisdiction), VA-related products which are considered complex products should only be offered to professional investors.

(3) **Virtual asset-knowledge test** – Except for institutional professional investors and qualified corporate professional investors, intermediaries should (i) assess whether clients have knowledge of investing in virtual assets or VA-related products prior to effecting a transaction in VA-related products on their behalf; and (ii) ensure that their clients have sufficient net worth to be able to assume the risks and bear the potential losses of trading VA-related products. The SFC has set out non-exhaustive criteria for assessing whether a client can be regarded as having knowledge of virtual assets.

(4) **Selling restrictions and suitability obligations** – Intermediaries are also required to observe any other selling restrictions in Hong Kong and other jurisdictions which may be applicable to a particular VA-related product (e.g.

prohibition on offering unauthorised investments to the Hong Kong public) and suitability obligations.

(5) **Requirements regarding financial accommodation** – When providing any financial accommodation for investing in VA-related products to clients, an intermediary should be cautious and should assure itself the client has the financial capacity to meet the obligations arising from leveraged or margin trading in VA-related products, including in a worst-case scenario. If there is no such assurance, the intermediary should not accept instructions from the client.

(6) **Provision of information in a clear and easily comprehensible manner** – Intermediaries should ensure that information relating to VA-related products and the underlying virtual asset investments are provided in a clear and easily comprehensible manner.

(7) **Disclosure of warning statements** – Intermediaries should provide warning statements (which can be one-off disclosure) to clients specific to virtual assets. The warning statements should include without limitation and where applicable, the general risks of trading in futures contracts, risks specific to virtual asset futures contracts, the continuing evolution of virtual assets and how this may be affected by global regulatory developments, price volatility, and other applicable risks.

B. Provision of VA dealing services

Intermediaries providing VA dealing services are also required to comply with the following requirements:

(1) **Professional investors only** – VA dealing services should only be provided to professional investors.

(2) **SFC and HKMA requirements** – Intermediaries are expected to comply with all the regulatory requirements imposed by the SFC and the HKMA when providing VA dealing services, regardless of whether the virtual assets involved are securities.

(3) **Partner with SFC-licensed VA trading platform** – In order to provide VA dealing services, intermediaries are required to partner only with SFC-licensed VA trading platforms.

(4) **Existing type 1 clients only** – VA dealing services can only be provided to the intermediaries' existing clients to which they provide type 1 (dealing in securities) regulated services.

(5) **Terms and conditions of licensing / registration** – The SFC (in consultation with the HKMA, where applicable) will impose as licensing / registration conditions (**Terms and Conditions**) the expected conduct requirements for intermediaries' provision of VA dealing services under an omnibus account arrangement. Under the Terms and Conditions, intermediaries will be under various obligations, including only permitting clients to deposit or withdraw fiat currencies from their accounts, and not to allowing the deposit or withdrawal of client virtual assets to minimize risks associated with such transfer.

(6) **Terms and conditions for virtual asset discretionary account management services** – In respect of virtual asset discretionary account management services, if a licensed corporation intends to invest 10% or more of the gross asset value of a portfolio in virtual assets, it will be subject to additional requirements as set in the *Proforma Terms and Conditions for Licensed Corporations which Manage Portfolios that Invest in Virtual Assets* which was published in 2019 (**Proforma Terms and Conditions**). Registered institutions should inform the SFC and HKMA if they wish to provide such services, and they will be required to comply with the Proforma Terms and Conditions.

(7) **Discretionary account management services** – Intermediaries with a type 1 licence that are authorised by their clients to provide VA dealing services on a discretionary basis as an ancillary service should only invest less than 10% of the gross asset value of the client's portfolio in virtual assets.

C. Provision of VA advisory services

Intermediaries providing VA advisory services are required to comply with the following:

(1) All the regulatory requirements imposed by the SFC and HKMA when providing advisory services, regardless of the nature of the virtual assets;

(2) VA advisory services should only be provided to intermediaries' existing clients to which they provide type 1 or type

4 (advising on securities) regulated services;

(3) Suitability obligations, and intermediaries should only offer VA advisory services to professional investors and conduct a virtual asset knowledge test before providing the services;

(4) Other applicable conduct requirements set out in 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 dated January 2022; and

(5) Where the advisory services are with regard to VA-related products, intermediaries should observe the requirements in relation to VA-related products set out in section A above and ensure the suitability of recommendations provided.

D. Implementation and transitional period

The Joint Circular will be implemented immediately for intermediaries which do not currently engage in VA-related activities. For intermediaries which are serving existing clients of VA-related activities, there will be a six-month transition period for full implementation of the requirements of the Joint Circular.

In view of the implementation timeframe, both intermediaries which are currently engaging in VA-related activities and those which intend to engage in VA-related activities should commence careful assessment of the relevant VA-related products and services to ascertain the relevant requirements which will apply pursuant to the Joint Circular, and to ensure that they are properly met within the implementation timeframe.

Consultation conclusions on regulating trustees and custodians of public funds

Alwyn Li and George Ho

On 22 February 2022, the Hong Kong Securities and Futures Commission (**SFC**) released its consultation conclusions (**Conclusions**) and began a further consultation on the details of its proposals in 2019 to introduce a new type 13 regulated activity (**RA13**) to regulate trustees and custodians (i.e. depositaries) of SFC-authorised collective investment schemes (**Relevant CIS**). Our article on the 2019 consultation is available here.

Entities that will need to be licensed

Subject to a number of exemptions, entities (typically local banks) will need to be licensed or registered for RA13 if they carry on an activity of providing depositary services in Hong Kong for one or more Relevant CIS.

Proposed regulatory framework

Under the Securities and Futures Ordinance (**SFO**), a depositary licensed for RA13 will be subject to the same requirements as other SFC-licensed corporations, including the appointment of responsible officers and managers-in-charge and compliance with SFC codes, guidelines and circulars. A depositary conducting RA13 will also need to maintain a minimum amount of (i) paid-up capital of HK$10 million; and (ii) liquid capital of HK$3 million.

The SFC is proposing to amend Schedule 11 to the Code of Conduct for Persons Licensed By or Registered with the Securities and Futures Commission (**Code of Conduct**) for RA13, which will incorporate the trustee and custodian requirements that exist under the Code on Unit Trusts and Mutual Funds, the Code on Real Estate Investment Trusts and other product-specific codes (the **Product Codes**). The Product Codes as well as various subsidiary legislation under the SFO will also be amended accordingly to reflect the introduction of RA13.

The proposed Schedule 11 (Appendix B of the Conclusions) sets out additional requirements on management and supervision, operational controls and compliance, etc., applicable to an entity licensed or registered for RA13.

The SFC is inviting comments by 30 April 2022 on the proposed amendments to the relevant subsidiary legislation and SFC codes and guidelines to implement the regime.

Way forward

The SFC takes the view that a transitional period of 18 months for the licensing / registration process for RA13 will be sufficient. However, the SFC will extend the application submission deadline to four months from the gazettal date.

The SFC indicated that if a depositary foresees that it may not be able to meet this general expectation due to exceptional circumstances, it should approach the SFC or the HKMA to discuss the specifics as soon as practicable.

Although the details of the proposals are undergoing a further public consultation before gazettal, existing trustees and custodians of Relevant CIS will be subject to the new RA13 regulatory regime in due course and they should be prepared to comply with the relevant regulatory requirements and make a timely application for an RA13 licence.

Amendment Bill to abolish MPF offsetting arrangement after years of consultation

Cynthia Chung and Bernie Ng

The Hong Kong Government published the Employment and Retirement Schemes Legislation (Offsetting Arrangement) (Amendment) Bill 2022 (**Amendment Bill**) on 11 February 2022 to implement the proposal to abolish the use of the accrued benefits of employers' mandatory contributions under the Mandatory Provident Fund (**MPF**) system to offset statutory severance payment and long service payment (**SP/LSP**) commonly known as the "**MPF Offsetting Arrangement**".

Abolition of the MPF Offsetting Arrangement

Employers are currently entitled to make use of the MPF Offsetting Arrangement to reduce the SP/LSP payable to their employees upon termination of employment. After the proposed amendments come into effect on a date to be appointed by after the enactment of the Amendment Bill (**Transition Date**), the MPF Offsetting Arrangement will be abolished and employers could no longer use its MPF mandatory contributions to offset the SP/LSP entitlements in respect of their employees' employment period starting from the Transition Date (but not before). In essence, under the Amendment Bill, the SP/LSP payable to an employee whose employment ends on or after the Transition Date will be divided into two components:-

(1) *Pre-Transition SP/LSP – SP/LSP payable in respect of the period up to the day immediately preceding the Transition Date.*

This portion of SP/LSP will not be affected by the Amendment Bill. Employers are entitled to use its mandatory contributions made before, on or after the Transition Date to offset Pre-Transition SP/LSP even after amendments come into effect.

(2) *Post-Transition SP/LSP – SP/LSP payable in respect of the period from the Transition Date*

The MPF Offsetting Arrangement is not applicable to this portion of SP/LSP.

Despite the above, voluntary contributions which employers make in excess of the mandatory requirement (and the returns derived therefrom) can continue to be used to offset both Pre- and Post-Transition SP/LSP. Offsetting by using gratuities based on length of service is also likewise not affected by the Amendment Bill.

As for MPF-exempted occupational retirement schemes under the Occupational Retirement Schemes Ordinance, the offsetting arrangement will also be abolished with respect to "non-offsettable benefits".

The calculation of SP/LSP will also be updated following the enactment of the Amendment Bill. Whilst the payment rate (i.e. 2/3 x monthly wages x years of service) and payment cap (i.e. HK$390,000) for monthly rated employees will remain unchanged, the monthly wages used to determine the Pre-Transition SP/LSP will generally be the monthly wages immediately preceding the Transition Date, whereas the monthly wages for calculating the Post-Transition SP/LSP will generally be the last monthly wages before the relevant date of termination. Where an employee has work for a long period

such that his/her aggregate SP/LSP exceeds HK$390,000, the Post-Transition SP/LSP will be the remainder of HK$390,000 after first deducting the Pre-Transition SP/LSP.

Government subsidy

Bearing in mind that the new regime would lead to additional financial burden being incurred by employers, the Government will put in place supporting measures to facilitate the transition. Based on the Legislative Council Brief issued on 8 October 2021, the current plan of the Government is to set up a 25-year subsidy scheme details of which are summarised as follows:

(1) For the first HK$500,000 of SP/LSP payable in a year, employers will only be required bear a specified share ratio of this portion of the SP/LSP and, for the first 9 years from the Transition Date, will not be required to bear any amount exceeding a specified cap.

(2) For the remaining part of the SP/LSP payment obligations, employers will only be required to bear a specified share ratio of this portion of the SP/LSP for the first 12 years from the Transition Date. No subsidy will be provided from year 13 onwards for this portion of the SP/LSP.

The Government subsidy scheme will likely be implemented through a reimbursement approach whereby employers will have to first settle any SP/LSP that arises and the Government will calculate and disburse the subsidy upon subsequent application.

Employer's obligations

The Amendment Bill also seeks to amend the record-keeping provisions of the Employment Ordinance to require employers to keep wage and employment records of their employees covering the 12 months of the employees' employment (or a shorter period for an employee who has worked for less than 12 months) immediately preceding the Transition Date.

In addition, and in connection with the Government subsidy scheme, the Government intends to introduce a Designated Saving Accounts (DSA) Scheme under which employers will be required to make mandatory contributions to designated accounts for meeting their future SP/LSP liabilities. Separate legislative amendments will be made.

What should employers do?

As evident from the above, the Amendment Bill contains technical amendments which may not be easy to follow in practice. As such, although it is expected that the amendments will not be implemented until at least 2025, it is advisable for employers to familiarise themselves with this new regime and seek professional advice where necessary to facilitate compliance.

Hong Kong SFC licensing and compliance hints

Rebecca Yip

How does your firm fare on AML/CFT compliance?

The SFC posted an updated AML/CFT Self-Assessment Checklist on 27 January 2022. This reflects the latest Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (For Licensed Corporations) which became effective on 30 September 2021 (except for the cross-border correspondent relationships requirements which will take effect on 30 March 2022).

Licensed corporations should use the self-assessment checklist to assess and monitor their AML/CFT compliance as part of the regular review.

Senior management of licensed companies (e.g. MIC for Anti-Money Laundering and Counter-Terrorist Financing) should ensure that any compliance deficiencies identified during the regular reviews are rectified in a timely manner.

The SFC may require licensed corporations to provide evidence to show that such review has taken place and appropriate actions were taken as part of the routine inspections.

Time to plan ahead of CPT hours for 2022

We have mentioned the new CPT requirements in our newsletter articles of 24 November 2021, 24 June 2021 and 25 January 2021. It would be best to plan ahead and communicate with the licensed representatives and the responsible officers concerning their new CPT obligations.

Licensed representatives are required to undertake a minimum of 10 CPT hours per calendar year while the responsible officers are required to undertake at least 12 CPT hours. Out of the required hours, all licensed individuals are required to attend at least five CPT hours on topics directly relevant to the regulated activities for which he/she is licensed, and two CPT hours on topics relating to ethics or compliance. In addition, responsible officers will also need to attend two CPT hours on topics relating to regulatory compliance.

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