

# SFC allows retail access to regulated VA dealing, advisory and discretionary account management

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## Introduction

On 20 October 2023, the Securities and Futures Commission ('SFC') and the Hong Kong Monetary Authority ('HKMA') published a joint [circular](#) on intermediaries' virtual asset-related activities ('**Circular**'), along with a set of updated appendices. The Circular supersedes an earlier [circular](#) issued on 28 January 2022. The most important change made in the Circular is the lifting of the restrictions on intermediaries licensed for virtual asset ('**VA**') dealing, advisory and management ('**Intermediaries**') against providing these services to retail investors subject to certain conditions. For a review of the joint circular issued in 2022, please refer to our [News Flash](#) issued in February 2022.

See below for an explanation of the key take-aways from the Circular.

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## Tokenised securities

The SFC re-iterated that intermediaries providing dealing, advisory and management services in tokenised securities should comply with (a) the existing requirements governing such activities on securities and (b) the expected standards of conduct and guidance on tokenised securities issued by the SFC from time to time.

However, as a general point, the SFC expects all licensed intermediaries to notify the SFC in advance before engaging in any activities involving VA, tokenised securities or VA-related products, or making any changes to these activities conducted (including expanding VA services to retail clients).

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## VA knowledge test

With respect to the VA knowledge test, the SFC has removed the exemption from having to conduct this test solely because a client has executed 5 or more transactions in VA or VA-related products within the past 3 years. No changes, however, have been made to the list of non-exhaustive criteria for assessing client's VA knowledge.

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## Type 1 – Distribution of VA products

The SFC has not made any material changes to the regulation on distribution of VA products, which are essentially divided into two broad categories: (1) non-derivative and (2) derivative VA products.

(1) Non-derivative VA products

- It remains the case that non-derivative VA products (e.g., spot BTC) are very likely to be considered "complex products" that can only be distributed to professional investors ('**PIs**').

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### (2) Derivative VA products

- Derivative VA products are further divided into two sub-categories:

#### (a) Unlisted VA derivative products

The SFC has made clear that (i) unlisted VA derivative products or (ii) those listed on non-specified exchanges (i.e., exchange not specified in Schedule 3 of the Securities and Futures (Financial Resources) Rules (**'Schedule 3 Exchanges'**)) are complex products and *can only be* distributed to PIs.

#### (b) Listed VA products

However, the SFC has stated that VA products (i) traded on Schedule 3 Exchanges and (ii) authorised for retail offering by a regulator in a designated jurisdiction under Appendix 2 to the Circular, or by the SFC in Hong Kong *may* be distributed to retail investors.

### Additional distribution requirements

Irrespective of the categorisation of the VA-related products, and except for institutional or qualified corporate PIs, intermediaries which are licensed with the SFC for Type 1 (dealing in securities) regulated activity (**'RA'**) (**'Type 1 Intermediaries'**) must impose a virtual-assets knowledge test on their clients and provide adequate training (where they assess the client does not have adequate knowledge), and ensure clients have sufficient net worth to bear the loss from VA trading.

As non-derivative VA products will likely be complex products, they are subject to the requirements applicable to complex products under the SFC, such as ensuring suitability, minimum information and warning statements and due diligence of product and issuer<sup>1</sup>.

The same complex products requirements also apply to derivative VA products. Derivative VA products must also comply with the derivative product requirements<sup>2</sup>.

Finally for listed VA products, although they are also subject to the derivative products requirements, they are not subject to the complex products requirements insofar as there has been no solicitation or recommendation (unless they are not of the same type as a complex exchange-traded derivative as set out in the SFC's [website](#)).

Interestingly, the SFC referred to the need for authorisation of certain "investments" if they were being offered to the Hong Kong public under Pt IV of the Securities and Futures Ordinance (Cap. 571) (**'SFO'**).<sup>3</sup> However, unless the VA products fall under the definitions of "securities", "structured products" or "collective investment schemes" (e.g., being security tokens of interests in tokenised funds), it seems unlikely that VA products would be caught under Pt IV and require authorisation.

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## Type 1 – VA dealing

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In terms of VA dealing services, the SFC has made the following material changes to the regulation:

### (1) Retail investors

The SFC now permits VA dealing services to be also provided to "retail" investors (that is, non-PIs), subject to the following conditions:

- (i) The service must be provided in partnership with SFC-licensed VA trading platforms (**'VATPs'**) which are also licensed for trading by retail investors (multiple partner VATPs are permitted);
- (ii) Dealing is only allowed for the types of VA for which the partner VATP is itself approved to offer to retail investors;
- (iii) Dealing must be conducted through an omnibus account maintained with a VATP that can serve retail investors; and
- (iv) the virtual-assets knowledge test, suitability, limit to exposure and other requirements to apply.

Type 1 Intermediaries are now also allowed to act as introducing agents for retail as well as PI clients, although the restrictions in relation to relaying orders on behalf of their clients, or holding client assets/VA remain.

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<sup>1</sup> See paragraph 5.5 of the Code of Conduct for Persons Licensed by or Registered with the SFC (**'Code of Conduct'**) and Circular "Minimum information to be provided and warning statements" issued by the SFC on 12 June 2019.

<sup>2</sup> See paragraph 5.1A and 5.3 of the Code of Conduct.

<sup>3</sup> See paragraph 10 of the Circular.

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### (2) Deposit / withdrawal in VA

Previously, clients were not allowed to deposit or withdraw amounts in VA but only fiat currencies. This restriction has now been lifted, but such withdrawal / deposit must be made through segregated accounts established either with the partner VATP, or an authorised bank (that meets the HKMA standards for VA custody).

### (3) Additional requirements under Appendix 6 T&Cs

The SFC has also amended the licensing or registration conditions and terms and conditions for licensed corporations or registered institutions providing VA dealing services and VA advisory services under the Appendix 6 to the Circular ('**Appendix 6 T&Cs**'), which Type 1 Intermediaries providing VA dealing services must comply with. Appendix 6 T&Cs impose comprehensive requirements in relation to, among other things, financial soundness, operations, prevention of market manipulation, dealing with clients, custody, client moneys, record keeping, audit, AML and counter financing of terrorism, conflicts of interest, and ongoing reporting obligations (to the SFC/HKMA).

In addition to the current requirements imposed under the existing T&Cs, the revised Appendix 6 T&Cs also requires Type 1 Intermediaries to

- not make arrangements with its clients to use client VA held with them to generate returns – which would have the effect of ruling out DeFi-related activities such as staking, lending, liquidity mining;
- where a recommendation/solicitation is being made to a retail client, ensure that the VA is of high liquidity, is a large-cap VA, and generally complies with the requirements imposed on VA that are accessible by retail investors under the VATP licensing regime (i.e., included in 2 independent indices, etc)<sup>4</sup>;
- take active steps to detect and prevent persons who are attempting to circumvent their home jurisdiction's ban on trading VA (for example, by using a VPN) from accessing their services;
- clearly inform their clients on how their VA voting rights will be handled by both the VATP and themselves;
- adopt a fee structure that is clear, fair and reasonable in the circumstances and characterised by good faith, and clearly set out how fees apply, including whether the client is providing or taking liquidity;
- when keeping records:
  - (1) document all suitability records and risk profiles of their clients;
  - (2) show separately and account for all receipts, payments, deliveries and other uses or applications of the client assets effected; and
  - (3) ensure the security, authenticity, reliability, integrity, confidentiality and timely availability of required records;
- disclose to retail and non-qualified PIs:
  - (1) that the extreme volatility and unpredictability of the price of a VA relative to fiat currencies may result in a total loss of the investment over a short period of time;
  - (2) the name and website of the same from the VATP through which client transactions are executed and settled;
  - (3) the list of VA available for trading by its retail clients (where applicable);
  - (4) the relevant information of the VA available for trading or inform clients where such information could be accessed, such as the website of the VATP.

### (4) Important clarifications

On the other hand, the SFC reiterated that only Type 1 Intermediaries are permitted to provide VA dealing services; and they are only allowed to provide VA dealing services to persons who remain at all times their clients in respect of their Type 1 business.

The SFC's clarification above is in line with our previous [analysis](#) that managers licensed with the SFC for Type 9 VA (asset management) RA ('**Type 9 VA Managers**') are prohibited from providing VA dealing services RA as an incidental activity (even though in the absence of any VA, Type 9 VA Managers are allowed to carry out Type 1 RA as an incidental activity). In

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<sup>4</sup> However, Type 1 Intermediaries are not required to ensure suitability for orders in VA which they have not made any solicitation or recommendation if they are placed by a client directly (a) on a VATP, or (b) with the Intermediary for onward transmission to a VATP for execution.

addition, the SFC has now clarified that even if dealing services do not amount to "dealing in securities", such services may still have an impact on a regulated entity's fitness and propriety to conduct RAs, and that "trading activities" involving VA form part of the dealing services provided by an Intermediary.<sup>5</sup> As such, the expectation is that such trading activities must comply with all regulatory requirements of the SFC/HKMA – including that they can only be provided by a Type 1 Intermediary with Appendix 6 T&Cs imposed ('**Type 1 VA Intermediary**'). As such, Type 9 VA Managers who wish to provide VA dealing services as part of its management mandate would need to either (a) separately engage a Type 1 VA Intermediary or (b) itself obtain a Type 1 RA licence (with the appropriate VA uplift).

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### Type 4 – VA advisory

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In a similar vein, intermediaries licensed with the SFC for Type 4 (advising on securities) RA ('**Type 4 Advisors**') are now able to also provide VA advisory services to retail clients.

However, in providing services to retail clients, Type 4 Advisors must, under the revised Appendix 6 T&Cs:

- assess a client's knowledge of VA (including relevant risks) and if the client does not possess sufficient knowledge, provide adequate training;
- assess a client's risk tolerance level and apply appropriate risk profiling to the client; and
- where a recommendation/solicitation is being made to a retail client, ensure that the VA is of high liquidity, is a large-cap VA, and generally complies with the requirements imposed on VA that are accessible by retail investors under the VATP licensing regime (i.e., included in 2 independent indices etc).

Similar to Type 1 VA dealing services, the SFC has reiterated its position that VA advisory services should only be provided by Type 4 Advisors (and to persons who are customers of their Type 1 RA or Type 4 RA business). As such, and as noted in our previous [article](#), this would presumably preclude a Type 9 VA manager from providing VA advisory services as part of its management mandate.

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### Type 9 – VA management

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#### (A) VA fund management

##### (1) Clarification on the 10% de minimis threshold for Type 9 VA licence

In the Circular, the SFC has clarified that the de minimis threshold in determining whether a manager licensed with the SFC for Type 9 RA ('**Type 9 Manager**') needs to uplift its Type 9 (asset management) RA licence is applied at the portfolio level (in line with the T&Cs in 2019), rather than at the manager level (as stated in the circular published by the SFC in November 2018). In other words, Type 9 Managers would need to apply for a licensing uplift and subject themselves to the latest terms and conditions for licensed corporations or registered institutions which manage portfolios that invest in VA under Appendix 7 to the Circular ('**Appendix 7 T&Cs**'), if they are proposing to manage a portfolio of VA in excess of 10% of the gross asset value of that portfolio in VA.

In determining the 10% threshold, however, tokenised securities are considered as "securities" and not VA.

##### (2) Significant changes made under the Appendix 7 T&Cs

Apart from the clarification above, the SFC has also made the following significant changes to Type 9 VA management activities:

- Type 9 VA Managers must now obtain insurance in respect of the fund's VA (previously they only had to use reasonable endeavours to obtain insurance); and
- by removing the requirement on Type 9 VA Managers to provide services only to Pls, it is contemplated now that a Type 9 VA Manager may manage and/or distribute a retail fund (subject to authorisation under Pt IV of the SFO and the prospectus rules under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32)).

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<sup>5</sup> See paragraph 17 of the Circular.

### (B) VA discretionary account management

VA discretionary account management services may now also be provided to retail clients, subject to the similar restrictions applied to VA advisory services provided to retail clients.

When providing VA discretionary account management services to retail clients, Type 9 VA Managers must:

- assess a client's knowledge of VA (including relevant risks) and if the client does not possess sufficient knowledge, provide adequate training;
- only trade (presumably through a Type 1 Intermediary with Appendix 6 T&Cs imposed unless they are themselves also Type 1 VA Intermediaries) VA that are highly liquid, large cap, and generally comply with the requirements imposed on VA that are accessible by retail investors under the VATP licensing regime (i.e., included in 2 independent indices etc);
- conduct a suitability assessment on a holistic basis and based on the client's personal circumstances and net worth; and
- enter into a Discretionary Client Agreement with appropriate warning statements and risk disclosures.

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## Implementation

In terms of implementation, the regulators have provided a 3-month transition period for existing Type 1 Intermediaries who are servicing non-qualified corporate PIs and individual PIs to update their systems and controls to align with the new Appendix 6 T&Cs as introduced by the Circular.

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## What this means for market participants

The Circular is certainly a welcome step in opening up VA distribution, VA dealing, VA advisory and VA management services to retail clients. This is good news for industry participants, and is also in line with what is happening with other parts of the ecosystem (for example, the introduction of the VATP licensing regime and allowing retail customers to access exchange services).

Nevertheless, the measures taken to liberalise the scope of services are considered incremental, rather than wholesale in their changes. Distribution activities, for example, are still mostly restricted to PIs except for a small selection of exchange traded VA derivative products.

In relation to VA dealing and VA advisory activities, allowing retail clients to withdraw and deposit VA as well as fiat currencies through VATP and/or authorised banks is certainly a positive development. Additionally, the requirements for servicing retail clients such as information rights/disclosures, suitability and knowledge tests and education, and restriction to only large cap and liquid VA, are all sensible protective measures.

As for VA management activity, while the rules around the de minimis threshold have now been clarified (such that most Type 9 Managers looking to manage VA funds will likely have to apply for a licence uplift and have Appendix 7 T&Cs imposed on them), the requirement that any VA dealing by the Fund will have to be done through a Type 1 VA Intermediary would appear to be quite restrictive on VA fund management. For example, the attendant restrictions around Type 1 VA Intermediaries being able only to transact on SFC-licensed VATPs, not being able to generate returns through DeFi type activities, and the requirements to have assets custodied on an SFC-licensed VATP or bank, would seem to rule out many "on-chain", DeFi, or high frequency/systematic strategies. On the plus side, opening up Discretionary Account Management services to retail clients would certainly be a boon for managers.

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## Next steps

It will be interesting to see how this "seismic shift" in allowing retail access to VA related services will impact Intermediaries in the coming days. Opening up an entirely new sector and revenues streams can only be a positive development for the industry as a whole. On balance, the safeguards the regulators have built around this nascent market are, in our view, measured and sensible.

## Let's talk

For a deeper discussion of how this impacts your business, please contact us.

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