

A Response to the EFRAG's Crypto-Assets – Outreach Questionnaire

By the Standard Setting Department of the HKICPA

Objective

1. The Hong Kong Institute of Certified Public Accountants (HKICPA) operates under the Hong Kong's Professional Accountants Ordinance and works in the public interest. The HKICPA has wide-ranging responsibilities, including setting and promulgating financial reporting, auditing and ethical standards in Hong Kong, and assuring the quality of entry into the profession through its postgraduate CPA qualification programme. The HKICPA has responsibility for regulating and promoting efficient accounting practices in Hong Kong to safeguard its leadership as an international financial centre.
2. The HKICPA Standard Setting Department has been monitoring developments in crypto-assets in Hong Kong and has engaged in local outreach to better understand crypto-related activities and identify crypto-asset accounting issues. We present this memorandum in response to the EFRAG's outreach questionnaire on crypto-assets.

Overview of the Hong Kong market for crypto-assets and examples of accounting issues

3. This section summarises our responses to the following sections of the EFRAG's questionnaire:
 - Section 1: crypto-assets issuance, holding and related services activities
 - Section 2: crypto-assets characteristics, rights, obligations and contractual arrangements
 - Section 5: crypto-assets market developments and trends
4. Hong Kong has seen a growing amount of activity related to crypto-assets over the past few years. Large market growth was seen from 2014 to 2017, as Hong Kong served as a launching pad for mainland Chinese entities. Major organisations working to support the crypto industry in Hong Kong include Cyberport, the Hong Kong Blockchain Society, the Bitcoin Association of Hong Kong, Blockchain HK, and Invest HK, among others.
5. For each of the following areas, we lay out some of the major players in the market and some examples of current accounting issues that are being encountered:
 - a. Issuers
 - b. Exchanges and custodian services
 - c. Holders
 - d. Mining
 - e. Payment and other services

Issuers

6. Hong Kong experienced a growing interest in crypto-asset issuances within the region up to 2018. Various reasons may be cited for this, amongst which include a ban on initial coin offerings (ICOs) entirely in mainland China in 2017, a ban on banking and payment institutions

in nearby Macau from dealing with ICOs, and a relatively lax regulatory environment in Hong Kong at that time. In September 2017, Invest HK's fintech office stated that between 10 and 20 companies would carry out ICOs in Hong Kong in the following months.

7. During 2018 issuance activity started to decline. Attributable reasons include a drop in crypto-asset prices and regulatory reasons (e.g. the Securities and Futures Commission (SFC) in Hong Kong advised in September 2017 that digital tokens that are offered or sold may be "securities" as defined in the Securities and Futures Ordinance (SFO), and accordingly subject to the securities laws of Hong Kong). The SFC has carried out a number of forms of regulatory activity to this effect, including a high-profile halting of the ICO of Hong Kong-based Black Cell in March 2018.

Example accounting issues:

- Which accounting standard to apply to issue proceeds (challenge to determine the credit side of the journal entry).
 - Issuers have been considering use of IFRS 15 (as a prepayment for future goods or services, e.g. access to platform), IAS 37 (as an obligation leading to a provision) and IAS 20 (by analogy).
- Revenue recognition if under IFRS 15.
 - Application of IFRS 15 raises a variety of challenges. A key issue is the determination of the timing of revenue recognition (i.e. timing of transfer of control, etc.). In particular, there is a lack of connection between the business and contractual terms, and an overall lack of contractual and legal evidence as to the rights and obligations of the issuer and the issued crypto-asset. For example, it is common to see the issuer attempt to retain a high level of legal protection and disclaim many potential obligations. This however leads to a situation where applying IFRS 15 and determining the asset transferred to the customer becomes judgmental.
- Some practitioners expressed disappointment about the limited scope of the IFRS Interpretations Committee's Agenda Decision on holdings of cryptocurrencies as it does not address accounting concerns for issuances.

Exchanges and custodian services

8. Hong Kong has a number of crypto-asset exchanges that serve the local market. Major exchanges at the time of writing of this paper include, among others: Abra, ANXPro, BC Group (OSL), Bitspark, Bitmex (offering Bitcoin futures trading), Tidebit, Weever. In February 2018, the SFC noted that in terms of daily trading volume, there are several cryptocurrency exchanges in Hong Kong that rank in the top 20 globally.
9. Major crypto-asset custodians in Hong Kong include BC Group and InVault.

Example accounting issues:

- Recognition and balance sheet treatment.
 - When holding crypto-assets as a custodian on behalf of clients, a major accounting question is whether the custodian should recognise those crypto-assets. The accounting conclusion is dependent on the legal situation and contractual structure.
 - The accounting could be impacted due to legal status of custodian and ownership. For

example, a Cayman fund should have a clear shareholder registry that identifies the legal owner, whereas an entity that simply lists owners in an Excel spreadsheet may not be legally effective.

- Principle versus agency issues.
 - There is an issue of identifying whether the entity is a principle or an agent in recognising revenue under IFRS 15. Furthermore for principles doing proprietary trading could lead to inventory accounting issues.
- Whether contracts to buy and sell crypto-assets give rise to derivatives, including interaction with IFRS guidance on contracts to buy or sell commodities and other non-financial items, the IFRS 9 own-use exception and net settlement/broker-dealer guidance.
- Smart contracts.
 - Smart contracts are essentially programmed processes. They can be used, for example, to process the purchase of a crypto-asset by means of performing know-your-client reviews on the purchaser, receiving the consideration, and then updating the shareholder registry. There are subsequently many questions such as whether the smart contracts are legally binding, and how the terms of the crypto-asset are legally established (e.g. whether conditions in white paper are legally binding in the smart contract).

Holders (including funds and asset management)

10. Hong Kong is home to a number of hedge funds and asset management entities that focus on crypto-asset investments.
11. Invest HK recently highlighted a case study of MaiCapital, one of the first SFC regulated hedge fund managers in blockchain technology and crypto-assets investment in Hong Kong, which launched its flagship product Blockchain Opportunity Fund in March 2019. Another fund in Hong Kong is Kenetic Capital, a proprietary trading and investment firm focused on digital assets and blockchain related companies.

Example accounting issues:

- Dissatisfaction with intangible asset treatment.
 - Some holders are not satisfied with applying the intangible asset accounting model in IAS 38 to holdings of crypto-assets.
 - These holders think that the cost model (cost less amortisation less impairment) is not representative of their business and that such accounting (particularly useful life and impairment) is judgmental and operationally challenging.
 - These holders also think that the revaluation model's use of other comprehensive income is not representative of their business. They also think that the model's reference to an "active market" is unhelpful as "active market" can be difficult for some holders to evidence.
 - Some have questioned whether the exclusions in paragraph 7 of IAS 38 could be applied to crypto-assets.
- Some holders prefer fair value through profit or loss measurement for crypto-assets because this measurement could better reflect the performance of their investments.
- Valuation.
 - Valuation is a difficult issue for crypto-assets because there are often not clear and sufficient inputs.

- Determination of whether an “active market” exists is difficult. This challenge increases for particular cases such as when dealing in crypto-asset currency pairs (where neither side of the pair is a fiat currency), given the challenge of demonstrating convertibility.
12. In view of the development of crypto-assets and the diversity in how they are accounted for, the HKICPA responded to the IFRS Interpretations Committee’s tentative agenda decision (TAD)¹ on holdings of cryptocurrencies to :
- a. express support for finalising the TAD as interim guidance to eliminate the diversity in how entities currently account for holdings of cryptocurrencies; and
 - b. recommend the IASB commence a standard-setting project to develop a more robust accounting suitable for cryptocurrencies, or more broadly for crypto-assets.

Mining

13. Hong Kong does not have a significant crypto-asset mining industry. Reasons for this include rent and energy costs. During 2019, the Beijing-based mining technology company Bitmain Technologies Ltd. performed initial work on a Hong Kong IPO, however the application lapsed.

Example accounting issues:

- Treatment of mining proceeds – e.g. whether as revenue in scope of IFRS 15 or other income/gains.

Payment and other services

14. Various blockchain payment activities are underway in the Hong Kong and greater China region. Notable activities include:
- a. AlipayHK is using blockchain technology to streamline the remittance process and other services.
 - b. In Q3 2019 the Hong Kong retailer Pricerite started to accept payment in Bitcoin (BTC), Litecoin (LTC) and Ethereum (ETH) at one of its branches.
 - c. Tencent Holdings Limited is working on blockchain-based invoicing for transport systems in Shenzhen.
 - d. Hong Kong Stock Exchange (HKEX) teamed up with Digital Asset to build a blockchain platform for post-trade allocation and processing of northbound trading.
 - e. Hong Kong Monetary Authority (HKMA) launched its new blockchain-based banking trade finance platform, ‘eTradeConnect’, at the end of last year.
 - f. The HKMA and the Monetary Authority of Singapore agreed to collaborate on developing the Global Trade Connectivity Network, a cross-border financial infrastructure platform based on distributed ledger technology.

¹ https://www.hkicpa.org.hk/-/media/HKICPA-Website/New-HKICPA/Standards-and-regulation/SSD/03_Our-views/PCD/2019/Fred/sub_TAD.pdf

Hong Kong accounting environment for crypto-assets

15. This section summarises our responses to section 3: crypto-assets accounting guidance for crypto-assets of the EFRAG's questionnaire.
16. Domestic companies in Hong Kong whose securities trade in a public market are required to use Hong Kong Financial Reporting Standards (HKFRS)² or IFRS. There are no specific accounting standards for crypto-assets or related activities in Hong Kong.

Hong Kong regulatory environment for crypto-assets

17. This section summarises our responses to section 4: crypto-assets regulation, investor and consumer protection of the EFRAG's questionnaire.
18. Until 2018, the market was largely unregulated, with no specific regulation to govern crypto-assets. Notably, Hong Kong does not define or recognise crypto-assets as a means of payment. The HKMA has previously described crypto-assets as not a legal tender but a virtual "commodity", which does not qualify as a means of payment or electronic money. Additionally, there are no specific regulations governing the mining of crypto- assets in Hong Kong.
19. Regulators in Hong Kong have however been taking notice. Since 2017 the most active regulatory body has been the SFC. In September 2017 the SFC stated that virtual assets³ may, depending on their characteristics, meet the regulatory definition of "securities" and hence be subject to the securities laws of Hong Kong. As such, depending on the facts and circumstances of an ICO, digital tokens that are offered or sold may be subject to securities regulation. Following that, in December 2017 the SFC notified the market that dealing in Bitcoin futures requires holding a Type 2 license (dealing in futures contracts), despite the underlying Bitcoin not being subject to SFC regulation.
20. Hence, by the end of 2017 markets for virtual assets were further regulated, but still not subject to the oversight of the SFC if the virtual assets fell outside the legal definition of "securities" or "futures contracts" (or equivalent financial instruments).
21. Since late 2018, there have been three major regulatory developments from the SFC:
 - 1) November 2018 new regulatory approach for virtual assets.
22. In November 2018 the SFC issued a new regulatory approach for virtual assets. The new regulatory approach is composed of two parts:
 - a) New regulatory approach for virtual asset portfolio managers and distributors of virtual asset funds.
 - i. Firms managing funds that invest solely in virtual assets (that don't meet the definition of "securities" or "futures contracts" under the Securities and Futures Ordinance (SFO) will typically require a license for Type 1 regulated activity (dealing in securities) and be subject to SFC oversight.

² HKFRS is fully converged with IFRS.

³ The term "virtual assets" is used in this section to align with the SFC's description of the phenomenon.

- ii. Firms that are licensed or are to be licensed for Type 9 regulated activity (asset management) and also manage virtual assets (exceeding 10% of gross asset value) will be subject to SFC oversight.
 - iii. Firms which distribute funds that invest (solely or partially) in virtual assets in Hong Kong will require a licence or registration for Type 1 regulated activity (dealing in securities).
- b) Conceptual framework for potential regulation of virtual asset trading platforms.
- i. The SFC also set out a conceptual framework for the potential regulation of virtual asset trading platforms, with a view to exploring (and forming a view after the exploratory stage) whether virtual asset trading platforms are suitable for regulation.
 - ii. This conceptual framework was realised in November 2019 (See point (3) below).

2) October 2019 Terms and Conditions for licensed corporations managing virtual assets.

23. New terms and conditions imposed on all licensed virtual asset fund managers that manage or plan to manage portfolios with (i) a stated investment objective to invest in virtual assets; or (ii) an intention to invest 10% or more of the gross asset value of the portfolio in virtual assets.
24. Terms govern items such as custody, operations, corporate governance, dealing, marketing, fees, and SFC reporting.

3) November 2019 new approach to virtual asset trading platforms.

25. November 2019 position paper sets out new regulatory framework for virtual asset trading platforms. Platforms may apply for a license if they offer trading in at least one virtual asset meeting the definition of a security. This is the culmination of the November 2018 conceptual framework for potential regulation of virtual asset trading platforms.
26. As of late November 2019, SFC staff have informed us that no entities are currently licensed to carry out virtual asset trading under the new regime
27. We include a timeline of virtual asset regulation in the **Appendix** of this paper.

Appendix – Timeline of virtual asset regulation in Hong Kong

Date	Entity	Announcements/Guidance
30 January 2014	Customs and Excise Department	<ul style="list-style-type: none"> Take reasonable measures to mitigate money laundering and terrorist financing risks associated with virtual commodities.
21 March 2014	SFC	<ul style="list-style-type: none"> (Circular) Exercise increased vigilance to mitigate money laundering and terrorist financing risks associated with virtual commodities.
11 February 2015	HKMA	<ul style="list-style-type: none"> Bitcoin is not a legal tender but a virtual “commodity”. It does not qualify as a means of payment or electronic money. Bitcoin and other similar virtual commodities are not regulated by the HKMA.
5 September 2017	SFC	<ul style="list-style-type: none"> (Statement) Depending on the facts and circumstances of an ICO, digital tokens that are offered or sold may be “securities” as defined in the SFO, and subject to the securities laws of Hong Kong. These include digital tokens with characteristics of shares, debentures, and interests in collective investment schemes. Where the digital tokens involved in an ICO fall under the definition of “securities”, dealing in or advising on the digital tokens, or managing or marketing a fund investing in such digital tokens, may constitute a “regulated activity”. Parties engaging in a “regulated activity” are required to be licensed by or registered with the SFC.
8 November 2017	Secretary for Financial Services and the Treasury, HKSAR Government	<ul style="list-style-type: none"> Digital tokens are not currencies. They are a type of virtual commodities. SFC published a statement on 5 September 2017 that points out digital tokens may be “securities” as defined in the SFO. Apart from those digital tokens falling within the definition of “securities”, Hong Kong does not have any targeted regulatory measures on virtual commodities, as well as the trading platforms or operators of such commodities. That said, HK’s existing laws provide sanctions against money laundering, terrorist financing, fraud and cyber-crimes, whether or not virtual commodities are involved.
11 December 2017	SFC	<ul style="list-style-type: none"> (Circular) Parties carrying on a business in dealing in Bitcoin Futures, including those who relay or route Bitcoin Futures orders, are required to be licensed for Type 2 regulated activity (dealing in futures contracts) under the SFO unless an exemption applies. This is despite the assets underlying Bitcoin Futures not being regulated by the SFO. Marketing a fund investing in Bitcoin Futures will normally constitute Type 1 regulated activity (dealing in securities) and managing such a fund may constitute Type 9 regulated activity (asset management). The provision of advisory services in

		relation to Bitcoin Futures may also constitute Type 5 regulated activity (advising on futures contracts).
9 February 2018	SFC	<ul style="list-style-type: none"> • SFC warns of cryptocurrency risks • SFC once again alerts investors to the potential risks of dealing with cryptocurrency exchanges and investing in ICOs. Following a statement on ICOs released on 5 September 2017, SFC has taken regulatory action against a number of cryptocurrency exchanges and issuers of ICOs. • SFC has sent letters to seven cryptocurrency exchanges in Hong Kong or with connections to Hong Kong warning them that they should not trade cryptocurrencies which are "securities" as defined in the SFO without a licence. • SFC has also written to seven ICO issuers. Most of them confirmed compliance with the SFC's regulatory regime or immediately ceased to offer tokens to Hong Kong investors.
19 March 2018	SFC	<ul style="list-style-type: none"> • ICO issuer Black Cell Technology Limited halted its initial coin offering (ICO) to the Hong Kong public and agreed to unwind ICO transactions for Hong Kong investors by returning them the relevant tokens following regulatory action by the SFC over concerns that Black Cell had engaged in potential unauthorized promotional activities and unlicensed regulated activities. • Where an ICO involves an offer to the Hong Kong public to acquire an interest or participate in a "Collective Investment Scheme", prior authorization or licensing requirements under the SFO may be triggered unless an exemption applies.
1 June 2018	SFC	<ul style="list-style-type: none"> • (Circular to intermediaries) There are notification requirements under the Securities and Futures (Licensing and Registration) (Information) Rules if entities intend to provide trading and asset management services involving crypto-assets.
1 November 2018	SFC	<ul style="list-style-type: none"> • SFC sets out new regulatory approach for virtual assets. The statement is composed of two parts: <ul style="list-style-type: none"> (1) New regulatory approach for virtual asset portfolio managers and distributors of virtual asset funds. • Firms managing funds that invest solely in virtual assets (that don't meet the SFO's definition of "securities" or "futures contracts" will typically require a license for Type 1 regulated activity (dealing in securities) and be subject to SFC oversight. • Firms that are licensed or are to be licensed for Type 9 regulated activity (asset management) and also manage virtual assets will be subject to SFC oversight. • SFC has developed a set of standard Terms and Conditions which captures the essence of the existing requirements, adapted to better address the risks associated with virtual assets. <ul style="list-style-type: none"> (2) Conceptual framework for potential regulation of virtual asset trading platforms. • SFC is also setting out a conceptual framework for potential

		<p>regulation of virtual asset trading platforms, with a view to exploring (and forming a view after the exploratory stage) whether virtual asset trading platforms are suitable for regulation.</p> <ul style="list-style-type: none"> • To conduct a meaningful study of the framework, SFC will work with interested virtual asset trading platform operators that have demonstrated a commitment to adhering to the high expected standards by placing them in the SFC Regulatory Sandbox.
28 March 2019	SFC	<ul style="list-style-type: none"> • (Statement on Security Token Offerings) In Hong Kong, Security Tokens are likely to be "securities" under the SFO and so subject to the securities laws of Hong Kong.
4 October 2019	SFC	<ul style="list-style-type: none"> • SFC issued Terms and Conditions for Licensed Corporations which manage portfolios that invest in virtual assets. • The proforma set of terms and conditions is now available on the SFC's website. Going forward, these terms and conditions will be imposed on all virtual asset fund managers, subject to minor variations and elaborations depending on individual virtual asset fund manager's business model and circumstances.
6 November 2019	SFC	<ul style="list-style-type: none"> • SFC issued a position paper setting out new regulatory framework for virtual asset trading platforms. Platforms that operate in Hong Kong and offer trading of at least one security token may apply to be licensed by the SFC. • Also, the SFC issued a statement warning investors about the risks associated with the purchase of virtual asset futures contracts.