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FSTB Consults on Proposed Licensing Regime for Virtual Asset Exchanges

Hong Kong's Financial Services and Treasury Bureau (the **FSTB**) published a consultation paper[1] proposing a new licensing regime for virtual asset exchanges under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (**AMLO**) on 3 November 2020. The new regime would require the licensing of virtual asset exchanges that are not required to be licensed under the Securities and Futures Ordinance (**SFO**) because they trade virtual assets which are not within the statutory definitions of "securities" or "futures contracts". The new regime would be administered and enforced by Hong Kong's Securities and Futures Commission (**SFC**) which will be given the necessary powers under the AMLO.

The new regime aims to implement the Financial Action Task Force's (**FATF**) requirement for jurisdictions to regulate virtual asset service providers (**VASPs**) for anti-money laundering (**AML**) and counter financing of terrorism (**CFT**) purposes and supervise their compliance, a requirement introduced in February 2019 with the revision of FATF's standards. The new AMLO regime will however only license virtual asset exchanges, at least initially. Its scope is thus significantly narrower than the FATF's definition of VASPs which also covers businesses involved in transferring virtual assets, providing safekeeping and/or administrative services of virtual assets or instruments enabling control over virtual assets (including certain wallet providers) or providing financial services related to the offer or sale of virtual assets (e.g. ICOs). This is because the FSTB considers virtual asset exchanges to be the most prevalent and developed virtual asset activity in Hong Kong, thus warranting the introduction of a tailored licensing regime. It will however continue to monitor other activities in virtual assets and may expand the licensing regime in future to cover them if necessary. As part of the follow-up process to Hong Kong's mutual evaluation[2] by the FATF from 2018 to 2019, Hong Kong will undergo an effectiveness assessment in June 2024, by which time Hong Kong is expected to have implemented AML/CFT regulation for VASPs, in addition to other enhancements.

The consultation paper also outlines proposals to introduce various other technical amendments under the AMLO, and a two-tier registration regime for dealers in precious metals and stones (**DPMS**) which is the subject of a separate newsletter. The consultation period closes on 31 January 2021.

Current Hong Kong Regulation of Virtual Asset Exchanges

While virtual assets are not legal tender and generally not accepted as a means of payment in Hong Kong, virtual asset trading activities are prevalent, which spurred the SFC to announce a conceptual framework[3] for the potential regulation of virtual asset trading platforms in November 2018. A position paper[4] was then issued in November 2019 outlining an opt-in regulatory regime for virtual asset trading platforms operating

1 FSTB. 3 November 2020. *"Public Consultation on Legislative Proposals to Enhance Anti-Money Laundering and Counter-Terrorist Financing Regulation in Hong Kong"*. Available at: https://www.fstb.gov.hk/fsb/ppr/consult/doc/consult_amlo_e.pdf

2 www.fatf-gafi.org/publications/mutualevaluations/documents/mer-hong-kong-2019.html

3 https://www.sfc.hk/-/media/EN/files/ER/PDF/App-2_-Conceptual-framework-for-VA-trading-platform_eng.pdf

4 https://www.sfc.hk/web/files/ER/PDF/20191106%20Position%20Paper%20and%20Appendix%201%20to%20Position%20Paper%20(Eng).pdf

in Hong Kong which trade at least one virtual asset which is a security within the definition under the SFO.[5] If the platform trades at least one virtual asset that is a security, the SFC's requirements then apply to all its operations, including in relation to virtual assets which are not securities. Accordingly, under the current legislative framework, platforms that only trade virtual assets that are not securities can operate "off the regulatory radar".[6] To date, the SFC has only granted in-principle approval to one virtual asset trading platform, OSL.[7]

For an overview of the SFC's conceptual framework and subsequent position paper, please see Charltons' November 2018[8] and November 2019[9] newsletters respectively.

FSTB Proposals for Licensing VASPs

The FSTB proposes introducing a licensing regime for virtual asset exchanges under the AMLO, which will require any person seeking to conduct the "regulated VA activity" of operating a virtual asset exchange in Hong Kong to obtain a VASP licence from the SFC. The licensing requirement will apply even if the exchange only trades virtual assets which are not securities. The licence will remain valid until revoked by the SFC and no exemptions to the licensing requirement are proposed, except for virtual asset exchanges that are already regulated under the SFC's opt-in regime.

(a) Scope of Regulated Activity of Operating a Virtual Asset Exchange

Virtual Asset Exchange Defined

A virtual asset exchange will be defined as any trading platform which is operated for the purpose of allowing an offer or invitation to be made to buy or sell any virtual asset in exchange for any money or any virtual asset (whether of the same or a different type) and which comes into custody, control, power or possession of, or over, any money or any virtual asset at any point in time during its course of business.

This definition will require centralised virtual asset exchanges to be licensed. Peer-to-peer trading platforms (that is platforms that only provide a forum for buyers and sellers of virtual assets to post their bids, with or without automated matching mechanisms) are excluded from the definition, provided that the actual transaction is conducted outside the platform and the platform is not involved in the underlying transaction by coming into possession of any money or virtual asset at any time. Decentralised virtual asset exchanges should therefore fall outside the scope of the licensing regime.

Virtual Assets Defined

The proposals will largely align the definition of virtual assets with FATF's definition. The AMLO will define a virtual asset as a digital representation of value that: is expressed as a unit of account or a store of economic value; functions (or is intended to function) as a medium of exchange accepted by the public as payment for goods or services or for the discharge of a debt, or for investment purposes; and can be transferred, stored or traded electronically. The definition will therefore cover virtual assets which are not securities, such as Bitcoin and Ether. The FSTB consultation paper also proposes to include stablecoins (i.e. virtual assets backed by assets) within the definition. It will however exclude digital representations of fiat currencies (including CBDCs), financial assets already regulated under the SFO and closed-loop, limited purpose items that are non-transferable, non-exchangeable and non-fungible including air miles, credit card rewards, gift cards, customer loyalty programmes and gaming coins.

(b) Virtual Asset Exchange Licensing Requirements

Eligibility

The FSTB is proposing that only Hong Kong-incorporated companies with a permanent place of business in Hong Kong will be eligible for licensing as a virtual asset exchange. Natural persons and businesses without a separate legal personality (e.g. sole traders or partnerships) will not be licensed.

Virtual asset exchanges that are incorporated offshore will also not be eligible for licensing under the new regime. The FSTB also proposes to prohibit the active marketing of a regulated VA activity or similar activity (i.e. services associated with a virtual asset exchange), whether in Hong Kong or elsewhere, to the public in Hong Kong without a VASP licence. This provision is similar to section 115 of the SFO and, since the SFC will not license an offshore entity, will prevent an offshore virtual asset exchange from marketing its services to Hong Kong investors.

5 Schedule 1 to the SFO.
6 Ashley Alder. 3 November 2020. *"Fintech: the regulatory response to evolving challenges: Keynote address at Hong Kong Fintech Week"*. At: https://www.sfc.hk/-/media/EN/files/ER/PDF/CEO_speech_FinTechWeek_Nov2020.pdf
7 OSL. 21 August 2020. *"Hong Kong SFC issues approval-in-principle to OSL for virtual asset automated trading and brokerage licenses"*.
8 https://charltonsquantum.com/sfc-opens-sandbox-to-crypto-exchanges/
9 https://www.charltonslaw.com/sfc-issues-regulations-for-licensed-crypto-exchanges/#:~:text=The%20SFC%20issued%20a%20Position,anti%2Dmoney%20laundering%20obligations%20and

An offshore exchange that wants to be able to market to Hong Kong investors will therefore need to establish a Hong Kong subsidiary which will need to be licensed as a VASP by the SFC.

Appointment of Responsible Officers

Licensing applicants will be required to appoint at least two responsible officers who will be responsible for ensuring the firm's compliance with the AML/CTF requirements and other regulatory requirements. As is the case for licensed corporations, all executive officers will need to be approved as responsible officers of a licensed virtual asset exchange.

Fit and Proper Test

The licensing applicant, its responsible officers and the ultimate owners of the corporate entity will need to satisfy a fit-and-proper test. This will assess the person's experience and qualifications and require that they have not been convicted of any money laundering or terrorist financing offence or other offence involving dishonesty and are not the subject of any liquidation or bankruptcy proceedings.

Any change to the responsible officers or ultimate owners of the virtual asset exchange will require the SFC's prior approval. The FSTB consultation paper does not specify who will be regarded as an "ultimate owner" of an exchange for these purposes.

(c) Obligations of Licensed Virtual Asset Exchanges

Licensed virtual asset exchanges will be required to observe the AML/CFT requirements under Schedule 2 to the AMLO, which prescribes certain requirements relating to customer due diligence and record-keeping.

The regulatory standards for virtual asset exchanges licensed under the AMLO will be essentially the same as those for exchanges licensed under the SFC's opt-in regime to ensure a level playing field for all virtual asset exchanges. The consultation paper proposes to empower the SFC to impose licensing conditions on virtual asset exchanges, which may be varied where appropriate, and other regulatory requirements, including the following:

i. Restriction to Professional Investors

Licensed virtual asset exchanges will only be able to provide trading services to professional investors, although the SFC may relax this position in the future as markets mature.

ii. Adequate Financial Resources

The FSTB proposes to set a minimum paid-up share capital requirement and, depending on the nature of business, a liquid asset requirement.

iii. Knowledge and Experience

Licensed virtual asset exchanges will be required to have a proper corporate governance structure staffed by personnel with appropriate knowledge and experience.

iv. Sound Business

Licensed exchanges should operate their virtual asset business in a prudent and sound manner and ensure that client and public interests are not adversely affected.

v. Risk Management

Exchanges will need to put in place appropriate risk management policies and procedures for managing money laundering and terrorist financing, cybersecurity and other related risks.

vi. Segregation and Management of Client Assets

A licensed virtual asset exchange will be required to place client assets with an associated entity to ensure they are properly segregated from its own assets. It will also need to have adequate policies and governance procedures in place to ensure the proper management and custody of client assets.

vii. Virtual Asset Listing and Trading

Virtual asset exchanges will have to implement and enforce robust rules for the listing and trading of virtual assets on their platforms. In particular, they will need to perform all reasonable due diligence on virtual assets before listing them for trading.

viii. Financial Reporting and Disclosure

It is proposed that licensed exchanges should follow specified auditing and disclosure requirements and publish audited accounts.

ix. Prevention of Market Manipulative and Abusive Activities

Written policies and controls will need to be implemented for the proper surveillance of activities on a virtual asset exchange to identify, prevent and report any market manipulative or abusive trading activities.

x. Prevention of Conflicts of Interest

To avoid any conflicts of interest, licensed virtual asset exchanges will be prohibited from engaging in proprietary trading or market-making activities on a proprietary basis.

The Consultation Paper notes that the SFC will publish a consultation on the regulatory requirements for licensed VASPs prior to the commencement of the licensing regime.

(d) Proposed SFC Powers in Respect of Licensed Virtual Asset Exchanges

The SFC will be empowered to supervise the AML/CFT conduct of licensed virtual asset exchanges and to monitor, investigate and enforce their other obligations under the AMLO licensing regime.

The SFC will be given powers to enter the business premises of a licensed virtual asset exchange and its associated entities to conduct a routine inspection, to request the production of documents and other records, to investigate instances of non-compliance and to impose administrative sanctions for non-compliance (including the suspension or revocation of a licence). The SFC may also apply to the Court for an injunction order to prevent a licensed virtual asset exchange continuing to breach any regulatory requirements.

In addition, the SFC will be provided with intervention powers to impose restrictions and prohibitions on the operations of a licensed exchange and its associated entities in certain circumstances, for example where it is necessary to protect client assets.

It is also proposed that Part 6 of the AMLO be amended to expand the scope of reviewable decisions of the AML/CFT Review Tribunal to cover appeals against future decisions made by the SFC in relation to implementing the VASP licensing and supervisory regime.

(e) Proposed Sanctions for Unlicensed VA Activities, Non-Compliance and Other Offences

The FSTB is proposing the following sanctions and penalties.

Conduct / Offence	**Proposed Penalties**
Carrying on a regulated VA activity without a VASP licence or actively marketing, whether in Hong Kong or from a place outside Hong Kong, a regulated VA activity, or any service which would be a regulated VA activity if conducted in Hong Kong	Fine of HK$5 million and seven years' imprisonment In the case of a continuing offence: a further fine of HK$100,000 per day during which the offence continues
Making a statement which is false, deceptive or misleading in a material particular in connection with a VASP licensing application	Fine of HK$1 million and two years' imprisonment
Non-compliance with the statutory AML/CFT requirements	The licensed VASP and its responsible officers may be fined HK$1 million and imprisoned for two years They may also be subject to a range of administrative sanctions including revocation or suspension of licences, reprimand, a remedial order or a pecuniary penalty no greater than HK$10 million or three times the amount of profit gained or costs avoided (whichever is greater)
Making a fraudulent or reckless misrepresentation for the purpose of inducing another person to acquire or dispose of a virtual asset, whether or not the transaction is conducted (or proposed to be conducted) within or outside a licensed virtual asset exchange	Fine of HK$1 million and two years' imprisonment

(f) 180 Day Grace Period

It is proposed that once the new licensing regime takes effect, virtual asset exchanges will have 180 days to obtain a VASP licence.

Technical Amendments to the AMLO

The Consultation Paper also proposes making a number of technical amendments to the AMLO.

(a) Definition of Politically Exposed Persons (PEPs)

The definition of foreign politically exposed persons who are subject to enhanced customer due diligence (**CDD**) will be revised to refer to an individual who is entrusted with a prominent public function in a place outside Hong Kong (rather than outside the People's Republic of China as is currently the case under the AMLO). This will require the conduct of enhanced CDD on PEPs from other parts of China outside Hong Kong.

It is also proposed to remove former PEPs (i.e. individuals who previously held a prominent public function) from the definition. Instead, a risk-based approach will be allowed to conducting enhanced CDD on former PEPs, so that it may not be necessary for former PEPs assessed to pose lower risks.

(b) Beneficial Ownership of a Trust

The definition of "beneficial owner" of a trust under the AMLO will be revised to clarify that it includes trustees, beneficiaries and class(es) of beneficiaries.

(c) Non-Face-to-Face Situations

It is proposed that section 9 of Schedule 2 to the AMLO, which deals with the CDD requirements where a customer is not physically present will be amended to allow the use of independent and reliable digital identification systems for customer identification and verification.

(d) Unlicensed Money Service Operations

The Consultation Paper proposes raising the penalties for operating an unlicensed money service business in Hong Kong from a fine of HK$100,000 and six months' imprisonment to a fine of HK$1 million and two years' imprisonment.

(e) Exchange of Supervisory Information

The FSTB proposes to replace sections 49 and 53ZI of the AMLO which provide for the exchange of information in the context of AML and CTF supervision by the Customs and Excise Department and the Companies Registry with a similar provision applicable to all regulatory authorities under the AMLO. It also proposes to add a confidentiality clause under this provision to prevent those subject to an AMLO investigation from divulging any information that may jeopardise the investigation.

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