



Hong Kong

May 2021

FSTB CONCLUDES CONSULTATION ON LICENSING REGIME FOR HONG KONG VIRTUAL ASSET EXCHANGES

On 21 May 2021, Hong Kong's Financial Services and Treasury Bureau (the **FSTB**) published its Consultation Conclusions¹ on legislative proposals to enhance anti-money laundering and counter-terrorist financing (**AML/CTF**) regulations in Hong Kong (**Consultation Conclusions**) in respect of Hong Kong virtual asset service providers (**VASPs**). These Consultation Conclusions are in response to the FSTB's consultation paper² issued in November 2020 proposing a new licensing regime for VASPs in Hong Kong. For a detailed discussion of the consultation paper, please see our newsletter FSTB Consults on Proposed Licensing Regime for Virtual Asset Exchanges.³

To address the AML/CTF risks posed by virtual assets (**Virtual Assets**), the Financial Action Task Force (**FATF**) now requires jurisdictions to regulate VASPs for AML/CFT purposes and to supervise their compliance. The FSTB proposes to follow the requirements of the FATF through the introduction of a licensing regime in Hong Kong for VASPs and certain miscellaneous technical amendments under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) (**AMLO**). The FSTB proposed establishing a licensing regime under the AMLO for VASPs in Hong Kong, which would require any person wishing to operate a virtual asset exchange (**Virtual Asset Exchange**) in

Hong Kong to apply for a licence from the Securities and Futures Commission (**SFC**). It is proposed that licensed VASPs would be subject to the AML/CTF requirements under Schedule 2 to the AMLO and other regulatory requirements.

The Consultation Conclusions also outline the FSTB's responses to the proposal to introduce a two-tier registration regime for dealers in precious metals and stones, which is not covered in this newsletter.

FSTB Proposals relating to the VASP Licensing Regime in Hong Kong

a. Scope of Regulated Activity of Operating a Hong Kong Virtual Asset Exchange

Virtual Assets Exchange Definition

It is proposed to designate the business of operating a Virtual Assets Exchange as a regulated activity (**Regulated Virtual Asset Activity**). The definition of a Virtual Assets Exchange covers any trading platform which is operated for the purpose of allowing an offer or invitation to be made to buy or sell any Virtual Assets in exchange for any money or any Virtual Assets, and which comes into custody, control, power or possession of, or over, any money or any Virtual Assets at any point in time during its course of business.

1 https://www.fstb.gov.hk/fsb/en/publication/consult/doc/consult_conclu_amlo_e.pdf
2 https://www.fstb.gov.hk/fsb/en/publication/consult/doc/consult_amlo_e.pdf
3 <https://www.charltonslaw.com/fstb-consults-on-proposed-licensing-regime-for-virtual-asset-exchanges/>

The definition of Virtual Assets Exchange does not cover peer-to-peer trading platforms, to the extent 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 any Virtual Assets at any point in time.

A Virtual Assets Exchange which falls within the scope of the licensing regime will have to apply for a licence from the SFC under the AMLO.

Virtual Assets Definition

The definition of a Virtual Asset will cover a digital representation of value that:

- i) is expressed as a unit of account or a store of economic value;
- ii) 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
- iii) can be transferred, stored or traded electronically.

The definition of a Virtual Asset does not cover digital representations of fiat currencies, including digital currencies issued by central banks, financial assets already regulated under the Securities and Futures Ordinance (Cap. 571) (**SFO**), stored value facilities which are separately regulated under the Payment Systems and Stored Value Facilities Ordinance (Cap. 584) as well as certain closed-loop, limited purpose items.

Closed-loop, limited purpose items refer to non-transferable, non-exchangeable and non-fungible closed-loop, limited purpose items, such as air miles, credit card rewards, gift cards, customer loyalty programmes and gaming coins.

The definition of Virtual Assets applies equally to virtual coins that are stable (for example, “stablecoins”) or not and irrespective of the purported form of underlying assets.

The FSTB recognises the fast-evolving nature of the Virtual Assets world and to deal with this, it is proposed that the legislation will provide for flexibility. To this extent, the SFC will be empowered to prescribe characteristics that constitute the definition of a Virtual Asset. In addition, the Hong Kong Secretary for Financial Services and Hong Kong Treasury, will be empowered to determine, either generally or in a particular case, whether any digital representation of value is to be regarded as a Virtual Asset or not.

b. Hong Kong Virtual Assets Exchange Licensing Requirements

Eligibility

The FSTB originally proposed that only locally incorporated companies with a permanent place of business in Hong Kong would be considered for the granting of a VASP licence in Hong Kong. However, in light of responses suggesting that non-Hong Kong companies should also be eligible for licensing, the FSTB amended its original proposal by also allowing companies incorporated outside of Hong Kong but registered in Hong Kong under the Companies Ordinance (Cap. 622) to apply for a VASP licence in Hong Kong.

Natural persons or business establishments without a legal personality will not be eligible for a VASP licence in Hong Kong.

Appointment of Responsible Officers

At least two responsible officers will have to be appointed by licensing applicants. They will be generally responsible for ensuring the VASP’s compliance with AML/CTF requirements and other regulatory requirements. All executive officers of a VASP will be required to act as responsible officers.

Fit and Proper Test

Applicants will have to satisfy a fit-and-proper test to be considered for the granting of a VASP licence in Hong Kong. Their responsible officers and ultimate owners will also be subject to a fit-and-proper test. Among other relevant considerations, the SFC will determine whether a person is fit and proper based on the following:

- i) whether the person has been convicted anywhere of a money laundering or terrorist financing offence, or another offence in which the person was found to have acted fraudulently, corruptly or dishonestly;
- ii) whether the person has failed or may fail to observe the AML/CFT or other regulatory requirements applicable to licensed VASPs;
- iii) the experience and relevant qualifications of the person; and
- iv) whether the person is of a good standing and financial integrity.

c. Regulatory Requirements for Licensed VASPs in Hong Kong

AML/CTF Requirements and Other Regulatory Requirements

A licensed VASP will be subject to the AML/CTF requirements, including customer due diligence (**CDD**) and record-keeping requirements set out in Schedule 2 to the AMLO. A licensed VASP will also be subject to additional regulatory requirements which will be aimed at investor protection.

To ensure that licensed VASPs have the capacity and know-how to operate the Virtual Assets Exchange in a manner consistent with the requirements under the licensing regime, a licensed VASP will also be required to meet certain prescribed regulatory requirements regarding the VASP's financial resources, knowledge and experience, soundness of the business, risk management, segregation and management of client assets, financial reporting and disclosure, prevention of market manipulative and abusive activities and prevention of conflicts of interest.

The FSTB has explained that to address concerns raised by the market as to the regulatory expectations discussed immediately above, the SFC will prepare and publish for consultation detailed regulatory requirements prior to commencement of the licensing regime.

Restriction to Professional Investors

In the Consultation Conclusions, the FSTB notes that over 40% of the submissions received supported allowing retail investors to participate in the trading activities of Virtual Assets Exchanges. However, given that the Virtual Asset industry is an emerging sector involving higher risks than conventional financial markets, the FSTB will only allow licensed VASPs to provide services to professional investors (**the Professional Investor Requirement**). The FSTB considers the Professional Investor Requirement to be necessary to ensure a proper degree of protection for the investing public due to the risk implications involved in the tech-savvy and highly speculative nature of Virtual Asset activities. Having said that, the FSTB explained that it will continue to monitor the industry and review the position as the market matures.

d. Hong Kong Open-ended Licences

A licence will remain valid until it is revoked by the SFC. The FSTB recognises that a licensed VASP will need to make a substantive investment in order to operate a competitive Virtual Assets Exchange. As a result, the FSTB considers that an open-ended

licence is necessary to provide a degree of certainty in the operating environment. Some respondents were of the view that periodic reviews were necessary to ensure that a licensed VASP Exchange is conducting the Regulated Virtual Asset Activity in a proper manner. However, the FSTB considered that this was not necessary given the SFC's ongoing power to review and revoke a licence where appropriate. The SFC will continue to closely supervise a licensed VASP's conduct and operation and will have the necessary power to take disciplinary actions, including suspension or revocation of licence, against VASPs which are found guilty of misconduct or are not considered to be fit and proper.

e. Hong Kong Exemption and Prohibition in respect of VASP Licensing Requirement

The FSTB will not grant any exemption from the VASP licensing requirement, except for Virtual Assets Exchange(s) that are already regulated as a licensed corporation in the voluntary opt-in regime supervised by the SFC under the SFO.

To protect investors from being exposed to risks from unlicensed Virtual Assets exchanges, the FSTB will also prohibit any person who is not a licensed VASP from actively marketing, whether in Hong Kong or elsewhere, to the public of Hong Kong a Regulated Virtual Asset Activity or a similar activity conducted outside Hong Kong.

180 Day Grace Period

For exchanges conducting the Regulated Virtual Asset Activity when the VASP licensing regime comes into effect, the FSTB proposed a 180-day transitional period for exchanges to obtain a licence from the SFC. While there were mixed responses to the proposal, with some respondents asking for a longer period and others submitting that applicants should be deemed to be licensed upon filing their licensing application, the FSTB ultimately decided that the 180-day transitional period should remain and that it was sufficiently long for the filing of applications.

f. SFC Powers in respect of Licensed Virtual Assets Exchanges

The SFC will be empowered to supervise the AML/CFT conduct of licensed VASPs and enforce other obligations under the AMLO.

The SFC will be empowered to enter the business premises of a licensed VASP 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 as mentioned above). Additionally, the SFC will have the necessary powers to impose restrictions and prohibitions on the operations of a licensed VASP and its associated entities in certain circumstances, for example where it is necessary to protect client assets. These powers will include the power to prohibit transactions or restrict the disposal of property.

Scope of Statutory Appeal

The scope of reviewable decisions of the Anti-Money Laundering and Counter-Terrorist Financing Review Tribunal will be expanded to cover appeals against future decisions of the SFC in implementing the VASP licensing and supervisory regime.

g. Sanctions for Unlicensed Virtual Assets Activities, Non-Compliance and Other Offences

Under the new VASP licensing regime, there will be administrative and criminal sanctions for unlicensed activities and non-compliance with the regulatory requirements. The administrative sanctions will include the suspension or revocation of licences, reprimands, remedial orders and pecuniary penalties (not exceeding USD10 million, or three times the amount of the profit gained or loss avoided, whichever is the greater) for misconduct such as contravening the AML/CFT or other regulatory requirements.

The proposed criminal sanctions are summarised in the table below.

Conduct/ Offence	Penalties
Carrying on a Regulated Virtual Asset Activity without a VASP licence	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	Fine of HK\$1 million and two years' imprisonment
Making a fraudulent or reckless misrepresentation for the purpose of inducing another person to acquire or dispose of a Virtual Asset	Fine of HK\$1 million and two years' imprisonment

Technical Amendments to the AMLO

To address technical issues raised in the FATF's Mutual Evaluation Report on Hong Kong, the FSTB proposes to make a number of technical amendments to the AMLO.

a) *Definition of Politically Exposed Persons (PEPs)*

The definition of a PEP will be amended in accordance with the FATF requirement, and regulatory authorities will be empowered to make guidelines to allow the exemption of enhanced CDD requirements in respect of former PEPs on a risk-sensitive basis.

b) *Beneficial Ownership of a Trust*

The definition of "beneficial owner" of a trust under the AMLO will be better aligned with that of "controlling person" under the Inland Revenue Ordinance (Cap. 112), by clarifying that it includes trustees, beneficiaries and class(es) of beneficiaries.

c) *Non-Face-to-Face Situations*

The use of digital identification systems will be allowed to assist the conduct of CDD where a customer is not physically present for customer identification and verification purposes.

d) *Unlicensed Money Service Operations*

The penalties for operating an unlicensed money service business in Hong Kong will be raised to a fine of HK\$1 million and two years' imprisonment.

e) *Exchange of Supervisory Information*

Different provisions under various Hong Kong Ordinances enabling the exchange of supervisory information for AML/CTF by regulatory authorities will be consolidated into a unified provision under the AMLO.

Implementation of the Consultation Conclusions

The Hong Kong Government will now prepare an amendment bill based on the Consultation Conclusions which it aims to introduce into the Legislative Council in the 2021-22 legislative session.

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