

Hong Kong to introduce licensing regime for virtual asset exchanges

July 27, 2022 | Client Update | 11-minute read

On July 6, 2022, the Hong Kong government introduced the Anti-Money Laundering and Counter-Terrorist Financing (Amendment) Bill 2022 (the Bill), which includes a new licensing regime for virtual asset exchanges to be supervised by the SFC and the criminalization of a range of virtual asset related misconduct. The Bill is the first virtual asset-specific legislation in Hong Kong and is expected to form the cornerstone of Hong Kong's virtual asset regulatory regime going forward.

Introduction

Following a consultation process which started in November 2020, on July 6, 2022, the Government of the Hong Kong S.A.R. introduced legislation to the Hong Kong Legislative Council to regulate and control virtual asset service providers (VASPs). Whilst introduced as part of Hong Kong's anti-money laundering regime, it introduces a licensing regime for VASPs, which, broadly, will control trading platforms, including exchanges, which offer trading in digital assets that are not securities.

The proposed legislation is the Anti-Money Laundering and Counter-Terrorist Financing (Amendment) Bill 2022 (the Bill)^[1], which amends Hong Kong's existing anti-money laundering and counter-terrorist financing (AML/CTF) legislation. The Bill, assuming it is passed, will introduce a licensing regime for VASP to be supervised by the Securities and Futures Commission of Hong Kong (SFC), and criminalize a range of virtual asset (VA) related misconduct. It will be the first virtual asset-specific legislation in Hong Kong.

The Bill follows the Consultation Conclusions published by the Financial Services and Treasury Bureau (FSTB) of the Hong Kong government in May 2021 (Consultation Conclusions), and is expected to form the cornerstone of Hong Kong's VA regulatory

regime going forward. In this memo, we address some of the most pertinent questions relating to the proposed amendments.

1. Why was the Bill introduced?

The regime was triggered by key concerns of anti-money laundering and counter-terrorist financing. It reflects guidance from the Financial Action Task Force (FATF)^[2] to subject VASPs to the same range of AML/CTF obligations applicable to financial institutions and designated non-financial businesses and professions. In addition, the Bill also punishes VA-related fraud to enhance investor protection.

2. How does the Bill change Hong Kong's VA regulatory regime?

Trading platforms that offer trading in VAs which are not securities (VA Exchanges) will be required to obtain a license from the SFC – see sections 3 and 4 below for further details.

By contrast, VA Exchanges that offer trading of any VA that constitutes “securities” are subject to conventional regulation under the existing provisions of the Securities and Futures Ordinance (the SFO) and the SFC’s existing licensing regime.^[3] As to the scope for full-blown exchanges operating in Hong Kong on which virtual assets that are securities are traded, significant restrictions are provided for by sections 19 and 59 of the SFO. For trading platforms, on which virtual assets that are securities are traded, which are less than full-blown exchanges, i.e. trading platforms providing automated trading services, two different tracks for regulation are provided: (i) licensing by the SFC for Type 7 regulated activities for intermediaries; and (ii) section 95, Part V authorization otherwise.

Separately, the Bill introduces the following VA-specific offences which apply to any VA transaction, whether processed through a licensed VA Exchange or not:

- The offence of making a fraudulent or reckless misrepresentation for the purpose of inducing another person to acquire or dispose of a VA.^[4]
- The offence of employing any device, scheme or artifice with intent to defraud or deceive, or engaging in any act, practice or course of business that is fraudulent or deceptive, in a transaction involving any VA.^[5]

These offences are broad in scope and may capture market misconduct similar to those under Part XIII of the SFO, such as market manipulation, spoofing, insider dealing, wash

trading and price rigging. Businesses engaged in the trading of VA, especially SFC-regulated entities, should implement appropriate systems and controls similar to those deployed in securities trading to avoid contravening these provisions.

3. How is VA defined under the Bill?

The Bill defines “*virtual assets*” as a cryptographically secured “*digital representation of value*” that^[6]:

(a) is expressed as a unit of account or a store of economic value;

(b) either:

- is used (or is intended to be used) as a medium of exchange accepted by the public for payment for goods or services, the discharge of a debt, or for investment; or
- provides rights, eligibility or access to vote on the management, administration or governance of the affairs in connection with, or to vote on any charge of the terms of any arrangement applicable to, any cryptographically secured digital representation of value; and

(c) can be transferred, stored, or traded electronically.

This definition is wide enough to capture most forms of cryptocurrencies in the market today, including for example stablecoins, utility tokens and governance tokens.

However, non-fungible tokens (NFTs) that are genuinely digital, non-interchangeable and non-fractional representations of rights over arts and collectibles are very likely not considered as VAs as they will not be a “unit of account” or a “store of economic value.”

The following are expressly excluded from the definition of VA^[7]: (i) Central bank digital currencies; (ii) Securities or futures contracts (which are regulated under the SFO instead); (iii) stored value facilities (which are regulated under the Payment Systems and Stored Value Facilities Ordinance (Cap. 584) (PSSVFO) instead); and (iv) limited-purpose digital tokens (which are nontransferable, non-exchangeable and non-fungible in nature, such as gift cards, customer loyalty programmes and gaming coins^[8]).

The Bill allows the SFC to prescribe whether a particular feature will render a digital representation of value a VA, and empowers the Secretary for Financial Services and the

Treasury of Hong Kong to prescribe a particular digital representation of value to be or not to be a VA.^[9] This is a similar model to that provided for by section 392 of the SFO in respect of securities, futures and other forms of instrument regulated under the SFO.

4. Which VA Exchanges have to be licensed?

The Bill currently only regulates the operation of a VA Exchange where^[10]:-

(a) (i) offers to sell or purchase virtual assets are regularly made or accepted in binding transactions, or (ii) persons are regularly introduced or identified to others with the reasonable expectation that they will negotiate or conclude binding sales or purchases of virtual assets; and

(b) client money or client virtual assets comes into direct or indirect possession of the person providing such service.

This definition is in line with prior indications in the Consultation Conclusions that peer-to-peer platforms (which merely provide a forum for users to post and/or match bids and offers but does not support trading on the platform) are not covered by the new regime, as long as 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 VA at any point in time. It follows that typical decentralised trading arrangements and liquidity pools are unlikely to fall within the regime, although this would be subject to detailed analysis of each structure.

5. What are the licensing requirements and conditions? What are the sanctions for non-compliance with the licensing regime?

Not unexpectedly, the licensing framework for VA Exchanges is very broadly similar to that for Regulated Types of activities.

Only companies incorporated or registered in Hong Kong will be allowed to apply for a license.^[11]

Licensed VA Exchanges will be required to have at least two responsible officers (RO) who will be responsible for the overall operations of the exchange.^[12]

The RO, licensed representatives and ultimate beneficial owner of the VA Exchange must be fit and proper persons.^[13]

Typical licensing conditions set out in the Bill include adequate financial resources, knowledge and expertise, AML/ CTF policies and procedures, VA asset listing and trading policies and mechanisms to prevent market manipulation, abusive activities and conflicts of interest.

Operating a VA service without a license would be an offense punishable, on conviction on indictment, to a fine of HK\$5 million and seven years of imprisonment. Continuing offenses would also be fined a further HK\$100,000 every day as the offense continues.^[14]

Licensed VA Exchanges and individuals are also susceptible to disciplinary action by the SFC, including reprimand, order for remedial actions, fines, suspension or revocation of licenses and exemplary penalties.^[15]

6. How does the Bill compare with other jurisdictions?

The Bill's focus on only VA Exchanges represents a narrower approach than other leading Asian jurisdictions. For example:

- In Singapore, the Payment Services Act 2019 regulates persons who carry on a business of providing services relating to “dealing in” virtual assets and “facilitating the exchange of” virtual assets, which in practice covers a larger range of crypto-related activities.
- In Japan, the Payment Services Act regulates persons who carry out the business of (a) sale and purchase of virtual assets, (b) brokerage or acting as agent of virtual assets transactions, (c) virtual assets asset management and (d) virtual assets custody.

Hong Kong's decision to restrict the focus to VA Exchanges appears to be deliberate. The FSTB noted^[16] that VA Exchanges are by far the most prevalent VA activity in Hong Kong. VA activity outside of VA Exchanges is relatively small, and their fund movements are traceable in any case when they interface with financial institutions. In addition, VA service providers that are not exchanges may still be subject to other laws and regulations in Hong Kong, including the SFO, PSSVFO and HKMA and SFC supervised regulatory regimes.

However, the Bill preserves the flexibility for the definition of “VA Service” to be expanded

in the future to cover other VA-related activities.

7. Is a VA Exchange based overseas required to be licensed under the new regime?

In line with the SFO, the VASP regulatory regime covers not only VA Exchanges carrying on its business or holding itself out as carrying on its business in Hong Kong, but also overseas VA Exchanges that actively market to the Hong Kong public.^[17]

In determining whether a regulated service is “actively marketed” to the Hong Kong public, the SFC takes a fact-sensitive approach, and considers factors such as whether the website is in the Chinese language and denominated in the Hong Kong dollar. Depending on the fact-pattern, reverse solicitation may be allowed. See the SFC’s FAQ in this regard (in the context of securities regulated under the SFO) for reference.^[18]

8. Does the new licensing regime allow VA Exchanges to offer trading in tokens which are securities?

No. The Bill’s definition of VA excludes securities and futures contracts. VA Exchanges that offer trading in tokens which are securities have to be licensed or authorised under the SFO, for dealing in securities (Type 1) and/or automated trading services (Type 7) activities or under section 95, Part V of the SFO. The SFC has published guidance on factors it would consider in determining whether a token is to be treated as securities.^[19]

9. What does the new regime mean for VA investors and financial institutions?

Most significantly, the Legislative Council Brief indicates that the Government plans to restrict licensed VASPs to serving only professional investors, at least in the “initial stage,” as a licensing condition. However, this is not listed as a sample condition in the Bill, which gives flexibility for this requirement potentially to be phased out eventually.

Financial institutions regulated by the SFC or the HKMA are currently required to partner only with SFC-licensed VA Exchanges for the provision of VA dealing services, whether by way of introducing clients to the platforms for direct trading or establishing an omnibus account with the platforms. Where Type 1 intermediaries provide VA dealing services as an introducing agent, they should only introduce clients which are professional investors to SFC-licensed platforms.^[20] Currently, the only trading platforms licensed by the SFC are

those that opted-in to the voluntary regime. The new regulatory regime is expected to enlarge the pool of market participants that financial institutions can partner with.

10. What supervisory powers will the SFC have?

A licensed VASP will be subject to the SFC's close and ongoing supervision over its conduct and operation. The Bill grants the SFC broad supervisory powers similar to those it currently exercises over entities licensed under the SFO, including the power to enter premises of VASP to conduct inspections, request production of documents and make enquiries of regulated persons.

The SFC will also be given the power to intervene in the operations of a VASP to protect client assets where necessary.^[21] For example, the SFC may prohibit licensees from entering into any further transactions, dealing in client assets, or require licensees to conduct its business in a specified manner.

11. Is there a transitional period?

After the Bill becomes law, existing VA Exchanges operating in Hong Kong may continue to operate without a license prior to March 1, 2023. Further, existing VA Exchanges that file a license application with the SFC before December 1, 2023 and undertake to comply with SFC regulatory requirements will be deemed licensed VASPs until the SFC has made a decision on its license application. The SFC will issue a notice to unsuitable applicants informing them that they will no longer have deemed licensed status. In this case, the applicant will be required to close down their business.

[1] Available at: <https://www.legco.gov.hk/yr2022/english/bills/b202206241.pdf>

[2] An international body that sets international standards for combating money laundering and terrorist financing

[3] See SFC's position paper on regulation of virtual asset trading platforms (November 6, 2019), available at: <https://www.sfc.hk/-/media/EN/files/ER/PDF/20191106-Position-Paper-and-Appendix-1-to-Position-Paper-Eng.pdf>

[4] Section 53ZRG

[5] Section 53ZRF

[6] Section 53ZRA(1)

[7] Section 53ZRA(2)

[8] Consultation Conclusions, paragraph 2.8, following on from paragraph 2.10 of the original Consultation Paper.

[9] Section 53ZRA(3) and (4)

[10] Schedule 3B (Part 1)

[11] Section 53ZRK(3)(a)

[12] Section 53ZRK(3)(b)(ii)

[13] See section 53ZRJ for the list of factors the SFC would consider in this assessment under the Bill, which is consistent with those under the existing SFO regime. The fit and proper guidelines of the SFC serves as a good reference point. January 2022 version available at <https://www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/guidelines/fit-and-proper-guidelines/Fit-and-Proper-Guidelines.pdf>

[14] Section 53ZRD(5)

[15] Division 8, Subdivision 1

[16] Consultation Conclusions, paragraph 2.9

[17] Section 53ZRB(3)(a) and (6)(a)

[18] <https://www.sfc.hk/en/faqs/intermediaries/licensing/Actively-markets-under-section-115-of-the-SFO>

[19] SFC's Statement on initial coin offerings (Sep 5, 2017); Statement on Security Token Offerings (Mar 28, 2019)

[20] SFC and HKMA Joint circular on intermediaries' virtual asset-related activities (January 28, 2022)

[21] Division 8, Subdivision 2

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