

CLIENT ALERT: 9 NOVEMBER 2020

Private and Confidential

RE: PUBLIC CONSULTATION ON LEGISLATIVE PROPOSALS TO ESTABLISH THE VIRTUAL ASSET SERVICES PROVIDER (VASP) LICENCE REGIME AND THE DEALERS IN PREVIOUS METALS AND STONES (DPMS) REGIME

On 3 November 2020, the Financial Services and the Treasury Bureau (the “FSTB”) of Hong Kong launched a public consultation (the “**Consultation Paper**”) on the legislative proposals to introduce, amongst other things:-

1. **VASP licensing regime** – any person who seeks to conduct regulated business of Virtual Assets (“**VAs**”) (defined below) trading platforms in Hong Kong (the “**Virtual Assets Service Providers**” or “**VASPs**”) will be required to apply for a licence from the SFC (the “**VASP Licence**”);
2. **DPMS registration regime** – a 2-tier regime whereby dealers in previous metals and stones (DPMS) will be required to register with the Commissioner for Customs and Excise (“**C&CE**”).

The purpose of the Consultation Paper is to bring Hong Kong’s regulatory regime up to date in line with the latest international standards, in particular Recommendation 15, in February 2019, on anti-money laundering (“**AML**”) and counter-terrorist financing (“**CTF**”) of 39 major economies in the world, including Hong Kong, as set out by the Financial Action Task Force (the “**FATF**”).

A. VASP Licensing Regime

Prior to the Consultation Paper, the SFC issued a conceptual framework in November 2018 (the “**2018 Concept Paper**”)¹, followed by the position paper in November 2019², whereby it stated clearly that non-securities virtual assets e.g. Bitcoins would fall outside the regulatory regime of the SFC, and adopted an “opt-in” approach whereby virtual assets platform operators may *voluntarily* obtain a licence (Type 1 and Type 7) from the SFC.³ So far, at least one virtual assets platform operator has announced that it has obtained the approval-in-principle from the SFC⁴. In addition, the licensed corporations who have obtained the Type 1 (dealing in securities), Type 4 (advising on securities) and/or Type 9 (asset management)

¹ Conceptual framework for the potential regulation of virtual asset trading platform operators by the SFC, 1 November 2018: https://www.sfc.hk/-/media/EN/files/ER/PDF/App-2_-_Conceptual-framework-for-VA-trading-platform_eng.pdf

² Position paper on regulation of virtual asset trading platforms by the SFC, 6 November 2019: [https://www.sfc.hk/web/files/ER/PDF/20191106%20Position%20Paper%20and%20Appendix%201%20to%20Position%20Paper%20\(Eng\).pdf](https://www.sfc.hk/web/files/ER/PDF/20191106%20Position%20Paper%20and%20Appendix%201%20to%20Position%20Paper%20(Eng).pdf)

³ The VA exchanges in the opt-in regime of the SFC will be exempted from applying for a VASP Licence: see paragraph 2.21 of the Consultation Paper.

⁴ For detail please refer to the announcement made by BC Technology Group Limited (Stock Code: 863): <https://www1.hkexnews.hk/listedco/listconews/sehk/2020/0821/2020082101499.pdf>

would be required to notify the SFC if they intend to expand their business activities to cover virtual assets⁵.

Now, FSTB has taken one further step – it proposes to amend the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) (“AMLO”) to introduce an “open-ended”⁶ licensing regime for VASP with a view to mitigating the AML/CTF risks of the VASP sector. Certain observations could be made on the new VASP licensing regime:

Licensee’s business must involve ‘Virtual Assets’.⁷ ‘Virtual Assets’ (the “VA”) will be defined 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”. However, it is not intended to cover (i) digital representations of fiat currencies; or (ii) closed-loop, limited purpose items which are non-transferable, non-exchangeable and non-fungible⁸. Whilst it is clear that digital currencies issued by central banks e.g. DCEPs issued by China would *not* be covered, it remains unclear whether tokens like Tethers (USDT) or USDC would be regarded as Virtual Assets under the new regime, in particular when the Consultation Paper makes it clear that stablecoins purportedly backed by some form of assets for the purpose of stabilizing their value are intended to be covered. In addition, financial assets (e.g. securities and authorized structured products) regulated under the Securities and Futures Ordinance (Cap. 571) (“SFO”) would not fall under the new VASP regime.

Licensee must be a “VA Exchange”. Consequently, “VA 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 VA in exchange for any money or any VA (whether of the same or different type), and which comes into custody, control, power or possession of, or over, any money or any VA at any point in time during its course of business”.⁹ Therefore, a peer-to-peer trading platforms¹⁰, 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

⁵ For detail please refer to the Statement on regulatory framework for virtual asset portfolios managers, fund distributors and trading platform operators issued by the SFC on 1 November 2018:

<https://www.sfc.hk/en/News-and-announcements/Policy-statements-and-announcements/Statement-on-regulatory-framework-for-virtual-asset-portfolios-managers>

⁶ The VASP Licence will, once obtained, remain valid until and unless it is revoked by the SFC: see paragraph 2.20 of the Consultation Paper.

⁷ Paragraphs 2.6 and 2.7 of the Consultation Paper.

⁸ e.g. air miles, credit card rewards, gift cards, customer loyalty programmes, gaming coins etc.

⁹ Paragraph 2.7 of the Consultation Paper.

¹⁰ i.e. platforms that only provide a forum where buyers and sellers of VAs can post their bids and offers, with or without automatic matching mechanisms, for the parties themselves to trade at an outside venue.

possession of *any money or any VA*¹¹ at any point in time, would not be regarded as a VA Exchange for the purpose of the new VASP licence regime.¹²

Typically, the VA Exchange would be involved in (i) exchange between VAs and fiat currencies; (ii) exchange between one or more forms of VAs; (iii) transfer of VAs; (iv) safekeeping and/or administration of VAs or instruments enabling control over VAs; and/or (v) participation in and provision of financial services related to an issuer's offer and/or sale of a VA (collectively, "**VA Activities**"). Nevertheless, FSTB reckons that certain VA Activities may be conducted outside VA Exchanges e.g. VA payment system or VA custodian services, over-the-counter (OTC) trade and crypto-ATMs etc. being operated on a stand-alone basis and they would *not* be subject to the new VASP licence regime at the initial stage.

In line with the opt-in regime of the SFC, the VA Exchange applicant shall demonstrate to have satisfied the following licensing¹³ and regulatory requirements¹⁴ to obtain the VASP Licence:

1. **Applicant must be a Hong Kong company with a permanent place of business in Hong Kong.**
2. **Responsible Officers¹⁵ and the Ultimate Owners of the Applicant must satisfy the "fit and proper test"**. It will take into account, among other factors, (i) the experience and relevant qualifications of the person; (ii) whether the person is of good standing and financial integrity; (iii) whether the person has been convicted anywhere of an AML/CTF offence or other offence where the person have acted fraudulently, corruptly or dishonestly, or have failed to observe the AMT/CTF or other regulatory requirements.
3. **Miscellaneous.** The Applicant will have to demonstrate, inter alia, that:
 - (a) It has adequate financial resources to operate its VA Business, including a specified paid-up share capital amount and liquid assets. It should observe prescribed auditing and disclosure requirements and publish audited accounts.
 - (b) It and its associated entities should operate its business in a prudent and sound manner and ensure client and public interests will not be adversely affected. It should implement proper segregation of client assets by placing them in an associated entity and implement procedures to ensure proper management and custody of client assets.

¹¹ It is noted that certain "decentralised exchanges" would safekeep either fiat currencies or VAs for one of the transaction parties, and such exchanges may still be regarded as a VA Exchange.

¹² It is to be noted that for (e), the FAFT Guidance Note on VA and VASPs states that peer-to-peer trading platforms may not constitute a VASP as defined under the FATF Standards.

¹³ see paragraph 2.14 of the Consultation Paper.

¹⁴ SFC will prepare and publish a consultation on the VASP regulatory requirements, including codes and guidelines

¹⁵ Applicant must appoint at least 2 responsible officers, and all executive directors of a licensed VASP must be made responsible officers upon approval by the SFC: see paragraph 2.15 of the Consultation Papers

- (c) It and its associate entities (i.e. separate corporate entity controlled by the licensed VASP) should have proper corporate governance structure staffed by personnel with necessary knowledge and experience. Application should have in place appropriate risk management policies and procedures to manage AML/CTF, cybersecurity and other risks.
- (d) It implements and enforces robust rules for listing and trading VAs on its platforms and perform all reasonable due diligence before listing the VAs. It should establish and implement written policies and controls for proper surveillance of activities on its platform(s) to identify, prevent and report any market manipulative or abusive trading activities.

It is worth noting that, even if a VASP applicant is successful in obtaining the VASP Licence, it will be allowed to offer services to professional investors¹⁶ only. Any VA Exchange would be prohibited from actively marketing, in Hong Kong or elsewhere, to the public of Hong Kong any of the VA Activities,¹⁷ in contravention of which such VA Exchange will be punishable, on conviction on indictment, to a fine of HK\$5,000,000 and to imprisonment for 7 years. In case of a continuing offence, to a further fine of HK\$100,000 for every day during which the offence continues.¹⁸ For any non-compliance with the statutory AML/CTF requirements, the licensed VASP and its responsible officers will be subject to criminal proceedings and liable to a fine of HK\$1,000,000 and to imprisonment for 2 years on conviction on indictment, subject to a range of administrative sanctions.

B. The DPMS Registration Regime

In addition to the VASP Licence regime, the Consultation Paper has also proposed to introduce a 2-tier DPMS registration regime in relation to “precious metal”, “precious stones”, “precious products” and “previous-asset-backed instrument”. Their definitions are as follows:

Terms	Definitions
Previous Metal	gold, silver, platinum or any other metal in the platinum group in a manufactured or unmanufactured state
Precious Stones	diamond, sapphire, ruby, emerald, jade, or pearl
Precious Products	any jewellery, watch, apparel, accessory, ornament or other finished product made up of, containing or having attached to it, any precious metals or precious stones or both, and at least 50% of its value is attributable to the precious metals or precious stones or both
Previous-Asset-Backed Instrument	any certificate or instrument backed by one or more precious metals, precious stones or precious products that

¹⁶ For definition of “professional investors”, please see Part 1 of Schedule 1 to the SFO.

¹⁷ paragraph 2.23 of the Consultation Paper.

¹⁸ paragraph 2.28 of the Consultation Paper.

	entitles the holder to such asset (in entirety or in part), but excluding securities, futures contracts, collective investment schemes or authorized structured products regulated under the SFO
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It is currently proposed that any activities involving (i) trading in,¹⁹ importing, exporting, manufacturing, refining or carrying out any value-adding work²⁰ on Previous Metals, Previous Stones or Previous Products; or (ii) issuing, redeeming or trading in precious-asset-backed instruments; or (iii) acting as an intermediary for (i) or (ii) above²¹ (the “**Regulated DPMS Activities**”) would require 2-tier registration as a DPMS with the C&CE²² as below:²³

- (a) **Category A (for those DPMS not engaging in cash transactions at or above HK\$120,000) Registration** – it is almost automatic and open-ended, subject only to the filing of an application accompanied by certain basic documents. Category A DPMS are not subject to the AML/CTF obligations stipulated in Schedule 2 in AMLO or any registration conditions other than to notify the C&CE (the “**Registrar**”) of any subsequent changes in particulars.
- (b) **Category B (for those domestic²⁴ DPMS engaging in cash transactions at or above HK\$120,000)²⁵ Registration**²⁶ – it is more complicated, subject to the “fit and proper” test similar to the VASP Licence regime mentioned hereinabove, and close-ended with validity of only 3 years²⁷. Category B DPMS would be subject to the AML/CTF obligations stipulated in Schedule 2 in AMLO.

A person is liable on conviction to a fine of up to HK\$100,000 and to imprisonment of six months for conducting Regulated DPMS Activities without a valid Category A or Category B registration. A Category B DPMS Registrant who contravenes the AML/CTF requirements in the AMLO will be subject to disciplinary proceedings and a range of administrative sanctions, including reprimand, remedial order and a pecuniary penalty not exceeding HK\$500,000.

¹⁹ i.e. selling, offering for sale, purchasing or possessing for sale/resale

²⁰ e.g. cutting, polishing, etc.

²¹ Paragraph 3.4 of the Consultation Paper.

²² Paragraph 3.2 of the Consultation Paper.

²³ Paragraphs 3.9 to 3.12 of the Consultation Paper.

²⁴ ‘Non-domestic dealers’ are exempted if the person satisfies the following conditions:

- (i) a natural person who does not ordinarily reside in Hong Kong, or is a legal person incorporated outside Hong Kong and is not registered under the Companies Ordinance (Cap. 622) as a non-Hong Kong company;
- (ii) has no permanent place of business in Hong Kong; and
- (iii) carries out a regulated activity in Hong Kong for no more than 90 calendar days in any given year.

²⁵ unless they are financial institutions or “non-domestic dealers” as defined. N.B. designated non-financial businesses and professions (DNFBPs) would not be exempted.

²⁶ see paragraph 3.7 of the Consultation Paper.

²⁷ though renewable upon expiry where fit-and-proper requirements are met

C. Conclusion

The new VASP Licence regime and DPMS 2-tier Registration regime intend to strike a balance between the need for introducing AML/CTF regulation and the need to maintain the competitiveness of the VASP and DPMS sectors. The consultation period will last until 31 January 2021. We have already received enquiries from our clients who have a wide range of feedbacks on the Consultation Paper. As Hong Kong has been scheduled with FATF to undergo a technical compliance assessment in February 2023 and an effectiveness assessment in June 2024, it is expected that the new VASP Licence regime would be implemented well before those timeframes. In light of the above, some VA Exchanges would also start to get prepared for the new standards for the new VASP Licence, as once the legislation is passed, any VA Exchange carrying out the Regulated VA Activity will be required to obtain the new VASP Licence within 180 days²⁸ as currently proposed.

Should you have any queries, please do not hesitate to reach out to a member of us to discuss further at hyu@lylawoffice.com or at +852 2115 9525.

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Disclaimer: The information provided in this article is not intended to be, nor does it constitute, legal advice and is not a substitute for obtaining proper legal advice in respect of any specific issue.

²⁸ see paragraph 2.22 of the Consultation Paper.