RE: CONSULTATION CONCLUSION ON LEGISLATIVE PROPOSALS TO ENHANCE ANTI-MONEY LAUNDERING AND COUNTER-TERRORIST FINANCING REGULATION IN HONG KONG

On 21 May 2021, the Financial Services and the Treasury Bureau (the "**FSTB**") of Hong Kong released the consultation conclusion (the "**Consultation Conclusion**") of a public consultation (the "**Consultation Paper**") conducted between 3 November 2020 to 31 January 2021 with respect to the legislative proposals of, amongst other things, introducing a licensing regime for virtual asset services providers ("**VASPs**") under the Anti-money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) ("**AMLO**"). Such legislative proposals are drawn up with the view to fulfilling Hong Kong's obligation under the Financial Action Task Force (the "**FATF**") to strengthen Hong Kong's anti-money laundering and counter-terrorist financing ("**AML/CTF**") system in general, so that Hong Kong retains its competitiveness as an international financial centre.[1]

The Consultation Conclusion is largely in line with the suggestions made in the Consultation Paper:

(i) **Only covers VA Exchanges.** The FSTB maintains the position that any person seeking to operate a *virtual asset exchange* in Hong Kong is required to apply for a VASP licence from the Securities and Futures Commission (the "**SFC**") under the AMLO. "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 assets ("**VAs**") in exchange for any money or any VA, 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".[2]

(ii) **P2P trading platforms and OTCs are not covered.** A peer-to-peer (P2P) trading platforms,[3] 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 VA at any point in time, would *not* be regarded as a VA Exchange under this definition. Similarly, it is confirmed that over-the-counter trades (OTCs) will not be covered by the new VASP licencing regime at the initial stage.[4]

(iii) **Definition of "VA".** The definition of "VA" under the Consultation Conclusion is defined as "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."[5] While the Consultation Conclusion suggests that this definition of VA

[1] Paragraph 5.3 of the Consultation Conclusion.
[2] Paragraph 2.5 of the Consultation Conclusion.
[3] Platforms that only provide a forum where buyer 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.
[4] Paragraphs 2.7 and 2.9 of the Consultation Conclusion.
[5] Paragraph 2.6 of the Consultation Conclusion.

follows the FATF parlance,[6] the FATF actually defines a VA to be "a digital representation of value that can be digitally traded, or transferred, and can be used for payment or investment purposes."[7] Obviously, the definition of "VA" under the Consultation Conclusion is broader than that under the FATF and is defined with the view in mind to mirror with the functions of "money", despite the fact that the Hong Kong Monetary Authority (the "**HKMA**") did not consider the crypto-currencies such as Bitcoin to be "money" in 2018.[8] It has also been clear that VAs would cover "stablecoins" irrespective of the purported form of underlying assets, but would *not* cover digital representations of fiat currencies (e.g. digital currencies electronic payments (DCEPs) issued by central banks).

(iv) **Professional Investors only.** Despite different views from the market, the FSTB maintains the view that the services of a licensed VASP, at least for the initial stage of the licensing regime, should be limited to professional investors[9] only, to ensure a proper degree of protection for investing public in Hong Kong.[10] This may not be satisfactory, as the existing Hong Kong investors who have been investing or trading cryptocurrencies but are not qualified to be professional investors would be forced to continue to use the services of certain unlicensed overseas VA Exchanges.

(v) **Both HK companies and overseas companies may apply for the new VASP Licence**. Based on the feedbacks from the consultation, the Consultation Conclusion suggests to refine the proposal to allow not just locally incorporated companies with a permanent place of business in Hong Kong to apply for the granting of a VASP licence[11] but also companies incorporated elsewhere, provided that they are registered in Hong Kong under the Companies Ordinance (Cap. 622) (the "**CO**").[12] On the other hand, no active marketing of any unlicensed VA Exchange being operated in Hong Kong or elsewhere to the public of Hong Kong would be allowed.[13]

Other suggested requirements for VASP licence applicants under the Consultation Conclusion include but not limited to (a) a pass of fit-and-proper test,[14] (b) at least two (2) responsible officers ("**ROs**") (without specifying the requirements for acting as ROs) to assume the general responsibility of ensuring compliance with AML/CTF requirements (notably customer due diligence ("**CDD**") and record-keeping requirements) stipulated in Schedule 2 to the AMLO,[15] (c) knowledge and experience, soundness of the business, risk management, segregation and

[6] Paragraph 2.6 of the Consultation Conclusion.
[7] Paragraph 2.6 of the Consultation Paper.
[8] See Keynote Speech at Treasury Markets Summit 2018: "Crypto-assets and Money" delivered on 21 September 2018 by Norman T.L. Chan, Chief Executive, Hong Kong Monetary Authority, Link: https://www.hkma.gov.hk/eng/news-and-media/speeches/2018/09/20180921-1/
[9] As defined under Part 1 of Schedule 1 to the SFO.
[10] Paragraph 2.17 of the Consultation Conclusion.
[11] Paragraph 2.10 of the Consultation Conclusion.
[12] Paragraph 2.11 of the Consultation Conclusion.
[13] Paragraph 2.22 of the Consultation Conclusion.
[14] Paragraph 2.12 of the Consultation Conclusion.
[15] Paragraph 2.12 of the Consultation Conclusion.

management of client assets, financial reporting and disclosure, prevention of market manipulative and abusive activities, and prevention of conflicts of interest.[16]

Conclusion

The adoption of VASP licensing regime has several implications towards the development of VA industry in Hong Kong. Firstly, it is a victory for the SFC to expand its regulatory territory. The amended AMLO will likely empower the SFC to regulate the trading of those crypto-assets even if they are not within the legal definition of "securities" under the Securities and Futures Ordinance (the "**SFO**").[17] In other words, any VA, regardless they are securities or not, will be completely under the SFC's regulatory radar. However, this does not necessarily resolve all the issues in the VA industry. As significant investment is required for applying and maintaining the VASP licence, it is likely that some of the local VA exchanges will retreat their physical operations in Hong Kong and conduct the business offshore. This may actually bring more regulatory challenges to the SFC. Secondly, the unequal treatment towards professional investors and retail investors may not necessarily result better investor protection. Under the current proposed VASP licensing regime, only professional investors can trade in the licenced VA exchange. Retail investors, on the other hand, do not have such privilege. This may push those crypto-interested retail investors to resort to unlicensed offshore VA exchanges. If that is the case, the extent of investor protection affords to those retail investors will solely depend on the jurisdiction of which the unlicensed offshore VA exchanges incorporate. Thirdly, it is currently unclear how the new VASP licence would overlap with the existing Type 1 (dealing in securities) and Type 7 (automated trading system) SFC licences being granted to certain VA Exchange e.g. OSL[18] under the opt-in regime pursuant to the SFO. For instance, if an VA exchange wishes to list both utility tokens and security tokens (not to mention, it remains unclear which tokens should be considered as "security tokens"), should it apply for the new VASP licence or the existing Types 1 and 7 licences, or both? In particular, for some tokens which are currently listed and classified by the VA exchanges as "utility tokens," whether the SFC would take the same view remains questionable. Lastly, the Consultation Conclusion has been silence on the criteria for listing the tokens on the new VASP licensee. Such uncertainty may likely have an impact towards the pipeline and the incentive to list any VA products in Hong Kong. Rather than listing in Hong Kong, some issuers may decide to list in other more crypto-friendly jurisdictions. The diversity and richness of VA products potentially available in Hong Kong will therefore likely suffer as a result.

[16] Paragraph 2.14 of the Consultation Conclusion.

[17] See Fintech: the regulatory response to evolving challenges – Keynotes address at Hong Kong FinTech Week delivered on 3 November 2020 by Mr. Ashley Alder, Chief Executive Officer of SFC, Link: https://www.sfc.hk/-/media/EN/files/ER/PDF/CEO_speech_FinTechWeek_Nov2020.pdf

[18] https://apps.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/corporate-news/doc?refNo=20PR127

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.

HENRY YU & ASSOCIATES

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