



Client Alert – Virtual Asset Service Providers to be Regulated by the SFC (November 2020)

On 3 November 2020, the Financial Services and Treasury Bureau ("FSTB") launched a public consultation on the introduction of a new licensing framework for virtual asset service providers ("VASP") which will be administered by the Securities and Futures Commission ("SFC").

Under the current regulatory environment, VASPs are regulated on a voluntary opt-in basis via participation in the SFC's "sandbox". This opt-in approach (originally introduced by the SFC in November 2019) misses out a large portion of virtual asset services as it applies only to trading platform operators that allow their clients to trade virtual assets that meet the definition of "securities" under the Securities and Futures Ordinance ("SFO").

The new regime will be introduced under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance ("AMLO") to enhance the anti-money laundering and counter-terrorist financing measures currently in Hong Kong.

The FTSB references the Financial Action Task Force definition of a Virtual Asset ("VA") but provides a more specific definition for Hong Kong 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.

In Hong Kong, a 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.

Exemptions

Peer-to-peer trading platforms (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), 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, are not covered under the above definition of VA exchange.

The proposed definition of VA does not cover digital representations of fiat currencies (including digital currencies issued by central banks), as well as financial assets already regulated under the SFO.

Closed-loop, limited purpose items that are non-transferable, non-exchangeable and non-fungible (e.g. air miles, credit card rewards, gift cards, customer loyalty programmes, gaming coins etc.) will also be carved out from the definition.

Proposed Licensing Changes

The FTSB will create a new regulated VA activity under the AMLO.

A key change is that those VASPs offering investment products that do not meet the definition of a security will now be in scope and be required to be licensed by the SFC and meet the following requirements:

- Any VASP planning on applying for an SFC license will be required to have a Hong Kong-incorporated company and a permanent place of business in Hong Kong and sufficient scale of operations.
- The VASP will be required to appoint two individuals to be Responsible Officers ("ROs") of the LC.
- Both RO's must meet the fit and proper criteria, as do the substantial shareholders / owners of the LC.
- The ROs must assume the general responsibility of ensuring compliance with AML/CTF requirements and other regulatory requirements, and will held personally accountable in case of contravention or non-compliance of the requirements

Fit and Proper Criteria

The SFC will take into account:

- Whether the person has been convicted anywhere of an ML/TF offence or other offence in which the person is found to have acted fraudulently, corruptly or dishonestly;
- Whether the person has failed or may fail to observe the AML/CTF or other regulatory requirements applicable to licensed VASPs;
- The experience and relevant qualifications of the person; and
- Whether the person is of a good standing and financial integrity (e.g. not being the subject of any bankruptcy or liquidation proceedings).

To ensure the SFC can effectively discharge its regulatory powers they will have the ability to impose licensing conditions on VASPs. The conditions will vary depending on the size and scope and level of experience of the ROs. It is likely that the SFC will impose similar conditions on VASPs as it does on existing security token trading platforms to ensure a level playing field.

Ongoing Regulatory Requirements

It is proposed that licensed VASPs must adhere to the following requirements:

1. Professional investors only – at the initial stage, the VASP should only offer services to professional investors. The SFC will continue to monitor the market and reconsider its position as the market becomes more mature in future;
2. Financial resources – the VASP should have adequate financial resources, for operating its VA business, including a paid-up share capital of a specified amount and liquid assets, depending on the nature of its business;
3. Knowledge and experience – the VASP and its associated entities should have a proper corporate governance structure staffed by personnel with the necessary knowledge and experience to enable the effective discharge of responsibility;

4. Soundness of the business – the VASP and its associated entities (i.e., a separate corporate entity with which the VASP has a controlling relationship) should operate its VA business in a prudent and sound manner, and ensure that client and public interests will not be adversely affected;
5. Risk management – the VASP should have in place appropriate risk management policies and procedures for managing ML/TF, cybersecurity and other risks arising from a regulated VA activity commensurate with the scale and complexity of the business;
6. Segregation and management of client assets – the VASP should implement proper segregation of client assets by placing them in an associated entity. Adequate policies and governance procedures should also be implemented to ensure the proper management and custody of client assets including VAs;
7. VA listing and trading policies – the VASP should implement and enforce robust rules for the listing and trading of VAs on its platform(s). The VA exchange should also perform all reasonable due diligence on VAs before listing them for trading;
8. Financial reporting and disclosure – the VASP and its associated entities should observe prescribed auditing and disclosure requirements and publish audited accounts;
9. Prevention of market manipulative and abusive activities – the VASP should establish and implement written policies and controls for the proper surveillance of activities on its platform(s) in order to identify, prevent and report any market manipulative or abusive trading activities; and
10. Prevention of conflicts of interest – to avoid any conflicts of interest, the VASP and its associated entities should not engage in proprietary trading or market-making activities on a proprietary basis. Suitable firewalls should also be instituted between the different functions of the corporate structure to avoid conflict of interests. The VASPs and its associated entities should also have a policy to eliminate, avoid, manage, or disclose actual or potential conflicts of interests for their employees who deal with VAs.

SFC Enforcement and Powers

The SFC will continue to have the statutory power to intervene in the business of a VASP if they are of the belief that the client's assets are in need of protection. The SFC can, if the situation presents itself, prohibit the VASP from entering into further transactions or restricting the VASP from disposing property including client assets.

The proposed framework will not only apply to VASP carrying on business in and from Hong Kong but will also apply to those who "actively market" to the Hong Kong Public their services. The marketing of these proposed services into Hong Kong will be considered holding out as carrying on a business in regulated activity in Hong Kong which will require the VASP license in order to do so.

VASPs who fail to be licensed under this new regime and continue to perform VA activities without holding this license will be guilty of a criminal offence and is punishable on conviction or indictment to a fine of HK\$5 million and a prison term of 7 years.



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The FSTB has warned that regulating VASP is only a start to regulations for virtual asset service providers. The licensing framework has been loosely written to allow the SFC increased flexibility to expand the scope of VASPs to be included in the framework. Ashley Alder, the CEO of the SFC, said in a recent speech “once this new regime is in place, all virtual asset trading platforms in Hong Kong would be regulated, supervised and monitored under one of two regimes”.

The consultation period will end on 31 January 2021.

How we can help

Having been at the forefront of the FinTech industry in Asia since its infancy, ComplianceAsia can assist prospective VASPs during the licensing application process with the SFC. Our dedicated licensing team will help draft the required forms, business plans and the various policies and procedures that will be expected of a VASP. If you are a current VASP that is in the SFC’s sandbox our dedicated project team can undertake a detailed gap analysis of your policies and procedures to ensure that they meet the enhanced requirements expected under this new regime.

About ComplianceAsia

ComplianceAsia is the longest established compliance consulting firm in Asia Pacific established in 2003 with key offices in Hong Kong, Shanghai, Singapore, Tokyo and London. We have an unmatched track record of completing complex compliance consulting projects for financial firms in the APAC region.

With over 70 staff, including compliance experts with experience in dealing with the SFC, HKMA, MAS, CSRC, JFSA and Asian exchanges, we provide independent, unbiased advice on Asian financial industry legislation and regulations. Our international client base consists of asset managers, hedge funds, private equity funds, family offices, broker-dealers, insurers, wealth managers and investment banks.

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