



Hong Kong Regulatory Update - FSTB Published Consultation Conclusions on VASP Licensing Regime (June 2021)

Introduction

In May 2021, the Financial Services and the Treasury Bureau (the "FSTB") published its Consultation Conclusions on a proposed licensing regime for virtual asset exchanges ("VA Exchanges") under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap.615) (the "AMLO"). The licensing regime will be administered by the Securities and Futures Commission (the "SFC").

The VASP licensing regime is aimed largely at implementing the Financial Action Task Force Recommendations, which, while being non-binding, ask jurisdictions to regulate VASPs for AML/CFT purposes.

The FSTB signaled that respondents were generally supportive of the proposed regime, which has remained largely unchanged from the original draft proposals. The FSTB aim to introduce an amendment bill into the Legislative Council in the 2021-2022 legislative session and detailed regulatory requirements are expected to be published by the SFC in due course.

In this regulatory update we will provide a detailed overview of the licensing regime.

Who will require a license?

Under the current opt-in regulatory regime, virtual asset trading platforms can apply to be licensed by the SFC if they trade at least one virtual asset which is a security, as defined under the Securities and Futures Ordinance (Cap.571) (the "SFO"). Therefore, virtual asset trading platforms which do not trade such virtual assets, operate outside the SFC's regulatory remit.

Under the new licensing regime, any person seeking to engage in the regulated activity of operating a VA Exchange in Hong Kong will be required to apply for a licence from the SFC. VA Exchanges which are already regulated under the opt-in regime will not be exempt from the licensing requirement. There will be a 180 day transitional period upon the commencement of the operation of the licensing regime. Conducting a regulated VA activity without a licence will be subject to a maximum penalty of HK\$5million and seven years' imprisonment, and a further fine of HK\$100,000 per day in the case of a continuing offence.

Any person who is not a licensed VA Exchange will be prohibited from actively marketing in Hong Kong, or elsewhere, to the Hong Kong public a regulated VA activity or a similar activity elsewhere.

"VA Exchange"

For the purposes of the licensing regime, a VA exchange will be defined as "a trading platform which is operated for the purposes of allowing an offer or invitation to be made to buy or sell any virtual asset in exchange for any money or any virtual asset, and which comes into custody, control, power or possession of, or over, any money or any virtual asset at any point in time during its course of business". This definition does not include peer-to-peer ("P2P") trading platforms, to the extent that the transaction is conducted outside the platform and the platform does not come into possession of any money or virtual asset at any point in time. VASPs should however bear in mind that while P2P trading platforms fall outside the scope of the regime, the FATF revised guidance (issued in March 2021) place an onus on VASPs to consider how ML/TF risks should be mitigated



and to consider the extent to which their customers or prospective customers may engage in P2P activities. FATF also urges countries to consider how ML/TF risks of P2P transactions may be mitigated. Therefore, P2P transactions will be, if not now, on Hong Kong's regulatory radar in the future.

Some respondents were in favour of a broader licensing regime, which is in line with the FATF Recommendations, however the FSTB consider that VA Exchanges are the most prevalent type of VASP in Hong Kong at the moment. Should the need arise, the FSTB has the flexibility to expand the licensing regime. While the pace of the evolution of the regulatory regime is unclear, it is prudent for businesses to consider how their operations may be impacted by regulation in the future, particularly in view of the FATF revised guidance, which further expands the definition of VASPs to include previously unregulated corners of the virtual asset industry.

"Virtual Asset"

In line with the FATF definition, virtual assets shall be 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.

This does not include digital representations of fiat currencies, digital currencies issued by central banks, financial assets already regulated under the SFO and certain closed-loop, limited purpose items (such as air miles and credit card rewards). SVFs are also not covered. Non-fungible tokens ("NFTs") would also be unlikely to meet this definition, however it would depend on the particular circumstances of each case.

Stablecoins will be considered virtual assets, irrespective of the underlying assets (i.e. fiat currency, gold, or other virtual assets, or a basket of any of the foregoing). The FSTB does however note that the Secretary for Financial Services and the Treasury shall have discretion to determine whether any digital representation of value is a virtual asset or otherwise both generally or on a case-by-case basis.

Looking forward, the FATF revised guidance stipulates that no financial asset should fall outside of the FATF standards, therefore requiring an asset to be considered either a traditional financial asset or a virtual asset, therefore an expansion of Hong Kong's relevant definitions is not out of the question.

Licensing Requirements

In order to be licensed, a VA Exchange must satisfy the following criteria:

1. **Incorporation** – the applicant must be either a **locally incorporated** company or an **overseas incorporated company registered in Hong Kong** under the Companies Ordinance (Cap.622) with a **permanent place of business** in Hong Kong. Originally, the FSTB proposed allowing only locally incorporated companies to be licensed, however this was amended in response to pushback from respondents.



2. **Fit-and-Proper Test** – the applicant must pass a fit-and-proper test and appoint at least two responsible officers (**ROs**), who will be responsible for ensuring compliance with AML/CFT requirements and other regulatory requirements. In assessing the fitness and propriety of the applicant, the SFC will consider:
 - a. any ML/TF offences or other fraudulent, corrupt or dishonest offences;
 - b. any non-compliance with AML/CFT or regulatory requirements applicable to VASPs;
 - c. experience and qualifications; and
 - d. good standing and financial integrity.

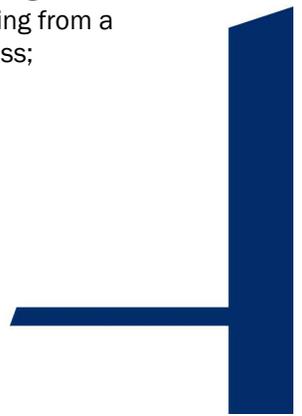
Providing a false, deceptive or misleading statement in material particular in connection with a licence application will be subject to a maximum penalty of HK\$1million and two years' imprisonment.

Requirements on Licensed VA Exchanges

A licensed VA Exchange will be subject to the AML/CFT requirements in Schedule 2 to the AMLO, for which non-compliance will be subject to a maximum penalty of HK\$1 million and two years' imprisonment, and other investor protection requirements, as follows:

1. **Investors** - services shall only be offered to Professional Investors;

Over 40% of respondents urged the FSTB to allow retail investor participation, however the proposal remained unchanged with the FSTB rationalising the restriction on the basis of the associated risks. The FSTB will however monitor the landscape and review the restriction in the future.
2. **Financial resources** – meet the paid-up share capital and liquid capital requirements (*to be determined*), depending on the nature of its business;
3. **Knowledge and experience** – the VA Exchange and its associated entities shall 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 VA Exchange and its associated entities (i.e., a separate corporate entity with which the VA Exchange 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 VA Exchange shall 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;





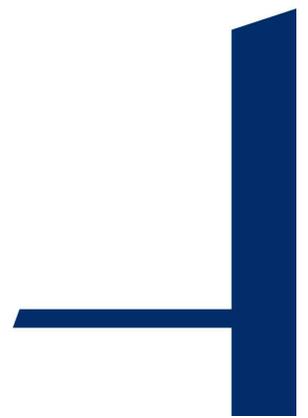
6. **Segregation and management of client assets** – ensure the proper segregation of client assets by placing them in an associated entity and adequate policies and governance procedures shall be implemented to ensure the proper management and custody of client assets, including VAs;
7. **VA listing and trading policies** – robust rules for the listing and trading of virtual assets on its platform(s) shall be enforced and all reasonable due diligence shall be conducted prior to listing;
8. **Financial reporting and disclosure** – the VA Exchange and its associated entities shall observe prescribed auditing and disclosure requirements and publish audited accounts;
9. **Prevention of market manipulative and abusive activities** – the VA Exchange shall 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 VA Exchange and its associated entities shall not engage in proprietary trading or market-making activities on a proprietary basis. Suitable firewalls shall also be instituted between the different functions of the corporate structure to avoid conflict of interests. The VA Exchange and its associated entities shall also have a policy to eliminate, avoid, manage, or disclose actual or potential conflicts of interests for their employees who deal with virtual assets.

Powers of the SFC

The SFC will be empowered to supervise the AML/CFT conduct of licensed VA Exchanges and enforce the regulatory requirements. As such, the SFC will be empowered to enter the licensed VA Exchange's business premises and that of its associated entities in order to conduct routine inspections; may request the production of documents and records; and may investigate non-compliance and impose administrative sanctions. The SFC will also be empowered to impose restrictions and prohibitions against the licensed VA Exchange and its associated entities.

How ComplianceAsia can help

ComplianceAsia can assist prospective licensing applicants 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 VATP. If you are a current VA Exchange 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.





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ComplianceAsia is the longest established compliance consulting firm in Asia Pacific established in 2003 with 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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