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## Hong Kong Formalises Legal Framework to Regulate Virtual Asset Exchanges

*Hong Kong's licensing regime for virtual asset service providers to take effect in March 2023.*

### Key Points:

- Two years after the Hong Kong government first proposed regulating virtual asset exchanges, it has published legislative amendments that create a framework for regulating virtual asset service providers (VASPs), focusing initially on regulating centralised virtual asset exchanges.
- The new legal framework is designed to give effect to the Financial Action Task Force's (FATF) recommendations on the regulation of VASPs and thus one of the key aspects of the new regulatory regime is anti-money laundering and counter-terrorist financing (AML/CTF) obligations.
- Hong Kong's VASP licensing regime will bring virtual asset exchange operators within the formal regulatory perimeter of the Securities and Futures Commission (SFC), marking the expansion of the SFC's supervisory remit beyond businesses that involve securities or futures activities.
- Any person operating a virtual asset exchange in Hong Kong or actively marketing virtual asset exchange services to the Hong Kong public will require a license from the SFC.
- Initially, licensed virtual asset exchanges will only be allowed to provide services to professional investors, consistent with the prevailing regulatory policy approach in Hong Kong that virtual assets are not suitable for retail investors.
- The VASP licensing regime is proposed to take effect on 1 March 2023. Existing virtual asset exchange operators that operate in Hong Kong will have nine months (i.e., until 1 December 2023) to apply for licences or withdraw from the market. Once an application is lodged with the SFC, the virtual asset exchange can continue operating until the SFC approves or rejects its application.
- The new legal framework also introduces investor protection safeguards that criminalise certain nefarious conduct in relation to virtual assets, including making fraudulent or reckless misrepresentations to induce the purchase or sale of virtual assets (whether or not such conduct takes place on or through a virtual asset exchange).

## Introduction

On 24 June 2022, the Hong Kong government published in the Gazette the Anti-Money Laundering and Counter-Terrorist Financing (Amendment) Bill 2022 (Amendment Bill). The Amendment Bill proposes amendments to the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Chapter 615) (AMLO) to introduce a new framework for a licensing regime for VASPs, impose statutory AML/CTF obligations on the VASP sector, and establish specific investor protection safeguards relating to virtual assets, amongst other amendments.

The Amendment Bill has been formulated following two years of consultation and policy development by the Hong Kong government and the SFC. In November 2020, the Financial Services and the Treasury Bureau (FSTB) issued a consultation paper outlining a new regulatory framework for virtual asset exchanges (see Latham's [Client Alert](#)). In May 2021, the FSTB issued its consultation conclusions (Consultation Conclusions) on implementing a regulatory regime for VASPs (see Latham's [blog post](#)). The Amendment Bill reflects the proposals set out in the Consultation Conclusions.

## The Licensing Regime for VASPs

The Amendment Bill formalises the proposals from the Consultation Conclusions that the SFC will become the regulator for VASPs based in Hong Kong or based overseas but dealing with Hong Kong persons. During the consultation period, the Hong Kong government determined that virtual asset exchanges would be the only VASPs within the scope of the regulatory regime and that other types of VASPs (e.g., OTC brokers) would not be subject to the regime.

The new VASP licensing regime will expand the SFC's existing supervisory remit established under the Securities and Futures Ordinance (Chapter 571) (SFO) for virtual asset trading platforms (VATPs) that trade at least one security token. As noted in the FSTB's consultation process, reference has been made to the existing VATP regime to ensure a level playing field.

In contrast to similar regulatory regimes in other markets, virtual asset exchanges in Hong Kong initially will only be permitted to deal with professional investors, meaning that the general retail public in Hong Kong will not be afforded the protections of dealing with a Hong Kong-regulated exchange.

As the regime develops and the virtual asset market matures, the Hong Kong government may assess whether to permit licensed virtual asset exchanges to provide services to retail customers, and if so, we expect that licensed VASPs will be subject to more stringent regulatory requirements.

The Hong Kong government acknowledges that the proposed VASP regulatory framework in Hong Kong is more rigorous and comprehensive than comparable regimes in Singapore, the United Kingdom, and Japan.

Scope	Amendment Bill proposals
Source of law and key provisions	<p>The Amendment Bill adds a new part 5B "Regulation of Activities Involving VAs" and Schedules 3B to 3G to the AMLO. The main provisions of the Amendment Bill are summarised as follows:</p> <ul style="list-style-type: none"> <li>sections 53ZR to 53ZRC define terms such as "VA", "VA service", and "regulated function";</li> </ul>

	<ul style="list-style-type: none"> <li>• sections 53ZRD to 53ZRG impose the requirement for a licence for VASPs and other restrictions on VA activities (including general investor protection measures that are intended to criminalise fraudulent or reckless misrepresentations intended to induce the purchaser or sale of virtual assets (e.g., activities like “shilling” fake initial coin offerings or other virtual asset projects or orchestrating ramp and dump schemes);</li> <li>• sections 53ZRH to 53ZRS provide for the grant of a licence to VASPs and their representatives, the fit and proper requirement, and the grant of approval to responsible officers (RO);</li> <li>• sections 53ZRT to 53ZRX set out obligations of licensed VASPs, their associated entities (AEs), and licensed representatives regarding notifications, annual fees, and annual returns;</li> <li>• sections 53ZRY to 53ZSM set out audit requirements applicable to licensed VASPs and their AEs;</li> <li>• sections 53ZSN to 53ZTG set out the SFC’s powers to discipline a licensed person and to intervene in the business of licensed VASPs or their AEs; and</li> <li>• section 53ZTX adds a new Schedule 3G to the AMLO to provide for transitional arrangements.</li> </ul>
Scope of the VASP licensing regime	<p>The operation of a VA Exchange (as defined below) will be a regulated activity under the AMLO. Any person operating a VA Exchange or “actively marketing” the service of a VA Exchange to the Hong Kong public will require a licensed from the SFC.</p> <p>“Active marketing” is a concept already found in the SFO; the SFC issued guidance in 2003 (which has not been updated since then) stating that it will look at factors such as whether services are extensively advertised via marketing to the Hong Kong public or packaged to target Hong Kong customers to determine whether active marketing has been triggered. However, if the service is sought out by customers on their own initiative (e.g., reverse solicitation), then this should present lower risks. Given the increasingly modern means of advertising in the VA space (e.g., marketing via influencers or through social media), the SFC may take this opportunity to update their guidance on active marketing.</p>
Definition of “VA Exchange”	<p>The Amendment Bill defines “VA service” as “Operating a VA exchange”, which means the provision of services through means of electronic facilities:</p> <p>(a) whereby –</p> <p>(i) offers to sell or purchase VAs (see definition below) are regularly made or accepted in a way that forms or results in a binding transaction; or</p> <p>(ii) persons are regularly introduced, or identified to other persons in order that they may (or with the reasonable expectation that they will) negotiate or conclude sales or purchases of VAs in a way that forms or results in a binding transaction; and</p>

	<p>(b) where client money or client VAs comes into direct or indirect possession of the person providing such a service.</p> <p>Decentralised exchanges and peer-to-peer trading platforms should not be covered by this definition provided that transactions are conducted outside the platform (i.e., the transaction takes place between two non-custodial wallets) and the platform is not involved in the underlying transaction by coming into possession of any client money or any client virtual asset at any point in time. In practice, some decentralised exchanges and peer-to-peer trading platforms could potentially fall within the scope of the definition and such platforms should consider reviewing the Amendment Bill if they are providing services to Hong Kong persons.</p>
Definition of VA	<p>The Amendment Bill, consistent with the recommendations of the FATF, defines a VA as:</p> <p>a cryptographically secured digital representation of value that:</p> <ul style="list-style-type: none"> <li>(i) is expressed as a unit of account or a store of economic value;</li> <li>(ii) either: <ul style="list-style-type: none"> <li>• is used (or is intended to be used) as a medium of exchange accepted by the public for payment for goods or services or for the discharge of a debt or for investment purposes; or</li> <li>• provides rights, eligibility, or access to vote on the management, administration, or governance of the affairs in connection with, or to vote on, any change of the terms of any arrangement applicable to any cryptographically secured digital representation of value; and</li> </ul> </li> <li>(iii) can be transferred, stored, or traded electronically.</li> </ul> <p>The definition would cover a broad range of VAs, such as Bitcoin, Ether, other types of alt-coins / utility tokens, and stablecoins (whether they are collateralised by fiat currency or algorithmically collateralised).</p> <p>To mitigate the risk of overlapping regulatory regimes, the VA definition expressly excludes financial products that are subject to existing regulatory regimes. This includes central bank digital currencies (which would be treated as money) and stored value facilities — both of which would be subject to the jurisdiction of the Hong Kong Monetary Authority (HKMA) — and securities and futures regulated under the SFO (e.g., security tokens), which would be subject to SFC jurisdiction.</p> <p>The Amendment Bill also excludes limited purpose digital tokens, including customer loyalty or reward points, in-game assets, or similar tokens that are not intended to be convertible into money or another medium of exchange accepted by the public. Whether GameFi tokens issued in connection with blockchain games fall within this exception will need to be determined on a case-by-case basis. If such tokens do</p>

	<p>constitute VAs, then the gaming platform's activities would require examination to assess whether the platform triggers the VA Exchange licensing requirement.</p> <p>Most non-fungible tokens (NFTs) should not be caught by the VA definition, therefore, platforms that only facilitate trading in NFTs (e.g., NFT marketplaces) should not be subject to regulation as VA Exchanges. This is consistent with the SFC's recent observations that the majority of NFTs appear to be genuine digital representations of collectibles, and such NFTs do not fall within the SFC's regulatory remit (see Latham's <a href="#">blog post</a>).</p> <p>NFT marketplaces operating in Hong Kong or with Hong Kong customers should implement guardrails and procedures to ensure that they are dealing only with virtual assets that are outside the VA definition in order to avoid any inadvertent breach of the new regime after it comes into effect.</p> <p>However, under the Amendment Bill, the Secretary for Financial Services and the Treasury will be empowered to prescribe whether a particular asset is to be considered a VA, so the definition of a VA could be expanded in the future, if deemed necessary.</p>
Supervisory powers	<p>The SFC will be given supervisory powers for enforcing the new regulatory regime, including to:</p> <ul style="list-style-type: none"> <li>• enter business premises of licensed VA Exchanges and their associated entities for conducting routine inspections;</li> <li>• request the production of documents and other records;</li> <li>• investigate suspected or detected non-compliance;</li> <li>• impose disciplinary sanctions (including reprimand, order for remedial actions, civil penalty, and suspension or revocation of licence) against licensed persons involved with non-compliance; and</li> <li>• appoint an auditor to look into the affairs of a licensed VA exchange and its associated entities.</li> </ul> <p>To strengthen investor protection and protect client assets, the SFC also will have intervention powers to impose prohibitions and requirements in relation to the operation of a licensed VA Exchange. In particular, the SFC may:</p> <ul style="list-style-type: none"> <li>• require the licensed VASP and its associated entities to conduct its business in a specified manner;</li> <li>• prohibit the licensed VASP and its associated entities from entering into any further transactions; and</li> <li>• restrict the licensed VASP and its AEs from disposing of client assets and other property.</li> </ul>

Review of SFC's decisions	The SFC's decisions in implementing the licensing and supervisory regime for licensed VA Exchanges and their officers will be subject to the review mechanism of the AML/CTF Review Tribunal.
<b>General licensing requirements</b>	
Local establishment requirement	<p>Only Hong Kong-incorporated companies or companies incorporated overseas but registered in Hong Kong under the Companies Ordinance (Chapter 622) are eligible to be licensed under the new regime.</p> <p>This means that offshore virtual asset exchanges that do business with Hong Kong customers would need to establish a local Hong Kong subsidiary or register a Hong Kong branch in order to apply for a VA Exchange licence.</p>
Fit and proper test requirement	<p>The SFC will only grant a licence to an applicant if it is a fit and proper person. In assessing a licence application under the new regime, the SFC will consider, among other factors, the applicant's management structure, business model, risk management policies, and other listing and counter-market manipulation measures.</p> <p>The fit and proper person test will also take account of whether the company is operated in compliance with the AML/CTF and other regulatory requirements.</p> <p>An applicant's ROs and licensed representatives must also be fit and proper to manage the VASP business and engage in the provision of a VA service, respectively.</p> <p>In addition, "ultimate owners" of a VA Exchange are required to obtain prior approval from the SFC, and must also be assessed to be fit and proper. An ultimate owner is an individual who owns or controls more than 25% of the issued share capital of the VA Exchange, is entitled to exercise more than 25% of the voting rights of the VA Exchange, or exercises ultimate control over the management of the VA Exchange. This definition is less onerous than the "substantial shareholder" test found in the SFO and means that companies are excluded from needing to obtain approval.</p> <p>The fit and proper requirements are intended to enhance the overall AML/CTF competency level of the sector, as well as provide a substantial level of investor and customer protection.</p>
Individual licensing requirement	<p><b>ROs:</b> A licence applicant is required to have at least two SFC-approved ROs to assume general responsibility of overseeing the licensed entity's operations and ensuring its compliance with AML/CTF and other regulatory requirements, and in case of non-compliance, the ROs are to be held personally accountable. Any executive director of the applicant must be approved as an RO.</p> <p>There is also a requirement that at least one of the RO must ordinarily reside in Hong Kong. This is similar to the existing requirement in the SFO under which licensed corporations are required to have at least one RO who is available at all times to supervise the business (and generally means that the RO should be resident in Hong Kong).</p>

	<p><b>Licensed representatives:</b> Individuals performing regulated functions for a VA Exchange must be licensed by the SFC as licensed representatives. Licensed representatives will be expected to meet qualification requirements as determined by the SFC (to be formulated and published at a later date) and should be competent to carry out VA trading services.</p> <p>The SFC is empowered to impose conditions on the licences of ROs and licensed representatives.</p>
Customer base	<p>Licensed VA Exchanges initially may offer their services only to “professional investors”, meaning high net-worth individuals with a portfolio of at least HK\$8 million (around US\$1 million), corporations with portfolios of at least HK\$8 million or total assets of at least HK\$40 million (around US\$5.16 million), or institutional investors such as licensed banks, broker-dealers, and asset managers. Retail customers (i.e., non-professional investors) may not trade virtual assets with VA Exchanges licensed under the new regime.</p> <p>This requirement is not set out in the Amendment Bill, but the SFC will impose it by way of licensing conditions on approved VA Exchanges.</p> <p>The government will continue to monitor developments and review its position as the virtual asset market in Hong Kong becomes more mature, implying that the exclusion of the retail market may be temporary and part of a longer-term implementation process, but without providing any indicative timeline for broadening the regime to include retail investors. The professional investor requirement will be imposed by way of licensing conditions, therefore, if the policy approach relaxes to permit VA Exchanges to deal with retail investors, then it should be straightforward for the SFC to remove such conditions (i.e., there would be no legislative process required to effect this change).</p> <p>Notably, virtual asset holdings do not count towards the portfolio/assets of a person for the purposes of professional investor classification in Hong Kong (as only securities and certain deposits are counted towards the portfolio/assets of a person). Accordingly, VA Exchange customers that only hold virtual assets and do not have securities or deposits meeting the relevant threshold may not satisfy the definition of a professional investor.</p>
Conditions	<p>The Amendment Bill empowers the SFC to impose licence conditions on VA Exchanges covering a broad range of areas and we would expect that the SFC to issue further guidance on some of these areas in due course, for example:</p> <ul style="list-style-type: none"> <li>• financial resources;</li> <li>• AML/CTF policies and procedures;</li> <li>• management of client assets;</li> <li>• VA listing and trading policies;</li> </ul>

	<ul style="list-style-type: none"> <li>• avoidance of conflicts of interest;</li> <li>• cybersecurity.</li> </ul> <p>For overseas-licensed virtual asset exchanges that intend to obtain a licence in Hong Kong, it should be possible to adapt their existing procedures to reflect these requirements as other regimes have also imposed similar measures. Existing unlicensed exchanges may also already have put in place similar policies.</p> <p>It will be important to keep the proposed licence conditions under review as the SFC formulates rules and publishes or consults on these specific requirements in the coming months. We would expect the SFC to have reference to the existing requirements that apply to VATPs.</p>
Exemptions from licensing requirement	Given that VA Exchanges represent a new line of business distinct from the traditional services provided by entities regulated under the AMLO (e.g., money services like remittance and foreign currency exchange), there will not be any statutory licensing exemptions for the new regime.
SFC's ongoing supervision	<p>A licensed VA Exchange will be granted an open-ended licence, which will remain valid until revoked by the SFC (e.g., due to misconduct or cessation of the licensed entity's operations). A licensed VA Exchange will be subject to the SFC's ongoing supervision in respect of conduct of business and operations.</p> <p>Particularly important is the protection of client assets in case of the default of a VA Exchange. The SFC will be given intervention powers to protect client assets in the event of an emergency, and to prevent the dissipation of client assets in case of misconduct. Given the relative ease with which VA can be transferred, the SFC will need to exercise these powers rapidly upon becoming aware of any emergencies or misconduct. We expect the SFC to add resources around monitoring of market updates and ensuring that its staff can act quickly in case of emergency.</p>

## Penalties and sanctions

The Amendment Bill proposes to impose criminal liability for any person providing a VA service without a licence, with a fine of HK\$5 million (approximately US\$637,000) (plus additional fines for continuing breaches) and imprisonment of seven years. The same offence may be constituted by any unlicensed person actively marketing, whether in Hong Kong or elsewhere, to the public of Hong Kong the service of a VA Exchange elsewhere.

Any person, in connection with an application for the grant of a VASP licence, making a false or misleading statement in a material particular is liable to a fine of HK\$1 million (approximately US\$127,000) and imprisonment of two years.

In addition, non-compliance with the statutory AML/CTF requirements under the AMLO is a criminal offence, whereby the licensed VASP and its ROs are liable to a fine of HK\$1 million (approximately US\$127,000) and imprisonment of two years. They may also be subject to a range of disciplinary sanctions, including suspension or revocation of licences, reprimand, an order to take remedial action, and a pecuniary penalty for misconduct.



Any person making a fraudulent or reckless misrepresentation for the purpose of inducing another person to acquire or dispose of a VA, whether or not the transaction is conducted (or proposed to be conducted) within or outside a licensed VA Exchange, is liable to a fine of HK\$1 million and imprisonment of seven years (as opposed to two years in the consultation document).

## Next Steps

The Amendment Bill was introduced to the Legislative Council for its first reading on 7 July and the amendments to the AMLO to reflect the VASP regime are expected to come into effect on 1 March 2023.

Thereafter, there will be a transitional period of nine months (i.e., until 1 December 2023) for operators of virtual asset exchanges to apply to the SFC for a VA Exchange licence. If a person files a licensing application within that transitional period and confirms that it will comply with applicable regulatory requirements, it will be deemed to be licensed until the SFC decides on its licence application. If an applicant's licence application is rejected by the SFC, the person will have three months to exit the market.

Virtual asset firms should assess whether they fall within the regulatory remit of the VASP licensing regime. In particular, GameFi platforms and NFT marketplaces should assess carefully whether their activities fall within the scope of the licensing obligation, particularly if their tokens may fall within the definition of VA and they have developed their own marketplace to buy and sell these tokens.

For VA Exchanges currently operating in Hong Kong, they should begin to assess how to comply with the licensing framework and identify individuals to become ROs and LRs. Those currently servicing retail customers should also prepare to off-board retail customers once the VASP licensing regime takes effect.

Offshore VA Exchanges should consider their Hong Kong nexus and whether their VA services will fall under the licensing regime. In particular, they should consider whether their existing marketing and distribution of services to Hong Kong persons would be considered active marketing the service of a VA Exchange to the Hong Kong public. If they are actively marketing to the Hong Kong public, they should consider whether to obtain a licence or else cease to actively marketing their services.

VA Exchanges should also monitor the rules and guidelines to be published by the SFC in relation to the VASP regime.

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