

Hong Kong Consults on a New Licensing Regime to Regulate Virtual Assets Exchanges

Hong Kong government issued a consultation to implement a new regulatory framework requiring virtual asset exchanges to be regulated by the SFC

Key Points:

- The Hong Kong Financial Services and the Treasury Bureau (FSTB) has issued a consultation paper outlining a new regulatory framework that will bring operators of virtual asset exchanges within the formal regulatory perimeter of the Securities and Futures Commission (SFC) for the first time.
- The new regulatory framework implements the Hong Kong Financial Action Task Force's (FATF) requirement to regulate virtual asset service providers for anti-money laundering and counter-terrorist financing purposes.
- The new regulatory framework requires centralised virtual asset exchanges that operate in Hong Kong or actively market their virtual asset services to the public of Hong Kong to be licensed by the SFC.
- Under the new regulatory framework, licensed virtual asset exchanges will be subject to similar regulatory requirements to those that apply to virtual asset exchanges trading in securities (i.e., security tokens), in particular, virtual asset exchanges will only be permitted to offer services to customers that qualify as professional investors.
- The consultation period runs until 31 January 2021 and a bill to bring the new regime into effect will likely be introduced to Hong Kong's Legislative Council in 2021.

Background

One year after the Hong Kong SFC announced a new regulatory regime for virtual asset exchanges (VA Exchanges) that facilitate trading in security tokens, the SFC has turned its sights on the regulation of non-security virtual assets¹, outlining a new regulatory framework to formalise and directly regulate trading of virtual assets, such as Bitcoin.

The SFC's Chief Executive, Ashley Alder, summarised proposals to regulate virtual asset service providers (VASPs) in his keynote speech on the second day of Hong Kong Fintech Week 2020, ([see Latham's 4 November 2020 blog post](#)) and, later the same day, the FSTB released a consultation paper (Consultation Paper) providing further detail on the proposals.

Following the consultation (open until 31 January 2021), a bill is expected to be introduced to the Legislative Council during 2021. Once the new framework becomes law, there will be a transitional period of 180 days to allow market participants to apply for and obtain the necessary SFC license or withdraw from the market.

Limitations of the current opt-in regulatory regime

The new regulatory framework is not entirely unexpected. Currently, the SFC's regulatory perimeter only extends to products that qualify under the Securities and Futures Ordinance (SFO) (including traditional securities such as stocks and bonds, futures contracts, and funds) and to intermediaries that provide services relating to those products. Most virtual assets, such as Bitcoin, other stablecoins, or alt-coins, fall outside of the SFO and therefore, the SFC's regulatory perimeter.

Under the existing regulatory regime, a virtual asset trading platform (VATP) offering trading of at least one virtual asset that is a security is able to "opt in" to be licensed and regulated by the SFC (Opt-In Regime). Once licensed, all of the VATP's business (including trading of non-security virtual assets, such as Bitcoin) would fall under the SFC's supervision. The SFC has, however, acknowledged the limitations of the Opt-In Regime, noting that VA Exchanges that only facilitate trading in non-security virtual assets would not need to be licensed by the SFC, and could continue to operate as unregulated businesses.

The new regulatory framework

The new regulatory framework outlined in the Consultation Paper marks a significant change to the way in which virtual assets are regulated in Hong Kong, and also implements the latest requirements of the Financial Action Task Force (FATF) in relation to virtual asset service providers (VASPs).

The net outcome of the new regulatory framework is that any Hong Kong-based VA Exchange (or overseas VA Exchanges that target Hong Kong customers) will need to be licensed by the SFC, and will, initially, only be able to deal with customers that qualify as "professional investors" — meaning that Hong Kong retail customers will not be permitted access to trade virtual assets on licensed VA Exchanges. This is the first time that the SFC's licensing and supervisory powers have materially extended beyond the SFO and its related subsidiary legislation.

Scope of the new regulatory framework

Scope	Consultation proposals
Source of law for the new regulatory framework	The new regulatory framework will be implemented through amendments to the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (AMLO), the primary source of law that subjects financial institutions and certain designated non-financial businesses and professions (e.g., lawyers and trustees) to statutory customer due diligence requirements and record-keeping obligations. Non-compliance with AMLO renders those persons liable to administrative or criminal sanctions.
Scope of the new regulatory framework	Under the new regulatory framework, the business of operating a VA Exchange is designated as a "regulated VA activity" under the AMLO, and any person seeking to engage in a regulated VA activity is required to obtain a license from the SFC.

	<p>The scope of regulated VA activity under the new regulatory framework is notably narrower than the scope of how the FATF defines VASPs' activities. In the FATF parlance, a VASP is a person who, as a business, engages in specified activities involving virtual assets. The specified activities cover:</p> <ul style="list-style-type: none"> (i) Exchange between virtual assets and fiat currencies (ii) Exchange between one or more forms of virtual assets (iii) Transfer of virtual assets (iv) Safekeeping and/or administration of virtual assets or instruments enabling control over virtual assets (v) Participation in and provision of financial services related to an issuer's offer and/or sale of a virtual assets <p>The FSTB explained that the scope of the new regulatory framework only covers VA Exchanges as they are the most prevalent and developed embodiment of VASPs in Hong Kong.</p> <p>While VASPs could also include virtual asset payment systems, virtual asset custodian services, over-the-counter (OTC) trading service providers, and crypto-ATMs, the FSTB considers the presence of these VASPs in Hong Kong to be negligible, therefore these types of VASPs will not be subject to regulation under the new regulatory framework.</p> <p>However, the Consultation Paper does not rule out widening the scope of the regulatory regime in the future, and states that flexibility will be built into the licensing regime such that it may be expanded to cover other types of VASPs should the need arise.</p>
Definition of a VA Exchange	<p>The Consultation Paper defines a VA Exchange as any trading platform that is operated for the purpose 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 (whether of the same or different type), 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.</p> <p>The definition would cover centralised VATPs that provide trading services in virtual assets. In addition, as the definition is quite broad, OTC virtual asset trading service providers would need to consider whether their operations could inadvertently fall within the definition of a VA Exchange.</p> <p>The Consultation Paper specifically excludes peer-to-peer trading platforms (i.e., platforms that only provide a forum in which buyers</p>

	<p>and sellers of virtual assets 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 virtual asset at any point in time.</p> <p>Accordingly, most de-centralised VA Exchanges should fall outside the scope of the new regulatory framework and would not need to be licensed.</p>
Definition of “virtual assets”	<p>“Virtual assets” are defined as a digital representation of value that is expressed as a unit of account or a store of economic value; that 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 that can be transferred, stored, or traded electronically.</p> <p>The definition would cover different types of virtual assets, including Bitcoin, Ether, and other alt-coins. The Consultation Paper also specifically provides that virtual assets purportedly backed by some form of assets for the purpose of stabilising their value (i.e., stablecoins, such as Tether) will be covered by the definition of virtual assets.</p> <p>The proposed definition of virtual assets does not, however, extend to digital representations of fiat currencies (including central bank digital currencies), as well as financial assets (e.g., securities and authorised structured products) already regulated under the SFO.</p> <p>Additionally, consistent with exemptions that exist under the regulations governing stored value facilities, 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 excluded from the definition of virtual assets.</p>
Jurisdictional scope of the new regulatory framework	<p>To protect the Hong Kong public from exposure to unlicensed VA Exchanges, the Consultation Paper also proposes to prohibit any person from “actively marketing”, whether in Hong Kong or elsewhere, a regulated VA activity or a similar activity elsewhere (i.e., services associated with a VA Exchange) to the public of Hong Kong, unless the person is properly licensed and regulated by the SFC for the purpose of conducting regulated VA activity.</p> <p>There are notable considerations here:</p> <p>The Consultation Paper explains that there is a similar concept of “active marketing” under existing securities laws (i.e., the SFO). As</p>

	<p>an indication of how the term actively marketing may be construed under the new regulatory framework, the SFC has previously issued guidance on what actively markets means under the SFO in the form of a frequently asked question (FAQ). The FAQ sets out a number of non-exhaustive factors that the SFC will consider in determining whether or not a person is actively marketing their services to the public of Hong Kong, including whether:</p> <ul style="list-style-type: none"> • There is a detailed marketing plan to promote the services • The services are extensively advertised via marketing means, such as direct mailing, advertisements in local newspapers, broadcasting, or other “push” technology over the internet (as opposed to situations in which the services are passively available e.g. on a “take it or leave it” basis) • The related marketing is conducted in a concerted manner and executed in accordance with a plan or schedule that indicates a continuing service, rather than an one-off exercise • The services are packaged to target the public of Hong Kong, e.g., written in Chinese and denominated in Hong Kong dollars • The services are sought out by the customers on their own initiative <p>As mentioned in the section on “Licensing requirements under the new regulatory framework” below, only locally incorporated companies with a permanent place of business in Hong Kong will be considered for a VA Exchange license by the SFC. In effect, this means that overseas VA Exchanges will not be able to obtain an SFC license. If overseas VA Exchanges wish to actively market their VA Exchange services to the public of Hong Kong, they will need to incorporate a local entity in Hong Kong to obtain a license from the SFC.</p>
Exemptions from the new regulatory framework	<p>VA Exchanges that are already regulated by the SFC under the existing Opt-In Regime for VATPs are exempt from the new regulatory framework, to avoid duplicate regulation.</p> <p>The Consultation Paper has not, however, indicated whether VA Exchange licensees will be exempt from other regulatory regimes in Hong Kong. For example, it is unclear whether licensed VA Exchanges would automatically be exempt from the money services operator licensing regime (which applies to remittance and money changing services) and the trust or company service provider licensing regime (which applies to trust businesses) under AMLO, to the extent that a VA Exchange is providing any of these services ancillary to its functions as a VA Exchange.</p>

Proposed licensing requirements under the new regulatory framework

The Consultation Paper also outlines the general licensing requirements for VA Exchanges. Broadly speaking, a VA Exchange will need to satisfy the SFC that the exchange is “fit and proper” and will comply with the AML/CTF requirements under Schedule 2 to the AMLO and other regulatory requirements for investor protection purposes (e.g., only dealing with customers that are professional investors).

Requirement	Description
Local establishment requirement	Only Hong Kong-incorporated companies with a permanent place of business in Hong Kong will be considered for licensing by the SFC as VA Exchanges.
Responsible officer requirement	<p>A VA Exchange is required to appoint at least two responsible officers (ROs) to assume the general responsibility of ensuring compliance with AML/CTF and other regulatory requirements, and will be held personally accountable in case of contravention or non-compliance of such requirements.</p> <p>All executive directors of a licensed VA Exchange are required to be ROs.</p>
Fit and proper requirement	<p>All ROs and ultimate owners of a VA Exchange are required to satisfy a fit and proper test.</p> <p>In considering whether a person is a fit and proper person, the SFC will take into account various factors, including:</p> <ul style="list-style-type: none"> • Whether the person has been convicted, in any jurisdiction, of a money laundering or terrorist financing 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 VA Exchanges • The experience and relevant qualifications of the person • Whether the person is of good standing and financial integrity (e.g., not being the subject of any bankruptcy or liquidation proceedings) <p>Any changes to ROs or ultimate owners would also require the SFC’s prior approval.</p> <p>Certain aspects will need to be clarified during the consultation process.</p> <p>The concept of an “ultimate owner” is well-entrenched under AMLO. In relation to the money services operator licensing regime and the trust or company services provider licensing regime, an “ultimate owner” of a corporation means an individual who (i) owns or</p>

	<p>controls, directly or indirectly, including through a trust or bearer share holding, more than 25% of the issued share capital of the corporation; (ii) is, directly or indirectly, entitled to exercise or control the exercise of more than 25% of the voting rights at general meetings of the corporation; or (iii) exercises ultimate control over the management of the corporation.</p> <p>However, in respect of VATPs and other licensed financial institutions, the SFC applies a different threshold. The SFC assesses the fitness and properness of “substantial shareholders”, as defined in the SFO, which, in certain respects, is broader than the definition of “ultimate owner”.</p> <p>The threshold to identify an ultimate owner of a VASP will need to be clarified during the consultation process.</p> <p>In respect of VATPs and other licensed financial institutions, the SFC requires certain senior management functions (known as managers-in-charge) to be designated. These include functions such as risk management, finance and accounting, information and technology, and compliance. While the Consultation Paper requires licensed VASPs to have a minimum of two ROs, the Consultation Paper does not discuss whether licensed VASPs will need to designate certain individuals as managers-in-charge.</p>
<p>Licensing conditions to which VA Exchanges must comply</p>	<p>The Consultation Paper proposes empowering the SFC to impose licensing conditions on licensed VA Exchanges.</p> <p>The overarching principle is that the new regulatory framework will impose the same regulatory standards that apply to VATPs under the Opt-In Regime to VA Exchanges, thereby creating a level playing field for all market participants, whether they are VATPs or VA Exchanges.</p> <p>The Consultation Paper notes that the licensing conditions proposed are based on the licensing conditions that apply to VATPs under the Opt-In Regime.</p> <p>The SFC will publish a separate consultation to further consult on the details of these licensing conditions.</p> <p>The proposed licensing conditions for VA Exchanges include the following:</p> <p><u>Professional investors only</u>: At the initial stage, only offer services to professional investors. Broadly speaking, professional investors include 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 (around US\$1 million) or total assets of at least HK\$40 million (around US\$5.16 million), or institutional investors such as</p>

licensed banks, broker-dealers, and asset managers. The SFC will, however, continue to monitor the market and reconsider its position as the market matures.

Financial resources: A VA Exchange must have adequate financial resources for operating its virtual asset business, including a paid-up share capital of a specified amount and liquid assets, depending on the nature of its business. The minimum financial resources thresholds have not been outlined in the Consultation Paper.

Knowledge and experience: A VA Exchange must have a proper corporate governance structure staffed by personnel with the necessary knowledge and experience to enable the effective discharge of responsibility.

Soundness of the business: A VA Exchange must operate its virtual asset business in a prudent and sound manner, and ensure that client and public interests will not be adversely affected.

Risk management: A VA Exchange must have implemented appropriate risk management policies and procedures for managing money laundering/terrorist financing, cybersecurity, and other risks arising from a regulated virtual asset activity that are commensurate with the scale and complexity of the business.

Segregation and management of client assets: A VA Exchange must implement proper segregation of client assets by placing them in an associated entity, and implement adequate policies and governance procedures to ensure the proper management and custody of client assets including virtual assets.

Virtual asset listing and trading policies: A VA Exchange must implement and enforce robust rules for the listing and trading of virtual assets on its platform. VA Exchanges should also perform all reasonable due diligence on virtual assets before listing them for trading.

Financial reporting and disclosure: A VA Exchange must observe prescribed auditing and disclosure requirements, and publish audited accounts.

Prevention of market manipulative and abusive activities: A VA Exchange must 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.

	Prevention of conflicts of interest: A VA Exchange must not engage in proprietary trading or market-making activities on a proprietary basis, in order to avoid any conflicts of interests.
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Penalties and sanctions

The Consultation Paper proposes to impose criminal liability for any person operating a VA Exchange without a license, with a fine of HK\$5 million (US\$645,000) (plus additional fines for continuing breaches) and imprisonment of seven years.

Additionally, the SFC is also given a range of supervisory and intervention powers to regulate VA Exchanges. In particular, the SFC will be empowered to enter the business premises of a licensed VA Exchange to conduct routine inspections, request the production of documents and other records, impose certain restrictions, investigate non-compliances, and impose administrative sanctions.

The range of administrative sanctions includes suspension or revocation of a license, reprimands, remedial orders, and pecuniary orders. Additionally, non-compliance with the statutory AML/CTF requirements under AMLO is a criminal offence, whereby licensed VA Exchanges and their ROs are liable to a fine of HK\$1 million (around US\$129,000) and imprisonment for two years.

Broadly speaking, the powers granted to the SFC mirror the supervisory and intervention powers that the SFC currently exercises in relation to financial institutions under the SFO.

Conclusion

The new regulatory framework represents a significant development for VA Exchanges currently based in Hong Kong, or overseas VA Exchanges that provide services to persons in Hong Kong and other market participants.

VA Exchanges

VA Exchanges should start considering whether they fall within the regulatory perimeter of the new regulatory framework, and, if they will require an SFC license, whether they satisfy the requirements under the new regulatory framework to obtain a license, including the fit and proper test and AML/CTF requirements. As the new regulatory framework is still under consultation, VA Exchanges may wish to consider responding to the Consultation Paper, and should continue monitoring developments in this area, including monitoring for further guidance that the SFC may propose in relation to the licensing requirements and applicable conditions.

Retail customers of VA Exchanges

As VA Exchanges can only provide services to professional investors, Hong Kong retail customers (i.e., customers that are not professional investors) will effectively be prohibited from accessing licensed VA Exchanges' services once the new regulatory framework is in effect. If Hong Kong retail customers would like to deal in non-securities virtual assets or exit their positions in these virtual assets, once the new regulatory framework is in effect, they may need to deal through OTC virtual asset trading service providers (that could operate in Hong Kong without a license), or access the services of overseas VASPs on a reverse solicited basis. Given the significant attention on this topic since the publication of the Consultation Paper, further clarification from regulatory authorities may be required during the consultation process.

Issuers of virtual assets

The new regulatory framework does not impact the laws and regulations applicable to issuers issuing virtual assets to Hong Kong persons. Issuers of virtual assets that are securities will need to continue to comply with Hong Kong securities laws and regulations, and issuers of virtual assets that are not securities or other regulated financial products will continue to fall outside of the Hong Kong securities legal and regulatory framework. In the Consultation Paper, the FSTB explained that initial coin offerings were not included as a regulated activity under the new regulatory framework as the FSTB did not see initial coin offerings as being active in Hong Kong following repeated warnings by the SFC in the past few years.

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Endnotes

¹ In this *Client Alert*, the term virtual assets is used interchangeably with the terms cryptocurrencies, crypto-tokens, and crypto-assets.