

## Corporate Finance

### Proposed licensing regime for virtual asset service providers

#### Introduction

On 3 November 2020, the Financial Services and the Treasury Bureau (“**FSTB**”) issued a public consultation paper proposing, inter alia, a new licensing regime (“**Proposal**”) for virtual asset services providers (“**VASPs**”) in Hong Kong. The Proposal seeks to enhance anti-money laundering (“**AML**”) and counter-terrorist financing (“**CTF**”) regulation of VASPs in Hong Kong having regard to the latest standards set by the Financial Action Task Force.

The public consultation will end on 31 January 2021 and a bill to bring the Proposal into effect will likely be introduced to the Hong Kong Legislative Council in 2021.

#### Highlights

Under the Proposal, any person seeking to conduct a regulated business of virtual asset trading platforms in Hong Kong must apply for a licence from the Securities and Futures Commission (“**SFC**”) and satisfy the fit-and-proper test. Licensed VASPs will be subject to the AML/CTF requirements under Schedule 2 of the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) (“**AMLO**”) and other regulatory requirements for investor protection purposes.

#### Definitions

The business of operating a virtual asset exchange (“**VA Exchange**”) will be designated as a “regulated virtual asset activity” (“**Regulated VA Activity**”) under the AMLO. A VA Exchange will be defined as any trading platform which (i) is operated for the purpose of allowing an offer or invitation to be made to purchase or sell any virtual asset (“**VA**”) in exchange for any money or any VA and (ii) 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. VA Exchange will not cover peer-to-peer trading platforms (i.e. platforms that only provide a forum for buyers and sellers of VAs to post their offers and bids for the parties to trade at an outside venue), to the extent that the actual transactions are conducted outside the platform, and the platform is not involved in the underlying transactions by coming into possession of any money or VA.

VA will be defined as a digital representation of value which are expressed as a unit of account or a store of economic value, functions or 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. The

proposed definition covers different types of virtual assets including Bitcoin and Ether. It also includes stablecoins such as Tether that are backed by some form of assets for the purpose of stabilizing their value.

On the other hand, the proposed definition of VA does not cover the following:

1. Digital representations of fiat currencies, including digital currencies issued by central banks;
2. Financial assets such as securities and authorized structured products regulated under the Securities and Futures Ordinance (Cap. 571); or
3. Closed-loop, limited purpose items that are non-transferrable, non-exchangeable and non-fungible such as air miles, credit card rewards, gaming coins etc.

The FSTB acknowledges that VA activities conducted outside VA Exchanges are limited in Hong Kong. Thus, the licensing regime under the Proposal only applies to VA Exchanges and not to other VASP activities for the time being. The licensing regime may be expanded to include VA activities other than VA Exchanges in the future.

#### Eligibility

Any person who seeks to operate a VA Exchange in Hong Kong or market a Regulated VA Activity to the public of Hong Kong is required to be licensed by the SFC as a licensed VASP under the AMLO. The licensing requirement does not apply to VA trading platforms that have already been placed in the SFC Regulatory Sandbox (the “**opt-in scheme**”, being the SFC’s current opt-in regime that only applies to platforms that trade VAs with securities feature) as they are already regulated as a licensed corporation.

To ensure that SFC will be able to supervise the conduct of licensed VASPs and enforce regulatory requirements, only locally incorporated company with a permanent place of business in Hong Kong is eligible to apply for a licence. Natural persons or business establishment without a legal personality such as sole proprietors or partners will not be considered.

#### Licensing requirements

Applicants will have to satisfy the fit-and-proper test, which will cover all responsible officers and ultimate owners of the applicant, and any change in such relation shall be pre-approved by the SFC. The relevant considerations that the SFC will take into account when assessing whether a person is fit and proper include:

1. whether the person has been convicted of any money-laundering or terrorist financing offence, or any other offence in which the person is found to have acted fraudulently, corruptly or dishonestly;
2. whether the person has failed or may fail to observe the AML/CTF or other regulatory requirements applicable to licensed VASPs;
3. the experience and relevant qualifications of the person; and
4. whether the person is of a good standing and financial integrity, such as whether or not he is facing any bankruptcy or liquidation proceedings.

### Regulatory requirements

With reference to the opt-in scheme, the SFC is minded to impose licensing conditions and regulatory requirements covering, inter alia, the following with a view to mitigate risks posed to investors:

1. Professional investors only: licensed VASPs should only render services to professional investors at the initial stage.
2. Financial resource: Licensed VASPs should have sufficient financial resources to operate their VA business, including a paid-up share capital of a specified amount and liquid assets.
3. Knowledge and experience: Licensed VASPs and their associated entities should have a proper corporate governance structure staffed by personnel with the necessary knowledge and experience to operate the business.
4. Soundness of the business: Licensed VASPs and their associated entities should ensure their VA business is operated in a responsible and sound manner, and ensure that client and public interests will not be adversely effected.
5. Risk management: Licensed VASPs should adopt appropriate risk management policies and procedures for managing money laundering and terrorist financing, cybersecurity and other risks arising from a Regulated VA Activity.
6. Segregation and management of client assets: Licensed VASPs should segregate client assets by placing them in an associated entity, and have in place adequate policies and governance procedures for proper management and custody of client assets.

7. VA listing and trading policies: Licensed VASPs should conduct all reasonable due diligence before listing VAs for trading, and adopt robust rules for listing and trading of VAs on their platforms.
8. Financial reporting and disclosure: Licensed VASPs and their associated entities should comply with prescribed auditing and disclosure requirements and publish audited accounts.
9. Prevention of market manipulative and abusive activities: Licensed VASPs should have in place policies and controls to monitor activities on their platform(s) to identify, prevent and report any market manipulative and abusive trading activities.
10. Prevention of conflicts of interest: Licensed VASPs and their associated entities should not engage in proprietary trading or market-making activities on a proprietary basis. They should have in place suitable policies to eliminate, avoid, manage or disclose actual or potential conflicts, as well as instituting firewalls between different functions of the corporate structure to avoid conflict of interests.

Licensed VASPs which fail to comply with the AML/CTF and other regulatory requirements promulgated by the SFC will be subject to disciplinary and investigative proceedings and enforcement actions.

#### The Licensing Authority and its Powers

The SFC will be responsible for supervision of the AML/CTF conduct of licensed VASPs and enforcement of regulatory requirements, and will be vested with the following supervision and intervention powers:

1. enter business premises of licensed VASPs and their associated entities to carry out regular inspections;
2. request for documents and other records from licensed VASPs;
3. investigate non-compliances and impose administrative sanctions against non-compliance such as reprimand, order for remedial actions, civil penalty and suspension or revocation of license;
4. appoint an auditor to look into the affairs of licensed VASPs and their associated entities for suspected non-compliance;
5. apply to court for injunction order against licensed VASPs;

6. prohibit licensed VASPs and their associated entities from entering into further transactions, and/or require them to conduct their business in a specified manner;
7. restrict licensed VASPs and their associated entities from disposing of or otherwise dealing with its property, including client assets; and
8. require licensed VASPs and their associated entities to maintain their property in the prescribed manner so as to ensure that they will be able to meet their liabilities.

## Sanctions

Offence	Criminal liability
Carrying out a Regulated VA Activity without VASP license	<ul style="list-style-type: none"> <li>• A fine of HKD5,000,000, and an additional fine of HKD100,000 per day during which the offence continues</li> <li>• Imprisonment for 7 years</li> </ul>
Making false, deceptive or misleading statement in a material particular in connection with an application for licence	<ul style="list-style-type: none"> <li>• A fine of HKD1,000,000</li> <li>• Imprisonment for 2 years</li> </ul>
Non-compliance with statutory AML/CTF requirements by licensed VASP and/or its responsible officers	<ul style="list-style-type: none"> <li>• A fine of HKD1,000,000</li> <li>• Imprisonment for 2 years</li> <li>• Administrative sanctions               <ul style="list-style-type: none"> <li>○ suspension or revocation of licence;</li> <li>○ reprimand;</li> <li>○ remedial order;</li> <li>○ pecuniary penalty not exceeding HKD10,000,000 or three times the amount of the profit gained or costs avoided, whichever is greater</li> </ul> </li> </ul>
Making fraudulent or reckless misrepresentation to induce another person to acquire or dispose of a VA (whether or not within or outside a licensed VA Exchange)	<ul style="list-style-type: none"> <li>• A fine of HKD1,000,000</li> <li>• Imprisonment for 2 years</li> </ul>

## Transition period

Operators seeking to carry on the regulated activity of operating a VA Exchange will be required to have a valid licence within 180 days upon commencement of operation of the licensing regime.

## **Conclusion**

The Proposal, when introduced, will be a major development in Hong Kong's VA regulation, which will have a significant impact on the VA industry in Hong Kong. We will keep you updated of any future development in this regard.

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**Important:** The law and procedure on this subject are very specialised and complicated. This article is just a very general outline for reference and cannot be relied upon as legal advice in any individual case. If any advice or assistance is needed, please contact our solicitors.

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