

The upcoming virtual assets service provider regime for Hong Kong

July 2022

Introduction

On 24 June 2022, the Hong Kong SAR Government published in the Gazette the Anti-Money Laundering and Counter-Terrorist Financing (Amendment) Bill 2022 (the '**Amendment Bill**'). To combat emerging money laundering and terrorist financing ('**ML/TF**') risks posed by the increasing adoption of virtual assets ('**VA**'), one of the main focuses of the Amendment Bill is to introduce a new licensing regime ('**VASP Licensing Regime**') for virtual asset service providers ('**VASPs**'). In this article, we undertake a review of the VASP Licensing Regime and share some of our insights on its potential impact on the VA market and its participants in Hong Kong.

Scope of the VASP Licensing Regime

VA activities that fall into the scope

Under the new VASP Licensing Regime, any person seeking to operate a VA exchange is required to apply for a licence ('**VASP Licence**') from the Securities and Futures Commission ('**SFC**').

'Operating a VA Exchange' is defined as the provision of services through means of electronic facilities,

(a) whereby -

- (i) offers to sell or purchase VAs are regularly made or accepted in a way that forms or results in a binding transaction; or
- (ii) persons are regularly introduced, or identified to other persons in order that they may negotiate or conclude, or with the reasonable expectation that they will negotiate or conclude sales or purchases of virtual assets in a way that forms or results in a binding transaction; and

(b) where client money or client virtual assets comes into direct or indirect possession of the person providing such service.

While it would seem that centralised exchange services would be clearly captured by the first limb of the definition, there appears to be some ambiguity around peer-to-peer trading ('**P2P**').

Where a centralised exchange ('**CEX**') facilitates a P2P transaction, the second limb of definition (a) would still be applicable as the two parties are 'regularly introduced or identified' to each other for the purpose of negotiating or concluding the transaction. Also, if the CEX holds client assets in escrow for a period of time, paragraph (b) would be clearly applicable, in which case, the platform would still be caught by the definition of 'Operating a VA Exchange').

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Decentralised exchanges ('DEX') that facilitate P2P transactions may, however, still be caught by the definition because they would be providing a platform (it is rare for transfers to take place between two unhosted wallets whose users are acting on their own behalf), and they often take a fee from the participants using the DEX's native token (which could satisfy paragraph (b) of the definition). In practice, our view is that it would be rare for any DEX to be able to host a pure P2P transaction – for example, it would still be possible for DEX's or aggregators to be considered a centralised party that can be identified with a Decentralised Finance ('DeFi') application.

In our view, clarity is needed around the mechanism for introducing/identifying the participants to each other (second limb of para (a)), and the concept of client moneys or VAs coming into the direct or indirect possession of the service provider. What is clear, however, is that activities such as providing for redemptions and subscriptions (whether in fiat or in VA) as part of the management of a VA fund, or carrying on VA trading activities, will not be considered as 'Operating a VA Exchange'.

VAs that fall into the scope

Consistent with the definition adopted by the Financial Action Task Force ('FATF'), the Amendment Bill defines VA as a digital representation of value that (a) is expressed as a unit of account or a store of economic value, (b) (i) functions (or is intended to function) as a medium of exchange accepted by the public (1) as payment for goods or services or (2) for the discharge of a debt or (3) for investment purposes; or (ii) provides rights, eligibility or access to vote on the management, administration or governance of any cryptographically secured digital representation of value, and (c) can be transferred, stored or traded electronically.

The Amendment Bill has expressly excluded from the definition of VA, a digital representation of value that (i) is issued by central banks, (ii) constitutes securities or a futures contract which are already regulated under the Securities & Futures Ordinance ('SFO'), (iii) constitutes a stored value facility or (iv) is a limited purpose digital token. In the Consultation Conclusions¹ published by the Financial Services and the Treasury Bureau (the 'FSTB'), examples of limited purpose items that are excluded from the definition of VA, are assets that are non-transferable, non-exchangeable and non-fungible in nature. The Amendment Bill ties in with those examples by laying out the three types of limited purpose digital tokens: (i) customer loyalty or reward points, (ii) in-game assets or (iii) tokens similar to customer loyalty or reward points or in-game assets and that are not intended to be convertible into money or another medium of exchange accepted by the public.

Based on the above definition of VA and carve-outs in the Amendment Bill, it is likely that the following categories of VAs will fall into the regulatory net of the VASP Licensing Regime:

| Categories | Examples |
|--|----------------------------------|
| Payment tokens | Bitcoin, Ripple, Monero |
| Infrastructure tokens | Ethereum, Algorand, Cardano |
| Service tokens | Chainlink, Filecoin |
| Exchange and financial tokens | Binance Coin, FTX Coin, Compound |
| Stablecoins | Tether, USD Coin, Dai |
| Decentralised autonomous organisation ('DAO') tokens | MKR Token, ApeCoin, Dash |

The Amendment Bill, however, has left some ambiguity as to whether some trending VAs such as non-fungible tokens ('NFT') and Metaverse tokens would be subject to the VASP Licensing Regime. For example, a digital artwork which takes the form of an NFT, despite being non-fungible, would usually be transferable and traded electronically in secondary markets. Certain NFTs also grant their owners rights and access to vote on the governance of the NFT community. It is also uncertain whether Metaverse tokens that are used as an in-game currency for purchasing goods and services in the Metaverse, can fall squarely within the exemption of being 'a limited purpose token' since they can also be monetised and traded on a VA exchange.

¹ The FSTB had conducted public consultations on its proposal to amend the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) from November 2020 to January 2021, and had published its conclusions in May 2021. See https://www.fstb.gov.hk/fsb/en/publication/consult/doc/consult_conclu_amlo_e.pdf.

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In view of the changing landscape of the VA economy, the Amendment Bill has built in flexibility for the FSTB to expand the definition of a VA and the forms of VA activities to be covered under the VASP Licensing Regime where the need arises in the future. What is clear, however, is that once the VASP Licensing Regime becomes effective, many market participants, managers, operators, etc. will need to seek legal advice as to the exact scope and applicability of the regime, and whether they or their proposed activities are captured by the legislation.

Eligibility and regulatory requirements

Similar to the existing licensing regime for carrying out regulated activity under the SFO, the VASP Licensing Regime also imposes certain base-line requirements on potential applicants, including the following:

- Sufficient presence in Hong Kong**
 - To ensure proper governance and continuity, only companies with sufficient nexus to Hong Kong will be permitted to apply for a VASP Licence. Only locally incorporated companies with a permanent place of business in Hong Kong and non-Hong Kong companies that are registered under the Companies Ordinance (Cap. 622) are eligible to be granted a VASP licence.
- Fit-and-proper test:**
 - Applicants will need to satisfy the fit-and-proper test which is also applicable to the applicants' ROs, each of the applicants' directors and their ultimate owner.
 - In determining whether a person is fit and proper, the SFC will take into account, among other considerations, (a) the financial status of the person, (b) the person's ability to provide the VA service, (c) the person's reputation, (d) whether the person has been convicted anywhere of an ML/TF offence or other offences in which the person is found to have acted fraudulently, corruptly or dishonestly and (e) whether the person has failed or may fail to observe the AML/CTF or other regulatory requirements applicable to licensed VASPs.
- Responsible Officers ('RO'):**
 - The applicant will also need to appoint at least two ROs approved by the SFC to assume the general responsibility of ensuring compliance with the AML/CFT requirements and other regulatory requirements, with at least one of them ordinarily residing in Hong Kong. The ROs will be held personally accountable for non-compliance.
 - At least one of the ROs must act as an executive director of the applicant.

Regulatory requirements

Licensed VASPs are subject to the following regulatory requirements:

- AML/CTF requirements**
 - A licensed VASP will be considered to be a financial institution and will be required to observe AML/CTF requirements, including baseline customer due diligence requirements according to Schedule 2 of the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615).
- Provision of services to Professional investors only:**
 - At the initial stage, a licensed VASP can only offer services to professional investors².
- Licence Conditions:**
 - On granting a VASP licence, the SFC may impose on the licence any conditions, including but not limited to (a) financial resources, (b) knowledge and experience, (c) risk management policies and procedures, (d) AML/CTF policies and procedures, (e) management of client assets, (f) soundness of business, (g) financial reporting and disclosure, (h) VA listing and trading policies, (i) prevention of market manipulation and abusive activities, (j) avoidance of conflicts of interests, (k) keeping of records and accounts and (l) cybersecurity.

² "Professional investors" include (1) institutional professional investors which fall under paragraphs (a) to (i) of the definition of "professional investor" in section 1 of Part 1 of Schedule 1 to the SFO; (2) corporate professional investors which fall under sections 4, 6 and 7 of the Securities and Futures (Professional Investor) Rules (Cap. 571D), including (a) trust corporations with total assets of not less than HKD40 million or its foreign currency equivalent, (b) corporations and (c) partnerships, which have a portfolio of at least HKD8 million or its foreign currency equivalent or total assets of at least HKD40 million or its foreign currency equivalent; and (3) individual professional investors who have a portfolio of at least HKD8 million or its foreign currency equivalent.

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Comparison with the existing opt-in regime

As compared to the 'opt-in regime' announced by the SFC back in late 2019³, the Amendment Bill does not set out specific details for each licence condition. For example, the '*Terms and Conditions for Virtual Asset Trading Platform Operators*' under the opt-in regime have specified clear restrictions in relation to custody of client assets (e.g. 98% cold storage requirement), whereas these particularised restrictions are not included in the Amendment Bill. Nevertheless, as the Amendment Bill empowers the SFC to impose on each VASP licence conditions in areas largely similar to that in the opt-in regime (e.g. financial soundness and cybersecurity), and it was expressly stated in the legislative brief for the Amendment Bill⁴ that the SFC is empowered to impose licence conditions 'with reference to the opt-in regime', applicants for VASP licences can expect licence conditions under the VASP Licensing Regime to be substantially similar to the ones under the opt-in regime.

Professional investors only

While there are voices in the market that support the opening of the VASP Licensing Regime for licensed VASPs to offer services to retail investors as well, we note that the SFC/FSTB has taken the conservative approach to limiting the offering of services to professional investors only. Notably, as VA holdings do not count towards the portfolio required for individual investors to qualify as a 'professional investor'⁵, licensed VASPs will not be allowed to provide services to investors who only hold VAs (but not securities or bank deposits) in the equivalent amount that meet the portfolio threshold for 'professional investors'.

Nevertheless, the regulators have emphasised that while the restriction is necessary for the initial stage of the VASP Licensing Regime, they will continue to review their position as the market becomes more mature going forward.

Restricted marketing activities

Any person, who is not a licensed VASP, is prohibited from actively marketing, whether in Hong Kong or elsewhere, to the public of Hong Kong, the services associated with a VA exchange that are not licensed in Hong Kong, including the services of an overseas VA exchange.

The SFC has provided examples to explain the meaning of 'actively markets' in the context of the SFO, which include making frequent calls to Hong Kong investors for marketing one's services and offering products, running a mass media programme that targets at the investing public in Hong Kong and internet activities targeting Hong Kong investors. In determining whether or not a person 'actively markets' its services to the public, the SFC will also consider the nature of the business activities as a whole and take into account a number of factors, including but not limited to:

- the existence of a detailed marketing plan;
- whether the services are packaged to target public in Hong Kong (e.g. denominated in Hong Kong dollars and written in Chinese); and
- whether the services are sought out by the customers on their own initiative⁶.

The fact that there have been actual sales made is also evidence of active marketing, according to a court decision on this issue⁷.

³ The opt-in regime was opened to VA trading platforms that have at least one VA traded on such platforms falling within the definition of "Securities" under the SFO. See <https://www.sfc.hk/-/media/EN/files/ER/PDF/20191106-Position-Paper-and-Appendix-1-to-Position-Paper-Eng.pdf>.

⁴ See <https://www.legco.gov.hk/yr2022/english/panels/fa/papers/fa20220207cb1-32-2-e.pdf>.

⁵ Under the Securities and Futures (Professional Investor) Rules (Cap. 571D), "portfolio" means a portfolio comprising any of the following – (a) securities; (b) a certificate of deposit issued by (i) an authorised financial institution; or (ii) a bank which is not an authorised financial institution but is regulated under the law of any place outside Hong Kong; (c) in relation to an individual, corporation or partnership, money held by a custodian for the individual, corporation or partnership.

⁶ SFC FAQ, "Actively markets" under section 115 of the SFO, see <https://www.sfc.hk/en/faqs/intermediaries/licensing/Actively-markets-under-section-115-of-the-SFO#9CAC2C2643CF41458CEDA9882E56E25B>.

⁷ *Ng Chiu Mui & Anor v Securities and Futures Commission* [2010] 4 HKC 528.

Statutory powers

The Amendment Bill has granted the SFC broad supervisory powers for overseeing the conduct of licensed VASPs. These powers are substantially the same as SFC's powers in relation to supervising licensed corporations, including:

- Power to enter business premises of the licensed VASP and its associated entities for conducting routine;
- Power to request for documents and other records;
- Power to investigate non-compliances and to impose administrative sanctions (including reprimand, order for remedial actions, civil penalty, and suspension or revocation of licence) against non-compliances;
- Power to appoint an auditor to examine and audit accounts and records of the licensed VASP; and
- Power to prohibit further transactions and restrict the licensed VASP from dealing with or disposing of the relevant property in case of misconduct.

Transition period and exemption

It is proposed that the Amendment Bill will come into effect on 1 March 2023 (the '**Effective Date**'). Transitional arrangements are available to corporations in two scenarios:

- First, corporations that have been providing a VA service (i.e. operating a VA exchange) in Hong Kong immediately before the Effective Date and that continue providing such service during the first 12 months commencing from the Effective Date. These corporations will not be deemed in breach of the new regulatory regime.
- Second, corporations that have been providing a VA service in Hong Kong immediately before the Effective Date and that have made an application for a VASP licence within the first nine months commencing from the Effective Date will be deemed licensed VASPs pending SFC's determination of their licence applications.

Except for VA exchanges that are already regulated as licensed corporations under the opt-in regime (as mentioned above and that are being supervised by the SFC), the Amendment Bill does not provide for other exemptions in respect of the VASP licensing requirements.

What it means for market participants?

The VASP Licensing Regime certainly represents a concrete step by the Hong Kong regulatory authorities in 'closing the loop' on VA by bringing exchange related activity under the remit of the SFC. We expect further expansionary steps to be taken in the future until the SFC has comprehensive jurisdiction over all VA related activities.

It is a significant development because for the first time, the SFC is seeking to extend its governance directly over VA (including any type of VA that would not typically be caught by the definition of a 'security'). This can be contrasted to the existing regime, where the SFC's starting point is that if an asset is not a 'security', it has no jurisdiction, but in certain limited circumstances, its remit may be extended piecemeal either by way of participants opting-in (for example, under the Type 1 and 7 licence applications for VA exchanges who first list at least one security token), or through extension of existing powers (for example, Type 9 asset managers who want to manage more than 10% of their AUM in VA).

Some of the key takeaways we have identified from the above are as follows:

- For VA exchanges which are looking to enter into the Hong Kong market, applications for a VASP licence should be made as soon as possible in order for them to take advantage of the transitional arrangements as detailed above.
- Applicants should be prepared to answer initial questions in the application process for a VASP licence which, from our experience dealing with the SFC on other VA related licence applications or uplifts (for example, the Type 9 VA licence), would require the applicant to be geared up for an institutional level build-out – so at a minimum, applicants need to be prepared to answer questions in relation to things such as custody arrangements, insurance, cybersecurity protocols, IT infrastructure, wallet management, wallet transfer protocols, risk management processes, personnel / service providers supporting functions such as compliance, legal, accounting, administration, anti-market manipulation and AML/KYC procedures. We expect the SFC to quite quickly turn down applicants who are either unable to make sufficient rectifications on deficiencies identified by the SFC while processing the applications, or who do not have a reasonable prospect of complying with the relevant regulatory requirements.

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- For existing VA exchanges operating in Hong Kong, steps should be taken to off-board, in an orderly manner, any retail customers, given the VASP Licensing Regime restricts the offering of services to professional investors only.
- For overseas VA exchanges, steps should be taken to assess the existing marketing and distribution channels to Hong Kong persons. It is important to consider and obtain advice on whether certain marketing efforts (e.g. in-app/website advertisements that target users in Hong Kong) may breach the prohibition from actively marketing an overseas VA exchange as provided in the Amendment Bill.

One of the biggest drawbacks we have observed from the VASP Licensing Regime is, of course, the restriction on licensees to serve retail customers. Given that a large part of the economic incentive from operating a VA exchange comes from the retail segment, we see that this would dissuade many participants from applying. In addition, from our experience with dealing with the SFC on other similar VA-related licences, the regulator's expectations (in terms of the level of sophistication of the applicant and the build-out of its infrastructure) and the ongoing cost of compliance, would set a very high bar for entry. Nevertheless, it is good to see that there is sufficient flexibility built into the regime, such that at a later date, and perhaps when the regulator is more comfortable with the regime's operation, there may be scope for allowing services to be offered to retail customers. The future is certainly bright for the VA market in Hong Kong – and we look forward to further regulatory development/innovation in this space.

Let's talk

For a deeper discussion of how this impacts your business, please contact us.

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