

CLIENT ALERT: 8 July 2022

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RE: AMENDMENT BILL ON NEW VIRTUAL ASSETS SERVICES PROVIDERS LICENSING REGIME

BACKGROUND & OVERVIEW

The Anti-Money Laundering and Counter-Terrorist Financing (Amendment) Bill 2022 (the “**Amendment Bill**”) with respect to, amongst other things, the introduction of a licensing regime for virtual asset services providers (“**VASPs**”), was gazette on 24 June 2022.

The Amendment Bill is primarily based on the consultation conclusions (the “**Consultation Conclusions**”) published by the Financial Services and the Treasury Bureau (the “**FSTB**”) in May 2021¹ but with significant refinements. As expected, the Securities and Futures Commission (the “**SFC**”) will be the statutory body to administer this VASP licensing regime and is given wide powers for licensing, supervising, and imposing sanctions under the Amendment Bill. At the initial stage, VASPs will be permitted to provide services to professional investors² only.

Definition of Virtual Asset (“VA”)

“Virtual Asset”³ under the Amendment Bill is defined as:

- (a) a cryptographically secured digital representation of value that –
 - (i) is expressed as a unit of account or a store of economic value;
 - (ii) either:
 - (A) is used, or is intended to be used, as a medium of exchange accepted by the public, for any one or more of the following purposes –
 - (I) payment for goods or services;
 - (II) discharge of a debt;
 - (III) investment purposes; or
 - (B) 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;
 - (iii) can be transferred, stored or trade electronically; and
 - (iv) satisfies other characteristics prescribed by the SFC by notice published in the Gazette; or
- (b) a digital representation of value prescribed as a virtual asset by the Secretary for Financial Services and the Treasury by notice published in the Gazette.

VA does not cover (i) digital representation of fiat issued by the central bank; (ii) a limited purpose digital token (e.g. air miles, credit card rewards, gift cards, customer loyalty programmes and

¹ See “Public Consultation on Legislative Proposals to Enhance Anti-Money Laundering and Counter-Terrorist Financing Regulation in Hong Kong: Consultation Conclusions” (May 2021), FSTB.

² As specified in Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap 571) (the “**SFO**”). The “professional investor-only” restriction will be imposed as a regulatory requirement made by the SFC with the power given in the Amendment Bill. See paragraphs 6 and 15 of the Legislative Council Brief File Ref.: R&M/4/1/41C.

³ See Section 53ZRA(1) of the Amendment Bill.

gaming coins); (iii) securities or futures contracts;⁴ (iv) deposits in stored value facilities;⁵ (v) a digital representation of value prescribed by the SFC not having the characteristics as a VA by notice published in the Gazette; and (vi) a digital representation of value prescribed not as a VA by the Secretary for Financial Services and the Treasury (the “**FSTB Secretary**”) by notice published in the Gazette.⁶

The broad and expansive definition of VA covers a wide range of VAs, regardless of whether they are “securities” or not under the SFO, which would include “virtual commodities”, e.g. Bitcoins and Ethereum. It would be interesting to see whether non-fungible tokens (“**NFTs**”) are included, as some of them may arguably be considered as “a store of economic value” or “a medium of exchange”.

An additional limb to the definition of VA (see (a)(ii)(B) above) which was not included in the definition in the Consultation Conclusions previously appears to be targeting the so-called “governance tokens”. It seems that the tokens issued for decentralized autonomous organization (“**DAO**”) will likely fall under this definition and therefore shall be subject to this Amendment Bill. Whether this is really the intention of this Amendment Bill remains to be seen, as no explanation has been provided by the Government as to why this additional limb of (a)(ii)(B) has been added.

Moreover, the FSTB Secretary has the power to designate a particular asset to be or not to be VA by way of notice published in the Gazette.⁷ The SFC also has the similar power to prescribe what characteristics would render a digital representation of value included in or excluded from the definition of VA.⁸ It seems that the discretionary power given to the FSTB Secretary is intended to target specific individual VA and is more likely to be exercised on a case-by-case basis, whilst the characteristics prescribed by the SFC will likely become a benchmark for token issuers, intermediaries and other interested parties to consider other existing or future VAs to be developed.

VA Service and VA Exchange

A VASP licence is required from the SFC to carry out any VA service. Currently, the only VA service required to be licensed under the Amendment Bill is “operating a VA exchange” but it can be varied in the future to cover other services.⁹

“Operating a VA exchange”¹⁰ is defined as providing services through means of electronic facilities

–
(a) whereby –

⁴ The terms “securities” and “futures contracts” are defined in section 1 of Part 1 of Schedule 1 to the SFO.

⁵ As defined in the Payment Systems and Stored Value Facilities Ordinance (Chapter 584 of the Laws of Hong Kong).

⁶ See Section 53ZRA(2) of the Amendment Bill.

⁷ See Section 53ZRA (4) of the Amendment Bill.

⁸ See Section 53ZRA (3) of the Amendment Bill.

⁹ The Amendment Bill provides for the meaning of VA service to be varied by the FSTB Secretary by subsidiary legislation, e.g. over-the-counter trade and peer-to-peer trading platforms.

¹⁰ See Schedule 3B Part 1 of the Amendment Bill.

- (i) offers to sell or purchase virtual assets 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.

Although the Consultation Conclusions previously stated that the proposed VASP licensing regime would target centralized VA exchanges only, the definition of “operating a VA exchange” in the Amendment Bill may potentially include certain decentralized exchanges, as decentralized exchange may require some degree of support from a dedicated development team to maintain and upgrade the system in which they may also receive certain rewards or benefits. Arguably, such a decentralized exchange may be regarded as having “indirect possession” of client money or client VAs. It is therefore very important to carefully analyze the structure of the crypto-exchange to assess whether it may potentially fall within the definition of a VA exchange.

Licensing and Sanction

Only companies incorporated in Hong Kong and foreign companies registered in Hong Kong are eligible to apply for a VASP licence from the SFC.¹¹ For any applicant of VASP licence, it must have at least two responsible officers to overlook the operation and compliance of the VA exchange. The applicant and its responsible officers, directors and ultimate owners¹² will be subject to fit and proper test and a robust set of regulatory requirements to be imposed as licence conditions by the SFC. We expect the application requirements and the compliance standard of the proposed VASP licensing regime will be very similar to the current SFC voluntary opt-in regulatory regime of VA platform operator which requires application for licences for both Type 1 (dealing in securities) and Type 7 (providing automated trading services) regulated activities.¹³

To effectively supervise the VASP licensing regime, the SFC is given the wide powers (i) to enter business premises of the licensed VASP and its associated entities for conducting routine inspections; (ii) to request the production of documents and records; (iii) to investigate non-compliances; and (iv) to impose disciplinary sanctions (including reprimand, order for remedial actions, civil penalty and suspension or revocation of licence).

Under the Amendment Bill, unlicensed operation of a VA exchange in Hong Kong, actively marketing the services of a VA exchange to the public of Hong Kong (whether from Hong Kong or elsewhere) without the VASP licence and application for a VASP licence with a false or misleading statement are all punishable offences subject to different levels of penalties and imprisonment.

¹¹ See Section 53ZRK(3)(a) of the Amendment Bill.

¹² “Ultimate owner” is defined in Section 53ZR of the Amendment Bill as an individual who: (i) directly or indirectly owns more than 25% of the issued share capital of the corporation; (ii) is directly or indirectly entitled to exercise more than 25% of the voting rights at general meetings of the corporation; or (iii) exercises ultimate control over the management of the corporation.

¹³ See SFC Position Paper: Regulation of virtual asset trading platform dated 6 November 2019.

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Furthermore, fraudulent or deceptive acts in transactions involving VAs¹⁴ and fraudulently or recklessly inducing others to invest in VAs¹⁵ would also constitute offences and would be liable for a fine and/or imprisonment.

Timeline and Transitional Period

The Amendment Bill was tabled for first reading in the Legislative Council on 6 July 2022 and is expected to become effective on 1 March 2023 (the “**Effective Date**”). For existing VA exchange operators which are carrying on the business of offering VA service immediately prior to the Effective Date, there will be a transitional period of twelve months (i.e. until 29 February 2024). Additionally, an existing VA exchange operator which (i) makes a licence application to the SFC within nine months (i.e. before 1 December 2023) after the commencement of the new licensing regime and (ii) agrees to comply with the relevant regulatory requirements applicable to a licensed VASP will be deemed to be licensed to provide VA service until the determination of its licence application.

OUR OBSERVATION

As admitted by the Hong Kong Government, the proposed VASP regulatory regime is more rigorous and comprehensive than similar regimes in Singapore, UK and Japan.¹⁶ This may be because the government considers Hong Kong as a leading international financial centre with advanced development and adoption of VAs, such regulatory approach is more in line with the needs and situation of Hong Kong, particularly in light of the global development of the VA market. For those who are interested in operating a VA exchange in Hong Kong, commencing the business prior to the Effective Date may help to demonstrate the operational capability and competency in compliance, which will likely facilitate its application for the VASP licence with the SFC.

We have assisted a number of clients with existing SFC licences in expanding their businesses involving VAs. Should you have any queries, please do not hesitate to reach out to a member of us to discuss further at hyu@lylawoffice.com or at +852 2115 9525.

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¹⁴ See Section 53ZRF of the Amendment Bill.

¹⁵ See Section 53ZRG of the Amendment Bill.

¹⁶ See Para 6 of the LegCo Brief.