

Crypto Regulation in Hong Kong

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Overview of Crypto Regulation in Hong Kong

Hong Kong regulates entities conducting activities in cryptocurrencies where the relevant cryptocurrencies are “securities” or “futures contracts” as defined in Hong Kong’s Securities and Futures Ordinance (**SFO**). Intermediaries conducting regulated activities in relation to cryptocurrencies that are securities or futures contracts are required to be licensed or registered by Hong Kong’s Securities and Futures Commission (**SFC**) and must comply with the anti-money laundering (**AML**) and counter-terrorist financing (**CTF**) requirements of Hong Kong’s Anti-Money Laundering and Counter-Terrorist Financing Ordinance (the **AMLO**). However, the vast majority of cryptocurrencies (such as Bitcoin) are not securities. The SFC has however imposed specific regulatory requirements on fund managers and managers of discretionary investment portfolios which invest in cryptocurrencies which are not securities in addition to traditional securities. Similar requirements apply to distributors of cryptofunds even where the funds only invest in cryptocurrencies that are not securities or futures contracts. Operators of exchanges which trade cryptocurrencies are currently only required to be licensed by the SFC where the exchange trades at least one cryptocurrency that is a security. Licensed exchanges are subject to stringent licensing conditions.

Cryptocurrencies are also not regulated by Hong Kong’s other financial regulators. The Hong Kong Monetary Authority (**HKMA**) has said that it does not regulate cryptocurrencies such as Bitcoin which it regards as a virtual “commodity” and not as legal tender, or a means of payment or money.¹ Hong Kong’s banking laws and regulations therefore do not apply to entities accepting or dealing in cryptocurrencies.

The Money Service Supervision Bureau of the Customs and Excise Department has also said that Bitcoin and other similar virtual commodities are not money for the purposes of the AMLO, and are thus outside the scope of its regulatory regime for money service operators.²

However, on 3 November 2020, Hong Kong’s Financial Services and Treasury Bureau (the **FSTB**) published a consultation on proposals to introduce a new licensing regime under the AMLO for virtual asset exchanges that are not required to be licensed under the SFO because they only trade cryptocurrencies that are *not* securities or futures contracts. The proposals will require virtual asset exchanges to be licensed by the SFC and comply with the AML and CTF obligations set out in Schedule 2 to the AMLO and the SFC will monitor and enforce compliance with these obligations. Exchanges will also be subject to stringent licensing conditions which will be broadly the same as those imposed on exchanges licensed under the SFO in order to create a level playing field. If implemented, the new regime will fulfil FATF’s requirements for virtual asset exchanges. Hong Kong is not however considering regulating other entities within the FATF’s definition of virtual asset service providers or VASPs at this stage, such as certain types of wallet providers.

¹ HKMA. Press release “*The HKMA reminds the public to be aware of the risks associated with Bitcoin*”. 11 February 2015.

² Money Service Supervision Bureau. Customs and Excise Department. “*Statement in relation to “Bitcoin and Money Service Operator Licence*”. August 2014.

For the purposes of this note, the terms “cryptocurrency” and “virtual asset” are used interchangeably.

1. REGULATORY STATUS OF CRYPTOCURRENCIES

Hong Kong’s regulators generally consider cryptocurrencies such as Bitcoin and Ether to be “virtual commodities” which are not regulated in Hong Kong. However, as noted in its September 2017 [Statement on initial coin offerings](#),³ the SFC determines the regulatory status of cryptocurrencies on a case-by-case basis depending on whether they carry rights equivalent to traditional securities, for example if:

- i. they carry rights similar to those provided by shares, such as a right to a portion of the issuing company’s profits or surplus assets on winding up;
- ii. they have rights similar to debentures such as a right to repayment of the purchase price; or
- iii. they are similar in nature to an interest in a Collective Investment Scheme (or **CIS**) where the purchase price will be invested in assets or projects and any return will be distributed to the holders.

Very few cryptocurrencies have features similar to shares or debentures.

There is a question mark as to whether cryptocurrencies could be considered to be interests in a CIS, particularly given the lack of Hong Kong case law on the SFO’s definition of a “collective investment scheme”. The essential features of a CIS under the SFO are that:

- i. it must involve an arrangement in respect of property (property is broadly defined);
- ii. the participants do not have day-to-day control over the management of the property (even if they have the right to be consulted or to give directions about the management of the property);
- iii. the property must be managed as a whole by or on behalf of the person operating the arrangements, and/or the participants’ contributions and the profits or income are pooled; and
- iv. the purpose of the arrangement should be to provide participants with profits, income or other returns from the acquisition or management of the property.

There have been no court decisions on the meaning of “collective investment scheme” in Hong Kong and whether or not any particular ICO falls within the definition will depend on the facts and circumstances of the ICO and ultimately, the courts’ interpretation of the statutory definition.

³ SFC. “[Statement on Initial Coin Offerings](#)”. 5 September 2017

1.1 ICOs

Most ICOs in Hong Kong, as elsewhere, have typically been structured as offers of “utility tokens”, (tokens which give holders rights to access a product or service provided by the platform either now or in the future) which the SFC’s February 2018 statement⁴ suggested are outside the scope of Hong Kong’s securities legislation. The SFC noted that ICO issuers it had contacted either confirmed that their tokens did not constitute securities or ceased to offer tokens in Hong Kong. Similarly, crypto exchanges contacted by the SFC reportedly also confirmed that they only trade non-security tokens or ceased to sell tokens which could be securities. The SFC has not published the names of the relevant ICO issuers or provided any further guidance on the features of an ICO token which are likely to render it a security.

Despite writing to a number of ICO issuers asking for confirmation that their ICO tokens were not securities, the SFC has only put a stop to one ICO – Black Cell Technology’s ICO in March 2018 on the basis that the offering may have been a collective investment scheme.⁵ However, this was an extreme case since the tokens sold in the ICO were redeemable for equity shares in the ICO issuer, Black Cell. The SFC’s regulatory action resulted from concerns that Black Cell had engaged in potential unauthorised advertising activities in contravention of Section 103 of the SFO and may have breached the SFO’s licensing requirements, although it did not specify which regulated activity was involved. Black Cell stopped ICO transactions with Hong Kong investors and undertook not to establish or market any CIS except in compliance with the SFO.

While Hong Kong saw a number of ICOs in 2017 and 2018, ICO activity in Hong Kong has virtually ceased in 2019 and 2020 following repeated warnings from the SFC. The lack of activity may also be due to the lack of clarity as to the features of an ICO token which would bring it within the definition of a security, which is also true in many other jurisdictions.

1.2 Securities Token Offerings (STOs)

STOs emerged in 2017 (with two STOs raising collectively US\$22 million) and began to pick up in 2018 (with a total of 28 STOs raising US\$442 million) and 55 in 2019 (raising US\$452 million). Security tokens were then heralded in some quarters as the “next big megatrend” in the blockchain revolution, however this is yet to materialise, with some citing the lack of a secondary market for tokenised securities, an undeveloped regulatory environment and high upfront costs.⁶ However, there has been steady growth. The value of the STO market is expected to grow from US\$983 million in 2018 to US\$2.6 billion by 2023, particularly in view of the institutionalisation of the digital asset ecosystem.⁷

⁴ SFC. “[SFC warns of cryptocurrency risks](#)”. 9 February 2018

⁵ SFC. “[SFC’s regulatory action halts ICO to Hong Kong public](#)”. 19 March 2018

⁶ Cointelegraph. “What’s happened with the so-called next big thing in fintech?” 13 July 2020. Available at: <https://cointelegraph.com/news/sto-whats-happened-with-the-so-called-next-big-thing-in-fintech>

⁷ <https://www.lcx.com/sto-market-size-the-state-of-the-industry-of-tokenization-and-security-token-offerings/>

STOs can be differentiated from ICOs however as while ICOs sought to position themselves outside the securities regulatory framework, STOs are being used in some jurisdictions, notably the US, to bring crypto assets within the regulatory net as a means to achieve regulatory certainty, which means greater certainty for fundraisers and investors alike. Despite this, STOs have not been popular in Hong Kong as yet as it is still very uncertain how the Hong Kong regulatory framework applies to security token offerings, and more fundamentally, as to the characteristics which make a cryptocurrency a security token in the first place.

(a) SFC Statement on Security Token Offerings

The SFC issued a [Statement on Security Token Offerings](#)⁸ (or **STOs**) on 28 March 2019 setting out the regulatory requirements applicable to STOs and reiterating the SFC's earlier warnings to the public of the potential risks involved in investing in digital assets.

What does the SFC consider to be a security token?

The SFC describes security tokens as digital assets which have the features of traditional securities, including tokens which represent economic rights such as a share of profits or revenue. Thus, tokens which are essentially tokenised shares (e.g., entitling holders to a share of profits in the form of a dividend or to participate in the distribution of the issuer's assets on winding up) will be a security token, and thus a security under Hong Kong law. Similarly, a token which has the features of a debt or liability owed by the issuer, will likely be a "debenture" for the purposes of Hong Kong's securities laws.

According to the SFC's March 2019 statement, a token representing ownership of assets, such as gold or real estate, would also amount to a security token, although the SFC does not elaborate on why this should be the case. The SFC may be alluding to what is essentially a tokenised real estate or gold fund - where money raised from a token offering is invested in gold or real estate on the understanding that token holders will receive a share of the future proceeds of sale of the gold/real estate when sold at a profit. In that case, the tokens would likely constitute securities as interests in a collective investment scheme under the SFO.

Alternatively, the SFC could be suggesting that tokens whose value/price is linked to the value/price of an underlying commodity such as gold or real property constitute either "regulated investment agreements" or "structured products" under the SFO definitions.

Structured products

Structured products are defined broadly and include any product where all or part of the return or amount due (or both), or the settlement method, is determined by reference to any one or more of:

⁸ SFC. Statement on Security Token Offerings. 28 March 2019. Available at: <https://www.sfc.hk/en/News-and-announcements/Policy-statements-and-announcements/Statement-on-Security-Token-Offerings>

- i. changes in the price, value or level (or within a range) of securities, commodities, indices, property, interest rates, currency exchange rates or futures contracts, or any combination or basket of any of these; or
- ii. the occurrence or non-occurrence of any specified event(s) other than an event relating only to the issuer and/or the guarantor of the product.

The SFC's March 2019 statement suggests that, depending on how the tokens are structured, tokens representing an underlying asset could constitute structured products subject to Hong Kong's securities laws. There has been no official guidance from the SFC on how it would regard stablecoins that are pegged to the price of assets such as gold or fiat currencies whose value may appreciate or not. Unlike jurisdictions such as the US, Hong Kong does not regulate commodities such as gold. It would therefore be illogical for a token representing a commodity, which is more akin to a deposit slip than a security, to be regarded as a security subject to Hong Kong's securities regulatory regime. The Financial Services and Treasury Bureau's (the **FSTB**) November 2020 Consultation Paper proposing a licensing regime for exchanges trading non-security cryptocurrencies confirmed that cryptocurrencies that are backed by assets for the purpose of stabilising their value are virtual assets for the purposes of the proposed new licensing regime. Thus, an exchange trading stablecoins which are not securities will need to be licensed under the new AMLO licensing regime when it is implemented.

Regulated investment agreements

A 'regulated investment agreement' is an agreement, the purpose or effect is to provide to any party to the agreement a profit, income or other return calculated by reference to changes in the value of any property (e.g., equity-linked deposits) (but does not include a collective investment scheme).

Unless a security token offering is essentially a tokenised fund offering which is a collective investment scheme, there seems to be little support for the SFC's statement that tokens representing digital ownership of assets such as gold or real estate constitute securities under the SFO. Further guidance on this from the SFC would be welcome.

(b) Regulatory Implications of STOs being "securities" under the SFO

Selling restrictions

The SFC's March 2019 statement on STOs provides that where an intermediary markets or distributes security tokens, it should only offer them to professional investors. An offer of security tokens only to professional investors as defined in the SFO has the advantage of being exempt from the requirement for SFC authorisation of any advertisement or invitation issued in relation to an offer of securities (under section 103 SFO) where the security tokens are offered to more than 50 persons in Hong Kong.

Where STO tokens constitute interests in a collective investment scheme, restricting the offer to professional investors will mean that the stringent requirements of the SFC's

Code on Unit Trusts and Mutual Funds will not apply. Those requirements would likely render an STO unworkable given:

- the requirements for the appointment of a qualified fund manager and a custodian that is a bank or trust company registered under the Trustee Ordinance; and
- the investment restrictions applicable to retail funds which include a prohibition on real estate investment and a restriction on investing no more than 15% of the fund's net asset value in investment products that are not listed on the HKEx or another recognised stock exchange.

Licensing Requirements for Intermediaries Marketing / Distributing Security Tokens

Where crypto assets are “securities” under the SFO, any exchange which provides trading in the security tokens and any intermediary which markets and distributes the security tokens must be licensed or registered by the SFC for Type 1 regulated activity (dealing in securities), and each of its staff members conducting trading or marketing of security tokens must also be licensed for Type 1. The SFC states in its March 2019 statement that security tokens should only be offered to professional investors.

Conduct Requirements for Licensed Intermediaries

STO suitability for intermediaries' customers

Intermediaries which market and distribute security tokens must comply with the conduct provisions of the SFC's Code of Conduct, in particular the requirement under paragraph 5.2 to ensure that customer recommendations and solicitations with respect to security tokens are reasonably suitable for the particular customer, given the information about the particular customer of which the intermediary is or should be aware through the conduct of due diligence.

Intermediaries should also refer to the SFC's Suitability FAQs and FAQs on Triggering the Suitability Obligations. Although not referred to in the SFC statement, all licensed intermediaries are also under an obligation to conduct customer due diligence and anti-money laundering checks on their customers and these apply irrespective of the type of product being recommended or the subject of a customer solicitation.

STOs as Complex Products

The SFC regards security tokens as “complex products” as defined under paragraph 5.5 of the Code of Conduct. Paragraph 5.5 imposes additional obligations on licensed intermediaries which make recommendations or solicit investors with respect to complex products. In particular, licensed intermediaries and their licensed staff are required to ensure that:

- (a) the security token is suitable for the client in all the circumstances;

- (b) the client is provided with sufficient information on the key nature, features and risks of the security token to understand it before making an investment decision; and
- (c) the client is provided with clear warning statements about the security token's distribution.

Intermediaries' Due Diligence Obligations

The SFC's March 2019 statement mentions the need for intermediaries who market or distribute security tokens to conduct proper due diligence on the offering which should cover (among others):

- the background and financial soundness of the management, development team and the issuer of the security token; and
- the existence of and rights attached to the assets which back the security token.

Licensed intermediaries are also required to study security tokens' whitepapers and all relevant marketing materials and other published information. The SFC's March 2019 statement also notes intermediaries' obligation to ensure that information provided to customers in respect of an STO is accurate and not misleading. This is the first time the SFC has raised the issue of the standard of due diligence it expects in relation to security token offerings and intermediaries' responsibility for the accuracy of information.

Information to be Provided to Customers

Intermediaries should provide their customers with clear and comprehensible information on STOs which should include prominent warning statements alerting potential investors to the risks associated with digital assets. The SFC reminds licensed intermediaries to implement adequate systems and controls to ensure compliance with their regulatory obligations prior to engaging in security token distribution.

Requirement to Notify the SFC before Dealing in Security Tokens

The SFC also requires licensed intermediaries to notify it in advance prior to conducting any business in security tokens.

Shortcomings of the SFC's Regulatory Approach

A loophole in the SFC's regulatory approach to security token offerings is that the investor protection driven measures of the SFC Code of Conduct (the obligation to ensure the suitability of investment products for individual clients, anti-money laundering and counter-terrorist financing obligations etc.) only apply where a traditional intermediary is involved. The SFC Code of Conduct does not apply to issuers of securities and thus, on a typical security token offering, there is no obligation on the issuer to ensure the accuracy of the information provided in its marketing documents nor to assess the suitability of its tokens for prospective purchasers.

Additionally, token issuers and their designers and developers are typically based offshore, outside the regulatory remit of the SFC, and so, protection for Hong Kong investors against fraudulent or incompetent issuers is scant. The SFC Code of Conduct requirements referred to in the SFC's March 2019 Statement will only ever apply where a Hong Kong SFC licensed or registered intermediary is engaged to market the tokens to Hong Kong investors – a scenario which has not yet occurred in Hong Kong. However, if security tokens are to be traded on a Hong Kong crypto exchange, the operator of the exchange will need to be licensed and thus secondary market trading will be subject to SFC regulation.

Under the SFO, security tokens, in the same way as traditional securities, cannot be marketed to Hong Kong investors except by an SFC Type 1-licensed entity. However, if security tokens are not “actively marketed” to the Hong Kong public, there is nothing to prevent Hong Kong investors from subscribing for tokens via an offshore platform and in this situation, none of the SFC Code of Conduct's investor protection mechanisms will apply. Further, if the offering turns out to be a scam, Hong Kong investors have no means of redress other than a contractual claim or common law action against the token issuer. Given that whitepapers generally do not even contain the issuer's legal name and registered address, this route to recovering losses will not be straightforward.

These issues are of course by no means unique to Hong Kong and regulators worldwide face similar challenges.

1.3 Virtual Asset Futures and CME and CBOE Bitcoin Futures

Virtual asset futures contracts are largely unregulated, highly leveraged and subject to extreme price volatility which urged the SFC to issue a [statement](#) warning investors of the risks in November 2019.⁹ The SFC noted in the same statement that trading platforms or persons which offer and/or provide trading services in virtual asset futures contracts without being licensed under the SFO may be in breach of the SFO. Virtual asset futures contracts may also constitute “contracts for differences” under the Gambling Ordinance which may be illegal unless authorised under that ordinance.

Further, according to the [SFC Circular on Bitcoin futures contracts and cryptocurrency-related investment products](#) of December 2017,¹⁰ a Hong Kong entity which enables Hong Kong investors to trade Bitcoin futures contracts which are traded on the Chicago Mercantile Exchange (the **CME**) or Chicago Board Options Exchange (the **CBOE**), including by relaying or routing orders for these Bitcoin futures contracts, will need to be licensed by the SFC for Regulated Activity Type 2 (dealing in futures contracts). These intermediaries are also expected to strictly observe the suitability requirement of

⁹ SFC. SFC issues warnings on virtual asset futures contracts. 6 November 2019. Available at: <https://www.sfc.hk/en/News-and-announcements/Policy-statements-and-announcements/SFC-issues-warnings-on-virtual-asset-futures-contracts>

¹⁰ SFC. Circular to licensed corporations and registered institutions on Bitcoin futures contracts and cryptocurrency-related investment products. 11 December 2017. Available at: <https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=17EC79>

paragraph 5.2 of the SFC Code of Conduct and the conduct requirements in relation to providing services in derivative products to clients under paragraphs 5.1A and 5.3 of that Code.

2. THE LICENSING REGIME UNDER THE SECURITIES AND FUTURES ORDINANCE

The SFO gives the SFC authority over the securities and futures industry, which only gives it authority over entities conducting business activities in the very limited category of cryptocurrencies which are “securities” or “futures contracts” within the statutory definitions. The SFC has however issued statements which bring the following within the scope of the licensing regime under the SFO:

- i. firms managing funds that invest in virtual assets (in addition to traditional securities or futures contracts);
- ii. firms distributing funds which invest in virtual assets (irrespective of whether they are securities or not); and
- iii. exchanges providing trading services in virtual assets where at least one virtual asset is a security or futures contract.

However, despite many of the world’s largest crypto exchanges operating in Hong Kong, these currently remain unlicensed since they are outside the scope of the SFC’s licensing regime as they only trade cryptocurrencies (such as Bitcoin and Ethereum) which are not “securities” or “futures contracts” under the SFO (“**non-SF virtual assets**”). Thus, an exchange which only trades non-SF virtual assets or a firm which only manages funds investing in non-SF virtual assets is completely unregulated at present. Primary market issues and offers of cryptocurrencies (such as ICOs) which are not securities are also unregulated.

2.1 Regulation of Virtual Asset Portfolio Managers

As outlined, the SFC’s regulatory jurisdiction under the SFO does not extend to activities in the many cryptocurrencies (including the most widely traded, such as Bitcoin and Ethereum) which are not securities or futures contracts (i.e. non-SF virtual assets). The SFC has issued a number of warnings to potential investors of the risks of investing in cryptocurrencies.

In November 2018, the SFC published a [regulatory framework](#) which deals with its regulation of portfolio managers which invest in cryptocurrencies which are not securities or futures contracts. Portfolio managers include both fund managers and managers of discretionary accounts (in the form of an investment mandate or a pre-defined model portfolio). The statement extends the SFC’s regulation of the activities of licensed portfolio managers to cover their crypto-related services.¹¹ Where a firm is already or will be licensed for Type 9 regulated activity (asset management) for managing

¹¹ SFC. “[Statement on regulatory framework for virtual asset portfolios managers, fund distributors and trading platform operators](#)”. 1 November 2018

portfolios in traditional securities and/or futures contracts, its management of portfolios (or portions of portfolios) which invest in cryptocurrencies which are not securities or futures contracts is also subject to the SFC's oversight. The SFC exercises oversight over the firm's crypto-related activities through the imposition of [licensing conditions](#).¹²

However, a portfolio manager which only manages funds which invest only in cryptocurrencies which are not securities or futures contracts does not need to be licensed for Type 9 regulated activity since managing funds investing only in cryptocurrencies that are not securities or futures contract is not a regulated activity. To the extent that the portfolio manager distributes the fund in Hong Kong, it will however need to be licensed for Regulated Activity Type 1 (dealing in securities) (see further at 2.2 below).

(a) De minimis provision

The additional licensing conditions are subject to a *de minimis* provision: they apply to firms which manage or plan to manage virtual asset funds or investment portfolios which:

- have a stated investment objective to invest in virtual assets; or
- intend to invest or have invested more than 10% of their gross asset value (**GAV**) in virtual assets directly or indirectly).

The licensing conditions do not however apply to:

- licensed corporations which only manage funds/portfolios investing in virtual asset funds (i.e. funds of funds); or
- licensed corporations managing portfolios whose mandate is to invest mainly in securities and/or futures contracts and their investment in virtual assets exceeds 10% of GAV only because of an increase in the prices of the virtual assets held in one or more of the portfolios. The licensed corporation is required to take all reasonable steps to reduce the portfolio's investment in virtual assets below the 10% of GAV threshold. If, however, the position is expected to continue (i.e. virtual assets will continue to exceed 10% of GAV), the licensed corporation must alert the SFC which will consider imposing licensing conditions. Failure to notify the SFC may result in disciplinary action.

(b) Requirement to notify the SFC

Licensed corporations and licence applicants are required to inform the SFC if they currently manage, or plan to manage, one or more funds/portfolios that invest in cryptocurrencies, or intend to hold cryptocurrencies on behalf of funds/portfolios under their management. The notification requirement applies even if the fund/portfolio intends to invest less than 10% of the portfolio's gross asset value in cryptocurrencies and

¹² SFC. "[Proforma Terms and Conditions for Licensed Corporations which Manage Portfolios that Invest in Virtual Assets](#)". October 2019.

whether or not the cryptocurrencies involved are “securities” or “futures contracts.” Failure to inform the SFC may constitute a breach of the Securities and Futures (Licensing and Registration) (Information) Rules.

On being informed that a firm is managing or plans to manage virtual asset portfolios, the SFC will send the [standard licensing conditions](#)¹³ to the firm and these may be varied following discussions with the firm according to its particular business model. Licensed corporations which do not agree to comply with the licensing conditions will be prohibited from managing virtual asset portfolios and must unwind their cryptocurrency positions.

A new licence applicant has to agree to the licensing conditions proposed, or its licensing application will be rejected.

(c) The Licensing Conditions

The SFC has published [Proforma Terms and Conditions for Licensed Corporations which Manage Portfolios that Invest in Virtual Assets](#)¹⁴ that it will impose on a fund manager that manages a fund (or portion of a fund) that invests in virtual assets and meets the de minimis threshold (a **Virtual Asset Fund Manager**). The conditions are onerous and include the following principal obligations.

1. *Restriction to professional investors and disclosure requirements*

Investors in a fund with a stated investment objective of investing in cryptocurrencies or which intends to invest 10% or more of its GAV in cryptocurrencies are restricted to “*professional investors*” as defined in the SFO (including high net worth investors under the Securities and Futures (Professional Investor) Rules). If a virtual asset fund will be distributed through distributors, the Virtual Asset Fund Manager must implement measures to ensure that the fund is only distributed to professional investors.

2. *Safeguarding of assets*

Despite the SFC acknowledging that crypto funds face “*a unique challenge due to the limited availability of qualified custodian solutions*”, the SFC has imposed onerous obligations on licensed Virtual Asset Fund Managers in relation to custodians.

A manager of a virtual asset fund is firstly required to assess and select the most appropriate custodial arrangement – that is whether to hold the assets itself or with a third-party custodian or an exchange - taking into consideration the advantages and disadvantages of holding cryptocurrencies at different host locations by way of “hot” or “cold” wallets, considering (among others) the ease of accessibility to cryptocurrencies and the security of the custodial facility.

¹³ SFC. October 2019. “Proforma Terms and Conditions for Licensed Corporations which Manage Portfolios that Invest in Virtual Assets”. Available at: [https://www.sfc.hk/web/EN/files/IS/publications/VA_Portfolio_Managers_Terms_and_Conditions_\(EN\).pdf](https://www.sfc.hk/web/EN/files/IS/publications/VA_Portfolio_Managers_Terms_and_Conditions_(EN).pdf)

¹⁴ Ibid

Virtual Asset Fund Managers are also required to exercise due skill, care and diligence in selecting, appointing and conducting on-going monitoring of custodians by reference to factors such as the custodian's:

- (a) experience and track record in providing custodial services for cryptocurrencies;
- (b) regulatory status, particularly whether its cryptocurrency custodial business is subject to regulatory oversight;
- (c) corporate governance structure and the background of its senior management;
- (d) financial resources and insurance cover for compensating customers for loss of customer assets; and
- (e) operational capabilities and arrangements, for example, its "wallet" arrangements and cybersecurity risk management measures.

Where cryptocurrencies are held by the licensed fund manager itself, it is required to document the reasons for self-custody and disclose the risks of self-custody to investors. Appropriate measures must be implemented to protect the fund's assets and to effectively segregate the cryptocurrencies from the fund manager's own assets in the event of its insolvency. The fund manager is also required to use best endeavours to acquire and maintain insurance cover over the cryptocurrencies.

3. *Portfolio valuation*

The SFC recognises that there are currently no generally accepted valuation principles for virtual assets, particularly ICO tokens. The licensing conditions however require licensed corporations to select valuation principles, methodologies, models and policies which are *reasonably appropriate* in the circumstances and in the best interests of investors. These also need to be disclosed to investors.

4. *Risk management*

Virtual Asset Fund Managers are required to set appropriate limits for each product or market the fund invests in. They should, for example, consider setting a cap on a fund's investment in illiquid cryptocurrencies and newly-launched ICO Tokens and its exposure to counterparties. According to the risk management procedures set out in Appendix 2 to the Proforma Terms and Conditions, Virtual Asset Fund Managers should consider using more than one custodian to hold the fund's assets to avoid undue concentration of risk. Periodic stress testing is also required to assess the effect of abnormal and significant changes in market conditions on the fund.

Before transacting with a crypto exchange, a licensed Virtual Fund Manager is required to assess the reliability and integrity of the virtual asset exchange taking into account matters such as its:

- i. experience and track record;
- ii. legal or regulatory status;
- iii. corporate governance structure and background of its senior management;

- iv. operational capabilities;
- v. mechanisms (e.g., surveillance systems) implemented to guard against fraud and manipulation with respect to products traded on the exchange;
- vi. cybersecurity risk management measures; and
- vii. financial resources and insurance cover.

Exposure to individual crypto exchanges must be limited by setting appropriate caps.

5. *Auditors*

The SFC has noted that the accounting profession has no agreed standards and practices for how an auditor can perform assurance procedures to obtain sufficient audit evidence for the existence and ownership of virtual assets and ascertain the reasonableness of the valuations. Despite this, the SFC requires the appointment of an independent auditor to audit the financial statements of managed funds. The SFC also requires licensed corporations to consider auditors' experience and capability in checking the existence and ownership of virtual assets, and ascertaining the reasonableness of their valuation, in their selection of an auditor.

6. *Liquid capital*

A licensed fund manager which holds cryptocurrencies on behalf of the funds it manages is required to maintain liquid capital equal to the higher of HK\$3 million or the amount of its variable required liquid capital).

(d) SFC licensed crypto fund managers

To date, only one fund management firm, Venture Smart Asia Limited, has succeeded in obtaining a Type 9 asset management licence to manage funds investing in crypto assets. It is also licensed for regulated activities Types 1 and 4 and the firm acted as advisor to, and distributor of, the Bitcoin tracking fund launched by the firm's blockchain arm, Arrano Capital.¹⁵

2.2 Regulation of Virtual Asset Fund Distributors

Fund distribution requires a securities dealer licence (Type 1) because a fund is a "collective investment scheme" which is a security irrespective of whether the fund invests in virtual assets which are securities or not. Accordingly, firms distributing virtual asset funds (whether as fund managers under an asset management licence or as fund distributors under a securities dealer licence) are required to comply with:

- the SFC's regulatory framework for licensed corporations including its Code of Conduct for Persons Licensed by or Registered with the SFC (the **Code of Conduct**), including (among others) Know-your-Client (**KYC**) and AML and CTF

¹⁵ The Standard. 21 April 2020. "HK first approved crypto fund eyes US\$100 million". Available at: [https://www.thestandard.com.hk/section-news/section/2/218298/HK-first-approved-crypto-fund-eyes-US\\$100m](https://www.thestandard.com.hk/section-news/section/2/218298/HK-first-approved-crypto-fund-eyes-US$100m)

obligations, as well as an obligation to ensure the suitability of product recommendations and solicitations for particular clients; and

- additional requirements set out in the SFC’s “[Circular to intermediaries on the distribution of virtual asset funds](#)”¹⁶ of 1 November 2018 (the **SFC November 2018 Circular**) including extensive due diligence in relation to the virtual asset funds they distribute,¹⁷ their fund managers and counterparties.

A fund manager which only manages funds investing in cryptocurrencies that are not securities does not need to be licensed for Type 9. This is because “asset management” is defined in the SFO as the management of “securities” or “real estate”. Managing a fund investing only in cryptocurrencies which are not securities is not therefore “asset management” and does not require a Type 9 licence.

However, the distribution of a fund which invests in cryptocurrencies that are non-securities will require the distributor (whether that is the fund manager or a third party distributor) to be licensed for Type 1 – dealing in securities. A fund is a collective investment scheme, which is within the SFO’s definition of “securities”, irrespective of the type of assets the fund invests in. A Type 9-licensed asset manager which also distributes the funds it manages can rely on the incidental exemption from need to be separately licensed for Type 1.

The SFC November 2018 Circular requires licensed corporations to comply with the SFC’s Code of Conduct for Persons Licensed by or Registered with the SFC (the **SFC Code of Conduct**) in distributing virtual asset funds (both authorised and unauthorised). In particular, they must ensure the reasonable suitability of any recommendation or solicitation made to a client under paragraph 5.2 of the SFC Code of Conduct.

The SFC November 2018 Circular also sets out additional requirements which apply to distributors of virtual asset funds which:

- are not authorised by the SFC for retail distribution under section 104 SFO; and
- have a stated investment objective of investing in virtual assets or intend to invest or have invested more than 10% of their GAV in virtual assets (i.e. funds which the licensed corporation knows, or should reasonably have known, to be investing more than 10% of their GAV in virtual assets at the time it distributes the fund, unless it has been advised that the fund manager intends to reduce the fund’s investment in virtual assets to below 10% of the fund’s GAV in the near future). The investment in virtual assets may be direct or indirect (i.e. through fund of funds and funds which invest in derivatives, for example, total return swaps, with virtual assets as the underlying).

Additional Requirements

¹⁶ SFC. Circular to intermediaries: Distribution of virtual asset funds. 1 November 2018. Available at: <https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=18EC77>

¹⁷ The additional requirements will not apply to funds authorised by the SFC for retail distribution.

The additional requirements that apply to licensed corporations distributing these funds include the following:

1. *Selling restrictions*

A distributor of a Virtual Asset Fund can only target professional investors as defined under the SFO. Except in the case of institutional professional investors (broadly, banks and regulated securities intermediaries), the distributor must also assess whether its clients have knowledge of investing in cryptocurrencies or related products before effecting a transaction on their behalf. A transaction can only be executed for a client without such knowledge, if this would be in the best interest of the client. However, the SFC has given no guidance on when a transaction can be considered as being in the client's best interests. For the purposes of the knowledge assessment, a licensed corporation can take into account a client's prior investment experience in private equity or venture capital or whether they have provided capital for a start-up business in the previous two years.

2. *Concentration assessments*

Licensed corporations must consider the aggregate amount to be invested by a client in virtual asset funds to be reasonable given the client's net worth.

3. *Due diligence on virtual asset funds not authorised by the SFC*

Licensed corporations will need to conduct extensive due diligence on virtual asset funds (unless they have been authorised by the SFC for retail distribution), their fund managers and parties providing trading and custodian services to the funds. However, licensed corporations' compliance with these obligations very much depends on the willingness of the various parties to disclose the required information. The assessments licensed corporations are required to make are difficult given the lack of developed standards in the industry. The due diligence is required to include (without limitation) an examination of the fund's constitutive documents and completion of a due diligence questionnaire, in addition to making enquiries of the fund manager to obtain an in-depth understanding of the matters referred to below.

The due diligence the SFC expects to be conducted in relation to the fund manager covers:

- (a) the fund manager's background, relevant experience and (where applicable) the track record of its senior management, including its chief investment, operation, risk and technology officers;
- (b) its regulatory status (e.g. whether it is subject to any regulatory oversight);
- (c) its compliance history (i.e. whether it has been subject to any disciplinary or regulatory actions);
- (d) its operations including its internal controls and systems, e.g.:
 - the existence of proper segregation of key functions (such as portfolio management, risk management, valuation and custody of assets) or of adequate compensating controls to prevent abuse;

- who has authority to transfer assets from the fund or custodians and what safeguards are in place;
 - the persons responsible for, and the procedures for, reconciling transactions and positions, including the frequency of reconciliations; and
 - the methodology and the persons responsible for determining the pricing and assessment of the reasonableness of the determined price of cryptocurrencies;
- (e) the fund manager's IT infrastructure (e.g., in terms of security and access management); and
- (f) its risk management procedures (including concentration limits, counterparty risk management procedures, stop-loss arrangements and stress testing), its liquidity risk management policy and disaster recovery plan.

In terms of the due diligence the SFC expects a licensed distributor to conduct in relation to the fund, this should cover:

- (a) the fund's targeted investors;
- (b) list of instruments the fund intends to trade or invest in and any limitations on the size of its holding of ICO tokens, pre-ICO Tokens or other illiquid or hard-to-value instruments;
- (c) its valuation policy (especially for ICO Tokens, pre-ICO Tokens or other illiquid or hard-to-value instruments); and
- (d) the custody arrangement for the fund assets, including the policy on the allocation of assets to be kept at different host locations, such as exchanges, custodians, hot storage, cold storage;
- (e) its use of leverage and derivatives;
- (f) the fund's targeted risk and return per annum;
- (g) key risks (as described in "Information for clients" below); and
- (h) the fund's auditors and audited financial statements, including whether the fund has received a qualified audit opinion in the past, and whether the audited statements are up to date.

The SFC expects a licensed distributor to perform the following due diligence on the fund's counterparties that covers:

- (a) their legal and regulatory status (e.g. whether they are regulated by any authorities to undertake custody business or trade in cryptocurrencies);
- (b) their experience and track record in dealing in cryptocurrencies;
- (c) the robustness of their IT systems (including cybersecurity risk management measures) and contingency plans; and

(d) their financial soundness and insurance coverage, e.g. whether they have insurance covering loss of customer assets.

4. *Provision of information to clients*

To assist clients in making informed investment decisions, licensed distributors are required to provide prominent warning statements covering certain risks including (among others):

- (a) the continuing evolution of virtual assets and how this may be affected by global regulatory developments;
- (b) price volatility;
- (c) potential price manipulation on exchanges or trading platforms;
- (d) lack of secondary markets for certain virtual assets;
- (e) that most exchanges, trading platforms and custodians of virtual assets are currently unregulated;
- (f) counterparty risk when effecting transactions with issuers, private buyers/sellers or through exchanges or trading platforms;
- (g) the risk of loss of virtual assets, especially if held in “hot wallets”;¹⁸ and
- (h) cybersecurity and technology-related risks.

For licensed fund managers which both manage funds investing in virtual assets and distribute those funds, the requirements should not prove problematic, particularly where they provide custody for the virtual assets. The requirements are likely to be much more problematic for Type 1-licensed fund distributors where the extent of due diligence they will be required to perform on third party funds, their fund managers and custody arrangements may not be practical.

2.3 Regulation of Virtual Asset Exchange/Platform Operators

The SFC’s approach to the regulation of operators of crypto exchanges/trading platforms is set out in its November 2019 [Position paper: Regulation of virtual asset trading platforms](#).¹⁹ According to that paper, the SFC will regulate trading platforms operating in Hong Kong only if they trade at least one cryptocurrency which is a security. Since the vast majority of cryptocurrencies are not securities, crypto exchanges which only trade cryptocurrencies that are not securities or futures contracts are not currently regulated. Indeed, the precondition that an exchange must trade at least one cryptocurrency which is a security (i.e., a security token) makes most ineligible for licensing even if they want to

¹⁸ A “hot wallet” refers to a wallet used for holding virtual assets in an online environment which provides an interface with the internet, which is more susceptible to cyber-attacks.

¹⁹ SFC. “[Position Paper: Regulation of virtual asset trading platforms](#)”. 6 November 2019.

be licensed. More fundamentally, the SFC licensing framework applies only to centralised exchanges and not to decentralised exchanges on which investors trade on a peer-to-peer basis.

To date, the SFC has only licensed one crypto exchange. The SFC issued the first virtual asset trading platform licence on 16 December 2020 to OSL Digital Securities, a platform which will only provide services to professional investors which is one of the licensing conditions. The platform will be subject to the SFC’s “close supervision” and the Terms and Conditions for Virtual Asset Trading Platform Operators.

(a) Licensing Conditions for Hong Kong Crypto Exchanges

The SFC will impose the following licensing conditions on crypto exchange operators (**Licensees**):

- a. services may only be provided to professional investors;
- b. the Licensee must comply with “Terms and Conditions for Virtual Asset Trading Platform Operators” (the **Terms and Conditions**);
- c. the SFC’s prior written approval will be required for offering a new service or activity, or making a material change to an existing service or activity;
- d. prior written approval of the SFC must be obtained for any plan or proposal to add a product to a Licensee’s trading platform;
- e. the Licensee must provide the SFC with monthly reports on its business activities in the format prescribed by the SFC; and
- f. the Licensee must engage an independent professional firm to conduct an annual review of its activities and prepare a report confirming compliance with the licensing conditions and all relevant legal and regulatory requirements.

As noted in paragraph (b), it is a licensing condition that the licensed platform operator must comply with the [Terms and Conditions for Virtual Asset Trading Platform Operators](#)²⁰ which focus on the platform’s operations. A breach of any of the licensing conditions will constitute ‘misconduct’ under Part IX of the SFO and may also reflect adversely on the fitness and properness of the platform operator to remain licensed.

The terms and conditions which a licensed crypto exchange operator must satisfy relate firstly to providing safe custody of cryptocurrencies. The SFC expects a Licensee to adopt an appropriate operational structure and use technology to protect its clients equivalent to those required of traditional financial institutions in the securities sector.

1. *Trust structure*

²⁰ SFC. Terms and Conditions for Virtual Asset Trading Platform Operators. Available at: https://apps.sfc.hk/publicreg/Terms-and-Conditions-for-VATP_10Dec20.pdf

Licensed platform operators must hold client assets on trust to enhance safekeeping of client cryptocurrencies and ensure that they are properly segregated from those of the platform operator. Any material legal uncertainties, particularly as to the nature of any legal claims they may have over cryptocurrencies traded by them on the platform, must be disclosed in full to clients.

The SFC mandates that client assets must be held through a company which is incorporated in Hong Kong which is a wholly-owned subsidiary of the licensed platform operator and holds a trust or company service provider licence under the AMLO.

There is uncertainty as to whether cryptocurrencies constitute 'property' under Hong Kong Law, which may affect a client's rights in insolvency proceedings. Notwithstanding this, the SFC has said that this should not preclude the implementation of an interim regulatory regime.

2. Hot and cold wallet storage

The SFC requires the segregation of customers' virtual assets. Licensed platform operators must store 98% of client cryptocurrencies in "cold wallets" (i.e. where private keys are kept offline) and limit their holdings of client virtual assets in "hot wallets" (i.e. where private keys are kept online rendering them vulnerable to external threats) to no more than 2%. Licensed platform operators must also minimise transactions out of the cold wallet in which a majority of client cryptocurrencies are held.

Platform operators are also required to have adequate processes in place for handling requests for deposits and withdrawals of client cryptocurrencies to guard against loss arising from theft, fraud and other dishonest acts, professional misconduct or omissions. The platform operator and its subsidiary holding the clients' cryptocurrencies must also set out in writing details of the mechanism for transferring cryptocurrencies between hot, cold and other storage and the procedures for dealing with events such as hard forks and air drops from an operational and technical perspective,

3. Insurance

Licensed platform operators must have an insurance policy covering the risks associated with the custody of cryptocurrencies held in both hot storage (full coverage) and cold storage (a substantial coverage) which is in effect at all times.

4. Private key management

The SFC expects a licensed platform operator to set up and implement strong internal controls and governance procedures for private key management to ensure all cryptographic seeds and keys are securely generated, stored and backed up.

SFC KYC Requirements for Crypto Exchanges

The SFC requires licensed platform operators to take all reasonable steps to establish the true and full identity of each of its clients, and of each client's financial situation,

investment experience and investment objectives. Except for institutional and qualified corporate professional investors (as defined in the SFC Code of Conduct), before providing any services to the client, a platform operator must ensure that the client has sufficient knowledge of cryptocurrencies, including knowledge of the relevant risks associated with them. Where a client does not have that knowledge, services can only be provided to the client if the platform operator provides training to the client and enquires into the client's personal circumstances.

Concentration risks are also required to be assessed by setting a trading limit, position limit, or both by reference to the client's financial situation to ensure that the client has sufficient net worth to assume the risks and bear any potential trading losses.

Anti-Money Laundering (AML) and Counter Terrorist Financing (CTF) Requirements

Licensed platform operators are required to establish and implement adequate and appropriate AML/CTF policies, procedures and controls (**AML/CTF Systems**) to counter the money laundering and terrorist financing risks associated with cryptocurrencies' anonymity. Platform operators must also regularly review the effectiveness of their AML/CTF Systems and effect appropriate enhancements, taking into account any new SFC guidance and updates of the FATF Recommendations applicable to cryptocurrency-related activities including Recommendation 15 and its related interpretive note. Cryptocurrency tracking tools can also be used to trace transaction histories against a database of known addresses connected to criminal activities.

Prevention of Market Manipulation and Abusive Activities

Licensed platform operators are required to establish and implement written policies and controls for the proper surveillance of activities on its platform in order to identify, prevent and report any market manipulative or abusive trading activities. They must also adopt an effective market surveillance system and provide the SFC access to this system to perform its own surveillance. Policies should be established for the proper surveillance of platform activities to identify, prevent and report market manipulative or abusive trading practices or activities.

Accounting and Auditing Requirements

Licensed platform operators are required to exercise due skill, care and diligence in selecting and appointing their auditors.

Risk Management and Conflict of Interest Identification

Licensed trading platforms are required to have a risk management framework which enables them to identify, measure, monitor and manage the full range of risks arising from their businesses and operations. Clients should pre-fund their own accounts, as licensed platforms are prohibited from providing any financial accommodation for clients to acquire cryptocurrencies.

Licensed platforms are prohibited from engaging in proprietary trading or market-making activities on a proprietary basis. If a platform plans to use market-making services to enhance liquidity in its market, this must be done at arm's length and be provided by an independent external party using normal user access channels. A licensed platform operator must also have a policy governing employees' dealing in cryptocurrencies to eliminate, avoid, manage or disclose actual or potential conflicts of interests.

Cryptocurrencies for Trading

Licensed platform operators are prohibited from offering or trading cryptocurrencies that are crypto futures contracts or crypto derivatives.

Licensed platform operators need to set up a function responsible for establishing, implementing and enforcing the rules setting out the obligations of, and restrictions on, issuers of cryptocurrencies, and the criteria for a cryptocurrency to be included on and/or withdrawn from its platform.

The platform operator is also obliged to conduct reasonable due diligence prior to including a cryptocurrency on its platform and must ensure that the cryptocurrencies traded on its platform continue to satisfy all of the application criteria. Matters which must be considered include:

- i. the background of the management or development team of the issuer of the cryptocurrency;
- ii. the regulatory status of the cryptocurrency in each jurisdiction in which the platform operator provides trading services which includes whether the cryptocurrency can be traded under the SFO;
- iii. the supply, demand, maturity and liquidity of the cryptocurrency, its market capitalisation, average daily trading volumes, whether other platform operators trade the cryptocurrency in question, the availability of trading pairs and the jurisdictions where the cryptocurrency has been offered;
- iv. the marketing materials of the cryptocurrency which must not be misleading;
- v. the development and outcomes of any projects associated with a cryptocurrency should be included in the Whitepaper together with the major incidents associated with its history and development; and
- vi. in relation to cryptocurrencies which are "securities" under the SFO, the licensed platform operator should only include those that are: (i) asset-backed; (ii) approved by or registered with regulators in comparable jurisdictions (as agreed by the SFC from time to time); and (iii) have a track record of 12 months or more since issue.

The operator of a virtual asset trading platform will typically be licensed by the SFC for Regulated Activities Type 1 (dealing in securities) and Type 7 (providing automated trading services). Once licensed, a platform operator will be required to comply with all

relevant regulatory requirements in relation to all its business (i.e. in relation to cryptocurrencies that are securities and those that are not). The SFC also requires that all virtual asset trading activities conducted by the platform operator and its group companies which are actively marketed to Hong Kong investors or are conducted in Hong Kong are carried out by a single legal entity licensed by the SFC. This includes all virtual assets trading activities on and off the platform and activities incidental to the trading activities.

3. FSTB PROPOSALS FOR A NEW LICENSING REGIME FOR VIRTUAL ASSET EXCHANGES UNDER THE AMLO

The FSTB published a consultation in November 2020 proposing a new licensing regime for virtual asset exchanges under the AMLO, which will require any person seeking to conduct the “regulated VA activity” of operating a virtual asset exchange in Hong Kong to obtain a VASP licence from the SFC, even if the exchange only trades virtual assets which are not securities. The proposed regime aims to implement the FATF requirement for jurisdictions to regulate virtual asset service providers (**VASPs**) for AML/CFT purposes and supervise their compliance, a requirement introduced in February 2019 with the revision of FATF’s standards. The application of the proposed regime will however be much narrower than the FATF’s definition of VASPs, which also covers businesses involved in transferring virtual assets, providing safekeeping and/or administrative services of virtual assets or instruments enabling control over virtual assets (including certain wallet providers) or providing financial services related to the offer or sale of virtual assets (e.g., ICOs). This is because the FSTB considers virtual asset exchanges to be the most prevalent and developed virtual asset activity in Hong Kong, therefore warranting the introduction of a tailored licensing regime, with the potential for expansion of the regime at a later date.

If the new licensing regime takes effect, virtual asset exchanges will have 180 days to obtain a VASP licence.

3.1 Scope of Regulated Activity of Operating a Virtual Asset Exchange

Definition of a Virtual Asset Exchange

A virtual asset exchange will be defined as any trading platform which 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 a 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. This definition will require centralised virtual asset exchanges to be licensed, however peer-to-peer trading platforms (that is platforms that only provide a forum for buyers and sellers of virtual assets to post their bids, with or without automated matching mechanisms) are excluded from the definition, provided 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 virtual asset at any time. Decentralised virtual asset exchanges should therefore fall outside the scope of the licensing regime.

Definition of Virtual Assets

The proposals will largely align the definition of virtual assets with FATF's definition (i.e., digital representations of value that can be digitally traded, or transferred, and can be used for payment or investment purposes). The AMLO will define a virtual asset as a digital representation of value that: is expressed as a unit of account or a store of economic value; 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 can be transferred, stored or traded electronically. The definition will therefore cover virtual assets which are not securities, such as Bitcoin and Ethereum. Stablecoins (i.e., virtual assets backed by assets) will also fall within the definition. Digital representations of fiat currencies (including CBDCs), financial assets already regulated under the SFO and closed-loop, limited purpose items that are non-transferable, non-exchangeable and non-fungible including air miles, credit card rewards, gift cards, customer loyalty programmes and gaming coins, will be excluded.

3.2 Virtual Asset Exchange Licensing Requirements

The FSTB is proposing that only Hong Kong-incorporated companies with a permanent place of business in Hong Kong will be eligible for licensing as a virtual asset exchange. So, natural persons and businesses without a separate legal personality (e.g., sole traders or partnerships) will not be licensed. Virtual asset exchanges that are incorporated offshore will also not be eligible for licensing under the new regime.

The FSTB also proposes to prohibit the active marketing of a regulated VA activity or similar activity (i.e., services associated with a virtual asset exchange), whether in Hong Kong or elsewhere, to the public in Hong Kong without a VASP licence. This provision is similar to section 115 of the SFO and, since the SFC will not license an offshore entity, will prevent an offshore virtual asset exchange from marketing its services to Hong Kong investors. An offshore exchange that wants to be able to market to Hong Kong investors will therefore need to establish a Hong Kong subsidiary which will need to be licensed as a VASP by the SFC.

Licensing applicants will be required to appoint at least two responsible officers who will be responsible for ensuring the firm's compliance with the AML/CTF requirements and other regulatory requirements. As is the case for licensed corporations, all executive officers will need to be approved as responsible officers of a licensed virtual asset exchange.

The licensing applicant, its responsible officers and the ultimate owners of the corporate entity will need to satisfy a fit-and-proper test, which will assess the person's experience and qualifications and require that they have not been convicted of any money laundering or terrorist financing offence or other offence involving dishonesty and are not the subject of any liquidation or bankruptcy proceedings. Any change to the responsible officers or ultimate owners will require the SFC's prior approval, however the FSTB do not clarify who will be regarded as an "ultimate owner" of a virtual asset exchange for these purposes.

3.3 Obligations of Licensed Virtual Asset Exchanges

Licensed virtual asset exchanges will be required to observe the AML/CFT requirements under Schedule 2 to the AMLO, which prescribes certain requirements relating to customer due diligence and record-keeping.

The regulatory standards for virtual asset exchanges licensed under the AMLO will be essentially the same as those for exchanges licensed under the SFO regime to ensure a level playing field for all virtual asset exchanges. The SFC will be empowered to impose licensing conditions and other regulatory requirements and may vary them where appropriate. These will include:

- (i) restrictions on providing trading services to professional investors only, although the SFC may relax this position in the future as markets mature;
- (ii) a required minimum paid-up share capital requirement and, depending on the nature of business, a liquid asset requirement (to be set by the FSTB);
- (iii) licensed virtual asset exchanges will be required to have a proper corporate governance structure staffed by personnel with appropriate knowledge and experience;
- (iv) requirements relating to operating their virtual asset business in a prudent and sound manner and ensuring that client and public interests are not adversely affected;
- (v) putting in place appropriate risk management policies and procedures for managing money laundering and terrorist financing, cybersecurity and other related risk;
- (vi) ensuring the proper segregation of client assets and ensuring adequate policies and governance procedures are in place to ensure the proper management and custody of client assets;
- (vii) implementing and enforcing robust rules for the listing and trading of virtual assets on their platforms. In particular, they will need to perform all reasonable due diligence on virtual assets before listing them for trading;
- (viii) following specified auditing and disclosure requirements and publishing audited accounts;
- (ix) implementing written policies and controls for the proper surveillance of activities on a virtual asset exchange to identify, prevent and report any market manipulative or abusive trading activities; and
- (x) to avoid any conflicts of interest, licensed virtual asset exchanges will be prohibited from engaging in proprietary trading or market-making activities on a proprietary basis.

3.4 Proposed SFC Powers in Respect of Licensed Virtual Asset Exchanges

The SFC will be empowered to supervise the AML/CFT conduct of licensed virtual asset exchanges and to monitor, investigate and enforce their other obligations under the AMLO licensing regime. The SFC will also be given certain powers in relation to entering and inspecting premises and documents in order to investigate instances of non-compliance and will be empowered to impose administrative sanctions (including suspending or revoking a licence). The SFC will also be provided with intervention powers to impose restrictions and prohibitions on the operations of a licensed exchange and its associated entities in certain circumstances, for example where it is necessary to protect client assets.

The FSTB also propose to amend Part 6 of the AMLO in order to expand the scope of reviewable decisions of the AML/CFT Review Tribunal to cover appeals against future decisions made by the SFC in relation to implementing the VASP licensing and supervisory regime.

4. MANAGING MONEY LAUNDERING AND TERRORIST FINANCING RISKS ASSOCIATED WITH VIRTUAL ASSETS

As for AML/CFT legislation in Hong Kong, the AMLO currently only applies to financial institutions (including HKMA-authorized institutions (i.e. banks), SFC licensed corporations, licensed insurance companies, stored value facility issuers and money service operators) and “designated non-financial businesses and professions” (“**DNFBP**”) (professions such as lawyers, public accountants, estate agents, and trust and company services agents). All entities that are licensed or registered by the SFC to conduct regulated activities are thus subject to the AML and CTF obligations of the AMLO.

The FSTB’s proposals to create a new licensing regime for virtual asset exchanges under the AMLO, if adopted, will also require virtual asset exchanges licensed under the new regime to comply with AML and CTF obligations of the AMLO.

The Hong Kong Monetary Authority and the SFC have also reminded regulated bodies of the need to comply with the FATF’s latest recommendation.

In response to the FATF’s revised Recommendations, the HKMA published a notice on [16 December 2019](#)²¹ (the “**HKMA FATF Notice**”). The purpose of the HKMA FATF Notice was to provide guidance to authorised financial institutions in relation to the revised FATF Recommendations.

The HKMA FATF Notice reminded authorised institutions that when they establish and maintain business relations with VASPs, appropriate risk assessments should be carried out to differentiate the risks of each VASP, recognising that there is no ‘one size fits all’ approach. The approach adopted by authorised institutions will depend on the nature of

²¹ HKMA notice on Managing ML/TF risks associated with virtual assets (VAs) and virtual asset service providers. Available at: <https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2019/20191216e2.pdf>

the relationship between the authorised institution and the VASP. As such, authorised institutions must undertake additional customer due-diligence measures, which includes the collection of sufficient information to adequately understand the nature of the VASPs business, determining from publicly available information whether or not the VASP is licensed or registered and subject to AML/CTF supervision, and assessing the AML/CTF controls of the VASP as appropriate. The HKMA FATF Notice explains that the extent of the customer due-diligence measures employed by the authorised institution should be commensurate with the assessed money laundering/terrorist financing risks of the VASP.

Before introducing new banking or investment products, authorised institutions should also undertake money laundering / terrorist financing risks assessments, take appropriate measures to manage and mitigate the identified risks in accordance with the applicable legal and regulatory requirements which includes the requirements set out in the Guideline on Anti-Money Laundering and Counter-Financing of Terrorism.

This note is provided for information purposes only and does not constitute legal advice. Specific advice should be sought in relation to any particular situation. This note has been prepared based on the laws and regulations in force at the date of this note which may be subsequently amended, modified, re-enacted, restated or replaced.