

Virtual assets in Hong Kong – an evolving regulatory approach

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In the Financial Secretary's 2020 – 2021 budget speech, the Hong Kong Government announced that it will consider extending the anti-money laundering/counter terrorist financing requirements to cover crypto currency service providers. This marks the latest move of the city's regulation of cryptocurrencies, which have been classified as virtual assets and have been primarily regulated by the Securities and Futures Commission of Hong Kong ("**SFC**").

Initially, virtual assets only came within the SFC's regulatory regime if their terms of issuance resembled those of "securities", or their trading fell within the confines of "futures contracts". Started in November 2018, the SFC extended its oversight of virtual assets and their service providers by tackling the management and distribution of virtual assets. This is followed by its position paper in November 2019 which sets out a new regulatory framework for virtual asset trading platforms ("**VA Platforms**"). The new regulatory standards are comparable to those applicable to traditional licensed securities institutions, and apply to VA Platforms to the extent any of the virtual assets being traded amounts to "securities" or "futures contracts".

Whereas public consultations on the extension of AML/CTF requirements to virtual assets will commence later this year, this alert highlights the SFC's licensing requirements on VA Platforms, the new regime's reception by industry players and some other notable recent developments.

VA Platforms

Most cryptocurrencies, such as Bitcoin and Ether, are not "securities" as defined in the Securities and Futures Ordinance (Cap. 571) ("**SFO**"), and thus outside of the SFC's regulatory remit. One notable exception is, where virtual assets take up more than 10% in a fund's portfolio, the management and distribution of such funds are subject to additional SFC requirements.

Similarly, VA Platforms that only trade in non-security crypto assets are not required to be licensed by the SFC. It follows that a prerequisite for licensing is that the VA Platforms must trade at least one crypto asset which is a security (i.e. a security token). Such VA Platforms would then fall within the jurisdiction of the SFC and require a licence for Type 1 (dealing in securities) and Type 7 (providing automated trading services) regulated activities.

The SFC requires that a VA Platform operator to ensure that all virtual asset trading business activities carried out by its group of companies and the active marketing of such trading services to Hong Kong investors must be conducted by one group entity under a single licence. Once the VA Platform is licensed with the SFC, its entire trading business activities, be it trading of security tokens or non-security tokens, will be subject to the SFC's oversight.

Licensing Conditions

In order to qualify for a license, the applicant must:

- a.** only provide services to professional investor as defined under section 1 of Part 1 of Schedule 1 to the SFO. "Professional investor" includes specified entities set out in subsections (a) to (i) of the definition (such as banks and insurance companies) and persons belonging to a class which is prescribed under subsection (j);
- b.** comply with the "Terms and Conditions for Virtual Asset Trading Platform Operators" ("**the Terms and Conditions**");

- c. obtain SFC's prior written approval for any plan or proposal to (i) introduce or offer a new or incidental service, or activity, or (ii) to make a material change to an existing service or activity;
- d. provide monthly reports to the SFC on its business activities in a format as prescribed by the SFC; and
- e. engage an independent professional firm acceptable to the SFC to conduct an annual review of its activities and operations and prepare a report confirming that it has complied with the licensing conditions and all relevant legal and regulatory requirements.

Key requirements under the Terms and Conditions

In addition to the existing requirements applicable to other traditional licensed intermediaries, the Terms of Conditions has provided specific requirements in the context of virtual assets. Some of the key features are as follow:

Financial soundness

- The licensed VA Platform must maintain at all times sufficiently liquid assets, equivalent to at least 12 months of its actual operating expenses calculated on a rolling basis

Submission of legal advice

- The licensed VA Platform should obtain and submit to the SFC written legal advice in the form of a legal opinion or memorandum on the legal and regulatory status of every virtual asset that will be made available in Hong Kong, in particular, whether that virtual asset falls within the definition of "securities" under the SFO
- The licensed VA Platform should exercise professional scepticism before relying on any legal advice, and review such advice with due care and objectivity

Custody of virtual assets

- Client assets (virtual assets and client money) must be held on trust through an associated entity in a segregated account
- Not more than 2% of the client virtual assets can be stored in hot wallets, and at least 98% of the virtual assets must be kept in cold wallets. Storage in a "cold wallet" refers to the private keys which are kept offline, and therefore provide more security
- An insurance policy covering risks associated with the client virtual assets must be in effect at all times

Know-Your-Client

- The licensed VA Platforms must ensure that the client has sufficient knowledge of virtual assets and their associated risks
- If a client does not possess such knowledge, the licensed VA Platform may only provide services to the client after providing training to the client and enquired into the client's personal circumstances

AML/CFT

- The licensed VA Platform must employ effective procedures and controls, such as virtual asset tracking tools which enable it to trace the on-chain history of specific virtual assets, to manage AML/CFT risks

Limitations of the regulatory regime

Unless and until the SFO is amended, the current legislative framework does not enable the SFC to take action against market misconduct committed by a licensed VA Platform, because it is not a recognized stock or future market and the virtual assets are not "securities" or "futures contracts" listed or traded on such a market. Also, there are no mandatory disclosure requirements applicable to an offer of non-security virtual assets.

Furthermore, the new regulatory regime applies only to centralised exchanges (i.e. where the VA Platforms have control over investors' assets) and not to decentralised exchanges on which many cryptocurrency investors trade on a direct peer-to-peer basis.

Warnings on virtual asset futures contracts

When issuing the Position Paper, the SFC also issued a warning on virtual asset futures contracts, emphasizing the extremely risky and volatile nature of such derivatives products. Any trading platforms or persons which offer/or provide trading services in virtual asset futures contracts, without a proper licence or authorization, may contravene the SFO and/or the Gambling Ordinance (Cap. 148).

In any event, the SFC stated that it would be "unlikely to grant a licence or authorisation to carry on a business in such contracts".

Public reception of the new regime

There are gives and takes for VA Platforms to opt in to the SFC's new regime. While they can boost investor confidence that assets held by licensed VA Platforms will be safeguarded by SFC's stringent procedures and measures, the new regime applies only to centralised exchanges, where investors do not have direct control over crypto funds. This means trading virtual assets through licensed VA Platforms could potentially eliminate some of the benefits of dealing in virtual assets itself (such as anonymity) in light of SFC's recommendation to deploy virtual asset tracking tools for AML purposes.

In addition, the requirements to operate as a single legal entity for licensing purposes, and the restriction against servicing non-professional investors, could potentially limit the scope of business and target clients.

In light of the above, it is not surprising that public receptions to the new regulatory regime are quite diverse. Since launching the VA Platform licensing regime last November, the SFC has received a number of licence applications from several institutional VA Platforms, including HashKey Group and BC Group. Those who are enthusiastic about the licensing opportunity believe that it can step up constructive oversight in the region and enhance investor confidence in FinTech, blockchain and digital asset industries.

However, there have been voices from the industry that played down the importance of the new licensing regime. They claimed that the new regime is redundant, as most VA Platforms in Hong Kong focus on offering liquidity for non-security tokens, such as Bitcoin and Ether (ETH) rather than those security tokens that are regulated. Others have expressed concerns that, even if licensed, banks in Hong Kong may remain unwilling to open accounts for business areas they don't want to service, because of the uncertain or costly AML/CTF compliance requirements. Indeed, the Bitcoin Association of Hong Kong has identified that banks are "highly hesitant to open accounts to financial services companies, and even more so for cryptocurrency businesses".

It is in this regard that most market players await in earnest the government's upcoming consultation to clarify and standardize their compliance obligations, so that virtual asset service providers can further develop their businesses whether they want to be licensed by the SFC or not.

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