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**2022 Hong Kong
Crypto Regulation
Webinar Series**

Webinar 3 - Hong Kong II



REGULATORY STATUS OF VIRTUAL ASSETS

- SFC regulates virtual assets with features of traditional securities (eg shares, debentures or interests in a collective investment scheme (CIS))
- Definition of a CIS
 - 1.involves an arrangement in respect of property;
 - 2.the participants do not have day-to-day control over the property's management;
 - 3.the property is managed as a whole by or on behalf of the person operating the arrangement, and/or the participants' contributions and the profits or income from which payments are made to them are pooled; and
 - 4.the purpose of the arrangement is to provide participants with profits, income or other returns from the property's acquisition or management

REGULATORY CONSEQUENCES OF VIRTUAL ASSETS BEING SECURITIES

- SFC authorisation required for invitation to the Hong Kong public to acquire virtual assets that are securities (unless exempt) (S103(1) SFO)
- SFC authorisation of a public offer of virtual assets that are interests in a CIS requires compliance with the provisions of the SFC's Code on Unit Trusts and Mutual Funds
- Persons conducting regulated activities (eg dealing, asset management) in virtual assets that are securities must be licensed/registered by the SFC

MARCH 2018

SFC halted Black Cell Technology Limited's ICO in Hong Kong

JULY 2021

SFC warning re. Binance offering of stock tokens to HK investors



**REGULATORY
CONSEQUENCES OF
VIRTUAL ASSETS
BEING SECURITIES**

SFC STATEMENT ON SECURITY TOKEN OFFERINGS – 28 MARCH 2019

- Securities tokens = digital representations of:
 - ownership of assets (eg gold or real estate); or
 - economic rights (eg share of profits or revenue)
- Any person marketing/distributing security tokens in HK or targeting HK must be licensed/registered for Regulated Activity Type 1 (dealing in securities)



CONDUCT REQUIREMENTS FOR LICENSED **INTERMEDIARIES**

- **Selling restrictions:** must offer securities tokens only to professional investors
- **Suitability:** must comply with the SFC Code of Conduct including para 5.2 obligation to ensure customer recommendations and solicitations re. security tokens are reasonably suitable for customers given the information about customers of which intermediaries should be aware through the conduct of due diligence
- **Due diligence:** under obligation to conduct due diligence on security tokens on (among others):
 - background and financial soundness of the management, development team and the token issuer;
 - rights attached to the assets backing the securities tokens;
 - must review all materials published in relation to STO including whitepaper and marketing materials



CONDUCT REQUIREMENTS FOR LICENSED **INTERMEDIARIES** (CONT'D)

- Complex products: securities tokens are “complex products” – intermediaries must comply with additional investor protection requirements for complex products under para 5.5 of the SFC Code of Conduct and Ch 6 of the Guidelines on Distribution and Advisory Platforms
- Provision of information to clients: intermediaries must:
 - provide information to enable clients to make informed investment decisions;
 - provide warning statements of risks of investing in virtual assets;
 - ensure that information given to clients is accurate and not misleading

“SFC reminds investors of risks associated with non-fungible tokens” (6 June 2022)

CURRENTLY UNREGULATED

NFTs which are a genuine digital representation of a collectible (e.g. a digital representation of a unique copy of an underlying asset such as a digital image, artwork, music or video)

REGULATED

Fractionalised NFTs structured in a form similar to securities or interests in a CIS

NON-FUNGIBLE TOKEN (NFT) REGULATION

SFC REGULATION OF CRYPTO EXCHANGES

- SFC “Position Paper on Virtual Asset Trading Platforms” 6 November 2019
- SFC regulates platforms operating in HK that trade at least one virtual asset that is a security under the SFO
- SFC framework applies to *all* platform’s operations – even if majority of virtual assets traded are not securities
- Only applies to centralised platforms providing trading, clearing and settlement services for virtual assets, and having control of clients’ assets
- Eligible platforms licensed for RA Type 1 (dealing in securities) & Type 7 (providing automated trading services)

LICENSING CONDITIONS FOR OPERATORS OF VIRTUAL ASSET TRADING PLATFORMS

- Restricted to providing services to professional investors
- Require SFC approval before: introducing or offering a new or incidental service or activity; making any change to an existing service or activity; or adding any product to the trading platform
- Must provide the SFC with monthly reports on their business activities
- Must engage an independent professional firm to conduct an annual review of their activities and prepare a report confirming compliance with the licensing conditions and all relevant legal and regulatory requirements

Trust structure

- Must hold client assets on trust and ensure segregation from assets of platform operator
- Client virtual assets must be held through a company which is a HK incorporated wholly-owned subsidiary of the licensed platform operator which is an associated entity under the SFO and holds a trust or company service provider licence under the AMLO

Hot and cold wallet storage

- Must store 98% of client virtual assets in “cold wallets”
- Must limit holdings of client virtual assets in “hot wallets” to no more than 2%
- Must minimise transactions out of the cold wallet in which a majority of client virtual assets are held
- Must have adequate processes in place for handling requests for deposits and withdrawals of client virtual assets to guard against loss from theft, fraud and other dishonest acts, professional misconduct or omissions

STANDARD TERMS AND CONDITIONS FOR VIRTUAL ASSET TRADING PLATFORM OPERATORS

STANDARD TERMS AND CONDITIONS FOR VIRTUAL ASSET TRADING PLATFORM OPERATORS (CONT'D)

Insurance

Must have an insurance policy at all times covering the risks associated with the custody of cryptocurrencies held in both hot storage (full coverage) and cold storage (substantial coverage)

Private key management

Must set up and implement strong internal controls & governance procedures for private key management so that cryptographic seeds and keys are securely generated, stored and backed up

STANDARD TERMS AND CONDITIONS FOR VIRTUAL ASSET TRADING PLATFORM OPERATORS (CONT'D)

KYC requirements

- Licensed platform operators must take all reasonable steps to establish true & full identity of each client & each client's financial situation, investment experience & investment objectives
- VA knowledge test – except for institutional and qualified corporate professionals - must ensure client has sufficient knowledge of virtual assets & their risks before providing services to client
- Platform operators should set a trading limit, position limit, or both by reference to the client's financial situation

STANDARD TERMS AND CONDITIONS FOR **VIRTUAL ASSET TRADING PLATFORM OPERATORS** (CONT'D)

AML/CFT requirements

- Licensed platform operators must establish and implement adequate and appropriate AML/CFT policies, procedures and controls
- Must regularly review the effectiveness of their AML/CFT systems and effect appropriate improvements (including to reflect updates to SFC guidance and FATF Recommendations)
- Crypto tracking tools can 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 must establish and implement written policies and controls for the proper surveillance of activities on their platforms to identify, prevent and report market manipulative or abusive trading activities
- Must adopt an effective market surveillance system and give the SFC access to this system to perform its own surveillance

Accounting & auditing requirements

- Must exercise due skill, care & diligence in selecting and appointing auditors to audit their financial statements

STANDARD TERMS AND CONDITIONS FOR VIRTUAL ASSET TRADING PLATFORM OPERATORS (CONT'D)

STANDARD TERMS AND CONDITIONS FOR VIRTUAL ASSET TRADING PLATFORM OPERATORS (CONT'D)

Risk management and conflict of interest identification

- Must 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 must pre-fund their own accounts
- Licensed platforms are prohibited from engaging in proprietary trading or market-making activities on a proprietary basis
- Must have policy governing employees' dealing in crypto to eliminate, avoid, manage or disclose actual or potential conflicts of interests

STANDARD TERMS AND CONDITIONS FOR VIRTUAL ASSET TRADING PLATFORM OPERATORS (CONT'D)

Virtual asset trading

- Licensed platforms prohibited from offering, trading or dealing in crypto futures contracts or related derivatives
- Must have strict criteria for including virtual assets on platform
- Must conduct all reasonable due diligence on virtual assets before listing them for trading covering (among others):
 - background of the management or development team of the issuer
 - regulatory status including whether the virtual asset can be offered and traded under the SFO
 - the marketing materials which must not be misleading
 - the virtual asset's liquidity, market capitalisation and average daily trading volume
- Virtual assets that are securities must only be traded on the platform if they:
 - are asset-backed;
 - are approved by or registered with regulators in comparable jurisdictions (as agreed by the SFC from time to time); and
 - have a track record of 12 months or more since issue
- Platform operator must submit a legal opinion to the SFC for each virtual asset stating whether it is a security and the implications of that for the platform operator

SFC LICENSED VIRTUAL ASSET TRADING PLATFORM OPERATORS

Dec 2020

OSL Digital Securities Limited –
licensed for RA Types 1 & 7

April 2022

HashKey Group announced SFC's
grant of approval-in-principle of
application for Hash Blockchain
Limited to operate a virtual asset
trading platform



NEW LICENSING REGIME FOR VIRTUAL ASSET EXCHANGES UNDER THE ANTI-MONEY LAUNDERING AND COUNTER-TERRORIST FINANCING ORDINANCE (AMLO)

- New licensing regime for virtual asset service providers (VASPs)
- Anti-Money Laundering and Counter-Terrorist Financing (Amendment) Bill 2022
- Due to take effect on 1 March 2023
- Amendments aim to meet FATF Recommendations 15 and 16
- Detailed regulatory requirements to be set by SFC following further public consultation after AMLO amendment



VASP LICENSING REQUIREMENT

- Any person carrying on a business of providing a virtual asset service (VA service) in HK, or holding themselves out as doing so, required to be licensed as a VASP
- Providing a VA service – currently only operating a VA exchange
- Definition can be amended by the Secretary for Financial Services and the Treasury by notice published in the Gazette

OPERATING A VA EXCHANGE

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

(a) where:

(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 others so that they can 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 the direct or indirect possession of the person providing the service

“Virtual assets” are defined as 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 intended to be used, as a medium of exchange accepted by the public for payment for goods or services, for the discharge of a debt and/or for investment; 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; and

(iii) can be transferred, stored or traded electronically



VIRTUAL ASSETS DEFINITION

VIRTUAL ASSETS DEFINITION (CONT'D)

Virtual assets definition excludes digital representations of:

- fiat currencies
- central bank digital currencies
- securities or futures contracts under the SFO
- stored value facilities regulated under the Payment Systems and Stored Value Facilities Ordinance
- "limited purpose digital tokens" - non-transferable, non-exchangeable and non-fungible closed-loop, limited purpose items, such as air miles, credit card rewards, gift cards, customer loyalty programmes and gaming coins

TRANSITIONAL ARRANGEMENTS FOR EXISTING VA EXCHANGES

- VA exchanges operating in HK immediately before 1 March 2023 can continue to operate without a VASP licence for up to 12 months (i.e. until 29 February 2024)
- Provided that an existing VA exchange submits its VASP licence application to the SFC on or before 30 November 2023, the VA exchange can continue to operate after 29 February 2024 under a deemed licence if its licence application is still pending until the earlier of: (i) the SFC's grant or refusal to grant a licence; and (ii) withdrawal of the licence application
- To rely on deeming provision, VA exchange must confirm to SFC:
 - it has been providing a VA service in Hong Kong immediately before 1 March 2023; and
 - with effect from 1 March 2024, it will comply (and will have arrangements in place to ensure its compliance) with the regulatory requirements applicable to licensed VASPs
- An existing VA exchange which withdraws its licence application or is refused a VASP licence has 3 months to close down its business in HK
- Similar transitional provisions apply to individuals who provide VA services on behalf of a VA exchange operating in Hong Kong immediately before 1 March 2023

VASP LICENSING REQUIREMENTS

- **Eligibility for VASP licensing:** VASP must be a Hong Kong incorporated company or an overseas company which is registered under the Companies Ordinance
- **Appointment of responsible officers (ROs):** at least 2 ROs must be approved by the SFC
 - responsible for overseeing the operation of the licensed VASP and ensuring compliance with AML/CFT and other regulatory requirements;
 - at least one RO must be an executive director of the VASP;
 - if more than one executive director, they must all be appointed as responsible officers;
 - at least one responsible officer must be ordinarily resident in HK; and
 - at least one responsible officer must be available at all times to supervise the business of the VA service
- **Licensed representatives:** individuals who will provide VA services (including ROs) must be approved by the SFC as licensed representatives accredited to the VASP

VASP LICENSING REQUIREMENTS

Fit and proper test

- VASP licensing applicant, its ROs, licensed representatives, directors and ultimate owners must pass fit and proper test
- Relevant factors include the person's financial status or solvency, their educational or other qualifications and experience; evidence of their competence, honesty and financial integrity; their conviction in Hong Kong or elsewhere for any money laundering or terrorist financing offence or other offence involving fraudulent, corrupt or dishonest conduct; and failure to comply with the AML/CTF obligations or other obligations of licensed VASPs
- Ultimate owner is any individual who:
 - owns or controls (directly or indirectly) >25% of the VASP's issued share capital;
 - controls (directly or indirectly) >25% of the voting rights at its general meetings; or
 - controls its management

SFC approval of premises

- for keeping records/documents required to be kept under the AMLO

OBLIGATIONS OF LICENSED VASPs

Licensed VASPs will be required to comply with:

- AML/CFT requirements and customer due diligence and record-keeping requirements in Schedule 2 to the AMLO
- Licensing conditions covering VASP's
 - financial resources
 - knowledge and experience
 - risk management policies and procedures
 - management of client assets
 - virtual asset listing and trading policies
 - financial reporting and disclosure
 - prevention of market manipulation and abusive activities
 - avoidance of conflicts of interest



OBLIGATIONS OF LICENSED VASPs (CONT'D)

- Restriction to professional investors
 - licensed VASPs will only be allowed to provide services to professional investors
 - restriction will be imposed as a licensing condition
 - FSTB & SFC will review the position re. retail investors as the market matures
- SFC approval of VASP's ultimate owner
 - SFC must give its written approval before a person becomes a VASP's ultimate owner
 - SFC must be satisfied that the VASP will continue to be fit and proper if the ultimate owner is approved

OBLIGATIONS OF LICENSED VASPs (CONT'D)

Licensed VASPs must:

- Submit an annual return and pay an annual fee to the SFC
- Appoint an auditor and file audited financial statements w/in 4 months of their financial year-end
- Notify SFC of (among others):
 - any change in any information provided by the licensed VASP or its ultimate owner
 - an intention to cease business as a VA service provider
 - a change in the address at which a VA service is provided
 - a change in the VASP's directors
 - an auditor of a licensed VASP or an associated entity ceasing to act
 - a licensed representative ceasing to act

Offence	Maximum Penalty
Offence to carry on a business of providing a VA service in Hong Kong, or to hold oneself out as doing so, without a licence	HK\$5 million fine and 7 years' imprisonment and daily fine of HK\$100,000 for each day the offence continues
Offence for a person to actively market a VA service it provides outside Hong Kong to the Hong Kong public without a VASP licence	HK\$50,000 fine and 6 months' imprisonment
Offence for an unlicensed person to issue, or possess for the purpose of issue, an advertisement which holds the person out as prepared to provide a VA service	HK\$50,000 fine and 6 months' imprisonment

Offence	Maximum Penalty
Offence of making a fraudulent or reckless misrepresentation to induce an acquisition, disposal, subscription for or underwriting of any virtual assets (whether the transaction takes place on a licensed VA exchange or not)	HK\$1 million fine and 7 years' imprisonment
A person will commit an offence, if in a transaction involving virtual assets, the person: (i) employs any device, scheme or artifice with intent to defraud or deceive; or (ii) engages in any fraudulent or deceptive act, practice or business	HK\$10 million fine and 10 years' imprisonment

SFC POWERS RE. LICENSED VA EXCHANGES

SFC has powers to:

- enter business premises of licensed VASPs and their associated entities
- request production of documents and records
- sanction licensed persons in breach of the AMLO or no longer considered by the SFC to be fit and proper to remain licensed – possible sanctions include a reprimand, order to take remedial action, a fine and licence suspension or revocation

IMPLEMENTATION OF FATF TRAVEL RULE REQUIREMENT

- New section 13A to Schedule 2 AMLO will require financial institutions – including licensed VASPs – to obtain and pass on information in relation to transfers of virtual assets
- Originating financial institution must obtain and record identifying information for the originator and the recipient and submit the information to the beneficiary institution
- A financial institution acting as an intermediary institution in a virtual asset transfer must submit all the information it receives with the transfer to the institution to which it passes on the transfer instruction

HKMA PROPOSALS FOR REGULATION OF PAYMENT-RELATED STABLECOINS

- HKMA Discussion Paper on Crypto-assets and Stablecoins published 12 January 2022
- Stablecoin arrangements may fall outside the scope of the stored value facility licensing regime under the Payment Systems and Stored Value Facilities Ordinance (the PSSVFO)
- Under the PSSVFO, a facility is a stored value facility if it can be used for:
 - a. storing the value of an amount of money that:
 - i. is paid into the facility from time to time; and
 - ii. may be stored on the facility under the rules of the facility; and
 - b. for either or both of the following purposes:
 - i. as a means of making payments for goods or services under an undertaking (express or implied) given by the issuer of the facility;
 - ii. as a means of making payments to another person (other than payments mentioned in (i) above) under an undertaking (express or implied) given by the issuer of the facility

PROPOSED REGULATORY SCOPE

- HKMA proposes risk-based approach
- Regulation will focus initially on payment-related stablecoins
- HKMA proposes to regulate asset-linked stablecoins (eg a stablecoin whose value is linked to a specific fiat currency) rather than algorithm-based stablecoins
- Certain activities relating to stablecoins will require HKMA licensing either under an expanded version of the PSSVFO or new legislation
- As stablecoin arrangements usually involve more than one entity, multiple entities in a stablecoin arrangement may need HKMA authorisation

PROPOSED REGULATED ACTIVITIES RELATING TO STABLECOINS

- issuing, creating or destroying stablecoins
 - i.e. the issuer minting and burning stablecoins
- managing reserve assets to stabilise the value of stablecoins
 - i.e. managing the reserve assets that back the value of the stablecoins and providing custody or trust for these assets
- validating transactions and records
 - i.e. authorising or verifying the validity of transactions and records
- storing the private keys providing access to stablecoins
 - i.e. safe-keeping of the keys used to digitally sign transaction instructions on behalf of stablecoin holders

- facilitating the redemption of stablecoins
 - i.e. facilitating stablecoin holders' redemption of their stablecoins for fiat currencies or other assets
- transmission of funds
 - i.e. ensuring the accurate and final settlement of transactions to minimise the risk of default by counterparties
- executing transactions in stablecoins
 - i.e. conducting transactions on behalf of others

PROPOSED REGULATED ACTIVITIES RELATING TO STABLECOINS (CONT'D)

PROPOSED REGULATORY REQUIREMENTS FOR ENTITIES CONDUCTING STABLECOIN-RELATED ACTIVITIES

- Prudential requirements including requirement for licensed entities to have adequate financial resources and liquidity
- Fit and proper requirements for management and owners
- Maintenance and management of reserves of backing assets
- Systems, controls, governance and risk management requirements
- AML/CFT requirements
- Redemption requirements
- Financial reporting and disclosure requirements
- Safety, efficiency and security requirements
- Settlement finality

LICENSING REQUIREMENT

- HKMA proposing that any entity wanting to conduct any of the regulated stablecoin-related activities in Hong Kong will need to be:
 - incorporated in Hong Kong
 - licensed by the HKMA
- New regulatory regime will prohibit the active marketing of stablecoin-related activities to the Hong Kong public by an unlicensed entity
- A foreign company/group will need to incorporate a Hong Kong company to apply for an HKMA licence to provide regulated stablecoin-related activities in Hong Kong

REGIME IMPLEMENTATION

- HKMA aims to implement new regime in 2023/2024
- Proposes to draw reference from relevant international standards and recommendations e.g. those of the Financial Stability Board and the Bank of International Settlements
- Proposed regime expected to take relevant aspects of Hong Kong's approach to SVF and payment regulation as a minimum to avoid regulatory arbitrage
- Stablecoin issuers to be subject to higher prudential requirements to protect users



MCQs

Question 1

NFT proceeds are managed collectively by a 3rd party arranger to invest in a painting with the aim of enabling NFT holders to receive a share of the profit made on a future sale of the painting. In this case, the NFT may constitute what?

- ✓ (A) Interests in a Collective Investment Scheme
- (B) Bonds
- (C) Shares
- (D) Structured products

Question 2

Which of the following is FALSE with respect to security tokens and STOs in Hong Kong?

- (A) Security tokens are considered “complex products”
- (B) Security tokens should only be offered to professional investors
- ✓ (C) There is an obligation on issuers to ensure the suitability of security tokens for investors
- (D) Intermediaries marketing and distributing security tokens must be licensed or registered with the SFC for Regulated Activity Type 1 (dealing in securities)

Question 3

In which of the following scenarios would a crypto exchange which operates in Hong Kong be eligible to be licensed by the SFC under the existing opt-in licensing regime under the SFO?

- (A) A centralised exchange which trades an NFT which represents a unique copy of an underlying asset
- ✓ (B) A centralised exchange which trades at least one virtual asset that is a security
- (C) A centralised exchange which only trades non-security virtual assets
- (D) A decentralised exchange which enables transactions by investors who retain control over their own virtual assets

Question 4

Which of the following will be “virtual assets” under the new VASP licensing regime under the AMLO?

- ✓ (A) Non-securities virtual assets (e.g. Bitcoin and Ether)
- (B) Digital representations of fiat currencies (e.g. central bank digital currencies)
- (C) Air miles
- (D) Gaming coins

Question 5

Which of the following is TRUE about the HKMA proposals for regulating stablecoins?

- (A) The HKMA proposes to regulate algorithm-based stablecoins
- (B) Only banks will be allowed to issue stablecoins
- (C) Only one entity in a stablecoin arrangement will need to seek HKMA authorisation
- ✓ (D) Any entity wanting to issue stablecoins in Hong Kong will need to be incorporated in Hong Kong

Q&A

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