

CHARLTONS
易周律師行

Proposed Licensing Regimes

VIRTUAL ASSET OVER-THE-
COUNTER (OTC) SERVICES AND
STABLECOIN ISSUERS

2024



PART 1

FSTB consults on regulating OTC virtual asset trading

- Seek views on proposals to regulate OTC virtual assets (VA) trading under new licensing regime
- Under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (AMLO)

Background

- HK Government committed to comprehensive framework to regulate virtual assets under “same activity, same risks, same regulation” principle
- June 2023: licensing regime for VATP operators implemented
- Only 2 VATPs licensed by SFC
- 2023: shops providing OTC virtual asset trading services to retail investors made false / misleading claims re. licensed status

Virtual Asset OTC Service Provider Licensing Requirements

- “Virtual asset OTC business” defined as:
 - (a) by way of business, provision of service of spot trade of any virtual asset;
 - (b) irrespective of whether the service is provided through a physical outlet (i.e. including ATMs) or other (e.g. digital) platforms; and
 - (c) explicitly excluding the operation of a VATP as already covered under the VATP licensing regime
- Excludes peer-to-peer trading between individuals, unless the trade constitutes the business activity of either party

Eligibility

- Applicants must be:
 - (a) a Hong Kong incorporated company with a permanent place of business in Hong Kong; or
 - (b) a company incorporated overseas but registered in Hong Kong under the Companies Ordinance
- CCE will consider relevant factors when evaluating an applicant's suitability e.g. previous convictions for AML/CTF or other serious offences, convictions for fraudulent, corrupt or dishonest conduct



Permitted Activities

- Can engage in spot trading of any virtual asset for money, or vice versa
- Prohibited from providing virtual asset to virtual asset trading services which require a VATP licence
- Need to apply for a money service operator licence to remit fiat money to clients
- Need to apply to CCE re. the full list of wallets to be used in their operations and register the list with CCE
- Not permitted to provide other services such as virtual asset advisory or referral services, and offering virtual asset derivatives or other financial products (including staking, lending and margin trading)

Types of Virtual Assets Allowed to be Offered for Virtual Asset OTC Trading

- Virtual asset OTC licensees will only be allowed to offer spot trading in
 - virtual assets that can be traded by retail investors on at least one SFC-licensed VATP; and
 - stablecoins issued by HKMA-licensed issuers (under proposed regime)
- Under SFC's VATP Guidelines, licensed VATP operators can only offer retail trading in VAs that are “highly liquid”
 - “highly liquid”: an “eligible large-cap virtual asset”, which is defined as a virtual asset that is included in a minimum of two acceptable indices issued by at least two independent index providers
 - “acceptable index”: one measuring the largest virtual assets globally - e.g. top 10
- Proposed licensing regime for stablecoin issuers will only apply to issuers of fiat-referenced stablecoins

Proposed Licensing Requirements for Virtual Asset OTC Operators

- Observe the AML/CTF requirements set out in Schedule 2 to the AMLO re. customer due diligence and record-keeping

- Appoint a competent Compliance Officer and Money Laundering Reporting Officer

- Corporate governance

- (i) Have a proper corporate governance structure;
- (ii) Operate its business in a prudent and sound manner;
- (iii) Act honestly, fairly, with due skill, care and diligence and in the best interest of its clients and the integrity of the market;
- (iv) Have appropriate risk management policies and procedures to manage AML/CTF, cybersecurity and other risks; and
- (v) Keep records of transactions and fund flows

Licensing Period and Transitional Period Options

Licensing Period

The FSTB proposes an initial licence period of 2 years, with the possibility of renewal for an additional 2 years upon application to and approval from the CCE

Transitional Period Options

The FSTB is proposing a 6-month transitional period before the commencement of the new licensing regime for virtual asset OTC businesses already operating in Hong Kong

Option 1 - No Deeming Arrangement

Option 2 - With Deeming Arrangement

Prohibition on Marketing Activities

- The FSTB proposes to prohibit the active marketing of virtual asset OTC services, in Hong Kong or elsewhere, to the Hong Kong public
- Unless the person holds a valid licence as a virtual asset OTC service provider



Powers of the CCE

- Powers to
 - impose licensing conditions, including to add to, vary or modify existing conditions;
 - enforce the statutory and regulatory requirements;
 - enter licensees' business premises to conduct routine inspections;
 - investigate suspected non-compliances and remove evidence of the commission of an offence;
 - carry out arrests and searches; and
 - impose disciplinary sanctions for non-compliance
- Potentially, additional powers to prevent access to websites or digital platforms (in or outside Hong Kong) of virtual assets OTC operators involved in unlicensed or fraudulent activities
- Power to obtain information from other relevant authorities, e.g. the SFC and the HKMA

Sanctions

Offence	Proposed Sanctions
Conducting a regulated virtual asset OTC service without a licence	HK\$1 million fine and 2 years' imprisonment
Knowingly issuing an advertisement relating to an unlicensed person's provision of virtual asset OTC services	HK\$50,000 fine and 6 months' imprisonment
Non-compliance with the statutory AML/CTF requirements	HK\$1 million fine and 2 years' imprisonment
Making a fraudulent or reckless misrepresentation to induce a transaction involving virtual assets	HK\$1 million fine and 7 years' imprisonment
Fraudulent or deceptive behaviour in transactions involving virtual assets	HK\$10 million fine and 10 years' imprisonment

PART 2

Consultation conclusions on regulatory regime for stablecoin issuers

- Consultation Paper jointly issued by the FSTB and HKMA on 27 December 2023
- FSTB and HKMA received 108 submissions
- Consultation Conclusions jointly issued by the FSTB and HKMA on 18 July 2024
- Plan to introduce bill to Legislative Council later in 2024

Background

Regulatory Regime for FRS Issuers

- FSTB and HKMA closely monitoring international regulatory developments
- Risks from the perspectives of monetary and financial stability, consumer protection and anti-money laundering and terrorist financing
- Need for risk-based regulatory regime for fiat-referenced stablecoins (“FRS”) to mitigate risks

Current Regulatory Regime In Hong Kong

- Virtual asset trading platforms (“VATPs”) overseen by the SFC under the AMLO
- Stored value facilities overseen by the HKMA under the Payment Systems and Stored Value Facilities Ordinance (the “PSSVFO”)



Proposed Stablecoin Regulatory Regime

Rationale and Objectives

- Stand-alone new piece of legislation
- Key policy objectives:
 - appropriate safeguards
 - adequate protection of fiat-referenced stablecoin users
 - in line with international regulatory recommendations
 - foster virtual asset ecosystem in Hong Kong



Definition

“Stablecoin”

A cryptographically secured digital representation of value that, among other things, —

- is expressed as a unit of account or a store of economic value;
- is used, or is intended to be used, as a medium of exchange accepted by the public, for the purpose of payment for goods or services; discharge of a debt; and/or investment;
- can be transferred, stored or traded electronically;
- is operated on a **decentralised distributed ledger or similar technology**; and
- purports to maintain a stable value with reference to a specified asset, or a pool or basket of assets

- “A stablecoin where the specified asset is one or more fiat currencies”
- FRS pose more imminent monetary and financial stability risks compared to other types of stablecoins
- Regulators will closely monitor market developments and adjust the regulatory remit

Definition
**“Fiat-referenced
stablecoins”
(FRS)**

Scope of Regulated Activity

- Regulation of FRS issuance is priority
- “Issuance activity” is generally a matter to be decided on a case-by-case basis with respect to specific facts and circumstances
- Regulation of private key storage and the provision of wallet services will be explored in future



Summary of the Proposed Licensing Regime

An FRS issuer must obtain an FRS issuer licence from the HKMA to

- (i) issue, or hold itself out as issuing, an FRS in Hong Kong;
- (ii) issue, or hold itself out as issuing, a stablecoin purporting to maintain a stable value with reference to the value of HKD; or
- (iii) actively market its issuance of FRS to the Hong Kong public

“Actively marketing its issuance of FRS to the public of Hong Kong” - factors:

- (a) language used in the marketing messages;
- (b) whether message is targeted at a group of people that resides in Hong Kong; and
- (c) whether a Hong Kong domain name is used for its website

“Issued in Hong Kong” - factors:

- (a) FRS issuer’s place of incorporation;
- (b) location of its operations;
- (c) provision of subsequent customer service to FRS users; and
- (d) whether Hong Kong bank account is used to process issuance and redemption requests

Licensing Criteria and Conditions: Management of Reserves and Stabilisation Mechanisms

- FRS must be backed by reserve assets having a value equal to or greater than par value of FRS in circulation
- Reserve assets must be of high quality and liquidity, with minimal market, credit and concentration risks
 - e.g. coins and banknotes, deposits placed with licensed banks, marketable securities representing claims on or guaranteed by governments
- Effective trust arrangement must be in place to ensure the assets are segregated and available for redemption requests and legal claims
- FRS issuers must set up segregated accounts for reserve assets with HK licensed banks or, with HKMA approval, other custodians

Licensing Criteria and Conditions:

Management of Reserves and Stabilisation Mechanisms (cont'd)

- FRS issuers must have investment policies/controls and liquidity risk management practices and conduct periodic stress testing to ensure adequacy and liquidity of reserve assets to ensure redemption requests can be met
- Disclose regularly total amount of FRS in circulation, mark-to-market value and composition of reserve assets
- Independent auditor to attest monthly on above matters and on adequacy and liquidity of reserve assets
- Prohibition on paying interest to FRS users and income or loss from the reserve assets must be attributed to the FRS issuer
- FRS issuers ultimately responsible for effectiveness of stabilisation mechanism, even if third parties are engaged

Licensing Criteria and Conditions:

Redemption Requirements and Restrictions on Business Activities

- FRS users must have the right to redeem FRS at par without undue costs or unreasonable conditions
- Redemption requests must be met within one business day of receipt of redemption request
- FRS issuers must obtain prior HKMA approval before starting new business lines
- FRS issuers must avoid lending, financial intermediation and regulated activities under the SFO, Mandatory Provident Fund Schemes Ordinance and Insurance Ordinance

Licensing Criteria and Conditions:

Physical Presence in Hong Kong and Financial Resources Requirement

- Must be a company incorporated in Hong Kong with a registered office in Hong Kong
- Overseas incorporated companies (except AIs) must establish Hong Kong subsidiary
- Chief executive, senior management and key personnel must be based in Hong Kong
- Must have adequate financial resources, including minimum paid-up share capital of higher of HK\$25 million or 1% of par value of FRS in circulation



Licensing Criteria and Conditions:

Disclosure Requirements and Governance, Knowledge and Experience

- Publish a white paper including, among others,
 - general information about the FRS issuer;
 - rights of the FRS users;
 - relevant FRS stabilisation mechanisms;
 - reserve management arrangements;
 - information re. underlying technology;
 - risks associated with using the FRS; and
 - the mechanism and procedures for issuance, distribution and redemption
- Senior management, including controllers, chief executives and directors of an FRS issuer must be fit and proper persons
- Any appointment or changes in ownership or management of the FRS issuer require HKMA's prior consent

Licensing Criteria and Conditions:

Risk Management and Audit Requirements

- The FRS issuer must have appropriate risk management measures for its operations including, among others,
 - (i) adequate security and internal controls ensuring data security, detection measures for fraud and technological risks;
 - (ii) robust contingency arrangements to address operational disruptions; and
 - (iii) other operational and security safeguards
- Must carry out risk assessments at least annually
- When appointing an auditor, FRS issuers should consider the auditor's knowledge, expertise, resources and independence regarding relevant audit areas
- Must submit audited financial statements to the HKMA annually

Licensing Criteria and Conditions:

AML/CFT Requirements and Complaints Handling

- Adopt a risk-based approach
- FRS issuers must observe requirements on customer due diligence in relation to FRS issuance and redemption, transaction monitoring and wire transfers as required under the AMLO
- Provide FRS users with effective complaint handling and dispute resolution system

Eligibility for a Licence

- All entities would be eligible to apply for an FRS licence if they can satisfy the same set of licensing and regulatory requirements
- Exemptions for authorised institutions only pertain to licensing criteria regarding restrictions on business activities, physical presence in Hong Kong and financial resources requirements
 - Intended to prevent regulatory inconsistencies and overlaps with existing banking regulations
- When evaluating a licence application from an authorised institution, the HKMA will consider the risk profile of the authorised institution to determine if a separate entity should be set up

Ongoing Licensing Conditions

- The HKMA will be empowered to impose ongoing conditions on the licences of FRS issuers
 - Address matters regarding a specific FRS issuer, e.g. operation risks, risk management effectiveness and operation size
- FRS issuers will be notified of the HKMA's intention to impose licensing conditions
 - Have the chance to make representations before HKMA finalises decision to proceed with attaching licensing conditions

Issuing More Than One FRS

- FRS issuers are allowed to issue more than one FRS under existing licence without needing to set up a separate entity or apply for a separate licence
- To issue an additional FRS, FRS issuer must provide the rationale, justify use cases, and obtain prior HKMA consent



Open-ended Licence

- FRS licences will remain valid until the licence is revoked by the HKMA
- e.g. due to non-compliance with regulatory requirements or FRS issuer ceases operations

Register of Licensees

- Must display licence number in a prominent place on advertisements and in accessible locations on their websites and mobile applications for FRS users to identify licensed FRS issuers
- HKMA will maintain a central register of all FRS licensees that will be accessible by the public



Offering of FRS

- Only licensed FRS issuers, authorised institutions, licensed corporations and licensed virtual asset trading platforms can offer FRS in Hong Kong
- Licensed FRS issuers can only offer FRS they issue
- Authorised institutions, licensed corporations and licensed virtual asset trading platforms can only offer:
 - FRS issued by HKMA-licensed issuers to retail investors
 - FRS issued by unlicensed issuers to professional investors (as defined in Part 1 of Schedule 1 to the SFO)



Offering of FRS (cont'd)

- 'Offer' means public communication in any form that provides sufficient information about the terms of the offer and how the FRS can be obtained to allow decision whether to acquire
- The FSTB and HKMA do not see an immediate need to make a decision on whether to allow SVF licensees to offer FRS
 - FSTB and HKMA are working on the possibility to allow licensed virtual asset over-the-counter service providers to offer FRS
- The regulators will consider formal regulatory cooperation mechanisms with other jurisdictions as and when equivalent regimes are established

Authorities' Power to Modify the Proposed Stablecoin Regulatory Regime

- To address risks arising from emerging stablecoin types, activities or entities,
 - HKMA to have power to adjust the parameters of in-scope stablecoins and activities
- In exercising this power, the HKMA will take into account, among others:
 - (a) the number and type of users;
 - (b) the number and value of transactions;
 - (c) the size and type of reserve assets;
 - (d) the value in circulation;
 - (e) the market share;
 - (f) the interconnectedness with financial systems; and/or
 - (g) the business, structural and operational complexity

Supervisory and Investigation Powers of the HKMA

Power to intervene in the operations of an FRS licensee when, in consultation with the Financial Secretary, it is of the opinion that it:

- (a) is or likely to become insolvent or unable to meet its obligations;
- (b) is carrying on its business in a manner detrimental to the interest of its users or creditors; or
- (c) has contravened any of its licensing conditions or provisions of the proposed regulatory regime

Other HKMA supervisory powers to ensure FRS licensees meet the statutory requirements

- (i) gather information;
- (ii) give directions;
- (iii) make regulations; and
- (iv) issue guidelines

Power to conduct investigations where there is reasonable cause to believe that an offence may have been committed

- include directing an investigator to conduct investigations and applying to a Hong Kong Magistrate for search warrants and seizures

Offences and Sanctions

- Proposed criminal offences include:
 - conducting any activity requiring an FRS issuer licence while unlicensed
 - advertising an issuance of FRS by an unlicensed issuer
 - offering or advertising an FRS by anyone other than a licensed FRS issuer, authorised institution, licensed corporation or virtual asset trading platform
 - providing false information to, or failing to provide information required by, HKMA
- Proposed civil and supervisory sanctions for breach of regulatory requirements - any or combination of:
 - caution, warning, reprimand, order to take specified action(s), suspension or revocation of licence
 - pecuniary penalty not exceeding HK\$10 million or 3 x the profit gained or loss avoided as a result of the breach, whichever is higher

Transitional Arrangements

- Existing FRS issuers conducting FRS issuance activities with meaningful and substantial presence in Hong Kong prior to implementation of the new regulatory regime may continue to operate for a 6-month non-contravention period on condition that they submit an FRS licence application to the HKMA within the first 3 months
- Those that do not submit an FRS licence application within the stipulated 3 months must close down their business in an orderly manner by the end of the 4th month
- “Meaningful and substantial operations in Hong Kong” - factors:
 - whether the entity operating the FRS issuance is incorporated in Hong Kong
 - whether it has a physical office in Hong Kong with staff exercising central management
 - control over the FRS issuance
 - whether the FRS it issues have been circulated to independent FRS users

- Regulators are drafting bill to implement the regulatory proposal, which will be introduced into Legco later this year
- The HKMA will issue licensing and supervisory guidelines in due course

Implementation Timeline

Stablecoin Issuer Sandbox

- Sandbox participants test out feasibility of intended business models and communicate with the HKMA to understand how to comply with future regulatory requirements
- To be eligible, sandbox participant applicants must be able to demonstrate that they:
 - (1) have a genuine interest in and a reasonable plan for issuing fiat-referenced stablecoins in Hong Kong;
 - (2) have a concrete plan for participation in the sandbox; and
 - (3) have a reasonable prospect of complying with the proposed regulatory requirements
- - 18 July 2024: first batch of 3 participants admitted: (1) JINGDONG Coinlink Technology Hong Kong Limited; (2) RD InnoTech Limited; and (3) Standard Chartered Bank (Hong Kong) Limited, Animoca Brands Limited, and Hong Kong Telecommunications (HKT) Limited
 - Primary use cases proposed: payments, supply chain management and applications in capital markets