

Hong Kong Proposes New Licensing Regime for Virtual Asset Service Providers

November 11, 2020

On November 3, 2020, the Hong Kong Financial Services and Treasury Bureau (FSTB) issued a public consultation paper (Consultation) outlining, among other things, a proposed new licensing regime for virtual asset service providers (VASPs) in order to implement the recommendations of the Financial Action Task Force.¹

Under the proposed VASP licensing regime (VASP Regime) outlined in the Consultation, the business of operating a virtual assets exchange will be a regulated virtual asset activity under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (AMLO) and will require a VASP license from the Securities and Futures Commission (SFC).

It is proposed that the eligibility and regulatory requirements under the VASP Regime be similar to the requirements under the SFC's existing "opt in" regime for virtual asset trading platforms that trade securities (VATP) (see our update "[SFC Gives Green Light to Regulation of Virtual Asset Trading Platforms in Hong Kong](#)" dated November 12, 2019, for details). The VASP Regime will operate in parallel with the regulatory regime for VATPs.

Whom does this affect?

The VASP Regime affects all new and existing virtual asset exchanges (VA Exchange), defined to mean trading platforms that

- (i) operate for the purpose of allowing offers or invitations to be made to buy or sell any virtual asset (VA) in exchange for any money or any VA (whether of the same or different type), and
- (ii) come into custody, control, power, or possession of, or over, any money or any VA at any point in time during its course of business

Notably, peer-to-peer trading platforms are not within the scope of VA Exchange and are therefore not subject to the VASP Regime, but only to the extent that the actual transactions are conducted outside the platform and the platform is not involved in the underlying transaction by having possession of any money or any VAs at any time.

Other VA-related activities, such as transfer of VAs, safekeeping, and/or administration of VAs or instruments enabling control over VAs, and participation in and provision of financial services related to

an issuer's offer and/or sale of VAs (e.g., initial coin offerings), are not intended to be regulated in Hong Kong at this time.

Scope of virtual assets

For the purpose of the VASP Regime, a VA will be defined as a digital representation of value that satisfies each of the following

- (i) is expressed as a unit of account or a store of economic value
- (ii) 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 purpose
- (iii) can be transferred, stored, or traded electronically

This definition will capture VAs backed by some form of assets for the purpose of stabilizing their value (such as stablecoins), but it will not capture digital representations of fiat currencies (including digital currencies issued by central banks) or financial assets that are already regulated under the Securities and Futures Ordinance (SFO), such as securities and authorized structured products. This definition will also exclude closed-loop, limited-purpose items that are nontransferable, nonexchangeable, and nonfungible, such as air miles, credit card rewards, gift cards, customer loyalty programmes, and gaming coins.

How does it affect you?

Once the VASP Regime is introduced, any person who operates or is seeking to operate a VA Exchange will need to be licensed by the SFC as a VASP under the AMLO.

Overview of VASP Regime

We have summarized below the key proposed licensing requirements under the VASP Regime.

	Requirements
Eligibility	<ul style="list-style-type: none">• Only locally incorporated companies with a permanent place of business in Hong Kong will be considered for the granting of a VASP license.
Fit and Proper Test	<ul style="list-style-type: none">• A licensed VASP must satisfy a fit and proper test that is applicable to other financial institutions regulated under the AMLO. This will apply to all responsible officers and ultimate owners of the corporate applicant, and any change will require prior approval by the SFC.• Similar to the requirements under the SFO for licensed corporations, a licensed VASP will need to appoint at least two responsible officers, and all executive directors must be made responsible officers upon SFC approval.

Regulatory Requirements

- A licensed VASP is required to observe the AML/CTF requirements stipulated in Schedule 2 to the AMLO.
- A licensed VASP will also be subject to regulatory requirements similar to those that apply under the existing VATP regime, including these:
 - *Professional investors only:* A licensed VASP should offer services to professional investors only as defined under the SFO and its subsidiary legislation.
 - *Financial resources:* A licensed VASP should have adequate financial resources for operating its VA business, including a paid-up share capital of a specified amount and liquid assets.
 - *Knowledge and experience:* A licensed VASP and its associated entities should have a proper corporate governance structure staffed by personnel with the necessary knowledge and experience.
 - *Soundness of business:* A licensed VASP and its associated entities should operate its VA business in a prudent and sound manner and ensure that client and public interests will not be adversely affected.
 - *Risk management:* A licensed VASP should have in place appropriate risk management policies and procedures for managing money laundering/terrorist financing, cybersecurity, and other risks arising from a regulated VA activity.
 - *Segregation and management of client assets:* A licensed VASP should implement proper segregation of client assets by placing them in an associated entity as well as adequate policies and governance procedures to ensure the proper management and custody of client assets.
 - *VA listing and trading policies:* A licensed VASP should implement and enforce robust rules for the listing and trading of VAs on its platform(s) and should perform all reasonable due diligence on VAs before listing.
 - *Financial reporting and disclosure:* A licensed VASP and its associated entities should observe prescribed auditing and disclosure requirements and publish audited accounts.
 - *Prevention of market manipulative and abusive activities:* A licensed VASP should establish and implement written

	<p>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.</p> <ul style="list-style-type: none"> • <i>Prevention of conflicts of interests:</i> To avoid any conflicts of interest, a licensed VASP and its associated entities should not engage in proprietary trading or market-making activities on a proprietary basis and should have in place firewalls between the different functions of corporate structure to avoid conflict of interests; the licensed VASPs and their associated entities should also have a policy to eliminate, avoid, manage, or disclose actual or potential conflicts of interests for their employees who deal with VAs.
Open-ended License	<ul style="list-style-type: none"> • Licenses granted to VASPs will remain valid until revoked by the SFC (e.g., due to misconduct) or the licensed VASP ceases its operation.
Power of SFC	<ul style="list-style-type: none"> • The SFC will be empowered to supervise and regulate the licensed VASPs. This will include powers to do the following: <ul style="list-style-type: none"> • enter business premises for inspections • require production of documents and records • investigate noncompliance • impose administrative sanctions against noncompliance • intervene, for example, prohibit the VASP from entering any further transactions or require it to conduct its business in a specific manner, restrict the VASP from disposing of its property, and require the VASP to maintain its property in a specific manner to meet liabilities

It is proposed that a transitional period of 180 days upon commencement of operation of the licensing regime will be available. Any person carrying on VASP activities after expiration of the transitional period without a valid license will commit a criminal offense that will be punishable, on conviction on indictment, with a fine of HK\$5 million and imprisonment for seven years and, in the case of a continuing offense, with a further fine of HK\$100,000 for every day during which the offense continues.

What happens next?

The consultation period of the Consultation will end on January 31, 2021. Taking into account the views and comments received and subject to progress in the preparatory work, the FSTB aims to introduce a bill into the Legislative Council in 2021.

Although the requirements for VASPs are stringent and restrict the service offering to professional investors only (at least initially), the FSTB's proposed regulations nonetheless remain a critical milestone

in the development of the VAs industry in Hong Kong because they provide much-needed regulatory clarity and establish rigorous benchmarks, which in turn will boost investor confidence. This is essential to the development of a robust and dynamic VAs ecosystem and positions Hong Kong to be a hub and a market leader for VAs.

Sidley is at the cutting edge of VAs legal work in Hong Kong. Our experience is comprehensive in all core aspects that are relevant to the VAs ecosystem, including advising on the formation of VAs funds, advising on regulatory requirements for virtual asset exchange operators and VA fund managers, and advising on early-stage financing/merger and acquisition transactions for technology and VAs growth companies. Most notably, Sidley is the legal team behind Asia's first two (and so far only) tokenized funds.

If you would like to hear some of the insights we have gained from our groundbreaking work in the VA segment or explore how we may be able to assist you, please contact us.

¹ The Consultation also includes other enhancements in relation to anti-money-laundering/counterterrorist financing (AML/CTF) regulations, including the introduction of a two-tier registration regime for dealers in precious metals and stones and other miscellaneous technical amendments under the AMLO.

CONTACTS

If you have any questions regarding this Sidley Update, please contact the Sidley lawyer with whom you usually work, or

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