

Client Alert

Financial Services

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Virtual assets – licensing regime for virtual asset service providers; market misconduct

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The need for virtual asset service providers (**VASPs**) to be licensed in Hong Kong has moved closer with the bill setting out the licence regime, the Anti-Money Laundering and Counter-Terrorist Financing (Amendment) Bill 2022 (**AMLO Amendment Bill**), gazetted on 24 June 2022.

The licence regime is modelled on the regime for participants in the securities and futures markets under the Securities and Futures Ordinance (**SFO**).

The AMLO Amendment Bill also introduces specific offences for fraudulent activities relating to dealing in virtual assets.

Regulation of virtual assets market misconduct

The AMLO Amendment Bill includes offences for market misconduct related to virtual assets:

1. Offence involving fraudulent or deceptive devices in transactions in virtual assets – this offence is subject to a fine of up to HK\$10 million and to imprisonment for up to 10 years;
2. Offence to fraudulently or recklessly induce others to invest in virtual assets – this offence is subject to a fine of up to HK\$1 million to imprisonment for up to 7 years.

Licensing regime

When will the licence regime come into effect?

The AMLO Amendment Bill proposes a commencement date for the licence regime of **1 March 2023**.

Who is affected?

The following will need to be licensed:

1. Any person in Hong Kong that carries on a business of providing any VA service or holds themselves out as carrying on a business of providing any VA service;
2. Any person outside Hong Kong that (i) actively markets to the public in Hong Kong any services the person provides or purports to provide, and (ii) the provision of such services, if done in Hong Kong, would constitute providing a “VA service”.

Existing providers of VA services will either need to apply for a licence or will need to wind down their business in Hong Kong and their marketing activities directed at Hong Kong – see “Transitional provisions” below for further detail.

What are “VA services”?

“VA service” is defined to mean:

“operating a VA exchange, that is to say, providing services through means of electronic facilities-

- (i) whereby-

- (A) offers to sell or purchase virtual assets are regularly made or accepted in a way that forms or results in a binding transaction; or
- (B) persons are regularly introduced, or identified to other persons in order that they may negotiate or conclude, or with the reasonable expectation that they will negotiate or conclude sales of purchases of virtual assets of virtual assets in a way that forms or results in a binding transaction; and
- (ii) where client money or client virtual assets comes into direct or indirect possession of the person providing such service.”

Given the definition of “VA service”, virtual asset payment systems and virtual asset custodian services will be out of scope for licensing purposes, as will be services that match buyers and sellers but are not involved in settlement of such transactions.

What are “virtual assets”?

“Virtual asset” is defined to mean:

- “(a) 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 is intended to be used, as a medium of exchange accepted by the public, for any one or more of the following purposes-
 - (I) payment for goods or services;
 - (II) discharge of a debt;
 - (III) 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;
 - (iii) can be transferred, stored or traded electronically; and
 - (iv) satisfies other characteristics prescribed by the Commission under subsection 3(a); or
- (b) a digital representation of value prescribed as a virtual asset by notice published under subsection 4(a).”

There are various exclusions from the definition of “virtual assets”, including:

- digital currencies issued by central banks;
- “limited purpose digital tokens”, which include customer loyalty or reward points (e.g. air miles, credit card rewards, gift cards, customer loyalty programmes) and in-game assets that can only be used within or in relation to the relevant game;
- securities and futures contracts, which are regulated under the SFO.

There is power for the Secretary for Financial Services and the Treasury to prescribe by notice any digital representation of value to be a virtual asset or not to be a virtual asset, either generally or in any particular case.

It is an open question whether non-fungible tokens are “virtual assets”, although it is reasonably arguable that non-fungible tokens are not intended to be “representations of value” and not intended to be used as a medium of exchange.

Who is the regulator?

The regulator is the Securities and Futures Commission (**SFC**). Applicants for a licence must apply to the SFC and, in addition to complying with the statutory requirements in the AMLO Amendment Bill, must comply with SFC codes, guidelines and circulars relating to VA licensees.

Overview of licence regime

The features of the licence regime include the following:

1. The applicant must be either a Hong Kong incorporated company or an overseas company that is registered as a non-Hong Kong company under the Companies Ordinance.

2. The SFC must be satisfied that the applicant is “fit and proper”. Factors the SFC must have regard to for this purpose include:
 - (a) The financial status or solvency of the applicant;
 - (b) The educational or other qualifications or experience of the applicant;
 - (c) The ability of the applicant to provide the VA service competently, honestly and fairly;
 - (d) The reputation, character, reliability and financial integrity of the applicant;
 - (e) Whether the applicant has been convicted of an offence, either in Hong Kong or elsewhere, relating to money laundering, terrorist financing, fraud, corruption or dishonesty.

The SFC can also take into account information relating to, amongst others, employees, other companies within the same group as the applicant and the ultimate owner of the applicant in determining whether the SFC considers the applicant to be fit and proper.

3. The applicant must have at least 2 persons who will act as “responsible officers” of the applicant. The SFC must be satisfied that each such person is a fit and proper person to be associated with the business of providing the relevant VA services. Every executive director of the applicant must apply for approval as a responsible officer. At least one responsible officer must be ordinarily resident in Hong Kong. In addition, at least one responsible officer must be available at all times to supervise the business of the relevant VA services.
4. The SFC must be satisfied that each director of the applicant is a fit and proper person to be associated with the business of providing the relevant VA services.
5. The SFC must be satisfied that the “ultimate owner” (if any) of the applicant is a fit and proper person to be associated with the business of providing the relevant VA services. The “ultimate owner” of the applicant is “an individual who-
 - (a) owns or controls, directly or indirectly, including through a trust or bearer share holding, more than 25% of the issued share capital of the corporation;
 - (b) is, directly or indirectly, entitled to exercise or control the exercise of more than 25% of the voting rights at general meetings of the corporation; or
 - (c) exercises ultimate control over the management of the corporation”.

A person may not become the ultimate owner of a licensed provider unless that SFC has given its approval to such person.

6. The SFC must approve the premises to be used by the applicant for keeping records and documents required under the licensing regime.

The SFC may impose conditions on a licence when approving an application. It is likely that the conditions will be similar to those the SFC has published for corporations licensed under the SFO that wish to offer virtual asset dealing services and virtual asset advisory services. These conditions can be found in Appendix 6 to the joint circular on intermediaries’ virtual asset-related activities issued by the SFC and the Hong Kong Monetary Authority on 22 January 2022: <https://apps.sfc.hk/edistributionWeb/api/circular/openAppendix?lang=EN&refNo=22EC9&appendix=0>

Each individual that will provide a VA service on behalf of the applicant must also be licensed as a licensed representative of the applicant. The SFC must be satisfied that each such individual is a fit and proper person to be so licensed for the relevant VA services.

Once licensed, a licensed provider will be subject to a number of ongoing obligations, including:

1. Various notifications, including: (a) notifications of changes in information relating to the licensed provider and its ultimate owner (if any), (b) notification of any change in business address or its directors and of any intention to cease business, and (c) notification of a licensed representative ceasing to act for or on behalf of the licensed provider;
2. Payment of annual fees and filing of annual returns; and
3. Preparation and filing of audited accounts.

The AMLO Amendment Bill includes powers for the SFC to discipline current and former “regulated persons”, which include a licensed provider, a licensed representative, a responsible officer of a licensed provider and a person involved

in the management of the business of a licensed provider. The SFC's disciplinary powers include power to (i) publicly or privately reprimand the person; (ii) require the person to take specified action by a specified date to remedy any contravention, act or omission; (iii) order the person to pay a penalty not exceeding the greater of HK\$10 million and 3 times the amount of the profit gained or loss avoided by the person; (iv) suspend or revoke the licence of the person, in whole or in part; (v) suspend or revoke the approval of the person as a responsible officer, in whole or in part; (vi) prohibit the person from applying to be licensed or from applying to be approved as a responsible officer for a specified period.

Transitional provisions

The AMLO Amendment Bill contains transitional provisions for existing providers of VA services who are operating in Hong Kong prior to 1 March 2023.

1. Existing providers can continue to provide VA services for up to 12 months i.e. until 29 February 2024 (the **first 12 months**) without being licensed;
2. An existing provider that has been providing VA services in Hong Kong prior to 1 March 2023 and that wishes to continue to provide VA services after the first 12 months must make an application to the SFC for a licence not later than 31 December 2023. The applicant will be deemed licensed, and so will be able to continue providing VA services, until the later of (i) the end of the first 12 months, (ii) withdrawal of the application, (iii) refusal of the application by the SFC, and (iv) grant of a licence by the SFC.
3. If an existing provider withdraws its application or the SFC refuses its application, the existing provider has a period of 3 months to close down its provision of VA services in Hong Kong. During this period, the provider is only permitted to do acts solely for the purpose of closing down its VA services. The provider may apply to the SFC for an extension of the closing down period for such further period as the SFC considers appropriate, having regard to the circumstances of the provider's business and activities.

Similar transitional provisions apply in respect of individuals who are proposed as responsible officers or who provide VA services for or on behalf of existing providers.

How Deacons can help

The Deacons Licensing and Compliance Team has many years of experience in assisting clients with applications to the SFC for licences under the SFO. More recently, the Deacons Licensing and Compliance Team has assisted clients with current SFC licences who wish to expand their business to include the management of virtual assets.

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