

RE: GAZETAL OF AMENDMENT ORDINANCE ON NEW VIRTUAL ASSET SERVICE PROVIDER (VASP) LICENSING REGIME**BACKGROUND & OVERVIEW**

On 16 December 2022, the Anti-Money Laundering and Counter-Terrorist Financing (Amendment) Ordinance (Ord. No. 15 of 2022) (the “**Amendment Ordinance**”), which introduces, among other things, a licensing regime (the “**VASP Licensing Regime**”) for virtual asset services providers (“**VASPs**”), was published in the Gazette following the passage of the proposing bill (the “**Amendment Bill**”) by the Legislative Council on 7 December 2022. A report (the “**Report**”) has also been published by the Bills Committee of the Legislative Council (the “**Bills Committee**”) to provide clarifications on various aspects of the Amendment Bill and to explain the updated timeline for the implementation of the VASP Licensing Regime.¹

In our previous Client Alert circulated in July 2022 (the “**July 2022 Client Alert**”), we outlined the key concepts of the VASP Licensing Regime under the Amendment Bill. In this Client Alert, we will explain and comment on the additional clarifications provided by the Report.

I. VASP Licensing Regime

The VASP Licensing Regime introduced by the Amendment Ordinance requires any person who operates in Hong Kong or markets to the Hong Kong public a “VA service” to obtain a licence (the “**VASP Licence**”) from the Securities and Futures Commission (the “**SFC**”). Currently, the only VA service required to be licensed is “operating a VA exchange”,² although this could be amended by the Secretary for Financial Services and the Treasury (the “**FSTB Secretary**”) to cover other services related to virtual assets (“**VA(s)**”) in the future.

Licensed VASPs will be required to comply with existing requirements under the AMLO applicable to traditional financial institutions, including the customer due diligence and record-keeping requirements set out in Schedule 2 to the AMLO. A VASP and its responsible officers and licensed representatives will be subject to fit and proper tests. The SFC will also have the power to impose at its discretion a range of licensing conditions on a VASP licensee, including but not limited to conditions on financial resources, risk management, client asset management, cybersecurity, VA listing and trading policies, prevention of market manipulation and abusive activities and avoidance of conflicts of interest. At the initial stage, one of the licensing conditions will require that the VASP licensee provides VA services to professional investors³ only (the “**PI-Only Restriction**”). It is expected that the requirements and compliance standards under for VASPs will be very similar to those under the existing opt-in regime for VA platform operators applying for Type 1 and Type 7 licences from the SFC (which have been obtained by OSL⁴ and HashKey⁵ only).

¹ “Report of the Bills Committee on Anti-Money Laundering and Counter-Terrorist Financing (Amendment) Bill 2022” (LC Paper No. CB(1)855/2022), 7 December 2022.

² Please refer to the July 2022 Client Alert for the definition of “operating a VA exchange” under the Amendment Bill.

³ “Professional investor” is defined in Part 1 of Schedule 1 to the AMLO.

⁴ OSL Exchange, operated by OSL Digital Securities Limited.

⁵ HashKey Pro, operated by Hash Blockchain Limited.

II. Clarifications and interpretative guidance

Non-fungible tokens ("NFT(s)")

As discussed in the July 2022 Client Alert, the definition of "virtual asset"⁶ under the Amendment Bill covers a wide range of VAs and is likely to include "virtual commodities" such as Bitcoin and Ethereum, payment tokens such as USDC and USDT, as well as certain "utility tokens" and "governance tokens". However, limited purpose digital tokens, namely customer loyalty or reward points, in-game assets and other similar digital representations of value, are excluded from the definition of "virtual asset" for the purposes of the VASP Licensing Regime.⁷

In relation to NFTs, it is clarified in the Report that where a NFT merely represents a genuine digital representation of a collectible, it will unlikely fall within the definition of "VA" under the Amendment Ordinance as it will unlikely be a unit of account or a store of economic value, a medium of exchange accepted by the public, or a digital representation of value that provides holders with rights, eligibility or access to vote. More generally, NFTs which are not intended by their issuers to be convertible into money or other medium of exchange accepted by the public may fall within the "limited purpose digital token" exception. However, some NFTs may be VAs if they are cryptographically secured digital representations of economic value which are capable of being bought, sold, auctioned or otherwise transferred on trading platforms and which are used, or intended to be used, as a medium of exchange accepted by the public or allow holders to vote on their management, administration, governance or terms of arrangement.⁸

Peer to peer ("P2P") exchanges

In the July 2022 Client Alert, we pointed out that the definition of "operating a VA exchange" in the Amendment Bill raises the possibility that certain decentralised exchanges may be regarded as having "indirect possession" of client money or client VAs and may thus fall within the scope of regulation of the VASP Licensing Regime. In the Report, it has been clarified that VA trading platforms in which transactions are conducted on a P2P basis (eg. trading of NFTs on OpenSea) will not be required to be licensed under the VASP Licensing Regime as presently formulated.

Overseas VA exchanges and prohibited advertisements

As to overseas VA exchanges, it is emphasised in the Report that the Amendment Ordinance contains provisions prohibiting the active marketing of VA services by overseas VA exchanges to the Hong Kong public without a VASP licence. The term "active marketing" for the purpose of the

⁶ Please refer to the July 2022 Client Alert for the definition of "virtual asset" under the Amendment Bill.

⁷ It is important to note that, as explained in our July 2022 Client Alert, the definition of "virtual asset" in the Amendment Bill also contains a number of other exceptions, including digital representations of value which are "securities" or "futures" within the meaning of the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) (the "SFO"). Thus, cryptoexchanges that trade one or more "security tokens" are still required to obtain the Type 1 and Type 7 licences from the SFC under the existing regime.

⁸ See also the SFC's statement titled "SFC reminds investors of risks associated with non-fungible tokens" dated 6 June 2022, which is referred to in the Report.

Amendment Bill will likely be similar to that which is applied in the existing securities regulatory regime under section 115 of the SFO, and may include, without limitation, frequently calling on Hong Kong investors to market VA services, running a mass media programme targeting the investing public in Hong Kong and conducting internet activities that target Hong Kong investors.⁹ The prohibition on the issuance or possession of advertisements of unlicensed VA services under the Amendment Ordinance will also be interpreted similarly to the prohibition of advertisements of unlicensed services in regulated activities under section 109 of the SFO.

Licensing criteria

It is mentioned in the Report that the SFC will publish guidelines to specify the matters which the SFC will take into consideration in determining whether a person satisfies the fit and proper test. These standards are expected to be generally aligned with those set out in the guidelines published by SFC in relation to intermediaries under the existing securities licensing regime.¹⁰

III. Updated timeline

In order to allow additional time for VASPs, the SFC and other relevant authorities to prepare for the new regulations, the commencement of the VASP Licensing Regime has been postponed to **1 June 2023**. The timelines for the transitional arrangements and grace periods have also been updated accordingly.

OUR OBSERVATIONS

Whilst the Report provides some helpful clarifications and interpretative guidance, a number of issues relating to the interpretation and application of the Amendment Ordinance remain unclear. Most significantly, the meaning of “indirect possession” in the definition of “operating a VA exchange” has yet to be clarified. It is therefore uncertain whether over-the-counter (“**OTC**”) exchanges, in which the platform operator (i.e. the “OTC desk”) acts as the immediate counterparty in transactions for the sale and purchase of VAs, would be regarded as having “indirect possession” of client money or client VAs. It is also unclear whether “decentralised” exchanges which require users to link their wallets to the platform’s smart contract system to enable automatic withdrawal and transfer of VAs would fall within the regulatory scope of the VASP Licensing Regime. Further guidance in this regard from the SFC and other relevant authorities may be desirable.

Another noteworthy point is that, whilst the SFC maintains that PI-Only Restriction will be imposed as a licensing condition at the initial stage, it is mentioned in the Report that the SFC will conduct a consultation to consider, among other things, whether it is possible to allow VASPs to provide VA services to retail investors provided that additional investor protection measures are put in place. The Financial Services and the Treasury Bureau (the “**FSTB**”) also stated in its recent policy statement¹¹

⁹ See the SFC’s FAQ titled “‘Actively markets’ under section 115 of the SFO”, available at <https://www.sfc.hk/en/faqs/intermediaries/licensing/Actively-markets-under-section-115-of-the-SFO#9CAC2C2643CF41458CEDA9882E56E25B>

¹⁰ See “Fit and Proper Guidelines” published by the SFC (last updated January 2022).

¹¹ “Policy Statement on Development of Virtual Assets in Hong Kong” (31 October 2022), FSTB.

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that it recognised the increasing acceptance of VAs as a vehicle for investment allocation by institutional as well as individual investors globally. Indeed, the use of the phrase “initial stage” and the imposition of the PI-Only Restriction by way of a licensing condition rather than a provision in the Amendment Ordinance itself may suggest be intended to allow greater flexibility in this regard. The SFC’s views on the possibility of allowing retail investors to participate in trading on licensed VA exchanges and the additional investor protection measures required will likely become clearer after it releases its consultation paper.

We have assisted clients to tap into the new VA industry as well as clients with existing SFC licences to expand their businesses to involve VAs. Should you have any queries, please do not hesitate to reach out to a member of us to discuss further at hyu@lylawoffice.com or at +852 2115 9525.

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