THE DUAL LICENSING REGIME FOR VIRTUAL ASSET TRADING PLATFORMS IN HONG KONG– PART 1

KEY HIGHLIGHTS

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Hong Kong Policy and Regulatory Alert

The Hong Kong government is trying to support the growth of virtual asset and other Web3 industries. One of the first key steps they have taken is to put virtual asset trading platforms into a regulatory licensing regime where customer protections are properly placed and retail investors' access is permitted, which may foster the well-balanced growth of the virtual asset industries in Hong Kong. Not just virtual asset business enterprises but also traditional businesses such as banks, securities companies, other financial services companies, custody companies, and other technology companies are likely affected by, and will find new business opportunities deriving from, the licensed virtual asset exchanges' businesses.

Previously, virtual asset exchanges in Hong Kong were subject to an opt-in licensing regime introduced by the Securities and Futures Commission of Hong Kong (SFC) under the Securities and Futures Ordinance (Cap. 571) (SFO). Virtual asset exchanges that wished to trade nonsecurities-type virtual assets as well as securities-type virtual assets were able to apply for the licensing from the SFC and opt in to be subject to the SFC's supervisions even on the nonsecurities-type virtual assets.

In December 2022, amendments to the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615), as amended (AMLO), were introduced, providing for a new licensing regime (AMLO Licensing Regime) for centralized virtual asset service providers (VASPs) to be supervised by the SFC. It also proposed statutory anti-money laundering and counter-financing of terrorism (AML/CFT) obligations and introduced new monetary and imprisonment penalties for noncompliance.

The new dual-licensing regime (Dual Licensing Regime) for virtual asset trading platforms (VATPs) became effective as of 1 June 2023, pursuant to the AMLO, following the SFC's release of its Consultation Conclusions on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the Securities and Futures Commission in May 2023 (May 2023 SFC Consultation Conclusions) following its related consultation paper in March 2023.

This alert provides an overview of the new Dual Licensing Regime. It then highlights the consequences of violations of requirements imposed by the Dual Licensing Regime.

OVERVIEW OF THE DUAL LICENSING REGIME

Key Regulator

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The SFC has been granted authority to regulate VATPs in relation to their businesses on security and nonsecurity tokens under the SFO and the AMLO.

The SFC's power to regulate security tokens, or any other virtual asset product that falls under SFO's definition of "security," is derived from the existing SFO regime. The SFC was granted additional supervisory powers over the VATPs in respect to nonsecurity tokens under the new AMLO regime.

Key Laws and Guidelines

In addition to the SFO and AMLO, platform operators (Platform Operators), meaning VATPs duly licensed by the SFC, must comply with the *Guidelines for Virtual Asset Trading Platform Operators* (VATP Guidelines) published along with the May 2023 SFC Consultation Conclusions.

The VATP Guidelines set out a number of important requirements that Platform Operators must adhere to. The guidelines include requirements for establishment (e.g., fitness and properness, competency, and financial soundness requirements) and outline ongoing obligations (e.g., those relating to client take-on procedures and disclosure obligations to the client, custody of client assets, due diligence, cybersecurity, conflicts of interest, operations and internal control, recordkeeping, audits, and ongoing reporting and notification).

The May 2023 SFC Consultation Conclusions also provide other supplementary guidelines, including:

- *Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (For Licensed Corporations and SFC-licensed Virtual Asset Service Providers)* (AML Guideline for LCs and SFC-licensed VASPs): This is based on the existing AML/CFT regulatory requirements for licensed corporations under the SFO and sets out the relevant AML/CFT statutory and regulatory requirements and standards that licensed corporations and Platform Operators should meet.
- *Prevention of Money Laundering and Terrorist Financing Guideline issued by the Securities and Futures Commission for Associated Entities of Licensed Corporations and SFC-licensed Virtual Asset Service Providers*: This applies the AML Guideline for LCs and SFC-licensed VASPs to their "associated entities" as if such entities were licensed VASPs.
- *Disciplinary Fining Guidelines*: These set out the manner in which the SFC intends to adopt when exercising its disciplinary power to impose a fine and the considerations that it may take into account when exercising it.

When a License Is Required

Under the AMLO Licensing Regime, you will need to obtain an SFC license if you are:

- A person in Hong Kong which carries on, or holds yourself out as carrying on, a business of providing any virtual asset service (i.e., operating a virtual asset exchange) (VA Service).
- A person (whether in Hong Kong or elsewhere) that actively markets any VA Service to the public of Hong Kong.

Preexisting VATP operators that were providing VA Services prior to June 2023 may be eligible for transitional arrangements under the AMLO Licensing Regime.

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NONCOMPLIANCE AND MONETARY AND CRIMINAL SANCTIONS

There are a variety of consequences for failing to comply with the licensing requirements set forth under the AMLO. These consequences include fines of HK$5 million and imprisonment for seven years, and in the case of a continuing offense, a further fine of HK$100,000 can be imposed for every day during which the offense continues. In the case of a summary conviction, a fine of HK$500,000 and imprisonment for two years can be imposed, and in the case of a continuing offense, a further fine of HK$10,000 can be imposed for every day during which the offense continues.

The AMLO Licensing Regime also introduces two criminal offenses for fraudulent activities involving virtual assets. These offenses are applicable to any person, not just VASPs. They include:

- Offense for fraudulent or deceptive devices in virtual asset transactions, which are subject to a fine of HK$10 million and imprisonment for 10 years.
- Offense for fraudulently or recklessly inducing others to invest in virtual assets, which is subject to a fine of HK$1 million and imprisonment of seven years.

CONCLUSION

Those carrying out VATP businesses in Hong Kong will now need to comply with the new Dual Licensing Regime, which took effect on 1 June 2023. Those who were already operating prior to 1 June 2023 in Hong Kong should take notes of the transitional arrangements provided by the SFC and consider applying for the licenses in accordance with the timelines given by the SFC. We will be addressing such transitional arrangements in a forthcoming article. Ensuring continued compliance with the new regime should be of paramount importance, as the new regulations impose new and potentially severe monetary and criminal penalties for breaches, including imprisonment.

This is the first article in our Hong Kong Dual Licensing Regime series. Our forthcoming articles will highlight key provisions of the VATP Guidelines, which include requirements for the establishment of Platform Operators and ongoing obligations and restrictions. We will also examine the transitional arrangements scheme under the new regime available to certain preexisting VASPs. We will continue to watch this space and keep you informed about important developments that may impact you.

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