BRIEFINGNOTE

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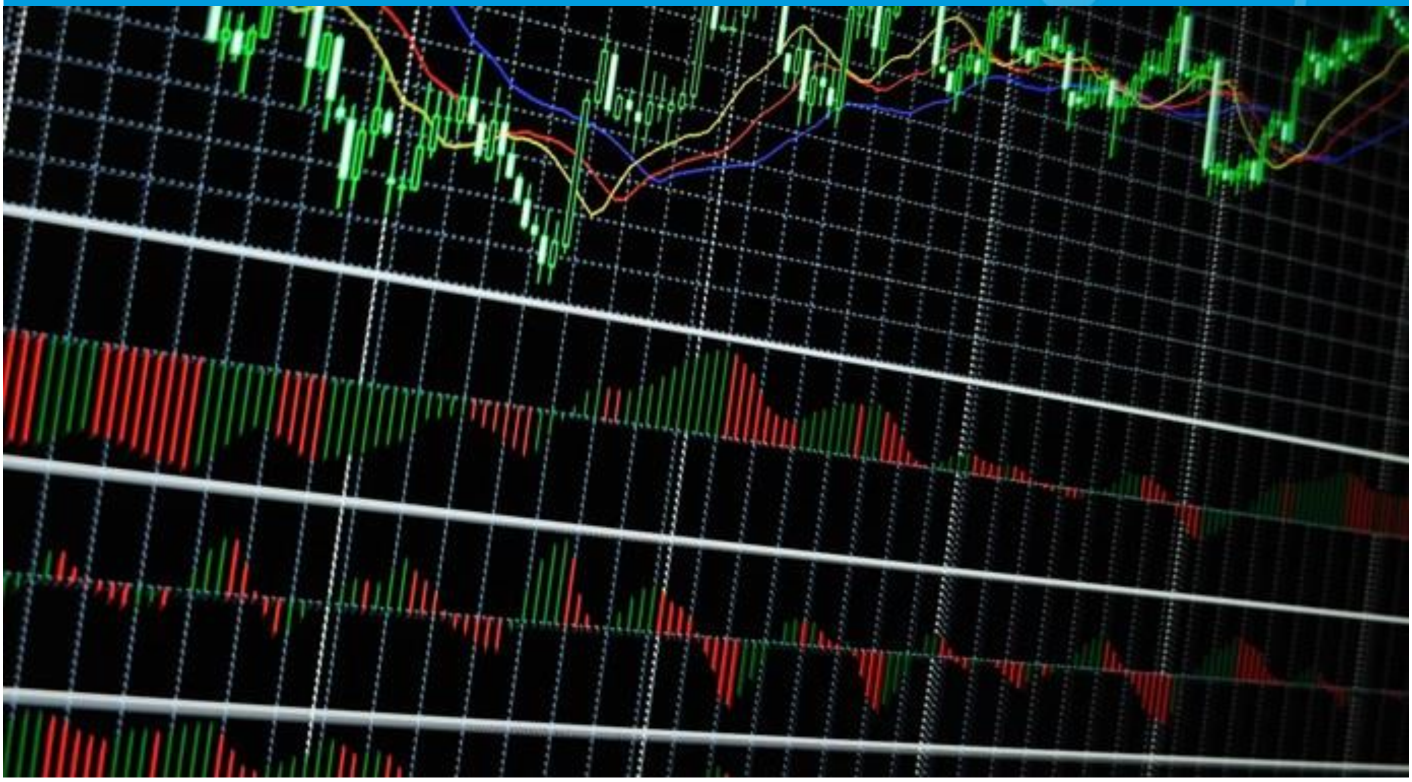
Proposed regulation on provision of VA OTC trading services



Background

In February 2024, the Financial Services and the Treasury Bureau (“**FSTB**”) issued the consultation document seeking views on the regulation of over-the-counter ("**OTC**") trading of virtual assets ("**VA**") through introducing a licensing regime for VA OTC service providers under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) (“**AMLO**”). The consultation period is now over and it is anticipated that the FSTB will be publishing further updates on this shortly.

This client alert summarises the proposed regulatory regime as set out in the consultation document.

A. Regulators

It is proposed that the Commissioner of Customs and Excise ("**CCE**") will be empowered to supervise the Anti-Money Laundering and Counter-Terrorist Financing (“**AML/CTF**”) conduct of and the grant of licensing to VA OTC licensees ("**VA OTC Licensee(s)**"), and enforce the relevant regulatory requirements (including by blocking access to unlicensed person's websites). The CCE will have power to impose licensing conditions and/or add to, vary or modify existing conditions.

B. Scope of regulation

All VA OTC services will be covered, irrespective of how the service is being provided, and only a VA OTC Licensee can operate a VA OTC business in Hong Kong, or actively market the provision of VA OTC services as a business to the Hong Kong public. A VA OTC Licensee must also meet the fit and proper test and other regulatory requirements of the CCE.

Regulated activities under the licence

VA OTC business[1] will be defined as:

- by way of business, the provision of service of spot trade of any VA;
    - The FSTB explained that spot trade of VA is not intended to cover peer-to-peer trading of VA between individuals, unless the trade forms the business activity of either party. In other words, only the person who is a party to the contract or binding transaction would be covered, but not the person facilitating the peer-to-peer trades.
    - It is also proposed that spot trading of VA will only include "spot trade of any VA for any money", but not "VA to VA" trading.
- irrespective of whether the service is provided through a physical outlet (i.e. including ATMs) or other (e.g. digital) platforms; and
    - The FSTB explained that this intends to cover all VA OTC businesses that are being carried out in any form.
- explicitly excluding the operation of virtual asset trading platforms ("**VATP**") that are already covered under the VATP licensing regime of the SFC.

Furthermore:

- Remittance of exchange proceeds (i.e. fiat currency) is only permitted if the VA OTC also holds a money service operator licence ("**MSO Licence**").
- Transfer of VA to clients is only permitted if it is from the registered wallets of the VA OTC Licensee and to a whitelisted client wallet.
- Other services will be prohibited, including VA advisory, VA referral services and offering of VA derivatives and other products (including staking, lending and margin trading). However, the consultation paper has yet to clarify what these services would specifically include.
- A VA OTC Licensee can only provide services for: (i) VAs that are listed on at least one SFC-licensed VATP and are available to retail investors; and (ii) stablecoins issued by HKMA-licensed issuers.

The FSTB also noted that VA OTC business may involve the provision of temporary custody/escrow service of the client's VA. The initial thinking is that only temporary custody/escrow would be permitted but the FSTB is inviting the public to comment on whether such service should form part of the current VA OTC regulatory regime, or whether there should be a separate regime.

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[1] Note that the consultation paper only provided the proposed definition of "VA OTC business" but not "VA OTC services". This is likely to be clarified in the AMLO when the specific provisions are being introduced. For this client alert, we have assumed the definition of "VA OTC services" means all the activities within the definition of VA OTC business.

C. Eligibility and AML/CTF obligations

Eligibility

A licence applicant must be (i) a locally incorporated company with a permanent place of business in Hong Kong, or (ii) a company incorporated elsewhere but registered in Hong Kong under the Companies Ordinance (Cap. 622).

An applicant must have a suitable premises for its operation in Hong Kong, or, in the case of digital operators, an address for its local management office and storage of books and records. For fitness and properness, this will be similar to the test for existing money service operator licensees that are also regulated by the CCE.

Furthermore, a VA OTC Licensee must also keep the CCE updated with the list of registered wallets that it will use.

AML/CTF obligations

It is proposed that a VA OTC Licensee will be subject to AML/CTF obligations that are similar to those imposed on MSO Licence holders. This includes observing the requirements under Schedule 2 of the AMLO and appointing a fit and proper compliance officer and money laundering reporting officer.

In addition, a VA OTC Licensee: (1) must have a proper corporate governance structure staffed by personnel with the competence, knowledge and experience with VA; (2) is expected to submit an accurate and up-to-date staff list for CCE's retention, which will be used to show that the VA OTC Licensee can operate its business in a prudent and sound manner; (3) must subscribe for AML tools to carry out fund trancing functions; and (4) is required to keep records of transactions and fund flows.

Exemptions

It is proposed that VATPs, licensed corporations, authorised institutions and licensed stablecoin issuers, if providing VA OTC services, will be exempted from the new licensing requirement.

D. Offences and statutory appeal

It is proposed that the relevant offences will be:

- in the case of carrying out a business of regulated VA OTC services without a licence: on conviction on indictment, a fine of HK$1,000,000 and imprisonment for two years;
- in the case of knowingly issuing an advertisement relating to an unlicensed person's VA OTC services: a fine at level 5 and imprisonment for six months; and
- in the case of non-compliance: on conviction on indictment, a fine of HK$1,000,000, imprisonment for two years and other administrative sanctions.

The scope of decisions that can be reviewed by the Anti-Money Laundering and Counter-Terrorist Financing Review Tribunal will also be expanded.

E. Licence period and transitional period

Under the current proposal, a successful applicant would be granted a licence of two years, renewable for two years upon application and to the satisfaction of CCE.

To facilitate the transition into the new licensing regime, the FSTB is considering two transitional arrangements:

- Option 1 - pre-existing VA OTC service providers can continue to operate until the end of a six-month transitional period, provided that they make an application for the licence within the first three months, otherwise they must close down by the end of the fourth month. All VA OTC service providers must be licensed by the end of the sixth month; or

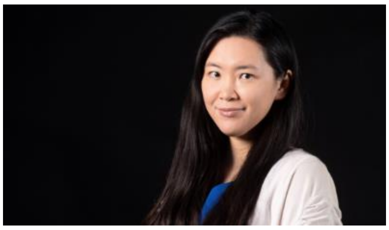
- Option 2 – similar to option 1, except that service providers who have submitted an application within the first three months will be deemed licensed and can continue their operations beyond the transitional period until a final determination.

How we can help?

The Hong Kong Government continues its effort to structure Hong Kong into a FinTech and Web3 hub of Asia, and new regulations are being introduced to tighten the gaps between legislation. Interested parties should keep an eye on the development in this area or seek legal advice if they wish to carry out VA OTC businesses.

We had experience in assisting payment companies including in relation to their traditional remittance services and/or their VA-related services. Please get in touch if you are interested in discussing any of the above.

Contact us



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