

**Client alert:**

# Over-the-counter virtual assets trading to be regulated in Hong Kong

## Executive summary

The Financial Services and the Treasury Bureau of Hong Kong ('FSTB') issued its latest virtual assets ('VA')-related consultation paper on 8 February 2024 to regulate over-the-counter ('OTC') trading of VA ('Consultation'). This alert provides the context for this Consultation as well as the key practical takeaways for prospective VA OTC applicants.

## Background

The current Hong Kong VA regulatory regime, whilst advanced on some fronts, has been silent until now when it comes to VA OTC trading.

- Securities and Futures Commission ('SFC') VA-related regulated activities cover (1) VA trading platforms under the VATP regime and (2) asset management activities either through licences or in certain cases licence uplifts if relevant activities are already carried on by existing regulated intermediaries. Aside from this, non-regulated entities can still engage in dealing, advisory, and management activities of pure VA (so long as the VA does not have features that amount to 'securities' as defined under the Securities and Futures Ordinance (Cap. 571)).

- Hong Kong Monetary Authority ('HKMA') VA-related regulated activities do not include trading activities (with a possible caveat regarding stablecoins which are still in consultation phase).

## An impetus for change

It has become apparent that the FSTB sees VA OTC services as playing a central role in channelling material money flows by the Hong Kong public when it comes to VA trading. It is also wary of scandals such as the fallout of the JPEX VA exchange that promoted its services through OTC shops. As a result, the FSTB has highlighted the need to bring the operations of these OTC service providers under some kind of regulatory oversight, among other things, to ensure that Anti-Money Laundering/Know Your Customer ("AML/KYC") and investor protection measures are put in place. In effect, this is another step towards building a comprehensive regime over VA-related activities in Hong Kong.

According to the Consultation, a new licensing and regulatory regime for VA OTC service providers will be introduced under the Hong Kong Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) ("AMLO"). Under the proposed regime, any business providing services of VA spot trading in Hong Kong is required to be licensed by the Commissioner of Customs and Excise ('CCE') (unless it falls under one of the exceptions mentioned in the below table).

The Consultation spans a wide range of topics, including transitional arrangements, senior management accountability, compliance (including AML/KYC) requirements and enforcement powers for CCE.

## Key practical takeaways

The following table addresses the key practical takeaways for prospective VA OTC licence applicants:

|                                       |  |
|---------------------------------------|--|
| <p><b>In scope applicants</b></p>     | <ul style="list-style-type: none"> <li>• Any person operating a VA spot OTC business in Hong Kong, or actively marketing the provision of VA spot OTC services to the Hong Kong public.</li> <li>• Local nexus requirement : a licence applicant must either be (1) a locally incorporated Hong Kong company with a permanent place of business in Hong Kong or (2) a company incorporated outside of Hong Kong but registered in Hong Kong under the Companies Ordinance (Cap. 622).</li> <li>• Applicants servicing retail traders and/or professional investors (currently no distinction in treatment is made by the CCE between those two categories).</li> <li>• Businesses exempt for applying for a CCE licence include (1) SFC-regulated VATPs, (2) HKMA-regulated stablecoin issuers (subject to the implementation of the stablecoin regime), (3) licenced corporations and (4) authorised institutions. None of these four types are required to obtain a VA OTC service provider licence to provide VA OTC services.</li> </ul> |
| <p><b>Requirements</b></p>            | <ul style="list-style-type: none"> <li>• Licenced VA OTC service providers will be required to comply with AML/CTF regulations and other regulatory requirements.</li> <li>• The new regime will cover all VA OTC services irrespective of whether their services are provided through a physical outlet and/or other platforms.</li> </ul>  |
| <p><b>Out of scope activities</b></p> | <ul style="list-style-type: none"> <li>• Peer-to-peer ('P2P') trading : the proposal would not cover P2P trading of VA between individuals unless the trade is part of the 'business activity' of either party.</li> </ul>   |
| <p><b>Prohibited activities</b></p>   | <ul style="list-style-type: none"> <li>• VA to VA OTC trading activities (those may trigger a requirement to apply for a VATP licence).</li> <li>• OTC trading of coins that are not listed on a SFC licensed VATP (or for stablecoins, non HKMA-licenced stablecoins).</li> <li>• The provision of any form of VA advisory or referral services.</li> <li>• The offering of VA derivatives or other financial products such as staking, lending and margin trading.</li> <li>• Direct or indirect custody/escrow service of clients' VA by licencees (unless such custody/escrow service is temporary in nature and is an indispensable part of the transaction process).</li> <li>• Remittance of fiat or transfer of VA (unless on specified conditions).</li> </ul>  |

# Detailed regulatory requirements that will apply to a licenced VA OTC service provider

|                            |   |
|----------------------------|---|
| <b>AML/CTF</b>             | Observe the AML/CTF requirements set out in Schedule 2 to the AMLO relating to customer due diligence and recordkeeping.  |
| <b>Officers</b>            | Appoint a competent compliance officer and a money laundering reporting officer.  |
| <b>Governance</b>          | Establish a proper corporate governance structure staffed by personnel with the necessary knowledge of and experience with VAs to enable the effective discharge of responsibilities.   |
| <b>Conduct of business</b> | Operate the OTC business in a prudent and sound manner and ensure that clients and public interests will not be adversely affected.   |
| <b>Integrity</b>           | Act honestly, fairly, with due skill, care and diligence, in the best interests of its clients and the integrity of the market. Comply with all statutory and regulatory requirements applicable to the conduct of its business activities. |
| <b>Risk management</b>     | Have in place appropriate risk management policies and procedures for managing AML/CTF, cybersecurity and other risks arising from its activities that are commensurate with the scale and complexity of the OTC business.                  |
| <b>Recordkeeping</b>       | Maintain proper records of transactions and fund flows, which will be accessible to the CCE as and when the CCE considers necessary.  |

The FSTB is keen to support existing legitimate VA OTC operators transition into the new licensing regime. In this regard, it is considering two potential transitional arrangements, each involving a six-month transitional period (see more details in the Consultation). Comments on the Consultation are due on 12 April 2024.

Please reach out to the Digital Assets Team at Tiang & Partners or PwC for further information and our thoughts on this.

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