

# Hong Kong's proposed pathway to fully licensing virtual asset exchanges –

## What, why and what's next?

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金杜律师事务所



*This article was written by Urszula McCormack, Leonie Tear, Evan Manolios and Kellie Tse*

The Financial Services and the Treasury Bureau (**FSTB**) of Hong Kong has [launched](#) a Public Consultation on Legislative Proposals to Enhance Anti-Money Laundering and Counter-Terrorist Financing Regulation in Hong Kong (Consultation). The Consultation aims to enhance the anti-money laundering and counter-terrorist financing (**AML/CTF**) regime in Hong Kong by amending the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) (**AMLO**).

Licensing of virtual asset exchanges

Registration of dealers in precious metals and stones

Upgrade and modernisation of certain AMLO standards

In this alert, we focus on the proposed licensing of virtual asset exchanges (**Proposed Licensing Framework**), with a concise summary of the other areas provided at the end.

This alert is structured as follows.

**Part A** Key details and drivers

**Part B** Deep dive on the Proposed Licensing Framework

**Part C** How the Proposed Licensing Framework compares with the SFC's existing "opt-in" regime and the FATF Recommendations

**Part D** Our views and insights

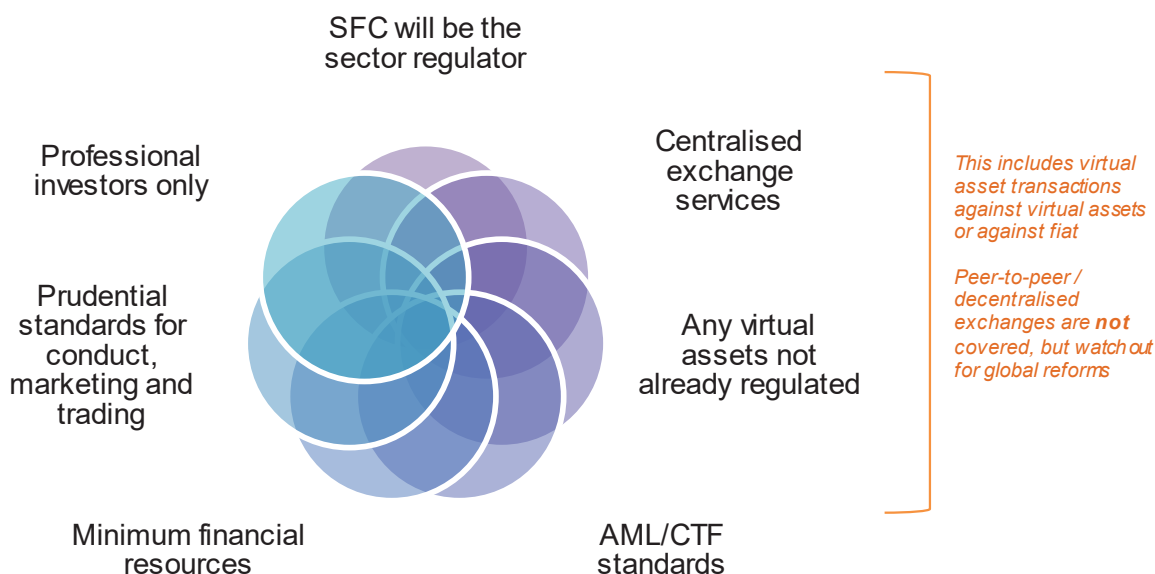
**Part E** Synopsis of additional key AMLO changes

The Consultation ends on **31 January 2020**. We strongly recommend engaging on this important new regime before it is

## Part A – Key details and drivers

Proposals at glance

The Proposed Licensing Framework involves the following draft key details:



We delve into the detail of these points further in **Part B**.

### What is driving this reform?

The Proposed Licensing Framework has been driven by the desire to introduce Hong Kong laws that accord with recent international guidance in respect of virtual assets and virtual asset service providers (**VASPs**), as well as the need to provide consumers additional protections by virtue of the heightened risks posed by virtual assets.

Specifically, in June 2019, the Financial Action Task Force (**FATF**), the international anti-money laundering and counter-terrorist financing standard setter, amended its standards to clearly place AML/CTF obligations on virtual assets and VASPs. This was achieved through the issuance of VASP specific guidance and amendment to the FATF Recommendations. Further details are set out in our [“9 key points” FATF alert](#).

In June 2020, FATF reported that 35 out of 54 reporting jurisdictions had implemented the revised FATF standards, with 32 regulating VASPs and three prohibiting the operation of VASPs.

Hong Kong was among the 19 other jurisdictions that had not yet implemented the revised standards in its local law. With its next mutual evaluation due to commence in 2023,<sup>1</sup> it is vitally important for Hong Kong to demonstrate progress with its regime.

## Part B – Deep dive on the Proposed Licensing Framework

### The SFC as virtual asset regulator

To date, the SFC has been the most directly engaged Hong Kong regulator in respect of virtual asset regulation and has been actively involved in market discussions and industry regulatory development. In November 2019, the SFC [announced](#) its formalised framework to regulate virtual asset exchange

operators (**Opt-in Regime**). It also issued a range of circulars for [virtual asset fund managers](#) and [virtual asset fund distributors](#), amongst others.

The Opt-in Regime provides a roadmap for willing and capable virtual asset exchanges to obtain Type 1 (dealing in securities) and Type 7 (automated trading services) regulated activity licences. Importantly, the Opt-in Regime is only triggered when an exchange wishes to include security tokens. This has left ample room for other virtual asset exchanges to carry on business without requiring a licence, provided they have appropriately assessed their virtual assets and related products and services to ensure they are not regulated. We support multiple exchanges with validating this.

The Proposed Licensing Framework on the other hand aims to cover all virtual asset exchanges (except those operating under the Opt-in Regime) through a mandatory licensing regime. Key features of the Proposed Licensing Framework are summarised in the following paragraphs.

### Key licensing triggers and exemptions of the Proposed Licensing Framework

Under the draft proposals, any person who operates a virtual asset exchange that trades any type of “virtual asset” would be considered as conducting a “regulated VA<sup>2</sup> activity” (Regulated VA Activity) and would be required to be a licensed virtual asset exchange under the AMLO.

The Consultation proposes to define “virtual asset” as:

- a digital representation of value that is expressed as a unit of account or a store of economic value;
- functions (or is intended to function) as a medium of exchange accepted by the public as payment for goods or services or for the discharge of debt, or for investment purposes; and
- can be transferred, stored or traded electronically.

1. Hong Kong is scheduled to undergo a technical compliance assessment in February 2023, and an effectiveness assessment in June 2024.

2. The FSTB refers to virtual assets in the Consultation as “VA”.



The proposed definition excludes digital representations of fiat currency, financial products regulated under the Securities and Futures Ordinance (Cap. 571) (**SFO**) and closed-loop limited purpose items. The proposed definition does however intend to capture “stablecoins” that are asset-backed.<sup>3</sup>

The AMLO would apply to any virtual asset exchange that operates in Hong Kong, or actively markets in, or into, Hong Kong. This would have the effect that even offshore virtual asset exchanges would commit an offence if actively marketing into Hong Kong. This aligns with the SFC’s regulatory framework for other regulated intermediaries.

Importantly, not all exchanges are covered. The Consultation proposes that “virtual asset exchange” will be defined as any virtual asset trading platform:

- that is operated for the purpose of allowing an offer or invitation to be made to buy or sell any virtual asset in exchange for any money or any virtual asset (whether of the same or different type); and

- which comes into custody, control, power or possession of, or over, any money or any virtual asset at any point in time during its course of business.

*Will there be exemptions to the Regulated VA Activity?*

The Consultation proposes to exempt virtual asset exchanges that have already been regulated under the Opt-in Regime will not be required to be licensed under the Proposed Licensing Framework.

### Licensing requirements

The SFC will be responsible for assessing the licensing applications.

We briefly set out an overview of the proposed key licensing requirements in the table below. This is not an exhaustive list of requirements, but seeks to provide a flavour of the key standards and requirements.

Requirement	Details
<b>Applicant requirements</b>	<p>The applicant must be a Hong Kong incorporated company with a permanent place of business in Hong Kong. Importantly, this means that applicants not incorporated in Hong Kong will not be granted a licence.</p> <p>Overseas entities are also prohibited from “actively marketing”<sup>4</sup> to the public of Hong Kong a Regulated VA Activity.</p>
<b>Responsible officers</b>	<p>The applicant must appoint at least two responsible officer (ROs). ROs are part of senior management and are responsible for the oversight and supervision of the regulated functions. The ROs must be “fit and proper” in accordance with the SFC’s competence requirements. The Consultation has set out factors the SFC will consider in assessing “fitness and propriety”. They include:</p> <ul style="list-style-type: none"> <li>• any previous money laundering or counter-terrorism convictions or offences going to the person’s honesty and character;</li> <li>• the experience and qualifications of the person; and</li> <li>• whether the person is of good standing and financial integrity.</li> </ul> <p>We expect more prescriptive guidance on the subject. However, the standards are likely to mirror other existing regulatory frameworks under the SFO or AMLO.</p> <p>All executive directors of the applicant company must also be approved as ROs. Any changes to ROs require approval from the SFC.</p>
<b>Ultimate owners</b>	<p>The ultimate owners of the applicant must be “fit and proper” in accordance with the SFC’s requirements. The FSTB has not shared the precise ownership threshold to be an “ultimate owner”. It may adopt the same term already used in the AMLO albeit with modifications to suit the virtual asset exchange context. It remains to be seen whether the SFC’s “substantial shareholder” test for other regulated entities will be applied.</p> <p>Any changes to the ultimate owners would require approval from the SFC.</p>
<b>Financial resources</b>	<p>The applicant should have adequate financial resources, including paid-up share capital and liquid assets of specified amounts. No minimum amounts have been specified as yet.</p>
<b>Internal control policies and procedures</b>	<p>In parallel to the licensing application, the applicant should ensure that it maintains internal systems and procedures for its business operations for the regulated activities, including the following:</p> <ul style="list-style-type: none"> <li>• <b>Soundness of business</b> - operating the business in a prudent and sound manner</li> <li>• <b>Risk management</b> - implementing risk management policies and procedures</li> <li>• <b>Segregation of client assets</b> - implementing proper segregation of client assets by placing them with associated entities<sup>5</sup></li> <li>• <b>Virtual asset policies</b> – having in place rules for the listing and trading of virtual assets</li> <li>• <b>Financial reporting</b> – ensuring compliance with prescribed auditing and disclosure requirements</li> <li>• <b>Prevention of market misconduct activities</b> – implementing policies and controls to prevent market misconduct activities</li> <li>• <b>Prevention of conflict of interests</b> – the applicant and its associated entities are not allowed to engage in proprietary trading or market-making activities</li> </ul>

3. The Consultation describes “stablecoins” as virtual assets backed by some form of assets for the purpose of stabilising their value. It is not clear whether stablecoins that are also regulated products under the SFO will be in-scope

4. The Consultation adopts a concept of “actively marketing” that is similar to that under section 115 of the SFO.

5. “Associated entities” are defined in the Consultation as separate corporate entities with which the licensed VA Exchange has a controlling relationship

## What about the HKMA?

The HKMA will undoubtedly have a role to play for any licensed banks or other “authorized institutions” under the Banking Ordinance (Cap. 155) that seek to establish a virtual asset exchange, given its role as primary regulator

In addition, the HKMA has an important role as regulator to the banks who hold the keys (no pun intended) to virtual asset industry participants’ bank accounts. In a positive move for the industry, the HKMA also released [balanced guidance in late 2019](#) on managing potential money laundering and terrorist financing (**ML/TF**) risks associated with the sector, emphasising the need for a risk-based approach and softening what was historically a more bearish stance. This tracks FATF’s increasingly more measured and nuanced approach, recognising the headway made on AML/CTF controls and chain analytics in the virtual asset arena.

## Part C – Comparing the two SFC virtual asset regimes and benchmarking against FATF standards

### The Proposed Licensing Framework vs the Opt-in Regime

The SFC has [announced](#) its proposal that once the Proposed Licensing Framework is in place, all virtual assets will be regulated under either:

- the Proposed Licensing Framework; or
- the Opt-in Regime.

The Proposed Licensing Framework and the Opt-in Regime will seek to impose the same regulatory standards to ensure a level playing field for all platform operators. The regimes will operate a mutually exclusive basis – that is, a virtual asset exchange is subject to the Proposed Licensing Framework or the Opt-in regime.

The table below provides a snapshot that compares the key features between the Proposed Licensing Framework and the Opt-in Regime. Importantly, the existing securities and futures laws will continue to apply to the extent that any virtual asset is a regulated product or service:

Key feature	Comparison summary	Proposed Licensing Framework	Opt-in Regime (current)
Main licensing legislation	Different	AMLO	SFO
AML/CTF legislation	Same	AMLO	AMLO
Regulator	Same	SFC	SFC
Mandatory or voluntary?	Different	Mandatory regime. Operating an unlicensed virtual asset exchange would be an offence.	Mandatory only if security tokens are involved. Considered “voluntary” insofar as it involves submission to regulatory oversight for other virtual assets (under conditions imposed on licence, not SFO).
Types of virtual assets	Different, but overlapping	Limited to those that fall within the definition of “virtual assets” as proposed in the Consultation. Importantly, the definition does not include products regulated under the SFO (eg securities, forwards or certain derivatives).	To be regulated under the Opt-in Regime, the platform operator must offer at least one security token on its platform - that is, a virtual asset that falls within the meaning of “securities” under the SFO. The SFC has placed certain conditions on the nature of the “security”. Services in relation to other virtual assets (which are not securities) are then rolled into the same regime.
Regulated platform activities	Different, with some similarities	Only applies to exchanges that satisfy the definition of virtual asset exchanges. For example, it does not apply to peer-to-peer platforms. The provision of automated trading services is not a pre-requisite.	<ul style="list-style-type: none"><li>• Requires the platform to provide trading, clearing and settlement services for virtual assets, and control the assets.</li><li>• The Opt-in Regime does not apply to peer-to-peer platforms that only provide order routing without automated trading services.</li></ul>

Key feature	Comparison summary	Proposed Licensing Framework	Opt-in Regime (current)
Clientele	Same	Professional investors only	Professional investors only
Licensed personnel	Different, although we expect alignment over time	There must be at least two ROs that are approved as “fit and proper”. Every executive director must be approved as an RO. Fit and proper standards obligations and broader governance rules to be confirmed.	There must be at least two ROs for each regulated activity that are approved as “fit and proper”. Every executive director must be approved as an RO. There are also other licensed persons including licensed representatives and managers-in-charge of certain core business functions.
Financial resource requirements	The position under the Proposed Licensing Framework is not clear at this stage – SFC likely to release further details	The exchange should have adequate financial resources, including paid-up share capital and liquid assets of specified amounts. Details of the exact share and liquid capital amounts have not been specified yet.	The platform operator must comply with the financial resources requirements under the Securities and Futures (Financial Resources) Rules (Cap. 571N). The platform operator should also maintain in Hong Kong its own assets that are sufficiently liquid equivalent to at least 12 months of its actual operating expenses (calculated on a rolling basis).
Custody	Different, although we expect alignment over time	There should be proper segregation of client assets by placing them in an associated entity of the exchange. Policies and procedures should be implemented to ensure proper management and custody of client assets, including virtual assets. We expect this will be area where further SFC regulatory codes and guidelines from more granular guidance given the importance of this consideration to exchange users.	<ul style="list-style-type: none"> <li>• <b>Segregated account:</b> the platform operator must ensure that client assets are properly segregated from the platform operator. This includes having adequate processes for withdrawals, loading of virtual assets to mitigate against misconduct, theft and/or fraud.</li> <li>• <b>Trust structure:</b> the platform operator must hold client assets on trust for its clients through an “associated entity”<sup>6</sup> of the platform operator (as defined under the SFO) under a trust structure.</li> <li>• <b>Hot and cold storage:</b> the platform operator should establish and implement internal policies governing the storage of virtual assets. The SFC requires the platform operator to ensure 98% of client virtual assets are in cold wallet storage, and no more than 2% of client virtual assets are stored in hot wallet storage.</li> <li>• <b>Private key management:</b> the SFC expects the platform operator to implement strong internal controls and governance procedures for private key management to ensure that all cryptographic seeds and keys are securely generated, stored and backed up. This is to avoid the risk of hacks and fraudulent activity.</li> <li>• <b>Forks / airdrops:</b> the policies should also consider and set out in detail procedures as to how to deal with hard forks and airdrops, from both a technical and operational perspective.</li> </ul>
Insurance	The position under the Proposed Licensing Framework is not clear at this stage – SFC likely to release further details	Not expressly set out. It is unclear if insurance will be a matter covered in further regulatory codes and guidelines, but we envisage alignment to prevent arbitrage.	The platform operator must have insurance covering the custody of virtual assets (in both hot and cold storage). For hot storage, the insurance must offer full coverage; for cold storage, the insurance must offer a substantial coverage, eg 95%.

6. The associated entity is required to be incorporated in Hong Kong and licensed as a “trust or company service provider”.

Key feature	Comparison summary	Proposed Licensing Framework	Opt-in Regime (current)
Risk management	Different	The exchange should have in place appropriate risk management policies and procedures for managing ML/TF risks, cybersecurity and other risks arising from a Regulated VA Activity that are commensurate with the scale and complexity of the business.	The platform operator should have a sound risk management framework which identifies and manages business/operational risks, including post-trade monitoring and automated pre-trade controls to prevent excessive, erroneous or unlawful orders. The platform operator should manage and supervise the design, operation, review, and maintenance of the platform, including the trading system and custody infrastructure. This includes pre- and post-trade controls.
Virtual asset listing and trading policies	Different, although we expect alignment over time	<ul style="list-style-type: none"> <li>Virtual assets due diligence: the licensed exchange should also perform all reasonable due diligence on virtual assets before listing them for trading.</li> <li>Trading rules: robust rules should be implemented for the listing and trading of virtual assets.</li> </ul>	<ul style="list-style-type: none"> <li><b>Rules/criteria for virtual assets and issuers:</b> the platform operator should set up a function which makes and enforces rules which set out virtual asset issuers' liability and restrictions, as well as the criteria for including and withdrawing virtual assets from the platform.<sup>7</sup></li> <li><b>Virtual assets due diligence:</b> the platform operator should conduct reasonable due diligence on virtual assets (with reference to a non-exhaustive list of considerations) before including them on the platform for trading.</li> <li><b>Trading rules:</b> the platform operator should prepare comprehensive trading/operational rules. In particular, the platform operator should require the customers to pre-fund their accounts and only execute trades within the limit of account balances.</li> </ul>
Other requirements	Different, but will ultimately align across activities and assets	There are various other requirements that are imposed under the Opt-in-Regime and which are proposed for the Proposed Licensing Framework that are different. Some of the requirements under the Proposed Licensing Framework have not been set out in detail yet. However, we envisage that there will be increasing alignment of core standards. That is, the SFC will ultimately take a "same activity / asset: same standards" approach to avoid regulatory arbitrage.	

7. There are specific criteria in respect of the one "security" that will be traded on the platform, including a requirement that the security has a post-issuance track record of at least 12 months.

## Benchmarking against the FATF standards



FATF's 2019 announcements set off a tidal wave of regulatory change, at pace with each jurisdiction's next FATF mutual evaluation. Industry has also moved swiftly, particularly to implement rules that are technically challenging for virtual assets such as the "travel rule" that requires essential information to accompany transfers, and chain analytics to support source of wealth and source of funds assessments.

For jurisdictions that have sought to regulate VASPs so far, the majority has sought to do so via regulating VASPs under existing AML/CTF laws.<sup>8</sup> As at June 2020, it is understood that take

up of licences has been low, with most reporting less than ten registered or licensed VASPs, although four jurisdictions reported having over 100. In some cases, long queues of applicants are making




For Hong Kong, meeting the FATF VASP standards has meant expanding the existing Opt-in Regime to ensure more fulsome coverage of the sector.

We set out below the key concepts and scope of the Proposed Licensing Framework, and how the Proposed Licensing Framework seeks to address applicable FATF standards.

FATF standards	Proposed Licensing Framework details
<p><b>Virtual asset definition:</b> Virtual assets be treated as property or funds</p> 	<p><b>Definition of "virtual asset"</b> The proposed AMLO definition of "virtual assets" closely follows the FATF definition by:</p> <ul style="list-style-type: none"> <li>• applying to a digital representation of value; and</li> <li>• excluding digital representations of fiat currency (which are typically central bank digital currencies), securities and other financial products already regulated under the SFO and closed loop limited purpose items. The proposed definition does however intend to capture "stablecoins" that are asset-backed.</li> <li>• The proposed AMLO definition of virtual assets provides more specific terms by adding:</li> <li>• that it is a digital representation of value that is expressed as a unit of account or a store of economic value;</li> <li>• that it includes use for the discharge of debt (in addition to payment and investment); and</li> <li>• that it includes assets capable of being stored electronically in addition to reference to trade and transfer.</li> </ul> <p>There are strong similarities between the "virtual asset" definition and the definition of "digital payment tokens" under the Singapore Payment Services Act 2019</p>
<p><b>Scope of regulation:</b> VASPs must be licensed or registered</p> 	<p><b>Definition of "VASP" versus "virtual asset exchange"</b> The Proposed Licensing Framework only seeks to apply to virtual asset exchanges in Hong Kong. In FATF terminology a VASP captures those conducting one or more of the following activities or operations in the course of business:</p> <ul style="list-style-type: none"> <li>• <b>exchange</b> between virtual assets and fiat currencies or between one or more forms of virtual assets;</li> <li>• <b>transfer</b> of virtual assets;</li> <li>• <b>safekeeping</b> and/or administration of virtual assets or instruments enabling control over virtual assets; and</li> <li>• <b>participation</b> in and provision of financial services related to an issuer's offer and/or sale of a virtual asset.</li> </ul> <p>The Proposed Licensing Framework is much narrower. It only extends to operating a virtual asset exchange as a regulated virtual asset activity. The proposed amendments do not apply to:</p> <ul style="list-style-type: none"> <li>• peer-to-peer trading platforms and certain over-the-counter trades where there is no possession or control of the virtual assets being traded. This in line with the FATF guidance paper which excludes peer-to-peer platforms from the definition of VASP;</li> <li>• the issuance of a token itself;</li> <li>• virtual asset advisory services; or</li> <li>• standalone virtual asset payment or custodian systems.</li> </ul> <p>Whilst payment systems (eg crypto-ATMs) may be linked to financial services already subject to AML/CTF controls and regulation, we believe failing to cover custodian services is a gap too far and is unlikely to meet FATF expectations. Whilst such services may be scarce now, we expect this may change with the evolving landscape and should be anticipated with the legislative changes now. Excluding custodian wallet services follows the approach adopted in Singapore under the Payment Services Act 2019. Singapore has recognised this as being out of line with international standards and proposed to amend this position by the end of 2020.<sup>9</sup></p> <p>However, it's critical to recognise that Hong Kong has a "trust or company services provider" licensing regime already under the AMLO, so custody services for virtual assets (amongst others) are already regulated.</p>

8. FATF 12-month Review of the Revised FATF Standards on Virtual Assets and VASPs

9. See the Explanatory Brief for Payment Services (Amendment) Bill, available at: <https://www.mas.gov.sg/news/speeches/2020/explanatory-brief-for-payment-services-amendment-bill>

FATF standards	Proposed Licensing Framework details
<p><b>VASP regulation and supervision</b></p> 	<p>Any person seeking to operate the regulated activity of a virtual asset exchange will have to apply for a licence from the SFC.</p> <p>A licensed virtual asset exchange will be required to observe the AML/CTF requirements stipulated in Schedule 2 to the AMLO and follow SFC guidelines on AML/CTF.</p> <p>It may be that this will be folded into the current guideline for licensed corporations or, ideally, a distinct and specific guideline will be developed for virtual asset exchanges.</p> <p>Virtual asset exchanges will be subject to the supervision of the SFC, this will include supervisory inspections and powers to prohibit or restrict a licence. Virtual asset exchanges will need to be ready and prepared for such inspections with systems and controls in place as required under the AMLO.</p>
<p>VASPs be required to conduct <b>customer due diligence</b></p> 	<p>Recommendations 10 to 21 apply to virtual asset exchanges. This means that virtual asset exchanges must, amongst other measures:</p> <ul style="list-style-type: none"> <li>• apply customer due diligence (CDD) before establishing a business relationship, carrying out an occasional transaction or where suspicion or doubt arises. FATF sets the occasional transactions threshold above which virtual asset exchanges are required to conduct CDD at USD/EUR 1,000. This is stricter than the general rule applying to fiat currency;</li> <li>• maintain adequate CDD and transactional records for at least 5 years; and</li> <li>• have controls in place to address the heightened risk of customers who are politically exposed persons (PEPs), including identifying PEP status and applying enhanced due diligence (EDD).</li> </ul> <p>Once under the AMLO, these requirements will apply.</p>
<p>Effective, proportionate and dissuasive <b>sanctions</b></p> 	<p>It is proposed that carrying out a regulated virtual asset activity without a licence should be a criminal offence carrying the threat of imprisonment and fines. The maximum penalty is a fine if \$5,000,000 and imprisonment of up to 7 years.</p> <p>Further criminal offences are proposed with sanctions in line with those that currently exist for financial institutions that can be applied for failing to comply with the AMLO. This includes fines up to \$10,000,000 or three times the profit gained or costs avoided, whichever is greater.</p>



## Part D – Our views and insights

### At a glance: key issues and challenges

The FSTB has asked for the public's view by **31 January 2021**, after which the FSTB will aim to introduce a bill into the Legislative Council in 2021.

The precise particulars of the Proposed Licensing Framework are not yet released, and may be subject to change following to consultation. In the meantime, we identify in this section some initial issues and challenges presented by the Consultation. These are not exhaustive, and illustrative in nature.

#### Issue 1: How does the Proposed Licensing Framework treat retail focussed virtual asset exchanges?

In short, the Proposed Licensing Framework contemplates that licensed virtual asset exchanges may only offer services to Professional Investors. This means that virtual asset exchanges with retail customers will not be able to obtain a licence, and will contravene the AMLO if they operate a virtual asset exchange without a licence.

We suspect this will be a focus areas arising from the Consultation, particularly given the nature of the industry and assets involved, the approach taken in other jurisdictions and the deeply problematic systemic risk of creating a shadow virtual asset economy.

#### Issue 2: foreign virtual asset exchanges – licensing triggers and entities

Foreign virtual asset exchanges will need to consider whether they actively market into Hong Kong, and their precise business model. If they wish to be licensed in Hong Kong under the Proposed Licensing Framework, they will need to incorporate a Hong Kong company.

#### Issue 3: satisfying the regulatory licensing conditions

Specific details of the regulatory requirements applicable to the Proposed Licensing Framework are not yet available. The precise details and requirements will affect whether certain virtual asset exchanges will seek, or be able to become licensed. For example:

- the financial resource requirements may act as a too great a barrier of entry; or
- the virtual asset exchange may not have personnel or capabilities that meet the requisite level of experience and knowledge to meet RO requirements.

The Opt-in Regime provides a useful guide in this regard for virtual asset exchanges to consider, although the exact standards may not be adopted in the Proposed Licensing Framework.

#### Issue 4: specific AML/CTF challenges

### Maintaining records

The FATF virtual asset guidance states that public information on a distributed ledger will not be sufficient of itself for record-keeping purposes as it may not link to the name of an individual. Given virtual asset exchanges will be SFC regulated, records will need to be available in Hong Kong, this may prove difficult for virtual asset exchanges seeking to rely on cloud storage (see our alert, [Cloud has us jumping through hoops](#)). This continues to be a rapidly evolving regulatory area.

### The travel rule

Requiring the originating virtual asset exchanges to obtain and hold accurate originator and beneficiary information, submit that to the beneficiary virtual asset exchange and any counterparts and make that information available on request to the regulator. This has posed significant challenges because the infrastructure for sharing originator and beneficiary information was not broadly available. Further, certain existing technologies suggested by FATF that could be adapted, such X.509 technology, still have architectural weakness and could pose data privacy issues.

According to a June 2020 review by FATF,<sup>10</sup> progress is understood to have been made to address this issue:

- an international industry-wide initiative has been established to set global technical standards for travel rule solutions to use. This involves a messaging standard which sets a common universal language for the communication of the required originator and beneficiary information between virtual asset exchanges; and
- several different travel rule technology solutions are being developed by VASPs to be integrated into their systems or as solutions that could be used by multiple virtual asset exchanges.

However, as of June 2020, FATF indicated that it was not aware of any sufficient holistic technological solutions for global travel rule implementation. This is said to be reflected in the low level of jurisdictions that have introduced or sought to enforce the travel rule. It is likely that Hong Kong will follow suite in waiting for available technology solutions before seeking to robustly enforce this requirement.

In the meantime, any jurisdiction that undergoes a FATF mutual evaluation will be assessed for compliance with the FATF technical standards in this area. For example, the Philippines was subject to a review in 2019 and a Follow-Up Report was published in 2020. The Philippines was downgraded from “compliant” to only “partially compliant” in relation to new technologies (Recommendation 15). This was as a result of only partially regulating the market (due to the definition of VASP in use) and deficiencies in the wire transfer provisions. This demonstrates that the FATF will not necessarily take a lenient approach because of this being a new area for AML/CTF compliance, or because of a lack of available technology to support compliance.

#### Bringing this together – and what you should do...

The Consultation, and in particular the Proposed Licensing Framework, is a significant development in Hong Kong because:

- it brings Hong Kong in step with international AML/CTF standards which is important for Hong Kong's international financial centre status enshrined under its Basic Law;
- it is evident that the Hong Kong Government and the SFC are serious about virtual assets and virtual asset regulation. Regulatory certainty and a commitment to the virtual asset market are critical to those in the industry; and
- it provides a path for the continual legitimatisation of virtual assets into mainstream finance. Licensed virtual asset exchanges bring legitimacy and trust. While the Proposed Licensing Framework may pose challenges, it also presents opportunities if the balance between regulation and innovation is rightly struck. Good regulation will allow virtual asset exchanges to develop, grow and mature their businesses, and also foster growth and confidence in the virtual asset industry generally.

10. FATF 12-month Review of the Revised FATF Standards on Virtual Assets and VASPs



We encourage those in the virtual asset space to participate in the consultation process. In the interim, virtual asset exchanges can begin to assess the impacts of the Proposed Licensing Framework on their business. While the precise nature of the Proposed Licensing Framework may be subject to change following the Consultation, there are preliminary steps virtual asset exchanges can undertake, for example:

- **Engage in the Consultation.** We are currently supporting industry on consultation responses, as well as individual clients on their feedback. It is important to provide practical input, backed up by solutions and interjurisdictional examples where possible.
- **Make a plan.** Speak to us for any questions about the proposals and what ancillary opportunities this may bring.
- **Bring internal control policies and procedures up to scratch** – we expect the SFC will require similar prudential requirements and risk management systems found in the Opt-in Regime and the current framework for licensed corporations. Even if the virtual asset exchange will not be subject to the Proposed Licensing Framework, it may be helpful to ensure that its AML/CTF and controls are in line with best practice.
- **Earmark senior managers as ROs**, and think about corporate structures and governance.
- **Take care with any “offshore models”** – we regularly advise on controls required for institutions that prefer not to market into the jurisdiction. These need to be layered and carefully executed.

We would be happy to have a detailed discussion about how the Proposed Licensing Framework may affect your business. We are uniquely placed as one of the largest fintech-focussed teams globally, with particularly strength in financial services regulation, AML/CTF controls and blockchain.

## Part E – Synopsis of additional AMLO changes

Finally, the Consultation also has two additional areas of change that will also be important to the financial services and commodities sectors. These are summarised as follows:

Area of change	Snapshot of details
<b>Precious metals and stones dealer registration (DPMS)</b> 	<p>The key change is to introduce a new registration regime for DPMS under the AMLO. The registration regime will be overseen by the Commissioner for Customs &amp; Excise (C&amp;CE).</p> <p><b>Regulated activities to be captured</b></p> <p>Under the proposed regime, registration will be required where a person trades, imports, exports, manufactures, refines or undertakes similar work in respect of defined precious metals, stones or products, as well as issues previous asset-backed instruments.</p> <p><b>Two-tiered registration regime</b></p> <p>A two-tiered registration regime is contemplated.</p> <p>Category A – “light-touch” regulation through registration</p> <p>A person falls within Category A if they do not engage in cash transactions below HKD120,000. Minimal information about the person and their business will be required as part of registration. Such persons will not be subject to AML/CTF obligations under Schedule 2 of the AMLO.</p> <p>Category B – more “hand on” regulation</p> <p>For persons above the HKD120,000 threshold who carry out regulated activities:</p> <ul style="list-style-type: none"> <li>• the applicant must be “fit-and-proper”; and</li> <li>• being subject to AML/CTF obligations under the AMLO when they engaged in specified cash transactions.</li> </ul> <p><b>Exemptions</b></p> <p>Registration is not required for financial institutions and non-domestic dealers.</p> <p><b>C&amp;CE powers</b></p> <p>The C&amp;CE will be given certain powers, including intervention and disciplinary powers.</p>
<b>Upgrade and modernisation of AMLO standards</b> 	<p>The Consultation also seeks to amend various parts of the AMLO. We give a flavour of these below:</p> <ul style="list-style-type: none"> <li>• <b>Amending the definition of PEPs:</b> the proposed change is to make clear that a PEP captures any person outside the jurisdiction of Hong Kong. Currently, the definition of PEPs, includes persons outside the People's Republic of China.</li> <li>• <b>Align “beneficial ownership” definition of trusts to the concept of “controlling person”:</b> this is to ensure consistent with FATF standards other international guidance and Hong Kong ordinances.</li> <li>• <b>Greater flexibility regarding CDD in non-face-to-face situations:</b> the proposed change is to permit reliable and independent digital identification systems with appropriate risk mitigation measures in order to satisfy CDD requirements in non-face-to-face situations.</li> <li>• <b>Increase sanctions for unlicensed money service operators:</b> this involves making it an indictable offence to operate an unlicensed money service business, and increasing the applicable sentencing level for the offence.</li> </ul>

## Key contacts



**Urszula McCormack**

Partner

[urszula.mccormack@au.kwm.com](mailto:urszula.mccormack@au.kwm.com)



**Leonie Tear**

Counsel

[leonie.tear@hk.kwm.com](mailto:leonie.tear@hk.kwm.com)



**Evan Manolios**

Senior Associate

[evan.manolios@hk.kwm.com](mailto:evan.manolios@hk.kwm.com)