

Response to the Public Consultation on Legislative Proposals to Enhance Anti-Money Laundering and Counter-Terrorist Financing Regulation in Hong Kong

The FinTech Association of Hong Kong ("FTAHK") welcomes the continued endeavours of the Financial Services and the Treasury Bureau ("FSTB") and the Securities and Futures Commission ("SFC") to enhance anti-money laundering and counter-terrorist financing ("AML/CTF") regulation in Hong Kong, and to create a robust, transparent and predictable regulatory framework for virtual assets.

The FTAHK is a not-for-profit ecosystem builder that has over 1,300 members representing 300+ firms and is the largest FinTech association in Hong Kong ("HK"). Our wide-ranging membership comprises global and domestic FinTechs, Financial Institutions, Technology Service Providers, Consultancies, Law Firms, Academia and Students.

We are grateful to have the opportunity to respond to this public consultation; the scope of which is focused on the proposed licensing regime for Virtual Asset Services Providers ("VASPs").

This Response has been prepared in consultation with FTAHK members representing a broad range of experience and backgrounds from fintech start-ups to established financial services firms, as well as stakeholders such as technology companies, consultancies, law firms and academia.

Overall, our Response draws out the following six key themes for the consideration of the FSTB:

(1) Differentiation of Virtual Assets

As a starting point, we believe that the aims of achieving a robust regulatory framework for virtual assets are best achieved when there is a recognition of the diversity of virtual assets that exist and which may be developed into the future.

In this respect, the FTAHK recognises that the FSTB has already signaled a number of important exclusions from this regime that we agree are best addressed through either general laws and contract, or via separate regimes.

However, we ask that the FSTB:

- Clarify the treatment of certain assets (described more fully below); and
- Consider *excluding* additional assets for which general laws are already sufficient. In this respect, we believe that at least Bitcoin ("BTC") would merit reconsideration as an in-scope asset given its relative simplicity, the widespread information that is readily accessible in relation to its structure and use, and that it has been widely bought, sold and used in Hong Kong for several years without evidence of material risk to consumers.

In relation to excluding BTC from this regime, consideration could be given to more streamlined regulatory standards for this and any designated assets considered appropriate. For example, the registration requirements proposed for dealers in precious metals and stones could be a more appropriate and proportionate mechanism, whilst still achieving AML/CFT policy aims.

The rest of our responses deal with virtual assets generally, but expressly reserve this point in relation to the exclusion of BTC and similar assets.

(2) Access at a Customer Level - Retail Investors

The current scope of the proposed regime excludes retail investors from accessing virtual asset exchanges in Hong Kong; a segment that we feel represents a significant portion of the market and an investor group that would derive relatively greater benefit from enhanced regulatory protections.

We understand there may be policy sensitivities associated with a robust regulator such as the SFC enabling retail investors to access virtual assets that are perhaps perceived as riskier than stocks or other assets. However, this exclusion must be understood properly as not the failure to “open up” to retail, but the “closing down” of an *existing* retail market. This has very material implications and we feel that the outright exclusion of retail investors could present the following issues:

- *Investor Impact:* In reality, Hong Kong retail investors who want to buy and sell virtual assets will continue to find a way to do so, be it through a licensed virtual assets exchange or otherwise. By preventing retail investors from dealing through an SFC-licensed VA Exchange, they will be pushed towards unregulated venues (e.g. P2P/decentralised exchanges, offshore exchanges, over-the-counter brokers, etc.) where they will be afforded no protection. Such platforms are widely available and easily accessible. We do not feel that this outcome would be in the best interests of the investing public in Hong Kong. We think the better approach is to permit retail investors to deal through SFC-licensed VA Exchanges and to create a regulatory framework that facilitates this from the outset rather than introducing amendments to the framework at a later date.
- *Commercial Impact:* VA Exchanges that currently operate in Hong Kong and have a large proportion of retail customers will ultimately be faced with three choices:

1. Remain in Hong Kong and off-board all retail customers to operate a fully-licensed, professional investor-focused business

This may not be viable from a commercial perspective for many market participants, given the high costs of compliance for smaller / mid-sized firms. This will also impact competition levels (which is of considerable benefit to end customers and broader industry innovation efforts), as we are likely to see only a small handful of well-funded VA exchanges dominating the market;

2. Move offshore

This would lead to a key talent drain to offshore markets. Some market participants may also continue to deal with Hong Kong customers (noting that this could technically be prohibited under the proposed licensing framework for VA Exchanges);

3. Shut down the business altogether

We see this as a major risk to continued growth of the virtual assets ecosystem in Hong Kong

We urge the FSTB to take into consideration that Hong Kong also has a 'best in class' suitability regime that applies to SFC-licensed firms that sell certain types of financial products to their clients. It is conceivable that appropriate suitability assessment procedures could be developed so as to permit a subset of the retail investing public to access virtual assets via licensed virtual asset exchanges. This has already been successfully deployed to enable retail investors to access other assets beyond listed stocks alone.

We therefore strongly recommend that the FSTB (and in due course the SFC) leverage the multiple transferable prudential standards, capabilities and tools from existing frameworks to develop an appropriately structured pathway for retail access. In particular, the established maturity of the SFC in respect of suitability assessment could potentially be adapted to mitigate corresponding risks.

If the FSTB decides to limit the regime to professional investors only, we urge it to consider providing a timeframe for developing appropriate measures to facilitate retail investors to access VA Exchanges in the future. This would give companies operating VA Exchanges a higher degree of predictability about the future development of the regime and allow them to better plan their Hong Kong businesses.

(3) Professional Investors

The FTAHK also advocates for the modernisation of the "professional investor" definition. Specifically, limiting qualifying assets for high net worth investors to securities, deposits and certificates of deposits ignores the integration of a far broader range of assets into investor portfolios. Bringing virtual assets into the regulatory fold as a recognised (and regulated) asset would be especially appropriate at this time.

Of course, given the wide range of potential assets and circumstances, which can be difficult to codify into specific rules, consideration could also be given to exploring a more principles-based approach that may better protect the investing public. For example, setting parameters (liquidity etc.) on eligible assets besides securities, deposits and certificates of deposit.

(4) Virtual Asset Definition

Besides our comments in section (1), adapting the very broad FATF definition of Virtual Asset to make it more specific is welcomed and deemed a pragmatic and sensible approach. Whilst the intention behind the carve-out of closed-loop, limited purpose items that are non-transferable, non-exchangeable, and non-fungible seems reasonable, we feel further guidance to elaborate on the underlying guiding principles driving such judgements would be helpful.

In particular, it is recognised that the Non-fungible Token ("NFT") arena is a very broad and dynamically evolving space, and greater precision on scope will better enable market participants to understand their compliance obligations in this regard.

It is also noted that the current definition of Virtual Asset potentially risks inadvertently capturing a wide range of assets which may not have been intended to fall within the scope of the licensing regime. This point becomes more acutely apparent when considering NFTs that are backed by physical assets, spanning across the value spectrum from art to collectibles to almost anything conceivable. We feel the emphasis here should be on the underlying asset substance, and ensuring consistency of treatment agnostic of technology - not driven purely by whether the asset is recorded in a certain type of database (i.e. blockchain).

For instance, we do not believe that NFTs representing digital artwork or digital collectibles should be a type of virtual asset that is subject to regulation (in the same way that auction houses and art galleries are not subject to regulatory licensing requirements). This would of course be subject to existing regulatory concepts – for example, we recognise that a fractionalised asset (e.g. an expensive artwork or real estate) in token form could still well be a collective investment scheme if it merely amounts to a scheme designed to generate passive profits for holders based on an underlying asset.

National stock exchanges across the globe are also looking to dematerialise their shares in coming years. In March 2019, India's SEBI announced that no transaction or transfer of securities of a listed company can occur in physical certificate form, rendering physical securities illiquid. In Hong Kong, we understand the SFC and HKEX are exploring the Uncertificated Securities Market ("USM") regime, allowing dematerialised securities in Hong Kong, with a target implementation date of 2022. As these "virtual assets" will be available to retail investors, it would be beneficial to further understand the treatment of dematerialised securities under this regime, and whether they meet the definition of a Virtual Asset.

(5) Foreign VASPs

Regarding the requirement for local incorporation of VASPs, we feel that this potentially creates additional friction that could be counterproductive and dissuade VA Exchanges from providing services to Hong Kong customers. That local incorporation would be a preference is understandable from a regulatory perspective in terms of enforceability and day-to-day supervision by the SFC. However, we would encourage the FSTB to consider whether it would be possible for the SFC to discharge effective supervision without requiring local incorporation (e.g. allowing a Hong Kong branch of an overseas company to be licensed by the SFC as a VA Exchange while the management and operations of the VA Exchange are offshore).

Further, additional clarity on the threshold that constitutes a VASP operating in Hong Kong would be helpful.

For example, it would be helpful for the SFC to produce new guidance on what would constitute "active marketing," to enable offshore exchanges to understand what is, and is not, permitted. This guidance could be specifically designed for VA Exchanges or the SFC's existing guidance on "active marketing" for securities businesses (issued in 2003) could be updated for this purpose.

Such guidance is in fact more broadly required given the increasing digital (and indeed often online-only) nature of businesses and the global and open footprint of many social media and other communication platforms.

(6) Existing Opt-in Regime vs Proposed Regime

We understand 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, whilst operating on a mutually exclusive basis.

However, observations from information that has been released to date indicates key differences across the respective regimes (i.e. custody, personnel, insurance and financial resource requirements). It is not clear what differences may initially be reflected and what the path towards convergence is. Further consideration on the relative benefits of running parallel regimes could be further explored, and whether it may be simpler to consolidate the regulatory requirements at initiation.



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Conclusion

In conclusion, the FTAHK fully supports the proactive approach being taken to develop an appropriate licensing regime for VASPs in Hong Kong. We trust that our Response will be received in the constructive manner for which it is intended, and we are open to further discussion on any aspect, as may be required.

Individual responses to the questions related to VASPs posed through the consultation document are further expanded in **Appendix A** for your consideration.

Appendix A: Responses to Questions 1 - 14

Please find below individual responses by the FTAHK to questions 1 - 14 from the consultation document¹.

Q1 Do you agree that Hong Kong should continue with efforts to strengthen the AML/CTF system having regard to international standards, in keeping with our status as an international financial centre that is safe and clean for doing business?

Yes. Maintaining obligations to FATF compliance are critical to sustain Hong Kong's positioning as an international financial hub for the global markets.

Q2 Do you agree that a balanced approach should be adopted for the current legislative exercise, complementing the need to have an effective system for tackling ML/TF risks in the VASP and the DPMS sectors in accordance with the FATF Standards, while minimising regulatory burden and compliance costs on the businesses?

Yes. We agree that a balanced approach should be taken that serves to mitigate the risks of financial crime and which protects Hong Kong persons, but also which does not unnecessarily impose restrictions on doing business in Hong Kong. However, we feel that the current legislative proposals require further calibration to more appropriately balance these factors.

The proposals in the consultation paper may impose a significant regulatory compliance and cost burden on VA Exchanges, which may stifle competition in this sector and, in turn, this may be detrimental to Hong Kong virtual asset investors. The proposals also prohibit VA Exchanges from dealing with retail customers entirely, representing a sizeable proportion of the market, which appears somewhat inconsistent with regimes adopted in other comparable markets.

Our concerns about the impact of the scope of the regime on retail investors and on VA Exchanges are summarised above in section "(2) Access at a Customer Level - Retail Investors."

Q3 Do you agree with the proposed scope and coverage of the regulated activity of operating a VA exchange?

No. It is understood that central bank issued digital currencies ("CBDC") shall be exempted, however the underlying rationale for their exclusion is not clear. Our suggestion would be to include CBDCs to follow the same regime to avoid favoring VASPs that are operators for the government to have unfair competitive advantage. The ML/TF risks of all VASP is the same regardless of the underlying. Creating a separate framework for CBDC could also risk creating interoperability issues in future when both kinds of VAs are further matured.

Further considerations should also be given to whether the scope and coverage is appropriately balanced and flexible to enable the evolution of business models that are yet to develop. As the technology, industry and business models are very new, it's not clear the full scope of what can be done with security tokens, other types of crypto assets, etc. and drawing hard lines around the existing business may risk creating an artificial ceiling on the industry.

The Consultation Paper has not indicated whether VA Exchange licensees will be exempt from other regulatory regimes in Hong Kong. For example, it is unclear whether licensed VA Exchanges would automatically be exempt from the money services operator licensing regime (which applies to remittance and money changing services) and the trust or company service provider licensing regime (which applies to trust businesses) under AMLO, to the extent that a VA Exchange is providing any of these services ancillary to its functions as a VA Exchange.

¹ https://www.fstb.gov.hk/fsb/ppr/consult/doc/consult_amlo_e.pdf

Q4 Do you agree with the proposed definition of VA? Other than closed-loop, limited purpose items, are there other digital items that should be excluded from the definition?

No. We think the current definition may require further refinement to avoid unintended consequences (e.g. NFTs should be excluded) as reflected above in section "(4) Virtual Asset Definition."

Q5 Should peer-to-peer VA trading platforms be covered under the licensing regime?

Not pragmatic at this point. Given the challenges on how to implement such a regime in practice and that the Decentralised Finance markets are not yet matured, it would seem unlikely that including P2P VA platforms would be an appropriate measure at this stage.

It is also noted however that if peer-to-peer VA trading platforms are excluded from the licensing regime and retail investors are not able to access VA Exchanges because they are prohibited from dealing with retail customers then the outcome may be that retail customers' will trade through unregulated peer-to-peer trading platforms. Arguably this could put consumers in a worse position than they would be if they were able to trade through a regulated VA Exchange. The solution appears to be to permit retail investors to access regulated VA Exchanges or to bring peer-to-peer VA trading platforms within the scope of the regime.

Q6 Do you agree that only locally incorporated companies may apply for a VASP licence?

HK is traditionally a center for international business and if only HK businesses are eligible for a VASP license, it could reduce competition, stifle innovation, reduce diversity and most of all suffocate revenue growth and jobs. In practice, this requirement could simply lead to VA Exchanges moving out of Hong Kong but continuing to provide services to HK persons because the ability of the SFC to enforce rules outside Hong Kong is relatively limited. Accordingly, allowing offshore companies to obtain a VA Exchange licence might be a more pragmatic approach. However, this may require a re-think of how the regime would work with respect to offshore entities and how the SFC could effectively supervise offshore entities. Perhaps offshore entities could be licensed through a HK branch but stopping short of requiring a local subsidiary etc. to be established. This would still give the SFC the ability to go to a physical business premises in Hong Kong to conduct inspections, audits, etc. but allow VA Exchanges to have their substantive operations run from another jurisdiction.

Q7 Should other criteria be added to the fit-and-proper test given the nature and risks of VASPs?

No. The fit and proper test should be tailored more specifically to the needs of virtual assets in a thoughtful and reasonable way.

The concept of an "ultimate owner" is well-entrenched under AMLO for other regulatory purposes. In relation to the money services operator licensing regime and the trust or company services provider licensing regime, an "ultimate owner" of a corporation means an individual who (i) owns or controls, directly or indirectly, including through a trust or bearer share holding, more than 25% of the issued share capital of the corporation; (ii) is, directly or indirectly, entitled to exercise or control the exercise of more than 25% of the voting rights at general meetings of the corporation; or (iii) exercises ultimate control over the management of the corporation. However, in respect of VASPs and other licensed financial institutions, the SFC applies a different threshold. The SFC assesses the fitness and properness of "substantial shareholders", as defined in the SFO, which, in certain respects, is broader than the definition of "ultimate owner". The threshold to identify an ultimate owner of a VASP will need to be clarified during the consultation process.

In respect of VASPs and other licensed financial institutions, the SFC requires certain senior management functions (known as managers-in-charge) to be designated. These include functions such as risk management, finance and accounting, information and technology, and compliance. While the Consultation Paper requires licensed VASPs to have a minimum of two ROs, the Consultation Paper does not discuss whether licensed VASPs will need to designate certain individuals as managers-in-charge. We do not believe that it would be proportionate or necessary for the manager-in-charge framework to be replicated for VA Exchanges and we would welcome further clarity from the FSTB and the SFC on this in due course.

Q8 Should other regulatory requirements be added to mitigate the risks of VASPs?

Not at this time. The more immediate priority is to place some regulation and restrictions for now, with the ability to grow the guidelines as the industry grows. Seeking to place regulation ahead of an emerging industry can be devastating - we feel the intention should be more to seek to balance it when it is imbalanced, not before.

Q9 Do you agree that a VASP licence should be open-ended or should it be periodically renewed?

Open-ended seems sensible and is consistent with the other types of licences administered by the SFC.

Q10 Do you agree with the exemption arrangement and the 180-day transitional period for application of a VASP licence?

Difficult to say without having visibility of the final ruling and the potential applicant pipeline (to ensure that there is adequate time for processing).

Q11 Do you agree that, for investor protection purpose, persons without a VASP licence should not be allowed to actively market a VA exchange business to the public of Hong Kong?

Yes. Please refer to the response above in relation to making it more possible for offshore VA Exchanges to obtain a licence without having to set up a locally incorporated company, etc. In addition, the Consultation Paper's concept of "active marketing" is similar to the concept that exists under existing securities laws (i.e., the SFO).

As an indication of how the term actively marketing may be construed under the new regulatory framework, the SFC has previously issued guidance on what actively markets means under the SFO in the form of a frequently asked question (FAQ). Guidance on whether the same test will be applied to VA Exchanges under the new regulatory framework would be welcomed.

This question spawns additional questions such as what will be the test for establishing whether a VA Exchange is "offshore" or "onshore" or does the "mind of management" need to be in HK or is it the contractual counterparty that enters into the user agreement with the customer or some combination of factors that will determine whether a VA Exchange is deemed to be carrying on business in Hong Kong or offshore? This is an area where further guidance will be required by market participants prior to the regime being enacted into law.

Q12 Do you agree that the penalty level for carrying out unlicensed VA activities should be sufficiently high to achieve the necessary deterrent effect?

Yes.



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Q13 Do you agree with the proposed sanctions, including that it shall be a criminal offence for a person to make a fraudulent or reckless misrepresentation to induce someone to acquire or dispose of a VA?

Yes.

Q14 Do you agree that the Tribunal be expanded to hear appeals from licensed VASPs against future decisions of the SFC?

Yes.