

HKCGI Technology Guidance Note (Ninth Issue) - 2022 wrap up and what to expect in 2023 (Part 2) – other developments

Hong Kong virtual asset regulation – 2022 wrap up and what to expect in 2023 (Part 2)

Part 1 of our guidance note discussed a statement by the Securities and Futures Commission (SFC) on risks associated with virtual asset (VA) platforms claiming to offer investment returns, as well as the implementation and transitional arrangements relating to the new virtual asset service provider (VASP) licensing regime. In this part, we consider various aspects of the new regime, other enhancements under the AMLO, and upcoming regulatory developments.

VAs and non-fungible tokens

In brief terms, a VA is defined as a cryptographically

secured digital representation of value that is expressed as a unit of account or a store of economic value; can be transferred, stored or traded electronically; and either (i) is used for the purposes of payment for goods or services, discharge of a debt and/or investment, or (ii) provides rights, eligibility or access to vote on the affairs in connection with any cryptographically secured digital representation of value. However, certain digital representations of value (such as those issued by a central bank or a government, “limited purpose digital tokens”, securities, and futures contracts) are excluded from the definition of VA.¹

A market issue is whether a non-fungible token (NFT) falls within the definition of VA. This was discussed at the Bills Committee meetings to review the proposed

1 [To be renumbered to note 1] See section 53ZRA under the new Part 5B of the amended AMLO

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amendments to the AMLO (see Bills Committee Report²). The SFC observed that tokens which are labelled as NFTs in the market may have different terms and features and noted that it is important to consider the nature and functions of the NFTs **in practice** rather than the marketing terminology used.

In most cases, where an NFT merely represents a genuine digital representation of a collectible, it will unlikely fall within the definition of VA. However, where the characteristics of a specific NFT go beyond the boundary of a collectible (such as containing fungible elements or allowing holders to vote on its arrangement), it may be used as a medium of exchange accepted by the public or a digital representation of value that provides holders with rights, eligibility or access to vote. If it also contains the other elements of the definition of VA under the amended AMLO, it is very likely to qualify as a VA.

Invariably, as part of risk management, governance professionals should seek professional advice in case of doubt.

Additional customer due diligence measures in relation to VAs

Financial institutions (including licensed VASPs under the amended AMLO) will need to perform customer due diligence (CDD) measures before carrying out an occasional transaction that is a transfer involving VAs amounting to no less than HK\$8,000, whether the transaction is carried out in a single operation or in several operations that appear to be linked.

A significant change to the original proposed amendments to the AMLO is that licensed VASPs will also need to perform CDD measures before carrying out an occasional transaction involving HK\$8,000 or above (or equivalent) which is **not** a wire transfer or VA transfer, whether the transaction is carried out in a single operation or in several operations that appear to be linked. In comparison with other financial

institutions, licensed VASPs will need to perform CDD measures for a much broader range of occasional transactions.

Client assets

From the angle of investor protection, the protection of client assets is of paramount importance. The SFC has been empowered to protect a licensed VASP's client's assets in the event of an emergency and to prevent the dissipation of client assets in case of misconduct on the part of a licensed VASP.

Another significant change to the original proposed amendments to the AMLO is the addition of a new section (section 53ZRT), which provides that client assets are not liable to be taken in execution against the licensed VASP or its associated entities under an order or process of a court. Put simply, client assets are not subject to any execution orders issued by the court against the licensed VASP for the purpose of enforcing a judgment (such as a writ of *fi fa*, warrant of distress, and charging order). This serves to further protect client assets by ringfencing and excluding them from any orders or processes for enforcement of judgments and execution of those orders against a licensed VASP.

Criminal offences for fraud involving VAs

Notwithstanding the fact that the VASP licensing regime will come into effect on **1 June 2023** (as mentioned in part 1 of the guidance note), the following new criminal offences specific to fraud involving VAs will take effect from **1 April 2023**:

- **Offence involving fraudulent or deceptive devices etc., in VA transactions** (section 53ZRF) – It will be an offence if a person, directly or indirectly, in a transaction involving any VAs: (a) employs any device, scheme or artifice with intent to defraud or deceive; or (b) engages in any act, practice or course of business that is fraudulent or deceptive, or would operate as a fraud or deception. On

2 [To be renumbered to note 2] <https://www.legco.gov.hk/yr2022/english/bc/bc05/reports/bc0520221207cb1-855-e.pdf>

indictment, the offence carries up to HK\$10 million and 10 years' imprisonment, and on summary conviction up to HK\$1 million and 3 years' imprisonment³.

- **Offence to fraudulently or recklessly induce others to invest in VA** (section 53ZRG) – It will be an offence for a person to make any fraudulent misrepresentation or reckless misrepresentation for the purpose of inducing another person to enter into, or offer to enter into, an agreement to acquire, dispose of, subscribe for or underwrite any VAs. On indictment, the offence carries up to HK\$1 million and 7 years' imprisonment, and on summary conviction a level 6 fine and 6 months' imprisonment⁴.

These criminal offences are aimed at addressing concerns relating to fraud. They will be applicable to any person regardless of whether that person is providing a VA service (currently limited to operating a VA exchange), and will therefore also be applicable to overseas VA exchanges that are not licensed by the SFC.

Upcoming SFC consultation on the detailed regulatory requirements for the VASP regime

Looking ahead, the SFC is expected to soon consult on the detailed regulatory requirements of the VASP regime. It will consider whether the professional investor-only requirement could be relaxed, and, if so, the governance procedures and listing criteria for the VASP to admit tokens for secondary market trading by retail investors.

The SFC and the Financial Services and the Treasury Bureau have also been communicating with the industry on security token offerings (STOs), including in relation to the SFC's regulatory principles for STOs and

the latest regulatory direction in this area,⁵ especially on the SFC's proposed relaxation of the professional investor-only requirement and guidance on STOs.

The SFC will publish guidelines under the new section 53ZTK of the amended AMLO to specify, among others, the matters that it will take into consideration in determining whether a person satisfies the fit and proper test in order to be licensed or to remain licensed, and to be a responsible officer or licensed representative. The standards to be set out in these guidelines are expected to be generally aligned with those under the SFC's 'Fit and Proper Guidelines'.

Other enhancements to the AMLO

The amended AMLO will also include the following enhancements:

- The definition of a politically exposed person (PEP) is amended to an individual who is or has been entrusted with a prominent public function in a place outside Hong Kong. This means that the special requirements under section 10 of Schedule 2 to the AMLO applies not only to a PEP from a place outside the People's Republic of China but also to a PEP from a place outside Hong Kong. Financial institutions will be allowed to take a risk-sensitive approach in determining the degree of CDD to be taken in respect of former PEPs who are no longer entrusted with a prominent public function.
- The definition of beneficial owner for trusts has been amended to align with that of controlling person under the Inland Revenue Ordinance by clarifying that, where a trust is concerned, it includes trustees, beneficiaries and class(es) of beneficiaries of the trust entitled to a vested interest in the trust property.

3 [To be renumbered to note 3] <https://www.elegislation.gov.hk/hk/2022/06/24/supp3/1/en> (see section 53ZRF of the amended AMLO)

4 [To be renumbered to note 4] See note 1 above (see section 53ZRG of the amended AMLO), and section 113B and Sch 8 of the Criminal Procedure Ordinance which set out a level 6 fine at HK\$100,000.

5 [To be renumbered to note 5] <https://sites-herbertsmithfreehills.vuturvex.com/103/29016/november-2022/retail-access-for-virtual-assets---risky-business-or-radical-open-mindedness-.asp?sid=280a066f-5294-47f7-948f-4ddb25ff5e51>

- Recognised digital identification systems may now be used for the purposes of CDD, which also satisfies the special requirements in situations where a customer is not physically present for identification purposes (ie, non-face-to-face situations).
- The penalties for unlicensed money service operation have also been increased to enhance the deterrent effect. The maximum penalty has been increased to a fine of HK\$1 million and imprisonment for two years on conviction on indictment.
- Lastly, a registration regime for dealers in precious metals and stones has been introduced. Under this regime, any person seeking to carry on a business dealing in precious metals and precious stones in Hong Kong will be required to register with the Commissioner of Customs and Excise.

The increased penalties for unlicensed money service operation and the registration regime for dealers in

precious metals and stones will come into operation on 1 April 2023. The remaining amendments to the AMLO listed in this section will become effective on 1 June 2023 to provide sufficient time for preparatory work.

As indicated in the HKMA's circular of 7 December 2022⁶ and the Bills Committee Report⁷, the HKMA will work with the Hong Kong Association of Banks and consult the banking sector to update the HKMA's 'Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (For Authorised Institutions)' and relevant FAQs. The HKMA has since launched a consultation on proposed amendments⁸ to the guideline. In addition, the HKMA intends to develop a new guidance paper on PEPs with the help of an external consultant, to provide holistic guidance on all types of PEPs taking into account international practices.

Other regulators with a remit under the AMLO (such as the SFC) are likely to also update their anti-money laundering and counter-terrorist financing guidance.

6 [To be renumbered to note 6] <https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2022/20221207e1.pdf>

7 [To be renumbered to note 7] See note 2 above.

8 [To be renumbered to note 8] [https://www.hkma.gov.hk/media/eng/regulatory-resources/consultations/AML_Guideline_\(AI\)_20230118.pdf](https://www.hkma.gov.hk/media/eng/regulatory-resources/consultations/AML_Guideline_(AI)_20230118.pdf)