

## **Public Consultation on Legislative Proposals to Regulate Over-the-Counter Trading of Virtual Assets**

### **The Law Society's Submissions**

The Financial Services and the Treasury Bureau (“FSTB”) on 8 February 2024 issued a consultation paper on legislative proposals to regulate over-the-counter (“OTC”) trading of virtual assets (“VA”) (“Consultation Paper”).

In response, the Law Society provides the following submissions. Unless otherwise defined, the same abbreviations and definitions appearing in the Consultation Document are used in this paper.

Q1 *Do you agree that the regulation of VA activities should be widened to cover OTC trading of VA?*

**Law Society's response:**

Yes, we agree.

Q2 *Do you agree that [FSTB] should observe the “same activity, same risks, same regulation” principle in drawing up a new regulatory framework for VA OTC services, incorporating Anti-Money Laundering/ Counter-Terrorist Financing [AML/CTF] requirements in accordance with international standards while ensuring sufficient investor protection?*

**Law Society's response:**

Yes, we agree.

Q3 *Do you agree with the proposed scope and format of VA OTC services to be regulated and that operators of VA OTC services who provide*

*temporary custody/escrow service as part of the transaction process should be brought within the regulatory remit?*

**Law Society's response:**

*Regulatory scope*

Presently, the proposed scope of regulation is that a person who conducts a business in providing services of spot trade of any virtual assets in Hong Kong will be required to obtain a licence. The licence will be required irrespective of whether the service is provided through a physical outlet (including an automatic teller machine ("ATM")) or any other platform (such as a digital platform). We broadly agree with the proposed scope for VA OTC regulation.

In addition, we believe the draft legislation should provide more clarity on the following points:

1. The proposed definition of VA OTC business is the provision of spot trading services in virtual assets "*by way of business*". This phrase is different from similar phrases appearing in related legislation in Hong Kong. For instance, the statutory definition of remittance service in the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) refers to "*a service ... this is operated in Hong Kong as a business*". The formulation used in Cap 615 makes it clear that a money service operator licence for remittance services is not needed if the service in question is incidental to the main business. We recommend a similar approach is used in the proposed definition of VA OTC business.
2. It would be helpful to include a specific definition of spot trade. For instance, crypto payment acquiring services would not generally be considered spot trading business. The core service of crypto payment acquiring is not the immediate settlement of the sale and purchase of a virtual asset. The service is a broader service of arranging or facilitating the payment for goods or services using virtual assets as a medium of payment. The conversion of fiat to virtual asset in the course performing that service should not be considered a spot trade or VA OTC business. A clear definition of spot trade may assist in making this distinction.
3. We note the proposed exclusions from the scope of the licensing requirement are:
  - (a) operation of VA trading platforms ("VATPs") as they are already covered under the VATP licensing regime;

- (b) licensed corporations regulated by the Securities and Futures Commission (“SFC”) under the Securities and Futures Ordinance (Cap. 571);
- (c) authorised institutions regulated by the Hong Kong Monetary Authority (the “HKMA”) under the Banking Ordinance (Cap. 155); and
- (d) stablecoin issuers to be licensed by the HKMA under the proposed stablecoin regulatory regime upon its implementation.

We agree with these proposed exclusions. In addition, other exclusions from the scope of regulation may be required in future. The legislation should provide flexibility for the Commissioner of Customs and Excise (“CCE”) to supplement exclusions by regulation.

4. We note that the CCE has been proposed as the intended competent regulator. Until now, regulation of virtual assets has largely been conducted by the SFC, and the SFC has developed internal resources, experience and expertise in respect of its regulatory brief. We acknowledge an analogy between VA OTC services and money services. However, and with due respect to the CCE, we wonder whether the SFC would be better positioned to be appointed the competent regulator for VA OTC services. This could avoid duplication of regulatory resources, avoid potential differences in regulatory treatment for similar matters, and result in more efficient regulation.

#### *Custody and escrow services*

We agree that the proposed regulatory regime should cover temporary custody or escrow services provided by licensed VA OTC service operators. This position can be reviewed if there are regulatory developments generally in future for separate regulation of custody or escrow of virtual assets.

We envisage that the VA OTC service operator licensing requirement will be triggered by the provision of VA OTC services, and not the provision of virtual asset custody and escrow services. Consequently, the proposed regulation of temporary custody or escrow services should only apply to persons who hold (or are required to hold) a VA OTC service operator’s licence.

We do not envisage that the scope of regulation should extend to wallet service providers who provide non-custodial wallet services, or who do not provide VA OTC services.

Regulations in respect of temporary custody and escrow services should generally align with the principles applied by the SFC and the HKMA.

Q4 *Do you agree that a licence applicant must have a local nexus and suitable premises/relevant local addresses for CCE's effective supervision and monitoring?*

**Law Society's response:**

We agree that licence applicants should either be (a) a locally incorporated company with a permanent place of business, or (b) a company incorporated elsewhere but registered in Hong Kong under the Companies Ordinance (Cap. 622).

We also agree that digital VA OTC service operators should be required to provide information on the address of the local management office, correspondence address and the place for local storage of books and records.

We recommend that the draft legislation or implementing guidelines provide express guidance on any other local nexus or residency requirements. We consider it appropriate that, for instance, a VA OTC licensee should be required to employ a competent person resident in Hong Kong with responsibility for compliance with anti-money laundering obligations, and for responding to requests of the CCE.

Q5 *Do you agree that VA OTC licensees should only be allowed to provide VA-fiat (and vice versa) spot trading services, and subsequent remittance of exchange proceeds on specified conditions?*

**Law Society's response:**

We believe VA OTC licensees should be allowed additionally to provide VA-VA spot trading services, including subsequent transfer of the acquired virtual asset. A VA OTC licensee will handle both client money and client VAs. No material additional risk will arise if the scope of the VA OTC licence also allows for exchange between VAs. To the extent that the CCE considers there are additional risks, those risks can be addressed by additional licensing restrictions.

It is not correct, in our view, to state that VA OTC service providers who wish to provide VA-VA spot trading services should apply for a VATP licence. The regulatory scope for a VATP licence is specifically limited to trading platforms which use an automation engine. This is not the case for VA OTC spot trading services. We suggest the FSTB should consider whether it is necessary for the draft legislation to clarify and confirm this distinction and state that operators of VA trading services that use an automation engine must apply for a VATP licence.

We agree that:

- (a) VA OTC licensees who provide services for remittance of fiat should be required to also hold a money service operator licence;
- (b) VA OTC licensees should be required to register and maintain with the CCE a list of wallets used by the VA OTC licensee in its business;
- (c) VA OTC licensees should be prohibited from providing VA advisory or referral services, and from offering other VA financial products; and
- (d) VA OTC licensees should only be permitted to provide temporary custody or escrow services for the purpose of implementing the transaction process.

Q6 *Do you agree that VA OTC licensees should only be allowed to offer services in respect of VA available for retail trading on at least one SFC-licensed VATP and stablecoins issued by issuers licensed by the HKMA?*

**Law Society's response:**

We agree that the scope of virtual assets that VA OTC licensees should initially align with the VA available for retail trading by SFC-licensed VATP. We are mindful that this proposal at present effectively limits the permitted VA to Bitcoin and Ethereum.

We reserve our comment on the suitability of limiting the VA available to stablecoins issued by issuers licensed by the HKMA. The regulatory regime for stablecoin issuers in Hong Kong is still under consultation, with no definite timeline for commencement of the regime.

We suggest the legislation should provide flexibility to assist the CCE in its regulation of permitted VA. This may allow for expansion of permitted VA to VA available on licensed trading platforms in jurisdictions with equivalent standards of regulation.

Q7 *Should other regulatory requirements be added to mitigate the potential ML/TF and fraud risks of VA OTC services?*

**Law Society's response:**

We agree with the proposed regulatory requirements. We expect the proposed legislation or implementing guidelines will also address conditions for temporary custody/escrow, and segregation of client assets.

Q8 *Do you agree that a VA OTC licence should be renewed biennially?*

**Law Society's response:**

We see no particular benefit to a biennial renewal process for VA OTC licensees. We believe an open-ended licence will have a lower administrative burden, without reducing the standard of oversight and regulation. VA OTC licences could be suspended, or revoked for breach of laws, regulation or licensing conditions, non-payment of licence fees, or cessation of business. The CCE should be empowered to conduct on-site inspections and reviews at its own initiative, and to perform investigations where there are suspicion of breach of laws.

Q9 *In respect of the transitional arrangement, do you prefer Option 1<sup>1</sup> or Option 2<sup>2</sup>, and why?*

**Law Society's response:**

We believe the deeming arrangement under Option 2 is significantly preferable. Option 2 will allow for a more orderly transition to a regulated environment for all stakeholders, and will facilitate the CCE in allocating its resources to meet the challenges of a new system of regulation.

The absence of a deeming arrangement under Option 1 means, practically, the CCE would have only three months to process a licence in many cases. If the CCE is unable to meet that processing time, the relevant VA OTC service operator would be required to close down even if its application was still pending a determination.

Existing SFC licensed entities with VA capabilities should also be allowed to conduct VA OTC service immediately if they are to be exempted and under SFC's current oversight.

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<sup>1</sup> Option 1 – No Deeming Arrangement: A transitional period of six months. During the transitional period, pre-existing VA OTC service providers will be allowed to continue their operations until - 14 - the end of the six-month period, on condition that they have to submit within the first three months a licence application to CCE. Upon the end of the transitional period, all VA OTC service providers have to be licensed to carry out any regulated activity. Pre-existing VA OTC service providers that do not submit a licence application to CCE within the first three months of the commencement of the transitional period will need to close down their business in an orderly manner by the end of the fourth month of the commencement of the transitional period.

<sup>2</sup> Option 2 – With Deeming Arrangement: Similar to option 1, preexisting VA OTC service providers will be allowed to continue their operations until the end of a six-month transitional period, on condition that they have to submit within the first three months a licence application to CCE. For those applicants that are able to meet the requirements specified by CCE, a “deemed licence” will be granted in the interim for them to continue their operations beyond the transitional period and until a final determination of the licence applications is made by CCE. Powers will be provided to CCE to revoke or amend the “deemed licence” as CCE considers appropriate.

Q10 *Do you agree with the exemption arrangement?*

**Law Society's response:**

Yes, we agree. The CCE should also be given flexibility and authority under the legislation to put forward exemptions by regulation.

Q11 *Do you agree that, for the purpose of protecting the investing public, persons without a VA OTC licence should not be allowed to actively market a regulated VA OTC service to the public of Hong Kong?*

**Law Society's response:**

Yes, we agree. This is similar to section 115 of SFO. A body of case law has been established under section 115 of SFO and that can be readily referred to.

Q12 *Do you agree that CCE should be provided with the proposed powers?*

**Law Society's response:**

We acknowledge the CCE's experience in regulating money service operators ("MSOs") would be helpful to implement certain aspects of the new regime. However, it may not fully address concerns on whether the CCE has the necessary skillset to assess VA-specific aspects, such as whether a VA OTC licensee or applicant has appropriate risk management policies in place to manage cybersecurity and risks specific to VAs and is staffed by personnel with the necessary knowledge of VAs. The FSTB may therefore wish to further explain how the CCE will gain sufficient knowledge and experience to implement the proposed regime, and consider whether the SFC (in light of its role and experience in regulating the VA space to-date, and the overlap of the proposed regime with VATPs) should also have a role in administering the proposed regime.

Whilst it has been proposed that CCE will be the primary regulator for VA OTC services and that other SFC and HKMA regulated entities would be exempted from the regime, we are of the view that this will likely create an unlevel playing field and/or confusion in the market. In particular, as SFC currently supervises and grants licences to entities conducting various VA activities in Hong Kong, it would be logical for them to cover VA OTC services (which will most likely complement other VA licensed activities for existing SFC licensed entities).

For an asset class or a group of industry participants to be regulated by different bodies, this may create inconsistency in the market practice as well as potential

regulatory arbitrage undermining Hong Kong's regulatory philosophy on investors' protection.

*Q13 Do you agree that the proposed penalty level for carrying out unlicensed VA OTC services will be sufficient to achieve the necessary deterrent effect?*

**Law Society's response:**

Yes, we agree. The level of penalty is generally comparable to that under the SFO.

*Q14 Do you agree with the proposed sanctions, which are comparable to those under the existing regulatory regimes for VATPs and MSOs?*

**Law Society's response:**

Yes, we agree and note it is comparable to those applicable to VATPs and MSOs under AMLO.

*Q15 Do you agree that the purview of the Anti-Money Laundering and Counter-Terrorist Financing Review Tribunal should be expanded to hear the appeals from VA OTC licensees against the future decisions of CCE?*

**Law Society's response:**

Yes, we agree it should be expanded to cover the VA OTC licensing regime in respect of specified decisions impacting VA OTC licensees and applicants.

**The Law Society of Hong Kong  
2 April 2024**