ONE COUNTRY, TWO CRYPTO SYSTEMS

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Crypto trading is banned in Mainland China but in Hong Kong, China it is being actively promoted. In June 2023, a new regulatory regime became operative through amendments to the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) ("AMLO") as part of a consolidated push by Hong Kong to embrace the development of financial innovation befitting its status as a leading international financial centre.

Under the regime, a virtual asset ("VA") service becomes a regulated function. A VA service consists of operating a VA exchange providing services by means of electronic facilities whereby offers to sell or purchase VAs are regularly made, or persons are regularly introduced in order that they may negotiate or conclude such transactions; and where client money or client VAs comes into direct or indirect possession of the person providing such service. Peer-to-peer trading platforms are not covered under the regime, nor are other activities conducted outside electronic exchanges such as over the counter ("OTC") shop trades.

A VA is defined as a cryptographically secured digital representation of value that can be used as a medium of exchange accepted by the public for payment of goods or services, discharge of a debt, or investment and which can be transferred, stored, or traded electronically. The definition excludes digital representations of fiat currencies or financial assets already regulated under the Securities and Futures Ordinance (Cap. 571) ("SFO"). A person seeking to engage in a regulated VA function must obtain a licence from the Securities and Futures Commission ("SFC") and is subject to a fit and proper test and other regulatory requirements. Only locally incorporated businesses with a permanent place of business in Hong Kong or companies incorporated elsewhere but registered in Hong Kong may apply for a licence.

The stated aim of the new regime is to introduce regulation while the sector is still developing to mitigate money laundering and terrorist financing risks, provide an appropriate level of investor and customer protection, and foster the development and adoption of financial innovation in a proper and orderly manner.(1)

Clearly "getting the balance right" between promoting financial innovation and protecting the public at large is no easy task.Hong Kong attracted some early players in the game, including Sam Bankman-Fried and his team at FTX (before they relocated to the Bahamas), due to Hong Kong's status as an open and relatively free-wheeling financial centre.

Such activities were initially left unregulated, except for an opt-in arrangement offered by the SFC under the SFO for those exchanges allowing clients to trade VAs with at least one token having securities features. Under the new regime, existing operators without a licence wishing to continue VA activities are required to file an application for a licence to the SFC within nine months (from June 1, 2023).The original proposal aimed to limit participation in the market to professional investors but following a recent consultation exercise and strong public support for allowing licensed VA trading platforms to provide their services to retail investors, the SFC will now allow such activity.(2)

Nevertheless, the continuing risks for retail investors are real. This has been demonstrated by the recent collapse in Hong Kong of JPEX, a Dubai-based exchange (according to its website) which promoted high returns to investors through widespread media advertising and local influencers. As things transpired, JPEX had not applied for a licence in Hong Kong under the transitional arrangements for the new regulatory VA regime and this fact was not known to the public at large. JPEX ran into liquidity problems around September 2023 when some investors were unable to withdraw their funds.

(1) Legislative Council Panel on Financial Affairs, Anti-Money Laundering and Counter-Terrorist Financing (Amendment) Bill 2022, January 2022.

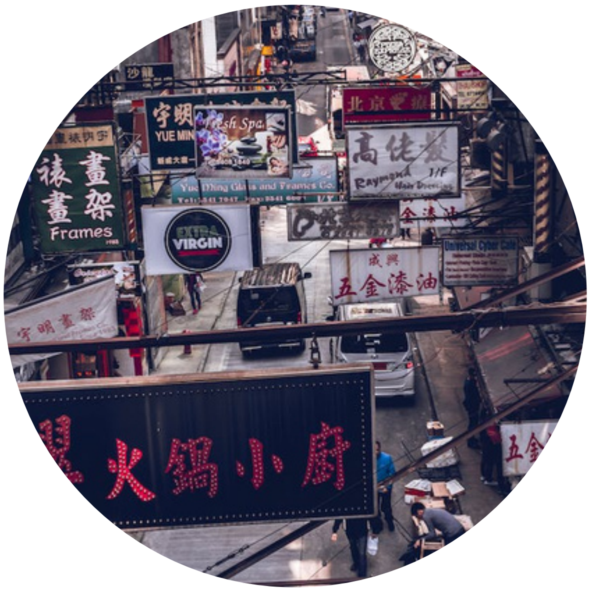
(2) Consultation Conclusions on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the Securities and Futures Commission, 23 May 2023.

This led to complaints to Police who commenced a criminal investigation into potential large-scale fraudulent activity by individuals behind JPEX. Over 25 persons including influencers have been arrested, while victims are believed to number in the thousands and their losses are reportedly more than HKD 1.5 billion. The incident has also highlighted the absence of controls over OTC shops, some of which worked heavily with JPEX to promote their services.

Since this incident the SFC has published a list of pending applications under the transitional arrangements for the new licensing regime to plug the information gap (i.e., that investors previously had no way of knowing whether the exchange they were transacting with was in the process of applying for a licence). According to the SFC list, seven licence applications were pending as of 20 November 2023. Four of these are applications already made under the earlier opt-in arrangements for those exchanges trading at least one security token, with three applications having been made after June 2023 under the new VA regime. Additionally, two licences were granted under the earlier opt-in arrangements, and these have now been approved to serve retail investors in addition to professional investors (OSL Exchange and HashKey Exchange).

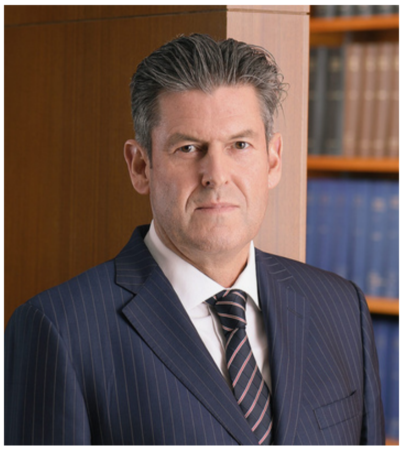
The application process under the VA licensing regime is time-consuming, rigorous, and demanding. It is nevertheless expected that new entrants to the VA platform operator space will follow in due course, and that the regulated digital asset market will continue to grow in Hong Kong. The SFC has published a Virtual Asset Trading Platform Licensing Handbook setting out detailed procedures about how to apply for a licence as a licensed corporation under the SFO and/or as a licensed asset service provider providing a VA service under AMLO.

The SFC has also published a Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (For licensed Corporations and SFC-licensed Virtual Asset Service Providers). VA exchanges are treated as financial institutions under AMLO and are subject to usual customer due diligence and record keeping requirements. In addition, AMLO has been amended to implement the FATF travel rule for virtual asset transfers.



Despite the change of position in Hong Kong to allow retail trading in VAs alongside professional investors, the target audience for the new VA regime remains professional and institutional investors from countries such as those in the Middle East and Europe. The Hong Kong government aims to be a world leader in VA activities by offering high standards of regulation and oversight to attract the right players to a stable and liquid market environment.

This is the model Hong Kong has long followed in traditional finance and the authorities clearly hope to replicate the same in the digital finance space. Who knows…if it works, the rest of China may follow.



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