

Submission to the Public Consultation on Legislative Proposals to Regulate Over- the-Counter Trading of Virtual Assets (the “Consultation”)

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For inquiries on this submission, please contact Josephine Chung at jchung@complianceplus.hk. CompliancePlus Consulting Limited understands and agrees that our name and/or submission may be published to the public.

The Consultation

The Financial Services and the Treasury Bureau (“FSTB”) issues the Consultation Paper for seeking views on legislative proposals to regulate over-the-counter (“OTC”) trading of virtual assets (“VA”) through the introduction of a licensing regime for providers of VA OTC services under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) (“AMLO”). In recent years, we have noted many OTC trading activities and services offered to the public. In this submission, we want to offer our comments on consultation questions posed in the Consultation Paper.

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

We acknowledge the need to broaden the regulation of Virtual Asset (VA) activities to encompass Over-the-Counter (OTC) trading of Virtual Assets. In recent years, certain Money Services Operators have applied Money Services Operators Licenses from the HK Customs for businesses potentially involving OTC trading of Virtual Assets. However, their license applications were not approved as this was deemed beyond the current legislative scope. Considering the advancements and evolving landscape of the Virtual Assets business environment, we support expanding the scope and authority of the HK Customs to license OTC trading of Virtual Assets.

Nevertheless, it is essential to manage the entire license application process efficiently, with the implementation of the following administrative measures:

- The HK Customs should introduce a Performance Pledge and clearly state it on their website, outlining the estimated processing time for license applications in the industry
- To optimize the utilization of HK Customs' limited resources in the licensing process, a 6-9 month long stop date period should be introduced. If an application accepted by the HK Customs cannot be processed successfully within this timeframe, it should be considered lapsed
- The application forms of the HK Customs should be refined and improved to ensure clarity and standardization. Applicants should complete a required questionnaire on VA business activities to provide their business information in a clear and standardized format for easy reference by the HK Customs
- The HK Customs should issue checklists to assist applicants in submitting their application packages with documentation that aligns with HK Customs requirements
- Enhanced transparency in the licensing process should be ensured by the HK Customs through regular publication of information on the number of applications received, submitted, and granted. This will provide the industry with a better understanding of the timing of applications
- If feasible, the HK Customs should standardize the application processes. Currently, the MSO licenses application process can take 1-2 years, which is inefficient for both the HK Customs and the industry. Standardizing application documentation will help streamline processing time by frontline staff of the HK Customs

Q2 Do you agree that we should observe the “same activity, same risks, same regulation” principle in drawing up a new regulatory framework for VA OTC services, incorporating AML/CTF requirements in accordance with international standards while ensuring sufficient investor protection?

Agreed.

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?

Agreed.

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?

Agreed

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?

We disagree with this proposal as it has the potential to unnecessarily limit the business scope of VA OTC licensees. Furthermore, the requirement of applying for a Money Services Operator (MSO) license to offer fiat money remittance services is redundant and duplicates the licensing procedure.

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?

We do not entirely endorse this approach as it could limit the range of services available to the public, which may not be in the public's best interest. Additionally, there is currently no clear timeline regarding the issuance of stablecoins by issuers licensed by the HKMA. The types of virtual assets that OTC operators can offer exchange or remittance services for should be determined based on market demand and customer preferences taking into account of factors such as liquidity, market depth, trading demand, and exchange support, especially traded on reputable exchanges with high accessibility to investors and traders.

Instead, we propose that VA OTC licensees should be permitted to offer services for Virtual Assets that meet the following criteria:

- Cryptocurrencies that are traded on cryptocurrency exchanges that have obtained regulatory approval or operate under regulatory oversight in various jurisdictions, as specified by the HK Customs; and
- Cryptocurrencies that are traded on Virtual Asset Trading Platforms (VATP) licensed by recognized jurisdictions (including SFC-licensed VATP).

The HK Customs may consider that exchange services for cryptocurrencies not meeting the criteria above will only be offered to Professional Investors as defined under the Securities and Futures Ordinance.

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

ML/TF risks should be adequately managed under the current Anti-Money Laundering and Counter-Terrorist Financing Ordinance (AMLO). However, it is anticipated that compliance risk is one of the primary concerns for VA OTC services. Many current VA OTC businesses may lack dedicated compliance resources, and operators may lack prior experience working in regulated or licensed financial institutions. We recommend that VA OTC operators strongly consider employing compliance officers. Their profiles and CVs should be submitted to the HK Customs for consideration in the licensing process. Preferably, compliance officers should possess the following experience:

- Any academic research or educational background in the field of Anti-Money Laundering (AML) and related regulations, including studies in AML courses or qualifications as a certified AML specialist; and/or
- Previous employment history in regulated or licensed financial institutions involving roles related to compliance, such as monitoring financial resources, understanding financial reporting, conducting compliance checks and monitoring activities, or relevant experience.

Additionally, the following risks should also be addressed and require attention of the HK Customs:

- **Default Risks or Non-Delivery by the OTC Operators:** Ensuring the financial stability and credibility of OTC operators to mitigate the risk of default or non-delivery
- **Enhanced Disclosure of Bid and Ask Prices:** Implementing improved disclosure practices during the exchange process
- **Standardized Disclosure Requirements:** Establishing standardized disclosure requirements for bid and ask prices, as well as handling fees and charges
- **Confirmation of Additional Activities or Services:** Verifying whether the OTC operators engage in other activities or offer investment schemes or advice during the exchange process
- **Proper Disclosure of Trading Risks:** Providing customers with adequate disclosure regarding the risks associated with trading virtual assets
- **Consideration of Refund Mechanisms:** Exploring the possibility of implementing refund mechanisms for customers within a specified period, along with determining the maximum refund amount. OTC operators may charge handling fees for refunds

- Implementation of Controls to Prevent Market Manipulation: Putting controls in place to prevent market manipulation by VA OTC operators or their affiliates, including measures to address price manipulation, opposite trading, false trading, and wash trading aimed at misleading customers
- Disclosure of Proprietary Trading Positions: Requiring OTC operators to disclose any proprietary trading positions in virtual assets and any related or connected transactions
- Disclosure requirements concerning any potential conflicts of interest that may arise for OTC operators in relation to virtual asset transactions, such as their affiliations with issuers or proprietary positions held
- Process to be in place to ensure best execution for customer trade orders, including clearly defined procedures for handling orders, execution methods, and order routing protocols. This involves considering factors such as order size, urgency, and client preferences to determine the optimal execution strategy
- Specific and cyber security testing requirements for the IT infrastructure of VA OTC operators, such as conducting penetration tests by approved service providers or third-party IT consultants on the infrastructure and IT security before formal license grant
- Requirements on regular reporting, ongoing supervision, and compliance monitoring, including monthly or quarterly financial reporting to HK Customs. This includes reporting on trading and proprietary positions, active customer numbers, top cryptocurrencies involved in OTC trading, and any provision of margin financing or lending facilities
- Requirement for OTC operators to conduct regular reviews, self-assessments, or checks on regulatory frameworks to adapt to market dynamics and emerging risks
- Assessment of the financial stability and solvency of OTC operators by HK Customs, ensuring sufficient capital reserves to cover liabilities and withstand market fluctuations. This may involve financial audits, capital adequacy requirements, and risk management assessments. Setting a minimum paid-up capital requirement for OTC operators may also be considered
- Regulatory requirements for marketing materials and marketing campaigns to prevent the dissemination of misleading information to the public, with appropriate warnings and disclosures
- Implementation of operational requirements to ensure OTC operators have adequate middle and back-office resources for operations and risk management

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

Currently, the MSO license regime contains the renewal requirement of renewing of the MSO licenses biennially. In the long run, we suggest removal of licenses renewal requirement as this may be more beneficial to the business operators so that they can operate their business with certainty. We noted from the market that some MSO licenses operators are not successful in renewal their licenses that may create business uncertainty. Instead, the HK Customs should adopt a more proactive post licensing reporting and inspection process on these business operators.

Q9 In respect of the transitional arrangement, do you prefer Option 1 or Option 2, and why?

We prefer Option 1 and agree that the transitional period should be 6 months.

To enhance protection to the public, during the transitional arrangement, the HK Customs should publish list of applicants that their applications are **submitted** and the list of applicants that their applications are **accepted** that provide more information to the public.

Q10 Do you agree with the exemption arrangement?

We agree with the exemption arrangement.

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?

Agreed

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

Agreed

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?

Agreed

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

Agreed

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?

Agreed.

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