10 June 2022

Legal Update - Crypto Regulation in Hong Kong

Readers will recall that in May last year, Hong Kong's Financial Services and Treasury Bureau ("**FSTB**") announced plans to introduce a new licensing regime to directly regulate all cryptocurrency exchanges in Hong Kong. This was meant to close the legal loopholes that have allowed crypto to be traded and most crypto exchanges operating in Hong Kong without restrictions.

Subsequent announcements by the FSTB and the Securities and Futures Commission ("**SFC**") implied that amending legislation to implement this new regime would be tabled before Hong Kong's Legislative Council by the end of 2021. That never happened but in a coordinated action on 28 January 2022, the FSTB, the SFC, the Hong Kong Monetary Authority ("**HKMA**") and the Insurance Authority ("**IA**") all issued guidance circulars (the "**Circulars**") to banks, securities firms, and insurers looking to undertake activities related to crypto.

This update merely aims to summarise Hong Kong's cryptocurrency regulatory regime in the wake of the Circulars[1].

The key takeaways are as follows:

- banks, securities firms and other intermediaries looking to distribute, deal in, or provided advisory services in relation to virtual assets now have a fairly comprehensive regulatory framework for dealing with customers seeking to increase their exposure to crypto;
- within the context of that framework, all cryptocurrency is referred to as "virtual assets", whereas "virtual asset-related products" refers to derivatives and other products that: (i) have a principal objective of being used to invest in crypto; or (ii) derive their value principally from the value and characteristics of crypto; or (iii) track or replicate the investment results or returns which closely match or correspond to crypto;
- operators of crypto exchanges that facilitate trading in any virtual assets which fall within Hong Kong's statutory definition of securities or futures contracts must be licensed as a "virtual asset trading platform" by the SFC and comply with the AML and CTF obligations set out in the AMLO if they wish to continue operating in Hong Kong. Exchanges that handle trading in virtual assets that are not securities or futures can apply to participate in the SFC's regulatory sandbox on an opt-in basis;
- banks and intermediaries can only partner with SFC-licensed virtual asset trading platforms;
- intermediaries providing services in relation to either virtual assets and virtual asset-related products are restricted to serving clients that meet the statutory criteria for "professional investors";
- banks and insurers seeking to deal with virtual assets on a proprietary basis or as part of their banking or insurance products now have clear directives for how virtual assets should be treated from a prudential and risk perspective.

Although the Circulars represent an important step forward in efforts to develop a regulated market for cryptocurrency, a few problems remain.

1 The full commentary of the Circulars are available upon request to the key contacts listed at the end of this newsletter.

Firstly, the new framework is essentially ad hoc and needs to be formalised by legislation that will tie these changes together with pre-existing laws and regulations governing financial services. That is expected to happen later this year.

Secondly, even after legislation has been passed, the new rules will only apply to banks, insurers and intermediaries that are already regulated but not to service providers that advise or deal solely with virtual assets such as coins, NFTs and utility tokens that are not classified as securities. The new rules will also not apply to crypto exchanges that facilitate trading in such non-securities crypto if they choose not to seek regulation voluntarily through the SFC's opt-in scheme. To be truly comprehensive, the regime will need to be expanded further so that all of these crypto activities are regulated.

Finally, these reforms are, at best, a half-measure in pursuit of strengthening and protecting the integrity and soundness of Hong Kong's financial services markets because they completely exclude retail investors and in so doing, will drive those investors to overseas exchanges where sensible, well-intended regulations may be absent.

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For any further clarification or research please contact:

Stefano Beghi
Managing Partner
Hong Kong office
Head of China Desk
Hong Kong
+852 21563490
sbeghi@gop.it

Massimo Sterpi
Partner
Head of Intellectual Property,
TMT and Cybersecurity
Rome
+39 06 478751
msterpi@gop.it

Richard Grams
Counsel

Corporate/M&A
Hong Kong
+852 21563490
rgrams@gop.it