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Consultation on Legislative Proposals to Enhance Anti-Money Laundering and Counter-Terrorist Financing Regulation in Hong Kong

To whom it may concern,

Global Digital Finance (“GDF”) support efforts by global standard setters, national authorities and regulators to consult and work with the nascent global digital / virtual asset industry.

To that end, we are hereby providing input to the FSTB consultation (“Consultation”) on the proposed amendments to the Anti-Money Laundering and Counter-Terrorist Financing Regulation in Hong Kong.

About GDF

GDF is a not-for-profit industry body that promotes the adoption of best practices for crypto and digital assets, and digital finance technologies through the development of conduct standards, in a shared engagement forum with market participants, policymakers and regulators.

Established in 2018, GDF has convened a broad range of industry participants, with 300+ global community members - including some of the most influential digital asset and token companies, academics and professional services firms supporting the industry. GDF is proud to include 100x Group, Coinbase, Diginex, DLA Piper, EY, Hogan Lovells, the London Stock Exchange Group, R3, and SDX as patron members.

The GDF Code of Conduct (the “Code”) is an industry-led initiative driving the creation of global best practices and sound governance policies. GDF is informed by close conversations with regulators and developed through open, inclusive working groups of industry participants, legal, regulatory and compliance experts, financial services incumbents and academia. The principles set out in the Code undergo multiple stages of community peer review and open public consultation prior to ratification.

The input has been drafted and led by the GDF Anti-Money Laundering Working Group. Questions 1 to 14 with direct relevance to virtual assets have been answered. Should you have any questions in regards to this submission, GDF remains at the disposal of the FSTB to respond as required, and can be reached at: kycamlwg@gdf.io.

Yours faithfully

The GDF Board

CONSULTATION RESPONSE

Q1 Do you agree that Hong Kong should continue with efforts to strengthen the AML/CTF system having regard to international standards, in keeping with our status as an international financial centre that is safe and clean for doing business?

Yes. The FSTB's proposals to amend the local anti-money laundering and counter-terrorist financing regulations in Hong Kong are consistent with measures taken in other Financial Action Task Force (FATF) jurisdictions to implement the latest updates to the FATF Recommendations regarding the regulation of virtual asset service providers (VASPs). As the question acknowledges, efforts to enhance local AML/CTF regulations are important not only for Hong Kong as an international financial centre but also for the VASP industry and the Hong Kong investing public. Providing a clear system for the operation and regulation of VASPs in Hong Kong ensures that the VASP industry can continue to grow and develop, while at the same time protecting the interests of investors. As always, it is important to ensure that the regulation is clear and 'right-fit' for the AML/CTF risks it seeks to mitigate.

Q2 Do you agree that a balanced approach should be adopted for the current legislative exercise, complementing the need to have an effective system for tackling ML/TF risks in the VASP and the DPMS sectors in accordance with the FATF Standards, while minimising regulatory burden and compliance costs on the businesses?

We broadly agree but it is unclear precisely what the FSTB means by a 'balanced approach'. It would be helpful for the FSTB to elaborate on this point. For example, under the current proposals, the costs of compliance could well introduce significant financial and operational burdens to the smaller VASPs in particular. Further, some of the proposals, particularly limiting to professional investors, go beyond the FATF Recommendations and appear counter to Paragraphs 1.2 of the consultation with regard to risk mitigation. It may be more appropriate to introduce a more agile regime with lower thresholds to begin with, and to increase over time as the risks and mitigations that VASPs can apply become better understood.

The VASP industry is unquestionably unique and it is important to develop appropriate AML/CTF standards for VASPs that do not compromise the innovative and entrepreneurial nature of the industry. In particular, the FSTB must recognise that there are challenges faced by start-up businesses in keeping pace with the evolving regulatory landscape. For this and other reasons, it is crucial to ensure that there is an appropriate transition period in any new regulation to give VASPs

sufficient time to apply for the requisite licences and adapt internal processes to comply with specified obligations.

Q3 Do you agree with the proposed scope and coverage of the regulated activity of operating a VA exchange?

The FSTB proposes to define a VA exchange as “as any trading platform which is operated for the purpose of allowing an offer or invitation to be made to buy or sell any VA in exchange for any money or any VA (whether of the **same** or different type), **and** which comes into custody, control, power or possession of, or over, any money or any VA at any point in time during its course of business” [emphasis added].

We seek clarity on the scope of the definition as follows:

- The definition implies that a VA exchange performs both exchange and custody/safekeeping activities but it is not entirely clear from the drafting (the comma before “and” creates ambiguity). We ask the FSTB to confirm.
- Relatedly, the FSTB notes in the Consultation Paper that businesses that operate standalone custodian activities are limited and accordingly, the FSTB does not intend to regulate standalone VA custodial activities at this time. We ask the FSTB to confirm custodian services are exempt from the AMLO because they are already regulated under the TCSP regime.
- Some platforms may deal in assets already covered under the SFO but in addition, perform ancillary custody activities of VAs. We ask the FSTB to confirm that such businesses would not be caught under the proposed AMLO regime.
- The definition refers to buying or selling of any VA in exchange for...”any VA...of the same or different type”. It is not clear what the intention is here. How does the exchange of a VA for the same type of VA work? Does this, in fact, mean ‘transfer of virtual assets’ as provided for in the FATF Glossary definition for a VASP ¹? We also request that the FSTB confirm it is not intended to cover structured products which involve the buying and selling of synthetic VAs.

In addition, we note:

- It is conceivable that some regulated trust and company service providers (TCSPs) may perform custody activities in respect of VAs. FSTB to confirm that the new proposals are not intended to capture businesses that may already be regulated as TCSPs.

¹ <https://www.fatf-gafi.org/glossary/u-z/>

Q4 Do you agree with the proposed definition of VA? Other than closed-loop, limited purpose items, are there other digital items - 39 - that should be excluded from the definition?

We largely agree with the proposed definition but we note that the consultation paper expressly excludes central bank digital currencies from the definition (paragraph 2.10). We think it is important to ensure that these virtual assets are subject to the same (if not higher) standards. We therefore encourage FSTB to consider whether they should be subject to this regime and, if not, to explain the reasons for excluding them.

Q5 Should peer-to-peer VA trading platforms be covered under the licensing regime?

In line with FATF recommendations, we do not think it is necessary to include peer-to-peer platforms within the scope of the proposed licensing regime at this stage given it is a nascent industry and the lack of centralised exchange means it would be difficult to implement the proposed regime.

We note that FATF indicated in November 2020 that they are keeping peer-to-peer platforms under review and are likely to issue guidance on appropriate recommendations later this year. We support the development and implementation of appropriate standards on an internationally consistent basis.

A concern does exist that, in conjunction with our response to question 8 regards professional investors, excluding peer-to-peer VA trading platforms may see non-professional investors move towards unregulated platforms that may create new areas of financial crime risk, as has recently been seen in Hong Kong with the theft of virtual assets in face-to-face transactions.

We would also recommend to the FSTB that any regulatory approach looks to build a flexible legislative framework that can adapt in line with the rapid development of the virtual asset industry.

Q6 Do you agree that only locally incorporated companies may apply for a VASP licence?

We believe the position is more nuanced as set out in our comments below.

At paragraph 1.13(a) of the Consultation Paper, the FSTB states that it proposes to “introduce a licensing regime for VASPs, whereby any person seeking to conduct the regulated business of virtual asset trading platforms **in Hong Kong** will be required

to apply for a licence...” [emphasis added]. It would be helpful for the FSTB to confirm what is meant by “in Hong Kong” in this context. For example, what of locally incorporated companies that do not service Hong Kong investors but otherwise fall within the definition of a ‘VA exchange’; would they fall within the proposed licensing regime?

In addition to locally incorporated companies, we believe that an overseas company registered with the Companies Registry of Hong Kong should be permitted to apply for a VASP licence consistent with the approach taken with respect to foreign corporations applying to be registered as licensed corporations under the Securities and Futures Ordinance.

We would also like the FSTB to consider the position with the respect to companies that are licensed or regulated under equivalent or substantially similar regimes in other FATF jurisdictions. Given the global nature of the VASP industry, the FSTB should consider a regime which allows for the recognition of such firms in Hong Kong without necessarily having to go through a separate and full licensing process.

Q7 Should other criteria be added to the fit-and-proper test given the nature and risks of VASPs?

We broadly agree with the criteria of the fit-and-proper test outlined at paragraph 2.14 of the consultation paper. However, we note that it includes an assessment of “experience and relevant qualifications”. We are mindful that experience and qualification requirements should be sector-appropriate. By this we mean that it would not be appropriate to transpose only qualifications and experience that apply in the traditional financial sector. Instead, crypto-specific experience and qualifications should also be considered and given appropriate weight, bearing in mind that the industry remains nascent so a comparative depth of experience with the traditional financial sector may not be possible. We encourage FSTB to take this into account when developing its thresholds.

Q8 Should other regulatory requirements be added to mitigate the risks of VASPs?

We broadly agree with the regulatory requirements in mitigating the risks of VASPs. However, we noted that the licensed VASPs will only be permitted to offer services to professional investors. Given the VASPs licensed under the proposed regime will not be providing a service in securities tokens, we would like to propose the FSTB to reconsider removing this condition for licensed VASPs. We believe the condition could result in an unintended consequence for the investing public in Hong Kong will have no access to a licensed VASP but to reach out to unlicensed VASPs and

peer-to-peer platforms and thus be exposed to much greater risks. Referencing approaches taken by overseas regulators such as the Monetary Authority of Singapore (MAS), the Japan Financial Services Agency (JFSA) and the Financial Conduct Authority in the United Kingdom (FCA), virtual assets that are not securities are not excluded for the retail market. The limitation may inhibit innovation and hinder competitiveness of the Hong Kong financial market in the virtual assets space.

Q9 Do you agree that a VASP licence should be open-ended or should it be periodically renewed?

Yes, we agree that a VASP license should be open-ended, considering the substantive investment required for operating a competitive VA exchange and the VASP will already be subject to the ongoing supervision of the SFC.

Q10 Do you agree with the exemption arrangement and the 180-day transitional period for application of a VASP licence?

We broadly agree with the proposal of a transitional period, however, considering the scale of necessary review a VASP may face in its organisational, systematic and operational aspects and time required for implementation of changes required to ensure compliance with the license requirements and conditions and preparation for a VASP license application, we encourage the FSTB to consider a transitional period of not less than 12 months, taking into account the experience from the FCA in the UK having to grant an extension in for AML registrations to VASPs, and MAS in Singapore still unable to issue any license to VASP due to workload and backlog.

Q11 Do you agree that, for investor protection purposes, persons without a VASP licence should not be allowed to actively market a VA exchange business to the public of Hong Kong?

We broadly agree that persons without a VASP license should not be allowed to actively market a VA exchange business targeting the public of Hong Kong. Considering the global nature of the VASP industry, the FSTB should provide clear guidance of what will constitute actively marketing a VA exchange business to the public of Hong Kong in the context of a VA exchange. In addition, as suggested in our response to Q6 in this consultation, the FSTB should consider VA exchanges that are licensed or regulated under equivalent or substantially similar regimes in other FATF jurisdictions. Given the global nature of the VASP industry, the FSTB should consider a regime which allows for the recognition of such firms to actively market

and provide services in Hong Kong without necessarily having to go through a separate and full licensing process.

Q12 Do you agree that the penalty level for carrying out unlicensed VA activities should be sufficiently high to achieve the necessary deterrent effect?

Yes, we agree that the penalty level for carrying out unlicensed VA activities should be sufficiently high to achieve the necessary deterrent effect.

Q13 Do you agree with the proposed sanctions, including that it shall be a criminal offence for a person to make a fraudulent or reckless misrepresentation to induce someone to acquire or dispose of a VA?

Yes, we agree with the proposed sanctions, including that it shall be a criminal offence for a person to make a fraudulent or reckless misrepresentation to induce someone to acquire or dispose of a VA. However, we suggest the FSTB to consider providing clear guidance for the VASPs industry of matters that could constitute a fraudulent or reckless misrepresentation to induce someone to acquire or dispose of a VA.

Q14 Do you agree that the Tribunal be expanded to hear appeals from licensed VASPs against future decisions of the SFC?

Yes, we agree that the Tribunal should be expanded to hear appeals from licensed VASPs against future decisions of the SFC.

Q15 Do you agree generally with the proposed scope of “regulated activities” and related definitions for DPMS, which draw - 40 - reference from the FATF requirement and overseas legislation?

N/A

Q16 Are there any other business activities in respect of precious metals, precious stones, precious products, and precious-asset backed instruments that should be covered under the registration regime?

N/A

Q17 Do you agree with the proposal to have a two-tier registration regime, such that registrants who do not engage in large cash transactions can be separated from those who do, with the former being subject to simple and mere registration requirements and the latter to standard AML/CTF requirements currently applicable to other DNFBPs?

N/A

Q18 Do you agree generally with the respective requirements for Category A and Category B registrations, including that Category B registration should be renewed every three years?

N/A

Q19 Do you agree that financial institutions which are already regulated under the AMLO should be exempted from the registration regime when carrying on a DPMS business that is ancillary to their principal business?

N/A

Q20 Do you agree that non-domestic dealers who visit Hong Kong only occasionally should be exempted from the registration regime, subject instead to the requirement of filing cash transaction reports with possible sanctions for failure to do so?

N/A

Q21 Do you agree with a 180-day transitional period and the deemed registration arrangement for incumbent dealers to facilitate their migration to the registration regime?

N/A

Q22 Do you think the proposed sanction is adequate in deterring the operation of a DPMS business without registration?

N/A

Q23 Do you agree that Category B registrants should be subject to the same administrative sanctions as other DNFBPs, and not to criminal sanctions, for non-compliance with the AML/CTF - 41 - requirements in the AMLO?

N/A

Q24 Do you agree that the Tribunal be expanded to hear appeals from registrants against future decisions of the Registrar?

N/A

Q25 Do you agree with the miscellaneous amendments proposed by the Government to address some technical issues identified in the Mutual Evaluation Report and other FATF contexts?

N/A