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

Consultation Conclusions

Financial Services and the Treasury Bureau

May 2021

Chapter 1

Introduction

1.1 The Financial Services and the Treasury Bureau conducted a public consultation from 3 November 2020 to 31 January 2021 on legislative proposals to enhance anti-money laundering and counter-terrorist financing ("AML/CTF") regulation in Hong Kong through the introduction of (a) a licensing regime for virtual asset services providers ("VASPs"); (b) a two-tier registration regime for dealers in precious metals and stones ("DPMS"); and (c) miscellaneous technical amendments under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) ("AMLO").

1.2 We received 79 responses to the proposals by the end of the consultation, with 47 submissions focusing solely on the VASP regime, 13 submissions focusing solely on the DPMS regime, and the rest commenting on all the proposals under consultation and Hong Kong's anti-money laundering and counter-terrorist financing ("AML/CTF") system in general. Respondents came from a good mix of backgrounds, including industry associations and professional bodies, political party, individual firms or companies, as well as individual members of the public. A list of the respondents is set out in **Annex A**, and an analysis of the respondents by background is at **Annex B**. We also attended 15 engagement sessions with key stakeholders during the consultation period. A list of the industry bodies which attended these sessions is at **Annex C**.

1.3 Overall speaking, there is broad support for the Government to strengthen Hong Kong's AML/CTF system having regard to international standards, in keeping with our status as an international financial centre. A majority of the respondents indicated agreement with the overall direction and principles, as well as the broad framework of the legislative proposals. They expressed understanding of the need to regulate the VASP and the DPMS sectors in fulfillment of our obligations under the Financial Action Task Force ("FATF"), and shared our view that a balanced approach to legislation should be adopted, complementing the need to have an effective system for addressing money laundering and terrorist financing ("ML/TF") risks in the

concerned sectors, while minimising regulatory burden and compliance costs on the businesses. Respondents also expressed views regarding the precise scope, coverage and parameters of the legislative proposals, by and large reflecting their sectoral interests or industry backgrounds. We will give a summary of the views received and our responses in Chapters 2 to 4.

1.4 We would like to take this opportunity to thank all respondents who sent in submissions or participated in the consultation sessions for their valuable views and comments on the legislative proposals. Having regard to the responses, we will fine-tune certain parameters of the legislative proposals to address stakeholders' concerns as discussed in Chapters 2 to 4. The way forward is set out in Chapter 5.

1.5 Encouraged by the general support from the respondents for the legislative exercise, we will proceed to prepare the AMLO amendment bill based on the consultation conclusions. Our target is to introduce the amendment bill into the Legislative Council in the 2021-22 legislative session.

Chapter 2

Proposal to Introduce a Licensing Regime for Virtual Asset Services Providers

Comments Received and Our Responses

Overview

2.1 We received 60 written submissions in response to the proposal of introducing a licensing regime for VASPs under the AMLO. We have carefully analysed the submissions, and below is a summary of the major views expressed and our responses.

The Need for Regulation

2.2 In recent years, trading in cryptocurrencies and other asset classes in the virtual world has significantly blossomed. It is widely recognised that these virtual assets ("VAs"), for all their potentials, pose significant ML/TF risks to the international financial system and considerable challenges for investor protection. To address the ML/TF risks of VA activities, the FATF revised its Standards in February 2019 to require jurisdictions to regulate VASPs for AML/CTF purposes and supervise their compliance. Jurisdictions are asked to impose on VASPs the full range of AML/CTF obligations that are currently applicable to financial institutions[1] and designated non-financial businesses and professions[2] ("DNFBPs").

2.3 While VAs are not legal tender and not generally accepted as a means of payment in Hong Kong, we have noticed some VA trading activities operating locally. To harness opportunities presented by financial innovation while ensuring the healthy and orderly development of the market, we propose to establish a licensing regime under the AMLO for VASPs in Hong Kong

[1] Financial institutions required by the FATF to be regulated for AML/CTF purposes include banks, securities firms, insurance companies, money service operators, stored value facility operators and money lenders.

[2] DNFBPs required by the FATF to be regulated for AML/CTF purposes include casinos, legal professionals, accounting professionals, estate agents, trust or company service providers, and dealers in precious metals and stones.

having regard to the FATF Standards. Any person seeking to engage in the regulated activity of operating a VA exchange in Hong Kong will be required to apply for a licence from the Securities and Futures Commission ("SFC"), subject to passing a fit and proper test. Licensed VASPs will be subject to the AML/CTF requirements stipulated under the AMLO, as well as other regulatory requirements designed to ensure the protection of market integrity and investor interest.

2.4 Recognising that the VA industry is an emerging sector posing significant ML/TF risks to the financial system, most respondents expressed support for the introduction of a statutory licensing regime for VASPs in Hong Kong. There is general support for the proposed direction and framework of the regulatory regime, and for the SFC to become the regulatory authority of the regime.

Scope and Coverage

2.5 We propose to designate the business of operating a VA exchange as a "regulated VA activity" under the AMLO and require any person seeking to operate a VA exchange in Hong Kong to apply for a licence from the SFC as a licensed VASP under the AMLO. A VA exchange will be defined 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, 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. Peer-to-peer trading platforms[3], to the extent that the actual transaction is conducted outside the platform and the platform is not involved in the underlying transaction by coming into possession of any money or any VA at any point in time, are not covered under the definition of VA exchange.

2.6 Following the FATF parlance, a VA will be defined as a digital representation of value that (i) is expressed as a unit of account or a store of economic value; (ii) functions (or is intended to function) as a medium of exchange accepted by the public as payment for goods or services or for the discharge of a debt,

[3] Peer-to-peer platforms refer to platforms that only provide a forum where buyers and sellers of VAs can post their bids and offers, with or without automatic matching mechanisms, for the parties themselves to trade at an outside venue.

or for investment purposes; and (iii) can be transferred, stored or traded electronically. The definition does not cover digital representations of fiat currencies (including digital currencies issued by central banks), financial assets already regulated under the Securities and Futures Ordinance (Cap. 571) ("SFO"), as well as certain closed-loop, limited purpose items.

2.7 The majority of the respondents agreed with the proposed definition of VA, as well as the proposed scope and coverage of the regulated activity of operating a VA exchange. A number of respondents considered that a broader range of VA activities including over-the-counter trade and peer-to-peer trading platforms should be covered. Some respondents sought clarifications on the definition of VA, including the scope of closed-loop, limited purpose items proposed to be carved out from the definition, the coverage of the so-called "stablecoins" under the definition, and whether the definition overlaps with that of stored value facilities.

2.8 We note the majority support for the proposed scope and coverage of the regulatory regime, which has been formulated having regard to the FATF Standards and the risks presented by VA activities in Hong Kong. For the avoidance of doubt, the proposed definition of VA does not cover stored value facilities which are separately regulated under the Payment Systems and Stored Value Facilities Ordinance [4] (Cap. 584). Closed-loop, limited purpose items intended for carve-out from the definition are those non-transferable, non-exchangeable and non-fungible in nature, such as air miles, credit card rewards, gift cards, customer loyalty programmes and gaming coins etc.. The definition of VA applies equally to virtual coins that are stable (i.e. the so-called "stablecoins") or not and irrespective of the purported form of underlying assets. To cater for the fast-evolving nature of the VA world, we will provide flexibility in the legislation by empowering the SFC

[4] Under the Payment Systems and Stored Value Facilities Ordinance (Cap. 584), a facility is a stored value facility if—

(a) the facility may be used for storing the value of an amount of money that—
  (i) is paid into the facility from time to time; and
  (ii) may be stored on the facility under the rules of the facility; and
(b) the facility may be used for either or both of the following purposes—
  (i) as a means of making payments for goods or services under an undertaking (whether express or implied) given by the issuer;
  (ii) as a means of making payments to another person under an undertaking (whether express or implied) given by the issuer.

to prescribe characteristics that constitute the definition of a VA, and the Secretary for Financial Services and the Treasury to determine, either generally or in a particular case, whether any digital representation of value is to be regarded as a VA or not.

2.9 On the view of some respondents in favour of regulating a broader coverage of VA activities, we note that a VA exchange is by far the most prevalent and developed embodiment seen in Hong Kong covering the types of activities intended for regulation by the FATF[5]. While the FATF-regulated activities may also exhibit themselves in business forms other than a VA exchange, we note that the presence of VA activities conducted outside VA exchanges is scanty and negligible in Hong Kong, and their fund movements are traceable for AML/CTF purposes where they interface with financial institutions. Like all other legal and natural persons in Hong Kong, they are also subject to the statutory obligations of reporting suspicious transactions and implementing targeted financial sanctions promulgated by the United Nations Security Council. We will nevertheless keep in view the evolving landscape in Hong Kong and consider the need for regulation as the market evolves. For now, flexibility will be built in the licensing regime such that it may be expanded to cover forms of VA activities other than VA exchanges where the need arises in future.

Licensing Requirements

Eligibility

2.10 Considering that the effective operation of a VA exchange will necessarily entail a permanent establishment of proper scale and construction to ensure governance and continuity, we propose that only locally incorporated companies with a permanent place of business in Hong Kong will be considered for the granting of a VASP licence. Natural persons or business establishments without a legal personality will not be eligible for a licence. While some respondents agreed that only locally incorporated companies should be allowed to apply for a licence, over a dozen respondents considered

[5] The five types of activities specified by the FATF for AML/CTF regulation are: (i) exchange between VAs and fiat currencies; (ii) exchange between one or more forms of VAs; (iii) transfer of VAs; (iv) safekeeping and/or administration of VAs or instruments enabling control over VAs; and (v) participation in and provision of financial services related to an issuer's offer and/or sale of a VA.

that non-locally incorporated companies should also be allowed to participate in the regime. One respondent sought clarification on the requirement for a VASP to have a permanent place of business in Hong Kong.

2.11 As an international financial centre, we welcome enterprises from all over the world to set up business in Hong Kong subject to their meeting the relevant regulatory requirements. The local incorporation and physical presence requirements are designed to ensure that local anchorage is available for the SFC to effectively supervise the conduct of licensed VASPs and enforce regulatory requirements. In light of the considerable market preference for allowing non-locally incorporated companies to participate in the VASP regime, while balancing the need for VASP licensees to have a Hong Kong nexus to enable supervision and enforcement by the SFC, we will **refine** the proposal by allowing also companies incorporated elsewhere but registered in Hong Kong under the Companies Ordinance (Cap. 622) to apply for a VASP licence.

Fit-and-Proper Test

2.12 To ensure the integrity of the management of a licensed VASP, we propose that an applicant has to pass a fit-and-proper test to be considered for the granting of a VASP licence. In considering whether an applicant is a fit and proper person, the SFC will take into account, among other relevant considerations, whether the person has been convicted anywhere of an ML/TF offence or other offence in which the person is found to have acted fraudulently, corruptly or dishonestly; whether the person has failed or may fail to observe the AML/CTF or other regulatory requirements applicable to licensed VASPs; the experience and relevant qualifications of the person; and whether the person is of a good standing and financial integrity. We also propose that an applicant will have to appoint at least two responsible officers to assume the general responsibility of ensuring compliance with AML/CTF requirements and other regulatory requirements.

2.13 Noting the nature and risks of the VA business, most respondents expressed support for subjecting VASP applicants to a fit-and-proper test and the criteria for determining an applicant's fit-and-properness, which are consistent with those applicable to financial institutions and DNFBPs regulated under the

AMLO. For accountability consideration, they also acknowledged the need for requiring a licensee to appoint at least two responsible officers who have to be held personally accountable in case of contravention or non-compliance of the requirements. One respondent was nevertheless concerned about the cost implications of such a requirement.

Regulatory Requirements

2.14 Licensed VASPs will be subject to the AML/CTF requirements (notably customer due diligence ("CDD") and record-keeping requirements) stipulated in Schedule 2 to the AMLO, as well as other regulatory requirements for investor protection purposes. Among other things, a licensed VASP can only offer services to professional investors and must impose rigorous criteria for the inclusion of VAs to be traded on its platform. A licensed VASP should also meet the prescribed regulatory requirements concerning financial resources, knowledge and experience, soundness of the business, risk management, segregation and management of client assets, financial reporting and disclosure, prevention of market manipulative and abusive activities, and prevention of conflicts of interest.

2.15 There is general support for the imposition of the proposed regulatory requirements to mitigate the risks of VAs. Individual respondents sought clarifications on the regulatory expectations in respect of specific requirements, such as the knowledge and experience and financial resources expected of an applicant, due diligence measures expected of a VA exchange before listing VAs for trading, and the consideration for prohibiting a licensed VASP and its associate entities to engage in proprietary trading. Views were split on the proposal of requiring a VA exchange to offer its services to professional investors only, with over 40% of the submissions considering that retail investors should also be allowed to participate in the trading activities of the VA exchange.

2.16 We note the general support for the AML/CTF and other regulatory requirements which are proposed having regard to the specific risks of VAs. It is necessary for licensed VASPs to be subject to a robust set of regulatory requirements to ensure that they have the capacity and know-how to operate

the VA business properly, so as to mitigate the risks posed to investors arising from system failure, security breach or market manipulation etc.. The SFC will prepare and publish for consultation the detailed regulatory requirements before commencement of the licensing regime, with a view to providing more guidance for the industry on the regulatory expectations.

2.17 While we note the view of prospective market players that a VA exchange should be allowed to offer its services to retail investors as well, we are mindful of the risk implications considering the tech-savvy and highly speculative nature of VA activities. As the VA industry is an emerging sector involving higher risks than conventional financial markets, the requirement of confining the services of a VA exchange to professional investors only is necessary to ensure a proper degree of protection for the investing public, in line with the policy objective of promoting the healthy and orderly development of the market. We consider that the requirement is appropriate at least for the initial stage of the licensing regime. We will continue to monitor the evolving landscape and review the position as the market becomes more mature in future.

Open-ended Licence

2.18 We propose that a licensed VASP will be granted an open-ended licence, i.e., it will remain valid until the licensed VASP is revoked by the SFC, for example, due to misconduct or cessation of operation. The majority of the respondents are in agreement with the proposal, although a handful of respondents considered that a licence should be subject to periodic review to ensure that the VASP would carry on the regulated activity in a proper manner.

2.19 As a licensed VASP will need to make substantive investment in order to acquire the necessary scale and sophistication for operating a competitive VA exchange, we consider that a degree of certainty in the operating environment is necessary. An open-ended licence is therefore appropriate for the purpose. In any case, a licensed VASP will be subject to the SFC's close and ongoing supervision in respect of conduct and operation, and the SFC will have the power to review and revoke a licence as need be notwithstanding the open-

ended nature of the licence. The SFC will also have the power to take disciplinary actions, including suspension or revocation of licence, against VASPs which are found guilty of misconduct or not fit and proper.

Exemption and Prohibition

2.20 Considering that a VA exchange is a new line of business that is distinct from the more traditional services currently available in the financial market, we do not propose any exemption in respect of the VASP licensing requirement, except for VA exchange(s) that are already regulated as a licensed corporation in the voluntary opt-in regime being supervised by the SFC pursuant to the SFO. There is consensus among the respondents on the proposed arrangement, having regard to the specific risks of VA activities and the need for a tailored set of regulation and obligations for VASPs.

2.21 We propose a 180-day transitional period upon commencement of operation of the licensing regime to facilitate application by interested parties. There is majority support for the transitional arrangement. One respondent considered that there should not be any transitional period lest it would create a period of regulatory vacuum notwithstanding the higher risks of VAs, whereas over a dozen respondents requested a longer transitional period ranging from 270 days to two years. Few respondents suggested that an applicant should be deemed to have been licensed for operating the business upon the filing of a licence application. We appreciate the majority support for the proposed transitional period, and consider that 180 days should be sufficiently long for the filing of applications.

2.22 For investor protection purpose, we propose to prohibit any person who is not a licensed VASP from actively marketing, whether in Hong Kong or elsewhere, to the public of Hong Kong a regulated VA activity or a similar activity elsewhere. There is broad support for the prohibition to prevent local investors from being exposed to risks from unlicensed VA exchanges.

Powers of the Licensing Authority

2.23 We propose to empower the SFC to supervise the AML/CTF conduct of licensed VASPs and enforce other regulatory requirements in accordance with the AMLO stipulations. Such will include the power to enter business premises of the licensed VASP and its associated entities for conducting routine inspections; to request the production of documents and other records; to investigate non-compliances and to impose administrative sanctions (including reprimand, order for remedial actions, civil penalty, and suspension or revocation of licence) against non-compliances.

2.24 Drawing reference from similar empowering provisions under the SFO, we also propose to provide the SFC with the necessary intervention powers to impose restrictions and prohibitions against the operation of a licensed VASP and its associated entities where the circumstances so warrant (e.g. to prohibit further transactions or restrict the disposal of property in case a VA exchange defaults). This will enable the SFC to protect client assets of a licensed VASP in the event of an emergency, and to prevent the dissipation of client assets in the case of misconduct on the part of a licensed VASP.

2.25 Respondents indicated general support for the SFC to be suitably empowered such that it can effectively discharge its regulatory functions under the VASP regime. Individual respondents sought clarification on the need for the SFC to enter the business premises of a licensed VASP, noting that the operation of VASPs is quite different from that of conventional financial institutions. As a licensed VASP will have to maintain a permanent place of business in Hong Kong and observe the licensing conditions and regulatory requirements in much the same way as financial institutions, we see the need for the SFC to enter business premises for routine inspections to ensure that the relevant statutory obligations have been met. Regulatory authorities overseeing other financial institutions and DNFBPs are similarly empowered under the AMLO for the purpose of enforcing regulatory requirements.

Sanctions

2.26 The VA business operates largely in the virtual world with a high inherent risk both in terms of ML/TF and other criminal activities such as fraud. To

achieve the necessary deterrent effects, we propose that there should be effective and proportionate sanctions in relation to unlicensed activities and non-compliance of regulatory requirements. In gist, in addition to a range of administration sanctions[6], we propose the following maximum level of criminal sanctions, on conviction on indictment –

(a) conducting a regulated VA activity without a licence: a fine of $5,000,000 and imprisonment for seven years; and, in the case of a continuing offence, a further fine of $100,000 for every day during which the offence continues;

(b) provision of a false, deceptive or misleading statement in a material particular in connection with a licence application: a fine of $1,000,000 and imprisonment for two years;

(c) non-compliance with the statutory AML/CTF requirements: a fine of $1,000,000 and imprisonment for two years; and

(d) fraudulent or reckless misrepresentation for the purpose of inducing another person to acquire or dispose of a VA: a fine of $1,000,000 and imprisonment for two years.

2.27 Respondents offered general support for the proposed criminal and administrative sanctions, which are similar to those applicable to financial institutions regulated under the AMLO. One respondent suggested that the maximum level of imprisonment for unlicensed activities and misrepresentation should be equivalent to that for the offence of fraud under the Theft Ordinance (Cap. 210), i.e. 14 years. Most respondents agreed that the proposed penalty levels for the said activities are high enough to achieve the necessary deterrent effect. They also indicated support for making it a criminal offence for a person to make a fraudulent or reckless misrepresentation to induce someone to acquire or dispose of a VA given the risk of investor fraud associated with VA.

[6] Including suspension or revocation of licences, reprimand, remedial order and a pecuniary penalty (not exceeding $10,000,000, or three times the amount of the profit gained or loss avoided, whichever is the greater) for misconduct such as contravening the AML/CTF or other regulatory requirements.

Statutory Appeal

2.28 We propose to expand the scope of reviewable decisions of the Anti-Money Laundering and Counter-Terrorist Financing Review Tribunal to cover appeals against future decisions made by the SFC in implementing the licensing and supervisory regime for licensed VASPs. Most respondents supported the proposed arrangement. Two respondents suggested that the Securities and Futures Appeals Tribunal should be in a better position to handle appeals relating to VAs.

2.29 The Anti-Money Laundering and Counter-Terrorist Financing Review Tribunal is the dedicated authority established under the AMLO for reviewing decisions made thereunder by regulatory authorities pertaining to financial institutions' compliance with the AMLO requirements. As the licensing regime for VASPs will be accommodated under the AMLO, and VASPs will be required to observe the AML/CTF requirements thereunder, we consider it appropriate for the Tribunal to handle appeals relating to the VASP regime.

Chapter 3

Proposal to Introduce a Two-tier Registration Regime for Dealers in Precious Metals and Stones

Comments Received and Our Responses

Overview

3.1 We received 26 written submissions responding to the proposal of introducing a two-tier registration regime for DPMS under the AMLO. We have carefully analysed the submissions, and below is a summary of the major views expressed and our responses.

The Need for Regulation

3.2 DPMS are among the six categories of DNFBPs appointed by the FATF for AML/CTF regulation primarily due to their involvement in cash-based transactions, which may be abused by criminals to launder and disguise proceeds in valuable commodities, or by terrorist and their associates to finance terrorism. Specifically, the FATF requires that DPMS which engage in cash transaction exceeding USD/EUR15,000 (approximately HK$120,000) should be subject to the same AML/CTF obligations as other DNFBPs. The FATF identifies the absence of DPMS regulation as a gap in the AML/CTF regime of Hong Kong in the latest round of mutual evaluation and recommends that appropriate AML/CTF obligations be put in place for the DPMS sector as a matter of priority.

3.3 To implement the FATF requirement, we propose amending the AMLO to introduce a two-tier registration regime for DPMS and subject registrants engaging in cash transactions at or above HK$120,000 to the AML/CTF obligations stipulated in Schedule 2 to the AMLO. The registration regime will be administered by the Commissioner of Customs and Excise ("C of C&E"), who as the Registrar will maintain a register of DPMS for public information.

3.4 Noting the important role played by the DPMS sector in Hong Kong's overall trade and the FATF's requirement for the DPMS sector to be subject to AML/CTF regulation, respondents expressed understanding of the need for Hong Kong to introduce regulation for DPMS in fulfilment of our obligations under the FATF. There is general support for the proposed direction and framework of the regulatory regime, and for the C of C&E to become the regulatory authority of the regime. Respondents also underlined the importance of adopting a risk-based approach to regulation, with DPMS engaging in large cash transactions (i.e. HK$120,000 or above) to be subject to more rigorous AML/CTF scrutiny while allowing the rest a lighter touch of supervision. It was hoped that a simple and straightforward registration regime would help enhance the recognition of the DPMS trade domestically and in the international arena.

Scope and Coverage

3.5 To allow the Registrar an oversight of the DPMS trade such that he/she can maintain an up-to-date understanding of the overall landscape of the sector, fully grasp the ML/TF risks involved and apply risk-based mitigation measures accordingly as required by the FATF, we propose that registration as a DPMS under the AMLO is required before any person may, by way of business, conduct one or more of the following regulated activities – (i) trading in, importing or exporting precious metals, precious stones or precious products; (ii) manufacturing, refining, or carrying out any value-adding work on precious metals, precious stones or precious products; (iii) issuing, redeeming, or trading in precious-asset-backed instruments; or (iv) acting as an intermediary for (i), (ii) or (iii) above.

3.6 We propose to define – (i) "precious metals" to cover gold, silver, platinum or any other metals in the platinum group (i.e. iridium, osmium, palladium, rhodium or ruthenium) in a manufactured or unmanufactured state; (ii) "precious stones" to cover diamond, sapphire, ruby, emerald, jade, or pearl; (iii) "precious products" to cover any jewellery, watch, apparel, accessory, ornament or other finished product made up of, containing or having attached to it, any precious metals or precious stones or both, and at least 50% of its value is attributable to the precious metals or precious stones

or both (hereafter as the "50% value threshold"); and (iv) "precious-asset-backed instruments" to cover any certificate or instrument backed by one or more precious metals, precious stones or precious products that entitles the holder to such assets, but excluding securities, futures contracts, collective investment schemes or authorised structured products regulated under the SFO.

3.7 Respondents are in general agreement with the proposed scope of regulated activities and related definitions for DPMS. One respondent, an industry body representing the watch industry, sought clarification on the 50% value threshold to be adopted for determining whether an article ornamented with precious metals or precious stones would fall within the definition of "precious products". For more clarity, the respondent suggested – which we also agree – that the 50% value threshold should be determined in relation to the retail price of the product.

3.8 We appreciate the need for clarity in the proposed definition of "precious products" and will take care to reflect in the legislation that the 50% value threshold for determining whether elements of precious metals or precious stones would render an article to be deemed a "precious product" will be considered with reference to the retail price of the article.

3.9 As noted by some respondents, businesses other than the DPMS trade (e.g. manufacturing of medical devices or industrial equipment) may engage the use of precious metals and precious stones in their product designs whether for functional or ornamental purposes. It is however not the intention of the current exercise to regulate those who incidentally encounter or deal with precious metals or precious stones in their business operations. We will therefore take care to require only those whose business ordinarily engages in the regulated activities to be registered as DPMS and carve out those incidental operations. This will allow us to meet the FATF requirement without unnecessarily affecting the other trades.

Two-Tier Registration

3.10 Given the FATF requirement for DPMS engaging in large cash transactions to be subject to more rigorous AML/CTF scrutiny, there is a need to distinguish persons who engage in large cash transactions from those who do not for application of risk-based regulation. We therefore propose a two-tier registration regime for DPMS under the AMLO to reflect the FATF intention for DPMS who engage in cash transactions at or above HK$120,000 to be subject to the same set of AML/CTF obligations now applicable to other DNFBPs, while allowing the rest a lighter touch of supervision.

3.11 Specifically, Category A registration is required for DPMS who do not intend to and will not engage in any cash transactions at or above HK$120,000, while Category B is reserved for DPMS who intend to or may engage in any cash transaction at or above HK$120,000. The C of C&E as the Registrar will maintain a register of DPMS for public information and supervise the two categories of registrants following a risk-based approach.

3.12 Category A registration is simple and straightforward. Applicants only need to present a valid business registration certificate[7], addresses of all premises in Hong Kong pertaining to the place of business, and a declaration that the registration is obtained for a lawful purpose. Category A registrants are not subject to the AML/CTF requirements stipulated in the AMLO or any registration conditions other than the requirement to notify the Registrar of any subsequent changes in particulars. A Category A registration will remain valid for as long as the registrant continues to stay in business, subject to the payment of an annual fee. As for Category B registration, an applicant will be subject to a fit-and-proper test similar to that applicable to other DNFBPs regulated under the AMLO. Category B registrants will also be required to observe the AML/CTF obligations under Schedule 2 of the AMLO. A Category B registration will be valid for three years and renewable upon expiry where fit-and-proper requirements are met. Migration between the two categories of registration is permissible upon application, provided that the applicable registration criteria are met.

[7] For hawkers licensed under the Hawker Regulation (Cap. 132AI) who are exempted from business registration, they may register under Category A on the strength of their hawker licence without a business address.

3.13 The majority of the respondents were in agreement with the proposed design of the registration regime including the respective registration criteria and regulatory requirements for Category A and Category B. One respondent considered that all DPMS should be subject to the same set of regulatory requirements. A handful of respondents opined that a single-tier registration regime covering only those DPMS who engage in cash transactions at or above HK$120,000 would suffice. Few others suggested that in addition to Category B registrants, Category A registrants could also be allowed to engage in large cash transactions subject to certain safeguards, such as an annual limit on the number of large cash transactions allowed to be made, or requiring registrants to file cash transactions reports with the C of C&E upon the conduct of such transactions. Several respondents sought clarification on the consideration behind adopting the threshold of HK$120,000 for delineating Category A and Category B registrants. Individual respondents requested further guidance on the regulatory requirements to facilitate the DPMS trade's migration to the registration regime and considered that registration fees should be set at the minimum so as to reduce the compliance costs of the trade.

3.14 We appreciate the majority support for the registration proposal and the DPMS sector's wish for compliance burden to be kept at the minimum to ensure the competitiveness of the trade. It is with this objective in mind that we propose a tiered registration system, which allows the C of C&E to separate DPMS with higher risks from those less so for AML/CTF supervision while maintaining an up-to-date understanding of the overall sectoral landscape as required by the FATF. The threshold of HK$120,000 is set with reference to that stipulated by the FATF (i.e. USD/EUR 15,000) for defining large cash transactions warranting close scrutiny.

3.15 We note the alternative regulatory options suggested by some respondents. We are mindful that a single-tier regime that indiscriminately subjects all DPMS, irrespective of whether they would engage in large cash transactions, to the fit-and-proper test for registration and AML/CTF requirements under the AMLO would only add to the compliance burden of the trade. A differential regime that allows registrants in both categories to engage in large cash transactions but to a varying extent while with the same AML/CTF obligations, would add to the complication of the regime and not be conducive

to the maintenance of a level playing field for all. We believe that the current proposal has struck a proper balance between the need for regulation and the need to minimise the compliance burden in accordance with a risk-based approach.

Exemption

Financial Institutions

3.16 It is noted that some financial institutions have a substantial footprint in the DPMS trade. To avoid regulatory overlap, we propose to exempt financial institutions that are already regulated under the AMLO for AML/CTF purpose from the registration requirement, where they conduct the regulated activities of DPMS as an ancillary to their principal business. With one exception, most respondents indicated support for the proposal to exempt financial institutions from the registration requirement.

3.17 While expressing support for the proposed registration regime for DPMS, the pawnbroker trade suggested in their submission that pawnbrokers licensed under the Pawnbrokers Ordinance (Cap. 166) should be exempted from the regime. This is because pawnbrokers are subject to an even more stringent set of licensing requirements pursuant to the Pawnbrokers Ordinance and are supervised by the Hong Kong Police Force for crime prevention (including AML/CTF) purposes. For instance, pawnbrokers are required to keep record of each and every transaction of articles pledged with them, and each transaction is subject to a statutory cap of HK$100,000 (i.e. less than the FATF's threshold for defining large cash transactions). The granting and renewal of a licence as a pawnbroker is subject to the applicant meeting a fit-and-proper test conducted by the Hong Kong Police Force. Having regard to the stringent regulation of pawnbrokers under the Pawnbrokers Ordinance, we will **refine** the proposal by expressly exempting licensed pawnbrokers from the DPMS registration regime so as to avoid a regulatory overlap.

Non-domestic Dealers in Precious Metals and Stones

3.18 Having regard to the fact that dealers from other jurisdictions visit Hong Kong occasionally for jewellery trade fairs organised throughout the year, we

propose to exempt these non-domestic dealers from the registration requirement as they pose lower ML/TF risks due to their transitory nature. Yet, they will be required to file a cash transaction report with the C of C&E when they engage in a cash transaction at or above HK$120,000 in Hong Kong and within one day upon completion of the transaction (and in any event before their departure from Hong Kong). A non-domestic dealer qualified for exemption will be a person who (i) does not ordinarily reside in Hong Kong (or is a legal person incorporated outside Hong Kong and is not registered under the Companies Ordinance as a non-Hong Kong company); (ii) does not have a permanent place of business in Hong Kong; and (iii) carries out a regulated activity in Hong Kong for no more than a total of 90 calendar days in any given year.

3.19 The majority of the respondents noted that non-domestic dealers should be subject to an appropriate level of oversight under the registration regime, although views differ on the extent of regulation. Some respondents considered that non-domestic dealers should be subject to the same set of regulation as their domestic counterparts for consideration of ensuring a level playing field. Some respondents suggested alternatives such as shortening the 90-day threshold for defining one as a non-domestic dealer to be considered for exemption, or subjecting non-domestic dealers to temporary registration requirements, or regulating premises that host jewellery fairs or trade exhibitions. Others considered that participation of non-domestic dealers in Hong Kong's trade fairs should be facilitated to the extent possible given their contribution to our economy and onerous registration requirements might create a disincentive for them to come.

3.20 We note the diverse views from respondents on the treatment of non-domestic dealers under the regime. On the suggestion of regulating non-domestic dealers in exactly the same way as domestic dealers, we consider it not commensurate with a risk-based approach given the lower ML/TF risks involved due to the occasional and transitory nature of these visits. From an operational point of view, it would also be impractical for the Registrar to supervise the AML/CTF compliance of these non-domestic dealers as they do not have a permanent establishment in Hong Kong and may have been regulated already in other jurisdictions. An excessively stringent registration requirement for non-domestic dealers may also affect the

attractiveness of our exhibition market vis-à-vis other regional competitors. As a matter of fact, similar exemption arrangements for non-domestic dealers are also established in some jurisdictions (e.g. Singapore). Balancing all considerations, we propose to **refine** the original proposal by shortening the 90-day exemption threshold to 60 calendar days. Non-domestic dealers will still be required to file cash transaction reports with the C of C&E when they engage in a cash transaction at or above HK$120,000 in Hong Kong.

3.21 We propose that a non-domestic dealer who fails to observe the requirement of filing cash transaction report commits an offence and is liable to a fine at level 5 ($50,000) and imprisonment for three months. Two respondents enquired about the rationale behind the determination, suggesting that non-domestic dealers should be subject to a similar set of sanctions as their domestic counterparts. We consider the proposed penalty appropriate, having referenced that applicable to the offence of failing to file a suspicious transaction report under the Organized and Serious Crimes Ordinance (Cap. 455), the Drug Trafficking (Recovery of Proceeds) Ordinance (Cap. 405) and the United Nations (Anti-Terrorism Measures) Ordinance (Cap. 575).

Transitional Arrangement

3.22 We propose that DPMS who have been in operation immediately before commencement of the regime will be allowed 180 days to apply for registration. During the transitional period, DPMS carrying on a business of regulated activities will be deemed to have been registered for the purpose until such time when an application is granted. There is overwhelming support from the DPMS trade for a 180-day transitional period and the deemed registration arrangement to facilitate the trade's migration to the registration regime.

Powers of the Registrar

3.23 To ensure that the C of C&E can effectively discharge its supervisory functions over the DPMS registrants, we propose to empower the C of C&E to enforce the registration requirements, and supervise the AML/CTF conduct

of Category B registrants in accordance with the AMLO stipulations. Such will include the power to enter a DPMS' place of business for routine inspection, to investigate non-compliances, and to impose administrative sanctions where Category B registrants are in breach of the AML/CTF requirements under Schedule 2 to the AMLO. Two respondents sought clarifications on the need for empowering the C of C&E to enter a DPMS' place of business for routine inspection. As in the case with other businesses and professions (e.g. money service operators and trust or company service providers) regulated under the AMLO, we see a genuine need for the Registrar to have the powers for routine inspection so as to ascertain whether registrants are complying with the AMLO.

Sanctions

3.24 We propose the following sanctions to deter unlawful practice and non-compliance of AML/CTF obligations –

(a) a fine at level 6 ($100,000) and to imprisonment of six months for conducting by way of business one or more of the regulated activities or purporting to be a registered DPMS without a valid Category A or Category B registration; or engaging in cash transaction at or above HK$120,000 whilst carrying out any regulated activity without a Category B registration;

(b) a fine at level 5 ($50,000) and imprisonment for six months for the making of a false, deceptive or misleading statement in a material particular in connection with a registration; and

(c) a Category B registrant who contravenes the AML/CTF requirements in the AMLO will be subject to disciplinary proceedings and a range of administrative sanctions, including reprimand, remedial order and a pecuniary penalty not exceeding $500,000.

3.25 There is broad support for the proposed sanctions. A couple of respondents enquired about the rationale behind subjecting VASPs to, overall speaking, a more stringent set of sanctions than DPMS. We note that VASPs and DPMS

are vastly different in terms of the nature of their business and the ML/TF risks involved. In contemplating the sanctioning levels for DPMS, following the FATF's classification we have drawn reference from those applicable to other DNFBPs regulated under the AMLO. Whereas for VASPs, we consider their business nature to be more akin to that of licensed corporations regulated under the SFO, hence attracting a comparable level of penalties. This will ensure a proportionate response to address the respective risks of the VASP and the DPMS sectors, in accordance with the risk-based approach we adopt for pursuing the current legislative exercise.

Statutory Appeal

3.26 We propose that the Anti-Money Laundering and Counter-Terrorist Financing Review Tribunal, established under the AMLO, be empowered to hear appeals against future decisions made by the Registrar in implementing the registration and supervisory regime for DPMS. There is general support for the scope of the Tribunal to be expanded accordingly to review future decisions of the Registrar pertaining to the regime.

CHAPTER 4

Miscellaneous Amendments

Overview

4.1 Taking the opportunity of amending the AMLO, we propose to introduce certain miscellaneous amendments to address some technical issues identified in the FATF's Mutual Evaluation Report on Hong Kong and other FATF contexts, including –

(a) Amending the definition of "politically exposed person" ("PEP") in accordance with the FATF requirement, and empowering regulatory authorities to make guidelines to allow the exemption of enhanced CDD requirements in respect of former PEPs on a risk-sensitive basis;

(b) Better aligning the definition of "beneficial owner" in relation to a trust under the AMLO with that of "controlling person" under the Inland Revenue Ordinance (Cap. 112) ("IRO"), by clarifying that, where a trust is concerned, it includes trustees, beneficiaries and class(es) of beneficiaries;

(c) Allowing the engagement of digital identification systems to assist the conduct of CDD in situations where a customer is not physically present for customer identification and verification purposes (i.e. non-face-to-face, or "NFTF" situations);

(d) Enhancing the deterrent effect for unlicensed money service operation by raising the sentencing level to a fine of $1,000,000 and imprisonment for two years; and

(e) Consolidating the different provisions under various Ordinances enabling regulatory authorities to exchange supervisory information for AML/CTF purposes into a unified provision under the AMLO.

4.2 The majority of the respondents welcomed the proposed amendments to keep pace with international standards, supervisory need and technological

advancement. Individual respondents also made suggestions regarding the definitions of PEP and beneficial owner under the AMLO and the amendment to address NFTF situations.

4.3 On the PEP proposal, most respondents recognised the need to amend the definition of PEP in accordance with the FATF Standards and welcomed in particular the adoption of risk-based exemption for former PEPs. Two respondents considered that the definition of PEP should stay as it is, and one respondent expressed reservation on the proposal to exempt former PEPs on a risk-sensitive basis on the ground that former PEPs might still retain their influence even after they stepped down from a prominent public function. Four respondents suggested that the regulated sectors would benefit from more guidance on the application of the amended definition and the risk-based approach.

4.4 On the definition of "beneficial owner", the majority of respondents supported better alignment of the corresponding definitions under the AMLO and the IRO. One respondent noted difficulties in identifying the beneficial owners of a trust, and another respondent opined that settlors, protectors and enforcers of a trust are not necessarily the beneficial owners of the trust.

4.5 On the proposal to facilitate the use of digital identification solutions during NFTF situations, there is overwhelming support from the respondents. They noted that the relaxation would provide more flexibility for financial institutions and DNFBPs to adopt financial technologies in satisfying the CDD requirements under the AMLO. One respondent suggested repealing the requirement for enhanced CDD measures to be adopted for NFTF situations.

4.6 Broad support was received for the proposals to increase the deterrent effect for unlicensed money service operation and to standardise the parameters for exchange of information in the context of AML/CTF supervision. Respondents noted that the proposals would enhance the operation and effectiveness of our AML/CTF regime.

Chapter 5

Conclusions

5.1 Hong Kong is reputable internationally for being an open, trusted and competitive place to invest and do business. In the latest round of mutual evaluation conducted by the FATF to assess the effectiveness of a jurisdiction's AML/CTF regime, Hong Kong has become the first jurisdiction in the Asia Pacific region to have attained an overall compliant result. Hong Kong is commended for having a strong legal foundation and effective system for combating ML/TF, which is particularly effective in the areas of risk identification, law enforcement, asset recovery, CTF and international cooperation.

5.2 There is no room for complacency notwithstanding the satisfactory results achieved during the FATF Mutual Evaluation. Regular review of our AML/CTF regime is pertinent to safeguarding the robustness of our system.

5.3 In drawing up the legislative proposals, we are guided by the principles that the amended AML/CTF regime should enable Hong Kong to meet the FATF Standards so as to maintain our competitiveness as an international financial centre. At the same time, the additional regulatory burden and compliance costs on businesses should be minimised as far as reasonably practicable. We are encouraged to see that these guiding principles are widely shared by respondents, who also offer many constructive suggestions for fine-tuning the legislative parameters.

5.4 Encouraged by the broad-based support for enhancing AML/CTF regulation, we will proceed to prepare an amendment bill for the proposals discussed in this document. The bill will take into account views received during the consultation and the refinements we discussed in Chapters 2 to 4. Our target is to introduce the amendment bill into the Legislative Council in the 2021-22 legislative session. We look forward to the community's continuous support for our efforts to ensure that Hong Kong remains an open and trusted place for doing business.

Annex A

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

List of Respondents

1. Alvarez & Marsal Disputes and Investigations Limited
2. Baker & Mckenzie
3. The Bitcoin Association of Hong Kong
4. Bitquant Digital Services
5. The British Chamber of Commerce in Hong Kong
6. Cherry
7. The Chinese General Chamber of Commerce, Hong Kong
8. Chinese Gold and Silver Exchange
9. David Gunson
10. Diamond Federation of Hong Kong, China Limited
11. Diginex Limited
12. Estate Agents Authority
13. Esther
14. Evan W.
15. Eversheds Sutherland
16. Federation of Hong Kong Industries
17. The Federation of Hong Kong Watch Trades & Industries Ltd.
18. FinTech Association of Hong Kong
19. Gareth H. Hayes
20. Global Digital Finance
21. Hashkey Group
22. HK Bitcoin ATM
23. The Hong Kong Association of Banks
24. Hong Kong & Kowloon Pawnbrokers Association
25. The Hong Kong Chinese Importers' and Exporters' Association
26. Hong Kong Digital Asset Exchange Limited
27. The Hong Kong General Chamber of Commerce

28. Hong Kong Indian Diamond Association
29. The Hong Kong Institute of Certified Public Accountants
30. The Hong Kong Institute of Chartered Secretaries
31. Hong Kong Jade Association
32. The Hong Kong Jewellers' & Goldsmiths' Association Ltd.
33. Hong Kong Jewellery & Jade Manufacturers Association
34. Hong Kong Jewelery Manufacturers' Association
35. Hong Kong Professionals and Senior Executives Association
36. Hong Kong Securities & Futures Professionals Association
37. Hong Kong Virtual Asset Exchange Limited
38. Institute of Compliance Officers
39. Institute of Financial Technologists of Asia
40. Ken Yiu
41. King & Wood Mallesons
42. The Law Society of Hong Kong
43. Leonhard A. Weese
44. Liberal Party
45. Matrixport
46. Mavis
47. Michael Peter Walczak
48. Mikael More
49. MyEthShop
50. ONC Lawyers
51. Peter Chan
52. Pierre-Maxime Aime
53. Private Wealth Management Association
54. Prosynergy Consulting Limited
55. PricewaterhouseCoopers Limited
56. Rickael Cheung
57. Singularity Financial Limited
58. Society of Trust and Estate Practitioners (Hong Kong) Limited
59. Stewart Mackenzie
60. Swartz, Binnersley & Associates
61. SWCS Corporate Services Group (Hong Kong) Limited

62. Tonghorn Trading Limited
63. Winston Chan
64. 孫偉康
65. 鍾小姐
66-74. Nine respondents with unidentifiable names
75-79. Five respondents requested not to disclose his/her identity

Annex B

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

Analysis of Respondents by Background

Types of Respondents	No. of Submissions
Industry associations and Professional bodies	27
Political party	1
Individual firms/companies	22
Individual members of the public	29
Total	**79**

Annex C

Industry Bodies Present at Consultation Sessions on the Legislative Proposals

1. Chinese Gold and Silver Exchange
2. Diamond Federation of Hong Kong, China Limited
3. The Federation of Hong Kong Watch Trades & Industries Ltd.
4. Hong Kong General Chamber of Commerce
5. Hong Kong Indian Diamond Association
6. Hong Kong Jade Association
7. The Hong Kong Jewellers' & Goldsmiths' Association Ltd.
8. Hong Kong Jewellery & Jade Manufacturers Association
9. Hong Kong Jewelry Manufacturer's Association
10. Hong Kong Trade Development Council
11. Hong Kong & Kowloon Jade Merchants & Workers Union Association
12. Hong Kong & Kowloon Pawnbrokers' Association
13. Kowloon Jewellery and Gold Association
14-15. Two engagement sessions with the virtual asset industry, including members of the FinTech Association of Hong Kong