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

Dear Sirs,

We are a group of individuals in Hong Kong active in the fintech industry. We submit these comments to the Public Consultation on Legislative Proposals to Enhance Anti-Money Laundering and Counter-Terrorist Financing Regulation in Hong Kong (“Consultation Paper”).

No one disputes the need for Hong Kong to fight money laundering and financing terrorist (“ML/TF”) activities. The question is whether the proposed scheme is the best way forward to achieve the level of compliance recommended for Hong Kong in the Mutual Evaluation Report (“MER”) dated September 2019 which was adopted by the FATF in its June 2019 plenary meeting. In the MER, the FATF made 40 recommendations and assessed the level of effectiveness of Hong Kong’s AML/CFT system and discussed areas where the system could be strengthened.

The detailed report thoroughly assessed and analyzed the level of Hong Kong’s compliance and listed nine Priority Actions. It also rated Hong Kong’s effectiveness and technical compliance with FATF standards. The fifth listed Priority Action stated that Hong Kong “should review and put in place the appropriate level of AML/CFT requirements for the DPMS sector having regard to ML/TF risks”. We agree that the FATF recommendation for strengthening the DPMS sector should be implemented as proposed in the Consultation Paper.

However, we note that in the MER, there was no indication in either the Priority Actions or the 40 Recommendations that urgent action relating to virtual asset (“VA”) must be taken as implied in the Consultation Paper. In fact, on page 36 of the MER, on the issue of VA, the FATF noted: “Recognising virtual assets as an emerging globally risk, HKC included an initial assessment, assessing it as medium-low risk” (emphasis added). Thus, expanding the power of the Securities and Futures Commission (“SFC”) over all VA and virtual asset services providers (“VASPs”) does not appear to be a recommendation of the FATF as suggested in the Consultation Paper.

VAs is a class of ever evolving assets of which only a small sub-class are securities as defined in the Securities and Futures Ordinance (“SFO”). Perhaps recognizing the broad range of this asset class, in a recent publication, the FATF defined VA thusly:

A virtual asset is a digital representation of value that can be digitally traded, or transferred, and can be used for payment or investment purposes. Virtual assets do not include digital representations of fiat currencies, securities and other financial assets that are already covered elsewhere in the FATF Recommendations.

<https://www.fatf-gafi.org/media/fatf/documents/recommendations/12-Month-Review-Revised-FATF-Standards-Virtual-Assets-VASPS.pdf>, p. 23.

To grant the SFC jurisdiction over all classes of VAs and all VASPs seems excessive and disproportionate to the handling ML/TF risks as assessed by the FATF. Such expansion of authority may not help HK improve its effectiveness or technical compliance ratings as the thrust of the FATF recommendations did not specifically address VAs. On the other hand, the proposal seems to be a disguised attempt to circumvent the limitations of authority delineated in the SFO. The claim that such expansion is needed to comply with

FATF ML/TF recommendations seems unsupported by the MER. Thus, we oppose this aspect of the proposal.

In recent years, with better understanding of the underlying technology and improvement in industry practices, VAs have become accepted as a mainstream asset class. Major financial institutions, banks and fund managers have included VAs as part of their investment portfolio. Even before the entrance of these established investors, retail investors, including those in or from Hong Kong, have been active in VA investments. These investors understand that the most actively traded VAs, such as bitcoin, ether and USDT, are not 'securities' and do not grant holders any right in the issuing entity. Retail investors are under no illusion that holding such VAs will provide them with any rights similar to those of shareholders in the entities distributing the VAs. Since most VAs are clearly not 'securities', it is unreasonable to subject these assets and their services providers to the SFC's jurisdiction.

A result of the proposal will be a severe limitation of the ability of such retail investors to trade their VA in Hong Kong. Most VAs are traded directly on VA trading platforms without brokers or intermediaries. It will significantly increase transaction costs for most retail investors in managing their VA investment portfolio if they cannot trade directly as will be the case if the proposal is implemented. It is clearly inadvisable to lump all types of VAs together under the regulatory reach of the SFC, whose jurisdiction arguably extends only to VAs that are representative of 'securities' or futures contracts. To go beyond that limitation is unwise as it will require all VAs, such as bitcoins, ether, USDT, stable coins, utility tokens, asset tokens, non-fungible tokens or even game tokens, to fit into a mould intended for securities and subject their services providers, who do not deal in securities, to be licensed as intermediaries under the SFC's authority.

If VAs pose significant ML/TF risks to the international financial system as stated in the Consultation Paper, so do other assets such as fiat currencies and DPMS. In fact, the US dollar is probably the most used instrument for ML/TF activities but no one would seriously propose that the US dollar and all services providers, such as banks, merchants, travel agents, and currency traders, should be licensed by and subject to the powers of the SFC. The Consultation Paper correctly does not propose that DPMS or fiat currencies should be regulated by the SFC and services providers subject to SFC's licensing regime. It correctly recognizes that these assets are properly regulated by other agencies. The same approach should also apply to non-securities VAs.

Much is said of the potential for VAs to be used for ML/TF activities. The anonymity and decentralization of VAs may help facilitate layering or conversion of crime proceeds into fiat currencies through interfaces with the financial system as noted in the Consultation Paper. However, given the nature of the underlying technology that creates and records VAs, all VA transactions are immutably recorded on a blockchain. This uniquely provides a digital trail, which is a significant tool for investigation of potential ML/TF crimes unavailable for any other assets used for ML/TF activities.

Thus, anonymity (it is really pseudonymity) and decentralization are only one aspect of VAs. The immutability of blockchain records cannot be underestimated. Ultimately, VAs are converted into fiat currencies. After all, that is the point of money laundering! The digital trail leading to such conversion provides forensic law enforcement investigators the ability to track and identify criminals and have led to successful indictment and confiscation of funds. The same cannot be said of other assets, such as fiat currency, PDMS, art or antiques, used for ML/TF activities where no trail, whether digital or paper, is left behind for investigators to find. On balance, pseudonymity and decentralization are not barriers to law enforcement investigators fighting ML/TF activities.

Hong Kong's current legal framework grants various agencies with regulatory and enforcement authority over non-securities VAs and other asset classes; to change the current system in favour of the SFC appears to be a reduction of their authority. Nowhere in the MER does the FATF recommend that all VAs should

be regulated as securities or that all VASPs must be licensed as securities intermediaries. The FATF considers the current system in Hong Kong as robust and capable. Indeed, as noted in the Consultation Paper, Hong Kong is the first jurisdiction in the Asia-Pacific region to have achieved an overall compliant result in the latest round of FATF mutual evaluations. Wholesale changes as proposed is uncalled for.

We agree with the FATF that the best way forward is for relevant regulators to enhance their understanding of ML/TF risks in their enforcement effort. We agree that the proposal regarding DPMS will help in this effort. However, we disagree that the extension of SFC regulatory powers over non-securities VAs or the licensing of VASPs that do not deal in securities VAs is the best way forward.

**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?**

We agree with efforts to strengthen the AML/CTF system as recommended by the FATF but we do not agree that extending SFC regulatory authority is the correct approach.

**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?**

Yes, but SFC regulating all VASPs is not a balanced or needed approach. Only VASPs dealing in securities VAs should be regulated by the SFC. Others should be governed by other agencies, perhaps in a manner similar to other DNFbps.

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

No. The proposed scope and coverage of regulated activities is too broad. It gives power to the SFC that exceeds the scope of authority as delineated in the SFO and as acknowledged by the SFC of their lack of regulatory authority over non-securities VAs. The proposal allows the SFC to significantly expand its regulatory reach beyond what is permitted by the SFO. Most VAs are not securities and should not be force fed into the regulatory regime of the SFC created for supervision of a securities industry.

We agree that VA trading platforms handling 'securities' may be covered under SFC licensing regime but not VA trading platforms that do not handle securities VAs. The current approach is the correct one approach and it should not be expanded to reach non-securities VAs. To have the SFC regulate non-securities VAs with the same broad brush as securities would have unintended results including creation of overwhelming burden on trading platforms such as peer-to-peer platforms which do not trade digital representations of securities and on retail investors desiring to trade VAs as their transaction costs would be significantly increased.

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

To be consistent with FATF Standards, Hong Kong should accept the FATF definition. It is noted that the FATF does not include digital representations of securities in its definition of "virtual assets". By excluding digital representations of securities, the FATF accepts that generally, VAs are not 'securities' and are not to be regulated in the same manner. As this consultation is intended to align Hong Kong's regulatory regime with FATF Standards for AML/CTF, the same definition of VA should be used to follow international standard and minimize potential for confusion. Other types of VAs should be within the province of other regulators.

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

No, but current regulatory schemes may be improved through better education and awareness.

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

Yes

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

No.

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

No.

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

It should be open-ended.

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

Please refer to our answers to Q3 and Q4.

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

Please refer to our answers to Q3 and Q4.

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

Please refer to our answers to Q3 and Q4.

**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?**

Please refer to our answers to Q3 and Q4.

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

Please refer to our answers to Q3 and Q4.

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

Yes.

**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?**

No comment.

**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?

Yes.

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?

Yes.

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?

Yes.

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?

Yes.

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?

Yes.

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

Yes.

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 requirements in the AMLO?

Yes.

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

Yes.

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?

Yes.