

# Legal Commentary

April 19, 2024

## Venturing Out: Web 3.0 (I) — Hong Kong Virtual Asset Regime Overview

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### Introduction

Web 3.0 is the latest evolution of the World Wide Web that envisages a more decentralized version of the web, underpinned by a constellation of advanced technologies and applications such as virtual assets (“**VA(s)**”) of cryptocurrencies and non-fungible tokens (“**NFT(s)**”), and blockchain technology.

Hong Kong has taken significant steps to establish an appropriate regulatory framework for the VA sector. Cybersecurity alongside investor protection are matters of utmost importance in Web 3.0 development. The regulation of VA trading platforms (“**VATP(s)**”) took effect in June 2023, after an amendment to the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Chapter 615 of the laws of Hong Kong) (“**AMLO**”). The Financial Services and the Treasury Bureau (“**FSTB**”) consulted the public in February 2024 on legislative proposals to regulate over-the-counter (“**OTC**”) trading of VAs. The Hong Kong Monetary Authority (“**HKMA**”) and the FSTB also proposed a licensing and regulatory regime for fiat-referenced stablecoins (“**FRS**”) in December 2023. This article aims to highlight the key points to note for commencing Web 3.0 VA-related businesses in Hong Kong.

### An overview of Hong Kong’s VA regulatory landscape

Understanding the regulatory regime in relation to VAs is vital for those intending to commence a Web 3.0 business in Hong Kong.

In many facets of the regulatory regime surrounding VAs, it is essential, yet sometimes challenging, to ascertain whether the specific VA constitutes a security. For example, where an NFT is a genuine digital representation of a collectible, the activities related to it fall outside the regulatory remit of the Hong Kong Securities and Futures Commission (“**SFC**”). However, where an NFT constitutes an interest in a collective investment scheme, it may fall within the definition of “securities” under the Securities and Futures Ordinance (Chapter 571 of the laws of Hong Kong) (“**SFO**”). Considering the intricacies involved, it is advisable to seek legal advice on determining whether a VA constitutes securities if needed.

The table below is an overview of the existing regulatory regime for VA and the proposed regulatory regime for VA OTC trading and FRS.

Categories of VAs		
	VAs which are securities	VAs which are NOT securities
<b>Issuance</b>	<ul style="list-style-type: none"> <li>■ Subject to certain exemptions, must comply with the <b>prospectus regime</b> under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Chapter 32 of the laws of Hong Kong) and the <b>offers of investments regime</b> under Part IV of the SFO.</li> <li>■ Must also comply with related guidelines.</li> </ul> <p><u>Tokenised securities</u></p> <ul style="list-style-type: none"> <li>■ According to the SFC Circular on intermediaries engaging in tokenised securities-related activities, tokenization generally involves the process of recording claims on assets that exist on a traditional ledger onto a programmable platform, which includes the use of distributed ledger technology in the security lifecycle.</li> <li>■ Tokenised securities are fundamentally <b>traditional securities with a tokenization wrapper</b>. As such, the existing legal and regulatory requirements governing the traditional securities markets shall continue to apply to tokenised securities.</li> <li>■ Where intermediaries issue or are substantially involved in the issuance of the tokenised securities which they intend to deal in or advise on, they <b>are responsible for the overall operation of the tokenization arrangement</b> notwithstanding any outsourcing to third-party vendors/service providers. Intermediaries should take into account the features and risks of the tokenised securities in order to assess <b>the most appropriate</b></li> </ul>	<ul style="list-style-type: none"> <li>■ No direct regulation.</li> <li>■ Stablecoins falling within the definition of “securities” are already regulated (see column to the left).</li> </ul> <p><u>The proposed regulatory regime for FRS (pending consultation conclusions)</u></p> <ul style="list-style-type: none"> <li>■ Issuers of FRS in Hong Kong must obtain a licence from the HKMA. They must also observe a range of licensing conditions and requirements.</li> </ul> <p><i>Definition of FRS</i></p> <ul style="list-style-type: none"> <li>■ A “stablecoin” is defined as a cryptographically secured digital representation of value that, among other things,               <ul style="list-style-type: none"> <li>(a) is expressed as a unit of account or a store of economic value;</li> <li>(b) is used, or is intended to be used, as a medium of exchange accepted by the public, for the purpose of payment for goods or services; discharge of a debt; and/or investment;</li> <li>(c) can be transferred, stored or traded electronically;</li> <li>(d) uses a distributed ledger or similar technology that is not controlled solely by the issuer; and</li> <li>(e) <b>purports to maintain a stable value with reference to a specified asset, or a pool or basket of assets.</b></li> </ul> </li> <li>■ “FRS” is defined as a stablecoin where <b>the specified asset is one or more fiat currencies.</b></li> </ul> <p><i>Regulatory Framework for FRS Issuers</i></p> <ul style="list-style-type: none"> <li>■ No person shall:               <ul style="list-style-type: none"> <li>(a) issue, or hold oneself out as <b>issuing, FRS in Hong Kong;</b></li> </ul> </li> </ul>

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	<p><b>custodial arrangement for the tokenised securities</b> to manage ownership and technology risks.</p>	<p>(b) issue, or hold oneself out as, <b>issuing a stablecoin</b> that purports to maintain a stable value <b>with reference to the value of the Hong Kong dollar</b>; or</p> <p>(c) <b>actively market</b> its issuance of FRS to the public of Hong Kong; unless it is a company that holds a FRS issuer licence granted by the HKMA.</p> <p><i>Key licensing conditions and requirements for FRS issuers (non-exhaustive)</i></p> <ul style="list-style-type: none"> <li>■ FRS holders must be able to redeem their FRS on a <b>timely basis</b>, at <b>par value</b> and <b>in the referenced currency</b>, without the need to meet unreasonable conditions on redemption.</li> <li>■ The FRS issuer must meet <b>minimum financial resources requirements</b> (i.e. paid-up share capital must be HKD25,000,000 or 2% of the par value of the FRS in circulation, whichever is higher).</li> <li>■ The FRS issuer must be a <b>Hong Kong company</b> with a registered office in Hong Kong. Its chief executive, senior management and key personnel must be <b>based in Hong Kong</b>.</li> <li>■ The FRS issuer must have an <b>effective stabilisation mechanism</b> for its FRS by maintaining a pool of segregated, high-quality, and highly liquid reserve assets in an amount at least equal to the par value of the FRS in circulation at all times.</li> <li>■ FRS issuer must comply with licensing conditions and requirements relating to restrictions on business activities, fitness and propriety, auditing, anti-money laundering/counter-financing of terrorism, risk management etc.</li> </ul>
<b>Exchange</b>	<ul style="list-style-type: none"> <li>■ Must comply with the SFO regime (i.e. for security tokens).</li> </ul>	<ul style="list-style-type: none"> <li>■ Must comply with the VA service provider ("<b>VASP</b>") regime under the</li> </ul>

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	<ul style="list-style-type: none"> <li>■ Given that the terms and features of a VA may evolve over time, a <b>VA's classification may change from a non-security token to a security token (or vice versa)</b>. To avoid contravention of the licensing regimes and to ensure business continuity, VATPs are advised to apply for licences under both the SFO and AMLO regimes (see column to the right).</li> <li>■ Must also comply with the SFC Guidelines for Virtual Asset Trading Platform Operators ("<b>VATP Guide</b>").</li> </ul> <p><i>Key requirements (non-exhaustive)</i></p> <ul style="list-style-type: none"> <li>■ <b>Paid-up share capital</b> of at least HKD5,000,000 and <b>liquid capital</b> of at least HKD3,000,000.</li> <li>■ Holding liquid assets equivalent to at least 12 months of actual operating expenses.</li> <li>■ <b>Fitness, propriety and competence</b> requirements for personnel.</li> <li>■ Must have at least 2 Responsible Officers.</li> <li>■ <b>At least 98% of client VA in cold storage</b> except in limited circumstances approved by the SFC.</li> <li>■ Must have in place a <b>compensation arrangement</b> approved by the SFC that provides an appropriate level of coverage to deal with risk associated with the custody of VAs.</li> <li>■ Only "<b>large-cap VAs</b>" (i.e. those which have been included in a minimum of two acceptable indices issued by at least</li> </ul>	<p>AMLO (i.e. for non-security tokens).</p> <ul style="list-style-type: none"> <li>■ VATPs are advised to apply for licences under both the SFO (see column to the left) and AMLO regimes.</li> <li>■ Must also comply with the VATP Guide.</li> </ul> <p><i>Applicability of the AMLO regime</i></p> <ul style="list-style-type: none"> <li>■ Applicable to persons operating a <b>VA exchange</b>, meaning the provision of services via an <b>electronic facility</b>: <ul style="list-style-type: none"> <li>(a) where: <ul style="list-style-type: none"> <li>(i) offers to sell or purchase VAs are regularly made or accepted in a way that forms or results in a binding transaction; or</li> <li>(ii) persons are regularly introduced, or identified to other persons in order that they may negotiate or conclude, or with the reasonable expectation that they will negotiate or conclude sales or purchases of VAs in a way that forms or results in a binding transaction; and</li> </ul> </li> <li>(b) where client money or client VAs come into the direct or indirect possession of the person providing such service</li> </ul> </li> </ul> <p><i>Key requirements (non-exhaustive)</i></p> <ul style="list-style-type: none"> <li>■ See column to the left.</li> </ul>

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	two different index providers) can be offered to retail.	
<b>Brokerage</b>	<ul style="list-style-type: none"> <li>■ Must comply with the existing SFC licensing regime. Must also comply with the joint circular on intermediaries' virtual asset-related activities issued by the HKMA and the SFC ("<b>Joint Circular</b>"), which is applicable to intermediaries that are licensed corporations with the SFC or registered institutions with the HKMA.</li> </ul> <p><u>Provision of VA dealing services</u></p> <p>According to the Joint Circular:</p> <ul style="list-style-type: none"> <li>■ The SFC and the HKMA only allow intermediaries <b>licensed or registered for Type 1 (dealing in securities) regulated activity</b> to provide VA dealing services. Furthermore, intermediaries should provide such services only to their Type 1 regulated activity clients.</li> <li>■ Intermediaries shall notify the SFC (and the HKMA, where applicable) in advance if they intend to provide VA dealing services, or make any changes to these activities conducted (including changes in the type of clientele served).</li> <li>■ Intermediaries <b>must partner only with SFC-licensed VATPs for the provision of VA dealing services</b>, by either introducing clients to the platforms for direct trading or establishing an omnibus account with the platforms.</li> <li>■ The expected conduct requirements for intermediaries' provision of VA dealing services under an omnibus account arrangement will be imposed by the SFC (and in</li> </ul>	<ul style="list-style-type: none"> <li>■ For SFC- or HKMA- regulated intermediaries, must comply with the Joint Circular.</li> <li>■ Stablecoins falling within the definition of "securities" are already regulated (see column to the left).</li> </ul> <p><u>The proposed regulatory regime for FRS (pending consultation conclusions)</u></p> <ul style="list-style-type: none"> <li>■ Only HKMA-licensed FRS issuers (i.e. a licensed FRS issuer could only offer FRS that it issues), SFC-regulated licensed corporations, authorized institutions or licensed VATPs can offer FRS in Hong Kong or actively market such offering to the public of Hong Kong.</li> <li>■ Authorized institutions, licensed corporations and licensed VATPs can offer FRS issued by entities not licensed by the HKMA only to professional investors.</li> </ul> <p><u>Customs &amp; Excise Licensing (pending consultation conclusions)</u></p> <ul style="list-style-type: none"> <li>■ Any person operating VA OTC Business in Hong Kong, or actively marketing the provision of VA OTC services to the Hong Kong public, will be required to obtain a licence issued by the Commission of Customs and Excise.</li> </ul> <p><i>Definition of VA OTC Business</i></p> <ul style="list-style-type: none"> <li>■ "<b>VA OTC Business</b>" is defined as providing spot trade services for any VA, regardless of whether the service is offered through physical outlets (such as ATMs) or digitally.</li> </ul> <p><i>Permitted and restricted activities</i></p> <ul style="list-style-type: none"> <li>■ Licensees are only allowed to offer services in respect of tokens that may be accessed by retail investors on at least one VATP licensed by</li> </ul>

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	consultation with the HKMA, where applicable) as licensing or registration conditions.	<p>the SFC.</p> <ul style="list-style-type: none"> <li>■ Licensees can perform spot trade of any VA for any money (or vice versa) in their course of businesses. However, they would not be permitted to covert a VA to another VA.</li> </ul> <p><i>Key requirements (not exhaustive)</i></p> <ul style="list-style-type: none"> <li>■ Must appoint a competent Compliance Officer and a Money Laundering Reporting Officer.</li> <li>■ Must have a proper corporate governance structure staffed by experienced personnel.</li> <li>■ Must operate its business in a prudent and sound manner and ensure that clients' and public interests will not be adversely affected.</li> </ul>
<b>Custody</b>	<ul style="list-style-type: none"> <li>■ Regulated by the exiting regime for “trust or company service providers” (“<b>TCSP</b>”) under the AMLO.</li> <li>■ Custody standards are also applicable to SFC-regulated VATPs and other entities.</li> </ul> <p><u>SFC-regulated VATPs</u></p> <ul style="list-style-type: none"> <li>■ A VATP should only hold client assets on trust for its clients through its <b>associated entity</b>. An associated entity means a company which: <ul style="list-style-type: none"> <li>(a) has notified the SFC that it has become an “associated entity” of a VATP;</li> <li>(b) is incorporated in Hong Kong;</li> <li>(c) holds a “TCSP licence” (unless exempted); and</li> <li>(d) is a wholly owned subsidiary of the VATP.</li> </ul> </li> <li>■ The associated entity <b>should not conduct any business other than that of receiving or holding client assets</b> on behalf of the VATP.</li> <li>■ In the handling of client transactions and client assets, a VATP should act to ensure that client assets are accounted for properly and promptly. Where the VATP or its associated entity is in possession or control of client assets, the VATP should ensure that client assets are <b>adequately safeguarded</b>.</li> </ul>	

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	<p><u>TCSP licensing regime</u></p> <ul style="list-style-type: none"> <li>■ A person who carries on or wishes to carry on a <b>trust service business</b> in Hong Kong is required to apply for a TCSP license, such as holding client VAs on trust for its clients. The said trust service business involves acting, or arranging for another person to act:               <ul style="list-style-type: none"> <li>(a) as a <b>trustee</b> of an express trust or a similar legal arrangement; or</li> <li>(b) as a <b>nominee shareholder</b> for a person other than a corporation whose securities are listed on a recognized stock market.</li> </ul> </li> <li>■ <b>Licensing exemptions</b> are available to, among others, authorised institutions and licensed corporations that operates a trust or company service business in Hong Kong that is ancillary to the corporation’s principal business.</li> </ul> <p><i>Key requirements (non-exhaustive)</i></p> <ul style="list-style-type: none"> <li>■ <b>Fit and proper test:</b> A statutory requirement for determining whether a TCSP and every relevant person of the TCSP are fit and proper to carry on or be associated with a trust or company service business. Unless exempted, for corporate applicants, each director and ultimate owner is subject to the fit and proper test.</li> <li>■ A TCSP licensee has an <b>ongoing obligation</b> to comply with the requirements of the AMLO and the guidelines issued by the Company Registry, including the <b>customer due diligence and record-keeping requirements</b>.</li> </ul>	
		<p><u>Customs &amp; Excise Licensing (pending consultation conclusions)</u></p> <ul style="list-style-type: none"> <li>■ Under the current proposal, licensed VA OTC service providers are not allowed to provide custody/escrow services of client’s VA, unless such service is temporary in nature and is an indispensable part of the transaction process.</li> </ul>
<b>Advice</b>	<ul style="list-style-type: none"> <li>■ Regulated via the existing SFC licensing regime.</li> <li>■ According to the Joint Circular, provision of advisory services forms part of an intermediary’s advisory business and may affect its fitness and properness to conduct regulated activities. The SFC and the HKMA are only prepared to allow <b>intermediaries licensed or registered</b></li> </ul>	<ul style="list-style-type: none"> <li>■ No direct regulation.</li> </ul> <p><u>Customs &amp; Excise Licensing (pending consultation conclusions)</u></p> <ul style="list-style-type: none"> <li>■ Under the current proposal, <b>provision of other services, including any form of VA advisory or referral services, offering of VA derivatives or other financial products</b> (including but not limited to staking, lending and margin trading), <b>will not be permitted</b> for VA OTC</li> </ul>

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	<p><b>for Type 1 (dealing in securities) or Type 4 (advising on securities) regulated activity</b> to provide VA-advisory services.</p> <ul style="list-style-type: none"> <li>■ Accordingly, the regulated entities are expected to comply with all the regulatory requirements imposed by the SFC and the HKMA when providing advisory services, irrespective of the nature of the VAs. Furthermore, regulated entities should provide such services only to their Type 1 or Type 4 regulated activity clients.</li> <li>■ When recommending any VA to retail clients, regulated entities should take all reasonable steps to ensure that the VA is: (i) of high liquidity; in assessing the liquidity of a specific VA for trading by <b>retail clients</b>, regulated entities should ensure that the VA is an eligible <b>large-cap VA</b>; and (ii) <b>made available by SFC-licensed platforms</b> for trading by retail investors.</li> </ul>	<p>licensees.</p>

## Conclusion

To promote the development of the Web 3.0 ecosystem in Hong Kong, the Hong Kong government has developed a robust and wide-ranging regulatory framework governing relevant VA activities. Beyond regulating just VATPs, Hong Kong has proposed rules for other VA business lines such as VA OTC trading and FRS. This demonstrates Hong Kong’s determination to strengthen investor protection and promote the development of Web 3.0 in Hong Kong in a stable and responsible manner through a multi-pronged approach. Web 3.0 industry participants in Hong Kong are recommended to seek legal advice to proactively address compliance requirements and mitigate potential risk exposure.



## ***Important Announcement***

This Legal Commentary has been prepared for clients and professional associates of Han Kun Law Offices. Whilst every effort has been made to ensure accuracy, no responsibility can be accepted for errors and omissions, however caused. The information contained in this publication should not be relied on as legal advice and should not be regarded as a substitute for detailed advice in individual cases.

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