Hong Kong regulators call for all cryptocurrency trading platforms to be regulated

DENTONS

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On 3 November 2020, the chief executive of the Securities and Futures Commission (SFC), Ashley Alder, said in a speech that Hong Kong will soon regulate all cryptocurrency trading platforms, whether or not they trade securities.

Introduction

Cryptocurrency and other virtual asset investment products have sparked investors' interests globally in the past few years, and Hong Kong is no exception, with certain ICOs and crypto projects based there. Regulators in Hong Kong have been assessing whether and how the cryptocurrency industry should be regulated, in order to facilitate investor protection and prevent money laundering, among other concerns.

Financial hubs in Asia were amongst the first to respond to such changing market tides. Whilst Japan and Singapore have already implemented their licensing regimes to require all cryptocurrency trading platforms to be regulated, Hong Kong also launched a regulatory framework for virtual asset trading platforms last year.[1]

Existing regulatory regime under the 2019 Position Paper

In the 2019 Position Paper, the SFC put in place an "opt-in" licensing regime for operators of centralised online trading platforms and offer trading of at least one security token. Under this regulatory framework, these operators fall within the jurisdiction of the SFC and can apply for a licence for conducting Type 1 (dealing in securities) and Type 7 (providing automated trading services) regulated activities. Subject to meeting other licensing requirements, including the fit and proper criteria, the SFC may then grant a licence to a qualified platform operator to carry on its virtual asset trading business.

Currently, the SFC is categorical that it will not accept licensing applications from the following types of platforms:

- platforms which only provide a direct peer-to-peer marketplace for transactions by investors who typically retain control over their own assets; and
- platforms which trade virtual assets for clients, including order routing, but do not provide automated trading services themselves.

The SFC is of the view that, for a platform operator to be licensed, its infrastructure, core fitness and properness, and conduct of virtual asset trading activities should be viewed as a whole. Although trading activities in non-security tokens are not "regulated activities", the SFC's regulations will apply to all aspects of platform operations once a platform involves trading activities in security tokens, even if they only constitute a small part of its business.

When assessing a platform operator's licence application, the SFC will consider the manner in which a virtual asset trading platform conducts its entire trading business and, in particular, whether it follows, or is willing and able to follow, the following expected regulatory standards.

Further regulations going forward

Among other initiatives, the SFC observed a growing concern that some virtual asset trading platform operators have found ways to operate so that they fall outside the regulatory remits of the SFC and other Hong Kong regulators.

"This is a significant limitation, as under the current legislative framework if a platform operator is really determined to operate completely off the regulatory radar it can do so simply by ensuring that its traded crypto assets are not within the legal definition of a security," said Ashley Alder, chief executive of the SFC, in his speech on 3 November 2020.[2]

Alder further indicates that, consequently, the Hong Kong government will propose a new "catch-all" licensing regime under its anti-money laundering legislation, requiring all cryptocurrency trading platforms operating or targeting investors in international financial centres to apply for an SFC licence. In other words, whether or not these platforms are offering or trading "securities", they will soon fall within the new regulatory ambit.

To date, dozens of cryptocurrency exchanges operate in Hong Kong, including some of the world's largest, though many chose not to apply for a licence under the existing regime.

Potential impact on cryptocurrency markets in Hong Kong

There are several crypto exchanges operating in Hong Kong which provide trading services for cryptocurrencies in and out of Hong Kong dollars. Since the rates of these local exchanges remain relatively high, investors would normally buy their crypto (mainly Bitcoin and Ethereum) via these exchanges, and then transfer them to other exchanges not based in Hong Kong to trade them against other cryptocurrencies. Conversely, they may cash out the profits that they have made by cashing out their cryptocurrencies in Hong Kong dollars.

It remains to be seen whether the SFC will go as far as regulating crypto exchanges not based in Hong Kong, by, for example, imposing denial of access to these sites from Hong Kong IP addresses, and mandating anti-money laundering measures such as know-your-client (KYC) requirements on these exchanges. The US, for example, has been taking a number of measures to regulate these aspects to enable the IRS to trace capital gains made by crypto investors. The difficulty is in the implementation – retail investors can still gain access to such exchanges easily by using a VPN service.

The crypto community may see further regulations by the SFC as a threat to the decentralisation concept of cryptocurrencies. On the other hand, a properly drafted set of regulations, such as those currently in Singapore and Japan, may attract crypto operators who were considering Hong Kong as a base but were discouraged by the uncertainty under the previous framework regulations. Faced with less uncertainty, operators will be able to go through the regulatory requirements and set up the exchanges without having to worry about whether adding a certain coin to their trading platform will breach the SFO.

Depending on the stance taken by the SFC, the regulations may mean more protection for investors in Hong Kong and further prevention of money laundering via cryptocurrencies. On the flip side, if the regulations are more stringent, this may impact cryptocurrency trading in Hong Kong, in which case investors may have to resort to other means to trade their cryptocurrencies. A fine balance of both aspects, however, will enable the regulators to keep cryptocurrency trading by Hong Kong investors under their jurisdiction, yet offer more protection to cryptocurrency investors.

For further details, please get in touch with the authors, Enoch Wong (Partner, Hong Kong) and Didi Chan (Trainee Solicitor, Hong Kong).

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1. Securities and Futures Commission (2019). “Position Paper: Regulation of virtual asset trading platform.”↩
2. Thomson Reuters (3 November 2020). “Hong Kong wants cryptocurrency trading platforms to be regulated – SFC.”↩

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