Abstract: Due to its ability to undertake some monetary functions, in recent years, the types and scale of virtual assets represented by virtual currencies have rapidly expanded, and virtual assets have become one of the important financial assets due to their financial attributes. Due to its certain security risks, however, regulatory authorities in mainland China completely prohibited virtual asset transactions, including virtual currencies since 2017. Unlike the regulatory attitude in mainland China, Hong Kong SAR has shown a proactive embrace towards virtual assets. This article first analyzes the considerations of the Hong Kong Securities and Futures Commission regarding the inclusion of virtual assets such as virtual currencies in the regulatory framework, as well as the objects and requirements for inclusion in regulation. At the same time, it also points out the problems faced by the Hong Kong Securities and Futures Commission in regulating virtual currencies, providing reference for the regulatory behavior of other financial regulatory institutions, including mainland China, and proposing suggestions for understanding the value of virtual assets and regulating virtual asset services through legislation.

Keywords: Virtual Assets; Financial Regulation; Hong Kong SFC; Anti-money Laundering; Investor Protection.

1. Introduction

Currency mainly has five major functions: exchange medium, value storage, value scale, payment method, and world currency. It is different from the centralized issuance characteristics of ordinary currency, and the decentralization of virtual assets, including digital currency, makes it avoid the centralized settlement of traditional financial institutions. Market participants can act as recorders and managers of distributed ledgers, possessing the low cost, high speed, wide range and other characteristics that traditional finance does not possess. However, the rapid development of virtual assets has exposed significant problems in some economies. Qi Meng (2020) summarized these issues into four main points, namely the price risk of severe fluctuations caused by complex factors in prices, the prominent security risks faced by the centralization of virtual asset storage sites, the impact on the seigniorage revenue of sovereign financial institutions, and the illegal hidden dangers that facilitate illegal and criminal activities such as money laundering and tax evasion. Although technology neutrality is a key consensus in the development of fintech, the unregulated development of fintech, represented by virtual assets, poses a huge hidden concern for investors’ wealth loss and financial stability decline.

In 2017, with the surge in the number of tokens issued ICOs, the potential regulatory gaps caused by their securities attributes also attracted the attention of global regulatory agencies. The regulatory authorities in mainland China have a firm attitude towards this. On September 4th of that year, seven ministries, including the People's Bank of China, jointly issued the "Announcement on Preventing the Risks of Token Issuance Financing", which clearly classified ICO as a criminal act of illegal financing, and gradually upgraded the supervision intensity of virtual currencies represented by Bitcoin, while clearing and closing the mainland virtual currency exchange. Since then, all virtual currency activities have become illegal in mainland China (Yin Zhentao, 2020).

Unlike the supervision attitude in mainland China, the attitude of Hong Kong towards virtual assets, including virtual currencies, is not completely contradictory. In 2017, the Hong Kong Securities and Futures Commission (hereinafter referred to as the SFC) established a fintech group within the licensing department of the intermediary agency department responsible for supervising licensed institutions in response to the booming development of token issuance. The group is specifically responsible for policy formulation and research related to fintech, and plans to incorporate the trading of related virtual currencies into the regulatory framework.

2. Considerations for Inclusion in the SFC Supervision and Regulatory Targets

As an important global financial center and a port of working capital, the Hong Kong authorities do not have the power or motivation to prohibit virtual asset transactions, whether in terms of legal system or policy mechanisms. From a legal perspective, according to the Anti Money Laundering and Terrorist Financing Ordinance, virtual assets include two categories: the first category is the value of encrypted protection digital forms that meet the listed instructions, and the second category is the virtual assets that are generally or individually recognized by the Hong Kong Treasury in a notice published in the gazette, as listed in the "Consultation Document on Recommended Regulatory Requirements for Operators of Virtual Asset Trading Platforms Licensed by the Securities and Futures Commission". Based on the property status granted to virtual assets in the legal system, it is natural for them to be protected by law and regulated by regulatory agencies.

In terms of policy mechanisms, Hong Kong has long been an Asian and international financial center, with an inclusive and welcoming attitude towards financial innovation, and an open and inclusive attitude towards financial personnel engaged in virtual asset business. As stated by the Hong Kong Financial Services and Treasury (hereinafter referred to as the
Treasury), Hong Kong has a world-class financial infrastructure, legal and regulatory system, committed to promoting the sustainable development of financial services in all aspects of the virtual asset value chain. The Hong Kong government not only embraces the future development of finance and commerce, but also continues to support the development of virtual asset technology and social and economic benefits (2022).

In this context, based on factors such as providing sufficient risk warning and protection to investors, regulating the development of financial technology, and preventing virtual asset risks, the Hong Kong SFC is considering how to reasonably introduce virtual assets into the scope of its supervision, and making every effort to regulate to prevent global investors from suffering losses from illegal securities activities.

The regulatory targets of the Hong Kong SFC are participants and investors in the securities and futures markets, so regulated individuals need to obtain ten types of business licenses stipulated by the Hong Kong SFC before they can operate legally. According to the current provisions of the Securities and Futures Ordinance in Hong Kong, virtual assets can only be regulated by the Hong Kong Securities and Futures Commission if they meet the definition of "securities". If they do not possess the property of securities, they cannot be regulated under current regulations. On this basis, there are currently three types of regulatory targets for the Hong Kong Securities Regulatory Commission, which focus on securities tokens, namely the Central Virtual Asset Exchange, Virtual Asset Service Providers (VASPs), and Virtual Asset Fund Distributors.

1. Central Virtual Asset Exchange

Despite the decentralized nature of virtual currency, the current virtual asset exchange is still a centralized trading model, which matches buyers and sellers on a virtual platform and charges corresponding transaction fees. Due to the need for both trading parties to place orders on the central virtual exchange and store the trading subject matter in the accounts specified by the exchange, any risk arising from the exchange will result in asset losses for both trading parties. In November 2022, the bankruptcy of the FTX exchange due to runs and other reasons resulted in losses to a large number of investors' assets, forming a blow to various virtual assets and investors (Zaber Lawler, 2023). Therefore, it is necessary to include the central virtual asset exchange within the regulatory framework.

However, if the central virtual asset exchange does not operate tokens with securities attributes and only performs basic functions such as virtual currency exchange and trading, the Hong Kong Securities Regulatory Commission is still unable to directly supervise them according to current regulations. As an alternative, the Hong Kong SFC conveys unable to directly supervise them according to current regulations. If they do not possess the property of securities, they cannot be regulated under current regulations. Therefore, the current virtual asset exchange is still a centralized trading platform, which can only be regulated under current regulations. On this basis, there are currently three types of regulatory targets for the Hong Kong Securities Regulatory Commission, which focus on securities tokens, namely the Central Virtual Asset Exchange, Virtual Asset Service Providers (VASPs), and Virtual Asset Fund Distributors.

2. Virtual Asset Service Providers, VASPs

In May 2021, the Hong Kong Treasury released a consultation summary on the VASP licensing system, which is called balancing regulatory and development needs. In accordance with the requirements of the Financial Action Task Force (FATF) related to anti money laundering (AML) and anti-terrorism financing (CTF), companies providing virtual asset services are required to apply for a license from the Hong Kong SFC before they can operate.

The regulatory requirements for VASP are similar to those of the Hong Kong SFC for other licensed corporations, both of which have requirements for internal control, asset financial indicators, and user fund custody. The Hong Kong SFC believes that as a provider of investment trading services, its regulatory obligations should not be exempted or differentiated due to the financial innovation nature of its services.

3. Virtual Asset Fund Distributors

Traditional funds target financial products such as stocks and bonds, while virtual asset funds invest in virtual assets such as virtual currencies and NFTs. For distributors engaged in related virtual asset business, the Hong Kong SFC also requires them to operate under license.

3. Regulatory Requirements of Hong Kong SFC

As stated by the Secretary for the Treasury of Hong Kong, Xu Zhengyu, in terms of virtual assets, the Hong Kong government and regulators are unable to make a substantive judgment on whether this situation is a "flash in the pan" or a "milestone" in the current era of the proliferation of cryptocurrencies and the flourishing development of non-homogeneous token NFTs. Therefore, in order to balance regulation and development, Regulatory agencies need to act in protecting investors' interests and preventing money laundering and terrorist financing. Therefore, at present, the regulatory requirements of the Hong Kong SFC for virtual asset business are also focused on the above two aspects.

The services provided by regulated entities that operate on virtual assets are still financial services. Therefore, the overall regulatory principle of the Hong Kong Securities Regulatory Commission for the three types of regulated individuals and licensed corporations mentioned above is "same business, same risk, and same rules". Specifically, regulatory requirements related to investor protection mainly include protecting customer property, knowing your client (KYC), risk management, trust structure, and insurance; The regulatory requirements related to anti money laundering focus on combating money laundering and terrorist financing, preventing market manipulation and violations. (Qi Meng, 2020)

There are five regulatory requirements related to investor protection. One is the preservation requirements for customer property. Licensed corporations and regulated individuals need to take sufficient technical measures to ensure that customers' assets stored in them are protected in the same way as those stored in other financial institutions. The specific preservation measures are chosen by the licensed corporation based on its business model, which can be self-safeguarded by opening different accounts or entrusted to a third party for safekeeping. At the same time, licensed corporations need to have written internal policies and management procedures to ensure the safety and compliance of asset preservation.
The second requirement is to meet your customer (KYC). Identifying the identity, financial situation, investment ability, and experience of target customers is a key compliance preparation that licensed corporations engaged in virtual asset business need to focus on. Unlike traditional financial businesses that mostly do not impose restrictions on investors' investment ability and experience, based on the characteristics of virtual assets in the ascendant and sharp price fluctuations, currently only licensed corporations are allowed to handle business with qualified investors.

The third is risk management. Considering the strong volatility of virtual assets and the easy contagion of risks between various products, the Hong Kong SFC has imposed special requirements on the risk management capabilities of licensed corporations, including risk exposure limits with a single counterparty, to avoid extreme risks such as zero FTT value caused by the collapse of the FTX exchange from causing serious erosion of customer assets.

The fourth is the trust structure. For virtual asset trading platforms, they need to hold assets for customers through a company holding a trust license in accordance with regulatory requirements, to avoid the impact of the exchange on customers' assets during bankruptcy liquidation.

The fifth is insurance requirements. Just as banks need to insure accounts for depositors, virtual asset licensed corporations need to ensure their customer assets, covering both online and offline storage of customer assets.

There are two points related to the requirements of international regulatory agencies. One is to establish anti-money laundering (AML) and anti-terrorism financing (CTF) clauses in accordance with FATF requirements, requiring licensed corporations to manage risks through appropriate measures, including obtaining sufficient customer information, conducting fund transactions in Hong Kong recognized financial institutions or bank accounts, and conducting inquiries and evaluations of potential suspicious transactions. In fact, the anonymity of virtual assets makes it the best way to launder illegal and criminal business. Without necessary retention and judgment of customer information for transactions, the Hong Kong virtual asset market may become a transit point for illegal funds.

The second is to prevent market manipulation and other violations. The trading scale of a single product in the virtual asset market is still relatively small compared to financial products in traditional financial markets, so its price is more prone to extreme changes when facing huge capital flows or extreme information. For example, when mainland China announced that virtual currencies such as Bitcoin were illegal financial activities, the price of the world’s largest virtual currency, Bitcoin, experienced a significant decline in the short term. Therefore, for licensed corporations, measures such as determining transaction rules and conducting transaction monitoring can effectively identify market manipulation and other violations, ensuring the asset safety of small and medium-sized investors in the virtual asset market.

4. Regulatory Dilemmas Faced by Virtual Assets

Since 2017, the regulatory actions and systems of the Hong Kong SFC on virtual asset activities and related licensed institutions have set a model for other regulatory agencies, including the Monetary Authority of Singapore. However, Hong Kong's existing regulation of virtual assets still faces some difficulties, and it is still necessary to continue to improve the relevant legal supply and clarify relevant legal jurisdictional issues.

One is that regulation highly relies on licensed corporations that embrace regulation. According to the definition of securities in the Hong Kong Securities and Futures Ordinance mentioned earlier, if a virtual asset does not possess securities attributes, it does not constitute a regulatory object of the Hong Kong SFC. The so-called securities attribute refers to the ability of related virtual assets to appreciate and bring related economic benefits to investors.

At present, the regulation of virtual currency exchanges by the Hong Kong SFC relies on the "embrace regulation" of licensed corporations with the purpose of self-commitment enhancement. While trading platforms that may pose risks to the market can still conduct business in a dignified manner, the Hong Kong SFC can only provide moral advice to investors through announcements and other means.

Secondly, the restrictions on qualified investors can currently be easily circumvented. On the one hand, retail investors can still trade through unlicensed exchanges and other service providers, while on the other hand, even if licensed institutions make appropriate judgments on investors through strict means, similar to the threshold setting for qualified investors in mainland private equity funds, which can easily be bypassed. Hong Kong licensed institutions still cannot prevent. There is also a lack of motivation to prevent certain appropriate investors from investing as "representatives" of other investors.

Thirdly, Hong Kong's law enforcement system for virtual assets is not yet mature. In response to the violation of laws and regulations by general licensed institutions, the Intermediary Department of the Hong Kong SFC will refer the relevant situation to the Enforcement Department, and impose disciplinary penalties within the SFC or refer it to the Department of Justice for criminal prosecution based on the relevant situation. However, at present, virtual assets, especially emerging asset categories such as NFT, have feature developers and operators located overseas, and the likelihood of relevant personnel coming to Hong Kong for investigation by the Hong Kong SFC is extremely low. Therefore, it is difficult to prove that relevant personnel have violated local laws and regulations, and thus cannot protect the legitimate rights and interests of investors through legal means.

5. Enlightenment for Regulatory Agencies in Mainland China and Others

The regulatory attitude towards virtual assets in mainland China exhibits a significant "risk aversion" characteristic, choosing to prevent and control risks in the efficiency and financial risks brought about by financial innovation, while to some extent inhibiting financial innovation. The regulatory spirit, including the joint issuance of documents by five departments, has not endowed virtual assets, including digital currencies, with the asset attribute of legitimate wealth. Virtual assets, including private digital currencies and other non-homogeneous token NFTs, are considered illegal
financial activities in mainland China.

In the Hong Kong region, virtual assets in a broad sense are a relatively active and increasingly prosperous emerging financial asset class. Considering that the development prospects of virtual assets are still uncertain, in order to maximize the protection of local investors, the Hong Kong government has included virtual assets in the regulatory scope of the Hong Kong SFC. The regulatory targets include virtual asset exchanges, virtual asset service providers (VASPs), and virtual asset fund distributors, requiring them to review internal control systems, customer selection, asset custody, trading strategies, implement corresponding systems and strict requirements for anti-money laundering and anti-terrorism financing. By setting up "traffic lights" for virtual assets, financial regulation in Hong Kong has shown a shift in regulatory paradigms. By introducing talent, encouraging innovation, establishing fault tolerance, and setting bottom lines, multiple methods such as "trial and error" have been adopted to change the regulatory philosophy of passive response and risk avoidance. These can become the "pioneering experience" for financial regulatory agencies in mainland China and other regulatory authorities.

One is to comprehensively understand the potential value of virtual assets. Virtual assets are generated based on the development of multiple technologies, including blockchain technology, which to some extent meets the needs of investors worldwide for wealth management and the practical needs for more convenient trading channels. The positive regulatory philosophy and long-term regulatory awareness adopted by the Hong Kong Securities Regulatory Commission are a positive response to market behavior when investors have investment needs. Although the mainland's "zero tolerance" regulatory attitude towards virtual assets, including virtual currencies, has not yet had a significant impact in the short term, it has also given up the dividends of participating in world virtual asset transactions and abandoned its dominance in pricing rights, seigniorage, and other aspects. Specifically, if virtual assets develop into another pillar industry other than physical assets in the future and are widely developed in other countries and regions, it may be necessary for mainland China to adjust its strategies from "complete prohibition" to "moderate liberalization", so that the spontaneous behavior of the market can be subject to necessary supervision. On the one hand, it can better protect the legitimate rights and interests of mainland investors, and on the other hand, it can also increase channels for absorbing foreign investment. It is more conducive to the increase of RMB application scenarios and modes.

The second is to identify virtual assets through differentiation and regulate virtual asset services through legislation and other administrative behaviors. Although virtual assets possess the attributes and potential of currency, they still cannot replace the role of sovereign currencies such as the US dollar in the current international financial order and trade environment. They can only partially exercise the rights and interests of currency in limited scenarios and environments, and it is also difficult to fully undertake risk management functions like financial derivatives. Therefore, while recognizing the potential value of virtual assets, it is still necessary to standardize the definition of virtual assets from various aspects, including legislation, clarify the services they can provide, and formulate corresponding rules to refine the constraints on various aspects and participants of virtual asset services. Only by clarifying the boundaries of rights and responsibilities through legislative and administrative means can the financial attributes and trading capabilities of virtual assets be maximized, while achieving good protection for investors.

References


