

LCQ10: Trading of digital assets

Following is a question by the Hon Chan Kin-por and a written reply by the Secretary for Financial Services and the Treasury, Mr Christopher Hui, in the Legislative Council today (February 16):

Question:

It is learnt that in recent years, digital assets such as non-fungible tokens (NFTs) and virtual currencies have attracted the attention of quite a number of Hong Kong investors. This type of assets can be traded on quite a number of overseas online platforms. Owing to such assets' extremely volatile prices and their characteristics of anonymity and decentralisation, the trading of such assets is susceptible to being used by lawbreakers in the absence of regulation. In this connection, will the Government inform this Council:

(1) whether it has grasped the current situation of NFTs trading in Hong Kong; if so, whether it will publish the relevant information; if it will not publish such information, of the reasons for that;

(2) of the trend in the past three years in respect of those crimes involving NFTs and virtual currencies;

(3) whether it has plans to regulate the trading of NFTs to prevent such trading from becoming tools for money laundering and terrorist financing; if so, of the details; if not, the reasons for that; and

(4) whether it will actively take measures to raise public vigilance against the risks involved in trading digital assets such as NFTs and virtual currencies; if so, of the details; if not, the reasons for that?

Reply:

President,

In recent years, trading of "virtual assets" (VA) has increased significantly. For all the potential of VA, such transactions also pose money laundering and terrorist financing risks to the international financial system due to the anonymity and decentralised nature. As the inter-governmental organisation responsible for setting international standards for combating money laundering and terrorist financing, the Financial Action Task Force (FATF) added a new standard in 2019, requiring member jurisdictions to take measures to regulate VA service providers and monitor their compliance with anti-money laundering and counter-terrorism financing measures. As a member of the FATF, Hong Kong should also establish a regulatory regime for VA service providers, and the Government has therefore proposed to set up a licensing regime for VA service providers by amending the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615).

In this regard, we consulted the public on the proposed regulatory regime for VA service providers from November 2020 to January 2021, and published the consultation conclusion in May 2021. Based on the views gathered from the public consultation, we are preparing legislative amendments with the aim of introducing the amendment bill to the Legislative Council in the second quarter of this year. Moreover, the Hong Kong Monetary Authority (HKMA) issued in January 2022 a discussion paper on cryptocurrencies and stablecoins, setting out the HKMA's thinking on the regulation of payment-related stablecoins and inviting views from the industry and public.

After consulting the Securities and Futures Commission (SFC), the HKMA and the Police, my reply to the Hon Chan's question is as follows:

(1) & (2) According to Police statistics, in the past three years (i.e. 2019, 2020 and 2021), the total number of crimes related to VA were 360, 494 and 1 397 respectively, involving funds of approximately \$33 million, \$114.4 million and \$824.1 million respectively. However, it should be pointed out that among the above-mentioned figures, quite a large number of cases (40 per cent for 2021) only involved the perpetrators mentioning VA without involving actual trading of VA.

As for "non-fungible tokens" (commonly referred to as "NFTs"), the Police has not received any cases involving "non-fungible tokens" in the past three years. The SFC and the HKMA do not maintain figures on the trading of "non-fungible tokens".

(3) Considering the rapidly changing landscape of VA, the FATF has recommended in its guidelines that, for the purpose of regulation, VA should be defined using a functional approach. Accordingly, under the proposed licensing regime for VA service providers, the Government has proposed to define VA having regard the definition adopted by the FATF which will require that the asset must be a medium of exchange accepted by the public for payment, settlement of debts or investment, and that it can be transferred, stored or traded electronically. Any VA, so long as it meets the definition and does not fall into the exempted categories to be specified in the Ordinance (e.g. digital currency issued by central bank, airline miles, credit card rewards, etc. that are closed-loop and limited use tokens that cannot be transferred, traded or exchanged), will be covered in the definition of VA.

There is currently no universally recognised definition of "non-fungible tokens". In fact, some "non-fungible tokens" may be used for collection purposes, while others may be linked to other assets (even securities). Therefore, in line with the functional approach adopted by the FATF, whether a "non-fungible token" is covered by the proposed VA service provider licensing regime will depend on its specific terms and characteristics.

(4) On public education, as VA are highly speculative and may involve fraud, security breach and market manipulation, it will also bring challenges in

respect of investor protection. In this regard, the proposed licensing regime for VA service providers will include elements that can address investor protection considerations. At the same time, the Government and regulatory agencies have been strengthening public education through different channels. For example, through the "the Chin Family" platform of the Investor and Financial Education Council (IFEC), educational articles and infographics are used to make it easier for the public to understand the characteristics and risks of VA. In May 2021, the IFEC published an article on "non-fungible tokens" to explain its characteristics, valuation and risks involved.

In addition, the SFC has also reminded investors of the risks of trading VA through statements and circulars from time to time, including for instance a statement issued in July 2021, reminding investors that when investing in VA, they should pay attention to the use of unregulated trading platforms. The SFC and the HKMA have also issued circulars to the banking and securities sectors to give guidance on the arrangements for intermediaries in the banking and securities sectors to provide VA-related services.