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JPEX Is Test Case for Hong Kong's New Regulatory Regime for Virtual Asset Exchanges

Hong Kong regulators recently brought criminal enforcement actions against virtual asset trading platform JPEX and individuals associated with the platform. This case has become the first opportunity for local authorities to clarify how to apply Hong Kong's new cryptocurrency regulations, especially as they relate to licensing requirements.

Virtual asset exchanges operating in Hong Kong or targeting Hong Kong investors would be well advised to follow these developments closely.

Background

Hong Kong introduced its new licensing regulatory regime for virtual asset trading platforms on June 1, 2023. The new regulations allow such platforms, in particular centralized platforms that use an automated trading engine to match client orders and provide custody services, to offer trading services to both institutional and retail investors, with the following licensing requirements:

- For securities trading: Must obtain licenses under the Securities and Futures Ordinance (SFO) and the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (AMLO).
- For non-securities trading: Must obtain a license under AMLO.

However, Hong Kong's Securities and Futures Commission (SFC) advises that virtual asset trading platforms — without regard to whether they offer trading in securities — should apply for licensing under both regimes to ensure compliance with the new regulations. This is especially important given the evolving features of most virtual assets — that a non-security token may later evolve into and thus be reclassified as a security token. Failure to obtain a license is a criminal offense.

Licensed platforms are subject to certain regulatory requirements, such as safe custody of client assets, internal controls, know-your-client (KYC) and other client onboarding requirements, criteria for admitting virtual assets for trading, due diligence on tokens and disclosures, and insurance and compensation arrangements.

The JPEX Fraud Case

In September 2023, the SFC accused JPEX of engaging in suspicious practices and making misleading claims about its licensing status.

According to the SFC, JPEX actively promoted its services and products to the public through social media influencers and over-the-counter crypto exchange shops (OTC shops) while operating without a license for virtual asset trading. In particular, JPEX claimed that it had obtained licenses from certain overseas regulators, and certain influencers and OTC shops suggested that JPEX had submitted a licensing application with the SFC. However, these statements were allegedly false because, according to the SFC, JPEX had not, in fact, been licensed anywhere and had not made any licensing application with the SFC. Furthermore, the SFC and the Hong Kong Police Force received complaints from retail investors who were unable to withdraw their virtual assets from their JPEX accounts and, in some cases, saw their account balances reduced.

As a result of the alleged misconduct, several OTC shops were shut down; at least 36 people were arrested, including certain JPEX officers and directors, JPEX employees and social media influencers who assisted JPEX in promoting its products; and more than 2,500 customers were adversely affected.

According to the SFC, JPEX had been on its radar since March 2022, when the SFC began to make inquiries about the platform's suspected false and misleading representations and unlicensed activities. JPEX was allegedly uncooperative.

Following the JPEX incident, the SFC has begun publishing the names of virtual asset trading platforms with valid licenses and those that have applied for licensing with the SFC.

Regulatory Hurdles

Jurisdictional Questions

Even with the new licensing regulations, Hong Kong regulators face challenges in asserting jurisdiction over foreign cryptocurrency exchanges. Under the current regulatory regime, all virtual asset trading platforms that "carry on business" in Hong Kong or "actively market" products or services to Hong Kong investors must be licensed under the SFO or the AMLO, or both. However, even if a foreign virtual asset trading platform is subject to the SFC's jurisdiction, it may be difficult for Hong Kong regulators to institute enforcement actions against the exchange if it does not have any offices, employees or assets in Hong Kong.

For example, in September 2017, ETRADE Securities (Hong Kong) Limited (ETrade H.K.), an e-platform that offers stocks and futures trading services, was convicted for actively marketing to the Hong Kong public brokerage services provided by its overseas parent company E*TRADE Securities LLC (ETrade U.S.). While ETrade H.K. was licensed under the SFO, ETrade U.S. was not. ETrade H.K. was convicted of aiding and abetting ETrade U.S. in violating the SFC's licensing requirements and fined HK$20,000 (about US$2,500). However, the SFC did not seem to have initiated any enforcement actions against ETrade U.S.

DeFi Activities

Another challenge the Hong Kong regulators face is regulating decentralized finance (DeFi) activities. In 2019, when the SFC first introduced an initial regulatory framework for virtual asset trading platforms, it explicitly stated that it would "not accept licensing applications from platforms which only provide a direct peer-to-peer marketplace for transactions by investors who typically retain control over their own assets."

However, this stance has changed over time, and in April 2023, the SFC noted in a public speech that, so long as a decentralized virtual asset trading platform's activities fall within the scope of the SFO, they would be subject to the same regulatory requirements as applicable to the centralized platforms under the "same business, same risks, same rules" principle.

One key challenge in regulating decentralized platforms is identifying the appropriate target subject to regulation. Unlike centralized trading platforms, which serve as an intermediary between buyers and sellers, where the SFC can easily identify the controlling body to be held accountable, "decentralized" protocols are structured in such a way that regulators may have a difficult time identifying any central intermediary subject to regulations. Instead, users transact through the protocol on their own, with their interactions governed by smart contracts, which are pieces of self-executing code and protocols that automate transactions on a decentralized ledger. In addition, some developers issue governance tokens to DeFi product users, allowing ordinary token holders to vote on product changes or new features — thus potentially making it more challenging for regulators to hold anyone accountable.

Recognizing that "some DeFi protocols may be decentralized in name only" but "in reality, a small group of developers, operators or their related parties may be in de facto control," the SFC noted that in determining the responsible intermediary or entity for any misconduct, it will "assess each DeFi service or activity on a case-by-case basis after understanding the inner workings and arrangements of a DeFi protocol."

Finally, because decentralized platforms typically do not take custody of or exert control over investors' assets, it is difficult to impose enhanced KYC procedures on these platforms to identify suspicious transactions or wallets.

Other Potential Challenges

Derivatives. Trading derivatives on virtual asset platforms is currently prohibited, although the SFC acknowledged the importance of digital asset derivatives to institutional investors and noted that it will revisit this topic "in due course."

Stablecoins. Similarly, trading stablecoins (such as USDT) is prohibited in Hong Kong, primarily because regulators are still developing and debating a regulation strategy. The Hong Kong Monetary Authority, which regulates stablecoins in Hong Kong, is expected to introduce a regulatory regime for stablecoins as early as 2024.

Conclusion

In the wake of the JPEX fraud case, Hong Kong authorities have initiated several regulatory measures. In early October 2023, the Hong Kong Police established a special working group to target virtual asset-related crimes in collaboration with the SFC. The SFC also recently published its "watchlist" of "suspicious platforms," which "have come to the attention of the SFC because they are unlicensed in Hong Kong and are believed to be, or have been, targeting Hong Kong investors."

Foreign virtual asset exchanges that may have Hong Kong touchpoints, including those platforms whose marketing materials are accessible to Hong Kong investors, should closely monitor these regulatory developments.

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