

SFC's consultation conclusions on the new dual licensing regime for virtual asset trading platform operators

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Since our [Legal Update](#) of 25 April 2023, the new dual licensing regime under the Securities and Futures Ordinance (Cap. 571) (the "SFO") and the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) (the "AMLO") for operators ("VATP Operators") of centralised virtual asset ("VA") trading platforms ("VATPs") carrying on their businesses in Hong Kong, or actively marketing their services to Hong Kong investors, came into effect on 1 June 2023.

To recap:

- under the SFO regime, centralised VATP Operators providing trading services in security tokens using an automated trading engine which matches client orders and also providing custody services as an ancillary service to their trading services are required to obtain licences for Type 1 (dealing in securities) and Type 7 (providing automated trading services) regulated activities;
- under the new AMLO regime, centralised VATP Operators providing trading services in non-security tokens using an automated trading engine which matches client orders and also providing custody services as an ancillary services to their trading services are required to obtain a licence for "providing a VA service" (i.e. operating a VA exchange). In other words, over-the-counter VA trading activities and VA brokerage activities would not fall under the scope of the AMLO regime; and
- the Securities and Futures Commission (the "SFC") has indicated that it would be prudent for VATP Operators (including their proposed responsible officers and licensed representatives) to apply for approvals under both the SFO regime and the new AMLO regime given the constantly evolving terms and features of VAs. The SFC is prepared to adopt a pragmatic approach in handling dual licence applications. For instance, an individual may concurrently be approved as a responsible officer of a licensed VATP Operator under both regimes.

In preparation for this new dual licensing regime, the SFC published its [Consultation Conclusions on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the Securities and Futures Commission](#) (the "Consultation Conclusions") on 23 May 2023 in respect of the regulatory requirements applicable to VATP Operators.

In addition, the following was published for the new regime:

Guidelines	1.	Guidelines on Virtual Asset Trading Platform Operators (June 2023) (the "VATP Guidelines")
	2.	Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (For Licensed Corporations and SFC-licensed Virtual Asset Service Providers) (revised June 2023)
	3.	Prevention of Money Laundering and Terrorist Financing Guideline issued by the SFC for Associated Entities of Licensed Corporations and SFC-licensed Virtual Asset Service Providers (revised June 2023)
	4.	SFC Disciplinary Fining Guidelines (1 June 2023)
	5.	Scope of External Assessment Reports (June 2023)
Circulars	6.	Circular on implementation of new licensing regime for virtual asset trading platforms (31 May 2023)
	7.	Circular on transitional arrangements of the new licensing regime for virtual asset trading platforms (31 May 2023)
Licensing handbook	8.	Licensing Handbook for Virtual Asset Trading Platform Operators (June 2023)
FAQs	9.	FAQs on licensing related matters
	10.	FAQs on conduct related matters

Consultation Conclusions on the VATP Guidelines

Below is a summary of the key revisions to the proposed regulatory requirements for VATP Operators under the VATP Guidelines as set out in the Consultation Conclusions, together with the SFC's clarifications on certain issues after taking into consideration comments from the public:

Key revisions and clarifications by the SFC

Retail access

The SFC confirmed that licensed VATP Operators are allowed to serve both professional and retail investors, provided that they comply with a range of robust investor protection measures including:

- **Onboarding requirements:** The SFC maintained that all investors, except institutional professional investors and qualified corporate professional investors, are subject to onboarding requirements. The onboarding requirements applicable to individual professional investors will be the same as those applicable to retail investors. In line with the existing requirements regarding derivatives knowledge assessment and suitability obligations, the SFC emphasised that it is vital to:
 - ensure suitability in the onboarding of an investor, which includes an assessment of the investor's risk tolerance; and
 - ensure that the investor has sufficient knowledge of VAs before trading is allowed by conducting a holistic assessment of the investor's understanding of the nature and risks of VAs, including an assessment of (a) VA training or courses attended by the investor; (b) the investor's prior trading experience in VAs; and (c) the investor's work experience related to VAs.

The SFC will provide further guidance on such onboarding requirements by way of FAQs, such as how to assess an investor's risk tolerance and exposure to VAs. Further, the SFC considers it inappropriate for it to prescribe exposure limits for investors given that VATP Operators (not the SFC) would be in the best position to impose such limits which take into account information obtained from their know-your-client process.

- **Disclosure obligations:** To address the public's concerns about the potentially onerous burden of ensuring the accuracy of the product information that licensed VATP Operators are required to disclose, the SFC refined the disclosure requirements in the VATP Guidelines to require licensed VATP Operators to "*take all reasonable steps*" to ensure the product information they disclose is not false, biased, misleading or deceptive, and amended the list of information requiring disclosure. In other words, licensed VATP Operators are required to act with due skill, care and diligence when disclosing product information.
- **Governance:** In respect of the requirement for licensed VATP Operators to set up a token admission and review committee, the SFC clarified that members from senior management "*principally responsible for*" managing the key business line, compliance, risk management and information technology should at least include the corresponding managers-in-charge ("**MIC**") of the VATP Operators. The SFC will issue guidance in the form of FAQs on this MIC regime to augment accountability of the senior management of VATP Operators. Further, VATP Operators should implement internal policies and procedures to deal with any possible conflicts of interest involving committee members and the relevant VATP Operators. Provided that adequate internal policies and procedures are in place, it would not be necessary to appoint independent external members to the committee.
- **Token due diligence and admission criteria:** The SFC has revised the proposed due diligence requirements to be more principle-based and will supplement by way of FAQs. In particular, the SFC stressed that when selecting VAs to be made available for trading, the underlying principle is that licensed VATP Operators should exercise due skill, care and diligence through conducting all reasonable due diligence. Amongst other things, when conducting due diligence on each VA before admission for trading:
 - instead of requiring a licensed VATP Operator to consider the VA's regulatory status in each jurisdiction in which the VATP Operator provides trading services, the SFC merely requires the VATP Operator to consider the regulatory status of the VA in Hong Kong;
 - the licensed VATP Operators should consider whether a non-security VA has at least a 12-month track record;
 - in respect of the requirement to conduct a smart contract audit, the SFC clarified that licensed VATP Operators are only expected to engage an independent assessor or, where reasonable, to rely on an audit conducted by an independent assessor engaged by another party (e.g. the issuer), and as such, the SFC changed "*independent auditor*" to "*independent assessor*" in the VATP Guidelines;

	<ul style="list-style-type: none"> ➤ contrary to what was previously proposed, licensed VATP Operators need not submit a written legal advice to the SFC confirming that each of the VAs made available for trading by retail clients does not fall within the definition of "securities" under the SFO. However, the SFC noted that it may still request legal opinions on specific tokens in light of developments in other jurisdictions as part of its approval process; and ➤ VAs eligible for trading by retail investors must meet additional minimum criteria (i.e. the specific criteria applicable to retail investors only). That is, the licensed VATP Operators should ensure that the VA is eligible large-cap VAs, i.e. the specific VA should be included in at least two acceptable indices issued by two different independent index providers. One of the index providers is required to have experience in publishing indices for the conventional securities market complying with the International Organization of Securities Commissions (IOSCO) Principles for Financial Benchmarks, and the index providers are required to be independent of each other, and independent of the VA issuer and the licensed VATP Operator. • Stablecoins: The SFC maintained that stablecoins should <u>not</u> be admitted for retail trading before any regulatory arrangements governing stablecoins are in place. In this connection, the Hong Kong Monetary Authority has published the Conclusion of Discussion Paper on Crypto-assets and Stablecoins in January 2023, and it is anticipated that the regulatory arrangements for stablecoins will be implemented in 2023/24. • Investor protection: The SFC made it explicit in the VATP Guidelines that licensed VATP Operators would be prohibited from offering gifts (other than discounts of fees or charges) to their clients for the trading of VAs. The SFC also considered that imposing a cooling-off period after a trade is not practicable for automated trading services where VA trades are matched between clients as unwinding or cancelling a transaction would affect another client.
Insurance / compensation arrangements	<p>In light of the different views on the most appropriate level of coverage to cover potential loss and the SFC-approved compensation arrangements, the SFC confirmed that:</p> <ul style="list-style-type: none"> • Coverage threshold: Client VAs held in cold storage would be subject to a 50% coverage threshold (as opposed to the previously proposed threshold of 95%), on the basis that 98% of client VAs would be required to be held in cold storage, whilst client VAs held in hot storage and other storages would be subject to a full 100% coverage threshold. • Compensation arrangement: The types of assets that could form part of an SFC-approved compensation arrangement include: <ul style="list-style-type: none"> ➤ third-party insurance; ➤ funds (held in the form of a demand deposit or time deposit which will mature in 6 months or less) or VAs of the VATP Operator (or any corporation within its group). Such funds or VAs forming part of the compensation arrangement must be set aside on trust and segregated from (a) the other assets or VAs of the VATP Operator and its associated entity (which is defined in the VATP Guidelines to mean a wholly owned subsidiary of a VATP Operator subject to certain requirements) and group companies; and (b) any client assets or client VAs. In addition, the funds forming part of the compensation arrangement should be held in a segregated account with an authorized financial institution, and the VAs forming part of the compensation arrangement should be held in cold storage by VATP Operator's associated entity; and ➤ bank guarantees provided by an authorized financial institution in Hong Kong.
Custody of client VAs	<ul style="list-style-type: none"> • Custodian of client VAs: In response to the SFC's earlier proposal that the custodian of client VAs must be an associated entity (which is defined in the VATP Guidelines to mean a wholly owned subsidiary of a VATP Operator subject to certain requirements), many respondents suggested that third-party custodians should be permitted to safekeep client VAs given their extensive technical expertise. However, the SFC maintained its original position that the use of third-party custodians is not allowed as there is currently no regulatory regime in Hong Kong for custodians of VAs. The SFC would prefer having a "<i>direct regulatory handle</i>" over the firm exercising control of client VAs (i.e. custody to be undertaken by a wholly-owned subsidiary of a licensed VATP Operator).

	<ul style="list-style-type: none"> • Safe custody in Hong Kong: For the same reason, the SFC requires all seeds and private keys holding client VAs to be securely stored in Hong Kong with appropriate certification (such as Hardware Security Module), noting that if they were stored overseas, this would substantially hinder the SFC's supervision and enforcement efforts. • New custodial technologies: The SFC will continue to monitor the developments of new custodial technologies such as multi-party computation and key sharding. • Cold to hot storage ratio: To ensure safe custody of client assets, the SFC maintains that the cold to hot storage ratio of 98% to 2% should not be lowered.
Trading in VA derivatives	The SFC confirmed that licensed VATP Operators would <u>not</u> be permitted to offer VA futures contracts or related derivatives at the current stage but will conduct a separate review in due course.
Proprietary trading	The SFC maintained that licensed VATP Operators are prohibited from engaging in proprietary trading in VAs for its own account or any account in which it has an interest (which is all encompassing and effectively prohibits even the group companies of a licensed VATP Operator from having any positions in VAs), except for off-platform back-to-back transactions entered into by the licensed VATP Operators and other circumstances permitted by the SFC on a case-by-case basis. However, it agreed that liquidity on VATPs is important for clients and noted that third-party market makers are allowed to conduct market making activities. In the circumstances, it revised the requirements in the VATP Guidelines to allow trading by affiliates other than trading through the licensed VATP Operators themselves.
Algorithmic trading	The SFC clarifies that while licensed VATP Operators are prohibited from providing algorithmic trading services to clients, clients can use their own algorithmic trading systems in connection with trading via the licensed VATPs.
Provision of VA related services only	A licensed VATP Operator's primary business is to act as an agent and provide an avenue for the matching of orders between clients. Other activities commonly seen in the VA market such as earning, deposit-taking, lending and borrowing may lead to potential conflicts of interest and require additional safeguards. Accordingly at this stage, the SFC does not allow licensed VATPs to conduct these other activities.

Consultation Conclusions on the Disciplinary Fining Guidelines

The SFC has clarified that all VATP Operators will be subject to the same fining criteria regardless of whether they are licensed under the SFO or the AMLO. Further, in rejecting the suggestion that fines should be determined with reference to the total annual turnover of a VATP Operator, the SFC stated that it will continue to determine quantum based on the statutory requirement in the AMLO that a fine should not exceed the higher of HK\$10 million or three times the profit gained or loss avoided.

Further practical guidance from the SFC

As noted above, we anticipate that the SFC will provide further guidance on certain practical aspects (such as onboarding requirements, the MIC regime, token due diligence requirements etc.) of the new regulatory framework for VATP Operators by way of FAQs and Circulars. The SFC has already indicated that it will revise the [Joint Circular on Intermediaries' Virtual Asset-related Activities](#) (together with its [appendices](#)) to set out the regulatory requirements applicable to intermediaries engaging in VA-related activities so as to maintain coherence and consistency between the different VA-related regulatory frameworks administered by the SFC, and will issue additional guidance in relation to security tokens in due course.

We will continue to monitor developments in the VA regulatory landscape and provide further updates.

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