

Hong Kong SFC Consults on Proposed Regulatory Requirements for Hong Kong's new Virtual Asset Service Provider Regime

On 20 February 2023, the Securities and Futures Commission of Hong Kong (SFC) published a [Consultation Paper](#) on the proposed regulatory requirements for virtual asset (VA) trading platform operators licensed by the SFC (SFC Hong Kong VASP Consultation Paper) in preparation for the new licensing regime for centralised VA trading platforms for the trading of non-security tokens which is set to come into effect on 1 June 2023. For more details of the law relating to the new licensing regime for Hong Kong VASPs, please see Charltons newsletter [Hong Kong Licensing Regime for Virtual Asset Exchanges to Take Effect on 1 March 2023](#).

SFC Consultation on Hong Kong Licensing Regime for Virtual Asset Exchanges

To regulate centralised VA trading platforms in Hong Kong and to adopt the standards promulgated by the Financial Action Task Force (FATF) on virtual asset service providers (VASPs), the HKSAR Government published a consultation document in November 2020 to seek views on legislative proposals to introduce a new licensing regime for VASPs under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615 of the Laws of Hong Kong) (AMLO). See Charltons newsletter [FSTB Consults on Proposed Licensing Regime for Virtual Asset Exchanges](#). Following the conclusion of such consultation, the HKSAR Government tabled before the Hong Kong Legislative Council the Anti-Money Laundering and Counter-Terrorist Financing (Amendment) Bill 2022 in July 2022, which was subsequently passed in December 2022 to regulate Hong Kong VA trading platforms which trade non-security tokens. See Charltons newsletter [Hong Kong Legislative Council delays the Implementation Timetable of the Hong Kong Virtual Asset Service Provider Regime and the Hong Kong Securities and Futures Commission Statement on Virtual Assets](#).

“Licensed VA trading platform operator” is defined by the SFC as a corporation which is granted a licence for Type 1 (dealing in securities) and Type 7 (providing automated trading services) regulated activities under section 116 of the Securities and Futures Ordinance (SFO) and/or a corporation which is granted a licence for providing a VA service under section 53ZRK of the AMLO,¹ which carries out any relevant activities.² Under the new licensing regime, on commencement of the AMLO VASP regime on 1 June 2023, all VA trading platforms carrying on business in Hong Kong or actively marketing their services to Hong Kong investors will need to be licensed by the SFC (unless they are a pre-existing VA trading platform which is eligible for transitional arrangements). It is also proposed that VA trading platforms licensed by the SFC must comply with the [Guidelines for Virtual Asset Trading Platform Operators \(VATP Guidelines\)](#) (set out in Appendix A to the SFC Hong Kong VASP Consultation Paper) which are based on, and will supersede, existing regulatory requirements applicable to SFO-licensed platform operators (particularly, the Terms and Conditions for VA Trading Platform Operations (VATP Terms and Conditions)). Such guidelines contain requirements including ensuring safe custody of client money and virtual assets (including secure generation of cryptographic seeds and keys); Know-Your-Client obligations; management of AML/CFT risks through appropriate policies; management of conflicts; admission criteria for virtual assets, prevention of market manipulation and abusive activities, risk management and proper accounting and audit functions.

The SFC Hong Kong VASP Consultation Paper (i) consults on certain regulatory requirements under the VATP Guidelines (set out in Part I of this newsletter) which are proposed additions or variations to the current requirements under the VATP Terms and Conditions. Importantly, the SFC is seeking views on whether retail investors should be allowed access to the services of licensed VA trading platforms for the trading of virtual assets; and (ii) seeks to provide more details on transitional arrangements and implementation in preparation for the coming into effect of the AMLO VASP regime.

Key Proposed Regulatory Requirements for Hong Kong Licensed VA Trading Platform Operators

A. SFC's proposal to allow retail access to Hong Kong licensed VA trading platforms

Previously, the SFC had considered that it would be prudent to restrict SFO-licensed VA trading platforms to professional investors only. Since then, the SFC states that it has observed diverse views as to whether retail investors should be allowed access to the services of licensed VA trading platforms, noting that trading of virtual assets may be subject to higher volatility and more prone to market manipulation given the absence of actual intrinsic value on the one hand, but the lack of access may, on the other hand, push retail investors to trade on easily accessible unregulated VA trading platforms online (such as FTX), which may offer limited recourse in the event of any collapse.

The SFC also noted that the virtual asset market has continued to develop over time and more global financial institutions and service providers have entered the space to provide institutional-grade infrastructure and it appears that policies and procedures, systems and controls comparable to those in mainstream finance are gradually being adopted with the entry of financial institutions. Retail investors now have limited access to regulated virtual asset-related derivative products and authorised funds.

Based on these developments, the SFC proposes that, and seeks public views as to whether, licensed VA trading platform operations should be allowed to provide their services to retail investors, subject to robust investor protection measures which are proposed in the SFC Hong Kong VASP Consultation Paper, as further discussed below.

(I) Hong Kong VASP requirements prior to onboarding retail investors

Under the proposed measures, in addition to the existing knowledge assessments required to be conducted on investors prior to provision of services, Hong Kong VA trading platform operators offering services to retail investors must ensure suitability of services by (i) assessing the client's risk tolerance level and risk profile in determining their suitability for participation in virtual asset trading;³ and (ii) requiring operators to set a reasonable exposure limit for clients based on their financial situation and personal circumstances.⁴

(II) Requirements concerning governance of Hong Kong licensed VA trading platform operators

It is proposed that Hong Kong licensed VA trading platform operators should set up a token admission and review committee (consisting of members of senior management responsible for the key business line, compliance, risk management and information technology) which would be responsible for, inter alia, establishing, implementing and enforcing (i) the criteria for admitting as well as halting, suspending and withdrawing virtual assets from trading, and making decisions in connection therewith accordingly; and (ii) the rules regarding the issuer's obligations and restrictions. The relevant criteria and rules are to be reviewed regularly by the committee.

It is proposed that the token admission and review committee would report to the board of directors of the Hong Kong VASP at least monthly, the details of the virtual assets made available for trading for retail clients. The Hong Kong licensed VA trading platform operators should monitor each of the virtual assets admitted for trading and ensure that review reports are regularly submitted to the committee. In the event of any halt, suspension or withdrawal of a virtual asset from trading, clients should be informed of the options available to them and should be fairly treated.⁵

(III) Hong Kong VA Token due diligence and admission criteria

General Hong Kong VASP token admission criteria

The SFC proposes to introduce a set of objective criteria for Hong Kong licensed VA trading platform operators to follow when determining whether to make a specific virtual asset available to retail clients, and operators should conduct reasonable due diligence to ensure such criteria are met prior to their admission to trading and are monitored on an ongoing basis following admission. The factors which should be considered (which are not intended to be exhaustive) as proposed in the SFC Hong Kong VASP Consultation Paper include, *inter alia*:

- the background of the management or development team of the virtual asset;
- the regulatory status of the virtual asset in each jurisdiction in which the operator provides trading services;
- the supply, demand, maturity and liquidity of a virtual asset;
- the technical aspects of the virtual asset, including security infrastructure of blockchain protocol, type of consensus algorithm, etc.;
- quality of relevant marketing materials used by the issuer of the virtual asset;
- market (including concentration risk) and legal risks associated to the virtual asset.⁶

Specific token admission criteria – the relevant virtual asset must be an “eligible large-cap virtual asset”

In addition to the general token admission criteria, Hong Kong licensed VA trading platform operators offering trading services for retail investors must ensure that the virtual assets involved satisfy the specific token admission criteria that they are an “eligible large-cap virtual asset”.

“Eligible large-cap virtual assets” are virtual assets that are included in at least two acceptable indices issued by two independent index providers,⁷ where an “acceptable index” is an index with clear objectives to measure the performance of the largest virtual assets (e.g. one which measures the top 10 largest virtual assets) which is investible (sufficiently liquid), objectively calculated and rules-based, and its methodology and rules should be transparent and well-documented.

Clearly, Bitcoin and Ethereum would currently be considered to be such “eligible large-cap virtual assets”, whilst many others may not. Licensed VA trading platform operators are expected to evaluate whether to consider facilitating the trading of virtual assets to retail investors where an admitted virtual asset falls outside of an acceptable index; in particular, where this was caused by adverse events.

The SFC is consulting the public in connection with the above proposed general and specific Hong Kong VASP token admission criteria.

Other Hong Kong token due diligence requirements

Hong Kong licensed VA trading platform operators are required to conduct reasonable due diligence on virtual assets before admitting them for trading as well as continue to monitor the admitted virtual assets to ensure ongoing compliance with token admission criteria.

In addition, the operators must: (i) ensure their own internal controls, systems, and technology can support and manage any risks associated with the virtual asset; (ii) conduct smart contract audit for virtual assets based on blockchains with a smart contract layer (unless already conducted by an independent auditor it may rely on); and (iii) submit a legal opinion or memorandum to the SFC confirming that the virtual asset does not fall under the definition of “securities” under the SFO.⁸

(IV) Hong Kong licensed VA trading platform operator disclosure obligations

As part of their disclosure obligations, Hong Kong licensed VA trading platform operators are expected to provide clients with adequate product information to enable them to evaluate their investments including, *inter alia*, price and trading volume of virtual assets on the platform; information about the management team or developer; issuance date and terms and features of virtual assets; and links to the virtual asset’s official website and smart contract audit report (if any). Additionally, the platform operator should clarify how voting rights will be handled for assets with such rights.⁹

B. Trading in virtual asset derivatives

Under the existing SFO regime, Hong Kong licensed VA trading platform operators are not currently allowed to offer, trade or deal in virtual asset futures contracts or related derivatives. However, the SFC acknowledges that there has been increasing interest in virtual asset derivative products, particularly among institutional investors, including for hedging of risks. Therefore, the SFC would like to consult the public on the type of business models and virtual asset derivatives that licensed platform operators may offer first, as well as market demand, which will form the basis for subsequent formulation of relevant policies concerning trading in virtual asset derivatives.

C. Other adaptations to existing requirements to be incorporated into the VATP Guidelines

The SFC proposes to make the following adaptations of existing requirements imposed on SFO-licensed platform operators (including the VATP Terms and Conditions) when incorporating the same into the VATP Guidelines:

- the requirement for security tokens to be (i) asset-backed; (ii) approved or registered for trading in comparable jurisdictions; and (iii) have a 12 months post-issuance track record, will not be incorporated, but rather replaced by the general token admission criteria and (to be published by the SFC in due course) the guidance on distributing security tokens¹⁰;
- platform operators would no longer be required to provide a written legal opinion or memorandum on virtual assets unless they are made available to retail clients;
- platform operators are only required to disclose how they will handle voting rights rather than require their facilitation of such exercise;
- to include exceptions to the proprietary trading requirement whereby platform operators would be permitted to conduct back-to-back transactions off-platform or in prescribed circumstances approved by the SFC;
- where virtual assets are made available to professional investors only, licensed platform operators will only need to notify the SFC in advance of any plans to add or remove such products from their trading platform. However, where virtual assets are made available to retail clients, platform operators are required to seek the SFC's approval before admitting them for trading.

The SFC seeks comments from the public as to how to enhance other requirements in the VATP Terms and Conditions when they are to be incorporated into the VATP Guidelines.

D. SFC's proposed requirements for insurance/compensation arrangements

The SFC proposes to modify the current insurance requirements applicable to SFO-licensed operators (which requires them to maintain at all times an insurance policy covering the risk associated with the client virtual assets held in hot storage (full coverage) and cold storage (substantial, up to 95%, coverage)) given the practical difficulties in obtaining insurance for hot storage based on commercially sustainable premiums. It is proposed that:

- a licensed platform operator should be required to establish a compensation arrangement approved by the SFC providing an appropriate level of coverage for risks associated with the custody of client virtual assets. This arrangement can consist of third-party insurance and funds set aside on trust by the operator or a corporation in the same group of companies as the operator;¹¹
- a licensed platform operator shall monitor the total value of client virtual assets under its custody on a daily basis. If the licensed platform operator becomes aware that the total value of virtual assets exceeds the approved compensation coverage amount, and this situation is expected to persist, it must inform the SFC and take prompt remedial action;
- to satisfy the compensation requirements, licensed platform operators can use their own funds or funds of a corporation within its same group of companies, but these funds must be held on trust and designated for that purpose. The funds should also be segregated from the assets of the licensed platform operator, its related entity, or any corporation in the same group of companies as the operator.

The SFC is consulting the public on the above proposed insurance and compensation arrangements, as well as any other proposed options and technical solutions to mitigate risks associated with taking custody of client virtual assets.

E. Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (For Licensed Corporations and SFC-licensed Virtual Asset Service Providers)

Under the new regime, Hong Kong licensed VA trading platform operators would be required to follow additional virtual asset-specific AML/CFT requirements to be outlined in a stand-alone Chapter 12 to be incorporated in the (to be renamed) *Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (For Licensed Corporations and SFC-licensed Virtual Asset Service Providers)* to be published by the SFC, along with other existing AML/CFT requirements applicable to SFC licensed entities. Some of the key requirements of Chapter 12 are:

- (i) **virtual asset transfers:** The specific requirements for virtual asset transfers stipulated in section 13A of Schedule 2 to the AMLO, which apply to financial institutions as defined therein, will take effect from 1 June

2023, and the requirements of which are to be outlined in Chapter 12. The general principle is to apply wire transfer requirements under FATF Recommendation 16 to virtual asset transfers. This would require, inter alia, Hong Kong licensed VA trading platform operators acting as ordering and beneficiary institutions to properly obtain, record and submit information of counterparty institutions; conduct due diligence on virtual asset transfer counterparties; and obtain and record each customer who may be originator or recipient of the required information in connection with virtual assets transfers from unhosted wallets; and

(ii) **Disciplinary Fining Guidelines:** the Disciplinary Fining Guidelines (set out in Appendix D of the SFC Hong Kong VASP Consultation Paper) will be published, and such guidelines will indicate the manner in which the SFC proposes to exercise disciplinary powers to impose pecuniary penalties on a regulated person who is guilty of “misconduct”. (i.e. contravenes a material requirement, or conduct an act or omission relating to the provision of VA services which is, or is likely to be, prejudicial to the interests of the investing public or to the public interest) The maximum fine that may be imposed is HK\$10 million or three times the profit gained or loss avoided as a result of the misconduct and the SFC will consider those matters set out in the Disciplinary Fining Guidelines (such as whether the act was reckless, intentional or negligent) in determining the appropriate fine.

The SFC seeks public comments on the requirements of Chapter 12 of the AML Guideline as well as the Disciplinary Fining Guidelines.

Transitional arrangements for existing SFO-licensed platform operators

The SFC proposes a 12-month transitional period for existing SFO-licensed platform operators to comply with the VATP Guidelines, AML Guideline for LCs and SFC-licensed VASPs, and other guidelines.

Transitional Arrangements and Implementation Details of the AMLO VASP Regime

The AMLO VASP regime will come into effect on 1 June 2023 and any VA trading platform carrying on any business in Hong Kong or actively marketing its services to Hong Kong investors without a valid licence will be in breach of the licensing requirements under the AMLO VASP regime, unless the transitional arrangements below apply.

The transitional arrangements are aimed at providing reasonably sufficient time for VA trading platforms operating in Hong Kong to either apply for a licence or close down in an orderly manner. Under the arrangement, a VA trading platform which is pre-existing and in operation in Hong Kong prior to 1 June 2023 with a meaningful and substantial presence may continue to operate in Hong Kong without a licence until 31 May 2024, which will then be subject to a deeming arrangement from 1 June 2024.

When considering whether a VA trading platform has a “meaningful and substantial presence in Hong Kong”, the SFC will consider, *inter alia*, whether it is incorporated or has a physical office in Hong Kong; whether central management and control over the platform and key personnel are based in Hong Kong; and whether the trading platform is live with a considerable number of clients and volume of trading activities in Hong Kong.

To be eligible for the deeming arrangement, individuals applying to be (i) responsible officers of a pre-existing VA trading platform must have been performing relevant regulated function for a VA trading platform on 1 June 2023 and at the time of application; and (ii) licensed representatives of a pre-existing VA trading platform must be performing relevant regulated function at the time of application.

Pre-existing VA trading platforms which intend to qualify for the deeming arrangement and apply for a licence

Pre-existing VA trading platforms which would like to qualify for the deeming arrangement must submit a fully completed licence application online under the AMLO VASP regime between 1 June 2023 and 29 February 2024.¹² The applicant must be able to demonstrate that it has been operating a VA trading platform in Hong Kong immediately before 1 June 2023 and that it will comply with, and have arrangements in place to ensure compliance with, applicable regulatory requirements upon being deemed.

If the SFC is satisfied that the applicant meets the deeming conditions, they will automatically be deemed to be licensed from 1 June 2024 until their licence applications are approved, withdrawn or refused. Conversely, the SFC will notify an applicant whose application does not meet necessary conditions, or who does not have a reasonable prospect of successfully showing it may comply with relevant legal and regulatory requirements, in which case the relevant VA trading platform must close down its business by 31 May 2024, or 3 months from the date of the SFC notice, whichever is later.

Pre-existing VA trading platforms which do not intend to apply for a licence

If pre-existing VA trading platforms do not intend to apply for a licence, the SFC suggests they commence closing down their operations in an orderly manner and should stop active marketing of their services to Hong Kong prior to 31 May 2024.

VA trading platforms already existing in Hong Kong

VA trading platforms that do not operate in Hong Kong immediately before 1 June 2023 must not carry on business in Hong Kong unless they have been formally licensed under the AMLO VASP regime.

Publication of Hong Kong VA trading platform lists

To avoid confusion in relation to Hong Kong VA trading platform status, the SFC will publish lists on its website to inform the public of the regulatory status of Hong Kong VA trading platforms. The SFC will publish lists of Hong Kong licensed virtual asset trading platforms, deemed Hong Kong licensed virtual asset trading platforms, closing-down VA trading platforms and unlicensed “illegal” virtual asset trading platforms.¹³

Dual licences

Upon commencement of the AMLO regime, the SFC will regulate the trading of security tokens under the existing SFO regime and regulate the trading of VA trading platforms under the AMLO VASP regime.

Given that terms and features of virtual assets may evolve over time, a virtual asset’s classification may change from a non-security token to a security token or vice versa. As such, the SFC suggests that VA trading platforms should be dual licensed under both the existing SFO regime and the AMLO VASP regime to avoid business disruption or contravention of any of the licensing regimes.¹⁴

To simplify the application process:

- in respect of applicants for dual licences, a single consolidated application must be submitted online with an indication that the platforms are applying for both licences simultaneously; and
- for SFO-licensed platform operators which currently provide trading in non-security tokens or those which have already applied for licences under the existing SFO regime, the applicant is only required to submit to the SFC additional information required under the AMLO VASP regime.

External assessment report

The SFC noted that some VA trading platforms did not fully understand the SFC’s regulatory expectations in making licensing applications in the past, partly due to the complexity of their business models, causing a delay in processing.

To streamline the application process, the SFC proposes that VA trading platforms should engage an external assessor to submit a “Phase 1 Report” when submitting the licence application, and such report should cover such areas as, *inter alia*, design effectiveness of the platform’s structure, governance, operations, systems and control, staffing, token admission and custody of virtual assets. Further, a “Phase 2 Report” should be prepared by an external assessor after the approval-in-principle of the licence is granted by the SFC and such report should assess the effectiveness and the implementation of the actual adoption of the planned policies, procedures, systems and controls. The SFC would then only grant the final approval upon being satisfied with the findings of the Phase 2 Report.

Responding to the SFC Hong Kong VASP Consultation

The SFC welcomes comments from the public and the industry on the proposals in the SFC Hong Kong VASP Consultation Paper, and feedback and comments on the SFC Hong Kong VASP Consultation Paper should be submitted to the SFC in writing by 31 March 2023.

Questions relating to the Hong Kong VASP licensing regime on which the SFC wishes to solicit feedback

The questions which the SFC wishes to solicit feedback on proposed regulatory requirements for licensed VA trading platforms are set out in the Annex to this newsletter.

Annex

Question 1:

Do you agree that licensed platform operators should be allowed to provide their services to retail investors, subject to the robust investor protection measures proposed? Please explain your views.

Question 2:

Do you have any comments on the proposals regarding the general token admission criteria and specific token admission criteria?

Question 3:

What other requirements do you think should be implemented from an investor protection perspective if the SFC is minded to allow retail access to licensed VA trading platforms?

Question 4:

Do you have any comments on the proposal to allow a combination of third-party insurance and funds set aside by the licensed platform operator or a corporation within its same group of companies? Do you propose other options?

Question 5:

Do you have any suggestions as to how funds should be set aside by the licensed platform operators (for instance, under house account of the licensed platform operator or under an escrow arrangement)? Please explain in detail the proposed arrangement and how it may provide the same level of comfort as third-party insurance.

Question 6:

Do you have any suggestions for technical solutions which could effectively mitigate risks associated with the custody of client virtual assets, particularly in hot storage?

Question 7:

If licensed platform operators could provide trading services in VA derivatives, what type of business model would you propose to adopt? What type of VA derivatives would you propose to offer for trading? What types of investors would be targeted?

Question 8:

Do you have any comments on how to enhance the other requirements in the VATP Terms and Conditions when they are incorporated into the VATP Guidelines?

Question 9:

Do you have any comments on the requirements for virtual asset transfers or any other requirements in Chapter 12 of the AML Guideline for LCs and SFC-licensed VASPs? Please explain your views.

Question 10:

Do you have any comments on the Disciplinary Fining Guidelines? Please explain your views.

[1] Guidelines for Virtual Asset Trading Platform Operators Part 1

[2] For details of the relevant activities [please see Hong Kong Licensing Regime for Virtual Asset Exchanges to Take Effect on 1 March 2023](#). Notably, the relevant activities also include any off-platform virtual asset trading activities and incidental services provided by the platform operator to its clients.

[3] SFC Hong Kong VASP Consultation Paper para 29

[4] The SFC considers the setting of a hard maximum dollar amount exposure not to be appropriate as they do not take into account the personal circumstances of each investor such as their risk tolerance / profile

[5] SFC Hong Kong VASP Consultation Paper para 36

[6] SFC Hong Kong VASP Consultation Paper para 40

[7] SFC Hong Kong VASP Consultation Paper para 43

[8] SFC Hong Kong VASP Consultation Paper para 48

[9] SFC Hong Kong VASP Consultation Paper para 51

[10] SFC Hong Kong VASP Consultation Paper para 61

[11] SFC Hong Kong VASP Consultation Paper para 55

[12] SFC Hong Kong VASP Consultation Paper para 79

[13] SFC Hong Kong VASP Consultation Paper para 87

[14] SFC Hong Kong VASP Consultation Paper para 90

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