

March 2023

The proposed regulatory requirements for the incoming virtual asset trading platform operators licences



Introduction

Following the gazette of the [Anti-Money Laundering and Counter-Terrorist Financing \(Amendment\) Bill 2022](#) (the "**Bill**") on 24 June 2022 and the first reading by the Legislative Council on 6 July 2022, the Bill was passed on 7 December 2022 and the licensing regime for virtual asset service providers ("**VASP(s)**") ("**AMLO VASP Regime**"), introduced under the Bill, will come into effect on 1 June 2023. Operators of centralised virtual asset trading platforms will need to be licensed and regulated by the Securities and Futures Commission ("**SFC**"). For details, please refer to our article "[New virtual asset service provider regime to take effect on 1 March 2023](#)".

In preparation for the AMLO VASP Regime, the SFC has published the [Consultation Paper on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the Securities and Futures Commission](#) on 20 February 2023 (the "**Consultation Paper**"). Appended to the Consultation Paper is the draft Guidelines for Virtual Asset Trading Platform Operators ("**New Guidelines**") which the SFC proposes to adopt and will set out the regulatory requirements of the AMLO VASP Regime. The SFC is inviting market participants and interested parties to make comments in respect of the New Guidelines and the consultation period will end on 31 March 2023.

This client alert summarises the key takeaway points in the Consultation Paper and the New Guidelines.

What is happening

Before the AMLO VASP Regime, the SFC only regulated operators of virtual asset trading platforms ("**VATPs**") that were licensed for the type 1 (dealing in securities) and type 7 (providing automated trading services) regulated activities under the Securities and Futures Ordinance ("**SFO**") (the "**SFO VATP Regime**"). After the implementation of the AMLO VASP Regime, both VATPs and VASPs (collectively, "**Platform Operators**") will be regulated by the SFC.

Based on the SFC's "same business, same risks, same rules" principle, the SFC proposes to apply the same regulations for both VASPs and VATPs. The New Guidelines were therefore compiled based on the existing virtual asset trading platform terms and conditions under the SFO VATP Regime (the "**Existing T&Cs**"), with appropriate amendments and improvements to allow the operation of the AMLO VASP Regime. From the effective date of the AMLO VASP Regime, the Existing T&Cs will be superseded and replaced by the New Guidelines.

The SFC expects and recommends Platform Operators to apply for licences under both the SFO VATP Regime and AMLO VASP Regime, and the SFC will streamline the applications from licensees who already hold a licence from one of the regimes.

What is new

The New Guidelines have introduced several substantial changes as a result of the SFC's observation of the virtual asset industry in the recent years. These are:

(i) Retail investors

The New Guidelines will no longer limit the Platform Operators' services to professional investors only (as defined under the SFO), provided that the Platform Operators can comply with certain requirements set out in the New Guidelines. These requirements are similar to those imposed by the SFC on licensed corporations under the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("**Code of Conduct**") and other various guidelines and codes. In summary, these are:

- (i) Know your client: Similar to the Existing T&Cs, Platform Operators are required to identify and assess the clients, but are no longer required to know the financial situation, investment experience and investment objectives and assess the risk tolerance level and risk profile of institutional and qualified corporate professional investors.
- (ii) Trading limit: In respect of institutional and qualified corporate professional investors, Platform Operators are no longer required to set trading limits for them to ensure that their exposure to virtual assets is reasonable.
- (iii) Client agreement: The client agreement requirements in the New Guidelines now mirror the client agreement requirements under the Code of Conduct.
- (iv) Suitability: The suitability obligation in the New Guidelines has been expanded so it will mirror the Code of Conduct. The New Guidelines also contain several paragraphs on how the Platform Operators can discharge their suitability obligations. References should also be made to the various guidance on suitability published by the SFC from time to time.
- (v) Risk disclosure statements and information: These are similar to the requirements under the Existing T&Cs except that Platform Operators are no longer required to provide these to institutional and qualified corporate professional investors.

(ii) Token due diligence and admission

The New Guidelines now contain more specific requirements on how virtual assets should be admitted for trading on a platform. Specifically, Platform Operators are required to establish a token admission and review committee to oversee anything relating to the admission, halting, suspension and withdrawal of virtual assets. The committee will also make the final decision concerning the same. The committee should consist of members from senior management who are principally responsible for managing the key business line, compliance, risk management and information technology of the Platform Operators, and should report to the board of directors at least monthly.

Similar to the Existing T&Cs, the New Guidelines also contain a list of factors that Platform Operators should consider when carrying out due diligence on virtual assets. Some changes were made to the list. Particularly, the level of activity within the development communities and the level of adoption across the ecosystem have been removed from the list, and, as additional factors to consider, the Platform Operators should consider the market risks and the legal risks of the virtual assets, and whether the utility offered, the novel use cases facilitated, or technical, structural or crypto-economic innovation exhibited by the virtual asset appears to be fraudulent or scandalous. Smart contract audit should also be conducted for smart-contract based virtual assets.

As an additional protection for retail investors (meaning anyone that is not a professional investor), retail investors can only trade virtual assets that have satisfied the new large-cap virtual asset test. In order to pass the test, a virtual asset should have been included in at least two acceptable indices issued by at least two index providers. More specifically:

- (i) The index should have a clearly defined objective to measure the performance of the largest virtual assets in the market, and should be investible, objectively calculated and rules-based. The index provider should also possess the necessary expertise and technical resources to provide the index, and the methodology and rules of the index should be well documented, consistent and transparent.
- (ii) The two index providers should be separate and independent from each other.
- (iii) At least one of the index providers should have experience in publishing indices for the conventional securities market.

The SFC will also allow Platform Operators to admit virtual assets that fail to satisfy the large-cap requirement upon an application to the SFC, and the SFC will consider this on a case-by-case basis. Finally, a legal opinion confirming that a virtual asset to be made available for trading by retail investors is not "securities" as defined under the SFO must be obtained and submitted to the SFC before the virtual asset is made available for trading.

For any virtual asset that ceases to be a constituent virtual asset of the acceptable index, the Platform Operators will need to make assessments themselves on whether to support the trading of such virtual asset on the platform.

(iii) Insurance arrangements

In light of the difficulty in the market to obtain adequate insurance arrangement for virtual assets, the SFC will relax the previous insurance arrangement in the Existing T&Cs. Platform Operators are now allowed to have an arrangement in place that consists of either, or both, third-party insurance and funds of the Platform Operators or any corporation within the same group. The arrangement must be pre-approved by the SFC, and prompt notification and remedial measures should be made upon the Platform Operators becoming aware that the total value of client virtual assets under custody exceeds the covered amount.

(iv) Restricted activities

The New Guidelines restrict certain activities that are popular in the virtual asset market. It would appear that SFC's view is that Platform Operators should focus their businesses on the provision of a centralised platform for trading only. The restrictions include:

- (i) No financial accommodation, unless the SFC approves on a case-by-case basis.
- (ii) No virtual asset futures contracts or related derivatives. This is the same as the Existing T&Cs except that the Consultation Paper is inviting the market to make comments on whether virtual asset derivatives should be made available, which may mean that derivatives may become available in the finalised guidelines.
- (iii) No algorithmic trading (which is referred to as computer generated trading activities created by a predetermined set of rules) services.
- (iv) No arrangement on using the clients' virtual assets held by the Platform Operators for the purpose of generating returns for the clients. This includes activities such as staking, which the SFC issued a [warning statement](#) about.
- (v) No proprietary trading. This is similar to the Existing T&Cs except that off-platform back-to-back transactions entered into by the Platform Operator, which includes OTC transactions, are now permitted.

Other changes

As Platform Operators licensed under the AMLO VASP Regime are not directly subject to all regulations of the SFC, many provisions not in the Existing T&Cs need to be included in the New Guidelines to ensure that all Platform Operators operate under the same rules.

In summary, these are:

- (i) Fitness and Properness Requirements under Section II that mirrors the SFC's [Fit and Proper Guideline](#);
- (ii) Competence Requirements under Section III that mirrors the SFC's [Guidance on Competence](#);
- (iii) Continuous Professional Training Requirements under Section IV that mirrors the [Guidelines on Continuous Professional Training](#);
- (iv) General Principles under Section V that mirrors the general principles in the Code of Conduct, with some additions that require Platform Operators to ensure the reliability and security of its trading platform, to maintain proper records, to respond to requests and enquiries from the regulatory authorities in an open and cooperative manner and to assess the risk tolerance level and risk profile of their clients;
- (v) Financial Soundness under Section VI, which was an expansion to the rules in the Existing T&Cs to implement provisions from the Securities and Futures (Financial Resources) Rules (Cap 571N), but the requirement on Platform Operators maintaining at least 12 months of their actual operating expenses calculated on a rolling basis remains;
- (vi) Provisions on Standing Authority to Deal with Client Assets under Section X, which mirrors the Securities and Futures (Client Securities) Rules (Cap 571H);
- (vii) Management, Supervision and Internal Control under Section XI, which mirrors the [Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission](#);
- (viii) Ongoing Report / Notification Obligations under Section XVI and Schedule 3, which contains a list of ongoing obligations, including, inter alia: (a) obtaining SFC's prior written approval to include new virtual asset for trading by retail clients; (b) notifying the SFC in respect of new virtual asset for

trading by professional investors; and (c) submitting to the SFC information on the monthly volume of virtual asset transactions, the operating expenses of the Platform Operator; and

- (ix) Schedule 1 which implemented the definition and assessment requirements for institutional professional investors and qualified corporate professional investors which are structured similarly to the requirements commonly referred to as the 15.3A and 15.3B assessment and procedure under the Code of Conduct.

What else?

The New Guidelines do not deal with anti-money laundering and counter-financing of terrorism obligations ("**AML/CFT**"). Accordingly, the SFC will update its existing [Guideline on Anti-Money Laundering and Counter-Financing of Terrorism \(For Licensed Corporations\)](#), and change it to the Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (For Licensed Corporations and SFC-licensed Virtual Asset Service Providers) ("**New AML/CFT Guide**"). The New AML/CFT Guide will, along with other administrative changes, include a new chapter 12 that deals with virtual asset-specific AML/CFT requirements. Chapter 12 requires Platform Operators:

- (i) to obtain, record and submit the required information of the originator and recipient of a virtual asset transfer to the beneficiary institution;
- (ii) to obtain and record the required information submitted by the ordering institution or intermediary institution when acting as a beneficiary institution;
- (iii) to conduct due diligence on a virtual asset transfer counterparty to identify and assess the associated money laundering and terrorist financing risks; and
- (iv) when conducting a virtual asset transfer to or from unhosted wallets (i.e. wallets that are held privately and not with another institution), to obtain and record the required information from their clients who may be the originator or recipient of the transfer.

Finally, Appendix D of the Consultation Paper contains a SFC Disciplinary Fining Guidelines which is made under Part 5B of the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap 615). The guidelines set out the SFC's consideration and approach that the SFC will take when determining and taking appropriate disciplinary actions against a Platform Operator. This is different from the [SFC Disciplinary Fining Guidelines](#) issued under the SFO but the contents are largely the same, except that the impact to the reputation of Hong Kong as an international financial centre will also be considered by the SFC.

Next steps

The consultation period will close on 31 March 2023 so to give the SFC sufficient time to make any appropriate amendments to the New Guidelines prior to the AMLO VASP Regime coming live on 1 June 2023. All Platform Operators that carry on businesses in Hong Kong or actively market their services to Hong Kong investors will need to be licensed after 1 June 2023 before they can carry on VASP business in Hong Kong, unless the Platform Operator is a pre-existing trading platform which is eligible for the transitional arrangements.

To be eligible for the transitional arrangements, the Platform Operator must be in operation in Hong Kong prior to 1 June 2023 and have a meaningful and substantial presence. When determining whether a Platform Operator has a meaningful and substantial presence, the SFC will look at the place of incorporation, the place of its physical office, the location of staff with central management and control, the location of key personnel and the location of the platform's customers.

An eligible Platform Operator can then continue its business until 31 May 2024 without a licence from the SFO provided that the Platform Operator submits a fully completed licence application between 1 June 2023 and 29 February 2024. If the SFC is of the view that a Platform Operator is not eligible, or does not meet all necessary conditions under the New Guidelines, then the Platform Operator will be notified accordingly and

must proceed to close down its business by 31 May 2024. Platform Operators that have applied accordingly but yet to have SFC's determination by 31 May 2024 will be deemed to hold the necessary licence and be permitted to carry on businesses until further notice. For platform operators in Hong Kong that do not wish to be licensed in Hong Kong, then they must proceed to close down their businesses by 31 May 2024.

Interested Platform Operators should start considering the requirements in the New Guidelines and ensure their internal operation and systems can meet the requirements of the SFC. In addition, the SFC will require applicants to submit an external assessor report when submitting the application (First Phase Assessment) and another external assessor report after an approval-in-principle has been granted (Second Phase Assessment), which the Platform Operators should prepare in advance. The requirements of the assessor(s), the areas of assessment that need to be covered and the form of the assessment report are set out under Appendix F to the Consultation Paper.

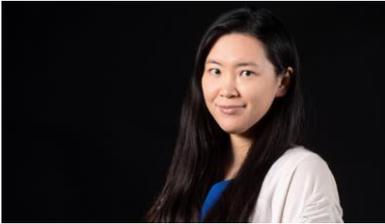
How we can help

The New Guidelines are good indications of the SFC's acknowledgement of the strong virtual asset retail market in Hong Kong. Although the new rules may not be exactly what the market is looking for, it is still a positive first step that the SFC is taking to create an open yet safely regulated environment for the virtual asset industry.

Many of our clients are intermediaries that provide virtual assets-related services. We regularly advise our clients on virtual assets-related issues and we have had numerous discussions with clients on the operation of virtual asset trading platforms in Hong Kong.

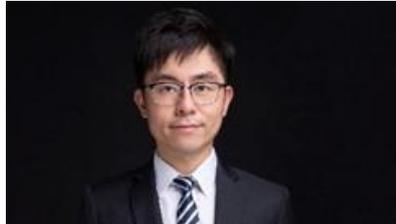
Please get in touch if you are interested in discussing any of the above.

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