

June 2023

## Conclusion to the regulatory requirements for the virtual asset trading platform operators licences



### Introduction

Following the [Consultation Paper on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the Securities and Futures Commission](#) published by the Securities and Futures Commission ("**SFC**") on 20 February 2023 (the "**Consultation Paper**"), the SFC has published the [Consultation Conclusions on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the SFC](#) on 23 May 2023 (the "**Consultation Conclusion**"). Appended to the Consultation Conclusion are the finalised Guidelines for Virtual Asset Trading Platform Operators ("**VATP Guidelines**"), the Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (For Licensed Corporations and SFC-licensed Virtual Asset Service Providers) ("**AML Guidelines**") and the Prevention of Money Laundering and Terrorist Financing Guideline issued by the Securities and Futures Commission for Associated Entities of Licensed Corporations and SFC licensed Virtual Asset Service Providers. For details on the Consultation Paper, please refer to our article "[The proposed regulatory requirements for the incoming virtual asset trading platform operators licences](#)".

This client alert summarises the key takeaway points in the Consultation Conclusion, the VATP Guidelines and the AML Guidelines.

## Recap

With the Anti-Money Laundering and Counter-Terrorist Financing (Amendment) Ordinance 2022 (Cap 615) ("**AMLO**") enacted in December 2022, the licensing regime for the virtual asset service providers ("**VASP Regime**") came into effect on 1 June 2023. Both VASP Regime and the existing virtual asset trading platform regime (for type 1/7 licensed corporation) ("**VATP Regime**") under the Securities and Futures Ordinance (Cap. 571) ("**SFO**") will be regulated by the SFC. Operators of cryptocurrency exchanges in Hong Kong ("**Platform Operator(s)**"), whether operating under the VASP Regime or the VATP Regime, will need to observe and comply with the VATP Guidelines and AML Guidelines, and the SFC urges all Platform Operators to be licensed under both regimes, regardless of whether their platforms support security tokens or not.

## What is new

Further to the public responses to the Consultation Paper, some changes have been made to the guidelines appended to the Consultation Paper. These are:

### (i) Knowledge assessment

Whilst the general requirement of a Platform Operator to assess the knowledge of a client in virtual assets remains the same, the SFC is of the view that this assessment should be done on a holistic basis. Accordingly, the suggestion to treat a client as having knowledge if five or more transactions were executed in the last three years is removed from the VATP Guidelines, and the SFC expects the Platform Operators to make their own assessments on when adequate training should be provided to a client.

### (ii) Token due diligence

Some changes have been made to the factors that Platform Operators should consider when carrying out token due diligence. These are:

- a) the regulatory status of a token in jurisdictions outside Hong Kong is no longer relevant for the two regimes, but the SFC stressed that Platform Operators should continue to be mindful of this as any breach of the laws and regulations in other jurisdictions will have an impact on the fitness and properness of the Platform Operators to continue their operations in Hong Kong;
- b) the Platform Operators are expected to use due skill, care and diligence in engaging an independent assessor to conduct a smart contract audit; and
- c) the Platform Operators are no longer required to obtain and submit to the SFC written legal advice confirming the non-securities status of a token, however, the SFC may request legal opinions on specific tokens in light of development in other jurisdictions during the SFC's approval process.

**(iii) Specific token admission criteria**

Some respondents to the Consultation Paper expressed concerns in relation to the large-cap test imposed in the guidelines. To address these concerns, the SFC proposes the following changes in the VATP Guidelines:

- a) the test now refers to the tokens being of large cap and high liquidity;
- b) the two index providers must be independent of each other, and of the issuer and the Platform Operators; and
- c) one of the two index providers must comply with the International Organisation of Securities Commission's Principles of Financial Benchmarks, in addition to having experience in publishing indices for the conventional securities market, when issuing the index.

Furthermore, the SFC stressed that the requirement for a virtual asset to be included in two indices is only a minimum requirement. A constituent virtual asset does not automatically satisfy the specific token admission criteria, and the Platform Operators must carry out their own token due diligence to ensure that the virtual assets meet all necessary requirements (i.e. the virtual asset must be of high liquidity).

The relevant sections in the VATP Guidelines were also amended so that a Platform Operator is not required to immediately suspend or withdraw a virtual asset from trading if the virtual asset is removed from the relevant index. Instead, the Platform Operator is expected to consider the reason for the removal of the virtual assets from the index and decide whether it will be in the client's interest to continue supporting the virtual assets.

The SFC also commented on stablecoins, which should not be admitted for retail trading until the proposed regulations from the HKMA are finalised.

**(iv) Gifts**

Gifts, other than a discount of fees or charges, to the clients of the Platform Operators for the trading of any specific virtual asset, is prohibited. The general view from the SFC is that a Platform Operator should not promote any specific virtual asset on its platform.

**(v) Insurance arrangements**

The SFC agrees to lower the compensation arrangement coverage threshold to 50% of the client's virtual assets held in cold storage and 100% of the client's virtual assets held in hot storage, since the VATP Guidelines already require 98% of the client's virtual assets to be held in cold storage, which SFC considers to be generally safe.

In terms of acceptable compensation arrangement, the SFC also added bank guarantees and funds (held in the form of a demand deposit or time deposit which will mature in 6 months or less) or virtual assets of the Platforms Operators that are set aside on trust and for compensation purposes.

In respect of the methods for storing the set-aside funds for compensation purposes, a Platform Operator is permitted to hold the funds itself in a segregated account with an authorised institution, or to deposit the funds with an independent third party (in which, the third party needs to provide a written acknowledgement to the SFC regarding its awareness of the designated purposes of the fund

and its consent to provide information of the funds to the SFC upon request), or to hold the set-aside virtual assets in segregated cold storage provided that the same virtual asset of the clients are stored.

**(vi) Proprietary trading and other restricted activities**

Proprietary trading is still prohibited. This is expanded to prohibit trading by group companies of the Platform Operator on the Platform Operator's platform, but the SFC confirms that such group companies may carry out proprietary trading as long as it is not done through the platform of the Platform Operator.

Market making on a proprietary basis is still prohibited but SFC allows market making activities to be conducted by third-party market makers.

Algorithmic trading is prohibited but the SFC clarified that clients of the Platform Operators can use their own algorithmic trading system when trading on the platform.

Earning, deposit-taking, lending and borrowing are not permitted.

**(vii) Travel rule**

Travel rule refers to the requirements for an institution to, when sending a transfer, obtain, hold and submit required information about the originator and recipient of the transfer to the receiving institution and, when receiving a transfer, obtain from the sending institution and hold the required information. The required information normally covers the name of the originator, the number of the originator's account, the originator's address and identification number, the recipient's name and the number of the recipient's account. The travel rule is being implemented in many jurisdictions but each jurisdiction is at a different stage of implementation, and institutions are also in the process of developing an effective system to facilitate the immediate submission of the information required under the travel rule.

Accordingly, the requirement to send the information immediately will not be in effect until 1 January 2024 (as specified in the AML Guideline), but other requirements of the travel rule must be observed and Platform Operators must use other interim measures to send the required information as promptly as possible.

**(viii) Unhosted wallets**

Unhosted wallets refer to wallets that enable a person to store and transfer virtual assets on his/her own behalf, and in relation to which the private key is controlled or held by the person. In addition to imposing requirements on the Platform Operators to obtain certain information before a transfer is made to an unhosted wallet, a Platform Operator should only transfer virtual assets to an unhosted wallet that was whitelisted by the Platform Operator, as required under the AML Guideline. A Platform Operator can consider using proof of ownership tests such as message signing or micropayment tests when whitelisting unhosted wallets.

Unhosted wallets should also be subject to periodic review, on a risk-sensitive basis, to ascertain their ownership and control.

The SFC also updated the VATP Guidelines to require Platform Operators to ensure they have adequate measures to prevent third party transfers, such as monitoring the IP address of clients to identify deposits from, or withdrawal to, third parties.

**(ix) Occasional transaction**

A Platform Operator will not be permitted to carry out any occasional transaction, which is defined under the AMLO as a transaction with a client that does not have a business relationship established. The SFC's expectation is that a Platform Operators must establish business relationships with all clients and have carried out the necessary customer due diligence against all clients before any transaction can be made.

**(x) Other non-VATP/VASP specific changes**

In light of the further amendments to the AMLO, the SFC has made some amendments in other chapters of the AML Guidelines that will apply to all licensed corporations ("**LC**"), whether it carries out any virtual assets-related services or not. These are:

- a) when identifying and verifying a client, a LC can also use a digital identification system that is reliable and independent, and is recognised by the SFC. At the moment, the SFC only recognises iAMSmart, but will look to approve other identification systems in the future;
- b) when identifying and verifying a beneficial owner of a client, a risk-based approach should be adopted to determine the measures to be used. A LC is not required to use the same method that it is required to adopt when identifying and verifying the client;
- c) in respect of a trust, its beneficial owner now includes the trustee, a beneficiary or a class of beneficiaries of the trust, and the reference to the entitlement to more than 25% of the capital of the trust property is removed; and
- d) Politically-exposed-persons ("**PEP**") now covers the PEP outside Hong Kong, instead of outside China only, and a LC can now adopt a risk-based-approach to consider whether it needs to continue applying enhance due diligence against a former PEP.

**Next steps**

The abovementioned guidelines came into effect on 1 June 2023. The SFC understands that the public may still have many questions in relation to the regulatory standard that SFC expects. The SFC will be publishing more FAQs and circulars to address these issues.

On 31 May 2023, the SFC also published a [circular](#) to clarify the transitional arrangement in respect of the VASP Regime. Platform Operators carrying out virtual asset services in Hong Kong prior to 1 June 2023 can continue to provide their services and will not be deemed to be in breach of the AMLO until 31 May 2024, provided that the Platform Operators make an application to the SFC under the VASP Regime between 1 June 2023 and 29 February 2024.

If such an application is made, then the Platform Operator will be deemed to be licensed after 1 June 2024, even if the SFC has yet to issue the official licence, provided that the SFC has not rejected the application and subject to the Platform Operator proving to the SFC that it has and will continue to comply with all relevant laws and guidelines. However, if a Platform Operator fails to submit the application on or before 29 February 2024, then it will not be able to enjoy the benefit of the deeming provisions and must close down

its business in Hong Kong, and wait for the result of the SFC's decision before returning back to Hong Kong. Furthermore, the SFC clarified that if an application is returned due to there being a fundamental issue that needs to be resolved, then the applicant will not be able to enjoy the deeming provisions if it cannot resubmit its application on or before 29 February 2024. This will also be the case if the application is returned by the SFC after 29 February 2024. Accordingly, the SFC urges Platform Operators to make an application as soon as possible, so they can have ample time to resolve any fundamental issue, if any.

Platform Operators who were carrying out virtual asset services in Hong Kong prior to 1 June 2023 but are not looking to apply for a licence under the VASP Regime must proceed to unwind and close down their businesses in Hong Kong before 31 May 2024. Platform Operators who were not carrying out virtual asset services in Hong Kong prior to 1 June 2023 must not operate in Hong Kong until a licence is obtained from the SFC.

To determine whether a Platform Operator was carrying out virtual asset services in Hong Kong prior to 1 June 2023, the SFC will consider factors such as whether the company was incorporated in Hong Kong, whether it has a physical office in Hong Kong, whether there are central management staff in Hong Kong, whether the operations are based in Hong Kong.

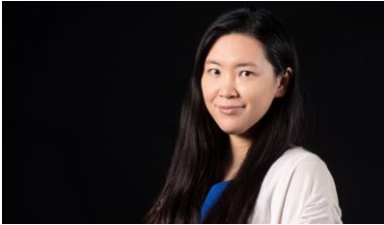
There are also similar transitional arrangements in respect of the responsible officers and licensed representatives of the Platform Operators.

### **How we can help**

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.

## Contact us



**Katherine Liu**  
Partner, Head of finance and  
financial services regulation  
T: +852 2533 2717  
E: katherine.liu@shlegal.com



**Alan Wong**  
Associate  
T: +852 2533 2719  
E: alan.wong@shlegal.com



**James Wong**  
Associate  
T: +852 3166 6933  
E: james.wong@shlegal.com

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