

RE: SFC CONSULTATION PAPER ON PROPOSED REGULATORY REQUIREMENTS FOR VIRTUAL ASSET TRADING PLATFORM OPERATORS LICENSED BY THE SFC**BACKGROUND & OVERVIEW**

On 20 February 2023, the Securities and Futures Commission (“**SFC**”) published the Consultation Paper on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the SFC (the “**Consultation Paper**”), in which the SFC sets out its views and proposals in relation to the regulatory requirements for virtual asset trading platform operators (the “**VATPs**”)¹ to be regulated under the new licensing regime (the “**VASP Regime**”) for virtual asset service providers² under the Anti-Money Laundering and Counter Terrorist Financing Ordinance (Chapter 615 of the Laws of Hong Kong) (the “**AMLO**”) as well as the treatment of VATPs regulated under the existing licensing regime (the “**SFO Regime**”) under the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) (the “**SFO**”). We have in our previous Client Alerts³ summarised and discussed the scope and overall framework of the VASP Regime. In this Client Alert, we outline the key changes being proposed by the SFC in the Consultation Paper in the licensing and regulatory requirements for VATPs and provide our observations on the subject.

SFC’S PROPOSALS ON REGULATORY REQUIREMENTS FOR VATPS

In the Consultation Paper, the SFC proposes to adopt a new set of guidelines for VATPs licensed by the SFC (the “**VATP Guidelines**”),⁴ which will supersede the current regulatory requirements for VATPs set out in the Terms and Conditions for VA Trading Platform Operators (the “**VATP Terms and Conditions**”) upon the commencement of the VASP Regime on 1 June 2023 with a number of significant modifications as explained below.

VATPs may offer services to retail investors subject to investor protection requirements

One of the most important changes being proposed by the SFC in the Consultation Paper is that licensed VATPs will be permitted to offer their trading services of non-security tokens⁵ to all types of investors, including retail investors, thus removing the “professional-investor only” restriction which is currently being imposed on the VATPs as a licensing condition under the SFO Regime, subject to compliance with a range of robust investor protection measures as mentioned below.

¹ In this Client Alert, “virtual asset trading platform operator” or “VATP” refers to an operator of a centralised virtual asset exchange which has direct or indirect possession of client money or client virtual assets, which is regulated by the SFC under either the Anti-Money Laundering and Counter-Terrorist Financing (Amendment) Ordinance (the “**AMLO Amendment Ordinance**”) or the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) (the “**SFO**”). The term “virtual asset” shall have the meaning given to it in the VATP Guidelines, which includes both security tokens and non-security tokens. Please refer to our Client Alerts dated 8 July 2022 and 20 December 2022 for details on the meanings and interpretation of “operating a VA exchange” and “virtual asset”.

² The AMLO Amendment Ordinance regulates the provision of “VA service”, which currently only includes the operation of a centralised virtual asset exchange.

³ Please refer to our Client Alerts dated 8 July 2022 and 20 December 2022.

⁴ Guidelines for Virtual Asset Trading Platform Operators, attached to the Consultation Paper as Appendix A.

⁵ “Security tokens” refers to virtual assets which fall within the definition of “securities” as provided by the SFO.

(a) VATPs shall establish token admission and review committee

The SFC proposes that each VATP should set up a token admission and review committee (the “**Token Committee**”), which should be in charge of establishing, implementing and enforcing (i) the criteria for a virtual asset to be admitted for trading; (ii) the criteria for halting, suspending and withdrawing a virtual asset from trading and options available to clients in such event; and (iii) the rules setting out the obligations of and restrictions on virtual asset issuers (for example, the obligation to notify the VATP of any proposed hard fork or airdrop, any material changes in the issuer’s business or regulatory action taken against the issuer). The Token Committee should also conduct regular reviews of the aforementioned rules and criteria and carry out ongoing monitoring of the virtual assets which have been admitted for trading. The Committee should, at a minimum, consist of members from the VATP’s senior management and should report to the Board of Directors at least on a monthly basis.

Where the virtual assets are available for trading by professional investors only, a licensed VATP will no longer be required to seek the SFC’s approval for any plan to admit or withdraw any virtual asset to or from its trading platform and will only be required to notify the SFC of the same in advance.

(b) VATPs shall establish token admission criteria

The SFC proposes that VATPs should adopt a set of general criteria for the admission of virtual assets, having regard to various factors including but not limited to: (i) the background of its management or development team; (ii) its regulatory status in each jurisdiction in which the VATP provides trading services; (iii) its supply, demand, maturity, liquidity, market capitalisation, trading volume and track record; (iv) its technical aspects (e.g. security infrastructure, size of the blockchain and network, resistance level to common attacks, risks relating to code defects, breaches and other threats); (v) the development of the virtual asset (including the outcomes of any projects associated with the virtual asset and any previous major incidents); (vi) its marketing materials; (vii) market risks (eg. concentration of holdings, price manipulation, fraud and adoption rate); and (viii) legal risks associated with the virtual asset (eg. any pending or potential civil, criminal, regulatory or enforcement action). The good news is that, in view of changes in the market landscape, certain admission requirements specific to security tokens (which may only offered to professional investors) will be removed, including the requirements for asset backing, approval by regulators in comparable jurisdictions and post-issuance track record of not less than 12 months. As is the case under the existing VATP Terms and Conditions, VATPs will continue to be prohibited from offering, trading or dealing in virtual asset futures and other derivatives (even though SFC has indicated that it is willing to further review its stance based on the feedback of this consultation).

For a virtual asset to be made available to retail investors, the SFC proposes that the virtual asset should also qualify as an “**eligible large-cap virtual asset**”, meaning a virtual asset which is included in at least two “acceptable indices” issued by at least two index providers which are independent of the VATP and of each other. An “acceptable index” should have a clearly defined objective to measure the performance of the largest virtual assets in the market, such

as an index tracking the performance of the top 10 largest virtual assets by market capitalisation.⁶ Furthermore, at least one of the indices should be issued by an index provider which has experience in publishing indices for products in the traditional financial market, such as an index provider which has issued an index tracked by an index fund authorised by the SFC.⁷

(c) VATPs shall adopt other token due diligence measures

The SFC proposes that a licensed VATP should also perform the following due diligence measures prior to admitting a virtual asset for trading:

- (i) **Internal control:** Ensuring that its own internal controls, systems, technology and infrastructure are capable of supporting and managing the risks specific to the particular virtual asset;
- (ii) **Smart contract audit:** Conducting a smart contract audit, focusing on whether the smart contract layer is subject to any security flaws or other vulnerabilities; and
- (iii) **Legal opinion:** For virtual assets to be made available to retail investors, obtaining and submitting to the SFC a legal opinion or memorandum confirming that the virtual asset does not fall within the definition of “securities” as set out in the SFO. No such written legal opinion is required if the virtual asset is offered to professional investors only.

(d) VATPs shall disclose sufficient information to clients

VATPs are required to disclose sufficient information on the virtual assets available for trading, including but not limited to the price and trading volume of the virtual asset, background information about the management team or developer of the virtual asset, the issuance date, brief description of the virtual asset’s terms and features and whether the virtual asset carries voting rights and how such voting rights will be handled by the VATP. Additionally, VATPs are also required to disclose to its clients the jurisdictions in which the trading of the relevant virtual assets is not permitted.

⁶ Additionally, the index should also fulfil certain other conditions, including that: (i) the index should be investible, i.e. its constituent virtual assets should be sufficient liquid; (ii) the index should be objectively calculated and rule-based; (iii) the index provider should have the requisite expertise and technical resources; and (iv) the rules and methodology of the index should be well-documented, consistent and transparent.

⁷ It is to be noted, however, the characterisations of tokens as “securities” or “non-securities” are unsettled and subject to change. Indeed, the Chairman of the U.S. Securities and Exchange Commission (SEC) has recently stated his view that all cryptocurrencies other than Bitcoin are securities. See “SEC Chairman Explains Why He Views All Crypto Tokens Other Than Bitcoin as Securities” (27 February 2023), available at <https://news.bitcoin.com/sec-chairman-explains-why-he-views-all-crypto-tokens-other-than-bitcoin-as-securities/>. It is possible that regulators in other jurisdictions, including Hong Kong, will adopt a similar view in the future.

(e) VATPs shall adopt suitability test and other investor protection measures in onboarding process

The SFC proposes that, except for institutional and qualified corporate professional investor,⁸ VATPs should adopt the following measures in the client onboarding process:

- (i) **Knowledge assessment:** conducting assessment of the client's knowledge in virtual assets, including the relevant risks associated with virtual assets, before opening an account for the client. Where a client does not possess the requisite knowledge, the VATP will be required to provide training to that client before providing services to them;
- (ii) **Suitability:** conducting comprehensive assessment of the client's risk tolerance level and overall risk profile to determine whether the provision of the VATP's services is suitable for the client; and
- (iii) **Trading limit:** on the basis that the client has the relevant knowledge and is suitable for virtual asset trading, setting a limit (which should be tailor-made and regularly reviewed) for each client to ensure that the client's exposure to virtual assets is reasonable having regard to the client's financial and personal circumstances and taking into account the client's overall holdings in virtual assets on a best effort basis.

VATPs will be required to apply for licences under both VASP Regime and SFO Regime

Strictly speaking, trading of security tokens by VATPs should be regulated by the SFC under the existing SFO Regime whereas trading of non-security tokens by VATPs should be regulated by the SFC under the VASP Regime. Given the difficulties in classifying the nature of a token, VATP should apply for both licences under the SFO Regime and the VASP Regime.⁹ In addition, a number of other modifications to the existing regulatory requirements for VATPs are also proposed by the SFC to be included in the VATP Guidelines, including without limitation:

- (a) **External assessment reports:** To expedite the licence application and review process, the SFC proposes that VATPs should be required to engage an external assessor to assess its business and submit to the SFC external assessment reports in two phases, namely when submitting the licence application and after obtaining approval-in-principle;
- (b) **Insurance:** Due to the difficulty to maintain at all times an insurance policy providing full coverage for risks associated with client virtual assets held in hot storage and substantial coverage (eg. 95%) for client virtual assets held in cold storage, the SFC proposes to

⁸ "Institutional professional investors" refers to persons falling under paragraphs (a) to (i) of the definition of "professional investor" in section 1 of Part 1 of Schedule 1 to the SFO, which include recognised exchanges and clearing houses, licensed corporations and registered institutions (and their wholly-owned subsidiaries and holdings companies), authorised financial institutions (and their wholly-owned subsidiaries and holdings companies), authorised insurers, authorised collective investment schemes, registered provident fund schemes, registered occupational retirement schemes, governments and central banks, as well as the overseas equivalents of such institutions and entities. "Qualified corporate professional investors" refers to corporate professional investors which have passed the assessment requirements under paragraph 15.3A of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (the "Code of Conduct") and completed the consent and annual confirmation procedures under paragraph 15.3B of the Code of Conduct.

⁹ To streamline the application process, the VATP applicants will only be required to submit a single consolidated application online. VATPs which are currently licensed under the SFO or whose licence applications under the SFO Regime are being reviewed will only be required to submit to the SFC information that is additionally required under the VASP Regime.

modify and to allow more flexible risk compensation arrangements, which may consist of third-party insurance and/or funds of the VATP or its related group entities which are held on trust and designated for such purpose, subject to approval by the SFC; and

- (c) **Prohibition of algorithmic trading and arrangements for generation of returns:** The SFC proposes to prohibit the offer of algorithmic trading services¹⁰ and arrangements which use client's virtual assets held by the VATP or its wholly-owned subsidiary providing custodial services for the purpose of generating returns for clients or any other persons.¹¹

Transitional arrangements for Pre-Existing VATPs

To provide sufficient time for VATPs now operating in Hong Kong to either apply for a licence under the AMLO or close down in an orderly manner, transitional arrangements are being proposed by the SFC for VATPs which are in operation with meaningful and substantial presence in Hong Kong immediately prior to 1 June 2023 (the "**Pre-Existing VATPs**"). The SFC will have regard to a number of factors in determining whether a VATP has meaningful and substantial presence in Hong Kong, including but not limited to (i) whether the VATP is incorporated in Hong Kong; (ii) whether it has a physical office in Hong Kong; (iii) whether its staff having central management and control of the trading platform is located in Hong Kong; (iv) whether its key personnel are based in Hong Kong; and (v) the trading platform's number of Hong Kong clients and volume of trading activities in Hong Kong.

Pre-Existing VATPs will be able to benefit from a 12-month non-contravention period from 1 June 2023 to 31 May 2024 (the "**Non-Contravention Period**"), during which they may continue to operate in Hong Kong without having obtained a licence from the SFC. In view that the VATP Terms and Conditions will be superseded by the VATP Guidelines, existing SFO-licensed VATPs will also be allowed to take advantage of the Non-Contravention Period to adapt and comply with the requirements of the VATP Guidelines in relation to existing clients and virtual assets which have been admitted for trading. Additionally, Pre-Existing VATPs which submit their licence applications on or before 29 February 2024 will be granted a deemed licence and may lawfully operate in Hong Kong until their licence applications have been determined (i.e. approved or rejected).

OUR OBSERVATIONS

The SFC's proposal in the Consultation Paper to allow licensed VATPs to offer their services to retail investors (provided that adequate investor protection measures being in place) represents an important step forward in Hong Kong's virtual asset regulatory development.

¹⁰ Under the VATP Guidelines, "algorithmic trading" refers to computer generated trading activities created by a predetermined set of rules aimed at delivering specific execution outcomes.

¹¹ See also the SFC's "Statement on virtual asset arrangements claiming to offer returns to investors" dated 13 December 2022, in which the SFC warns of the risks of virtual asset-related arrangements offering (or purporting to offer) returns through deposit of virtual assets by clients and further warns that such arrangements may potentially fall within the definition of "collective investment scheme" in the SFO, the offer, marketing and distribution of which requires licensing and authorisation from the SFC.

However, it is expected that retail access to virtual asset trading on licensed VATPs will remain very restricted at the initial stage due to the “eligible large-cap virtual asset” requirement and “non-securities” nature requirement proposed by the SFC, which would restrict retail investors to Bitcoin and a very limited suite of mainstream tokens, if any.¹² Given that high-profile actions have been taken by the U.S. Securities and Exchange Commission against some of the long-existing cryptocurrencies (e.g. Ripples)¹³ and some even start to question the nature of Ethereum after it has changed from the “proof of work” to “proof of stake”,¹⁴ it remains to be questionable which remaining tokens can be safely opined as a non-securities tokens.

In addition, given that Hong Kong retail investors could already access certain authorised virtual asset futures exchange-traded funds traded on conventional exchanges,¹⁵ it remains to be seen as to how attractive it would be for the retail investors to trade on the licensed VATPs. One of the important factors is whether retail investors would be allowed to withdraw virtual assets back to their own cold wallets. Under the current licensing requirements, the Type 1 licensed corporations are not allowed to permit their clients to withdraw virtual assets.¹⁶

Further, the prohibition on algorithmic trading, which was not previously imposed on VATPs licensed under the SFO regime, may also be unnecessary if effective qualification, testing and risk management policies and procedures similar to those required under the Code of Conduct are implemented by the VATP and sufficient information is provided to investors to enable them to understand the terms, features and operation of its algorithmic trading services.

Similarly, the continued ban on trading of virtual asset futures and other derivatives on the VATPs may be out of step with the rapid development of the virtual asset market landscape. Nevertheless, the SFC has indicated some willingness to adjust its position by inviting comments and feedback from market participants on the types of business models and virtual asset derivative products VATPs would like to offer.

Despite the restrictiveness of the new VASP Licence, certain market players have already indicated their intention to submit application.¹⁷ Whilst the traditional players could more easily take advantage of the Non-Contravention Period, it remains questionable as to how

¹² Based on the “eligible large-cap virtual asset” criteria, it is likely that only Bitcoin, Ethereum and some other mainstream tokens (possibly including Cardano, MATIC, Solana etc.) would be permitted to be offered to retail investors for trading, if these are not considered “securities” within the meaning of the SFO.

¹³ *SEC v. Ripple Labs Inc*, U.S. District Court, Southern District of New York, No. 20-CV-10832.

¹⁴ See “Gensler Says Proof-of-Stake Assets Could Be Securities: Report” (16 September 2022), available at <https://decrypt.co/109881/gensler-proof-of-stake-ethereum-securities>

¹⁵ See “Circular on Virtual Asset Futures Exchange Traded Funds” published by the SFC dated 31 October 2022. The first virtual asset exchange-traded funds listed on the Stock Exchange of Hong Kong, CSOP Bitcoin Futures ETF (Stock code: 3066) and CSOP Ether Futures ETF (Stock code: 3068), were made available to Hong Kong retail investors on 16 December 2022.

¹⁶ See paragraphs 19 and 20 of the Joint Circular.

¹⁷ See “Hong Kong’s new crypto regulation may lure Web3 firms back, experts say” (23 February 2023), available at <https://forkast.news/hong-kong-new-crypto-regulation-may-lure-web3-firms-back/>.

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SFC would be exercising their discretion in categorizing the VATP applicants as Pre-Existing VATPs, which depends, *inter alia*, on their number of Hong Kong clients and volume of trading activities in Hong Kong.

The SFC is currently inviting interested parties and market participants to submit their comments on key issues and questions raised in the Consultation Paper by **31 March 2023**. We intend to make a submission in response to the Consultation Paper. Please do get in touch with our team members at hyu@lylawoffice.com or at (+852) 2115-9525 if you have any views on the above or would like to further discuss any of the issues raised in this Client Alert or the Consultation Paper more generally.

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