

SFC issues public consultation on its proposals to regulate virtual asset trading platforms

Background

On 20 February 2023, the Securities and Futures Commission (“**SFC**”) launched a public consultation on the proposed regulatory requirements for virtual asset trading platform operators (the “**Consultation Paper**”), which invites market participants to submit written comments by 31 March 2023.

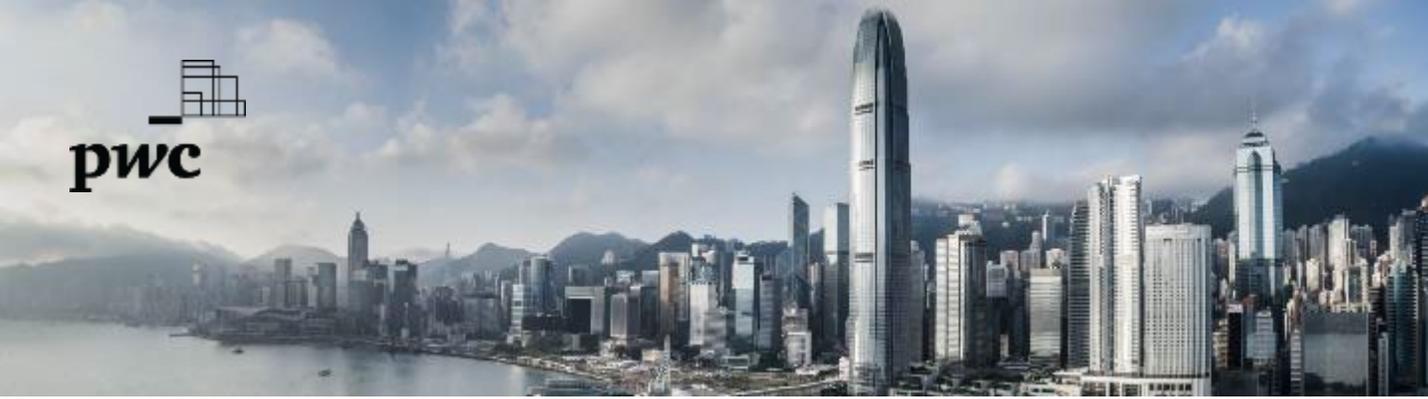
The Consultation Paper sets out (1) key proposed regulatory requirements for licenced virtual asset trading platform operators (“**VATP**”) and (2) key measures of the transitional arrangements and implementation details for the virtual asset service providers’ licensing regime under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (“**AMLO VASP Regime**”), which will become effective on 1 June 2023. In addition, the Consultation Paper includes 6 appendices setting out guidelines relating to the implementation of the VASP regime, the key ones being the Guidelines for VATP operators (Appendix A) (“**VATP Guidelines**”) and the Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (for licenced Corporations and SFC-licenced Virtual Asset Service Providers) (Appendix B).

Upon commencement of the new regime, all centralised VA trading platforms carrying on their businesses in Hong Kong or actively marketing their services to Hong Kong investors will need to be licenced and regulated by the SFC, irrespective of whether they provide trading services in relation to pure virtual assets (“**VA**”), or security tokens.

In this News Alert, we provide a high-level overview of the proposed regulatory requirements applicable to licenced VATPs. (A more detailed article will follow.)

1. Consolidated regulatory requirements for licenced VATPs

Currently, VATPs that are licenced to operate in Hong Kong are governed under the Securities and Futures Ordinance (Cap 571) (“**SFO**”) and are required to have obtained a Type 1 and Type 7 regulated activity licence, with specific terms and conditions imposed (“**VA T&Cs**”) (the “**SFO Regime**”). It is proposed that the SFO Regime will be consolidated with the AMLO VASP Regime, and that the VATP Guidelines will be applicable to all VATPs under the SFO Regime or the new AMLO VASP Regime. Whilst the existing VA T&Cs will be replaced by the VATP Guidelines, the VATP Guidelines are based largely on the VA T&Cs and are therefore substantially similar. Importantly, all VATPs (whether existing or new) will be required to be licenced under both the SFO Regime, and the AMLO VASP Regime.



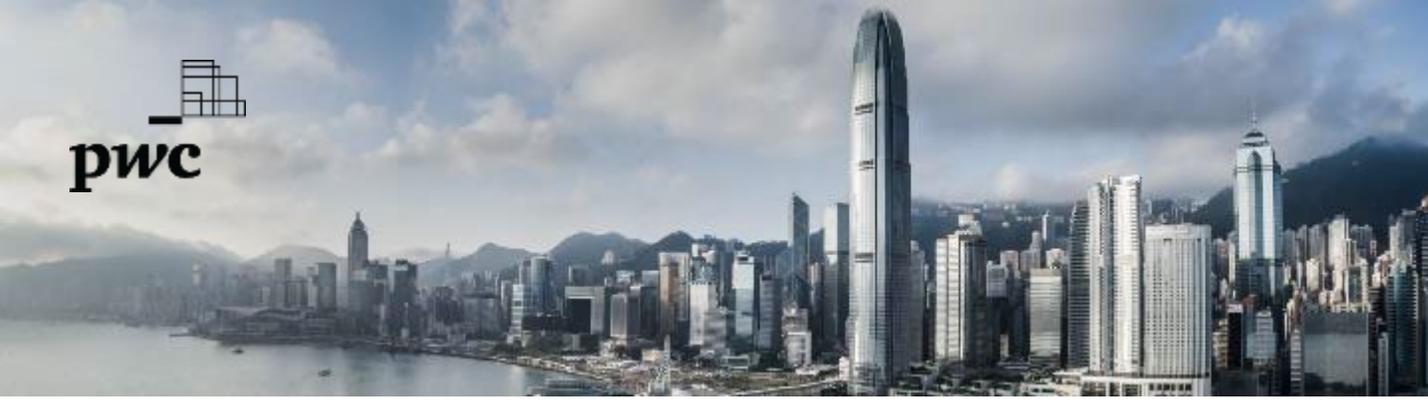
The VATP Guidelines govern the following areas:

- Custody of client assets
- Know-Your-Client
- AML/CFT
- Conflicts of interest
- Cybersecurity
- Admission of virtual assets for trading
- Risk management
- Accounting and auditing
- Suitability
- Prevention of market manipulative and abusive activities

2. Retail access to certain VAs on licenced VATPs

In light of recent VA market developments, the SFC proposes further to allow retail investors to access trading services provided by licenced VATPs, provided that the VATP complies with a range of robust investor protection measures as follows:

- **Onboarding requirements:** to assess client's risk tolerance level and risk profile; and to set a limit for each client to ensure that the client's exposure to VA is reasonable with reference to the client's financial situation and personal circumstances, as determined by the platform operator.
- **Governance:** to set up a token admission and review committee which is responsible for establishing, implementing and enforcing (i) the criteria for a VA to be admitted for trading; and (ii) the criteria for halting, suspending and withdrawing a VA from trading and the options available to clients holding with that VA. Moreover, ongoing monitoring of each VA admitted for trading should be conducted to consider whether to continue to allow such VA for trading in the platform.
- **Token due diligence and admission criteria:** The SFC listed some general non-exhaustive factors for licenced VATPs to consider when determining whether to make a specific VA available to retail clients, such as:
 - Background of the management or development team of a VA
 - Regulatory status of a VA in each jurisdiction in which the VATP provides trading services
 - VA's supply, demand, maturity & liquidity
 - Technical aspect of a VA, i.e. the security infrastructure of its blockchain protocol, the size of the blockchain, how resistant it is to common attacks, etc.
 - Marketing materials for a VA issued by the issuer
 - Any fraud or scandals in relation to the utility offered or the novel use cases facilitated
 - Market and legal risks
 - Development of a VA including the outcomes of any projects associated with it as set out in its Whitepaper and any previous major incidents associated with its history and development



Apart from the general token admission criteria listed above, the VATP should also ensure that the selected VA will satisfy the specific token admission criteria as an eligible large-cap VA. Such VA should be included in at least two “acceptable indices” issued by at least two independent index providers. In addition, the Consultation Paper also provides other token due diligence procedures to be performed.

- **Disclosure obligations:** A licenced VATP should disclose sufficient product information to enable retail investors to make an informed decision of their investments, such as price and trading volume of the VA on the platform in the last 24 hours; issuance date of the VA; brief description of the terms; link to the smart contract audit report to the VA etc.
- **Non-securities:** Only VAs that are not “securities” as defined under the SFO (written legal advice on this will be required) will be allowed to be offered to retail investors. VAs that fall within the definition of “securities” can only be offered pursuant to existing rules/regulations under the SFO (which means, practically, only private placements to “professional investors”(“PIs”), or where SFC authorisation is obtained for retail offerings).

3. Insurance / compensation arrangement

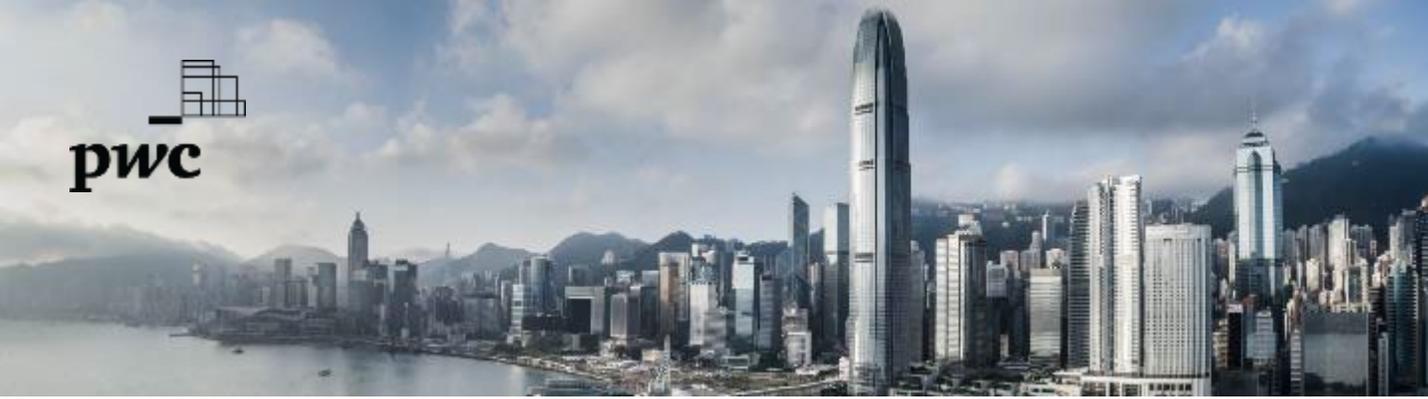
In view of the difficulty faced by VATPs in obtaining insurance coverage for risks associated with hot storage, or in being able to afford the associated insurance premiums, the SFC has proposed a more flexible approach by permitting VATPs to use a combination of third-party insurance together with a compensation arrangement (such as funds) set aside and held on trust for the benefit of the VATP. The VATP is obligated to notify the SFC should it become aware that the total value of client VA under custody exceeds the covered amount under the compensation arrangement approved by the SFC.

4. Travel rules

Citing money laundering and terrorist financing (ML/TF) risks arising from the distinct characteristics of VAs, the SFC proposes to align virtual asset-specific AML/CTF requirements with the latest standards and guidance promulgated by the FATF, specifically the Travel Rule.

The SFC has also noted that, in line with the FATF’s recommendation, jurisdictions should implement the Travel Rule as soon as possible to address the sunrise issue. Chapter 12 of the draft Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (for licenced Corporations and SFC-licenced Virtual Asset Services Providers) lists out specific requirements for virtual asset transfers in the following cases:

- when acting as an ordering institution of virtual asset transfers;
- when acting as a beneficiary institution;
- generally, conducting due diligence on a virtual asset transfer counterparty; and
- when conducting virtual asset transfers to or from unhosted wallets.



5. External assessment report

The SFC proposes to require a VATP applicant to engage an external assessor to assess its business going forward and submit the assessor's reports to the SFC (i) when submitting the licence application (Phase 1 Report) to assess the design effectiveness of key business processes and (ii) after approval-in-principle is granted (Phase 2 Report) to assess the operating effectiveness of key business processes.

6. Streamlined VA listing requirements

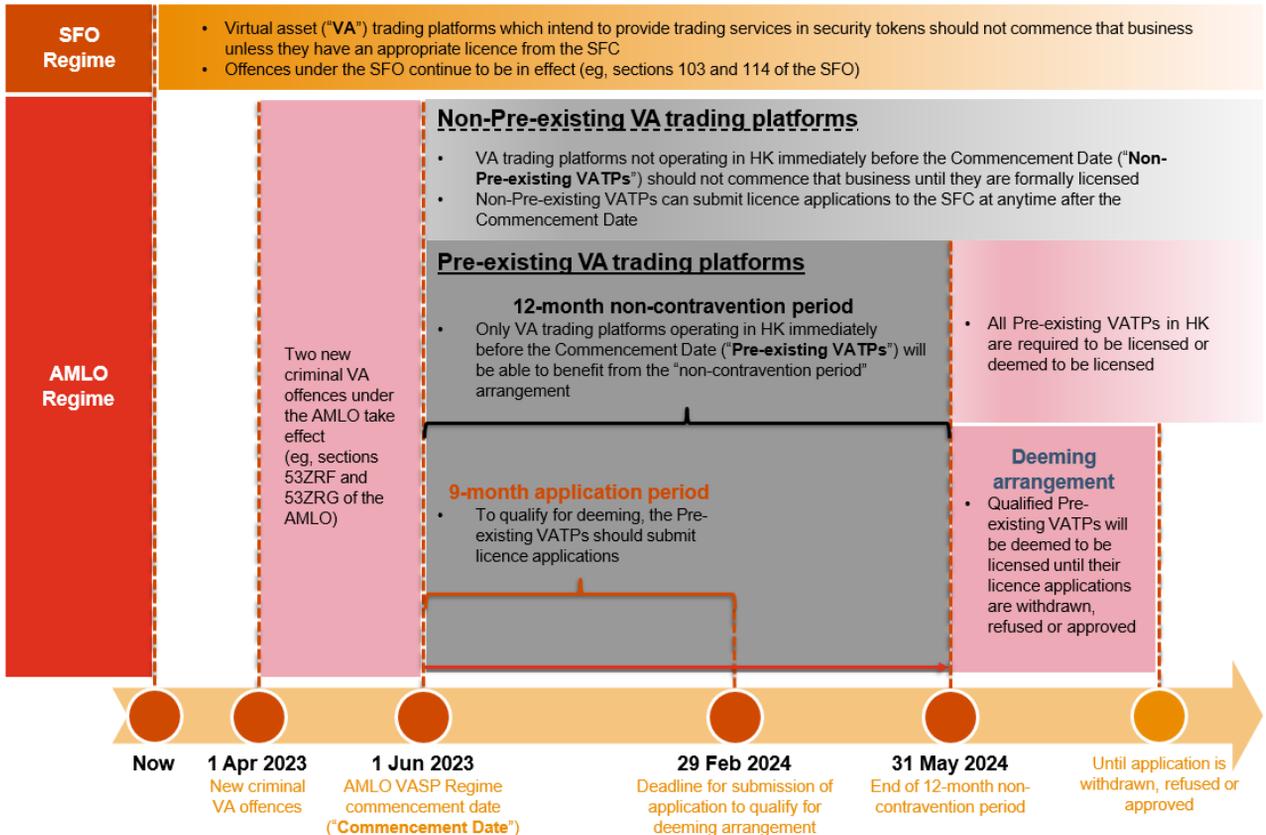
The requirement relating to “security tokens” (that requires a VATP to only admit for trading the security tokens that are asset-backed, approved or qualified by or registered with regulators in comparable jurisdictions and with a 12-month post-issuance track record) will be removed. Instead, the VATP should comply with the general token admission criteria as discussed above and other relevant guidelines.

7. VA derivatives

Last but not least, whilst the SFC acknowledged the increasing interest in the VA market to offer VA derivatives, particularly to institutional investors, its position remains unchanged – that is, VATPs will currently not be allowed to offer VA derivatives as of the date of the Consultation Paper. However, this may be revisited at a later stage.

8. Key measures of the transitional arrangements and implementation details

As mentioned above, the AMLO VASP regime will come into effect on 1 June 2023. Given that those platform operators currently licenced under the SFO may need to revise their systems and controls to meet some of the requirements in the relevant guidelines, the SFC proposes to provide a 12-month transitional period for compliance with the requirements. The chart below shows the key dates and implementation details of the transitional arrangements.



Source: Appendix E of the Consultation Paper

Next steps

Some of the key requirements that were previously mentioned by the SFC have now been significantly relaxed, for example, in relation to the need for insurance, the listing process, and offering to PIs only (only advanced notification needed). It is also clear that the SFC sees VATPs playing an integral role in the protection of retail investors and despite recent events in the VA industry, the SFC has not proposed overly prescriptive requirements. Instead, it has left VATPs with some flexibility to make their own assessments and to take proactive steps to provide for more robust customer protection. These are welcome developments.

While certain issues still remain to be addressed, the Consultation Paper represents a big step forward in terms of developing Hong Kong as a VA trading hub, and we are excited to see the regime progressing. In the meantime, we will continue to report on developments as they unfold – watch this space!

Please reach out to us if you have any questions or queries.



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