

Client Alert

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Hong Kong Securities and Futures Commission announces new framework for regulating virtual asset trading platforms

The Securities and Futures Commission (SFC) has taken another major step towards establishing a regulatory framework for virtual asset trading platforms, and is now inviting licensing applications from platform operators who are willing and able to comply with new licensing criteria and continuing compliance requirements outlined in the SFC's recently published [Position Paper - Regulation of virtual asset trading platforms](#) ("**Position Paper**"). Licensing applications are open from 6 November 2019.

Background

In November 2018, the SFC introduced a conceptual framework to explore the potential regulation of virtual asset trading platforms. An overview of the SFC's conceptual framework is set out in our client alert [The Dawn of Virtual Assets Regulations: New measures for crypto funds activities; Sandbox plans for crypto-exchanges](#).

After completing the exploratory analysis, the SFC has now concluded that some types of centralised platforms would be suitable to be regulated. The SFC emphasises that it is entirely up to the platform operators to decide whether or not they would like to obtain a licence and be regulated:

If a platform operator chooses not to be regulated, it has to ensure that the virtual assets traded on its platform are not "securities" or "futures contracts" under the SFO.

If a platform operator chooses to be regulated and apply for a licence, it must be committed and capable of complying with the licensing criteria as well as continuing conduct requirements, which apply to all aspects of the platform operations, regardless of whether the virtual assets are securities or non-securities and whether the trading is done on or off platform. The key licensing conditions and regulatory standards prescribed in the Position Paper are discussed in more detail below.

Licensing and supervisory regime for platform operators

The SFC will only accept licensing applications for Type 1 (dealing in securities) and Type 7 (providing automated trading services) regulated activities from platform operators which provide trading, clearing and settlement services for virtual assets (including those which are "securities"), and have control over investors' assets.

Upon being licensed, the licensee will be put in the SFC regulatory sandbox for a period of close and intensive supervision.

When assessing whether a platform operator should be licensed, the SFC will consider a number of factors, including the platform operator's infrastructure, core fitness and properness and conduct of virtual asset trading activities as a whole (despite its trading activities in security tokens being only a small part of its business). Platform operators must also ensure





that all virtual asset trading business activities ("**Relevant Activities**") conducted by their group companies which are actively marketed to Hong Kong investors or are conducted in Hong Kong, are carried out under a single legal entity licensed by the SFC.

Regulatory Standards

Licensed platform operators will be subject to strict licensing conditions and must comply with the relevant provisions of the SFO and its subsidiary legislation, as well as the Code of Conduct for Persons Licensed by or Registered with the SFC ("**Code of Conduct**") and other regulatory requirements when conducting Relevant Activities.

Licensing Conditions

Licensed platform operators will be subject to the following key licensing conditions:

- providing services only to "professional investors" (as defined in Part 1 of Schedule 1 to the SFO and the Securities and Futures (Professional Investor) Rules)
- complying with the SFC's prescribed "Terms and Conditions for Virtual Asset Trading Platform Operators" ("**Terms and Conditions**")
- obtaining the SFC's prior written approval for any plan or proposal to introduce or offer a new or incidental service, or activity, or to make a material change to an existing service or activity
- obtaining the SFC's prior written approval for any plan or proposal to add any product to its trading platform
- providing monthly reports to the SFC on its business activities
- appointing an independent firm to conduct an annual review of its activities and operations and prepare a report confirming compliance with the licensing conditions and all relevant legal and regulatory requirements

Terms and Conditions for Virtual Asset Trading Platform Operators

Under the Terms and Conditions, in addition to the existing requirements that apply to other SFC licensed intermediaries, the SFC has included specific requirements to address the unique features of virtual assets.

The key Terms and Conditions include:

Access to trading services

- Virtual asset trading services must be provided to "professional investors" only.
- In case of provision of white labelling services, all reasonable steps should be taken to ensure that both (i) the clients engaging the white labelling services as well as (ii) the end users whose transactions will be routed to and executed on the same platform as the direct clients of the licensee, are "professional investors".



Virtual assets for trading

- Proper due diligence should be made on all virtual assets before including them on the platform for trading.
- In relation to virtual assets which are "securities", these are limited to those which are (i) asset-backed, (ii) approved or qualified by, or registered with regulators in comparable jurisdictions, and (iii) with a post-issuance track record of 12 months.
- A legal opinion should be obtained on the legal and regulatory status of each virtual asset (including whether that virtual asset falls within the scope of "securities") and the implications for the platform operator. Professional skepticism should be exercised before relying on any legal advice.
- No financial accommodation may be provided by the licensee or its group companies to clients to acquire virtual assets. Trades can only be made if there are sufficient fiat currencies or virtual assets in the client's account with the licensee to settle the trade, with the exception of off-platform transactions conducted by institutional professional investors which are settled intra-day.
- No virtual asset futures contracts and related derivatives services may be provided by the licensee.

Know Your Client (KYC)

- All reasonable steps should be taken to establish the true identity of clients and their financial situation, investment experience and investment objectives.
- Assessment must be made of the client's knowledge of virtual assets before providing any services. If a client does not possess such knowledge, services may only be provided if relevant training has been provided to the client and the personal circumstances of the client have been considered to ensure suitability of the services to the client.

Safe custody of assets

- Client assets must be held on trust for clients through a wholly owned subsidiary of the platform operator which is incorporated in Hong Kong and holds a "trust or company service provider licence" under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance.
- At least 98% of client virtual assets should be stored in cold wallets (i.e., where private keys are kept offline), and not more than 2% in hot wallets (i.e., where the private keys to virtual assets are kept online and highly vulnerable to external threats).
- Private keys should be used to digitally sign transactions, with internal controls and governance procedures in place for private key management.

Insurance

- An insurance policy covering risks associated with the client virtual assets held in hot storage (full coverage) and risks associated with the client virtual assets held in cold storage (a substantial coverage, for instance, 95%) must be in effect at all times.



Anti-money laundering and counter-financing of terrorism (AML/CFT)

- AML/CFT systems should be regularly reviewed and enhanced, including possible use of virtual asset tracking tools to flag criminal activities and identified transactions.

Market manipulation

- Policies and controls for the proper surveillance of activities to identify, prevent and report any market manipulative or abusive trading activities should be put in place.
- An effective market surveillance system provided by a reputable and independent provider should be adopted. The effectiveness of the market surveillance system should be reviewed at least annually.

Risk management and Cybersecurity

- A sound risk management framework should be established to manage the full range of risks arising from the businesses and operations. Relevant pre-trade controls and post-trade monitoring measures should be put in place.
- A technology audit should be conducted by a suitably qualified independent professional at least annually.

Conflicts of interest

- Licensees must not engage in proprietary trading or market-making activities on a proprietary basis.
- Policies should be put in place governing employees' dealings in virtual assets to eliminate, avoid, manage or disclose actual or potential conflicts of interest.

Actions to Consider

Platform operators which operate a centralised virtual asset trading platform in Hong Kong should consider whether they want to apply for a licence from the SFC for Types 1 and 7 regulated activities. Specifically, they should consider whether their proposed business model:

- covers trading, clearing and/or settlement services for virtual assets
- can accommodate at least one virtual asset that falls within the definition of "securities" under the SFO
- can be operated by a single legal entity for licensing purposes
- can limit the clientele to "professional investors" only
- can put in place the necessary custody and insurance arrangements, as well as other appropriate controls, mechanisms and arrangements to comply with the SFC's licensing conditions and the prescribed Terms and Conditions

We are happy to assist a platform operator to assess its eligibility and capacity to comply with the SFC's licensing and sandbox requirements. Potential licensing applicants should note that the SFC has indicated the time required for processing a virtual asset trading platform licence application may be longer than that for a standard licensing application.

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