

RE: SFC POSITION PAPER ON REGULATION OF VIRTUAL ASSET TRADING PLATFORMS

On 1 November 2018, the Hong Kong Securities and Futures Commission (“**SFC**”) announced “Conceptual Framework for the Potential Regulation of Virtual Asset Trading Platform Operators”¹ (the “**Conceptual Framework**”), which introduced the concept of a new asset class called “virtual assets” (the “**Virtual Assets**”) ² and set out the potential regulations over “virtual asset trading platform operators” (commonly known as the “cryptocurrency exchanges”) (the “**Platform Operators**”). It is exciting to note that SFC has further issued the “Position Paper: Regulation of Virtual Asset Trading Platform” (the “**Position Paper**”) on 6 November 2019³ during the Hong Kong Fintech Week, announcing that, after one year of examination, it has come to the conclusion that “some types of centralized platforms⁴ trading security and non-security tokens would be suitable to be regulated” by the SFC with the regulatory standards similar to those required of licensed automated trading service (ATS)⁵ providers or brokers.

SFC has reiterated in the Position Paper that Platform Operators which trade only non-security Virtual Assets are not regarded as carrying out “regulated activities” for the purpose of the Securities and Futures Ordinance, Cap. 571 (the “**SFO**”), and such Platform Operators may continue to operate in Hong Kong without applying for an SFC licence. Nevertheless, if a Platform Operator decides to “opt-in” to the SFC regulatory remit which would require the Platform Operator to offer at least one security token on its platform, the SFC would be empowered to grant the licences for Type 1 (dealing in securities) and Type 7 (providing ATS). SFC will take a holistic approach with the infrastructure, core fitness and properness and conduct of all Virtual Assets (be they security or not) trading activities being viewed as a whole and being subject to the SFC’s supervision.

If the SFC decides to grant the licences (Types 1 and 7) to a Platform Operator (the “**Licensed Platform Operator**”), it will impose certain licensing conditions, including the 45-page “Terms & Conditions for Virtual Asset Trading Platform Operators” (the “**Terms & Conditions**”) being attached to the Position Paper. The Terms & Conditions aim to set out the detailed regulatory requirements for the Licensed Platform Operators, most of which are

¹ https://www.sfc.hk/web/EN/files/ER/PDF/App_2_Conceptual_framework_for_VA_trading_platform_eng.pdf

² “Virtual Assets” mean digital representations of value which may be in the form of digital tokens (such as digital currencies, utility tokens or security or asset-backed tokens), any other virtual commodities, crypto assets or other assets of essentially the same nature, irrespective of whether they amount to “securities” or “futures contracts” as defined under the SFO. See definition under the Terms and Conditions.

³ [https://www.sfc.hk/web/EN/files/ER/PDF/20191106_Position_Paper_and_Appendix_1_to_Position_Paper_\(Eng\).pdf](https://www.sfc.hk/web/EN/files/ER/PDF/20191106_Position_Paper_and_Appendix_1_to_Position_Paper_(Eng).pdf)

⁴ SFC has expressed that, at this initial stage, it only welcomes application from platforms which provide trading, clearing and settlement services for Virtual Assets, and have control over investors’ assets, but it will not accept licence applications from those platforms that only provide direct peer-to-peer marketplace for transactions by investors who typically retain control over their own assets or those that trade or intend to trade Virtual Assets for customers but do not provide automated trading services.

⁵ as defined in Part 2 of Schedule 5 of SFO.

in line with those set out in the 2018 Conceptual Framework but with further specifics and elaboration, including:

- a. **One single legal entity within a corporate group to carry out Virtual Asset trading activities in Hong Kong.** SFC would require the Licensed Platform Operator to ensure that all Virtual Asset trading activities conducted by its group of 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. However, such licensed entity should not offer any services relating to the management of Virtual Asset portfolios, distribution of Virtual Asset funds or any business activities other than trading of Virtual Assets.⁶
- b. **RO and Financial Requirements.** The Licensed Platform Operator should have at least one responsible officer (RO) for the overall management and supervision of its platform, with clear reporting lines and responsibilities assigned to appropriate staff members. The Licensed Platform Operator should, in addition to the requirements under the Securities and Futures (Financial Resources) Rules (Cap. 571N), maintain in Hong Kong at all times sufficiently liquid assets equivalent to at least 12 months of its actual operating expenses calculated on a rolling basis, which could be quite significant in light of the high compliance standard as required under the Terms and Conditions.
- c. **Offer at least one (1) security token.** The Licensed Platform Operator would, for the purpose of the SFC licences, be required to offer at least one or more security tokens on its platform. For the security tokens, they should be (i) asset-backed, (ii) approved or registered with regulators in comparable jurisdiction, and (iii) with a post-issuance track record of 12 months.⁷ It should be reminded that the Licensed Platform Operator is required to obtain the SFC's prior written approval for any plan or proposal to add any product to its platform.
- d. **No authorization or prospectus registration required.** As expected, the Licensed Platform Operators are only permitted to offer trading services to professional investors. As such, even if a Virtual Asset to be traded on such licensed platforms are security tokens,⁸ the authorization process for an offer of investment and the prospectus registration regime in Hong Kong would not be triggered.
- e. **Stringent criteria for inclusion of Virtual Assets to be traded on its platform, including submission of written legal opinion.** The Licensed Platform Operator

⁶ Presumably these other regulated activities could be carried out by other licenced entities.

⁷ In contrast with the 2018 Conceptual Framework, there is no further mention of any requirements for a Virtual Asset issued by way of an ICO to be traded at least 12 months after the completion of the ICO or when the ICO project has started to generate profit before such Virtual Asset could be admitted by the Licensed Platform Operator for trading on its platform. Also, there are currently limited number of security tokens in the market which could fulfil the criteria set by the SFC.

⁸ There are no mandatory disclosure requirements applicable to an offer of non-security Virtual Assets in Hong Kong.

should perform all reasonable due diligence on all Virtual Assets to be included on its platform and adopt clear criteria for such inclusion, including (i) its background of the management and development team, (ii) its regulatory status, (iii) its supply demand, maturity and liquidity of the Virtual Asset, (iv) its technical aspects, (v) its development, etc. In addition, the Licensed Platform Operator is required to obtain and submit to the SFC written legal opinion / memorandum on the legal and regulatory status⁹ of each Virtual Asset that will be made available.

- f. **KYC & Suitability test.** During the know-your-client (KYC) process to establish the true identity and location¹⁰ of their clients who must be “professional investors”¹¹, the Licensed Platform Operators shall also ensure their clients (save for institutional and qualified corporate professional investors) to have sufficient knowledge (including the relevant associated risks) in Virtual Assets. The assessment includes (i) whether the client has executed 5 or more transactions in any Virtual Assets within the past three years; (ii) whether the client has current or previous work experience related to Virtual Assets; or (iii) whether the client has undergone training or attended courses about Virtual Assets. Otherwise, the Licensed Platform Operator will have to provide training to its clients.
- g. **Trading limit and/or position limit with no financial accommodation to be provided.** The Licensed Platform Operator is required to set a trading limit and/or a position limit for each client based on his/her financial situation. It should ensure the client has sufficient net worth (i.e. fiat currencies or Virtual Assets in the client account) to assume the risks¹² and should not provide any “financial accommodation”.¹³
- h. **AML/CFT requirements for Virtual Assets.** The Licensed Platform Operator is required to have an adequate anti-money laundering/counter-financing of terrorism (“AML/CFT”) system, which should include deploying Virtual Asset tracking tools to trace the on-chain history of their clients’ Virtual Assets, even though such tools have limited reach and its effectiveness could be compromised by various techniques.
- i. **Segregation and safe custody of client Virtual Assets and client money.** The Licensed Platform Operator is required to set up a wholly owned subsidiary (the “Associated Entity”) in Hong Kong with the “trust or company service provider licence” (TCSP Licence) to safekeep the client Virtual Assets on trust for the clients,

⁹ In particular, the written legal advice would have to opine on whether that Virtual Asset falls within the definition of “securities” under the SFO, and the implications for the Platform Operator. Presumably, this written legal advice would need to be issued by a Hong Kong law firm, as contrary to any foreign law firm.

¹⁰ The Licensed Platform Operator is required to identify the IP address of its clients and, if it is masked, reasonable steps should be taken to unmask the IP address before any service is provided to such client. Also, the Licensed Platform Operator shall restrict access to its platform by clients from jurisdictions which have banned trading in Virtual Assets.

¹¹ The Terms & Conditions further cover that the “end users” of its platform shall also be professional investors.

¹² save for any off-platform transaction to be conducted by institutional professional investors which are settled intra-day.

¹³ as defined under section 1 of Part 1 of Schedule 1 of the SFO e.g. margin financing.

which shall be segregated from those of the platform. The Licensed Platform Operator or its Associated Entity shall store 98% of the client Virtual Assets in cold wallets (with minimizing transactions out of the cold wallets) and limits its holdings of client Virtual Assets in hot wallets to not more than 2%. The Licensed Platform Operator and its Associated Entity shall implement strong governance procedures and controls for private key management, which should be generated offline and kept in a secure environment, such as a hardware storage module (HSM), in Hong Kong. Client money received by the Licensed Platform Operator or its Associated Entity should be paid into a segregated account maintained with an authorized financial institution (e.g. a bank) in Hong Kong within 1 business day of receipt.

- j. **No proprietary trading.** The Licensed Platform Operator should not engage in proprietary trading and should adopt an employees' dealings policy to avoid conflicts of interest. Any market-making services to enhance liquidity on its platform shall be done by an independent external party on an arm's length basis.
- k. **Reputable external market surveillance system.** In order to identify, prevent and report market manipulative and abusive activities¹⁴, the Licensed Platform Operator should establish and implement written policies and controls which shall cover measures to restrict or suspend trading upon the discovery of the manipulative and abusive activities (e.g. the temporary freezing of accounts). In addition, the Licensed Platform Operator is expected to adopt an effective market surveillance system provided by a reputable and independent provide to identify, monitor, detect and prevent any market manipulative or abusive activities on its platform.
- l. **Mandatory Insurance.** Licensed Platform Operators are required to take out insurance policies for risks associated with the custody of Virtual Assets, such as theft or hacking, held in hot storage (100% coverage) and cold storage (substantial coverage e.g. 95%) at all times.
- m. **Monthly Report and Annual Review.** The Licensed Platform Operator is required to submit a monthly report on its business activities within 2 weeks after the end of each month and additionally upon the SFC's request. In addition, the Licensed Platform Operation is required to engage an independent professional firm to conduct an annual review of its activities and operations (including a technology audit) and prepare a report to conduct that all the licensing conditions and all relevant legal and regulatory requirements have been complied with. The first annual report shall be submitted within 18 months after the date of licence approval and subsequent reports should be submitted within 4 months after the end of each financial year and additionally upon the SFC's request.

The above is not meant to be an exhaustive list of all the Terms and Conditions to be imposed on the Licensed Platform Operators, and whoever is interested to make the application would be urged to read the Terms and Conditions in detail. It should be reminded that, save for the Terms and Conditions, the Licensed Platform Operator is also

¹⁴ Trading activities like churning, pump-and-dump schemes, ramping, wash trading and other market manipulation aimed at creating a false representation of price and/or quantity are prohibited.

required to comply with all other regulatory requirements as set out in the Code of Conduct for Persons Licensed by or Registered with the SFC and guidelines, circulars and frequently asked questions published by the SFC from time to time. It is important to note that any breach of the above could be considered as “misconduct” which may also reflect adversely on the fitness and propriety of a Licensed Platform Operator and may result in disciplinary action including licence revocation and fines. Despite the innovative approach by the SFC over the Virtual Assets Platform Operators, there remain certain limitations on the SFC regulatory power over the Virtual Assets Platform Operators and their licensed platforms, for example, SFC is unable to take action under Parts XIII and XIV of the SFO against market misconduct on such platforms in the same way as it does in the traditional securities and futures market.¹⁵ Such regulatory gaps can only be resolved in long term by way of legislative amendments, which will no doubt take a long time in particular under the current political environment.

SFC now welcomes licensing applications from Platform Operators, the vetting process of which is expected to take longer than the standard SFC licence application as they will be placed in the SFC Regulatory Sandbox for a period of close and intensive supervision. We have represented a number of Platform Operators to prepare or submit its applications. It is expected that platforms with “active trading, a broad customer base, substantial local presence and a sound corporate governance structure”¹⁶ would be more likely to succeed in the SFC licence application.

Since the publication of the Position Paper, we have been noticed that there are a lot of interests in relation to the above. Should you have any queries on the Position Paper or wish to understand more about the application process to become a Licensed Platform Operator, please do not hesitate to reach out to a member of us at hyu@lylawoffice.com or +852 2115 9525 to discuss further.

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Disclaimer: The information provided in this article is not intended to be, nor does it constitute, legal advice and is not a substitute for obtaining proper legal advice in respect of any specific issue.

¹⁵ SFC has also expressed that Virtual Asset trading platform operators have found ways to operate so that they fall outside the regulatory remit of the SFC and other Hong Kong regulators: see paragraph 22 of the Position Paper. Nevertheless, SFC has also published a statement setting out its view that platforms offering virtual asset futures contracts may be in breach of the laws of Hong Kong: see <https://www.sfc.hk/web/EN/news-and-announcements/policy-statements-and-announcements/sfc-issues-warnings-on-virtual-asset-futures-contracts.html>

¹⁶ Platforms with such features were invited by the SFC for further discussion after the announcement of the 2018 Conceptual Framework.