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HKCGI Technology Guidance Note (Thirteenth Issue) – Hong Kong SFC's newly implemented licensing regime for virtual asset trading platforms (Part 2)

Introduction

Part 1 of this guidance note provided some background to the new licensing regime for virtual asset trading platforms (VATPs) and discussed the meaning of virtual assets (VAs), the dual licensing regime under the Securities and Futures Ordinance (SFO) and the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (AMLO), transitional arrangements, as well as new and revised guidance issued by the Securiteis and Futures Commission (SFC).

Allowing retail access to eligible large-cap VAs

A major milestone achieved by this VA reform is allowing retail investors access to VATPs, provided that the VATPs comply with a range of robust investor protection measures. This was supported by a significant majority of respondents to the SFC consultation.

Licensed VATP operators may provide trading services to retail investors if the VAs offered are 'eligible large-cap VAs' (ie, VAs which are included in at least two 'acceptable indices' issued by at least two independent index providers). They must seek the SFC's advance approval before admitting VAs which would be made available to retail clients.

VATP operators are required to abide by robust investor protection measures, including those relating to onboarding, governance, disclosure, token diligence and admission, before providing trading services to retail investors.

Hannah Cassidy, Partner, Head of Financial Services Regulatory, Asia, and Valerie Tao, Professional Support Lawyer of Herbert Smith Freehills are co-authors of this guidance note. The Institute's Technology Interest Group members are Dylan Williams FCG HKFCG (Chairman), Ricky Cheng, Harry Evans, Gabriela Kennedy, and Philip Miller FCG HKFCG. Mrs April Chan FCG HKFCG, Institute Past President, is Chairman of the Institute's Technical Consultation Panel with oversight of the Institute's Interest Groups. Mohan Datwani FCG HKFCG(PE), Institute Deputy Chief Executive, serves as the Secretary of the Institute's Interest Groups and contributing editor of the guidance note. If you have any comments and/or suggestions relating to the Institute's Interest Groups, he can be contacted at: mohan.datwani@hkcgi.org.hk.

Key requirements discussed during the consultation

Token due diligence and general token admission criteria

The SFC has stressed the fundamental principle that a licensed VATP should perform all reasonable due diligence on each VA before admission for trading.

The licensed VATP operator should perform all reasonable due diligence on all VAs before including them for trading, and ensure that they continue to satisfy the criteria at all times, taking into account the non-exhaustive list of factors in the general token admission criteria as set out in the *Guidelines for Virtual Asset Trading Platform Operators* (VATP Guidelines).

The consultation proposals required a VATP to consider the regulatory status of a VA in each jurisdiction in which the operator provides trading services. Recognising the onerous burden on licensed VATPs, the SFC's finalised VATP Guidelines only require VATPs to consider the VA's regulatory status in Hong Kong, although VATPs are reminded that their operations should be compliant with local laws and regulations wherever they operate.

Where VAs are made available to professional investors only, the licensed VATP operator will only be required to notify the SFC in advance of any plan to add or remove such VA to or from its VATP without the need to seek approval from the SFC.

Specific token admission criteria for retail access

As mentioned above, licensed VATP operators may only provide trading services to retail investors if the VAs offered are 'eligible large-cap VAs', ie, VAs which are included in at least two 'acceptable indices' issued by at least two independent index providers (independent of each other and independent of the VA issuer). At least one of the two indices must comply with the IOSCO Principles for Financial Benchmarks, in addition to having experience in publishing indices for the conventional securities market.

The SFC does not plan to publish lists of VAs eligible for retail trading, acceptable indices or index providers.

VATP operators must obtain the SFC's prior written approval for any plan or proposal to include any VA for trading by retail clients. If the specific VA fulfils all the general token admission criteria but does not meet the requirements to be an 'eligible large-cap VA', the licensed VATP operator may submit a detailed proposal on the VA for the SFC to decide whether to allow the trading by retail clients of the non-categorised VA on a case-by-case basis.

Governance

Licensed VATP operators should set up a token admission and review committee to govern the criteria for VA to be admitted for trading, and to make final decisions as to whether to admit, halt, suspend and withdraw a VA for client trading.

The committee should consist of members from senior management who are principally responsible for managing key business line, compliance, risk management and information technology functions of the VATP operator. Such members should at least include the corresponding managers-in-charge of the VATP operator.

VATP operators should ensure that they have in place internal policies and procedures to handle conflicts. Provided that adequate policies and procedures are in place, the SFC has indicted that it would not be necessary to require operators to appoint independent external members to the committee.

Onboarding

Except for institutional and qualified corporate professional investors, licensed VATP operators should assess whether it is suitable for a client to participate in the trading of VAs. In addition to the existing knowledge assessment and training requirements under the SFO regime, licensed VATP operators should assess the client's risk tolerance level and risk profile, and set a limit for each client to ensure that the client's exposure to VAs is reasonable.

The VATP Guidelines provide a non-exhaustive list of criteria for VATPs to conduct VA knowledge assessments. The SFC stresses the need for VATPs to conduct a holistic assessment of investors' understanding of the nature and risks of VAs, including an assessment of the VA training or courses they have previously attended, their current or previous VA-related work experience and their prior VA trading experience. Investors will no longer be considered to have sufficient knowledge in VA only on the basis that they have executed five or more VA transactions within the past three years.

The SFC considered suggestions from respondents to the consultation to relax specific aspects of the onboarding requirements for retail investors under certain circumstances, but has decided against it. The SFC is of the view that risks of VAs are generally not likely to be understood by a retail investor. In addition, trading on VA trading platforms occurs automatically and the platforms are unable to intervene if a trade is unsuitable. It is therefore vital to ensure suitability in the onboarding of retail clients, which can only be achieved through the implementation of the full scope of the proposed onboarding requirements.

The SFC considers that individual professional investors should be subject to similar protections in relation to onboarding as retail investors, and should therefore not be exempted from the onboarding requirements, given that such requirements were designed with the spirit of suitability in mind.

Disclosure obligations

Except when dealing with institutional and qualified corporate professional investors, licensed VATP operators should take all reasonable steps to disclose, in a prominent manner, the nature and risks that clients may be exposed to in trading VAs and using their VATPs. They are required to disclose certain minimum information on their websites, including information in relation to their operations, trading rules and fees. They must also disclose material information for each VA to enable clients to appraise the position of their investments, for example, a link to the smart contract audit report of the VA (if any).

The SFC is conscious that it may be difficult to obtain and verify information from an issuer of VAs, which, unlike traditional securities, are not regulated at a product level and are traded on numerous platforms globally. However, a licensed VATP is required to conduct due diligence on each VA prior to admission for trading. To adequately discharge such obligation and enable it (particularly its token admission and review committee) to decide whether to admit a particular token for trading, a VATP is expected to obtain information for each VA (whether directly from the issuer or otherwise) which it can be reasonably satisfied is reliable and sufficient to base its token admission decision on.

Insurance/compensation arrangements

Licensed VATP operators should have in place a compensation arrangement approved by the SFC to provide an appropriate level of coverage for risks associated with the custody of client VAs. The arrangement should include any or a combination of third-party insurance and funds of the licensed VATP or a corporation within the same group of companies which are set aside on trust and designated for such purpose.

The coverage threshold for client VAs held in cold storage has been lowered to 50%, provided that 98% of the client VAs are held in cold storage. Bank guarantees, funds held in the form of demand deposits or fixed deposits, and VAs are acceptable as the types of assets forming part of a compensation arrangement.

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

Detailed guidance for licensed VATP operators has been added as a new chapter in the existing SFC AML/CFT guidelines, including the SFC's regulatory expectations for the statutory requirement on VA transfers (Travel Rule).

The SFC recognises it may take time to develop systems to facilitate the immediate submission of required information to a beneficiary institution under the Travel Rule, and has implemented an interim measure from 1 June 2023 to 1 January 2024, during which the required information may be submitted 'as soon as practicable' after the VA transfer (rather than 'immediately'). Licensed VATPs are required to comply with all other parts of the AML/CFT guidelines and the Travel Rule from 1 June 2023.

In addition, the SFC has also included related requirements for the identification of suspicious transactions and sanctions screening of all relevant parties involved in a VA transfer.

Proprietary trading

VATP operators are not permitted to engage in proprietary trading in VAs for its own account or any account in which it has an interest, except for off-platform back-to-back transactions entered into by the Platform Operator and other circumstances permitted by the SFC on a case-by-case basis.

The SFC agrees that liquidity on a trading platform is important for clients, and appreciates that the initially proposed prohibition on proprietary trading was all encompassing and effectively prohibited group companies of VATPs from having any positions in VAs. In light of the responses to the consultation, the SFC revised the requirements in the VATP Guidelines to allow trading by affiliates other than trading through the VATPs.

Disciplinary Fining Guidelines and senior management responsibility

The senior management of a VATP (including directors, responsible officers and managers-in-charge) should bear primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures.

The SFC will consider all circumstances (including the conduct of the VATP and the individuals in question) in deciding whether to take disciplinary action against individuals, VATPs or both.

The new Disciplinary Fining Guidelines applicable to AMLO-licensed VATPs are based on the existing disciplinary fining guidelines relevant to SFO-licensed VATPs. All VATPs will be subject to the same fining criteria irrespective of whether they are licensed under the SFO or AMLO regime.

Fraud-related offences

The govenance professional should take note of the following new criminal offences under the AMLO specific to fraud involving VAs, which took effect on 1 April 2023:

- Offence involving fraudulent or deceptive devices etc in transactions in VA (section 53ZRF) – It is an offence if a person, directly or indirectly, in a transaction involving any VAs: (a) employs any device, scheme or artifice with intent to defraud or deceive; or (b) engages in any act, practice or course of business that is fraudulent or deceptive, or would operate as a fraud or deception.

- Offence to fraudulently or recklessly induce others to invest in VA (section 53ZRG) – It is an offence for a person to make any fraudulent misrepresentation or reckless misrepresentation for the purpose of inducing another person to enter into, or offer to enter into, an agreement to acquire, dispose of, subscribe for or underwrite any VAs.

These criminal offences are aimed at addressing concerns relating to fraud and are applicable to any person regardless of whether that person is providing a VA service.

Concluding note

In addition to implementing the new regulatory regime for VATPs on 1 June 2023, the SFC has taken further investor protection measuers relating to VA trading.

In August and September 2023, the SFC issued various warning statements regarding improper practices by unlicensed VATPs, two of which were directed at an unlicensed VATP known as "JPEX", which has been under investigation by the SFC and the Hong Kong Police, with a number of arrests being made. The SFC alleges that JPEX has been actively promoting its products and services to the Hong Kong public through social media influencers, key opinion leaders and over-the-counter virtual asset money changers without a VATP licence. The SFC has also alleged that JPEX and its promotors have made false or misleading statements suggesting that JPEX is licensed or has applied for a licence, potentially falling foul of the newly enacted fraud-related offences referred to above (sections 53ZRF and 53ZRG of the AMLO).

The SFC has announed a number of other investor protection measures, including publishing lists of licensed VATPs, VATP applicants, closing-down VATPs and deemed licensed VATPs (see 'Transitional arrangements' in Part 1 of this guidance note), publishing a list of suspicious VATPs, launching a public compaign and enhancing investor education, strengthening its intelligence gathering process towards different business relating to VAs, and establishing a joint working group with the Hong Kong Police to enhance collaboration in monitoring and investigating illegal activities related to VATPs.

The emphasis Hong Kong places on creating a robust cyber ecosystem presents prospects. The new regulatory regime from the SFC is just one of the many initiatives, and therefore governance professionals should work to become informed about them all to meet the challenges and opportunities in providing governance consulting and other support services as needed.

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