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

On 23 May 2023, the Securities and Futures Commission (“SFC”) published the Consultation Conclusions on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the SFC (the “**Consultation Conclusions**”), which sets out the regulatory requirements for virtual asset trading platform operators (the “**VATPs**”), taking into account public feedback (including our submission) in response to the SFC’s consultation paper dated 20 February 2023 (the “**Consultation Paper**”).<sup>1</sup> The finalised Guidelines for Virtual Asset Trading Platform Operators (the “**VATP Guidelines**”) and the Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (For Licensed Corporations and SFC-licensed Virtual Asset Service Providers) (the “**AML Guideline**”) were also published in the Gazette on 25 May 2023.

The SFC has largely adopted the proposals made in the Consultation Paper. You may refer to our previous Client Alert dated 28 February 2023 (the “**Previous Client Alert**”) for the regulatory requirements for VATPs originally proposed by the SFC in the Consultation Paper. In this Client Alert, we highlight the key changes to the regulatory requirements applicable to VATPs contained in the Consultation Conclusions and provide our observations on the topic.

**SFC’S CONCLUSIONS ON REGULATORY REQUIREMENTS FOR VATPS*****VATPs may offer services to retail investors subject to investor protection requirements.***

The SFC has confirmed that licensed VATPs will be allowed to provide their services in the trading of non-security tokens<sup>2</sup> to retail investors subject to a range of robust investor protection requirements, comprising requirements relating to client onboarding, admission of tokens for trading, token due diligence measures and disclosure of information.

*Client onboarding and knowledge assessment*

As regards knowledge assessment as part of the client onboarding, the SFC has emphasised that VATPs should conduct a holistic assessment on an investor’s knowledge and understanding of the nature and risks of virtual assets (“**VAs**”) in a holistic manner, taking into account factors including but not limited to training or courses on VAs which the investor has attended, the investor’s current or previous work experience relating to VAs and prior trading experience in trading VAs. Notably, the presumption that an investor has the requisite knowledge of VAs if he or she has executed five or more transactions in VAs within the past three years has been removed.<sup>3</sup> Additionally, the SFC has also clarified that, even if a retail client is knowledgeable about VAs, a VATP will not be exempt from conducting risk tolerance assessment for the retail client.

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<sup>1</sup> Consultation Paper on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the SFC.

<sup>2</sup> That is, virtual assets which do not fall within the definition of “securities” provided by Schedule 1 to the SFO.

<sup>3</sup> Note 2 under paragraph 9.4 of the draft VATP Guidelines attached to the Consultation Paper containing the presumption has been removed.

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*General token admission criteria*

As discussed in our Previous Client Alert, a VATP is required to perform due diligence on each VA prior to its inclusion for trading on the platform. The SFC has refined the list of factors which must be considered by the VATP in its token due diligence, with the most significant change being that a VATP will now only be required to consider its regulatory status in Hong Kong (eg. whether or not the VA is a security token) rather than in each jurisdiction in which the VATP provides trading services. Nevertheless, a VATP is still required to ensure that its operations comply with the laws and regulations of all jurisdictions in which it or its affiliates operate, as a breach of legal and regulatory requirements in other jurisdictions would affect the VATP's fitness and properness to continue its operations in Hong Kong.

*Legal opinion not mandatorily required in every case*

Noting the potentially high costs of obtaining legal advice and written legal opinion on the nature and regulatory status of each VA, the SFC has removed the requirement for a VATP to submit a legal opinion to confirm the non-security nature of each VA to be admitted for trading by retail investors. Nevertheless, VATPs are still required to ensure that only non-security tokens are offered to retail investors for trading and the SFC may require the VATP to submit legal opinions in respect of specific VAs on a case by case basis as part of the approval process.

*Specific criteria for acceptable indices for "eligible large-cap VA"*

As to the "eligible large-cap VA" requirement, the SFC has clarified that the providers of the two acceptable indices must not only be independent of each other but must also be independent of the issuer of the relevant VA and also the VATP. Additionally, the index provider which has experience in publishing indices for conventional securities market will also be further required to comply with the IOSCO Principles for Financial Benchmarks (the "**IOSCO Benchmarks**"). The SFC has also stressed that inclusion in two acceptable indices is only a *minimum* criterion and that the VATP must also ensure that VAs admitted for trading by retail investors shall meet the general token admission criteria and shall have high liquidity. The SFC has, however, declined to publish any lists of VAs eligible for retail trading, acceptable indices or index providers, maintaining that it is the responsibility of the VATP to determine the admissibility of a token and ensure the continued eligibility of the token for trading based on the due diligence conducted by the VATP.

*Stablecoins should not be made available for trading by retail clients prior to the implementation of the stablecoin regulatory regime*

In addition to the prohibition of offer of security tokens for trading by retail investors, the SFC has also expressed its view that, due to the risks posed by the potential instability of the values of stablecoins and their heightened vulnerability to runs, stablecoins should not be admitted for trading by retail clients prior to the stablecoins being subject to regulation in Hong Kong. It is expected that the regulatory regime for stablecoins will, following the publication of the

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consultation conclusions of the Hong Kong Monetary Authority (the “HKMA”) in January 2023,<sup>4</sup> be implemented in 2023/2024.

### **Insurance and compensation arrangement**

#### *Coverage ratio reduced from 95% to 50% for cold storage of client VAs*

The SFC maintains the requirements for VATPs to store 98% or more of client VAs held in cold storage and to maintain full coverage for client VAs held in hot and other storages (which shall not exceed 2% of all client VAs). Nevertheless, in view of the significant costs of maintaining insurance or other compensation arrangement for client VAs, the SFC has substantially reduced the minimum coverage ratio from 95% to 50% of the value of client VAs held in cold storage.

#### *Types of assets acceptable to form part of compensation arrangements*

As mentioned in our Previous Client Alert, apart from third-party insurance, VATPs may also set aside funds of the VATP or its related group entities which are held on trust and designated for the purpose of compensation for risks to client VAs. The SFC has now clarified that the following types of assets will be acceptable to form part of the compensation arrangement:

- (a) bank guarantees provided by an authorised institution (i.e. bank) in Hong Kong ;
- (b) funds held in the form of demand deposits or fixed deposits with a maturity date of not more than six months (whether held under an escrow arrangement or held by the VATP itself); and
- (c) virtual assets which are of the same type as client VAs being covered and which are held in cold storage by the VATP’s Associated Entity (defined hereinbelow).

### **Custody of client assets must be held by an associated TCSP entity**

The SFC has re-affirmed that client assets must be held by the wholly-owned subsidiary of the VATP which holds a trust or company service provider (“TCSP”) licence granted by the Hong Kong Companies Registry (the “Associated Entity”) and that the SFC will not, at the present stage, accept custody of client assets by third-party custodians. Whilst the SFC currently expects storage of seeds and private keys (as well as their backups) in an appropriately certified Hardware Security Module, it has expressed willingness to consider allowing VATPs to adopt different custody solutions when the cryptography industry reaches a consensus on their security and appropriate certifications for such solutions.

### **Travel Rule**

The Travel Rule, which requires the ordering institution, the beneficiary institution and any intermediary institution in a VA transfer to obtain, record and submit or receive certain

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<sup>4</sup> Conclusion of Discussion Paper on Crypto-Assets and Stablecoins, HKMA, 31 January 2023. Please refer to our Client Alerts dated 17 January 2022 and 6 February 2023 for a summary of the HKMA’s proposed regulatory requirements for stablecoins in Hong Kong.

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required information of the originator and recipient of the transaction as provided by Chapter 12 of the AML Guideline, will be implemented with effect from 1 June 2023 despite feedback from numerous respondents suggesting to postpone its commencement. However, acknowledging that additional time may be required to develop systems to facilitate the immediate submission of the required information to a beneficiary institution, the SFC has indicated that, as an interim measure until 1 January 2024, it will be acceptable for a VATP to submit the required information “as soon as practicable” after the VA transfer where the information cannot be submitted to the beneficiary institution “immediately”.

### ***Dual licensing of VASP and Types 1 & 7***

The SFC has also further emphasised in the Consultation Conclusions that, although the Type 1 (dealing in securities) and Type 7 (providing automated trading services) licences under the SFO apply to the trading of security tokens whereas the VASP licence under the AMLO applies to the trading of non-security tokens, VATPs are expected to apply for both sets of licences in view that the terms and features of a VA may evolve over time so that its classification as “securities” or “non-securities” may be subject to change.

### **OUR OBSERVATIONS**

We are happy to see that some of our comments on the Consultation Paper have been accepted by the SFC as reflected in the Consultation Conclusions and the VATP Guidelines. In particular, the relaxation of the minimum compensation arrangement coverage threshold for client VAs held in cold storage, together with permission of other types of assets to form part of the overall risk compensation arrangement, will help reduce the high costs of maintaining insurance coverage without compromising the security of client VAs, given that client VAs held in cold storage are generally well-insulated from security threats such as hacking and other cyberattacks.

However, it can be expected that the blanket ban on the offer of stablecoins for trading by retail investors, in addition to the requirement that all VAs admitted for trading by retail investors must be non-security tokens, will leave retail investors with very few options given the uncertainty as to the classifications of tokens<sup>5</sup> and the fact that well-recognised stablecoins such as USD Coin (USDC), Tether (USDT) Binance USD (BUSD) and DAI are some of the tokens with the largest market capitalisations which have consistently been included in VA indices. With the prohibition of admission of stablecoins for trading by retail investors, it is questionable which tokens other than Bitcoin (BTC), Ethereum (ETH)<sup>6</sup> and possibly a few other similar tokens such as Litecoin (LTC) would meet all of the general and specific token admission criteria and could safely be offered by VATPs for trading by retail clients.

<sup>5</sup> Most recently, the United States Securities and Exchange Commission (the “SEC”) has asserted that Filecoin (FIL) meets the definition of security. See <https://cointelegraph.com/news/sec-filecoin-is-security-grayscale-investors> and <https://coingeek.com/sec-tells-grayscale-that-filecoin-is-a-security/>. The SEC has also taken other high-profile actions against other major VAs, such as Ripple (XRP). See *SEC v. Ripple Labs Inc.*, U.S. District Court, Southern District of New York, No. 20-CV-10832.

<sup>6</sup> It should be noted, however, that even the non-securities nature of ETH has come under doubt following the change of its consensus mechanism from proof-of-work to proof-of-stake. 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>.

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Further, the insistence that client VAs and client money must be held by the VATP's Associated Entity is inconsistent with the custody requirements applicable to other SFC-licensed corporations, which are permitted to engage suitable third-party custodians to carry out safekeeping of client assets. Provided that VATPs engage Hong Kong-regulated VA custody service providers, such as Hex Trust and Huobi Trust, which hold a TCSP licence, it may not be necessary to make it a mandatory requirement for VATPs to hold client VAs on trust through their Associated Entities. Safekeeping of client assets by third-party custodians would lower the operation costs for all VATPs as a whole due to economy of scale.

Another key outstanding issue is the extent to which pre-existing VATPs operating in Hong Kong immediately prior to 1 June 2023 (the **"Pre-Existing Platforms"**) which are eligible for the 12-month non-contravention period provided by section 2(1) of Schedule 3G to the AMLO (the **"Non-Contravention Period"**) are expected or required to comply with the requirements of the VATP Guidelines during the Non-Contravention Period. Given the revisions to the regulatory requirements for VATPs which have been incorporated into the VATP Guidelines and AML Guideline, Pre-Existing Platforms may face practical difficulties in adjusting their internal policies and operational models in accordance with such revisions (in particular the prohibition of offer of stablecoins for trading by retail investors) in such a short span of time, in particular as the Pre-Existing Platforms are expected to undertake to comply with the VATP Guidelines and the AML Guideline at the time of submitting the VASP licence application. In this regard, we look forward to further guidance and clarification from the SFC relating to the transitional arrangements.

Should you have any queries regarding the above or would like to further discuss any of the issues raised in this Client Alert or the Consultation Conclusions more generally, please do not hesitate to get in touch with our team at [hyu@lylawoffice.com](mailto:hyu@lylawoffice.com) or at (+852) 2115-9525.

**HENRY YU & ASSOCIATES**  
**29 May 2023**



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