

SFC Regulatory Requirements on Virtual Asset Trading Platform

On 6 November 2019, the Securities and Futures Commission (SFC) issued a position paper setting out a new regulatory framework for virtual asset trading platforms. Platforms which operate in Hong Kong and offer trading of at least one security token may now apply to be licensed by the SFC. Below are some points to note:

Points to Note

- i. Virtual Asset Trading Platforms that want to be licensed and regulated by the SFC (Licensed Platforms) must bring themselves within the regulator's ambit by offering for trading at least one virtual asset that is a "security" (Security) as defined under the Securities and Futures Ordinance ("SFO")
 - If the Platform 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
 - Platforms that trade only virtual assets that are not Securities will remain outside of the regulator's purview
 - 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
- ii. At present, the SFC is willing to accept licensing applications only from centralized Platforms that have control over investors' assets
 - Licensing applications will not be accepted from decentralized Platforms or Platforms for direct peer to peer trading
- iii. 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

- iv. When assessing whether a platform operator should be licensed, the SFC will consider a number of factors, including:
 - 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); and
 - 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**
- v. 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

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:

- i. covers trading, clearing and/or settlement services for virtual assets
- ii. can accommodate at least one virtual asset that falls within the definition of "securities" under the SFO
- iii. can be operated by a single legal entity for licensing purposes
- iv. can limit the clientele to "professional investors" only
- v. 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

Responsible Officer (“RO”) Requirements	
Academic/ Industry Qualification	<p>The proposed RO applicants should possess one of the following qualifications:</p> <ul style="list-style-type: none"> • Degree in the designated fields; or <ul style="list-style-type: none"> - refer to Accounting, Business Administration, Economics, Finance and Law • Other degree (with passes in at least 2 courses in the designated fields); or • Professional Qualifications; or <ul style="list-style-type: none"> - Internationally recognized professional qualifications in Law, Accounting or Finance - Internationally recognized professional qualifications in Finance include Chartered Financial Analyst (“CFA”), Certified International Investment Analyst (“CIIA”) and Certified Financial Planner (“CFP”) • Recognised Industry Qualifications <ul style="list-style-type: none"> - The recognized industry qualification and the local regulatory framework paper must not be completed more than 3 years prior to the date of application
Relevant Industry Experience	<ul style="list-style-type: none"> • At least 3 years over the past 6 years industry experience relating to Type 1 and Type 7 regulated activities in, for example, virtual asset trading/ investment and experience in operating an electronic trading platform for matching client orders (Note: other relevant/ similar industry experience may also be counted by the SFC) <ul style="list-style-type: none"> - In assessing the relevance of an individual’s experience, the SFC will consider the role and functions to be undertaken by the applicant and whether the applicant possesses the recognized industry qualification. Experience gained in Hong Kong or elsewhere that is closely related to the functions to be performed will be recognized

	<ul style="list-style-type: none"> Please refer to the SFC circular "Circular to clarify the "relevant industry experience" requirement for Responsible Officers under the Guidelines on Competence" in regard of their approach to assess the applicant's relevant industry experience especially when the business activities are related to highly innovative technology (https://www.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/licensing/openFile?refNo=17EC62)
Management Experience	<ul style="list-style-type: none"> 2 years of Management Experience
Local regulatory Framework Paper	<ul style="list-style-type: none"> The ROs will be required to take and pass HKSI LE Papers 1+2 if he/she has never taken the HKSI papers

Financial Resources Requirements		
Regulated Activity	Minimum Paid-Up Share Capital (HK\$)	Minimum Liquid Capital (HK\$)
Type 1 & 7	5,000,000	3,000,000

Licensing Conditions – Virtual Asset Trading Platform Operators

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

1	<p>Professional Investors</p> <ul style="list-style-type: none"> The licensee must only provide services to professional investors as defined under the SFO (Professional Investors)
2	<p>Terms and Conditions</p> <ul style="list-style-type: none"> The licensee must comply with the attached “Terms and Conditions for Virtual Asset Trading Platform Operators”
3	<p>SFC Approval</p> <ul style="list-style-type: none"> The licensee must obtain the SFC’s prior written approval for any plan or proposal <ul style="list-style-type: none"> (i) to introduce or offer a new or incidental service, or activity, or to make a material change to an existing service or activity (ii) must obtain the SFC’s prior written approval for any plan or proposal to add any product to its trading platform
4	<p>Reporting</p> <ul style="list-style-type: none"> The licensee must provide <u>monthly reports</u> to the SFC on its business activities in a format as prescribed by the SFC <ul style="list-style-type: none"> The report must be submitted to the SFC <u>within 2 weeks after the end of each calendar month</u> and <u>additionally upon the SFC’s request</u> The licensee must engage an independent professional firm acceptable to the SFC to conduct an <u>annual review of its activities and operations</u> and prepare a report confirming that it has complied with the licensing conditions and all relevant legal and regulatory requirements <ul style="list-style-type: none"> The first report must be submitted to the SFC <u>within 18 months of the date of approval of the licence</u> Subsequent reports should be submitted to the SFC <u>within 4 months after the end of each financial year</u> and <u>additionally upon the SFC’s request</u>

Overview of Regulatory Framework – Terms & Conditions	
<p><i>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.</i></p>	
<p>Access to trading services</p>	<ul style="list-style-type: none"> • 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"
<p>Virtual Assets for Trading</p>	<ul style="list-style-type: none"> • SFC approval is needed for each virtual asset included in the Licensed Platform • Criteria for inclusion on the Licensed Platform must be established <ul style="list-style-type: none"> ○ Proper <u>due diligence</u> must be conducted on all virtual assets • Securities can be included only if they <ol style="list-style-type: none"> i. are asset backed; ii. are approved or qualified by, or registered with, regulators in comparable jurisdictions; and iii. have a track record that is <u>at least 12 months</u> post-issuance • 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 <ul style="list-style-type: none"> ○ Professional skepticism should be exercised before relying on any legal advice • Establish and enforce rules setting out obligations of and restrictions on virtual assets issuers, and Platform trading rules

	<ul style="list-style-type: none"> • No financial accommodation may be provided by the licensee or its group companies to clients to acquire virtual assets <ul style="list-style-type: none"> ○ 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
<p>Know Your Client ("KYC")</p>	<ul style="list-style-type: none"> • 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 <ul style="list-style-type: none"> ○ 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
<p>Custody</p>	<ul style="list-style-type: none"> • <u>Client assets (virtual assets and client money) must be held on trust through an associated entity (Associated Entity) of the Operator incorporated in Hong Kong that</u> <ol style="list-style-type: none"> i. holds a "trust or company service provider licence" ("TCSP") under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance; ii. is a wholly owned subsidiary of the Operator and; iii. does not conduct any business other than holding client assets of the Licensed Platform • <u>At least 98% of client virtual assets should be stored in cold wallets</u> (i.e. where the private keys are kept offline)

	<ul style="list-style-type: none"> ○ <u>No more than 2% of client virtual assets should be held in hot wallets</u> (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 ● Client money should be <u>held in segregated accounts of the Associated Entity</u> that are maintained with an authorized financial institution in Hong Kong
Insurance	<ul style="list-style-type: none"> ● 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
AML/CFT	<ul style="list-style-type: none"> ● 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 and Abuse Prevention	<ul style="list-style-type: none"> ● 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 <ul style="list-style-type: none"> ○ The effectiveness of the market surveillance system should be reviewed <u>at least annually</u>

<p>Risk Management and Cybersecurity</p>	<ul style="list-style-type: none"> • A sound risk management framework should be established to manage the full range of risks arising from the businesses and operations <ul style="list-style-type: none"> ○ 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 <u>at least annually</u>
<p>Conflict of Interest</p>	<ul style="list-style-type: none"> • Licensees <u>must not engage in proprietary trading or market-making activities on a proprietary basis</u> • Policies should be put in place governing employees' dealings in virtual assets to eliminate, avoid, manage or disclose actual or potential conflicts of interest
<p>Investor Disclosure</p>	<ul style="list-style-type: none"> • The Operator must disclose certain prescribed risks in relation to virtual assets and the Licensed Platform • The Operator must provide contract notes, statements of accounts and receipts to clients (similar to a regular SFC-licensed corporation)
<p>Change in Business</p>	<ul style="list-style-type: none"> • The SFC's prior written approval is required for any plan or proposal (i) to introduce or offer a new or incidental service or activity or (ii) to make a material change to an existing service or activity of the Licensed Platform
<p>Reporting</p>	<ul style="list-style-type: none"> • The Licensed Platform must provide certain reports to the SFC on its business activities in accordance with the prescribed format and timing • The Licensed Platform must engage an independent professional firm acceptable to the SFC to conduct an annual review and confirm compliance with the T&Cs and all relevant legal and regulatory requirements
<p>Regulatory Requirement</p>	<ul style="list-style-type: none"> • The Operator is required to observe existing regulatory requirements, such as <ol style="list-style-type: none"> i. Code of Conduct for Persons Licensed by or Registered with the SFC; ii. Guidelines for the Regulation of Automated Trading Services; and iii. Guidelines on Online Distribution and Advisory Platforms



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