

SFC Consultation Paper on Proposed Licensing Regime for VATP Operators

February 2023



On 20 February 2023, the Securities and Futures Commission (“SFC”) published its proposed rules for virtual asset trading platforms (“VATP”), which are to take effect on 1 June 2023. The proposed regime incorporates certain existing requirements under the existing VATP Terms & Conditions (“T&C”) and guidelines for SFO licensed firms. The new regime requires VATPs to obtain a license to continue providing services, or prepare ceasing business operations, and are intended to facilitate VATPs preparation for the upcoming Anti-Money Laundering (“AML”) and Counter-Terrorist Financing (“CFT”) (Amendment) Bill (“AMLO VASP regime”).

In this brief, KPMG outlines the proposed regulatory requirements, and outlines next steps potential applicants should consider now in preparing their application.



Potential applicants for the VATP operator license should begin to consider the following actions:

1. Perform an assessment of internal policies, procedures and controls against requirements of the regime. In particular, applicants should focus on areas of operations, KYC, AML/CFT, asset custody, governance, risk management, cyber-security, accounting and auditing, system and controls, and market surveillance;
2. Identify and start process to set up the Token Admission and Review Committee. For existing operators, review listed tokens and cryptocurrencies against new admission requirements; and
3. Engage an external assessor to discuss processes and requirements for Phase 1 of the report.



Virtual Asset¹ Scope

In scope by AMLO:

- Bitcoin, Ether and other cryptocurrency;
- Stablecoins;
- Altcoins; and
- All other virtual assets that do not meet the SFO definition of a security.

In scope by SFO:

All instruments that fall within the definition of a security as per SFO guidelines.



Key Notable Regulatory Requirements the SFC has Proposed

- Publication of virtual asset trading platform lists;
- Safe custody of assets;
- Know Your Client (“KYC”);
- AML/CFT;
- Conflicts of interest;
- Admission of virtual asset for trading;
- Prevention of market manipulative and abusive activities;
- Accounting and auditing;
- Risk management;
- Cybersecurity;
- Existing arrangements for SFO licensed firms to be incorporated into VATP guidelines;
- Compensation arrangement;
- Expansion of services to retail investors;
- Retail investor safeguards (suitability, governance, token admission criteria & due diligence, eligible large-cap virtual assets and disclosure obligations);
- Transitional arrangements (licensing, dual licenses, VATP license list and external assessment report);
- Disciplinary fining guidelines as per section 53ZSS of the AMLO; and
- Implementation of FATF Travel Rule.

¹ virtual asset” or “VA” means:

(a) any “virtual asset” as defined in section 53ZRA of the AMLO; and
(b) any security token



Key Differences with Existing SFO and VATP Requirements

- Current insurance policy requirements are to be modified with the addition of an option to obtain approval for a compensation arrangement involving own funds set aside for this purpose, daily monitoring of client virtual assets under custody and notification to the SFC where amount of client virtual assets exceeds amount covered by the compensation arrangements;
- Wider scope of investors than current regime as SFC proposes to expand services to retail investors by VATPs subject to additional safeguards and controls being in place to ensure investor protection;
- Introduction of dual license application process to promote efficiency within application process;
- Change in requirement on how voting rights should be handled, from *facilitation to disclosure* only;
- Requirements by the platform operator to set up a a Token Admission and Review Committee and to follow general and specific token admission criteria, and due diligence requirements;
- Discontinuing the requirement relating to “security tokens” as introduced by the VATP T&C;
- Written legal advice is only required if the virtual asset is to be offered to retail investors;
- Introduced exceptions to the proprietary trading requirements to allow certain off platform back-to-back transactions; and
- Introduction of separate guideline governing the requirements for all AML/CFT matters.

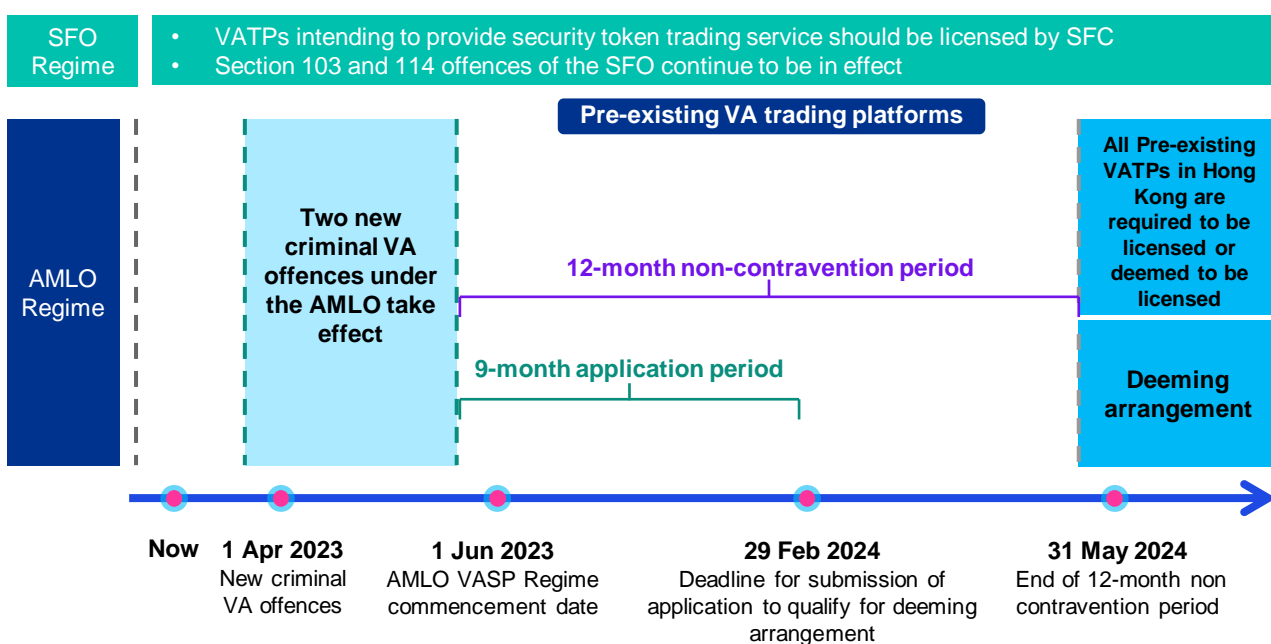


Transitional Arrangements, Licensing and Key Dates

- To be eligible for transitional arrangements, the SFC will consider a variety of factors to determine whether VATPs have been operating in Hong Kong prior to 1 June 2023;
- The licensing application requirements are as follows:
 - Submit application between 1 June 2023 – 29 February 2024;
 - If license application is rejected or not submitted, VATP should cease business operations by 31 May 2024 and not service Hong Kong clients; and
 - If VATP remains in business on 1 June 2024 they will be subject to enforcement action.
- Applicants for the existing SFO regime and the AMLO VASP regime can submit a consolidated dual license application;
- SFO licensed platform operators trading non-security tokens and firms whose SFO licenses are under review are only required to submit additional information as per the AMLO VASP regime;
- External assessment report to be submitted with license application and include:
 - Phase 1 report (focusing on design effectiveness of controls and processes); and
 - Phase 2 report (focusing on operating effectiveness of controls and processes).



Proposed Timeline





Key Impact on VATPs, Users and Other Market Participants

VATPs: to submit license application to SFC (including the external assessment report), or cease business operations by 31 May 2024, or transfer business out of Hong Kong and not service Hong Kong clients. VATPs to be licensed should consider whether they have the appetite, risk controls and safeguards to support service expansion to retail users.

Users: Both retail and institutional users in Hong Kong should consider the benefits of using licensed platforms.

Other Market Participants: Market participants (e.g. asset managers, banks and others) who offer regulated activities to investors should ensure they refer to the SFC VATP license list as applicable for their virtual asset related business.



SFC Guidance Still Pending

- Virtual asset derivatives (subject to SFC review of firm business models, market demand and existing trading volumes).



External Assessment Report

- Upon submission of the licensing application an external assessment report (**Phase 1 Report**) is required. The Phase 1 Report should cover:
 - Design effectiveness of the VATPs proposed structure, governance, operations, systems and controls, with a focus on key areas such as governance and staffing, token admission, custody of virtual assets, KYC, AML/CFT, market surveillance, risk management and cybersecurity.
- The assessor will review and evaluate whether the platform operator's policies and procedures are clearly written and in compliance with the applicable legal and regulatory requirements, particularly the VATP Guidelines and AML Guideline for LCs and SFC-licensed VASPs;
- Upon approval-in-principle, an external assessment report (**Phase 2 Report**) is required to assess the implementation and effectiveness of the actual adoption of the planned policies, procedures, systems and controls; and
- Full information on the procedures required and scope of the external assessment report can be found in Appendix 1 & 2 of Appendix F, pages 352-361 of the consultation paper.



KPMG is experienced in supporting virtual asset platforms in various capacities from audit to advisory. A team of seasoned experts with deep knowledge of the virtual asset space is ready to support you on the new external assessment report and requirements

Why KPMG?

KPMG is a leader in regulatory compliance

We have been named as Risk Management Consultant of the year by Asia Risk Award 2022, recognizing the strength of our regulatory and risk management advisory professionals across the Asia Pacific region.



Strong experience providing independent assessments under SFC rules

We provide advisory services on SFC regulated activities and regulatory compliance health checks against a variety of regulations as well as model and framework building for a wide range of financial institutions.



Strong presence in the virtual asset space

We have successfully supported firms with various licensing applications for their Virtual Asset businesses. Furthermore, we offer external assurance services to a number of virtual asset firms.



Strong technical knowledge

We have a team of seasoned experts ready to support in each of the assessment areas, including members with direct experience within the virtual asset space.





Others Areas Where We Can Support You:



Offer licensing support to VATPs, including transitional support for existing SFO-licensed platforms, and new licensing support for non-licensed VA platform operators.



Support firms in implementing the SFC requirements as per the deadline and transitional arrangements, including on areas of policies, procedures, and controls.



Perform cybersecurity and technology assessment through vulnerability scans and penetration tests.



Perform a gap analysis and readiness assessment of VATPs structure, governance, operations, systems and controls, staffing, token admission, custody of virtual assets, KYC, AML/CFT, market surveillance, risk management and cybersecurity.



Business roadmap support and target operating model support under the new VASP regime.

References

Securities and Futures Commission, Consultation Paper on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the Securities and Futures Commission

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<https://apps.sfc.hk/edistributionWeb/api/consultation/openFile?lang=EN&refNo=23CP1>

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