

# SFC Consultation Conclusions and Transitional Arrangements for VATP Operators

June 2023



Hong Kong's new licensing regime for Virtual Asset Trading Platforms (VATP) under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (AMLO) came into effect on 1 June 2023.

Previously, on 23 May, the Securities and Futures Commission (SFC) published its [Consultation Conclusions](#) on the proposed regulatory requirements for VATP operators. The Conclusions take into consideration the feedback and comments from market participants on the proposals and questions set out in the SFC's [Consultation Paper](#) issued in February. Please refer to our previous [brief](#) for a review of the Consultation paper.

On 31 May, the SFC issued the [Circular on transitional arrangements](#) for the new licensing regime for VATPs.

In this brief, KPMG outlines the key aspects of the Consultation Conclusions and the transitional arrangements, and provides insights into the implications for market participants.

## Consultation Conclusions on the proposed regulatory requirements for VATPs



### A. Allow retail access to licensed VA trading platforms



#### I. Retail access and onboarding requirements

##### Retail access

- As explained in the Consultation Paper, the SFC agrees that licensed VA trading platforms should comply with a range of **robust investor protection measures** covering **onboarding, governance, disclosure** and **token due diligence and admission**, before providing trading services to retail investors.
- The SFC will continue its efforts with the Investor and Financial Education Council to **educate investors** about all aspects of virtual assets and their trading.

##### Onboarding requirements

- Regarding suitability, **individual professional investors** should be **subject to similar protections as retail investors**. What's more, VA trading platforms should **not be exempt from conducting the risk tolerance assessment**, even if a retail client is knowledgeable about virtual assets.



## I. Retail access and onboarding requirements (cont'd)

### Onboarding requirements (cont'd)

- Platform operators should conduct a **holistic assessment** of an investor's understanding of the nature and risks of virtual assets, which could include:
  - i. An **assessment of virtual asset training or courses** that the investor has attended.
  - ii. The investor's current or previous **work experience** related to virtual assets.
  - iii. The investor's **prior trading experience** in virtual assets.
- The SFC has **revised the VATP Guidelines** accordingly. Corresponding amendments will also be made to ensure alignment for all **intermediaries** engaging in VA-related activities.
- The SFC will issue further guidance in the form of **FAQs**, for example, on how to **assess a client's risk tolerance and exposure to virtual assets**. The SFC is of the view that **platform operators would be in the best position to impose exposure limits** which take into account information obtained from the **know-your-client (KYC) process** on a best effort basis.



## II. Governance requirements

- A licensed VATP is required to establish a **token admission and review committee** to enhance its governance. Members "principally responsible for" **managing the key business line, compliance, risk management and information technology** will at least include the corresponding **managers-in-charge** of the platform operator. The SFC will issue further guidance in the form of **FAQs** on a **managers-in-charge regime**, which will be the **same** as that for licensed corporations under the SFO.
- **Conflicts of interest** should be dealt with through **declarations of interests by committee members** and **abstaining from considering matters** that relate to those virtual assets which the committee member has an interest in. It is not necessary for platform operators to appoint independent external members to the committee, provided that **adequate internal policies and procedures** are in place.



## III. Disclosure obligations

- A licensed VATP is required to conduct **due diligence on each virtual asset prior to admission for trading**. It is expected to obtain information for each virtual asset – whether directly from the issuer or otherwise – which it can be **reasonably satisfied is reliable and sufficient to base its token admission decision on**.
- The SFC has refined the disclosure obligations in the VATP Guidelines to require platform operators to **take all reasonable steps** to ensure the product specific information they disclose is not false, biased, misleading or deceptive. Amendments have also been made to the list of information to be disclosed.



## IV. General token admission criteria

- In the Revised VATP Guidelines, the SFC will **only** require VATPs to consider the **regulatory status of the virtual asset** in Hong Kong.
- Due to the inherent difficulties VATPs may face when conducting due diligence, it is required for a **non-security token** to have at least a **12-month track record**.



#### IV. General token admission criteria (cont'd)

- The VATP Guidelines includes clarifications on **smart contract audit**. The SFC expects a licensed VA trading platform to engage an independent assessor or, where reasonable, to rely on an audit conducted by an independent assessor engaged by another party (eg the issuer).
- The SFC has **removed** the requirement for VATPs to **obtain and submit written legal advice** confirming each token made available for trading by retail clients would not amount to a security token.



#### V. Specific token admission criteria

- The SFC requires the index provider with experience in publishing indices for the conventional securities market to comply with the IOSCO (International Organization of Securities Commissions) [Principles for Financial Benchmarks](#) in having proper internal arrangements in place to protect the integrity and ensure the quality of its indices. In addition, the **two index providers** are required to be **independent** of the **VA issuer** and the **VATP**.
- **Being included in two acceptable indices** is the **minimum criterion** for admitting a VA. VATPs are required to conduct further due diligence based on the platform's token admission criteria. In the case of tokens for **retail trading**, VATPs should ensure that they also have **high liquidity**.
- As the admissibility and continued eligibility of a token for trading depends on the due diligence conducted by a platform operator, the SFC has **declined to publish** the lists of VAs eligible for retail trading, acceptable indices or index providers.
- Prior to **stablecoins** being subject to regulation in Hong Kong (the [HKMA discussion paper in January 2023](#)), stablecoins should **not be admitted for retail trading**.
- The revised VATP Guidelines explicitly **prohibit offering gifts tied to trading of a specific virtual asset**, with the exception of discounts of fees or charges.
- The SFC currently does **not impose a cooling-off period** after account opening for retail clients of intermediaries conducting other regulated activities, including the provision of automated trading services.



#### B. Maintain an insurance or compensation arrangement

- The **coverage threshold for virtual assets held in cold storage is lowered to 50%**, given that clients of traditional financial institutions are not fully insured against the loss of their assets.
- **Virtual assets held in hot and other storages** should be **fully covered by the compensation arrangement** of a licensed VA trading platform.
- **Bank guarantees**, along with funds held in the form of **demand deposits or fixed deposits** with a **maturity of six months or less**, would be acceptable types of assets that could form part of a **compensation arrangement**.
- VATPs are allowed to **establish a pool of funds jointly or individually** in the form of an insurer to cover the loss of their client assets.
- **Virtual assets which form part of a compensation arrangement** should be **segregated** from the virtual assets of the platform operator and its group companies and be **held in cold storage by its associated entity**, which is subject to the host of private key management and custody requirements under the VATP Guidelines.

#### Independent Custodian

- The SFC requires a **direct regulatory handle** over the firm exercising control of client VAs (ie, a **wholly-owned subsidiary of a licensed VATP**), which forms the basis for requiring **all seeds and private keys** to be **securely stored with appropriate certification in Hong Kong**.



## C. Trading in virtual asset derivatives

- As explained in the Consultation Paper, licensed platform operators **are not allowed to offer, trade or deal in VA futures contracts or related derivatives** under the existing SFO regime. The SFC is aware of the importance of VA derivatives to institutional investors and **will conduct a separate review in due course**.



## D. Other adaptations to existing requirements

- VATPs should implement proper **VA withdrawal procedures** and **disclose** these procedure to their clients.
- The SFC **allows market making activities** to be **conducted by third-party market makers**. The VATP Guidelines is accordingly revised to allow trading by affiliates other than trading through the licensed VA trading platform.
- The platform's clients can use their own algorithmic trading systems in connection with trading via the licensed VA trading platform.
- A licensed VA trading platform's primary business is to act as an agent and provide an avenue for the matching of orders between clients. It is **not allowed to** conduct the following activities: **earning, deposit-taking, lending and borrowing**.



## E. AML / CFT matters



## I. Virtual asset transfers

### Implementation of the Travel Rule

- The Travel Rule is a key AML/CFT measure for virtual asset service providers (VASP) as it provides fundamental information for carrying out sanctions screening and transaction monitoring. The SFC considers "submission as soon as practicable" as an interim measure acceptable until **1 January 2024** where the required information cannot be submitted to the beneficiary institution immediately. Other Travel Rule requirements are proposed in the **Revised AML Guideline for Licenced Corporations and VASPs**, with effect from 1 June 2023.
- Regarding the situation where some clients of licensed VA trading platforms may **transfer virtual assets to or from unhosted wallets**, which may pose higher money laundering or terrorist financing (ML/TF) risks, the SFC sets out the below requirements:
  - Licensed VATPs should obtain the required information from the customer and conduct sanctions screening.
  - Licensed VATPs should only accept transfers with unhosted wallets that are assessed to be reliable, having regard to the screening results of the virtual asset transactions and the associated wallet addresses, as well as the assessment results of the ownership or control of the unhosted wallet.

### VA transfer counterparty due diligence and additional measures

- VA transfer counterparty due diligence and additional measures should be applied using a **risk-based approach**, taking into account factors such as the **types of products and services** offered by the VA transfer counterparty and the **types of customers** that it serves, as well as the **AML/CFT regime** in the jurisdiction that it operates.
- The **ongoing monitoring of VA transfer counterparties** would include screening virtual asset transfers using a **risk-based approach**.
- Where transfers are conducted with **several VA transfer counterparties that belong to the same group**, the licensed VATP should take this into account while **conducting due diligence on each of them independently** to enable a more holistic view of the risks they pose.



## E. AML / CFT matters (cont'd)



### I. Virtual asset transfers

#### Risk-based policies and procedure

- A licensed VATP should only **return VAs** where appropriate and when there is **no suspicion of ML/TF**, taking into account of the **results of VA transfer counterparty due diligence** as well as the **screening** of the VA transactions and the associated wallet addresses.
- **Returns** should be made to the **account of the ordering institution**, rather than the originator's account

#### VA transfers to or from unhosted wallets

- It is **mandatory for licensed VATPs** to take reasonable measures on a risk-sensitive basis to mitigate and manage ML/TF risks associated with VA transfers to or from an unhosted wallet. Below are some of the risk-based measures set out in the Revised AML Guideline.
  - i. conduct enhanced monitoring of virtual asset transfers with unhosted wallets
  - ii. accept virtual asset transfers only to or from unhosted wallets that the financial institution has assessed to be reliable, having regard to the screening results of the virtual asset transactions and the associated wallet addresses
  - iii. impose transaction limits or prohibitions



### II. Other VA-specific AML/CFT requirements

#### Occasional transactions

- Licensed VATPs **should not carry out occasional transactions** as they are required to establish a business relationship with all customers.

#### Cross-border correspondent relationships

- The requirements for **cross-border correspondent relationships apply to a licensed VATP when** it provides services in the course of providing a VA service as defined in the AMLO **to a VASP or financial institution located outside Hong Kong** which acts for its underlying customers. Such relationships includes instances where a licensed **VATP executes VA trading transactions** for these institutions but does **not include conducting VA transfers with them**.
- A new paragraph has been added to the AML Guideline for Limited Companies and VASPs to clarify that licensed **VATPs are required to conduct ongoing monitoring of virtual asset transactions** and the **associated wallet addresses**.

#### Screening of virtual asset transactions and the associated wallet addresses

- Screening should be performed:
  - i. before conducting a virtual asset transfer, or before making the transferred virtual assets available to the customer; and
  - ii. after conducting a virtual asset transfer on a risk-sensitive basis.



## F. Disciplinary Fining Guidelines

- The proposed Disciplinary Fining Guidelines are based on both the SFO Fining Guidelines and the AMLO Fining Guidelines. **SFO-licensed** VA trading platforms and **AMLO-licensed** VA trading platforms will be subject to the **same fining criteria** irrespective of the ordinance under which they are licensed.
- The SFC will consider each case on its own merits, taking into account of all relevant factors when determining the appropriate fine. The AMLO provides that the **fine should not exceed HK\$10 million or three times the profit gained or loss avoided by the regulated person, whichever is higher.**
- Depending on the nature and character of the misconduct, it may consist of a number of culpable acts or omissions which **may attract multiple penalties.** The SFC will closely monitor its implementation and consider legislative changes if necessary.

## Transitional Arrangements of the new licensing regime for VATPs

- The **transitional arrangements** apply only to VATPs providing trading services in **non-security tokens.**
- There is **no transitional arrangement** for compliance with the Securities and Futures Ordinance (**SFO**).
- VATPs which intend to provide trading services in **security tokens** will be subject to the **securities laws of Hong Kong** and should commence their businesses in providing trading in security tokens only upon **obtaining the relevant licence under the SFO.**

### Eligibility

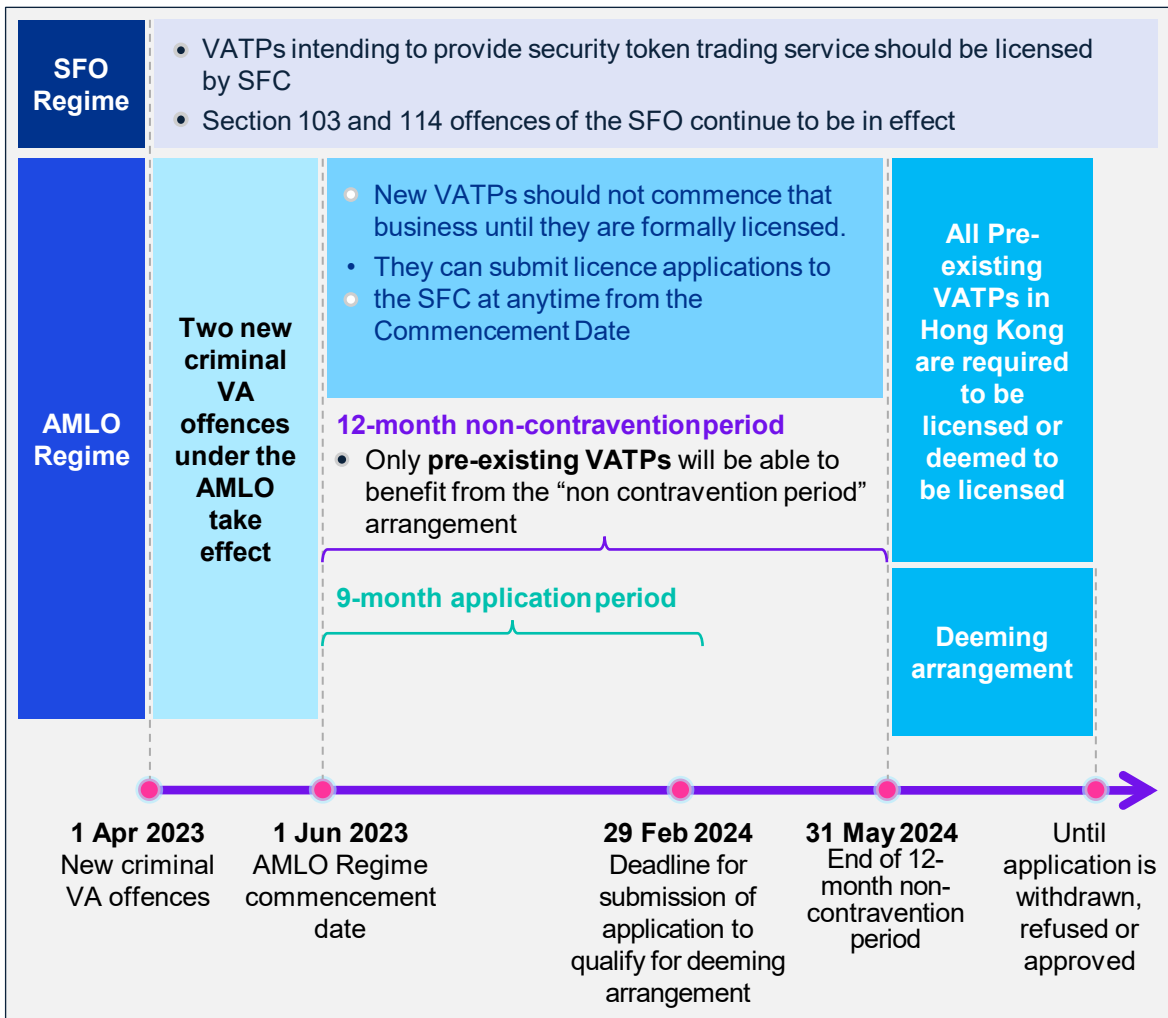
- The transitional arrangements (ie, a **non-contravention arrangement** and a **deeming arrangement**) aim to **provide reasonably sufficient time for** VATPs that were providing a VA service in Hong Kong before 1 June 2023, and are prepared to **comply with the SFC's standards to apply for a licence, to review and revise their systems and controls** to comply with the relevant requirements.
- Such **pre-existing VATPs** with meaningful and substantial presence, i.e. **carrying on a genuine business with genuine presence in Hong Kong**, may continue to provide VA service in Hong Kong until 31 May 2024 without being in breach of the licensing requirements under the AMLO by virtue of the non-contravention arrangement (**the non-contravention period**).

- **Responsible Officers and Licensed Representatives:** individuals may perform a regulated function in Hong Kong for pre-existing VATPs during the non-contravention period if they:
  - i. have been performing a regulated function in Hong Kong for a VATP immediately before 1 June 2023
  - ii. have been performing a regulated function in Hong Kong for the principal at the time of submission of application
  - iii. have demonstrated they will be able to comply with the regulatory requirements from 1 June 2024

**Licensed Representatives only need to comply with (ii) and (iii)** to benefit from the deeming arrangement.

### Dual Licences

- Given that virtual assets may evolve over time, a virtual asset’s classification may change from a non-security token to a security token, or vice versa. To avoid contravening any of the licensing regimes and ensure business continuity, it would be appropriate for **VATPs, together with their proposed Responsible Officers and Licensed Representatives**, to apply for approvals under both the **SFO and the AMLO** and become **dual-licensed**.
- **Pre-existing VATPs** should also submit a completed licence application for a licence to carry out a business of **Type 1 (Dealing in securities) and Type 7 (Providing automated trading services)** regulated activities under the SFO together with its application for a **licence to carry out a business providing a VA service under the AMLO**.





**KPMG is experienced in supporting virtual asset platforms across a range of capacities including audit and advisory. A team of seasoned experts with deep knowledge of the virtual asset space is ready to support you on the new requirements.**



## Areas Where We Can Support You:



Licensing support to VATPs, including transitional support for existing SFO-licensed platforms as well as new VA platform operators that are not SFO-licensed.



Support firms in implementing the SFC requirements to meet the deadline for transitional arrangements, in areas including policies, procedures and controls.



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



Perform a gap analysis and readiness assessment of VATP's 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.

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