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## 1. Introduction

Over the past few years, various forms of virtual asset investment products have sparked investors' interest globally, and Hong Kong is no exception<sup>1</sup>. As a result, the demand for local crypto exchanges which allow people to trade crypto assets with Hong Kong dollars via bank transfer is also increasing<sup>2</sup>. As was the case with other securities regulators in major jurisdictions, the initial regulatory approach taken by the Securities and Futures Commission (the "SFC") was to clarify how virtual assets and some specific activities involving these assets would fall under its regulatory regime. Among other initiatives, the SFC observed that some virtual asset trading platform operators have found ways to operate so that they fall outside the regulatory remit of the SFC and other Hong Kong regulators.

On 6 November 2019, the SFC issued a position paper, setting out its new regulatory regime for the virtual asset trading platforms operating in Hong Kong, following its conceptual framework announced in 2018. This article examines the paper and serves as a guidance to trading platform operators, product issuers and investors on the new SFC's regulatory regime for virtual asset trading platforms. It is intended to be a regulatory overview only and does not constitute any form of investment advice.

## 2. Framework for the regulation of virtual asset trading platforms

The new regulatory framework is essentially an "opt-in" licensing regime for operators of centralised online trading platforms and offers trading of at least one security token. Under this regulatory framework, these operators fall within the jurisdiction of the SFC and can apply for a licence for conducting Type 1 (dealing in securities) and Type 7 (providing automated trading services) regulated activities. Subject to meeting other licensing requirements including the fit and proper criteria, the SFC may then grant a licence to a qualified platform operator to carry on its virtual asset trading business.

Currently, the SFC is categorical that it will not accept licensing applications from the following types of platforms:

1. those which only provide a direct peer-to-peer marketplace for transactions by investors who typically retain control over their own assets; and
2. those which trade virtual assets for clients, including order routing, but do not provide automated trading services themselves.

The SFC is of the view that, for a platform operator to be licensed, its infrastructure, core fitness and properness and conduct of virtual asset trading activities should be viewed as a whole. Although trading activities in non-security

tokens are not “regulated activities”, the SFC’s regulations will apply to all aspects of platform operations once a platform involves trading activities in security tokens, even if they only constitute a small part of its business.

When assessing a platform operator’s licence application, the SFC will consider the manner in which a virtual asset trading platform conducts its entire trading business and, in particular, whether it follows, or is willing and able to follow, the following expected regulatory standards.

### 3. Regulatory standards

#### A. Licensing conditions under the new regulatory regime

Licences granted by the SFC may be subject to conditions which aim to address the specific risks associated with the platform operations. Licensing conditions which may be imposed under section 116(6) of the Securities and Futures Ordinance (the “SFO”) include:

Category	Licensing Condition
Professional Investors	The licensee must only provide services to professional investors.
Terms and Conditions	The licensee must comply with the “ <i>Terms and Conditions for Virtual Asset Trading Platform Operators</i> ” (as amended from time to time).
SFC Approval	<p>The licensee must obtain the SFC’s prior written approval for any plan or proposal to:</p> <ol style="list-style-type: none"> <li>1. introduce or offer a new or incidental service, or activity, or to make a material change to an existing service or activity; and</li> <li>2. add any product to its trading platform.</li> </ol>
Reporting	<ol style="list-style-type: none"> <li>1. The licensee must provide monthly reports to the SFC on its business activities in a format as prescribed by the SFC.</li> <li>2. The licensee must engage an independent professional firm to conduct an annual review of its operations and prepare a report confirming that it has complied with the licensing conditions and all relevant legal and regulatory requirements.</li> </ol>

A licensed platform operator must comply with all licensing conditions imposed on it. Breach of any licensing condition will be considered as “misconduct” under Part IX of the SFO.

#### B. Terms and conditions for virtual asset trading platform operators

One of the licensing conditions imposed on licensed platform operators is to comply with the “*Terms and Conditions for Virtual Asset Trading Platform Operators*”. Some of the terms and conditions are highlighted as follows:

Category	Terms and Conditions
Safe Custody of Assets	<p>The SFC expects the licensee to adopt an operational structure and use technology to ensure that it can offer client protection which is equivalent to that provided by traditional financial institutions. The measures include:</p> <ol style="list-style-type: none"> <li>1. to hold client assets on trust to ensure that they are properly segregated from those of the platform;</li> <li>2. to store 98% of client virtual assets in cold wallets (which refers to the practice where private keys are kept offline without access to the Internet) and limit its holdings of client virtual assets in hot wallets (which means private keys are kept online and are highly</li> </ol>

Category	Terms and Conditions
	<p>vulnerable to external threats) to not more than 2%;</p> <ol style="list-style-type: none"> <li>3. to have adequate processes in place to guard against loss arising from theft, fraud and other dishonest acts;</li> <li>4. to ensure that an insurance policy covering the risks associated with the custody of all virtual assets held is in effect at all times; and</li> <li>5. to set up and implement strong internal controls and governance procedures for private key management of all cryptographic seeds and keys.</li> </ol>
Know-Your-Client (“KYC”)	<p>The licensee should:</p> <ol style="list-style-type: none"> <li>1. take all reasonable steps to establish the true and full identity of each of its clients, and each client’s financial situation, investment experience and investment objectives;</li> <li>2. ensure that the client has sufficient knowledge of virtual assets before providing any services to that client; and</li> <li>3. assess concentration risks to ensure that the client has sufficient net worth to assume the risks and bear the potential trading losses.</li> </ol>
Anti-Money Laundering and Counter-Financing of Terrorism (“AML/CFT”)	<p>The licensee should:</p> <ol style="list-style-type: none"> <li>1. establish and implement adequate and appropriate AML/CFT policies, procedures and controls to manage AML/CFT risks; and</li> <li>2. regularly review the effectiveness of its AML/CFT systems and introduce enhancements where appropriate.</li> </ol>
Prevention of Market Manipulative and Abusive Activities	<p>The licensee is expected to establish and implement written policies and controls for the proper surveillance of activities on its platform in order to identify, prevent and report any market manipulative or abusive trading activities.</p>
Accounting and Auditing	<p>The licensee is expected to exercise due skill, care and diligence in the selection and appointment of auditors for its financial statements, and should have regard to their experience and track record in auditing virtual asset related businesses and their capability to audit a platform operator.</p>
Risk Management	<p>The licensee should:</p> <ol style="list-style-type: none"> <li>1. have a sound risk management framework to identify, monitor and manage the risks arising from their businesses and operations; and</li> <li>2. require customers to pre-fund their accounts without any financial accommodation provided by the platform operator.</li> </ol>
Conflicts of Interest	<p>The licensee should have a policy governing employees’ dealings in virtual assets to avoid, manage or disclose actual or potential conflicts of interest.</p>
Virtual assets for trading	<p>The licensee should:</p> <ol style="list-style-type: none"> <li>1. set up a function responsible for establishing, implementing and enforcing, <i>inter alia</i>, the rules which set out restrictions on virtual asset issuers and the criteria for inclusion of a virtual asset on the platform; and</li> <li>2. perform all reasonable due diligence on all virtual assets before including them on its platform for trading.</li> </ol>

## 4. Conclusion

The new SFC regulatory regime on the virtual assets in Hong Kong is expected to help position Hong Kong in the global virtual assets trading market. However, as stated by the SFC in its paper, since the new regulatory framework is created under the existing legislative regime, there are some limitations which can only be resolved by way of legislative amendments. For instance, the SFC has no power to regulate virtual assets which are not “securities or futures contracts” under the existing legislative regime. As indicated by the SFC, it will continue to monitor the evolution of crypto-assets and work with the Hong Kong government to explore the need for legislative changes in the longer term.

We encourage every virtual asset platform operator in Hong Kong to review the position paper and seek independent legal advice when considering whether it should be regulated under the current regulatory regime, and to assess changes it has to make for fulfilling the new requirements.

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For further details, please get in touch with the authors, Enoch Wong (Partner, Hong Kong) and Koey Chan (Trainee Solicitor, Hong Kong).

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1. Hong Kong Economic Journal. (2018). “HK regulator proposes 'sandbox' approach for crypto exchanges”. Retrieved from <https://www.ejinsight.com/eji/article/id/1981275/20181101-hk-regulator-proposes-sandbox-approach-for-crypto-exchanges>↵
  2. Jones, J. (2020). “Binance Open Hong Kong Dollar Gateway”. ICO Examiner. Retrieved from <https://icoexaminer.com/ico-news/binance-open-hong-kong-dollar-gateway/>↵

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