

Dual licensing regime under the Existing SFO Regime and the New AMLO Regime

On 7 December 2022, the Legislative Council passed the Anti-Money Laundering and Counter-Terrorist Financing (Amendment) Bill 2022 (the "**Bill**"). Amongst other things, the Bill introduces a new regulatory framework whereby all operators ("**VATP Operators**") of centralised virtual asset ("**VA**") trading platforms ("**VATPs**") carrying on business in Hong Kong or actively marketing their services to Hong Kong investors, will need to be licensed and regulated by the Securities and Futures Commission (the "**SFC**"), irrespective of whether they provide trading services in security tokens or not (the "**New AMLO Regime**"). The New AMLO Regime will come into effect on 1 June 2023.

Currently, under the existing regulatory framework within the Securities and Futures Ordinance (Cap. 571) (the "**SFO**") which was introduced on 6 November 2019, only centralised VATPs in Hong Kong which provide trading services in at least one security token are regulated by the SFC (the "**Existing SFO Regime**"). A "security token" means a cryptographically secured digital representation of value which constitutes "securities" as defined in section 1 of Part 1 of Schedule 1 to the SFO. In other words, centralised VATPs which provide only non-security tokens fall outside the jurisdiction of the SFC. Upon commencement of the New AMLO Regime, the Existing SFO Regime will remain in place and operate in parallel with the New AMLO Regime in the following manner:

- VATP Operators engaging in trading of security tokens will be regulated by the SFC under the Existing SFO Regime, meaning that the relevant VATP Operators should obtain licences for Type 1 (dealing in securities) and Type 7 (providing automated trading services) regulated services pursuant to section 116 of the SFO.
- VATP Operators engaging in trading of non-security tokens will be regulated by the SFC under the New AMLO Regime, meaning that the relevant VATP Operators should obtain licences for providing a VA service pursuant to section 53ZRK of the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) (the "**AMLO**").
- Despite the differentiation between security and non-security tokens at present, the SFC encourages VATP Operators (including their proposed responsible offers and licensed

representatives) to apply for approvals under both the Existing SFO Regime and the New AMLO Regime because the terms and features of VA evolve over time and a non-security token may later be categorised as a security token (or vice versa). To avoid any potential breach of the SFO, it would be most ideal for VATP Operators to obtain dual licences regardless of whether the trading services provided involve "securities" or not. To streamline the application process, only a consolidated application is required to be submitted online, indicating that they are applying for licences under both the SFC Regime and the New AMLO Regime.

Consultation on the proposed regulatory requirements for VATP Operators

On 20 February 2023, to prepare for the upcoming New AMLO Regime, the SFC published its highly anticipated [Consultation Paper on the proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the Securities and Futures Commission](#) (the "**Consultation Paper**"). The Consultation Paper sets out detailed proposed regulatory requirements for VATP Operators and includes, amongst others, the following draft guidelines:

- *Guidelines for Virtual Asset Trading Platform Operators* (the "**Draft VATP Guidelines**") (Appendix A of the Consultation Paper); and
- *Disciplinary Fining Guidelines* (the "**Draft Disciplinary Fining Guidelines**") (Appendix D of the Consultation Paper).

We will take a closer look at the abovementioned draft guidelines below.

Key proposals under the Draft VATP Guidelines

The Draft VATP Guidelines are based largely on, and will supersede, the existing [Terms and Conditions for VA Trading Platform Operators](#) (the "**Existing T&Cs**"). Going forward, the Draft VATP Guidelines will be applicable to all VATP Operators, whether licensed under the SFO and/or the AMLO.

With a view to striking a better balance between investor protection and market development, and to facilitate the operation of the New AMLO Regime, the SFC proposed the following key additions or variations to the current requirements under the Existing T&Cs:

Key proposals under the Draft VATP Guidelines

Retail access

Licensed VATP Operators will be allowed to serve both professional and retail investors, provided that they comply with expanded investor protection measures, including the following:

- **Onboarding requirements:** In addition to the existing knowledge assessment (including knowledge of relevant risks associated with VA) and training requirements (where a client does not pass the assessment), in respect of all investors except for institutional professional investors and qualified corporate professional investors, licensed VATP Operators should:
 - conduct suitability assessments on the client's risk level and risk profile; and
 - set a trading limit for each client to ensure the client's exposure to VA is reasonable with reference to the client's financial situation and personal circumstances.
- **Disclosure obligations:** Licensed VATP Operators should disclose sufficient product information (e.g. price and trading volume of the VA on the platform, background information about the management team or developer of the VA, brief description of the terms and features of the VA and issuance date of the VA) to enable clients to appraise the position of their investments. Except for institutional professional investors and qualified corporate professional investors, licensed VATP Operators should fully disclose the nature and risks that clients may be exposed to in trading VA.
- **Governance:** Licensed VATP Operators should set up a token admission and review committee consisting of members from senior management (who are principally responsible for managing the key business line, compliance, risk management and information technology) to perform the following functions:
 - establishing, implementing and enforcing (a) the criteria for admitting a VA for trading (i.e. the token admission criteria), and for halting, suspending and withdrawing a VA from trading; and (b) the rules which set out the obligations of and restrictions on VA issuers;
 - making the final decision as to whether to admit, halt, suspend and withdraw a VA for or from trading;
 - regularly reviewing the above criteria and rules to ensure they remain appropriate;
 - reporting to the Board of Directors on a monthly basis; and
 - monitoring each VA admitted for trading on an ongoing basis to ensure that it continues to satisfy all token admission criteria.
- **Token due diligence and admission criteria:** Licensed VATP Operators are required to exercise due skill, care and diligence when selecting VA to be made available for trading. In addition, licensed VATP Operators are obliged to perform reasonable due diligence on the VA before admitting them for trading. Whilst the SFC does not intend to regulate VA per se, it has introduced a set of objective criteria (both general (applicable to all investors) and specific (applicable to retail investors only) criteria) for licensed VATP Operators to determine whether a VA should be made available to retail investors. In particular, before making VA available to retail investors for trading, the VATP Operators should:
 - ensure that the VA offered to retail investors are "eligible large-cap VA" (that is, VA which are included in at least two "acceptable indices" issued by at least two independent index providers);
 - submit a written legal advice to the SFC in the form of a legal opinion or memorandum confirming that each of the VA made available for trading by retail investors does not fall within the definition of "securities" under the SFO; and
 - obtain prior written approval from the SFC for any plan or proposal to include any VA for trading by retail investors, or suspend or remove any VA which is made available to retail investors (whereas for any VA which is made available to professional investors only, licensed VATP Operators will only need to notify the SFC in writing in advance of any plan or proposal to include, suspend or remove such VA from their VATPs).

Insurance / compensation arrangements	<p>Given the practical difficulties in fulfilling the existing requirements requiring licensed VATP Operators to maintain an insurance policy covering the risks associated with VA held by clients in hot storage (full coverage) and in cold storage (substantial coverage) at all times, licensed VATP Operators will, instead, be required to:</p> <ul style="list-style-type: none"> ➤ have in place an SFC-approved compensation arrangement which consists of third-party insurance and/or funds of the licensed VATP Operators (or a corporation within the same group of companies as the VATP Operators) which are set aside on trust and designated for that purpose; and ➤ monitor the total value of client VA under their custody on a daily basis, and notify the SFC and take prompt remedial measures when they become aware that the total value of client VA under custody exceeds the covered amount approved by the SFC and it is anticipated that such a situation will persist.
Trading in VA derivatives	<p>Whilst the prohibition against offering, trading or dealing in VA futures contracts or related derivatives is preserved under the Draft VATP Guidelines, the SFC sought market views on the type of business model that licensed VATP Operators plan to adopt and the type of VA derivatives that licensed VATP Operators may offer to their clients, and will conduct a separate review exercise to formulate the relevant policies.</p>
Proprietary trading	<p>Licensed VATP Operators will continue to be prohibited from engaging in proprietary trading except for off-platform back-to-back transactions entered into by the licensed VATP Operators or in limited circumstances permitted by the SFC on a case-by-case basis.</p>
Voting rights	<p>Licensed VATP Operators will only be required to disclose to its clients how it will handle voting rights arising out of a client's ownership of a VA, as opposed to the current requirement of having to facilitate the exercise of such voting rights.</p>

Draft Disciplinary Fining Guidelines

The Draft Disciplinary Fining Guidelines indicate the manner in which the SFC proposes to exercise its disciplinary powers to impose pecuniary penalties on a regulated person who is guilty of "misconduct" (as defined in section 53ZSR of the AMLO), or the SFC is of the opinion that a regulated person is or was not a fit and proper. The SFC has the power to impose a fine up to a maximum of HK\$10 million or three times of the profit gained or loss avoided as a result of the misconduct, whichever is higher.

Transitional arrangements

It is noteworthy that pre-existing VATP Operators which are in operation in Hong Kong prior to 1 June 2023 and have a meaningful and substantial presence in Hong Kong may be eligible for transitional arrangements. This means that they may continue to operate in Hong Kong without an SFC licence until 31 May 2024, on the condition that they submit fully completed licence applications online under the New AMLO Regime between 1 June 2023 and 29 February 2024.

Preparations by VATP Operators

The consultation under the Consultation Paper has concluded on 31 March 2023. We will provide a further update when the SFC publishes its consultation conclusions.

In the meantime, in view of the New AMLO Regime coming into effect on 1 June 2023, all VATP Operators

which intend to carry on business in Hong Kong or actively market their services to Hong Kong investors after 1 June 2023 should:

- review their risk management and other internal policies, and revise their systems and controls as appropriate, to ensure compliance with both the Existing SFO Regime and the New AMLO Regime; and
- start preparing an application for the dual licences mentioned above.

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