

THE DUAL LICENSING REGIME FOR VIRTUAL ASSET TRADING PLATFORMS IN HONG KONG– PART 3

KEY HIGHLIGHTS

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Hong Kong Policy and Regulatory Alert

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In our previous alerts ([Part I](#) and [Part II](#)), we provided a brief overview of the new Dual Licensing Regime and highlighted some of the key aspects of the new regime, particularly those set out under the [Guidelines for Virtual Asset Trading Platform Operators](#) (VATP Guidelines) such as licensing requirements, enhanced investor protection measures for retail access and consequences of violations of requirements.

In this alert, we continue to examine the new Dual Licensing Regime, highlighting key topics such as the transitional arrangements which may be available to certain preexisting virtual asset trading platforms (VATPs), insurance or compensation requirements, and other restrictions.

TRANSITIONAL ARRANGEMENTS FOR PREEXISTING TRADING PLATFORMS

On 31 May 2023, Hong Kong's Securities and Futures Commission (SFC) issued the [Circular on Transitional Arrangements of the New Licensing Regime for Virtual Asset Trading Platforms](#) (Circular) to provide additional guidance on the transitional arrangements for VATPs following the commencement of the new Dual Licensing Regime on 1 June 2023.

The key transitional arrangements under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615), as amended (AMLO), which would be available to eligible preexisting VATPs are as follows.

First, these transitional arrangements, as provided under the AMLO, are only applicable to the trading of non-security tokens by VATPs. There is no transitional arrangement with respect to security tokens for compliance with the SFC guidance. VATPs which intend to offer trading in security tokens will be subject to the securities laws of Hong Kong and should commence their relevant businesses only upon obtaining the required license(s) from the SFC.

Second, to be eligible for the transitional arrangements, a VATP must have already been providing a virtual asset service (VA service) in Hong Kong prior to 1 June 2023. In assessing whether a VATP is operating and carrying on a genuine business with a genuine presence in Hong Kong before 1 June 2023 for the purpose of the transitional arrangements, the SFC will take into account the following factors, among others:

- Whether it is incorporated in Hong Kong;
- Whether it has a physical office in Hong Kong;

- Whether its Hong Kong staff exercises central management and control over the VATP;
- Whether its key personnel (for example, those responsible for the operation of the trading system) are based in Hong Kong;
- Whether the VATP's operation is live with independent clients and genuine trading volume in Hong Kong; and
- Whether there are other factors (for example, in relation to the VATP's trading system set-up, trading arrangements and organizational structure) which can support that the VATP has been operating in Hong Kong before 1 June 2023.

Hence, the mere setting up of a company in Hong Kong or only having “shell” operations in Hong Kong would not suffice.

Third, the transitional arrangements are non-contravention and deeming arrangements. A preexisting VATP which is providing a VA service with meaningful and substantial presence in Hong Kong before 1 June 2023 may be deemed eligible to continue to provide its VA service in Hong Kong during the transitional period (i.e., from 1 June 2023 to 31 May 2024) if it fulfills the deeming conditions required by the SFC.

Finally, a platform operator should, however, note that upon reviewing a licensing application, if the SFC considers that the VATP license applicant does not meet any of the deeming conditions (which includes, among others, proving to the SFC to its satisfaction that the VATP is capable of complying with the relevant regulatory requirements applicable to VATPs), the SFC may issue a notice (no-deeming notice) to the VATP to inform that the deeming arrangement will not apply to it.

A VATP which receives a no-deeming notice will be subject to a deemed withdrawal procedure of its license application and must proceed to close down its VA service business by 31 May 2024 or by the expiry of three months beginning on the day of the issuance of the no-deeming notice (whichever is the later), irrespective of whether it has objected to the deemed withdrawal of its licensing application.

INSURANCE OR COMPENSATION REQUIREMENTS

A compensation arrangement (as approved by the SFC) should be in place for clients' virtual assets held by a platform operator. Where a client's virtual assets are held in hot and other similar storage facilities (which types of virtual assets shall be, preferably, less than 2% of all the client's virtual assets), these types of virtual assets shall be 100% covered by the compensation arrangement of a platform operator. A client's virtual assets held in cold storage has a reduced coverage threshold of 50%.

The arrangement should include any or a combination of the options below:

- Third-party insurance;
- Funds (held in the form of a demand deposit or time deposit which will mature in six months or less) of the platform operator or its group companies which are set aside on trust and designated for such a purpose, provided that, where the funds are held in a manner controlled by the platform operator or its associated entity, the funds setting aside should be held in a segregated account with an authorized financial

institution and segregated from any assets of the platform operator, its associated entity, its group companies and client assets, among others;

- Virtual assets of the platform operator or its group companies which are set aside on trust and designated for such a purpose, provided that the virtual assets set aside should be the same as those client virtual assets covered under the compensation arrangement and be held by its associated entity in cold storage and segregated from any virtual assets of the platform operator, its associated entity, its group companies and client virtual assets; and
- Bank guarantee provided by an authorized financial institution in Hong Kong.

ANTI-MONEY LAUNDERING (AML) AND COUNTER-FINANCING OF TERRORISM (CFT) MATTERS—IMPLEMENTATION OF THE TRAVEL RULE

In the consultation conclusions paper published by the SFC on 23 May 2023 (May 23 Consultation Conclusions), the SFC echoes the view of the Financial Action Task Force (FATF) that the Travel Rule¹ in Hong Kong should be implemented as soon as possible. Considering that other major jurisdictions have already implemented, or will soon implement, the Travel Rule, there are concerns that any delay in its implementation in Hong Kong may deter VATPs and financial institutions operating in other major jurisdictions from transacting with platform operators in Hong Kong out of risk management concerns.

The SFC adds that where the required Travel Rule information cannot be submitted to the beneficiary institution immediately, the SFC considers that submission as soon as practicable after the virtual asset transfer to be acceptable as an interim measure until 1 January 2024.

Platform operators should comply with all other Travel Rule and relevant requirements with effect from 1 June 2023, including submitting the required information to the beneficiary institution securely, while adopting the said interim measures.

OTHER RESTRICTIONS

Other restrictions will be imposed on the following.

Proprietary Trading

Instead of the blanket ban on all types of proprietary trading by the platform operator and its group companies, irrespective of where the proprietary trading took place, the SFC has taken the suggestion to allow proprietary trading by affiliates other than trading through the platform operator, and in particular market making activities to be conducted by third-party market makers.

Algorithmic Trading

The SFC clarifies that while platform operators are prohibited from providing algorithmic trading services to its clients, clients can use their own algorithmic trading systems in connection with trading via the platform operators.

Provision of Other Services Commonly Seen in the Virtual Asset Market

The SFC emphasizes that a platform operator's primary business is to act as an agent and provide an avenue for the matching of orders between clients. Hence, platform operators are not permitted to provide such businesses as earning, deposit-taking, lending and borrowing.

CONCLUSION

Virtual asset trading platforms who are running VA services in Hong Kong are now required to obtain licenses from the SFC under the new Dual Licensing Regime which became effective as of 1 June 2023. However, certain eligible pre-existing trading platforms may be able to take advantage of the transitional arrangements provided by the SFC. The mere setting up of a company in Hong Kong or only having “shell” operations in Hong Kong would not suffice. Certain compensation arrangements including an insurance, bank guarantee and others (as approved by the SFC) should be in place to cover potential losses on client virtual assets.

Obtaining the licenses and continuous compliance with the new regime is critically important for those who wish to run VA services in Hong Kong, as new and potentially severe monetary and criminal penalties can be imposed on violations on the requirements imposed by the new regime.

If you have questions, or require assistance in obtaining the necessary SFC licenses or approvals, please contact our authors.

FOOTNOTES

¹ The Travel Rule refers to the requirements for virtual asset transfers to or from an institution set out in the AML guidelines stipulated by the SFC.

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