SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

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

23 May 2023

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Executive summary

1. On 20 February 2023, the Securities and Futures Commission (SFC) issued a consultation paper[1] inviting public comments on proposed regulatory requirements applicable to licensed virtual asset trading platform operators (VA trading platforms) as set out in: Guidelines for Virtual Asset Trading Platform Operators (VATP Guidelines); Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (For Licensed Corporations and SFC-licensed Virtual Asset Service Providers) (AML Guideline for LCs and SFC-licensed VASPs); Prevention of Money Laundering and Terrorist Financing Guideline issued by the Securities and Futures Commission for Associated Entities of Licensed Corporations and SFC-licensed Virtual Asset Service Providers (AML Guideline for AEs, together with the AML Guideline for LCs and SFC-licensed VASPs, the AML Guidelines); and Disciplinary Fining Guidelines.

2. During the consultation period, which ended on 31 March 2023, the SFC received 152 written submissions from industry and professional associations, professional firms, consultancy firms, market participants, licensed corporations, individuals and other stakeholders. A list of respondents (other than those who requested anonymity) is set out in Appendix E to this conclusions paper.

3. Respondents generally supported the proposed regulatory requirements for licensed VA trading platforms. Many of the comments sought clarification of the technical and implementation details. Key comments related to retail access to licensed VA trading platforms, the criteria for token admission, compensation arrangements for the risks associated with custody of client assets, trading in virtual asset derivatives, implementation details and the transitional arrangements. The key comments received and the SFC's responses are discussed in this conclusions paper.

4. The SFC has carefully considered the responses and revised the proposed regulatory requirements where appropriate. The marked-up texts of the revised proposed regulatory requirements are set out in Appendices A, B and C to this conclusions paper. We will also issue further guidance and clarifications where appropriate.

5. The SFC would like to thank all respondents for their time and effort in reviewing the proposals and providing us with their comments.

6. The revised proposed regulatory requirements will become effective on 1 June 2023.

7. The consultation paper, the responses (other than those from respondents who requested their submission be withheld from publication) and this conclusions paper are available on the SFC website at www.sfc.hk.

[1] Consultation Paper on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the Securities and Futures Commission (https://apps.sfc.hk/edistributionWeb/api/consultation/openFile?lang=EN&refNo=23CP1).

Comments received and the SFC's responses

Part I: Amendments to the proposed regulatory requirements for licensed VA trading platform operators

A. Allow retail access to licensed VA trading platforms

Question 1:

Do you agree that licensed platform operators should be allowed to provide their services to retail investors, subject to the robust investor protection measures proposed? Please explain your views.

Retail access

Public comments

8. A significant majority of respondents agreed to our proposal to allow licensed VA trading platforms to provide their services to retail investors. Many respondents echoed the view that denying retail access may result in investor harm as retail investors may be pushed to trade on unregulated VA trading platforms overseas.

9. A number of respondents expressed the view that allowing retail access to virtual assets traded on licensed VA trading platforms will not only provide retail investors with an opportunity to diversify their investment portfolios and deepen Hong Kong's liquidity pool but will also facilitate the development and growth of associated technologies and industries in Hong Kong.

10. Most respondents agreed that proper regulatory oversight is key to addressing the allegations of misuse of client assets and solvency concerns frequently seen in recent industry crises. A majority of these respondents were of the view that, if licensed VA trading platforms are required to comply with a range of robust investor protection measures in relation to, amongst other things, investor knowledge and training, investor risk assessments and information disclosures, then retail access to licensed VA trading platforms could be allowed.

11. Some respondents who disagreed with allowing retail access were of the view that many virtual assets did not have any substance or that retail investors would not have sufficient knowledge and understanding of the risks involved or lack the information needed to make an informed investment decision. While not objecting to the proposal, one respondent cautioned that allowing retail investors' participation should not be seen as an endorsement or an encouragement to trade virtual assets.

The SFC's response

12. We note the strong support expressed for allowing licensed VA trading platforms to provide their services to retail investors and will allow licensed VA trading platforms to provide their services to retail investors.

13. As explained in the consultation paper, we agree 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.

14. We also agree that it is important that retail investors understand the risks involved in investing in virtual assets. Before making any type of investment decision, investors should understand the features and risks and be prepared for losses. The SFC's approval of the admission of a virtual asset for retail trading by a licensed VA trading platform is not a recommendation or endorsement nor does it guarantee the virtual asset's commercial merits or performance. 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

Public comments

15. The majority of respondents agreed to the imposition of the requirements for onboarding retail clients. In particular, many respondents agreed that it is important to require knowledge and risk assessments and investor training as well as to impose an exposure limit. Most respondents who considered the issue were of the view that retail clients should have knowledge of virtual assets before trading. However, one respondent disagreed with the proposal that a client could be presumed to have knowledge of virtual assets if the client had executed five or more transactions in any virtual asset within the past three years.

16. Several respondents recommended various exemptions to the onboarding measures. For example, VA trading platforms serving clients subject to an exposure limit lower than a certain threshold (eg, retail clients who are purchasing a virtual asset for paying gas fees) could be exempt from the knowledge and risk assessment requirements, or clients who passed the knowledge assessment could be exempt from the risk assessment requirement. A few respondents requested that individual professional investors be exempt from the onboarding requirements entirely. Some respondents were of the view that onerous onboarding requirements would push retail investors to trade through unregulated platforms.

17. Many respondents suggested that the SFC work with industry associations to establish uniform standards for knowledge and risk assessments and investor education to ensure consistency amongst licensed VA trading platforms. Some respondents also asked that the SFC provide more detailed guidance, such as how to remedy a breach of the exposure limit due to market volatility.

The SFC's response

18. We welcome the general support for imposing the onboarding requirements in relation to retail clients.

19. As to whether individual professional investors should be exempt from the onboarding requirements, the proposed application of the requirements to individual professional investors is in line with the existing requirements governing derivatives knowledge assessments and suitability which apply without exception when intermediaries serve individual professional investors. Given that the onboarding requirements were designed in the spirit of suitability, it remains our view that

individual professional investors should be subject to similar protections as retail investors.

20. We have duly considered suggestions to relax specific aspects of the onboarding requirements for retail clients under certain circumstances. However, we are of the view that the terms, features and risks of virtual assets are generally not likely to be understood by a retail investor. Coupled with the fact that trading on VA trading platforms occurs automatically and VA trading platforms are unable to intervene if a trade is unsuitable, it is vital to ensure suitability in the onboarding of retail clients. This can only be achieved through the implementation of the full scope of proposed onboarding requirements. For example, the proposed requirement to assess a client's risk tolerance is part and parcel of the existing suitability requirement. As most virtual assets are high risk, they are only suitable for clients who have high risk tolerance. VA trading platforms thus should not be exempt from conducting the risk tolerance assessment even if a retail client is knowledgeable about virtual assets.

21. In light of the importance of ensuring retail investors have sufficient knowledge of virtual assets before they are allowed to trade, the SFC is of the view that platform operators should conduct a holistic assessment of an investor's understanding of the nature and risks of virtual assets, which could include an assessment of virtual asset training or courses that the investor has previously attended, the investor's current or previous work experience related to virtual assets and the investor's prior trading experience in virtual assets. We have thus revised the VATP Guidelines accordingly. As the knowledge assessment requirement applies not only to VA trading platforms but also to other intermediaries engaging in virtual asset-related activities, corresponding amendments will also be made to ensure alignment for all intermediaries.

22. The SFC fully acknowledges the requests for more guidance on the onboarding requirements. We will issue further guidance in the form of frequently-asked-questions (FAQs), for example, on how to assess a client's risk tolerance and exposure to virtual assets. While we understand that the industry may wish for more certainty, such as specifying the exposure limits for investors of different financial situations and risk tolerance levels, it may not be appropriate for the SFC to be prescriptive in this regard, as platform operators, and not the SFC, would be in the best position to impose limits which take into account information obtained from the know-your-client process on a best effort basis.

Governance

Public comments

23. A significant majority of the respondents who commented on this issue agreed to the establishment of a token admission and review committee. Queries on the proposal included who the persons "principally responsible for" different areas of the platform could be, and whether independent external members should be appointed to the committee due to members' possible conflicts of interest when considering token admissions.

The SFC's response

24. We are pleased to note the strong support for requiring a licensed VA trading platform to establish a token admission and review committee to enhance its

governance. It is our intention that members "principally responsible for" managing the key business line, compliance, risk management and information technology will at least include the corresponding managers-in-charge (MICs) of the platform operator[2].

25. We agree that any conflicts of interest involving committee members and the platform operator should be considered and adequately dealt with. This could be done through various measures such as declarations of interests by committee members and abstaining from considering matters in relation to those virtual assets which the committee member has an interest in. Platform operators should ensure that they have in place internal policies and procedures to deal with conflicts. Provided that adequate policies and procedures are in place, the SFC is of the view that it would not be necessary to require platform operators to appoint independent external members to the committee.

Disclosure obligations

Public comments

26. The majority of respondents agreed that the imposition of disclosure obligations for each admitted virtual asset is important for the protection of investors. However, considering that licensed VA trading platforms may republish information provided by an issuer or other parties, several respondents raised concerns about the potentially onerous burden of ensuring the accuracy of this information. A number of respondents weighed in by suggesting amendments to the list of information requiring disclosure.

The SFC's response

27. The SFC is aware that due to the unique nature of virtual assets, which unlike traditional securities are not regulated at a product level and are traded on numerous platforms globally, it may be difficult to obtain and verify information from an issuer.

28. On the other hand, a licensed VA trading platform is required to conduct due diligence on each virtual asset prior to admission for trading. To adequately discharge its due diligence obligations and enable it, and particularly its token admission and review committee, to decide whether to admit a particular token for trading, a platform operator 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.

29. Based on the above, the SFC thus proposed requiring licensed VA trading platforms to act with due skill, care and diligence when disclosing information. This is aligned with requirements imposed on other intermediaries which post information on their online platforms. We have further 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

[2] We will be issuing further guidance in the form of FAQs on a MICs regime to augment accountability of licensed VA trading platforms' senior management, which will be substantially the same as that for licensed corporations under the Securities and Futures Ordinance (Cap. 571) (SFO).

deceptive. We have also made amendments to the list of information requiring disclosure based on suggestions put forward by some respondents.

Question 2:

Do you have any comments on the proposals regarding the general token admission criteria and specific token admission criteria?

General token admission criteria and other token due diligence to be performed

Public comments

30. The majority of respondents agreed that licensed VA trading platforms should have regard to general token admission criteria prior to admitting any virtual asset for trading. Several respondents asked for exemptions for virtual assets with large market capitalisations, for virtual assets which have already been admitted for trading on a licensed VA trading platform or for unsolicited execution-only transactions.

31. Similar to the disclosure obligations, several respondents raised concerns about the potentially onerous burden on licensed VA trading platforms in conducting due diligence and ongoing monitoring of virtual assets based on the general token admission criteria (eg, they should be allowed to rely on information provided by an issuer or due diligence conducted by a third party). A few respondents requested that the SFC provide detailed guidance on the admission threshold for virtual assets (eg, how much of a concentration of holdings will make a virtual asset inadmissible).

32. Some respondents specifically asked that the SFC remove the requirement for a 12-month track record to facilitate the admission of newly-launched non-security tokens, while others took issue with the requirement for licensed VA trading platforms to conduct a smart contract audit.

33. Other respondents weighed in that retail investors should be allowed to trade security tokens and a licensed VA trading platform should not be required to seek and submit legal advice on whether a virtual asset is a “security”.

The SFC’s response

34. Fundamentally, an intermediary is required to know the product that it is offering. Intermediaries making investment products available on their online platforms are required to conduct product due diligence and this is irrespective of whether a client ultimately purchases an investment product via the online platform on an execution-only basis or under advice. Applying the same fundamental principle, a licensed VA trading platform should conduct due diligence on each token before admission for trading. As such, we do not deem it appropriate to provide any exemption from conducting due diligence such as for a token that has been admitted on another licensed VA trading platform.

35. The SFC believes that many technical comments arose due to the prescriptive nature of the due diligence requirements as set out in the proposed VATP Guidelines. For example, we proposed requiring a platform operator to consider the regulatory status of a virtual asset in each jurisdiction in which the platform operator provides trading services and also whether the virtual asset's regulatory status may affect the regulatory obligations of the platform operator. This was designed so that platform operators would consider whether a virtual asset should be admitted for trading in Hong Kong if, for example, it was found to be a security in another jurisdiction, and for platform operators to consider whether the continued provision of trading services in a particular token in another jurisdiction may be in breach of the laws of that jurisdiction.

36. Noting the comments that a token admitted for trading should comply with all laws, rules and regulations in Hong Kong and that any limitation in other jurisdictions which does not affect the token's regulatory status in Hong Kong may not be a relevant consideration, instead of requiring the platform operator to consider the token's regulatory status in each jurisdiction in which the platform operator provides trading services, we will only require the platform operator to consider the regulatory status of the virtual asset in Hong Kong. Nevertheless, platform operators are reminded that they should ensure that their operations are compliant with local laws and regulations in all jurisdictions where they or their affiliates operate, as any breach of those requirements would affect the fitness and properness of the platform operator to continue to provide services in Hong Kong.

37. Regarding the comments on the requirement for a non-security token to have at least a 12-month track record, this requirement was proposed specifically due to the inherent difficulties platform operators may face when conducting due diligence. While a 12-month requirement may not have prevented the recent collapses of some tokens, this requirement aims to reduce the risk of reasonably hard-to-detect fraud as well as the possible impact on the price of a token of the marketing efforts leading up to its initial offering, especially since token offerings are generally unregulated and not subject to the safeguards which are present in the traditional securities markets.

38. In relation to requiring a smart contract audit, we wish to clarify that the SFC only 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 (for example, the issuer). We have made corresponding clarifications in the VATP Guidelines. This is a key requirement as a successful exploitation of a flaw in the smart contract could cause material harm to investors.

39. Security tokens cannot be offered to retail investors in breach of the prospectus regime under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) (C(WUMP)O) and the offers of investments regime under Part IV of the SFO. We thus proposed that platform operators obtain and submit to the SFC written legal advice confirming that each token made available for trading by retail clients would not amount to a security token. Acknowledging the potentially significant costs of obtaining legal advice on the regulatory status of each virtual asset, we have removed the requirement to submit such legal advice to the SFC from the VATP Guidelines. Platform operators are nevertheless reminded of their obligations and to take reasonable steps under the relevant laws to ensure that retail trading of any token they make available will not breach the public offering regimes in Hong Kong. Notwithstanding this, as part of the approval process, the

SFC may request legal opinions on specific tokens in light of developments in other jurisdictions.

40. With regard to the comments on the due diligence requirements, we would like to stress again that the underlying principle is that when selecting virtual assets to be made available for trading, licensed VA trading platforms should exercise due skill, care and diligence through conducting all reasonable due diligence. We have revised the due diligence requirements to be more principles-based and will supplement them with guidance in FAQs which will address some of the comments received.

Specific token admission criteria

Public comments

41. Several respondents commented that it was not clear from the list of criteria which indices would be acceptable and asked that the SFC publish a list of acceptable indices or a list of index providers with experience in publishing indices for the conventional securities market, as well as a list of eligible large-cap virtual assets. Some suggested that licensed VA trading platforms should be able to admit virtual assets by relying on such lists published by the SFC or admission on other licensed VA trading platforms.

42. Other respondents requested that the SFC provide additional guidance on the underlying principles for approving virtual assets for retail trading and questioned whether other factors such as adverse news should form part of the specific token admission criteria. Several respondents raised further concerns regarding the reliability of indices, for example, that transaction data may come from unreliable sources and the risks of potential collusion and exploitation of insider information.

43. A few respondents queried the need for the SFC's prior approval for virtual assets for retail trading on licensed VA trading platforms.

44. Certain respondents commented that the specific token admission criteria will result in a small number of virtual assets being eligible for retail trading. These respondents suggest that the specific token admission criteria be relaxed (eg, to include the top 200 virtual assets instead of the top 10) to allow licensed VA trading platforms to provide retail clients with access to a broader range of virtual assets. Several respondents noted having a large market capitalisation does not automatically translate to high liquidity. They also expressed concern that stablecoins and locally developed virtual assets are unlikely to be eligible for retail trading under these criteria.

The SFC's response

45. The SFC would like to take this opportunity to articulate the principles underlying the specific token admission criteria.

46. As explained in the consultation paper, in the conventional securities markets, investment products offered to the retail public in Hong Kong are subject to the

offers of investments[3] and prospectus[4] regimes. Retail products are generally subject to the SFC's regulation at the product level. The SFC would have vetted or reviewed their offering and marketing materials prior to public offering. This does not apply to non-security tokens, and most, if not all, non-security tokens are not regulated at the product level by any regulatory authority anywhere. This explains the need for the SFC's approval before a token can be admitted for retail trading on a licensed VA trading platform.

47. Therefore, we proposed that tokens meet additional minimum criteria before they could be traded by retail investors. These criteria are based on the underlying principle that tokens accessible by retail investors should be less prone to market manipulation, not just on the platform operated by the platform operator but across the virtual asset market as a whole, given that most, if not all, VA trading platforms are currently unregulated or only regulated from an AML/CFT (anti-money laundering/counter-financing of terrorism) perspective across the globe. This is reflected in our proposed requirement that, to be eligible for trading by retail investors, tokens must be eligible large-cap virtual assets included in at least two acceptable indices issued by two independent index providers.

48. We appreciate the comments on acceptable indices and the independence of an index provider. We agree that it is important the indices are robustly constituted and administered, including ensuring their quality and integrity. The criteria for determining whether an index is an acceptable index were formulated with these principles in mind, and the additional requirement that one index provider should have experience in publishing indices for the conventional securities market was introduced to enhance reliability. We agree that, as raised by some respondents, the reliability of the underlying data and possibility of conflicts of interest may affect an index's integrity. We thus find it appropriate to further require that the index provider with experience in publishing indices for the conventional securities market complies with the IOSCO[5] Principles for Financial Benchmarks[6] such that it has proper internal arrangements in place to protect the integrity and ensure the quality of its indices. In addition to being independent of each other, we will also require that the two index providers should be independent of the issuer of the virtual asset and also of the platform operator.

49. We acknowledge that for virtual assets a large market capitalisation does not automatically correlate to high liquidity. The SFC would like to reiterate that being included in two acceptable indices is not the sole criterion for admitting a virtual asset. It is merely a minimum criterion. This highlights the importance attached to the due diligence conducted by a licensed VA trading platform. Platform operators are required to conduct further due diligence based on, and ensure tokens admitted to trading satisfy, the platform's token admission criteria, and in the case of tokens for retail trading, ensure that they also have high liquidity. Platform operators should also ensure that admitted tokens continue to satisfy the token admission criteria. As the admissibility and continued eligibility of a token for trading depends on the due diligence conducted by a platform operator, it would not be appropriate for the SFC to publish lists of virtual assets eligible for retail trading, acceptable indices or index providers.

[3] Part IV of the SFO.
[4] Parts II and XII of the C(WUMP)O.
[5] The International Organization of Securities Commissions.
[6] Principles for Financial Benchmarks Final Report (https://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf).

50. We thank respondents for their extensive comments on the specific token admission criteria and have revised the VATP Guidelines to reflect the discussion above.

51. We note the international focus on the risks posed by stablecoins and the push for regulation of stablecoins to ensure, amongst other things, that stablecoin reserves are properly managed to maintain price stability and enable investors to exercise redemption rights. These risks have fundamental implications for the stability of a stablecoin. A stablecoin which is unable to maintain its peg or return an investor's funds upon redemption cannot be said to be stable. In addition, heightened vulnerability to runs greatly affects their liquidity and renders them generally unsuitable for retail investors. The Hong Kong Monetary Authority (HKMA) published the conclusion on its discussion paper on crypto-assets and stablecoins in January 2023[7] and the regulatory arrangements for stablecoins are expected to be implemented in 2023/24. Prior to stablecoins being subject to regulation in Hong Kong, it is our view that they should not be admitted for retail trading.

Question 3:

What other requirements do you think should be implemented from an investor protection perspective if the SFC is minded to allow retail access to licensed VA trading platforms?

Public comments

52. Some respondents advocated for a prohibition on licensed VA trading platforms offering incentives and monetary benefits to retail investors to trade virtual assets. This could prevent the creation of inappropriate motives for retail investors to trade virtual assets.

53. Several respondents commented that the SFC may consider introducing a cooling-off mechanism for retail clients before (eg, the first 24 hours after account opening) and after (eg, with a right to unwind or cancel transactions or a right to request a buy-back) they conduct a transaction in a virtual asset.

The SFC's response

54. We agree that platform operators should not offer gifts tied to the trading of a specific virtual asset, as is the case with all other intermediaries. This principle formed the basis for the requirement that platform operators should not post any advertisement in connection with a specific virtual asset. In light of the comments received, we have now made the prohibition of gifts explicit in the VATP Guidelines, with the exception of discounts of fees or charges. The SFC would also like to take this opportunity to remind platform operators of their obligation to ensure that any product-specific materials they post, whether on- or off-platform, are factual, fair and balanced.

[7] Conclusion of discussion paper on crypto-assets and stablecoins (https://www.hkma.gov.hk/eng/news-and-media/press-releases/2023/01/20230131-9/).

55. 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. As platform operators are required to ensure suitability in the onboarding process, any retail client who was onboarded should have been assessed by the platform operator as being suitable for trading virtual assets. A cooling-off period after a trade is not practicable for automated trading services where trades are matched between clients as unwinding or cancelling a transaction would affect another client.

B. Maintain an insurance or compensation arrangement

Question 4:

Do you have any comments on the proposal to allow a combination of third-party insurance and funds set aside by the licensed platform operator or a corporation within its same group of companies? Do you propose other options?

Question 5:

Do you have any suggestions as to how funds should be set aside by the licensed platform operators (for instance, under house account of the licensed platform operator or under an escrow arrangement)? Please explain in detail the proposed arrangement and how it may provide the same level of comfort as third-party insurance.

Public comments

56. The majority of respondents supported requiring licensed VA trading platforms to have in place an insurance or compensation arrangement for risks associated with custody of client assets. However, some respondents pointed out that the arrangement to set aside funds would result in a high cost of capital and would affect the competitiveness of licensed VA trading platforms. While some respondents agreed that client virtual assets held in hot storage should be fully covered by insurance or funds set aside, they were of the view that client virtual assets held in cold storage need not be fully covered in view of the relatively lower risks involved. A number of respondents queried whether set aside funds could also include virtual assets. There were different views on the most appropriate arrangement.

57. Regarding the appropriate level of coverage, most respondents were of the view that full coverage over all client assets under custody may be too onerous, and their proposals included the following:

(a) a different coverage level for each platform based on the robustness of each platform's custody systems; and

(b) uniform coverage for each platform with decreasing coverage for each year during which no adverse custody-related events take place.

58. Several respondents asked the SFC to set out factors which it would consider in determining the appropriate level of coverage and the appropriate combination of arrangements.

59. With regard to the types of assets that could form part of a compensation arrangement in addition to third party insurance, suggestions included the following:

(a) bank guarantees, as they are currently allowed under the Hong Kong stored value facility regime;

(b) "eligible large-cap virtual assets"; and

(c) funds invested in guaranteed return products with high liquidity (or even virtual asset-related exchange traded funds).

60. In relation to how the compensation arrangement could be set up, suggestions included the following:

(a) an escrow agent could be used, as the funds would be segregated and would not form part of a VA trading platform's assets in the event of insolvency;

(b) a designated bank account could hold funds on trust (with an acknowledgement letter from the bank and monthly reports to be submitted to the SFC);

(c) a pool of funds could be established amongst licensed VA trading platforms which could take the form of an insurer authorised by the Insurance Authority or other compensation scheme; and

(d) a segregated wallet should be used if virtual assets could form part of the compensation arrangement. However, an escrow arrangement may not provide much comfort as it would require the use of a third-party custodian which may not be subject to the same custody requirements for wallet infrastructure and cybersecurity measures as licensed platform operators.

The SFC's response

61. We appreciate comments and suggestions received in response to this proposal and the requests for more clarity.

62. The risks to client virtual assets held in cold storage are generally similar to custody risks associated with client assets in the traditional financial markets, namely, misappropriation by employees and fraud. Noting that clients of traditional financial institutions are not fully insured against the loss of their assets, we believe there is room for lowering the coverage threshold for client virtual assets held in cold storage. This is especially so since licensed VA trading platforms are subject to a host of private key management and custody requirements under the VATP Guidelines which were designed to, amongst other things, reduce the risk of collusion amongst employees. However, as risks to client virtual assets held in hot and other storages (mainly hacking and other cybersecurity risks) are not typically associated with the custody of client assets in the traditional financial markets, we remain of the view that client virtual assets held in hot and other storages should be fully covered by the compensation arrangement of a licensed VA trading platform.

63. As client virtual assets will not be fully insured against loss, we find more comfort in knowing the bulk of client virtual assets are held in cold storage, which is generally safe from hacking and other cybersecurity risks. We are thus prepared to lower the coverage threshold to 50% for client virtual assets held in cold storage, on the basis that 98% of client virtual assets will be required to be held in cold storage. However, it may be preferrable for licensed VA trading platforms to hold less than 2% of client virtual assets in hot and other storages given that the platform operator would need to set aside its own funds if insurance coverage for hot and other storages is unavailable.

64. Regarding the types of assets that could form part of a compensation arrangement, we agree that 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. In terms of virtual assets, we see the benefits of holding reserve virtual assets that are the same as the client virtual assets required to be covered under the compensation arrangement, to reduce market risk given virtual assets' volatility.

65. We note the diverse views as to whether an escrow arrangement be put in place for the compensation arrangement or whether the licensed VA trading platform be allowed to hold the funds set aside. Both arrangements would be acceptable to us, provided that the funds set aside are segregated from the assets of the platform operator and its group companies, and are set aside on trust and designated for such purpose. Funds held by the platform operator or its associated entity should be held in a segregated account with an authorized financial institution. The VATP Guidelines have been revised accordingly.

66. We agree that licensed VA trading platforms should also have the flexibility to establish a pool of funds jointly or individually in the form of an insurer to cover the loss of their client assets. This flexibility has now been provided in the VATP Guidelines.

67. Finally, we also agree that 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. This is because the associated entity is subject to the host of private key management and custody requirements under the VATP Guidelines, while the custody standards of third-party custodians may vary greatly or could even be inadequate.

Question 6:

Do you have any suggestions for technical solutions which could effectively mitigate risks associated with the custody of client virtual assets, particularly in hot storage?

Public comments

68. Many respondents suggested that the SFC should allow third-party custodians to be engaged for the safekeeping of client virtual assets given their extensive technical expertise.

69. A number of respondents suggested that it should be mandatory for licensed VA trading platforms to provide publicly-accessible proof of reserves so that clients can verify the amount of virtual assets held in custody. Other respondents recommended that the SFC maintain a public register of wallet addresses of licensed VA trading platforms for a similar reason.

70. Many respondents further remarked that the latest custodial solutions, including multi-party computation, key sharding technology and other innovations, should be adopted for the storage of seeds and private keys. A few respondents took issue with the proposed requirement to keep all seeds and private keys in Hong Kong.

The SFC's response

71. We acknowledge that there may be third-party custodians with extensive technical expertise. However, there is currently no regulatory regime in Hong Kong for custodians of virtual assets. Given the importance of safe custody of client virtual assets, we would require a direct regulatory handle over the firm exercising control of client virtual assets (ie, a wholly-owned subsidiary of a licensed VA trading platform). This also forms the basis for requiring all seeds and private keys to be securely stored in Hong Kong. If the seeds and private keys are stored overseas, the corresponding client virtual assets would also be outside our jurisdiction. This would substantially hinder our supervision and enforcement.

72. We have noticed the increasing trend of VA trading platforms overseas providing proof of reserves or disclosing wallet addresses. Nonetheless, we are mindful that these disclosures mainly evidence a VA trading platform's assets, but not its liabilities, and disclosing the latter may require the involvement of external assessors (ie, an auditor).

73. We appreciate the views shared on technological advancements that may enhance the safe custody of client virtual assets. We are monitoring new custodial technologies such as multi-party computation and key sharding, and note the intense debate on these technologies in the cryptography industry. A requirement in the VATP Guidelines is that seeds and private keys (and their backups) should be stored securely with appropriate certification, for example, in an appropriately certified Hardware Security Module. We are open to allowing licensed VA trading platforms to adopt different custody solutions when the industry reaches a consensus on their security and appropriate certifications for the solutions emerge. The VATP Guidelines have retained such flexibility in its wording.

C. Trading in virtual asset derivatives

Question 7:

If licensed platform operators could provide trading services in VA derivatives, what type of business model would you propose to adopt? What type of VA derivatives would you propose to offer for trading? What types of investors would be targeted?

Public comments

74. Respondents expressed general support for allowing licensed VA trading platforms to provide trading services in virtual asset derivatives.

75. The proposed business model involved either an order-matching engine or over-the-counter trading where leverage is employed (eg, three times leverage) and with clients providing margin or premium (with client positions subject to automatic liquidation).

76. The type of virtual asset derivatives proposed included simple delivery futures, margined perpetual future contracts, options with settlement dates and other structured products. It was proposed that products could start with the major virtual assets acting as the underlying asset (eg, Bitcoin and Ether) with some suggesting products quoted and settled in stablecoins.

77. Most respondents suggested that virtual asset derivatives should be limited to professional investors. If retail investors were to gain access to virtual asset derivatives, extensive investor protection measures should be put in place (eg, confining eligible underlying assets to those meeting certain criteria).

The SFC's response

78. We are grateful for the detailed and informative responses submitted on this question. As we have explained in the consultation paper, the SFC is aware of the importance of virtual asset derivatives to institutional investors. We will take the large number of comments into consideration and conduct a separate review in due course.

D. Other adaptations to existing requirements

Question 8:

Do you have any comments on how to enhance the other requirements in the VATP Terms and Conditions when they are incorporated into the VATP Guidelines?

Public comments

79. Many comments were received in relation to the requirement that 98% of client virtual assets must be stored in cold storage and only 2% of client virtual assets could be stored in hot or other storages (cold to hot storage ratio). Many respondents requested the cold to hot storage ratio be lowered to more expediently deal with client withdrawal requests.

80. In response to the blanket ban on all types of proprietary trading by the licensed VA trading platform and its group companies, irrespective of where the proprietary trading took place, there were suggestions to allow proprietary trading, and in particular proprietary market making by the licensed VA trading platform's affiliates, to enhance the liquidity of the trading platform.

81. Some respondents noted the prohibition on platform operators providing algorithmic trading services to clients and asked whether a licensed VA trading platform's clients could use their own algorithmic trading systems.

82. Finally, respondents sought clarification of whether other virtual asset-related services such as earning, deposit-taking, lending and borrowing could be provided by licensed VA trading platforms.

The SFC's response

83. We maintain the view that to ensure the safe custody of client assets the cold to hot storage ratio should not be lowered and the bulk of client virtual assets should be held in cold storage, which is generally free from hacking and other cybersecurity risks. We would also like to remind platform operators that they should implement proper virtual asset withdrawal procedures and disclose these procedures to their clients. In particular, if a platform operator does not effect clients' withdrawal requests on a real time basis, it should specify the time generally required for transferring virtual assets to a client's private wallet after receiving a withdrawal request on its website.

84. With regard to proprietary trading, we agree that liquidity on a trading platform is important for clients. Hence, the SFC allows market making activities to be conducted by third-party market makers. However, the current prohibition on proprietary trading is all encompassing and effectively prohibits even the group companies of a licensed VA trading platform from having any positions in virtual assets. We have accordingly revised the requirements in the VATP Guidelines to allow trading by affiliates other than trading through the licensed VA trading platform.

85. In relation to algorithmic trading, the SFC would like to clarify that while platform operators are prohibited from providing algorithmic trading services to its clients, the platform's clients can use their own algorithmic trading systems in connection with trading via the licensed VA trading platform.

86. With respect to the provision of other services commonly seen in the virtual asset market such as earning, deposit-taking, lending and borrowing, the SFC does not allow licensed VA trading platforms to provide these services and this is covered by paragraph 7.26 of the VATP Guidelines. Ultimately, 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. Any other activities may lead to potential conflicts of interest and require additional safeguards. As such, licensed VA trading platforms will not be allowed to conduct these activities at this stage.

E. AML/CFT matters

Question 9:

Do you have any comments on the requirements for virtual asset transfers or any other requirements in Chapter 12 of the AML Guideline for LCs and SFC-licensed VASPs? Please explain your views.

87. The respondents generally welcomed the inclusion of virtual asset-specific AML/CFT requirements in Chapter 12 of the AML Guideline for LCs and SFC-licensed VASPs, which provides comprehensive guidance to assist the design and implementation of AML/CFT systems to mitigate the money laundering and terrorist financing (ML/TF) risks associated with virtual assets. The major comments received are discussed below.

(A) Virtual asset transfers

Implementation of the Travel Rule[8]

Public comments

88. While most respondents were supportive of or did not object to the implementation of the Travel Rule, some respondents suggested a transitional period ranging from 12 to 24 months given that the sunrise issue may make it difficult for licensed VA trading platforms to immediately comply. Those who supported the implementation of the Travel Rule with effect from 1 June 2023 commented that timely implementation is critical for Hong Kong's virtual asset businesses as any delay may drive international business partners away from our licensed VA trading platforms.

89. A few respondents expressed practical challenges to strict adherence to the Travel Rule. It takes time to develop systems and infrastructure for the exchange of the required information about originators and recipients between ordering and beneficiary institutions. One respondent suggested that, as an interim measure, licensed VA trading platforms should be given the flexibility to submit the required information manually and as soon as possible rather than "immediately" (ie, before or when the virtual asset transfer is conducted) when acting as the ordering institution.

90. Two respondents commented that the implementation of the Travel Rule may unintentionally force licensed VA trading platforms to conduct virtual asset transfers with unhosted wallets where the requirements appear to be less stringent and this may expose them to higher ML/TF risks.

The SFC's response

91. The Travel Rule is a key AML/CFT measure for virtual asset service providers (VASPs) and financial institutions as it provides fundamental information for carrying out sanctions screening and transaction monitoring, as well as other risk mitigating measures. It also helps to prevent the processing of virtual asset transfers for illicit actors and designated parties and detect such transfers when they occur.

92. The Financial Action Task Force (FATF) has reiterated the need for jurisdictions to implement the Travel Rule as soon as possible given the sunrise issue cannot be resolved until all VASPs and financial institutions operating in major jurisdictions comply with the Travel Rule.

[8] The Travel Rule refers to the requirements for virtual asset transfers to or from an institution set out in paragraphs 12.11.5 to 12.11.24 of the AML Guideline. Under the Travel Rule, licensed VA trading platforms are required to (i) when acting as the ordering institution, obtain, hold and submit required information about the originator and recipient to the beneficiary institution immediately and securely; and (ii) when acting as the beneficiary institution, obtain from the ordering institution and hold required information.

93. Other major jurisdictions (eg, the US, Singapore, the UK and Europe) have already implemented or will implement the Travel Rule soon[9]. Any delay in the implementation of the Travel Rule in Hong Kong would affect the competitiveness of the VA trading platforms licensed by us, as the VASPs and financial institutions operating in other major jurisdictions would be unable or unwilling to transact with them out of risk management concerns.

94. Nevertheless, it may take time to develop systems to facilitate the immediate submission of the required information to a beneficiary institution although licensed VA trading platforms have taken note of the FATF's advocacy of the Travel Rule over the past few years.

95. Considering that the active and rapid development of technological solutions and Travel Rule networks in recent years has gradually made it easier for institutions to exchange the required information, respondents' concerns about submitting information immediately will likely be resolved over time. In addition, more and more VASPs and financial institutions operating overseas will be subject to the Travel Rule.

96. Where the required 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[10], having regard to the implementation status of the Travel Rule in other major jurisdictions. Licensed VA trading platforms should comply with all other Travel Rule and relevant requirements in paragraphs 12.11 to 12.13 with effect from 1 June 2023, including submitting the required information to the beneficiary institution securely, while adopting the said interim measure. Amendments have been made to paragraphs 12.11 to reflect this.

97. Some clients of licensed VA trading platforms may transfer virtual assets to or from unhosted wallets. This may pose higher ML/TF risks given there is typically no intermediary carrying out AML/CFT measures on the owners of unhosted wallets.

98. As such, we have set out requirements governing transfers to or from unhosted wallets in paragraphs 12.14. These requirements are similar to, if not more stringent than, the Travel Rule. Licensed VA trading platforms should obtain the required information from the customer and conduct sanctions screening. Further, licensed VA trading platforms 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. Please also refer to the discussions in paragraphs 106 to 109 of this conclusions paper.

[9] While the US and Singapore have already implemented the Travel Rule, the Travel Rule will take effect in the UK on 1 September 2023; and it is expected that it will come into effect in Europe in January 2025.

[10] This means that paragraphs 12.11.10 and 12.11.13 will take effect on 1 January 2024. Licensed VA trading platforms should adopt the interim measure prior to 1 January 2024 where the required information cannot be submitted to the beneficiary institution immediately. An FAQ will be issued by the SFC to clarify our regulatory expectations in this regard.

VA transfer counterparty due diligence and additional measures

Public comments

99. While a few respondents were of the view that the requirements were too prescriptive or sought clarification of the extent of measures to be applied, two respondents commented that licensed VA trading platforms should conduct ongoing monitoring of VA transfer counterparties including screening of virtual asset transfers given risk exposures may change over time.

100. Some respondents sought clarification of which entity they should conduct due diligence on, in particular, when they conduct transfers with VASPs with group entities performing different functions or operating in different jurisdictions.

The SFC's response

101. The guidance on VA transfer counterparty due diligence and additional measures, including the factors that should be considered and the measures to be taken, are in line with FATF's standards and guidance. These measures should be applied using a risk-based approach, taking into account various 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.

102. In relation to the ongoing monitoring of VA transfer counterparties, this would include screening virtual asset transfers using a risk-based approach.

103. The due diligence measures should be applied to the entity which a licensed VA trading platform conducts virtual asset transfers with. Where virtual asset transfers are conducted with several VA transfer counterparties that belong to the same group, the licensed VA trading platform 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. Corresponding amendments have been made to paragraphs 12.13 to reflect this.

Risk-based policies and procedures for handling incoming virtual asset transfers lacking the required information

Public comments

104. Several respondents raised concerns about returning virtual assets to the originator for virtual asset transfers lacking the required information which may contravene the Travel Rule and other requirements if the originator is found to be a sanctioned party, or if the transfer is associated with illicit sources.

The SFC's response

105. A licensed VA trading platform should only return virtual assets where appropriate and when there is no suspicion of ML/TF, taking into account the results of VA transfer counterparty due diligence as well as the screening of the virtual asset transactions and the associated wallet addresses. Further, returns should be made to the account of the ordering institution, rather than the originator's account. Additional guidance is provided in paragraph 12.11.22.

Virtual asset transfers to or from unhosted wallets

Public comments

106. Most respondents supported the requirements for virtual asset transfers to or from unhosted wallets. In particular, several respondents commented that the risk mitigating measures set out in paragraph 12.14.3 should be mandatory.

107. One respondent commented that a one-off confirmation of the ownership or control of an unhosted wallet may not be effective to ensure its ongoing reliability given that the anonymous transfer of ownership or control of an unhosted wallet is effortless. Another respondent suggested periodic confirmation of the ownership or control of unhosted wallets.

The SFC's response

108. It is mandatory for licensed VA trading platforms to take reasonable measures on a risk-sensitive basis to mitigate and manage the ML/TF risks associated with virtual asset transfers to or from an unhosted wallet, including the non-exhaustive risk-based measures set out in paragraph 12.14.3.

109. Obviously, the ownership or control of an unhosted wallet may change over time. Where a virtual asset transfer is conducted via an unhosted wallet which has been whitelisted, the licensed VA trading platform should ascertain the ownership or control of the unhosted wallet on a periodic and risk-sensitive basis, particularly when it becomes aware of any heightened ML/TF risks from the ongoing monitoring of the transactions conducted through the unhosted wallet, or additional customer information. Corresponding amendments have been made to paragraph 12.14.3.

(B) Other virtual asset-specific AML/CFT requirements

Occasional transactions

Public comments

110. Several respondents sought clarification of whether and how the thresholds for customer due diligence apply to licensed VA trading platforms before carrying out any occasional transaction.

The SFC's response

111. Licensed VA trading platforms should not carry out occasional transactions as they are required to establish a business relationship with all customers pursuant to the VATP Guidelines. Corresponding amendments have been made to paragraphs 12.3.

Cross-border correspondent relationships

Public comments

112. Two respondents sought clarification of the scope of application of cross-border correspondent relationships in the context of virtual assets, whether this covers virtual asset transfers and whether the screening of virtual asset transactions and the associated wallet addresses should be an ongoing monitoring requirement.

The SFC's response

113. The requirements for cross-border correspondent relationships apply to a licensed VA trading platform when it provides services in the course of providing a VA service as defined in section 53ZR of the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) (AMLO) (ie, operating a VA exchange) to a VASP or financial institution located in a place outside Hong Kong which acts for its underlying customers. This includes instances where a licensed VA trading platform executes virtual asset trading transactions for these institutions but it does not include conducting virtual asset transfers with them.

114. A new paragraph 12.6.5 has been added to the AML Guideline for LCs and SFC-licensed VASPs to clarify that licensed VA trading platforms 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

Public comments

115. Many respondents supported the requirements for screening virtual asset transactions and their associated wallet addresses. A few respondents sought clarification of the timing of the screening.

The SFC's response

116. Screening should be performed before conducting a virtual asset transfer, or before making the transferred virtual assets available to the customer; and after conducting a virtual asset transfer on a risk-sensitive basis. This would help licensed VA trading platforms identify the source and destination of the virtual assets, and any involvement or subsequent involvement of wallet addresses associated with illicit or suspicious activities or designated parties, in a more timely and accurate manner. A corresponding footnote has been incorporated to paragraph 12.7.3.

Others

117. In addition to the amendments discussed above, we also made other textual amendments to the consultative draft which aim to provide greater clarity without altering the substance of the requirements. The marked-up texts of the amendments to the AML Guidelines are set out in Appendices B and C and highlighted in grey. We will monitor the industry's implementation of these guidelines and, where necessary, engage with the industry to develop FAQs to help them understand their application.

(C) Non-virtual asset-specific AML/CFT requirements

118. As set out in paragraph 70 of the Consultation Paper, we have been working closely with fellow AMLO regulators to provide guidance in relation to other revised statutory AMLO provisions which will also take effect on 1 June 2023. In addition, we and our fellow AMLO regulators have taken the opportunity to make other non-substantive amendments to enhance clarity, provide facilitative or elaborative guidance and better align with existing statutory provisions.

119. We also conducted soft consultations with representatives from several industry associations to gauge feedback on the amendments. These amendments are applicable to both LCs[11] and licensed VA trading platforms, and are now incorporated in the final form of the AML Guideline for LCs and SFC-licensed VASPs, with marked-up texts highlighted in yellow.

F. Disciplinary Fining Guidelines

Question 10:

Do you have any comments on the Disciplinary Fining Guidelines? Please explain your views.

Public comments

120. Respondents generally supported the proposed Disciplinary Fining Guidelines. However, some respondents questioned why they are not the same as the guidelines in the existing regime under the SFO. A respondent commented that it is difficult to see why the same set of fining guidelines should not be applied to both AMLO-licensed VA trading platforms and SFO-licensed VA trading platforms, when the activities carried out by the two types of VA trading platforms are essentially the same and the only difference lies in the "securities" or "non-securities" nature of the tokens being traded.

121. One respondent noted that the SFC may impose a fine up to a maximum of HK$10 million or three times of the profit gained or loss avoided, and that the SFC will not automatically link the fine imposed with profit gained or loss avoided. It suggested that the SFC provide examples or circumstances of when the SFC will link the fine imposed with profit gained or loss avoided. Another respondent suggested that the SFC consider determining the fines based on other approaches, such as the total annual turnover of the VA trading platform.

122. Some respondents sought clarification of the considerations the SFC takes into account in determining whether a fine would be imposed and, if so, the amount of the fine. On the general considerations under the proposed Disciplinary Fining Guidelines and the specific consideration regarding the duration and frequency of the conduct, a respondent sought guidance on whether there will be a specific amount or numerical values for these considerations. Another respondent sought clarification of whether conduct that is widespread in unregulated entities would be a mitigating factor in assessing the conduct of a regulated person.

123. One respondent suggested that the SFC elaborate on the specific considerations listed in the proposed Disciplinary Fining Guidelines and consider including more factors, such as the positions of the individuals involved, the level of sophistication of the market participants affected by the conduct and the remedial actions taken by the persons involved.

[11] A circular would be issued by the SFC summarising these amendments in due course.

124. Some respondents sought guidance on how the SFC determines whether to take disciplinary action against a corporation, an individual or both, noting that there are significantly more enforcement actions against individuals than against corporations. They suggested that the SFC set out a list of factors that it may consider when determining this.

125. A respondent commented that the board and senior management of licensed corporations should take more responsibility to enhance the security and reliability of the information systems which provide virtual asset trading services to their customers, as these assets are more prone to cyberattacks due to their intrinsic nature. The respondent suggested that the SFC consider requiring licensed corporations to appoint a MIC for information technology and security to enhance governance in this regard.

126. A respondent sought guidance on the process for challenging the proposal to impose a fine, and the imposition of a fine.

The SFC's response

127. We agree that the same set of fining criteria should be applied to both SFO-licensed VA trading platforms and AMLO-licensed VA trading platforms. The SFC has issued the following fining guidelines which are applicable to SFO-licensed VA trading platforms:

(a) the SFC Disciplinary Fining Guidelines issued under section 199(1)(a) of the SFO, which set out the factors the SFC takes into account in exercising its power to impose a pecuniary penalty on a regulated person under section 194(2) or 196(2) of the SFO (SFO Fining Guidelines); and

(b) the SFC Disciplinary Fining Guidelines issued under section 23(1) of the AMLO, which set out the factors the SFC takes into account in exercising its power to impose a pecuniary penalty on a financial institution under sections 21(1) and 21(2)(c) of the AMLO (AMLO Fining Guidelines).

128. 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.

129. It is not our intention to automatically link the fine with the profit gained or loss avoided as this may not always reflect the severity of the misconduct. Instead, we will consider each case on its own merits, taking into account all relevant factors when determining the appropriate fine. As such, we do not consider it to be helpful to give examples of specific circumstances where the fine imposed will be linked with the profit gained or loss avoided.

130. Section 53ZSP(3) of 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 culpable omissions which may attract multiple penalties. We note the suggestion to determine the fine with reference to the total annual turnover of the VA trading platform (as opposed to profit gained or loss avoided). While we consider the current statutory limit to be adequate, we will closely monitor its implementation and consider legislative changes if necessary.

131. The proposed Disciplinary Fining Guidelines already provide sufficient information regarding the factors we will consider in determining whether to impose a fine as well as the appropriate fine. As each case has to be considered on its own merits, we will not follow a rigid framework in applying a specific amount or numerical value to any of these factors. This will allow us to maintain the flexibility to respond to changes in market practices. We also do not consider the fact that the conduct in question is widespread in unregulated entities would be a mitigating factor. The fact that unregulated entities may also engage in similar conduct does not excuse or mitigate the gravity of a misconduct.

132. In determining the appropriate fine, we will take into account factors such as the positions of the individuals involved, the level of sophistication of the market participants affected by the conduct and the remedial actions taken by the persons involved. These factors are already reflected in the specific considerations listed in the proposed Disciplinary Fining Guidelines (under "the nature and seriousness of the conduct" and "other circumstances of the firm or individual").

133. With respect to the question of how the SFC decides in practice whether disciplinary action should be taken against individuals, corporations or both, we will consider all the circumstances including the conduct of the corporation and individual in question and, in relation to those involved in the management of a corporation, whether there is any consent, connivance or negligence on their part[12], any failure in supervision, or the management of business. By taking a holistic approach, we aim to ensure that all culpable parties are held accountable for their conduct. Whether we discipline a regulated person depends on the specific facts of each case. As such, we do not consider it to be helpful to provide a list of factors for determining whether to take disciplinary action against a corporation, an individual or both.

134. Paragraph 5.1(k) of the proposed VATP Guidelines already states that the "senior management of a Platform Operator should bear primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by the Platform Operator". The senior management of a licensed VA trading platform generally includes, amongst other things, its directors, responsible officers and MICs. We understand the importance of added clarity as to the scope of each senior manager's duties and obligations. As mentioned above in relation to the token admission and review committee, we will issue further guidance in the form of FAQs on the augmentation of the accountability of senior management (including in respect of the information technology function of a licensed VA trading platform).

135. Under the AMLO, there are established procedures which ensure a regulated person is entitled to due process. Before exercising any power to discipline, the SFC must first give the regulated person a reasonable opportunity to be heard by allowing that person to make representations explaining the matter in question and commenting on the appropriateness of the proposed sanctions. If a regulated person feels aggrieved by a disciplinary decision, that person may apply to the Anti-Money Laundering and Counter-Terrorist Financing Review Tribunal for a review of the decision.

[12] See section 53ZSR(5) of the AMLO.

Part II: Key measures of the transitional arrangements and implementation details of the new regulatory regime

Responses to the key measures and implementation details

Public comments

Licence application-related matters

136. We received many requests for clarification in relation to a wide range of technical matters. For example, there were questions about the scope of "providing a virtual asset service" as defined in the AMLO, including whether it covered over-the-counter virtual asset trading activities and virtual asset brokerage activities.

137. Regarding the dual licences arrangement, respondents asked whether there was a need to obtain both SFO and AMLO licences, particularly as some platform operators may not intend to trade security tokens. Noting the possibility that a non-security token may evolve into a security token, respondents also commented that the platform operator could discontinue trading services in that particular security token or only allow clients to sell down their positions in that token such that an SFO licence may not be required. In connection with the dual licences arrangement, respondents also asked whether a dually-licensed VA trading platform would be required to maintain two or four responsible officers, and whether a pragmatic approach could be adopted in assessing competence, including the relevant industry experience of responsible officers, in light of the shortage of talent having both virtual asset and traditional securities experience.

138. In relation to the external assessment report (EAR) requirements, questions asked included whether a firm which has drafted the policies and procedures for a VA trading platform applicant and provided system implementation advice could act as an assessor in the Phase 1 Report and also in the Phase 2 Report; whether the Phase 1 Report need not be submitted together with the licence application, whether platform operators which intended to seek a licence could submit the capability statements of their external assessors of choice to the SFC prior to submitting the EAR and whether only a Phase 2 Report could be submitted for established and operating VA trading platforms.

Transitional arrangement-related matters

139. Respondents also submitted many requests for clarification ranging from eligibility for the deeming arrangement and compliance with the VATP Guidelines during the transitional period to general questions about the application process under the deeming arrangement and how the deeming arrangement would operate.

140. There were also questions about the removal of the licensing conditions in respect of the VATP Terms and Conditions and whether compliance with the VATP Guidelines would be imposed as a licensing condition instead.

Other matters

141. In light of the proposals to allow retail access, respondents also enquired whether revisions would be made to the regulatory requirements for intermediaries under the SFO when engaging in virtual asset-related activities, such as, the joint circular on

intermediaries' virtual asset-related activities issued jointly by the SFC and the HKMA[13]. Respondents also sought additional guidance related to security tokens (eg, on conducting security token offerings).

The SFC's response

Licence application related matters

142. Regarding the scope of "providing a virtual asset service", the AMLO regime will cover VA trading platforms which are centralised and operate in a manner similar to traditional automated trading venues licensed under the SFO. Such platforms typically provide virtual asset trading services to their clients using an automated trading engine which matches client orders and also provide custody services as an ancillary service to their trading services. Accordingly, the provision of virtual asset services without an automated trading engine and ancillary custody services (for instance, over-the-counter virtual asset trading activities and virtual asset brokerage activities) would not fall under the scope of the AMLO regime.

143. As we have explained in the consultation paper, given that the terms and features of a virtual asset 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 contravention of the licensing regimes and to ensure business continuity, it would be prudent for VA trading platforms to apply for approvals under both the existing SFO regime and the AMLO VASP regime. We note with concern the suggestion that rather than obtain an SFO licence, a VA trading platform could simply suspend and ultimately withdraw trading services in a particular token which evolved into a security token. Fundamentally, withdrawing a token previously admitted for trading may not be in the best interests of clients, and should be a measure of last resort. The proposition that clients only be allowed to sell down their positions is also misconstrued, as any sell down order by one client would be matched with a buy order of another client.

144. We will adopt a streamlined application process so that only a single consolidated application needs to be submitted for a dual licences application. With respect to responsible officers, one individual may be concurrently approved under both the SFO and the AMLO so it is not required that a dually-licensed VA trading platform maintain four different responsible officers. As there may be a lack of talent with both virtual asset and traditional securities experience, we are prepared to adopt a pragmatic approach, details of which will be supplemented by way of further guidance.

145. As mentioned in the consultation paper, the EAR requirements were proposed to streamline the application process, particularly as the industry may not fully understand our regulatory expectations. We expect that the external assessor could substantially assist an applicant, for example, by advising on or drafting the applicant's policies and procedures, by advising on system implementation and by suggesting enhancements or rectification measures in case deficiencies in the design, implementation or effectiveness of the policies, procedures, systems and

[13] Joint circular on intermediaries' virtual asset-related activities issued by the SFC and the HKMA on 28 January 2022 (https://apps.sfc.hk/edistributionWeb/api/circular/openFile?lang=EN&refNo=22EC10).

controls are noted. As such, it would be acceptable for an external assessor to be involved prior to and in both the Phase 1 and 2 Reports[14].

146. As an external assessor is expected to be involved in the early preparation stages of applying for a licence and as the Phase 1 Report requirement was introduced to streamline the application process, the Phase 1 Report should be submitted together with the licence application. Further, given that the industry may not yet fully understand our regulatory expectations, the submission of a Phase 1 Report for established and operating VA trading platform applicants would still be necessary. VA trading platforms which are uncertain about whether the external assessor they intend to engage is sufficiently qualified are encouraged to discuss with the Fintech unit of the SFC in advance.

147. In light of the wide-ranging questions received, we will be issuing further guidance in the form of circulars, FAQs and a licensing handbook for common questions relating to the new AMLO VASP regime.

Transitional arrangement-related matters

148. Many of the questions received about the transitional arrangements were quite fundamental in nature (eg, when would VA trading platforms be required to comply with the AMLO). Given the vast number of diverse questions, we will issue further information on the transitional arrangements in the form of a circular.

149. Regarding the VATP Terms and Conditions, as explained in the consultation paper, the VATP Guidelines will supersede the Terms and Conditions for VA trading platform operators and compliance with the VATP Guidelines will be imposed as a licensing condition. For existing SFO-licensed VA trading platforms, given the 12-month transitional period for compliance with the requirements in the VATP Guidelines, the SFC will not remove the corresponding licensing conditions on compliance with the Terms and Conditions for VA trading platform operators from their licences until the VA trading platform can fully comply with the VATP Guidelines or by the deadline of the 12-month transitional period, whichever is earlier.

Other matters

150. We are mindful of the need to maintain coherence and consistency between the different virtual asset-related regulatory frameworks administered by the SFC (eg, ensuring consistent requirements for retail access to virtual assets under the joint circular). We will revise the joint circular to set out the regulatory requirements applicable to intermediaries engaging in virtual asset-related activities. In relation to security tokens, we will issue additional guidance in due course.

[14] The scope of external assessment report (which was also appended to the consultation paper) and, where appropriate, further guidance will be made available on the SFC website at www.sfc.hk..

Implementation timetable

151. In light of the public's general support, the SFC will implement the VATP Guidelines and the AML Guidelines with some modifications and clarifications as set out and discussed in this conclusions paper. Marked-up versions of the amendments to the VATP Guidelines, the AML Guideline for LCs and SFC-licensed VASPs and the AML Guideline for AEs are set out in Appendices A, B and C to this conclusions paper. The SFC will also implement the Disciplinary Fining Guidelines as set out in Appendix D to this conclusions paper.

152. We will proceed to publish the guidelines in the Gazette and they will become effective on 1 June 2023.

153. The SFC will publish further guidance so that the industry can better understand the implementation of the new regulatory regime.

154. Once again, the SFC would like to take this opportunity to thank all the respondents for their submissions.

SFC Disciplinary Fining Guidelines

Part 5B of the Anti-Money Laundering and Counter-Terrorist Financing Ordinance Considerations relevant to the level of a disciplinary fine

These guidelines are made under section 53ZSS(1) of Part 5B of the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Ordinance) to indicate the manner in which the Securities and Futures Commission (SFC) proposes to exercise the disciplinary power to impose a pecuniary penalty (fine) on a regulated person under section 53ZSP(3)(c). Section 53ZSS(3) requires the SFC to have regard to these guidelines in exercising its power of fining under section 53ZSP(3)(c). Factors that the SFC proposes to take into account in exercising its fining power are included in the considerations set out below.

Under section 53ZSP of the Ordinance, where a regulated person is, or was at any time, guilty of "misconduct", or the SFC is of the opinion that a regulated person is or was not a fit and proper person to be or to remain the same type of regulated person, the SFC may, either on its own or together with other disciplinary sanctions, 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 or other conduct which leads the SFC to form the opinion, whichever is the greater.

"Misconduct" is defined in section 53ZSR of the Ordinance and includes a contravention of a material requirement[1], or an act or omission relating to the provision of any VA service[2] by a regulated person which, in the opinion of the SFC, is or is likely to be prejudicial to the interests of the investing public or to the public interest.

"Misconduct" may, depending on its nature and characteristics, consist of a number of culpable acts or culpable omissions. Even if they are of the same generic nature, they may attract multiple penalties.

The SFC may use the number of persons affected by the misconduct as the multiplier in assessing the appropriate level of pecuniary penalty, for example, the SFC may impose a fine not exceeding HK$10 million for each affected person. Using the number of affected persons as the multiplier may not be appropriate in every case. The appropriate approach in each case will depend on its facts.

The SFC regards a fine as a more severe sanction than a reprimand. The SFC will not impose a fine if the circumstances of a particular case only warrant a public reprimand. As a matter of policy, the SFC will publicise all fining decisions.

When considering whether to impose a fine under section 53ZSP(3)(c) and the size of any fine, the SFC will consider all the circumstances of the particular case, including the Specific Considerations described below.

A fine should deter non-compliance with the requirements of the Ordinance and related regulatory requirements, so as to protect the reputation of Hong Kong as an international financial centre.

Although section 53ZSP(3)(c)(ii) states that one alternative maximum level of fine that can be imposed is three times the profit gained or loss avoided, the SFC will not automatically link the fine imposed in any particular case with the profit gained or loss avoided.

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[1] "Material requirement" is defined to mean any provision of the Ordinance or any condition of a licence or any other conditions imposed under or pursuant to any provision of Part 5B of the Ordinance.

[2] "VA service" is defined to mean any of the services specified in Schedule 3B of the Ordinance.

The more serious the conduct, the greater the likelihood that the SFC will impose a fine and that the size of the fine will be larger. In cases where the "misconduct" attracts multiple pecuniary penalties, the SFC will look at the totality of the penalties to ensure it is not disproportionate to the gravity of the conduct in question.

In determining the seriousness of conduct, in general, the SFC views some considerations as more important than others. The General Considerations set out below describe conduct that would be generally viewed as more or less serious. In any particular case, the General Considerations should be read together with the Specific Considerations in determining whether or not the SFC will impose a fine and, if so, the amount of the fine.

General considerations

The SFC generally regards the following conduct as more serious:

- conduct that is intentional or reckless
- conduct that brings the reputation of Hong Kong as an international financial centre into disrepute
- conduct that facilitates or increases the risks of money laundering or terrorist financing
- conduct that damages market integrity
- conduct that causes loss to, or imposes costs on, others
- conduct which provides a benefit to the firm or individual engaged in that conduct or any other person.

The SFC generally regards the following conduct as less serious and so generally deserving a lower fine:

- negligent conduct – however, the SFC will impose disciplinary sanctions including fines for negligent conduct in appropriate circumstances
- conduct which only results in a technical breach of a regulatory requirement or principle in that it:
  + causes little or no damage to market integrity and/or the reputation of Hong Kong as an international financial centre; and
  + causes little or no loss to, or imposes little or no costs on, others
- conduct which produces little or no benefit to the firm or individual engaged in that conduct and their related parties.

These are only general considerations. These considerations together with the other circumstances of each individual case including the Specific Considerations described below will be determinative.

Specific considerations

The SFC will consider all the circumstances of a case, including:

The nature and seriousness of the conduct

- the impact of the conduct on market integrity and/or the reputation of Hong Kong as an international financial centre

- whether significant costs have been imposed on, or losses caused to others, especially clients, market users or the investing public generally
- whether the conduct was intentional, reckless or negligent, including whether prior advice was sought on the lawfulness or acceptability of the conduct either by a firm from its advisors or by an individual from his or her supervisors or relevant compliance staff of the firm or group that employs him or her
- the duration and frequency of the conduct
- whether the conduct is widespread in the relevant industry (and if so, for how long) or there are reasonable grounds for believing it to be so widespread
- whether the conduct was engaged in by the firm or individual alone or whether as part of a group and the role the firm or individual played in that group
- whether a breach of fiduciary duty was involved
- in the case of a firm, whether the conduct reveals serious or systematic weaknesses, or both, in respect of the management systems or internal controls in relation to all or part of that firm's business
- whether the SFC has issued any guidance in relation to the conduct in question
- whether the conduct has facilitated or occasioned any offence or whether an offence is attributable to the conduct

The amount of profits accrued or loss avoided

- a firm or individual and related parties should not benefit from the conduct

Other circumstances of the firm or individual

- a fine should not have the likely effect of putting a firm or individual in financial jeopardy. In considering this factor, the SFC will take into account the size and financial resources of the firm or individual. However, if a firm or individual takes deliberate steps to create the false appearance that a fine will place it, him or her in financial jeopardy, eg, by transferring assets to third parties, this will be taken into account
- whether a firm or individual brings its, his or her conduct to the SFC's attention in a timely manner. In reviewing this, the SFC will consider whether the firm or individual informs the SFC of all the conduct of which it, he or she is aware or only part, and the manner in which the disclosure is made and the reasons for the disclosure
- the degree of cooperation with the SFC and other competent authorities[3]
- any remedial steps taken since the conduct was identified, including any steps taken to identify whether clients or others have suffered a loss and any steps taken to sufficiently compensate those clients or others, any disciplinary action taken by a firm against those involved and any steps taken to ensure that similar conduct does not occur in future
- the previous disciplinary record of the firm or individual, including an individual or firm's previous similar conduct particularly that for which it, he or she has been disciplined before or previous good conduct
- in relation to an individual, his or her experience in the industry and position within the firm that employed him or her

[3] See Guidance Note on Cooperation with the SFC published by the SFC.

Other relevant factors, including

- what action the SFC has taken in previous similar cases – in general similar cases should be treated consistently
- any punishment imposed or regulatory action taken or likely to be taken by other competent authorities
- result or likely result of any civil action taken or likely to be taken by third parties – successful or likely successful civil claims may reduce the part of a fine, if any, that is intended to stop a person benefiting from their conduct.

Appendix E

List of respondents

(in alphabetical order)

1. Accumulus GBA Technology (Hongkong) Co., Ltd.
2. Aimichia Technology Co., Ltd.
3. Alphalex Capital Management (HK) Limited
4. Amber Group
5. Angus Sze
6. Animoca Brands Limited
7. Asia Crypto Alliance
8. Asia Securities Industry and Financial Markets Association
9. Authento
10. Baker & McKenzie
11. BGE
12. Binance.com
13. BitGo
14. Bitquant Digital Services
15. Boswell Capital Management Limited
16. BTC Shop Hong Kong
17. CFA Society Hong Kong
18. Cherry Wong
19. Chi Zhang
20. Coded Solution
21. Coinbase Global, Inc.
22. ComplianceOne Consulting Limited
23. CompliancePlus Consulting Limited
24. Consumer Council

25. Crypto HK Limited
26. Custonomy Company Limited
27. DAB Kowloon City Branch
28. Daniel Lui
29. DEFINIS
30. DLA Piper Hong Kong
31. Elliptic
32. Fangda Partners
33. Financial Services Research Group
34. FinTech Association of Hong Kong
35. Fireblocks
36. FORMS Syntron Information (HK) Co. Ltd.
37. Hao Cui
38. Hauzen LLP
39. Henry Yu & Associates
40. Hex Trust Limited
41. Hippo Financial Services Limited and the Gate group of companies
42. HKBA.Club
43. HKFAEx Group Limited
44. HKVAEX
45. Hong Kong Digital Asset Ex Limited
46. Hong Kong Digital Asset Society
47. Hong Kong Digital Assets Group in Deloitte Touche Tohmatsu and Beosin Technology Limited
48. Hong Kong General Chamber of Commerce
49. Hong Kong Institute of Certified Public Accountants
50. Hong Kong Securities and Futures Professionals Association
51. Hong Kong Securities Association

52. Huobi
53. Institute of Financial Planners of Hong Kong
54. ISACA China Hong Kong Chapter
55. iSunCrowd Limited
56. Joseph Chow, Du Jinsong and Iu Kwan Yuen
57. Kaiko
58. Kaiser Securities Limited
59. King & Wood Mallesons
60. KPMG Advisory (Hong Kong) Limited
61. Latham & Watkins LLP
62. Linklogis International Company Limited
63. MaiCapital Limited
64. Man Ho Allen Au, Xiapu Luo and Paul Li
65. Matrixport
66. Mikołaj Barczentewicz
67. Mr. Chan
68. Mr. Hinson
69. Mulana Investment Management Limited
70. New Huo Technology Holdings Limited
71. Newton Wong
72. Nicholas Lo
73. Norton Rose Fulbright
74. Notabene Inc.
75. OKG Technology Holdings
76. OKX Hong Kong Fintech Company Limited
77. OneDegree Hong Kong Limited
78. OSL Digital Securities Limited

79. PricewaterhouseCoopers and Tiang & Partners
80. Prosynergy Consulting Limited
81. QReg Advisory Limited
82. Rakkar Digital (Hong Kong) Limited
83. Ripple Labs Inc.
84. Safeheron
85. Shawn Chang
86. Stevenson, Wong & Co.
87. Stratford Finance Limited
88. Thales
89. The Alternative Investment Management Association
90. The British Chamber of Commerce in Hong Kong
91. The Capital Markets Company Ltd.
92. The Chinese Gold and Silver Exchange Society
93. The Hong Kong Chartered Governance Institute
94. The Hong Kong Licensed Virtual Asset Association
95. The Law Society of Hong Kong
96. TKX Capital and Mura Consultancy
97. UD Blockchain
98. Vaultavo Inc.
99. Venture Smart Financial Holdings Limited
100. VerifyVASP
101. Victory Securities Group and Hong Kong Digital Assets Group in Deloitte Touche Tohmatsu
102. Vincent Tam
103. Xiang Li
104. Yuky Yu
105. zkMe Technology Limited

106. 白展堂

107. 谷炎

108. 東方文化控股有限公司

109. 香港南雅貨幣交易所

110. 章濤

111. 張明德

112. 張健恩

113. 貴州美酒鏈科技有限公司

114. 譚先生

115. Submissions of 25 respondents are published on a “no-name” basis upon request

116. Submissions of 13 respondents are withheld from publication upon request