THE DUAL LICENSING REGIME FOR VIRTUAL ASSET TRADING PLATFORMS IN HONG KONG– PART 2

KEY HIGHLIGHTS

Date: 23 August 2023

Hong Kong Policy and Regulatory Alert

In our previous alert, we provided an overview of the new Dual Licensing Regime and highlighted the consequences of relevant breaches of Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615), as amended (AMLO).

In this alert, we provide key takeaway points on the new Dual Licensing Regime, particularly focusing on the Guidelines for Virtual Asset Trading Platform Operators (VATP Guidelines), which are the essential part of the Dual Licensing Regime's regulations.

REQUIREMENT FOR DUAL LICENSING

In terms of licensing applications, the Securities and Futures Commission of Hong Kong (SFC) expects virtual asset trading platforms (VATPs) to adopt a prudent approach to apply for dual approvals under both the Securities and Futures Ordinance (Cap. 571) (SFO) and AMLO licensing regimes to avoid contravention of the licensing regimes and to ensure business continuity, given that the terms and features of a virtual asset may evolve and a virtual asset's classification may change (from a nonsecurity token to a security token or vice versa).

The SFC further adds that to the extent that there are differences in the requirements under the SFO and the AMLO, a dually licensed platform operator (Platform Operator) would need to comply with the more stringent requirement.

The SFC will implement a streamlined application process to enable applicants to submit a single combined application for both licenses to reduce administrative burden. Additionally, any individual appointed as a responsible officer under one regime may also be concurrently appointed as a responsible officer under the other regime.

EXTERNAL ASSESSMENT REPORTS

Further, the SFC also expects an applicant to engage an external assessor to assess its business covering such matters as the VATPs proposed structure, governance, operations, policies, procedures, systems, and controls, and submit the assessor's reports to the SFC: (a) when submitting the license application (Phase 1 Report), and (b) after approval-in-principle is granted (Phase 2 Report).

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ADDITIONAL PROTECTIONS FOR RETAIL INVESTORS

Platform Operators may provide trading services of certain virtual assets to retail investors, but Platform Operators will be required to comply with a range of robust investor protection measures. Key measures are highlighted below and cover client onboarding, governance, disclosure obligations, and token due diligence and admission criteria before the provision of such services to retail investors.

Client Onboarding and Suitability Assessment

Platform Operators should assess whether it is suitable for a client to trade virtual assets. For example, they should assess a client's risk tolerance, conduct a holistic assessment of an investor's understanding of the nature, and risks of virtual assets, and include similar knowledge assessment requirements on intermediaries engaging in virtual asset-related activities, to ensure alignment for all intermediaries.

Governance

A Platform Operator should set up a token admission and review committee.

Disclosure Obligations

When posting any information or materials on its platform or providing any information to clients, a Platform Operator should act with due skill, care, and diligence to ensure that all information is accurate. They should also present all information in a clear and fair manner. The information should not be misleading and should be communicated in an easily comprehensible manner.

Token Due Diligence and Token Admission Criteria

In the VATP Guidelines, the SFC outlined a nonexhaustive list of factors for Platform Operators to consider when admitting virtual assets for trading. These are the general due diligence requirements VATPs should adhere to.

For special tokens for trading by retail clients, when assessing the liquidity of a specific virtual asset, a Platform Operator should, at minimum, ensure that the virtual asset is an eligible large-cap virtual asset (i.e., virtual assets which should have been included in a minimum of two acceptable indices issued by at least two different index providers).

Additionally, before admitting any virtual asset for trading, Platform Operators must:

- Conduct due diligence on each token before admission for its trading (i.e., there is no exemption for the conducting of due diligence such as for a token that has been admitted on another Platform Operator); and
- Exercise due skill, care, and diligence in selecting and appointing an independent assessor to conduct a smart contract audit for smart-contract-based virtual assets, unless the Platform Operator demonstrates that it would be reasonable to rely on a smart contract audit conducted by an independent assessor engaged by a third party.

Platform Operators must also implement appropriate monitoring procedures to keep track of any changes to a virtual asset being traded by clients through its platform that may cause the virtual asset's legal status to change.

They should also regularly submit review reports to the token admission and review committee.

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CONCLUSION

In this alert, we highlighted key elements of the VATP Guidelines, which include the SFC's recommendation for applicants to apply for a license under both SFO and AMLO licensing regimes, and the requirement to engage an external assessor to submit external assessment reports. While Platform Operators will be able to provide trading services of certain virtual assets to “retail investors”, they are required to comply with a range of robust investor protection measures.

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