

Consumer Council

Submission to the Securities and Futures Commission on Consultation Paper on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators

24 March 2023

1. Consumer Council (the Council) is pleased to submit its views with respect to the consultation paper (the Consultation Paper) on the proposed regulatory requirements for virtual asset (VA) trading platform operators licensed by the Securities and Futures Commission (SFC), and to provide suggestions for the protection of consumer interests in the use of VA trading platforms.

General Views

2. The Council notes the proposed regulatory requirements for licensed VA trading platforms and the detailed "Guidelines for VA Trading Platform Operators" (the Guidelines) set out in Appendix A of the Consultation Paper which covers guidelines on operations, compliance, disclosure, internal controls, cybersecurity, etc. Market failures of VA trading platforms could result in losses up to billions of dollars. To protect consumers and retail investors from these risks, it is important to promote the responsible development of VAs with proper safeguards in place.

3. As mentioned in the Government's Policy Statement on Development of VA in Hong Kong¹, Hong Kong is open and inclusive towards the global community of innovators engaging in VA business. Certainly, being one of the first jurisdictions to regulate such VA trading platform operators, Hong Kong could not only reinforce its leadership in the global financial system and economic competitiveness but also facilitate VA innovations to thrive in the city in a sustainable manner. As a global role model, Hong Kong must adopt proactive policies to protect investors of VAs.

4. Indeed, a study report released by Visa in February 2023 revealed that 41% of the surveyed Hong Kong residents were quite familiar with cryptocurrencies or had invested in it². On the other hand, investment scams related to cryptocurrencies were also significant. According to the Hong Kong Police Force, it received 1,503 online investment scam complaints over the first 10 months of last year, up to 90% yoy, with 69% of them related to

¹ <https://www.info.gov.hk/gia/general/202210/31/P2022103000454.htm>

² https://www.visa.com.hk/en_HK/partner-with-us/market-insights/consumer-payment-attitudes-study-4-0.html

cryptocurrencies³. These figures demonstrate that related scams have been emerging with the growing popularity of cryptocurrencies. To reduce such scams, a well-developed regulatory framework is indispensable.

5. Given the rapid development of the concept and scope of VA in the market, the Council is concerned how the definition of VA in the Consultation Paper and the Guidelines can cater for the latest development of the VA market. The SFC may need to revisit the definition of VA regularly for effective governance.

6. In response to Question 1 in the Consultation Paper, as stated in para. 24 in the Consultation Paper, denying retail access may in fact result in investor harm as it may push retail investors to trade on unregulated VA trading platforms overseas, which could easily be accessed online. The Council is of the opinion that if the licensed VA platform operators were allowed to provide their services to retail investors, they should be subject to the robust investor protection measures proposed.

7. The Council puts forward the suggestions below to strengthen consumer protection under the proposed regulatory requirements for the consideration of the SFC.

Knowledge of Retail Investors

8. As mentioned in para. 28 in the Consultation Paper and para 9.4 in the Guidelines, an SFO-licensed platform operator is required to conduct knowledge assessments on investors before providing any services to them; where a client does not pass the assessment, the operator may provide services to that client only after providing training to him/her. Yet, the knowledge assessment methods and training materials offered by different platform operators could vary significantly, such that an investor may pass the assessment of one operator but fail that of another. To ensure retail investors possess sufficient knowledge on VA before engaging in trading activities, the SFC should mandate a comprehensive and stringent knowledge test. The questions and scope of the test should be updated frequently to cater to the fast-changing VA market. The result of the knowledge assessment test could be valid for a limited period to ensure retail investors have sufficient and up-to-date knowledge of VA. The SFC may also adopt standardised knowledge assessment methods and training materials, or require platform operators to submit the materials for approval in advance.

³ <https://news.rthk.hk/rthk/ch/component/k2/1682285-20230103.htm>

9. Furthermore, the Guidelines also mention that “an investor will be considered to have knowledge of VAs if he or she has executed five or more transactions in any VAs within the past three years.” Instead of making presumptions, the Council believes that a mandatory knowledge test mentioned above should be implemented for all retail investors.

Information Transparency

10. In terms of disclosure obligations, the Council agrees with the scope set out in para. 51 in the Consultation Paper and 9.27-9.28 in the Guidelines, such as trading and operational rules, fees, material information for each VA to enable investors to appraise the position of their investments, price and trading volume of their VAs on the platforms they use, etc. The Council is of the view that the SFC should demand VA trading platforms to make sure this information could be easily accessible to the public. It is also worth considering that VA trading platforms should be required to provide a written or downloadable document to the investor for record-keeping, or a reference number and a link to the blockchain by which the investor could track the transaction upon every transaction.

11. Besides the above information, it is suggested that the SFC may publish reports about complaints related to VA trading platforms and fraudulent websites regularly in order to alert retail investors.

Risk Assessment and Alert

12. As VAs are highly volatile, and the financial condition of a VA trading platform could change rapidly, a financially healthy platform could collapse in the span of a few days. The Council considers it important for the SFC to require VA trading platforms to submit risk assessment reports or volatility reports regularly and when significant changes are observed in their financial condition. Timely alert should be provided to investors to warn them about the potential risks faced by the VA trading platforms.

Cybersecurity

13. Concerning cybersecurity, the Council appreciates the proposed measures against cyber risks in para. 12.1-12.20 in the Guidelines. In addition to these measures, the SFC should impose requirement on VA trading platforms to remind investors regularly to transfer their VAs to their cold wallets for better security and prevention of online threats such as hacking and phishing.

14. Furthermore, as retail investors might often transfer their VAs from one platform to another, VA trading platforms may recommend their users to

do these transfers only between licensed ones and warn them of the consequences otherwise.

Advertisements

15. Regarding advertisements of VA trading platforms, the Council agrees that as mentioned in para. 9.2 in the Guidelines, a VA trading platform operator should make sure that invitations and advertisements do not contain information that is false, disparaging, misleading or deceptive. Besides, the Council suggests that similar to the “Guidance Note for Persons Advertising or Offering Collective Investment Schemes on the Internet”, the SFC should make it mandatory for VA trading platforms to submit their advertisements targeting the Hong Kong public to the SFC for authorisation prior to their launch in Hong Kong, given the high-risk nature of trading VAs and consumers’ general lack of knowledge.

16. The SFC could also consider demanding VA platform operators to display their licence numbers and the issuing authority in their advertisements. For instance, in New York, each “BitLicense” licensee engaged in virtual currency business activity shall display the phrase “licensed to engage in virtual currency business activity by the New York State Department of Financial Services”⁴, which is believed to help consumers rest assured.

17. Furthermore, there should be accessible channels for the public to report suspicious platform operators which use exaggerated claims, such as guarantees of unreasonably high “interest rates” on VA “deposits”, to attract retail investors, so that the SFC could conduct follow-up investigation.

18. In particular, vulnerable groups such as teenagers and the elderly could easily be tempted into trading VAs without knowing what they are, so the SFC should monitor platform operators strictly to preventing them from targeting the vulnerable in their marketing campaigns, or even fraud schemes and scams.

19. Nowadays, it is prevalent for VA trading platforms to cooperate with key opinion leaders (KOLs) or influencers to advertise their services, usually in the form of short videos or social media posts. The Council deems it important for the SFC to hold these platforms responsible for ensuring that the promoters or endorsers have sufficient understanding of the services and products they promote, and prohibiting the making of inaccurate or misleading statements.

4

[https://govt.westlaw.com/nycrr/Document/I85908c98253711e598dbff5462aa3db3?viewType=FullText&originationContext=documenttoc&transitionType=CategoryPageItem&contextData=\(sc.Default\)&bhcp=1](https://govt.westlaw.com/nycrr/Document/I85908c98253711e598dbff5462aa3db3?viewType=FullText&originationContext=documenttoc&transitionType=CategoryPageItem&contextData=(sc.Default)&bhcp=1)

Compensation Arrangement

20. Providing investors with VA “deposit” or “saving” services is common among VA trading platforms in Hong Kong⁵; nevertheless, some platforms might describe their related insurance policies ambiguously and thus cause retail investors to mistakenly believe they are protected against any type of loss, which in reality is untrue. Therefore, the Council recommends the SFC to take action to prohibit this kind of unscrupulous promotion practice.

21. In response to Question 4-6 of the Consultation Paper, the Council notices that the protection offered by the Investor Compensation Fund does not apply to transactions involving VAs (para. 9.26 (d) in the Guidelines). Yet, there are insurance-related requirements generally set out in para. 53-57 in the Consultation Paper and para. 10.22-10.26 in the Guidelines. For instance, VA trading platform operators are required to have in place a compensation arrangement approved by the SFC to provide an appropriate level of coverage for risks. The Council deems that more details about the compensation arrangement could be made available to the public, including criteria for approval by the SFC, maximum compensation for different scenarios or incidents with different risk levels, ways to make claims, etc. after finalising the Guidelines.

22. Besides, if third-party insurance is adopted, the SFC should ensure there is adequate background assessment about the insurance company, and ensure it has the financial strength to provide an appropriate level of protection to investors of that VA trading platform.

23. In fact, some platform operators have already set up their own consumer protection funds to increase trust by consumers. To take Binance, one of the largest VA exchanges, as an example, it established the Secure Asset Fund for Users (SAFU) in 2018 to protect its users against asset loss. The SAFU sustains itself by collecting a small percentage of users’ trading fees⁶. This approach could be a reference for the SFC in the formulation of insurance or indemnity requirements.

24. To maintain Hong Kong’s competitive edge, the SFC should also monitor the compensation arrangement overseas regularly to ensure that the local arrangement is on par with that of overseas counterparts.

⁵ <https://www.sfc.hk/en/News-and-announcements/Policy-statements-and-announcements/Statement-on-virtual-asset-arrangements-claiming-to-offer-returns-to-investors>

⁶ <https://academy.binance.com/en/glossary/secure-asset-fund-for-users>

Investor Education

25. The Council appreciates the education efforts mentioned in para. 88 in the Consultation Paper that the SFC will work with the Investor and Financial Education Council to enhance investor education in Hong Kong. The Council opines that education efforts may include risks involved with VAs, common fraudulent practices, and mechanisms to report misconduct of VA trading platforms. The Council would like to emphasise that, from a consumer protection perspective, education to retail investors about the highly volatile nature of VA-related investments and the associated high risk of loss is of vital importance. Concurrently, the SFC could encourage platform operators to take the initiatives to educate retail investors.

Trading in VA Derivatives

26. In response to Question 7 in the Consultation Paper, the Council suggests that licensed VA trading platform operators should only be allowed to offer trading of VA derivatives to institutional investors as VA derivatives involve high risks. In addition, the SFC should have clear mechanism to monitor the institutional investors to forestall the involvement of retail investors, especially those who invest large amount of money, in VA derivatives investments. This can avoid incidents similar to the mis-selling of risky derivatives linked to Lehman Brothers to retail investors from happening again.

Transitional Arrangements

27. According to para. 81 in the Consultation Paper, if a pre-existing VA trading platform does not intend to apply for a licence, it should close down its business in Hong Kong by 31 May 2024. The SFC should monitor the exit arrangement of these platforms and those that fail to obtain a licence to ensure that affected investors can withdraw their VAs or migrate to the licensed ones smoothly before the deadline.

Engagement with Overseas Jurisdictions

28. Recognising the rapid development of VAs across the globe, the Council believes that the SFC should regularly exchange information and communicate with its counterparts in other jurisdictions about topics such as problematic practices by fraudulent platforms, emerging risks and corresponding precautions, to prevent issues from occurring in Hong Kong and hence affecting local investors.

Conclusion

29. The Council hopes the SFC will take into consideration the above views and suggestions in response to the Consultation Paper to make sure that the interests of consumers can be safeguarded. It is believed that VAs will continue to grow in popularity, the SFC should also regularly review the Guidelines to provide up-to-date protection to consumers and investors.