



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

The Law Society's Submissions

The Securities and Futures Commission (the "SFC") issued the "Consultation Paper on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the Securities and Futures Commission" on 20 February 2023 ("Consultation Paper").

This paper sets out the Law Society's submissions on the Consultation Paper. The defined terms and abbreviations in the Consultation Paper or the proposed VATP Guidelines are used accordingly in this paper.

The Law Society supports the SFC's proposal to prescribe one set of guidelines for all licensed virtual asset trading platform operators, whether licensed by the SFC under the SFO regime or the AMLO VASP regime, and the SFC's approach of modelling the requirements under the AMLO VASP regime on the requirements under the SFO regime. This is also an opportune time for reviewing the requirements under the existing SFO regime in the light of the defaults and collapses of the VA service providers last year causing significant losses to investors.

We are not in a position to comment on every aspect of the detailed proposals especially the proposed operational and technological requirements. That said, a high level observation is that some of the proposed requirements are rather onerous. The views and feedback from the virtual asset industry on the practicality or necessity of the requirements will facilitate the SFC in striking an appropriate balance between investor protection and market development as well as conferring the flexibility needed to allow pragmatic implementation.

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.*

Law Society's response:

1. We agree, in principle, that licensed platform operators should be allowed to provide services to retail investors, subject to the appropriate investor protection measures.
2. The implementation of the AMLO VASP regime and the closure of unlicensed platform operators will deny retail investors in Hong Kong a legitimate channel for trading VA. This would undermine the effort in investor protection if retail investors turn to illegal channels in Hong Kong or trade on platforms operated outside of Hong Kong (whether regulated or unregulated in the home jurisdictions).
3. As a separate but related point, we note that, similar to the approach taken with the sale of complex products under the SFO regime, the proposed VATP Guidelines impose additional requirements on a Platform Operator in respect of transactions in any VA which constitutes a "complex product". (This would indicate, by implication, that not all VA would be regarded as "complex products".) Unlike the stock market where there is a general consensus on what products a retail investor can easily understand, we would ask the SFC to consider giving more in-principle guidance on what VA or VA types that it will regard as non-complex products, in addition to the guidance on classifying complex products. Such guidance will greatly help licensed platform operators in complying with the onboarding requirements (including the client risk tolerance and risk profiling assessment) and the sales, conduct and other related requirements.

Question 2: *Do you have any comments on the proposals regarding the general token admission criteria and specific token admission criteria?*

Law Society's response:

4. The SFC proposes that, where a licensed platform operator intends to make VA available to retail clients, it should ensure that the selected VA satisfy and continue to satisfy not only the general token admission criteria but also the specific token admission criteria as an eligible large-cap virtual asset. Having regard to the relative short track records compared to the traditional stock or other benchmark indices, the "acceptable indices" and index providers which meet the SFC's requirements and expectations may be limited.
5. We would ask the SFC to consider:
 - (a) Clarifying if there is any requirement or expectation that either or both of the acceptable indices must be issued in Hong Kong, or if there is any requirement or expectation that the relevant index providers must be incorporated or based in Hong Kong;

- (b) Whether it is feasible for the SFC to prescribe in-principle guidance on what VA or VA types can be regarded as non-complex products which can then be made available by a licensed platform operator to retail investors subject to the onboarding and suitability obligations, as an alternative to the specific token admission criteria; and
- (c) Clarifying whether a VA is a non-complex product if it satisfies the specific token admission criteria.

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?*

Law Society's response:

- 6. The SFC has already proposed robust and detailed requirements in the Consultation Paper.

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?*

Law Society's response:

- 7. The key to the effectiveness of the proposed requirements for insurance / compensation arrangement is the practicality of the relevant requirements.
- 8. We believe the proposed requirements may not be practical and may be unduly deterring. This is a novel subject and there is no readily available nor easy solution. Drawing from the experience and concepts in the traditional financial market, we would ask the SFC to consider other options such as accepting a letter of comfort or written undertaking from the holding company of the licensed platform operator to provide funds and support to the licensed platform operator. In particular, please consider whether such letter of comfort or written undertaking is acceptable to the SFC as a way to reducing the amount of idle funds which are required to be set aside on trust and designated for compensation purpose.
- 9. The proposed requirements are that platform operators must have an appropriate level of coverage approved by the SFC. We believe that it would be helpful for the SFC to give more guidance on what constitutes an appropriate level of coverage, and the considerations the SFC will take in account for its approval. This can be provided in the form of FAQ's or similar guidance without limiting the flexibility of the SFC to make decisions on a case-by-case basis.
- 10. The SFC has highlighted the lack of insurance products or coverage in respect of virtual assets generally and platform operators specifically. We encourage the SFC

to work with the Insurance Authority to encourage underwriters to make suitable lines of insurance available in Hong Kong. This may be in the form of a working group to assess the obstacles to a competitive offering in the Hong Kong market, and a clear, streamlined approach to any approvals necessary to offer those policies in Hong Kong to VATP applicants or licence holders.

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.*

Law Society's response:

11. Our preliminary view is that it is legally feasible to set up a trust arrangement to hold the funds set aside by the licensed platform operator (or a corporation within its same group of companies) in an in-house account rather than at an external party. In our view, it is not necessary nor appropriate for the VATP Guidelines to be prescriptive on this point to preserve flexibility.
12. Setting aside funds for compensation and taking third-party insurance cannot be compared directly in a simple manner as to the level of comfort given by them respectively.

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?*

Law Society's response:

13. Specialists on technology and system and controls design are better placed than us to respond to this question.

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?*

Law Society's response:

14. The practitioners in the VA market are better placed than us to respond to the question regarding various types of business model and VA derivatives. As regards the types of investors that may be targeted, we believe the access to the limited types of VA derivatives currently available to retail investors under the SFO regime should be preserved.

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?*

Law Society's response:

15. We have the following comments on the proposed VATP Guidelines:

(a) Paragraph 1.1 – definition of "retail client" or "retail investor"

In our view, it is simpler and more direct to define these terms as a client or investor who is not a professional investor. Please shed light on why the SFC proposes to define them as "does not include any person who is a professional investor".

(b) Paragraph 1.7 – inconsistency with other requirements under the SFO regime

It is useful to clarify that licensed platform operators under the AMLO VASP regime are not subject to the SFO or the codes, guidelines, circulars and FAQs issued by the SFC which apply to licensed persons under the SFO.

(c) Paragraph 2.5 – financial status or solvency

It is useful to clarify the phrase "unable to meet *any financial or capital requirements* applicable to it" in paragraph 2.5(b)(iii). We assume that it refers to the requirements imposed by legislation or regulators.

(d) Paragraph 2.7 – ability to act competently, honestly and fairly

This paragraph refers to an individual being unable to carry out the "*inherent* requirements" of the Relevant Activities. We suggest to replace "inherent requirements" by wording such as requirements applicable to the relevant individual.

(e) Paragraph 2.8 – reputation, character, reliability and financial integrity

As currently drafted, paragraph 2.8(a)(i) does not include a case where the individual is subject to investigation by a regulatory body or criminal investigatory body. It is useful to clarify whether the SFC will take into account such a case in assessing whether an individual is fit and proper.

(f) Paragraph 3.33 – LRP Conditional Exemption 1

Paragraph 3.33(c)(ii) requires the licensed platform operator and the exempted individual to "immediately" inform the SFC if the designated support person is "not available". It is useful to take a materiality and reasonableness angle by revising the requirement along the lines that the licensed platform operator and the exempted individual are required to inform the SFC *as soon as reasonably practicable* if the designated support person is not available *for a material period of time*.

(g) Paragraph 7.22 – no financial accommodation allowed

It is useful to clarify whether the restriction in paragraph 7.22 applies where a corporation within the same group of companies as the licensed platform operator that intends to provide financial accommodation to the clients of the licensed platform operator is an authorized institution under the Banking Ordinance (Cap. 155) providing the relevant financial accommodation in the course of its business.

(h) Paragraph 7.23 – no dealing activities in VA futures contracts allowed

It is useful to clarify whether this is an absolute prohibition or whether the relevant activities would be allowed subject to the licensed platform operator obtaining the Type 2 (dealing in futures contracts) licence under the SFO.

(i) Paragraph 9.27 – disclosure and information available on website

(A) The wording of paragraph 9.27(e) refers to "the rights and obligations of the Platform Operator and the client". This is too broad and it is useful to clarify the SFC's requirement and expectation.

(B) The last paragraph of paragraph 9.27 requires the licensed platform operator to publish *any revisions or updates* as soon as practicable on its website and *identify the amendments and provide an explanation for making them*. It is useful to take a materiality and reasonableness angle by revising the wording to apply the requirement to *material* revisions and updates.

(j) Paragraph 10.22 – third-party insurance

It is useful to clarify whether the third-party insurance requirement is met if the insurer is an authorized insurer under the Insurance Ordinance (Cap. 41) which is a corporation within the same group of companies as the licensed platform operator.

(k) Paragraph 16.1 – notification of changes

The 7-day notification timeline specified in this paragraph should be replaced by 7 business days, in line with the Securities and Futures (Licensing and Registration) (Information) Rules (Cap. 571S).

(l) Schedule 3 – notification of changes

It is useful to clarify whether a licenced platform operator is required to notify the SFC of a material change in its insurance / compensation arrangement.

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.*

Law Society's response:

16. The practitioners in the VA market and specialists on technology and system and controls design are better placed than us to provide input on Chapter 12 of the AML Guideline for LCs and SFC-licensed VASPs.

Question 10: *Do you have any comments on the Disciplinary Fining Guidelines? Please explain your views.*

Law Society's response:

17. The proposed guidelines are substantially similar to the disciplinary fining guidelines for traditional financial services, and we agree in principle that this is a suitable approach.

**The Law Society of Hong Kong
29 March 2023**