



31 March 2023

Fintech Unit
Securities and Futures Commission
54/F, One Island East 18 Westlands Road, Quarry Bay,
Hong Kong

Attn:

Dear ,

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

We refer to the Consultation Paper on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the Securities and Futures Commission ("Consultation") dated 20 February 2023 on the proposed regulatory requirements to be imposed on SFC-licensed VA trading platforms ("VATP"). We are presenting our comments in the same order they are laid out in the Consultation.

First of all, we would like to commend the Commission's efforts and engagement with the market in supporting the development of the Virtual Assets ("VA") industry, by putting in place timely and necessary guardrails to mitigate actual and potential risks, so that VA innovations can thrive in Hong Kong in a sustainable manner. With regulatory clarity and working with the market to put in place a comprehensive regulatory framework, we believe Hong Kong is on solid footing to embrace financial innovations and technology development brought by the rapid development of VA globally. While VA is still a relatively new asset class and not well understood by many of the retail public, Hong Kong has experienced rapid growth and development of the virtual asset ecosystem in recent years.

We are encouraged by the government's reinstatement of their aspiration in developing Hong Kong into a digital hub since the policy announcement in late 2022, and their stance towards developing a vibrant sector and ecosystem, being open and inclusive towards the global community of innovators engaging in VA businesses. We noted that the Government, in conjunction with the regulators, are working towards providing a facilitating environment for promoting sustainable and responsible development of the VA sector, which is also one of the key missions of ACA.

While ACA and market participants are supportive of a clear licensing regime and a robust framework for VA, given the distinctly different risk profile of VA and much faster lifecycle than the traditional finance industry, it may not be effectively addressing risks associated with VA by imposing same requirements to VATP for example requiring certain number of transactions in a period to demonstrate knowledge and experience in VA. On the one hand, we appreciate there is an urgent need for robust guidelines for digital assets in particular, putting in place appropriate measures to protect consumers. On the other hand, applying the same requirements and being overly prescriptive in how VATP should operate may not effectively address the inherent risks associated with VA and ultimately drive players to other unregulated avenues which may have the opposite outcome.

Feedback we have provided attached are primarily around certain key areas namely: custody, insurance requirements, financial accommodation, affiliate trading and VA derivatives. There are also some areas which market participants hope to seek clarifications on. Given the extensive framework that the

Commission is looking to roll out within a short timeframe, we would also like to suggest taking a “phase” approach where certain key requirements are issued in the initial stage. Instead of a straight out prohibition, the Commission considers allowing more complex requirements including margin, derivatives etc to be considered in the latter phase as these may require more in depth discussions with specific subset of key market players who may have vested interest to come together for more specific proposals.

We hope the Commission will consider fine tuning some of the requirements based on the feedback from the industry. Please feel free to reach out to us for additional context or to discuss specific comments if that would be helpful, as the Commission continues to develop and finalise the VA framework.

Yours sincerely

Asia Crypto Alliance



REFERENCE	TOPIC	RESPONSE
Pg 10 - Part III 19(a)	<p>III. Key proposed regulatory requirements for licensed virtual asset trading platform operators</p> <p>Safe Custody of Client Assets</p>	<p>Safe custody of client assets is critical to ensure trust for Virtual Asset Trading Platform Operators. As such, we propose modifying the custody guidelines to explicitly allow for the TCSP custodian entity to appoint sub-custodians.</p> <ul style="list-style-type: none"> • This is how traditional finance works: most financial institutions (including large banks) appoint as sub-custodians large global custody institutions. A similar approach to crypto maximises security and trust in Virtual Asset Trading Platform Operators. • It is essential that platform operators ensure appointed sub-custodians are regulated financial institutions, located in recognised jurisdictions such as FATF member states. Platform operators should ensure that due diligence is conducted on their sub-custodians, and that the legal arrangements for sub-custody ensure that clients' assets are segregated and bankruptcy remote at all times. • Following the principle of "same business, same risks, same regulation", custody guidelines should focus on client security, account segregation, and bankruptcy remoteness. Custody guidelines should not specify specific technologies, as these are highly likely to evolve over time. It is critical that Virtual Asset Trading Platform Operators have flexibility to adopt new technologies as they emerge, to maximise customer security and safety. • As such, the strict requirements for % of assets in hot/cold storage should be removed. In the alternate, it is essential to specify exact definitions of what constitutes "hot" and "cold storage". <p>Control of virtual assets should reside with the Hong Kong TCSP custody company at all times. For technical and security reasons, private keys and seeds may need to be stored outside of Hong Kong in a mutually-recognised jurisdiction, when appointing sub-custodians.</p> <p>The TCSP custodian, acting as trustee, should never take any actions over clients' assets without clients' instructions. Acting upon clients' instructions, however, the TCSP custodian should be able to deposit or pledge assets on behalf of their clients.</p>
Pg 11 - Part III 19(h)	<p>Risk Management</p>	<p>ACA wishes to seek clarity from the Commission as to whether platform operators can facilitate the matching of financial institutions (such as banks) who are looking to provide financial accommodation for clients (such as brokers), for the acquisition of virtual assets.</p> <p>We further seek clarity from the Commission as to whether the prohibition on platform operators providing financial</p>

		<p>accommodation to their clients restricts platform operators from conducting post-trade settlement.</p> <p>If platform operators are focused on institutional business, it is important that settlement processes match what traditional financial institutions are used to.</p>
P12 Question1	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.	<p>ACA is supportive of the Commission's effort to consider relaxation of the Professional Investor restriction, and fine tune requirements under the virtual asset framework to allow more products to be listed through VATPs and VASPs under the new regime. As part of the evolution of the virtual asset industry, we consider it an important step to take, to create a path for a certain type of retail investor to participate in the investments in virtual assets so that the sector can continue to progress and develop. The industry fully appreciates that virtual asset more than often is considered as a risky asset and not suitable for the general public, therefore creating a process where a subset can qualify to invest would be the right approach to take.</p>
Pg 13 -(II) 34	Proposal to allow retail access to licensed VA trading platforms Governance	<p>ACA wishes to seek clarification from the Commission whether "principally responsible for" refer to RO/MIC for such function or senior members of the dedicated function</p>
Pg17 Question 2	Do you have any comments on the proposals regarding the general token admission criteria and specific token admission criteria?	<p>ACA recommends the Commission to consider allowing VATP to leverage a more generic product due diligence framework, taking into account specific features or specific risks which are unique to VA and welcome guidance from regulators. We also recommend operators allow to apply existing product due diligence principles based on product type:</p> <ul style="list-style-type: none"> • adopt a streamlined/simplified product due diligence process for unsolicited transactions (i.e. execution-only); • full product due diligence on other VA; <p>and in either case, the product due diligence process should include assessment of the features and risks of the underlying assets.</p>
P19 - Question 4/5/6	Custody & Insurance Requirements Q4: Do you have any comments on	<p>ACA is of the view that If platform operators are allowed to appoint sub-custodians, they should also be allowed to rely on the insurance arrangements of the sub-custodians. The ability to use sub-custodians and independent custody solutions increases diversification and security.</p>

	<p>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?</p> <p>Q5: 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.</p> <p>Q6: Do you have any suggestions for technical solutions</p>	<p>It is important that platform operators ensure that such insurance arrangements of sub-custodians are at an appropriate level of coverage for potential risks associated with the sub-custody arrangement.</p> <p>We recommend further clarification on the level of coverage that is required for compensation arrangements. The compensation arrangements should be commensurate with the risks that are associated with the VATP and should not be connected with the amount of client funds that are custodied by the VATP. This is because the amount under custody will constantly fluctuate and will be operationally difficult to link the compensation arrangement with a moving amount. Reference is also made to the MiCA regime where MiCA does not seek to protect 100% of the assets under custody but instead requires VATP to put aside funds equal to a minimum capital amount.</p> <p>Some suggestions for technical solutions to mitigate risks associated with the custody of client virtual assets, particularly in hot storage include the following:</p> <ul style="list-style-type: none"> • Use Multi-signature or MPC wallets to ensure no single custodial key is in one location. Key shards could be secured on different tech stacks with access segregated. • Confidential compute to ensure data is encrypted in transit and at rest. • Use secure hardware devices (HSM or TPMs or both) to protect key data. • Protection against loss of digital keys - physical backup of shards/keys to protect against catastrophic loss of online keys. The shards/keys need to be segregated and stored offline & encrypted typically on Federal Information Processing Standards (FIPS) compliant devices. • Enforce policies on wallets which would terminate withdrawals if breached. • Limit the external addresses to which wallets may send funds to. • Maintain a robust risk, key and wallet management and segregation of duties policy, including regular velocity limits and if breached, such hot wallets should be suspended until administrators assess the policy breach. • Requirement to periodically test the key management process to ensure compliance with the key management policy.
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	<p>which could effectively mitigate risks associated with the custody of client virtual assets, particularly in hot storage?</p>	
<p>Pg.20 – Question 7</p>	<p>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?</p>	<p>ACA appreciates the SFC's recognition of the importance of derivatives to the development of the VA market, and we welcome the SFC's initiative to consider relaxing the existing prohibition on offering, trading or dealing in VA Derivatives by Licensed Platform Operators under paragraph 7.23 of the draft VATP Guideline.</p> <p>There is a strong demand for dealing in VA derivatives and they play an important role in risk mitigation. It is also important to note that to efficiently allow VA derivatives trading, a platform that offers such products must also be able to provide financial accommodation (either by itself or through an affiliate) as part of that product to enable efficient funding. It is also common for VA derivatives platforms to offer an "insurance fund" or similar service as a stop loss mechanism for their clients. We therefore recommend that the SFC permits platform operators and/or their affiliates to provide financial accommodation and be able to make arrangements to use client VAs with the express consent of clients provided the licensed entity adequately assessed and mitigated the relevant risks.</p> <p>We believe that the blanket prohibition on offering in VA derivatives should be removed to allow institutional and professional investors to deal in such assets in the upcoming VATP Guideline.</p> <p>VA derivatives can be offered to such Hong Kong professional clients under the upcoming VA regulatory regime, leveraging the SFC's existing regulations applicable to structured products and futures contracts (depending on the product specifications). Such approach is consistent with other jurisdictions like the EU and the UK, where VA derivatives are regulated pursuant to the existing MiFID II framework. In the UK, the prohibition on VA derivatives only relates to retail customers. Institutional and professional clients are permitted to access VA derivatives. Some EU member states have also taken a similar approach to only restrict retail clients from accessing VA derivatives.</p> <p>This is because, similar to the provision of financial accommodation for VA trading, Hong Kong customers can access a number of non-Hong Kong VA platforms that offer VA derivatives, many of which are not regulated in any jurisdiction and where customers can access up to 100 x leverage to engage in such trading. Prohibiting SFC</p>

		<p>regulated VA platforms to offer such services to Hong Kong customers will have the effect of driving Hong Kong residents to such foreign, non-SFC regulated platforms where they will not have the benefit of the investor protection framework afforded by the SFC. We therefore recommend that, instead of prohibiting the provision of VA derivatives, the SFC permits VA platform operators and/or their affiliates to provide such services to their clients under the upcoming VA regime, provided they carry out the relevant suitability assessment and that any credit and counterparty risks are appropriately assessed and mitigated.</p>
		<p>Margin trading</p> <p>ACA notes the SFC's proposal to prohibit VASP licensees from providing any financial accommodation for clients to acquire virtual assets and the limited exception to permit an affiliate to provide such financial accommodation at Paragraph 7.22 of the VATP Guidelines.</p> <p>ACA understands the SFC's concerns about the risks inherently associated with debt-financed and leveraged VA transactions, including both risks posed for investors as well as counterparty and credit risks posed for the firm. ACA recommends that, instead of imposing a blanket restriction on the provision of financial accommodation to any customers, there are carve outs for specific type of client base for VASP licensees and/or their affiliates to provide margin financing to <u>institutional professional investors and high networth/sophisticated corporates</u> provided that enhanced internal controls tailored for such purpose are in place.</p> <p>Based on industry feedback, there is genuine commercial demand for such services. It is commonplace for institutional investors to use margin trading to facilitate their internal capital management when sourcing liquidity to fill client's orders. Institutional investors are incentivised to magnify market exposures with the potential to increase returns or allow new purchases to diversify existing portfolios.</p> <p>Traditional institutional professional investors have been participating in the VA market for some time now. Institutional professional investors, as compared to individual professional investors and retail investors, should be subject to a different framework given their level of sophistication and ability to evaluate the level of risks associated with margin borrowing.</p> <p>Relevant risk management and client protection goals can be addressed through adequate internal controls. Securities margin financing is allowed in the traditional finance industry, subject to a series of measures and internal controls, which could also be adopted in the context of VASP licensees. Allowing VASP licensees and/or their affiliates to offer financial accommodation to institutional clients would be consistent with the "same</p>

		<p><i>risk, same regulation</i>” approach, and the overall regulatory attitude of the SFC and HKMA.</p> <p>We would recommend that the SFC consider allowing VATP and/or their affiliates to provide margin trading services to at least institutional and professional investor clients.</p> <p>Affiliates’ ability to provide liquidity to VA exchanges</p> <p>ACA welcomes the introduction of a limited carve out to the general prohibition on Platform Operators and their affiliates engaging in proprietary trading that allows such activity with the SFC’s approval and notes that paragraph 13.2 of the Guideline limits the prohibition on market making activities to Platform Operators but not to their affiliates. Based on feedback from the industry, ACA wishes the SFC to consider allowing affiliates of licensees to conduct proprietary market making on the VA exchange, provided the licensee adequately manages conflicts of interest and implements controls in order to prevent market abuse.</p> <p>Prohibiting affiliates of VA exchanges to conduct proprietary market making will reduce the liquidity available to Hong Kong investors, which may in turn result in adverse impact on price, reduction in trading volume as well as frequent suspensions of trading due to lack of liquidity. This can lead to significant adverse impact on the VA licensee’s financial performance and ability to operate as a going concern.</p> <p>Further, proprietary trading and market making by affiliates are permissible for Type 1 and Type 7 licensees. Existing guidance on managing conflict of interest adopted by LC can be considered to be modified to manage similar conflict of interest concerns for VA exchanges and their affiliates. For example, such conflicts of interest can be managed through:</p> <ul style="list-style-type: none"> • Segregation between the VA exchange and the affiliate that engages in proprietary market making (physical space, decision making personnel and legal entities); • Treating the affiliate in the same way as any other VA exchange clients; • Ensuring the affiliate does not have access to confidential information belonging to the VA exchange that other clients do not, or would otherwise result in actual / perceived conflicts of interest or market abuse. <p>Access to global order books</p> <p>ACA notes that successful VA exchanges with high trading volumes and deep liquidity operates using a global order. There is a real commercial demand for access to global order books as access to a global order book (as compared with a local order book) benefits Hong Kong investors by giving them deeper liquidity and better pricing.</p>
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Pg 67 Point 7.1	<p>VII. Operations</p> <p>Token admission and review committee</p>	<p>ACA query whether it is necessary for the Commission to prescribe such prescriptive requirements for the Token Admission and Review Committee to operate. ACA recommends the Commission allow VATP to put in place their risk control framework and policies to address their risk of admitting and reviewing tokens sold through the platform</p>
Pg 69 Point 7.9	<p>Due diligence on virtual assets</p>	<p>It is unclear why it is necessary for a VATP to obtain and submit to the SFC a written legal advice in the form of a legal opinion or memorandum confirming that each of the virtual assets made available for trading by retail clients does not fall within the definition of “securities” under the SFO. We respectfully request the Commission to consider allowing the VATP to confirm a written legal opinion is in place prior to allowing trading.</p>
Pg 69 Point 7.10		<p>ACA appreciates that ongoing monitoring is necessary for VA and members of the Token Review Committee are primarily responsible for decisions on tokens traded on the platform. However it may not be practical or the best interest of investors if every key decision requires convening the whole committee as it slows down critical decisions considerably. The Commission should consider allowing senior management to decide who within the VATP or TAC to be making such key decisions such as suspension and halting of trading</p>
Pg 74 Point 8.2	<p>VIII. Prevention of Market Manipulative and Abusive Activities</p> <p>Internal policies and controls</p>	<p>The Commission should consider only requiring VATP to make a notification if there is a material impact to the platform or investors in the product. It may not be practical for every potential manipulative activity to be reported to the SFC</p>