



By Email (VATP-consultation@sfc.hk)

31 March 2023

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

Dear Sir/Madam,

**RE: CONSULTATION PAPER ON THE PROPOSED REGULATORY
REQUIREMENTS FOR VIRTUAL ASSET TRADING PLATFORM OPERATORS
LICENSED BY THE SECURITIES AND FUTURES COMMISSION**

CFA Society Hong Kong has reviewed the proposed regulatory requirements and welcome the proposals in principle. The virtual asset market has grown over time, and more international financial institutions and service providers have entered the market to offer institutional-grade infrastructure. It appears that as more financial institutions enter the market, policies and procedures, systems, and controls similar to those in mainstream finance are gradually being adopted. Retail investors currently have restricted access to authorized funds and regulated derivative products linked to virtual assets. By implementing regulatory requirements and robust investor protection measures, retail investors would have opportunities to participate in this expanding market as well.

1. Services to Retail Investors

While we concur with licensed Platform Operators to provide services to retail investors, we suggest that the SFC consider the following proposed improvements to investor protection measures.

We agree that Specific Token Admission Criteria might effectively protect the interests of individual investors. To the long-term advantage of the industry, the SFC must also pay attention to the governance structure of Platform Operator given the rapid advancement of technology and the widening diversity of virtual assets.

Although the Token Admission and Review Committee (“the Committee”) and the Due Diligence requirements described in para. 7.1 to 7.10 provide a solid basis for the governance of Platform Operator, we would like to identify the following areas for improvement:





First, while the Committee acts as the primary decision-making body for token admission, removal, and rule enforcement, there are no explicit requirements (i.e., members' experience and qualification) on the composition of the Committee. (refer to para.7.1). The Committee might not be able to make wise decisions and effectively carry out its duty without the required knowledge.

Second, there are no rules describing how to prevent possible conflicts of interest between the Committee members, the Platform Operator, and the virtual assets issuers.

There may be a risk of conflicts of interest because there are no requirements regarding the nomination process or the appointment of independent members, which could jeopardize the impartiality of the Committee's decisions.

We suggest for the SFC to provide clear guidance on the composition of the Committee and make sure that there are mechanisms in place to minimize conflicts of interest in order to support a fair and transparent virtual asset market.

In addition to the aforementioned, it's critical to ensure that retail investors are completely aware of any risks connected to investing in virtual assets. We are concerned that the language in para. 7.7 ("A Platform Operator should ensure that its internal controls and systems, technology and infrastructure... could support and manage any risks specific to the virtual assets") will confuse retail investors who might not be aware that the Platform Operator might not be able to monitor risks at the issuer level of the virtual assets. Separately we suggest that Platform Operators should have the obligation to promote investor education on virtual assets, particularly since the risk characteristics of virtual assets can differ significantly from traditional assets. Before investing in virtual assets, Platform Operators should inform investors about the risks involved.

2. General and Specific Token Admission Criteria

We support the strategy of establishing two layers of admission criteria, which provides an extra layer of protection for retail investors. Furthermore, we agree that strict due diligence requirements should be imposed to ensure proper virtual asset admission and administration.

Concerning the General Token Admission criteria, we note that the guidance does not address the potential problems that may arise as a result of inconsistent decision-making by different Platform Operators. We are concerned that various Platform Operators' possible inconsistent decisions on virtual assets (e.g., admission, suspension, or delisting) can deliver asymmetrical information to the market that may harm investor confidence and a fair and orderly market.



As a result, we suggest that the SFC establish a mechanism to encourage each Platform Operator to make clear and consistent decisions regarding the admission and trading of virtual assets. This can help to keep the virtual asset market fair and orderly, as well as boosting investor confidence.

Furthermore, to ensure orderly handling, the SFC may issue additional requirements/guidance or require Platform Operators to reveal where one VA no longer meets admission criteria. Trade suspension or imposing a daily trading restriction can be chaotic. Retail investors who do not know how to transfer the token to another VA trading site may suffer a substantial loss, making them worse off than overseas investors.

3. Additional Measures for Investors Protection

Retail investors must be fully aware of the potential risks involved with investing in virtual assets, which include both issuer and/or product level risks as well as intermediary risks.

In addition to the disclosure requirements in para. 51, we suggest that Platform Operators disclose the holding concentration of virtual assets and establish an effective channel for timely disclosure of any technical changes, price sensitive news, and clarifications of any rumours regarding virtual assets. This will assist investors in making informed investment decisions while also ensuring a fair and orderly virtual asset market.

In terms of intermediary risks, we believe Platform Operators should disclose their liquidity positions, short exposures, and revenue streams on a regular basis to help investors better understand Platform Operators' financial health and ability to withstand market shocks, thereby protecting investors' interests.

4. Third-party Insurance & Funds Set Aside

We agree a hybrid approach (i.e., combination of insurance and funds set aside) to address the issues arising from the compensation arrangement of Platform Operators. In the interest of investors and the development of the virtual assets market, we believe that Platform Operators must prioritize good corporate governance and cybersecurity resilience. Therefore, we advocate for Platform Operators to set aside sufficient funds to assume the responsibility to compensate investors for cybersecurity risks and governance issues.

While third-party insurance can be a useful tool in mitigating potential asset losses, it is important for Platform Operators to adopt a robust corporate governance and risk management approach. This approach should include continuous protection, early



detection, and prompt crisis response to ensure a viable and sustainable business model for Platform Operator.

Also, it is essential to acknowledge the challenges associated with cyber-insurance, including insurers' reluctance to provide sufficient coverage for undetected intrusions and higher premiums for Platform Operators due to the inability of insurance companies to fully observe their self-protection efforts (Hulisi O. et al. (2011)¹).

In addition, we would like to emphasize the risk of moral hazard. According to Hulisi O. et al. (2011)¹, their research on cyber security risk management found that "if self-protection of a firm is not observable to an insurer, then self-protection and insurance behave as substitutes", in which "firms buy more than socially optimal insurance coverage and invest less than the socially optimal level in self-protection." Hence, we suggest that Platform Operators should invest in both self-protection (i.e., implementation of a robust corporate governance and risk management measures) and insurance coverage to address cybersecurity risks.

In short, we advocate for a hybrid approach that emphasizes good corporate governance, cybersecurity resilience, and a balanced risk and responsibility approach for Platform Operators.

Separately, given that the proposed reserve requirements impose high funding requirements on Platform Operators, which may hinder the development of the virtual asset market. As such, we suggest that authorities may consider lowering the bar for bond issuance of Platform Operators to finance the reserve requirements.

5. Proposed Arrangement for Funds Set Aside by Platform Operators

We propose that Platform Operators deposit funds into escrow accounts managed by trust to invest in virtual asset index funds. The purpose of the fund would be to compensate investors in the event of loss of virtual assets due to cyber-attacks, fraud or negligence of the Platform Operators, and as such, it should be designed to track virtual asset prices, and avoid the exposure to cybersecurity risks that holding a virtual asset portfolio directly would entail.

This would demonstrate the Platform Operators' commitment to cybersecurity resilience and provide investors with reasonable compensation for any asset losses that may occur. By investing in virtual asset index funds, Platform Operators can mitigate the risks associated with holding virtual assets directly while matching the exposure of clients' virtual assets.

¹ Ögüt, H., Raghunathan, S., Menon, N.: Cyber security risk management: Public policy implications of correlated risk, imperfect ability to prove loss, and observability of self-protection. *Risk Anal. Int J.* 31, 497-512 (2011)



Additionally, the use of a trust to manage the escrow accounts would ensure that the funds are held securely and transparently, further enhancing the credibility of the Platform Operators.

6. Risk Mitigation Technology

The CFA Institute recently released a report titled "[Cryptoassets: Beyond the Hype](#)", in which it makes the observation that a number of technological solutions were beginning to emerge to address some of the custody issues seen in the turmoil of 2022 with FTX and Celsius, for instance. Key sharding is a method that, among other things, enables private keys to be represented by numerous encrypted "shards," where no one party can approve the transfer or disposition of the digital asset. In addition, there might be methods to get around immutability to undo unauthorized or mistaken transfers. DeFi protocol administrators, for instance, may retain administrative keys that would enable them, if they so desired, to modify the code to fix errors. In a more drastic step, users on a blockchain network could also decide to perform a hard fork, which would reject the problematic transactions on the blockchain and allow users to begin fresh as if nothing had ever occurred.

Thank you again for the opportunity to participate in this consultation. Should you have any questions on our above comments, please do not hesitate to contact us.

Yours faithfully,
For and on behalf of
CFA Society Hong Kong

**CFA Society
Hong Kong**