

**To:**

Securities and Futures Commission
54/F, One Island East
18 Westlands Road, Quarry Bay
Hong Kong
VATP-consultation@sfc.hk

Date:

31 March 2023

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

Coinbase Global, Inc. (together with its subsidiaries, **Coinbase**) welcomes the opportunity to comment on the proposed regulatory requirements for licensed virtual asset (**VA**) trading platforms by the Securities and Futures Commission of Hong Kong (**SFC**).

We support the SFC's efforts in formulating the proposed regulatory framework stated in the Consultation Paper dated 20 February 2023 (**Consultation Paper**), and their welcoming of public comment. We look forward to the new licensing regime coming into effect on 1 June 2023.

As a publicly listed VA exchange, we at Coinbase are committed to ensuring appropriate investor protection, risk management, and governance practices for our platform. Drawing from our compliant operational experience in other jurisdictions, we set out in this response our suggestions on the VA trading regulatory framework.

We look forward to working with and supporting the SFC to foster a transparent regulatory environment, and to unlocking opportunities that VAs provide for Hong Kong.

Sincerely,



Coinbase's response to the SFC's proposed regulatory requirements for licensed virtual asset trading platforms

The global VA industry has taken note of the important steps that Hong Kong has taken with the recent passage of the Anti-Money Laundering and Counter-Terrorist Financing (Amendment) Bill 2022 and the SFC's commendable effort in formulating this regulatory framework. We view Hong Kong as a key venue for the next phase of the development of the VA industry. As a well-respected international financial centre with a strong legal tradition, highly sophisticated regulators, a wealth of talent, and a plethora of established financial institutions and investors, Hong Kong is well-positioned for this opportunity.

As a publicly-traded crypto exchange in the U.S., Coinbase provides a high level of transparency and regulatory compliance demanded by investors and regulators. We have long viewed regulation as a critical enabler of crypto adoption, and appreciate the opportunity to provide our perspectives to the SFC and Hong Kong in developing a regulatory framework for the VA industry.

This response has two parts. First, high-level observations on the SFC's Consultation Paper and Hong Kong's overall VA regulatory regime. Second, responses to some of the specific questions raised in the Consultation Paper.

High-level comments and suggestions on Hong Kong's VA regulatory regime

1. We support Hong Kong's VA initiatives and are committed to helping the industry grow in a compliant and safe way

First and foremost, we support recent initiatives by the Hong Kong Government and regulators and believe that recognition of the benefits of blockchain technology will serve Hong Kong well by capturing the most promising growth segment in financial technology.

In particular, we are pleased to see the shift in Hong Kong's policy and attitude towards VA as evidenced by the Financial Secretary's policy statement in October 2022 on the development of VA in Hong Kong, and the various statements made by Hong Kong financial regulators as part of FinTech Week 2022. We agree with the Government's view that VAs are "here to stay".¹

The SFC's permission for licensed entities to conduct VA distribution, introduction, trading and asset management activities and allowing retail access to Bitcoin and Ether futures ETFs in late 2022 are further concrete positive steps. So is the HKMA's consultation on stablecoin-related regulations.

We support balanced regulation. It is important for Hong Kong to provide broad and safe access to VA services and markets to all investors, including retail investors. Regulations are crucial to maintaining trust in the system.

While we understand that VA regulations may ultimately be informed by regulations in

¹ Policy Statement on Development of Virtual Assets in Hong Kong (31 October 2022)

place for traditional financial institutions, as is the case in other jurisdictions, we believe that effective, fit-for-purpose regulations must take into account the unique nature and characteristics of blockchain-based VAs.

In particular, distinct from traditional securities typically listed and traded within the jurisdiction that they are issued, VAs can be traded on any exchange, both centralized and decentralized, many of which do not have operations in Hong Kong. Competition for liquidity is global.

The benefits to investors transacting via Hong Kong licensed exchanges will be limited if these platforms are restricted from participating in the global market and unable to provide sufficient breadth of service or liquidity. Hong Kong investors will be attracted to transact on unregulated overseas exchanges, as further discussed below. This, in turn, risks undermining Hong Kong's efforts to develop into a regional virtual asset hub, and the policy objectives of investor protection.

2. Access to global liquidity

The proposed regulatory regime under the Securities and Futures Ordinance (SFO) and the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (AMLO) would effectively create a local liquidity model, walling-off access to global liquidity by prohibiting order routing by Hong Kong licensed entities to exchanges based outside of Hong Kong.

VAs are typically listed and traded on many venues. Global exchanges compete for liquidity for the same assets. For clients, as VAs are fungible, the level of liquidity of an exchange is key, as this affects the price point, spread and slippage of VAs. An isolated liquidity model limits available liquidity, tending to lead to worse prices for clients as compared to global prices. This will push investors away from Hong Kong licensed intermediaries and platforms, and deter institutional investors who would otherwise prefer to trade in Hong Kong.

This may also discourage global VA exchanges from coming to Hong Kong. To enter the Hong Kong market, such exchanges would be required under the proposed regime to set up a local exchange with local liquidity. This involves a wholesale re-implementation of their global infrastructure at their Hong Kong entity, presenting significant cost challenges. This, coupled with challenges of attracting investors, is a major commercial concern for viable exchanges.

We propose further consideration be given to four potential approaches to facilitate access to global liquidity: (1) allowing licensed VASPs to route orders to global centralised order books, (2) permitting back-to-back trading by VASPs, (3) creating a licensing pathway for VA brokers under the VASP regime, and (4) authorising VA exchanges under Part III of the SFO. We believe these proposals can allow effective access to global liquidity while maintaining a high level of investor protection. See our responses to **Question 8** below. We would like to discuss this further with the SFC.

3. Retail Access

We support the SFC's plan to open the VA spot trading market to Hong Kong retail investors. We note the SFC's rationale that differentiations between professional investors (PIs) and retail investors could provide a layer of protection for those with

limited capital.

However, the SFC's proposed requirements on suitability assessment (specifically, the individual trading limits) appear onerous and the restrictions on token admission (limited to large cap tokens) may mean that in practice a very limited set of tokens would be available for retail investors to trade. Importantly, this could potentially limit Hong Kong investors' ability to access tokens issued by early stage ventures and protocols, and to participate in, and help develop, those ecosystems. It is important to keep in mind that some VAs offer utility to their purchasers. As such, the SFC's proposed restrictions would unnecessarily limit retail investors' and consumers' options, risking adversely affecting Hong Kong's ability to be an innovation hub for VA development.

We support taking a balanced approach to address the risks that VAs pose to consumers and investors and believe that there should be a gradual relaxation of these strict limits. We would be glad to share more information about some of the best practices that we employ to maintain high standards of investor protection. See our responses to **Questions 1-3**.

4. Safekeeping and custody

We support the regulatory goal of providing assurance to VA market participants that their assets are protected against misuse and from risk of loss in the event that an intermediary or platform were to become insolvent. However, we think that this policy objective may not be best achieved by requiring local exchanges to set up a separate Hong Kong custodial infrastructure, or imposing a hard-coded numerical requirement for cold wallet custody.

The SFC's regulatory goals can be better achieved by requiring client VAs to be placed in segregated custody accounts at enterprise custodian solution providers. The ultimate outcome should be the same but at a lower cost and with enhanced customer protection. Customers should have priority over all other creditors in the insolvency of the relevant intermediary or platform.²

Today, Coinbase is able to provide both exchange and custodial services through an integrated global platform. Blockchain-based recordkeeping has both enabled this combination and made it more efficient than in the traditional financial system by removing the need for centralized settlement and clearance of market trading activity. Providing both exchange and custody services as part of an integrated business model serves the interest of customers, who gain the benefits of faster settlement and more liquidity. Having a separate local custodian would undermine the efficiency and potentially customer protection.

We would like to discuss the SFC's approaches for account segregation and wallet arrangements. See our responses to **Question 6** below.

5. Derivatives

The proposed regime prohibits VA exchanges from providing services on derivatives and financing arrangements, although the SFC has indicated that it will conduct a

² A good example of this is the "legal segregation with operational commingling" regime for cleared swaps adopted by the U.S. Commodity Futures Trading Commission.

separate review exercise to formulate its policies on derivatives. We look forward to that consultation.

As the SFC knows well, with respect to traditional securities, derivatives such as futures and options are critical to risk management for institutional and sophisticated investors. The same is true for VA derivatives. They offer economic exposure which clients, especially professional and institutional, are in search of, including for example the ability to risk manage, hedge, leverage or short.

We encourage the SFC to consider allowing VA exchanges to offer trading of VA derivatives to professional and institutional investors. Any digital asset platform catering to institutional investors, in Hong Kong or elsewhere, would need to be able to incorporate derivatives products. For Hong Kong to become a regional or global virtual asset trading hub, access to derivatives must be incorporated into its regulatory regime. See our responses to **Question 7** below.

Responses to the consultation questions

In light of the above, we set out below our responses to select consultation questions.

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.

We agree that licensed platform operators should be allowed to provide their services to retail investors, subject to proportionate consumer and investor protection measures.

The benefits of blockchain technology and VA should be available to anyone. This includes as a means to access the protocols for which the VAs are designed. Many market participants are consumers and not investors; they want to have access to VAs that have consumptive utility. Ether, for example, is used to pay gas fees for all manner of activities on the Ethereum network, from writing smart contracts to creating works of art as non-fungible tokens.

We encourage the SFC to anticipate and provide a framework for further development that could provide broader market access to retail investors and consumers. In our view, healthy participation from retail investors and consumers will be important to unlocking the full potential of VA ecosystems.

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

We agree that VA exchanges should put in place documented policies and procedures for assessing tokens before listing them on the platforms. Such policies and procedures should cover the key areas of assessments, namely reviews of security, compliance considerations and legal characteristics of the tokens. These are the key review areas of Coinbase's current asset listings process, based on the experience of making listing decisions on hundreds of tokens over the past several years.

While we agree with a risk-based approach to the token admission criteria for retail investors and consumers, we believe that this should ultimately not be limited by a capitalization threshold. The success of new protocols depends critically on their ability to reach a wide distribution of users, and if rules are imposed that make it difficult for users to use emerging protocols, then Hong Kong will be deterring innovation by encouraging developers to aim their efforts elsewhere.

The capitalization threshold currently proposed is unclear and appears arbitrary, and may have the practical effect of limiting available products to just Bitcoin and Ether. Limiting the tradable assets to large-cap VAs may have the undesirable effect of pushing Hong Kong retail investors to offshore, unregulated exchanges, which would undermine the regulatory objectives. It would be preferable to bring these assets into the Hong Kong regulatory regime than to push Hong Kong investors to trade unsuitable VAs on unregulated platforms.

Instead of a capitalization threshold, a better approach to achieve investor protection would be to require enhanced disclosure requirements for VAs (in addition to those

already required under section 9.28 of the proposed Guidelines). This could for example include disclosure of a set of standardised information that is common and comparable across projects and protocols.³ Moreover, because the market capitalisation of a particular token is easily accessible information, consumers and investors can, and do, already take that into account in their decisions.

If the SFC continues to believe that a market capitalisation threshold is appropriate, we suggest that the threshold should be based on specific regulatory concerns that its imposition would address. A requirement for VA exchanges to provide warnings as to any such concerns before transacting in a token with low market capitalisation could be a simple potential enhancement to achieve a similar investor protection goal.

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?

We agree that assessments of retail customers' knowledge of the risks of certain VA services are appropriate. But it is important to ensure that the assessments are appropriately calibrated to avoid unnecessarily excluding retail customers from VA services.

We agree that VA exchanges should educate users on the risks of VA services via transparent and easy-to-understand disclosure statements. This could be in the form of a Crypto Risk Disclosure Statement that describes the risks of trading or acquiring VAs, including the risks outlined in paragraph 9.26 of the Guidelines. We also believe that VA exchanges should retain a degree of flexibility to implement their own customer assessments, education programmes and disclosures that are tailored to their particular set of services.

We also support coordination among VA exchanges and between VA exchanges and the SFC to determine the most effective industry guidance on assessments, education programmes and disclosures. This could be coordinated through leading industry bodies like the Asia Securities Industry & Financial Markets Association and the Hong Kong Securities and Investment Institute. Such practices can help ensure a consistent baseline level for all retail customers.

We believe the need for VA exchanges to set a limit for each retail client's total exposure to VAs may be unduly restrictive. This is not required for traditional securities, would have limited utility, and may be difficult if not impossible to implement given the information collection and verification requirements entailed.

Retail investors and consumers, depending on their financial status, are generally in the best position to choose their desired risk profiles and investment objectives, provided of course they are properly educated and informed. As is also common in other jurisdictions, when risk-based impositions are deemed necessary, it is generally more efficient to allow investors to trade within investment concentration safeguards benchmarked to the investor's net worth, instead of prescribing a fixed limit.

³ Coinbase has proposed a disclosure framework for investment contracts involving digital assets in the United States. We believe similar requirements can be incorporated into the Hong Kong regime. See <https://www.sec.gov/comments/4-789/4789-20152418-320297.pdf>.

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?

Local custodian requirement

The new regime requires licensed VA exchanges to have a local custodian, in the form of a wholly-owned subsidiary incorporated in Hong Kong. The regime envisions platform operators establishing local Associated Entities as defined in the Consultation Paper, to hold client assets including both fiat and VA on trust. Section 10.5 of the Guidelines provides that client assets should be stored in wallets established by the Associated Entity.

We agree with the SFC's regulatory objectives of preventing misuse of client VAs and making sure that client funds remain protected at all times, including in an event of insolvency. However, in our view, the policy goal of effective protection of customer assets both while the platform is a going concern and upon its liquidation can be more efficiently achieved via segregation of accounts held through institutional custodial service providers.

As the SFC recognized in the Consultation Paper, large and sophisticated custodians are entering the market to provide institutional-grade custodial services. We believe that VA exchanges should have an option to engage these custodians (whether they are affiliated with the platform operator or not) to hold custody of client VAs, so long as client VAs remain appropriately segregated from assets of the VA exchange itself. Having a separate local custodian would undermine efficiency and customer protection by opening up additional attack vectors due to lower economies of scale to enable superior levels of security.

This is consistent with the approach taken by the SFC for Type 9 asset managers who manage virtual assets. These licensed corporations are allowed to engage external custodians for the purpose of holding their client virtual assets. In fact, we observe that many Type 9 VA licensed corporations are licensed with the condition that they do not hold client assets themselves. We believe this flexibility should also be offered to VA exchanges.

According to the *pro forma* licensing conditions for Type 9 VA licensed corporations, licensed intermediaries will be required to conduct proper due diligence in the selection, appointing and ongoing monitoring of the custodian. A formal custody agreement should be entered into between the licensed intermediary and the custodian, and such arrangement should be disclosed. We believe that VA exchanges should also be allowed to engage external custodians, or use affiliated custodians based in different jurisdictions, that operate subject to similar guidelines and equally high standards.

To alleviate any concerns over the property rights of the segregated assets upon insolvency of the custodian, the SFC may wish to limit the recognised jurisdictions to those with well-regarded insolvency regimes.

Coinbase provides a secure and compliant institutional custodian solution globally through Coinbase Custody Trust Co. (CCTC). CCTC enjoys full functional independence within Coinbase, and is regularly audited by a respected third-party

auditor. Allowing Hong Kong-based exchanges to engage a custodian (whether affiliated or not) like CCTC to hold client assets will enhance the security of customer assets.

Cold storage requirement

Section 10.6(c) of the proposed Guidelines provides that 98% of client VA should be stored in cold storage. While we agree with the SFC's regulatory objective of safeguarding client assets and believe that cold storage can help achieve that objective, a bright-line threshold of 98% is not appropriate for all custodial services. For example, as VAs held in cold storage have a relatively lengthy withdrawal process, maintaining 98% cold storage at times of high withdrawal demand would impede the best execution of orders and therefore would not be in the clients' best interest.

Further, technologies other than cold storage may be equally appealing. For example, other wallet storage technologies like multi-party computation (MPC)⁴ wallets used by Coinbase are also highly secure solutions for exchange use-cases and should be permitted.

While historically Coinbase has operated at or exceeded the 98% cold storage requirement on a global scale, that was largely because the technology used to store VA was still evolving and we believed it was the best security solution available at the time. We see areas of technological innovation maturing to a point where a suitable combination of wallet technologies can provide a high level of security while offering faster access to stored VAs, thereby better balancing the security versus availability trade-off. We would welcome the opportunity to discuss with the SFC Coinbase's wallet technologies, in the way we have productively discussed with the U.S. Government, for example.

It would be desirable to have the flexibility of engaging custodians, and to store VA in a variety of wallet types as long as a comparable level of security can be guaranteed and in tune with business needs. Prescribing a strict 98% threshold will largely foreclose VA custodians from responsibly adopting any technology outside of the traditional cold storage option.

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?

A large part of the daily crypto market volume is in derivatives, including perpetual futures. Most estimates put the daily volume of VA perpetual futures at over \$100 billion, greatly exceeding the daily spot trading volume. In the US, regulated derivatives exchanges offer VA futures referencing BTC and ETH.

Perpetual futures and other VA derivatives are effective risk management tools for institutional VA holders. They provide efficient access to economic exposures that

⁴ MPC is a cryptographic technology that allows multiple parties to each hold secret information and then solve a problem that requires the input of all these secrets in a decentralized way, without ever sharing the secret information with one another. It removes the single point of failure risk.

would otherwise be impossible (for short positions) or cost prohibitive (for long positions) if required to hold the underlying. As the SFC knows well, for institutional investors, risk management is fundamental not only to the investor itself, but for the health of the financial system. Poorly managed risks can cause contagion. We encourage the SFC to consider relaxing the restrictions on derivatives transactions. Any VA platform catering to institutional investors should be able to incorporate derivatives products. For Hong Kong to become a regional or global VA trading hub, access to derivatives must be allowed, with sensible restrictions.

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?

As explained above in the previous section, we believe that the proposed regime does not allow effective access to global liquidity by compelling a localised liquidity model that negatively impacts pricing and has the potential of pushing Hong Kong investors to unregulated overseas exchanges that offer better liquidity.

We believe that allowing Hong Kong customers to access global liquidity in a safe and regulated way is in the best interests of market participants and the Hong Kong government's goal of establishing Hong Kong as a global VA center. We propose exploration by the SFC of four different potential approaches to allowing Hong Kong users to access global liquidity, not all of which need to be implemented.

1. Allowing licensed VA exchanges to route client orders to their parent global platforms

This model is suitable for a Hong Kong-licensed VA exchange which is part of a group operating a global, non-Hong Kong-based, exchange, like Coinbase.

Under this model, the local Hong Kong licensed VA exchanges will not operate its own order book, but would instead show its Hong Kong clients selected trading pairs on its global order book, that would only include assets authorised under the Hong Kong regulatory regime. Client order trades from Hong Kong customers would then be matched and executed at the global exchange level.

Certain functions will be performed at the global exchange level, including trading policies, market surveillance and certain AML compliance obligations. Other, non-trading functions, such as customer onboarding procedures and token listing, will remain with the Hong Kong entity.

It is currently unclear whether this is an acceptable model under the new VA exchange regulatory regime. We would welcome the SFC's clarification. Coinbase would like to see this confirmed as an acceptable model and has readily available technologies that could provide the SFC full transparency of the subset of transactions, out of its global ledger, relating to Hong Kong users. If this is not allowed under the current Guidelines, we would encourage the SFC to reconsider and would be happy to offer our detailed views and proposals in a meeting with the SFC.

2. Allowing indirect access to global liquidity through relaxing back-to-back trading requirements

We believe that the SFC should, as a rule, approve back-to-back trades conducted by a global exchange operator (or its affiliated companies) where orders in its Hong Kong order book are matched with those on its global order book. Under this model, there would be a local Hong Kong order book that would mirror the global order book. When a Hong Kong client executes a trade, the platform operator would enter into back-to-back transactions with the Hong Kong client and the global counterparty to bridge the orders and complete the transaction. There is no concern of conflicts of interest as the execution price is determined by market demand in the global order book.

3. Creating a licensing pathway for VA brokers

Currently, Type 1 licensed corporations are allowed to provide VA dealing services to their clients by routing client orders to VA exchanges. However, as a Type 1 license is granted under the Securities and Futures Ordinance, Type 1 licensed corporations will necessarily have to deal in securities, in addition to VAs. This does not offer a way for VA-only brokers to be licensed in Hong Kong. VA brokers also cannot be licensed under the new VASP regime as they fall outside of the definition of a “VA Service” under Schedule 3B of the Anti-Money Laundering and Counter-Terrorist Financing (Amendment) Ordinance.

We propose adding VA brokerage as a type of regulated “VA Service” under Schedule 3B of the Anti-Money Laundering and Counter-Terrorist Financing (Amendment) Ordinance, thereby creating a licensing pathway for VA brokers. We understand that this change cannot be unilaterally done by the SFC, and requires a notice published in the Gazette by the Secretary for Financial Services and the Treasury.

We suggest that the licensing conditions applicable to VA brokers largely mirror those of traditional Type 1 licensed corporations, except that VA brokers should not be required to only partner with SFC-licensed VA exchanges⁵ and should be able to service retail investors, similar to licensed VA exchanges.

This would allow Hong Kong-licensed intermediaries to route orders to non-Hong Kong licensed platforms, subject to the requirement for these intermediaries to conduct proper due diligence on the offshore platform (including with respect to custodian arrangement), akin to existing product due diligence obligations. Investors will still be protected by the regulated nature of the VA broker, which shall remain ultimately responsible to the clients and ultimately to the SFC. The SFC may consider allowing VA brokers to partner only with exchanges licensed or registered in jurisdictions with commensurate investor protections rules acceptable to the SFC. We believe this affords an appropriate balance between investor protection and access to global liquidity.

⁵ See SFC’s Joint circular on intermediaries’ virtual asset-related activities dated 28 January 2022, and the enclosed Licensing or registration conditions and terms and conditions for licensed corporations or registered institutions providing virtual asset dealing services and virtual asset advisory services.

4. New licensing or authorization routes for offshore platforms.

We propose the SFC consider allowing authorization of offshore VA platforms operating in jurisdictions acceptable to the SFC to actively market to Hong Kong investors, comparable to authorization under Part III of the SFO of automated trading services (ATS), subject to appropriate home country VA regulation and the usual requirements of the SFC:

- (a) Adequate financial resources for the proper performance of its operations, functions and obligations;
- (b) Prudent risk management;
- (c) System integrity, with adequate capacity and contingency arrangements;
- (d) Robust governance arrangements;
- (e) Objective, risk-based and transparent criteria for participation, with adequate investor protection measures;
- (f) Transparency in its operations, products, transactional information;
- (g) Proper surveillance of activity conducted via the VA ATS;
- (h) Record keeping with proper audit trails; and
- (i) Regulator reporting to relevant regulatory authorities.

Additional requirements specific to VA ATS may include requiring SFC's prior approval with respect to products that can be offered to the Hong Kong market, and especially for retail investors.

Importantly, while the current ATS definition is confined to facilities for trading or clearing securities, futures contracts or OTC derivative transactions, we propose that the definition be expanded to include non-securities VAs irrespective of whether or not a particular VA falls into the definition of securities in the home jurisdiction.