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.

Response:

I would say yes but have to admit I was just using a better evil.

It is a fact that a large variety of token or token-based financial products got their access to retail investors, whether any government in the world tries to regulate it. When it comes to token exchange platforms (the only type of token service that is covered by the becoming VASP licensing regime), one has to admit there are quite a lot of unlicensed token exchanges available to Hong Kong investors and will keep (intentionally or unintentionally) that way for a long time even after the establishment of the VASP licensing regime. Without properly regulated token exchange service providers as an alternative, retail investors in Hong Kong are worse treated than with such an alternative.

Having said that, this regulated retail investor access to be established will face a dilemma, while too much investor protection (substantially more cumbersome or complicated account opening process for example as compared to those used by the unregulated token exchanges) will scare retail investors away, two less retail investor protection will do even more harm to the regime as, at the end of the day, it is a licensing regime and those licensed exchanges are expected to be held legal as long as those protection requirements are met. A good compromise therefore would be only allowing the retail investors to access to those "big" tokens, whose associated risks may be understood and assumed by retail investors in Hong Kong.

Another important issue is how to screen those retail investors from the PRC. The PRC token-related rules (no specific law or regulation yet) and, as a better indicator of its focus, the enforcement actions put quite some focus on events or circumstances where normal PRC residents/layman investors are involved. Also worth noting is the definition of "PRC residents" includes all those holding PRC passports but residing out of the mainland. A 2021 note issued by multiple PRC ministries made it clear the offshore token exchanges' provision of services to PRC residents is illegal from a PRC law perspective, and there is no "big token" exception. Therefore, if retail investor access is provided by the licensed token exchanges, the adjacency of Hong Kong to the mainland begs an effective screening system for the token exchange to deny access to most PRC residents if not all of them.

Question 2:

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

Response:

Please see our response to Question 8, we believe the "non-securities" analysis conducted by a law firm should be added into the general 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?

Response:

Summary of Existing Law Addressing DLT Risks

It is a fact that a lot of retail investors, as well as professional investors and institutional investors, are exposed to a large variety of token-related financial products. However, there is no "catch-all" token regulation regulating all token-related businesses. So far, the foreseeable token regimes in Hong Kong only cover 1) security token-related activities, generally applying the existing securities law; 2) token exchanges (coming into effect on 1 June 2023), covering "centralized" token exchanges; and 3) stablecoin related activities (law not yet drafted, will come into effect in 2023 or 2024, priority goes to HKD referenced stable coins). As a veteran lawyer in this area since 2016, I saw a lot of variety of financial products based on blockchain technology (or more generally Distributed Ledger Technology). My response to this question is not proposing more specific rules, but a "catch-all" regulation covering all token-related financial activities.

Compared with a typical continental law system, a common law system as implemented in Hong Kong shared the disadvantage of other common law systems, access to the law is more expensive. What makes the matter worse when it comes to token-related activities, is the new technology (i.e. DLT) makes people think those activities are unregulated. The law addresses risks or results of actions or inactions caused by this technology, rather than the technology itself. The technology is new, but the risks it creates are not new at all.

DLT can be used in a lot of different ways, and it is a key technology that promotes the Web 3.0 (internet of things) revolution. A typical transaction can be understood as three streams, information stream, payment stream, and property (including products, services, securities, and other things) stream. Web 1.0/2.0 created an effective international information stream, and Web 3.0 has the potential to facilitate the other two. Bearing this in mind, a lawmaker may focus on the risks created by DLT in connection to the payment stream and the property stream. Before DLT, the risks in the payment stream and the property steam were dealt with by traditional regulations and cases, DLT increases some of those risks (like ICOs) but it may also reduce some risks (e.g. it can make on-chain property transfers more transparent and it can automatically implement agreed smart "contracts"), but the principles reflected in those regulations and cases should still generally apply.

One of the biggest risks posed by this technology is it creates an independent financing system, a system without transitional licensed banks and financial institutions. The token-related products, be they securities tokens, stablecoins, or token derivatives, are solicited and sold directly to retail investors, the most vulnerable.

We understand that new lawmaking can take a long time, but a summary of existing law may not take too long. Piece-by-piece investor alerts may not work very well. The summary should cover the existing regulations and cases addressing the major risks posed by DLT and should be written in plain language so that layman retail investors can understand and protect themselves or at least be aware of the risks involved in those token-related transactions.

With such a "catch-all" summary of the existing law, at least, all investors are equipped with some "rules", and hopefully, with help of their lawyers, an analytic tool to analyze the risks involved in token-related financial products. With a more accurate risk assessment, the investors may therefore do better in terms of pricing the financial products and probably may be better prepared in the negotiation (if they have a chance to negotiate).

Defi Trading Platform

Defi, a short form of "Decentralized Finance", is one of the latest developments in the token industry. There are quite a lot of differences between a typical trading platform and typical Defi trading platforms. The transactions completed on a Defi platform are not between a buyer and a seller, it is between a trader (be a buyer or seller) and a pool of tokens (staked by liquidity providers) according to a pre-coded smart contract ($x*y=k$ in two token system). While the Executive Summary of the Consultation Paper (Page 6) says the regime only covers "centralized" virtual asset platforms, there is no place in the Consultation Paper elaborating on what constitutes a "centralized" VA platform and if a Defi platform will fall into the regime.

According to the definition of "Relevant Activities", the trading activities on a Defi Platform are caught, and the traditional "peer-to-peer trading platform" as an exception under the platform license regime, does not help as the transaction (although not between a real buyer and a real seller) is conducted on the platform.

However, when reading through the requirements for the VA trading platforms provided in the Consultation Paper, we found those requirements just cannot apply to a Defi Platform, because, most importantly, there is no platform operator, at least in a traditional sense. For a Defi trading platform, there is no one providing trading services (at least directly). The creator of a Defi trading platform is generally a group of coders who make smart contracts. They are not directly providing trading services, rather, they are creating a system, under which participants may trade VAs without any intermediary providing the trading services. Because of those, one may easily see that some VA platform requirements, such as those in Part IV on the "Continuous Professional Training Requirements", cannot apply to a Defi trading platform.

On one hand, it seems that a Defi trading platform may not fall into the VATP regimes, on the other hand, Defi trading platforms are very active in the market, and a lot of investors are using their "unregulated" services.

According to the "same risk, same regulation" approach, the Defi platforms may be subject to the same regulation applicable to traditional trading platforms. However, as explained above, those requirements, by nature, cannot apply to Defi platforms. This issue, like the other application issues created by the variety in the DLT applications, begs a "risk-focused" approach in regulation, rather than a "subject matter-focused" approach.

While this approach may be a deviation from the case law tradition, featuring regulation after the case and the law is for specific fact patterns, the risks faced by investors, institutional, professional, or retail, created DLT and various financial products based on it, may justify a more forward-looking and risk-focused approach in regulation.

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?

Response:

We believe third-party insurance is the way to go in the long run. Third-party insurance may reduce the risks of the industry systematically (by hedging and group techniques) as well as solve the "conflict of interests" issues in the self-insurance option (i.e. setting aside funds by the exchange).

However, without a good survey of the industry, we doubt if there are many well-established and battle-proved insurance products available for token exchanges. Therefore, as a supplemental or transitional measure, the law may require the license to set up funds, hold by an independent custodian, on top of buying third-party insurance issued by reputable financial institution insurance providers.

From another perspective, compared with breach of contracts and torts, insurance regulates people's behaviors in a forward-looking way. The effectiveness of an insurance regime relies on the accuracy and comprehensiveness of the underlying information and the insurance model (reflecting the expected behaviors of different parties and their reactions). That actually accords with the basis of effective legislature. From that perspective, the authorities may want to prioritize including insurers for the token industry in the VASP regime, so that they may get access to more and better industrial information and be equipped with more and better risk assessment and prediction of the behaviors in and the development of the token industry.

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?

Response:

It came to my attention that the requirement of the "securities" legal analysis made by a law firm in the VATP Terms and Conditions (4.4) has been changed into Section 7.9 in the VATP Guidelines. The change appears to have removed the requirement of the "securities" analysis for those tokens to be traded on VATPs, unless they are for retail investors.

Does that mean the professional investors are categorically deprived of the investor protection offered by the securities law in Hong Kong? I think the answer is no, since there is nothing in VATP Guidelines saying the application of the Hong Kong Securities Law will be somehow compromised for tokens. Therefore, even if a token has somehow satisfied the exchange criteria and is listed on a licensed exchange in Hong Kong, it does not mean it is securities law compliant. The token listing will not legalize an otherwise illegal securities issuance. From another perspective, if the answer is yes, that change would contradict with the publically announced "same activity, same risks, same regulation" principle, and a tech savvy misdemeanor can take advantage of the change by offering some tokenized securities to professional investors without complying with the securities law.

The removal of the "non-securities" analysis for a token listing without a safe harbor for tokens (and it should not be provided) in the securities law is quite misleading. One may feel that, compared with traditional securities, tokenized securities are "lighter" regulated in Hong Kong. The "misleading" signal may be corrected by expressly providing the "non-securities" analysis by a law firm in the general token admission criteria for a VATP. I would think the "securities" analysis is a key component in the token admission. If it is a security, it cannot be issued without compliance with the securities law, and the requirements for both securities and tokens will apply to such token's issuance and listing at a VATP; if it is not a security, only those token requirements provided by the exchange may apply. I would think the different requirements, approaches and the increased complexity and costs would justify that the VATP should make this important decision at the time of the admission, rather than later, and, to avoid any conflict of interest within the VATP, such analysis is better to be conducted by an outside law firm, rather than the VATP in-house legal team

Therefore, I would propose to expressly add the "non-securities" analysis (in the form of a legal opinion or memorandum) conducted by a law firm into the General Token Admission Criteria.