



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

Respondent: Financial Services Research Group

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The Financial Services Research Group ("FSRG") is pleased to make this submission to the Securities and Futures Commission ("SFC") in response to its Consultation Paper, together with brief additional comments.

We note that the SFC's publication of the Consultation Paper is timely, given the increased focus of global regulators and policy makers on virtual assets ("VA"s) and VA trading platforms. The Group of Seven major industrialised democracies recently announced that it will promote tougher regulation of the cryptocurrency sector. In 2022, the Financial Stability Board released a set of recommendations toward creating a regulatory framework, and the International Organisation of Securities Commissions is also prioritising policy work on crypto asset markets.

FSRG's remarks are based on discussions with the members of our internal Expert Groups and other market participants. We do not address every consultation question in detail, but focus on key areas and crosscutting themes.

1. Principle of "same business, same risks, same rules"

We support the SFC's adoption of the "same business, same risks, same rules" principle in regulating Virtual Asset ("VA") trading platforms. Risks associated with VA activities are not limited to money laundering, but also include investor protection concerns. Licensed platform operators will be subject to requirements to address the specific risks posed by VAs, including market, liquidity, credit, custody and cybersecurity risks. It is critical that the regulatory regime encompasses the full scope of digital currencies and assets to ensure the safety and stability of the financial system.

2. Retail access to licensed virtual asset trading platforms

We recognise that there is growing interest from retail investors to invest in VAs and that many individuals are already doing so via unregulated trading platforms outside Hong Kong. Recent turmoil in VA markets has highlighted their volatility, structural vulnerabilities and increasing interconnectedness with the traditional financial system.

Therefore, we believe that the availability of more access for retail investors to licensed trading platforms in Hong Kong, with enhanced scrutiny and appropriate safeguards - giving them an alternative to unregulated platforms - would be a positive development. We support the SFC's desire to create greater investor protection, but this must be balanced with enough regulatory flexibility to ensure that the licensed platforms remain attractive to this investor group.

3. Onboarding requirements

Education for retail investors on VAs is essential. If they have inadequate understanding of VAs and their inherent risks, they may take on more exposure than they would otherwise have been willing or able to bear. We recommend the SFC take an active role in educating the public, in partnership with academia, market participants and industry bodies, and that the SFC encourages licensed platform operators to provide education for potential and existing clients.

However, the specific requirements for knowledge assessments of potential investors, including the client's understanding of VAs and suitability to participate in trading, together with a specific exposure limit for each client, appear onerous, especially for new licensed platform operators, who may not be familiar with regulatory expectations on how to comply. We recommend the SFC consider developing, together with expert partners as listed above, standardised guidelines and tests for assessing retail clients' knowledge.

We also note that, unlike with most traditional securities, many retail investors purchase VAs not for investment, but to use as payment tools. This should be taken into consideration as part of the knowledge assessment process.

4. Specific token admission criteria

We note the proposal to limit retail trading in VAs to highly liquid assets, which are listed on at least two acceptable indices issued by at least two independent index providers. However, we recommend that the SFC provide greater clarity on how it defines its criteria for an acceptable index: for example, with regard to the methodology underpinning the index and the expertise, technical resources and experience of the index provider. Alternatively, we suggest that the SFC could compile a list of indices and index providers which it considers to be acceptable.

We would also like to register our concern as to whether inclusion in an acceptable index alone would provide adequate protection during volatile or chaotic market conditions, which impact widely on the crypto ecosystem.

5. General token admission criteria

We are concerned that the due diligence and especially the ongoing monitoring requirements on the licensed platform operators are overly onerous. Depending on how many VAs are admitted to the platform, it may not be achievable in practice for the operator to ensure that they continue to satisfy the criteria at all times, given rapid developments in the market. In addition, the costs and resources needed to meet the requirements may deter some operators from establishing businesses in Hong Kong.

6. Future market development

As the VA market matures in Hong Kong, there is likely to be increasing demand for sophisticated products to support a range of trading activities. Building on the existing retail access to a limited suite of VA related derivative projects, we recommend that the SFC consider allowing the offering and trading of a broader range of VA futures contracts and related derivatives. The SFC may wish initially to restrict trading of such instruments to those listed on recognised exchanges.

In addition, as the number of quantitative strategy driven fund managers in Hong Kong is increasing, especially in the crypto space, we recommend that the SFC consider allowing algorithmic trading services.

7. International alignment

We believe it will be important for Hong Kong to align with international practices and the regulations in other jurisdictions. Many VAs are interconnected and globalised, and investors access other platforms very easily. The SFC should regularly review what measures are adopted in other markets, in order to minimise the risk of regulatory arbitrage. The SFC must also pay close attention to any enforcement action taken by regulators in other jurisdictions when considering the approval of new VA platform operators.

We note that a VA may be traded on numerous exchanges around the world, and we are concerned about a potential situation where a licensed platform operator's token admission review committee would be required to halt trading in a VA in Hong Kong, while investors using exchanges in other jurisdictions are allowed to exit their positions.

8. Hong Kong's competitive positioning in VA markets

We believe that a clearer roadmap on the regime for VA trading in Hong Kong is likely to attract more financial institutions and service providers. Already, the Financial Services and the Treasury Bureau is reporting substantial interest from crypto firms in establishing businesses in Hong Kong. However, other factors also need to be considered if Hong Kong is to establish a leading position in VA markets in the region.

- **Banking facilities**

Existing VA trading platforms face significant challenges in establishing banking relationships. Few banks are active in the VA space in Hong Kong currently, and the recent collapse of banks in the United States, such as Silicon Valley Bank, in addition to the situation at Credit Suisse, is likely to lead to greater caution in the Hong Kong banking sector.

- **Taxation**

In addition, Hong Kong must be in a position to offer an attractive tax regime to VA platform operators and service providers. Hong Kong's corporate tax rate is relatively low, but other jurisdictions, such as Singapore and Dubai, are currently making available more competitive rates to crypto firms.

Financial Services Research Group

The Financial Services Research Group ("FSRG") was established in 2021 by a group of financial services and business professionals to support the development of Hong Kong's financial markets and to accelerate Hong Kong's leadership in the rapidly evolving areas of global asset management, green finance and virtual assets. FSRG draws on the expertise of the local business and financial communities, together with international best practice and a deep understanding of global trends, to build on Hong Kong's premier position in the region, as well as identifying new opportunities for growth and competitive advantage.