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Securities and Futures Commission

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By Email Only: VATP-consultation@sfc.hk

31 March 2023

Dear Commission,

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

We appreciate the opportunity to submit written comments to the Securities and Futures Commission (the **Commission**) on the captioned consultation paper (the **Consultation Paper**). Our responses below draw upon: (i) views of virtual asset (**VA**) exchange operators and other industry participants expressed to us in recent months; and (ii) our experience in, and lessons learned from, advising the Dubai Virtual Assets Regulatory Authority (**VARA**) on its VA-specific regulatory framework¹.

Unless otherwise stated, capitalised terms in this submission have the meaning given to them in the Consultation Paper and its appendices.

¹ For details, please see: <https://www.dlapiper.com/en-at/news/2023/02/dla-piper-advises-dubais-virtual-assets-regulatory-authority>

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Responses to questions in the Consultation Paper

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.

As noted by the Commission, retail investors currently have an abundance of options to trade VAs and other crypto-assets, should they choose to seek them out. These include centralised VATPs operating outside of Hong Kong who choose not to be regulated, as well as decentralised exchanges (**DEXes**) which run on smart contracts or other forms of peer-to-peer platforms without clearly identifiable persons acting as platform operator or intermediary, which may not have any client onboarding controls. Once onboarded, retail investors may also not have effective legal recourse against these overseas VATPs or DEXes.

Based on the draft VATP Guidelines, investors using the services of licensed VATPs would benefit from comprehensive protection, including safe custody of client assets, policies and procedures to prevent market abuse, and comprehensive disclosures to address information asymmetry. From an investor protection perspective, this would be a significant improvement from the status quo.

Therefore, allowing retail investors to access VAs via regulated platforms would align with the Commission's aim of investor protection.

To go one step further, the scope of restrictions imposed on retail investors' access to VAs should be balanced against the objective of incentivising their use of services provided by licensed platform operators. This ensures the proposed requirements would have the widest reach possible. To this end, our comments on specific investor protection measures mentioned in the Consultation Paper are set out below.

- (i) Having regard to the nascency of VAs and relevant knowledge areas (e.g. distributed ledger technology, tokenomics models), assessing a client's knowledge and experience of, and exposure to, VAs would be the most relevant test to ensure they can make informed investment decisions.
- (ii) Assessments relating to a client's general risk tolerance and risk profile are unlikely to be helpful given these are not tailored to VA markets and answers cannot be easily verified.
- (iii) We agree with the Commission's view that setting across-the-board hard limits for retail investors' maximum dollar amount exposure to VAs is not appropriate, due to the lack of flexibility of this requirement and difficulty of implementation.

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

General token admission criteria

We agree that licensed platform operators should have the responsibility to perform due diligence on VAs that they plan to list for trading, as well as to ensure that listed VAs satisfy the general token admission criteria on an ongoing basis. We also agree with the Commission's approach of issuing a non-exhaustive list of general token admission criteria, with licensed platform operators being expected to consider any other relevant factors.

We consider that the non-exhaustive list of factors in the Consultation Paper is comprehensive and would be effective in ensuring VAs accessible to Hong Kong investors are subject to adequate assessments. Our comments on specific factors proposed by the Commission are set out below.

- (i) In relation to the background of the management or development team of a VA, licensed platform operators should not be expected to identify all team members. Many VA project teams contain pseudo-anonymous members which are only identifiable by their online presence, with their real world identifies unknown to the public (even to certain team members). The reason for this is that, once doxed, there may be legitimate concerns in relation to the personal safety of a team member. For the purposes of performing adequate due diligence, the background of the entire management or development team should therefore be considered as a whole.
- (ii) It may be difficult for licensed platform operators to determine whether the marketing materials for a VA issued by its issuer is accurate and not misleading. We suggest specifying that the expectation is for licensed platform operators to perform due diligence in respect of information contained on the VA's official website and whitepaper (or a similar document which sets out information regarding the VA).
- (iii) Licensed platform operators may not be in a position to assess the utility, use cases and/or innovation exhibited by a VA. Considering the fast-moving nature of the VA industry, the expectation should be for licensed platform operators to consider whether these are clearly fraudulent or scandalous.
- (iv) We suggest including factors which would be more applicable to VAs which are security tokens and/or associated with real-world assets. For example, licensed platform operators should assess the enforceability of any rights extrinsic to the VA itself (e.g. holders' rights to any underlying assets) and the potential impact of trading activity involving the VA on underlying physical markets.

Specific token admission criteria

As above, we are of the view that the general token admission criteria (with or without incorporating our above comments) offer effective protection against low-quality or sham projects with native tokens. The level of protection afforded to professional investors and retail investors in this regard should be the same.

For this reason, we do not think additional restrictions on the types of VAs accessible by retail investors via regulated platforms are necessary or proportionate. In particular, the proposed specific token admission criteria would, in practice, limit qualifying VAs to an extremely small pool. Drawing from the reasoning in our response to Question 1 above, this outcome may go against our proposed objective of incentivizing retail investors' use of services provided by licensed platform operators.

Despite its objective nature, market capitalisation is unlikely to be a metric which can quantify the quality of a VA from an investment perspective. By way of illustration, LUNA (the native token of the Terra network) was a top-10 VA by market capitalisation before its value collapsed in May 2022, and was included in at least one acceptable index based on the proposed criteria. Due to the apparent reflexive nature of VA markets, the market capitalisation of a VA is often a measure of market expectations, more so than fundamentals.

The specific token admission criteria may also preclude retail investors from being able to purchase stablecoins on licensed VATPs, as many indices which aim to track the performance of large-cap VAs exclude those which are pegged to fiat currencies from their constituent selection. We acknowledge this may be due to the Hong Kong Monetary Authority's confirmation that it is aiming to implement a stablecoin licensing regime by 2024, and therefore retail investors are intentionally restricted to only being able to purchase stablecoins issued by licensed entities as and when the licensing regime takes effect.

In sum, we submit that no differentiation should be made between the token admission criteria applicable to VAs accessible by professional investors, and those accessible by retail investors.

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?*

The Commission may consider mandating licensed platform operators to provide publicly accessible proof of reserves (and liabilities). Many global VA exchanges already publish relevant information to allow users to verify that reserve assets held by an exchange at least match their liabilities (e.g. user deposits). This would improve transparency as regards an exchange's liquidity and solvency.

We also suggest prescribing requirements relating to the timely handling of client complaints, especially those relating to the access of accounts and/or client assets.

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?*

We agree with this proposal, particularly given that it is currently very difficult to for VA industry participants to be insured. For clarity, we suggest the Commission to issue guidelines or further information regarding the factors it may consider when assessing whether a proposed compensation arrangement provides an "appropriate level of coverage".

Question 5: *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 management)? Please explain in detail the proposed arrangement and how it may provide the same level of comfort as third-party insurance.*

We have no particular comments on this question.

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?*

We have no particular comments on this question.

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?*

We have no particular comments on this question.

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?*

We have no particular comments on this question.

Question 9: *Do you have any comments on the requirements for virtual asset transfers or any other requirements in Chapter 12 of the AML Guideline for LCs and SFC-licensed VASPs? Please explain your views.*

We have no particular comments on this question.

Question 10: *Do you have any comments on the Disciplinary Fining Guidelines? Please explain your views.*

We have no particular comments on this question.

Additional comments

We wish to highlight the following points which are not relevant to any particular question in the Consultation Paper:

A. Scope of regulated activity is narrower than industry understanding

We appreciate that the relevant AMLO provisions state that the only regulated “VA Service” so far is “[o]perating a VA exchange”, but the message that the current licensing requirement in the AMLO VASP regime is targeted at centralised custodial VATPs has not gotten through to the industry.

Various industry participants seem to share the same understanding that the AMLO VASP regime covers all types of VASPs. Certain media reports have also conveyed the same. We have received inquiries from VA projects and businesses who had believed that there is now a clear pathway for all VASPs to be regulated in Hong Kong. A potential reason for this is that the term “VASP” tends to include a wide spectrum of service providers (e.g. VA custodians and issuers) in industry parlance and certain regulatory frameworks.

To this end, we suggest the Commission to continue its efforts in engaging with the industry and the public to clarify the parameters and objectives of the AMLO VASP regime, in particular the licensing requirement for centralised custodial VATPs.

B. Clarity on whether staking-related services are permissible

We note the draft VATP Guidelines include restrictions on how Platform Operators and their Associated Entities may use and/or custody client VAs. In particular, such persons may not:

- (i) Deal with or create any encumbrance over client VAs except in accordance with the client’s written instructions (paragraph 10.6(b)); and
- (ii) Make any arrangements on using client VAs for the purpose of generating returns for the clients or any other parties (paragraph 7.24(b)).

We agree with these restrictions, which effectively require Platform Operators and their Associated Entities to hold client VAs in a bankruptcy-remote manner.

However, we seek clarity on whether Platform Operators may provide staking-related services, whereby pay-outs received by clients are VAs generated only from the normal functioning of proof-of-stake protocols (i.e. staking rewards distributed to validating nodes), rather than any other type of returns generated by the Platform Operator or any other person via investments or other yield-generating activities (e.g. lending activities facilitated by decentralised protocols).

Our view is that relevant provisions in the VATP Guidelines can be interpreted as Platform Operators can offer staking-related services described above, provided that the staking activities are conducted in accordance with the client’s written instructions. We believe that many investors and active participants in the VA industry would, if given the option, want to make full use of the functionalities of VAs via regulated service providers, for the same reasons as they may choose to rely on custodians to administer rights associated with traditional securities.

This interpretation would mean that investors will be allowed to contribute to the maintenance of decentralised distributed ledgers via regulated service providers. In light of Hong Kong’s ambitions to position itself as a VA hub, we believe this would be a desirable outcome that is tailored to characteristics unique to VAs and distributed ledger technology.

C. Dual licences

We note that the Commission suggests that VATPs should apply for approvals under both the existing SFO regime and the AMLO VASP regime and become dually licensed and approved. The reason cited

for this is that a VA's classification may change from a non-security token to a security token (or vice versa), therefore VATPs would be prudent to obtain licences under both regimes to avoid contravening relevant regulations and ensure business continuity.

Whilst we agree that the legal classification of VAs may be highly fluid, we seek further clarity on the reasoning behind the Commission's confirmation of this view, as this may affect how VA issuers and businesses monitor compliance with applicable laws. In particular:

- (i) Issuers may have to carefully formulate distribution mechanisms, even if the initial legal assessment suggests that a particular VA is not a security. For example, many VAs have ongoing distribution models whereby existing holders and/or new investors can receive VAs after the initial offering. If a VA has "morphed" into a security token at any point in time, the ongoing distribution may be subject to registration / approval requirements under securities laws.
- (ii) VA businesses will have to continuously assess the legal classification of VAs that they deal with, in order to ensure they are not conducting any regulated activities under the SFO without a licence. In practice, this may mean seeking legal advice when a VA's tokenomics undergo significant updates (e.g. moving towards a proof-of-stake consensus mechanism, implementing buyback schemes, paying out any form of returns (including staking rewards) to holders) to assess whether a VA may have morphed into a security token. For the industry to conduct such assessments, however, guidance on VA-specific factors and the Commission's expectations would be most helpful.

We would be pleased to engage in further discussions on our comments in this submission and other issues relating to the implementation of the licensing regime for VATPs generally.

Yours faithfully

DLA Piper Hong Kong