

Responses to the 10 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.

Gate Group welcomes the proposal of permitting licensed platform operators to extend their services to retail level. Permitting the retail public in Hong Kong to be onboarded by local licensed platform operators would reduce their incentive to open accounts at overseas platform operators which may not be regulated nor provide sufficient client protection.

Gate Group generally agrees to the investor protection measures proposed by the Commission. References have been made to paragraphs 28 – 47 of the Guidelines for Virtual Asset Trading Platform Operators (“VATP Guidelines”) for our following comments:

(1) Onboarding Requirements

Gate Group is in the view that the proposed requirements are in line with the current suitability requirements, and Gate Group supports that a prospect client must pass a training session if he does not pass the relevant knowledge assessments.

In relation to the limiting of exposure to virtual asset, Gate Group considers it not to be necessary for the following reasons:

(i) Rationale for Setting Limits

To establish a full and accurate understanding of a client’s financial situation and personal circumstances, unless evidence such as income proof and asset can be obtained, a licensed platform operator could only set a limit based on what has been declared by a client. The financial situation and risk tolerance of each client are different, and it is not recommended to set a limit based on certain representations made by a client.

Gate Group is not against the idea of setting appropriate limit for each client for the purpose of preventing illicit activities and to determine the appropriate limit for the credit facility (if any).

(ii) Unclear Definition of “Reasonable”

The Commission suggested the limit shall be “reasonable” which shall be determined by the platform operator. VA is an emerging asset class with high fluctuation, and there is little to no references to determine as to what a

“reasonable” limit should be. If the Commission is in the view that it is inevitable to have a limit to be set to limit the exposure of each client, it would be helpful if the Commission can provide practical benchmarks such as quantified guidelines and factors to be considered when determining this limit.

(iii) Restriction of Client Return

Setting a threshold to limit the exposure to virtual asset is a double-edged sword. On one hand, it limits the client’s loss in times of market turmoil, yet on the other hand, it restricts the client from accessing the opportunity to maximise their returns from investing into VAs. Gate Group is aware that other jurisdictions do not have rigid requirements in place to require platform operators to set limit to the exposure to VAs. Having a mandatory exposure limit may undermine the competitiveness of Hong Kong as a virtual asset hub.

(2) Governance

Gate Group supports the view that a licensed platform operator should set up a token admission and review committee.

(3) Token Due Diligence and Admission Criteria

Due to the specific nature of VAs, in conducting product due diligence, additional measures should be taken into consideration to formulate a token due diligence policy. Due to the variety of VAs tradeable, Gate Group considers it necessary to consider certain VAs as not suitable for the retail public to trade in.

For specific comments on the general token admission criteria and specific token admission criteria, please refer to our comments to Question 2 below.

Question 2

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

Further to our answer to Question 1 above, Gate Group considers it necessary to consider certain VAs as not suitable for the retail public to trade in. To identify such VAs which are not suitable for retail public, a strict token due diligence policy should be implemented for each licensed platform operator.

(1) General Token Admission Criteria

Gate Group agrees that licensed platform operators should have the ultimate responsibility for the due diligence and token admission procedures, and hence licensed platform operators should have autonomy to exercise their judgement within the regulatory framework.

Whilst the factors suggested to be taken into consideration are highly referenceable, Gate Group would appreciate if the Commission can clarify whether this is the regulatory expectation (i.e., compulsory) to meet all criteria as listed in paragraph 40 (a) – (i). Gate Group would like the Commission to reconsider the following criteria:

(i) Track Record

Hong Kong is a major financial hub for global investors and has been home to multiple successful startups and projects. It is noted that the Commission expects there to be at least 12 months of track record, unless such token is a security token. There are multiple projects that are in the preparatory stage and has not even issued their tokens, yet they may have very strong potential in the future. Restricting tokens that have not been issued over 12 months may encourage the Hong Kong public to join unlicensed platform operator overseas in order to purchase such tokens.

(ii) Other Platform Operators

Trading activities of a token in other platform operators may be a good indicator of its popularity. However, further to our comment on (i) above, certain new tokens may not be listed in local or overseas licensed platform operators due to certain regulatory restrictions – in fact, certain regulators would only permit 3 virtual assets to be traded on the platforms of their licensees.

Gate Group is in the view that whether a token is tradeable on other platform operators may be an indicator of its liquidity, yet the absence of a token on other exchanges does not imply its lack of potential.

(2) Specific Token Admission Criteria

Gate Group expects that licensed platform operators in Hong Kong would like to provide as many products to their clients as possible. Under the proposed regulatory framework, only eligible large-cap virtual assets can be made available to retail clients, under which at least one of the indices should be issued by an index provider which has experience in publishing indices for the conventional securities market (hereinafter referred to as an “Established Index Provider”).

Despite Note 3 to paragraph 7.6 of the VATP Guidelines provides certain relaxation to this requirement, Gate Group recommends having this specific requirement removed for the following reasons:

(i) Lack of Variety of Products

Currently there are only 2 major virtual assets which have been included in indices issued by Established Index Providers, namely Bitcoin (BTC) and Ethereum (ETH). It should be noted that certain major virtual assets that are popularly traded have not been included in the existing indices, in particular stablecoins which are

popularly used in platform operators, such as Tether (USDT) and Circle's USD Coin (USDC).

(ii) Overreliance on Established Index Providers

Gate Group understands that Established Index Providers would need to follow applicable rules in the issuance of new indices, and it may take a long period of time for them to issue new indices for virtual assets due to certain global regulatory restrictions or business concerns.

As such, instead of being driven by Established Index Providers, whether a virtual asset may be listed depends on the decision of the licensed platform operator and the regulator. We would appreciate if the Commission can consider removing this requirement directly and replace with other applicable requirements. Our suggestions are listed at the end of the response to this question.

(iii) Contradiction with the Purposes of Licensing Platform Operators

One of the main reasons for clients to consider trading through licensed platform operators is that they can gain access to a universe of virtual assets other than those that have been included into indices. If investors simply wish to gain exposure to virtual assets which are only recognised by Established Index Providers, instead of buying from spot markets, they can deal in the related futures contracts or ETFs instead of dealing in the virtual asset spot market, and this may discourage investors from holding virtual assets to enjoy other available specific features such as staking.

The restriction to deal in virtual assets which have been included in indices issued by Established Index Providers may somehow contradict with the intention to allow retail clients to deal in virtual assets through licensed platform operators.

(3) Alternative Proposals to Identify Eligible Large-Cap Virtual Assets

Gate Group understands that it is essential to protect the retail public from investing into virtual currencies which may not be highly recognised. Instead of using Established Index Provider as a safeguard, when it comes to determining the Commission may consider adding the following factors instead:

(i) Market Capitalisation

One of the strongest indicators of whether a virtual asset is popular would be having a large market cap, say virtual assets with an average market cap over US\$500 billion on a rolling basis over the past 6 months.

Market cap should only be considered an indicator of Licensed platform operators and other factors should also be taken into consideration, as tokens that have large market cap may still have significant fluctuations.

(ii) Use of Existing Blockchain

A token established on existing blockchain may be considered relatively safer, as the chances of having network failure would be lower. This would provide confidence to the market for the risks of having material network downtime could be lowered.

(4) Proposed Measures to Track Price Movements

Other than using the services of Established Index Providers to track price movements and to provide quoting services to clients, the Commission may consider requiring licensed platform operator to put mechanisms in place to monitor the price changes and deviations of virtual assets, in particular, cryptocurrencies. Such measures may include:

(i) Measurement against Market Cap

The price of each virtual asset can be calculated based on the formula:

$$\text{Price} = \text{Market Capitalisation} \div \text{Circulating Supply}$$

The Commission may request licensed platform operators to take information on market cap and circulating supply into account to calculate the price of a virtual asset real-time by connecting the trading platform with the relevant application programming interface (“API”).

(ii) Price Comparison between Global Platform Operators

In order to identify whether the price on a particular platform operator is consistent with the public price, i.e. the price by definition in (i) above, a licensed platform operator should compare the price on its trading platform with at least 3 other independent global licensed platform operator in other recognised FATF jurisdictions. This would help a Hong Kong licensed platform operator to identify whether there has been any potential price manipulation on its platform.

Gate Group recommends there to be a disclosure obligation to the Commission on the names of the 3 independent global licensed platform operators, and any price deviation of over 5% should be disclosed to the Commission within one (1) business day.

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?

Gate Group agrees that certain measures should be in place to protect investors, in particular, from making misinformed judgements.

Gate Group is in the view that, unless separate licence has been obtained, no incidental advice should be provided to clients on a specific virtual asset on the trading platform to avoid any “impulse buying” or “impulse selling”. Where a separate advisory licence (e.g. licences to conduct Type 4 and/or Type 5 regulated activity(ies)) is obtained, free advisory services should be restricted and advisory fees must be charged as a standalone service, i.e. clients must pay for the advisory services out of their pockets.

The above restriction should not be applied to the provision of factual information such as those listed in section 9.28 of the VATP Guidelines. Gate Group is in the view that the requirements in section 9.28 of the VATP Guidelines would help the clients of licensed platform operators make informed and independent judgements when making a decision to conduct a transaction.

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?

Gate Group is in the view that licensed platform operators must have compensation arrangements in place to protect its clients from errors arising from material failures caused by the licensed platform operators or their associated entities. Gate Group welcomes the proposal to allow a combination of third-party insurance and/or proprietary funds set aside held on trust.

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

For funds that are set aside for compensation purposes, as long as the funds are held on trust and be designated for such a purpose, Gate Group is in the view that the arrangement is appropriate.

Gate Group is aware that in other jurisdictions with similar arrangements where a designated trust account is required to be set up, it is possible to have the money in the designated trust account invested into guaranteed return products with high liquidity and have the return used to compensate the operating expenses of the platform operator. We would wish that the Commission could allow similar arrangements.

To ensure that the designated trust account has sufficient amount, say coverage of 5% of the cold wallet's total value, the Commission should require licensed platform operators to disclose the amount in the designated trust account in the monthly financial return.

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?

Where a licensed platform operator holds client virtual assets, Gate Group recommends that the handling of client virtual assets may only be performed by authorised persons ("Authorised Persons") of each licensed platform operator. The private key of a wallet must always be sharded according to an M-of-N scheme, such that each key shard would not contain the whole of the private key to the wallet, and a transaction can only be signed after a quorum is formed to generate the private key with the key shards.

In order to operate a hot wallet, Authorised Persons would need to operate so in a console which can only be accessed through a bastion server (jump server) from a designated IP address in the internal VPN network. The operation must first pass the computer environment security check and 2 factor authentication verifications. The console should not be used for purposes other than the effecting of transactions for the hot wallet, and must have security measures in place. Advanced software security layer using MPC and TSS technologies should be implemented.

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?

Gate Group is aware that platform operators generally tend to provide a full-scale service to clients where possible, including spot trading, leveraged/margin trading, as well as trading in other derivatives such as futures contracts, options and callable bull/bear contracts, and leveraged/wrapped token.

Where possible, platform operators would generally like to offer other non-trading related value-added services such as staking and lending & borrowing.

Gate Group would only commence business activities as permissible under the regulatory framework.

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?

Gate Group wishes the Commission to clarify on the scope of permissible activities and consider lowering the threshold for the cold wallet storage.

(1) Scope of Permissible Activities

Further to our answer to Question 7 above, platform operators generally tend to offer value-added services to clients. Under paragraph 7.5(b) of the VATP Terms and Conditions, a platform operator may not [...], lend, pledge, repledge or otherwise deal with, or create any encumbrance over the virtual assets of a client except for the settlement of transactions.

It is unclear whether staking services and lending & borrowing services can be considered as a “transaction”, and it would be appreciated if the Commission can consider permitting licensed platform operators to provide such services to clients under their instructions.

(2) Cold Wallet Storage

The current requirement for the cold wallet storage is 98%, and it remains the highest amongst all jurisdictions that welcome virtual asset trading activities. This requirement may put Hong Kong in a less favourable position when platform operators choose their next jurisdiction to expand their overseas business, and they may opt for jurisdictions with less stringent requirements.

Setting a high threshold for the cold wallet would seemingly protect client assets from cyberthefts since it is completely isolated from the internet. However, this would create operational difficulties by requiring more human resources to handle frequent transactions. This significant increase in the frequency of on-chain transaction between the wallets may in turn increase the risk of operational failure, such as sending client assets to a wrong address due to fat finger.

Having the threshold set at 98% would also imply that there may be a high possibility of breaching the regulatory requirement for licensed platform operators, especially in times of market volatility where there may be mass withdrawal or deposit within a short period of time.

Instead of having a 98% threshold, Gate Group suggests a regulatory threshold of 80% as long as a licensed platform operator can meet the following:

(i) Hot Wallet Security

The Commission may consider requiring licensed platform operators to enforce certain security controls for the hot wallets containing client assets. Please refer to our answer to Question 6 above for our suggested technical solutions for hot wallet security.

(ii) Tiered Notification Requirement

There should be a tiered regulatory threshold for the cold wallet storage. The threshold must be monitored by the Manager-In-Charge for Operational Control and Review on a daily basis – 85% can be set as the soft limit and 80% can be set as the hard limit. Where there is any breach of the soft limit, the shortfall must be reported to the Commission within one (1) business day, and all trading activities, including client asset withdrawal and deposit, must be halted should the threshold fall below 80%, until the Commission considers the licensed platform operator to be fit to resume its business activities.

The threshold must be reported to the Commission on a monthly basis.

(iii) Additional Client Protection Funds

Further to Questions 4 and 5 above, it is understood that there should be compensation fund (i.e. insurance) to cover the risks associated with the custody of client virtual assets. The former regulatory requirement per paragraph 7.17 of the VATP Terms and Conditions required licensed platform operators to have a full insurance coverage for the assets in the hot wallet and a substantial coverage for the assets in the cold wallet, and we understand that the currently proposed requirement does not have a specific threshold set.

On the basis that the cold wallet threshold can be lowered to 80%, Gate Group suggests to have an amount equivalent to 1bp (i.e. 0.01%) of the asset in the cold wallet kept in a segregated trust account as Client Protection Funds in addition to the insurance arrangement that it has in place with third-party insurance and/or client compensation fund.

Instead of solely acting as an insurance fund, the setup of the Client Protection Funds is to ensure that sufficient funds would be put in place to provide immediate support to clients. Licensed platform operators should have relevant policies in place in relation to how the Client Protection Funds should be used when incidents arise.

Question 9

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

Gate Group does not have any comments on the Chapter.

Question 10

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

Gate Group does not have any comments on the Disciplinary Fining Guidelines.