HAUZEN
Anjie Broad
安杰世泽

HAUZEN LLP
浩宸律師行有限法律責任合夥

in association with
AnJie Broad Law Firm LLP
北京安杰世澤律師事務所有限法律責任合夥

Suite 3708 Tower Two Lippo Centre
89 Queensway Admiralty Hong Kong

Fax 傳真 +852 2150 2901

31 March 2023

BY EMAIL: VATP-consultation@sfc.hk

Securities and Futures Commission
54/F, One Island East
18 Westlands Road
Quarry Bay
Hong Kong SAR, China

Dear Sirs,

RE: Consultation Paper on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators

We thank the Securities and Futures Commissions (the "**SFC**") for the opportunity to provide our comments and feedback to the proposals set out in the Consultation Paper on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the SFC dated 20 February 2023 (the "**Consultation Paper**").

We are supportive of the proposed new regime by the SFC requiring all centralised VA trading platforms carrying on their businesses in Hong Kong or actively marketing their services to Hong Kong investors to be licensed and regulated by the SFC.

Set out below are our responses to the questions raised in the Consultation Paper. Capitalised terms not defined herein shall have the same meanings as defined 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. Retail investors who wish to trade virtual assets can already do so through overseas online trading platforms. These platforms are not regulated by Hong Kong and it would be difficult for retail investors to seek recourse against them. Allowing retail access in Hong Kong could ensure that investors are protected under the Hong Kong legal and regulatory framework.

While we agree with the proposal to allow retail access, we believe that the retail timetable requires detailed planning and needs to be further discussed. Platform operators and the market should be given sufficient time to prepare for retail access.

Allowing retail access requires an understanding of the legal and practical implications involved, such as the performance, operations and compliance of licensed platforms under the new regime after June 2023, the proposed contractual terms between a retail investor and a platform operator, the number of platform operators available to ensure there are sufficient options to retail investors, and how a retail investor may seek recourse against a Hong Kong licensed platform operator.

Given the numerous high-profile virtual asset exchange failures in the past few years, a key takeaway in the design of any regulatory regime must be that measures should be put in place to protect client assets deposited with the exchanges. These measures however need to be practicable in the context of the fintech and cryptocurrency industry, and their novel and innovative ways of deploying capital. For example, many virtual asset exchanges not only act as exchanges for the trading of virtual assets, but also function as virtual asset banks, offering customers a return on their deposits through staking or otherwise, and also themselves stake deposits placed with them. Regulation to protect customers of licensed platforms should also take into account the fact that the virtual assets industry operates in some significant ways differently from traditional finance, and should also aim to allow a reasonable level of innovation in the industry.

While having sufficient investor protection measures in place is important, allowing retail investors' participation should not be seen as an endorsement or an encouragement to trade virtual assets.

Question 2

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

We agree with the proposed 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?

Platform transparency is key. The nature of crypto trading is that crypto exchanges operate independently from each other and each exchange has its own platform risk such as management risk, liquidity risk, operational risk, trading risk and default risk.

Some platform operators rely significantly on liquidity providers (or market makers) to generate liquidity which accounts for the majority of the trading volume on its exchange. These liquidity providers may be local or overseas institutional trading firms that have the capital and technology to influence the prices and trading volume on a particular exchange. In addition, some platform operators enter into lending and borrowing transactions with other crypto firms and there could be default risk and counterparty risk. As a result, the risk of a retail investor on one exchange could be significantly different from the risk on another exchange even if all exchanges are subject to the same investor protection regime by the SFC.

We believe that disclosure of price and trading volume under paragraph 51(a) of the Consultation Paper should also include information relating to the liquidity providers, such as volume traded by liquidity providers, whether they are paid or receive incentive for trading, to ensure full disclosure to retail investors with respect to that exchange. We believe that 24 hours of trading history under paragraph 51(a) of the Consultation Paper would not be sufficient. Trading information on an exchange should cover at least 3-5 years of trading history on that particular exchange for disclosure purpose. Any significant default risk or counterparty risk should also be disclosed.

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?

Insurance policy is generally maintained by the platform operator for the benefit of the platform operator only. Investors (whether retail or professional) have no rights or access to the benefits of the insurance policy. Whether a claim will be made under the insurance policy is the platform operator's decision. Contractually, investors do not obtain any direct benefit under the insurance policy. Therefore, we believe that setting aside funds in escrow is still a good option to explore. Our views on setting aside funds are given in our response to Question 5 below.

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.

Funds set aside under house account do not offer the same level of protection as funds set aside under an escrow. While the house account has to be held on trust, if it is controlled by personnel within the platform operator then it could still be subject to abuse as seen in the recent collapses of certain overseas crypto firms. If the money could not be traced then there is little protection offered to investors.

We believe that third-party insurance should still be maintained which is for the benefit of the platform operator as explained above. In addition, there should be a minimum amount of funds set aside under an escrow representing a percentage of the total client assets.

Contractually, the funds set aside are held by the escrow for the benefit of investors under an escrow arrangement. They are ring-fenced from other secured or unsecured creditors of the platform operator. In the event of a platform collapse or other default events (i.e., triggering events), only investors who have assets with the platform operator will have recourse through the escrow. An escrow agent will act on behalf of the investors to distribute the funds in the escrow.

The SFC could consider stipulating a certain percentage of customer funds that must be put into escrow, based either on the capital adequacy approach adopted by the banking industry (e.g. the Basel III accords), or else a risk-based approach (expected shortfall or conditional value at risk etc.), or some other approach for calculating minimum capital to be maintained in escrow.

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 do not have comment.

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?

Similar to non-large-cap virtual assets, we believe that VA derivatives should be limited to professional investors only.

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 agree with the proposed requirements. Under paragraph 61(c) of the Consultation Paper, while platform operators are no longer required to submit written legal advice to the SFC for non-retail virtual assets, there should still be an expectation on platform operators to conduct their own legal due diligence which may involve obtaining legal advice as to whether the virtual assets constitute securities.

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 agree with the proposed requirements.

Question 10

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

We agree with the proposed guidelines.

We would be happy to discuss any part of our submission with you. If you have any questions please feel free to contact