SFC Consultation Paper on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the SFC

Response from the Hong Kong Institute of CPAs

Q1 - 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 note that there has been significant interest among retail investors to invest in virtual assets ("VAs") in recent years. We also note the arguments for and against allowing licensed virtual asset trading platforms ("VATPs") to provide services to retail investors in Hong Kong, as set out in paragraph 24 of the consultation paper ("CP"). Certainly there are risks. While retail investors can easily go online to access VATPs overseas, which are not regulated in Hong Kong, to trade virtual assets ("VAs"), and they may have little recourse if those unregulated VATPs collapse (as exemplified by the recent collapse of FTX, previously one of the largest VATP operators), there is no guarantee that such investors will not continue to do so in future, despite having opportunities in Hong Kong, if they find other markets offer a greater range of products or fewer restrictions. As such, we do not see this a good reason per se to open up the market to retail investors in Hong Kong.

At the same time, the Securities and Futures Commission ("SFC") has already licensed VATPs under the Securities and Futures Ordinance (Cap. 571) ("SFO") and, over time, the SFC has introduced various policies that have gradually allowed retail investors to gain limited exposure to VAs, as explained in paragraph 25 of the CP. Given this, and also the general market developments, explained in paragraph 26, we would not have strong objections to allowing licensed VATP operators to extend their services to retail investors, provided there are sufficient robust investor protection measures in place. Please refer to our further comments below.

Q2 - Do you have any comments on the proposals regarding the general token admission criteria and specific token admission criteria?

It is proposed, in paragraph 33, of the CP that a licensed VATP operator should set up a token admission and review committee for establishing, implementing and enforcing the criteria for admission of VAs.

Referring to paragraph 38 of the CP, thousands of VAs are actively traded on the market today, the offering and marketing materials of which have not been vetted or reviewed by the SFC, as VAs per se are not regulated or authorised by the SFC. Therefore, the proposal is to introduce a set of objective criteria for licensed VATP operators to follow when determining whether to make a specific VA available to their retail clients. The SFC also emphasises, in paragraph 40 of the CP, that *"licensed platform operators have the ultimate responsibility to perform reasonable due diligence on the VAs and ensure they satisfy the token admission criteria before admitting them for trading. They should also continue to monitor the admitted VAs and ensure that the virtual assets continue to satisfy the criteria on an ongoing basis".*

It appears that the SFC does not plan to vet or review any VA offerings and marketing materials going forward but, instead, will put the responsibility on VATP operators to perform the due diligence and vet the VAs that they wish to offer, taking into account a non-exhaustive list of general token admission criteria and factors set out by the SFC.

In addition, it is proposed that before a VA is made available to retail clients, operators will be required to ensure that the relevant VA satisfies specific token admission criteria as an "eligible

large-cap VA". This refers to VAs that are included in at least two "acceptable indices" issued by at least two independent index providers.

Although the SFC has provided these general and specific "objective" criteria, VATP operators will have to carry out the assessment themselves on each VA, subjectively, before making it available for trading by retail investors. It is quite possible, therefore, that individual operators will have different views on specific VAs and on whether they can be offered to retail investors, and different "acceptable indices" may be referred to by individual operators in conducting their assessments. This could lead to inconsistent practices and some confusion in the market.

Furthermore, VATP operators may face conflicts of interest as, on the one hand, a VATP operator will be responsible for vetting each VA itself but, on the other hand, it will also face pressures to be competitive and offer a wider range of products than its competitors, so as to attract more investors to use its platform and generate more commission income. In some respects, this may be akin to the scenario where the Federal Aviation Authority in the United States (U.S.) implemented a policy of entrusting aviation manufacturers, including Boeing, to certify that their own systems complied with U.S. air safety regulations. This situation became a key concern following the grounding of all 737 Max 8 aircraft after two fatal crashes.

Given the proposals, we foresee that some VATP operators may seek to offer as many products as possible to the market, while other may adopt a more cautious approach. Different operators may also have a different perspective on the SFC criteria. For this reason, we would have concerns about the quality of some of the VAs that may be admitted for trading by operators and whether they are really suitable for investment by retail Investors. At the same time, unsophisticated retail investors may be confused about which VAs to invest in and may be easily persuaded to invest in higher risk VAs.

Members of the Hong Kong Institute of CPAs' Corporate Finance Committee have offered some suggestions to help address this issue. Firstly, the SFC may consider (a) grandfathering some well-established VAs based on the trading volumes of the VAs (such as Bitcoin and ETH); or (b) requiring the formation of an industry vetting committee, consisting of representatives from the main licensed VATP operators, for vetting of VAs.

Alternatively, the SFC could require VATP operators to publish an independent financial advisor report on a particular VA for retail investors, which could be reviewed by professional accountants and lawyers, discussing the financial risks (for example, if it is a physical asset linked VA, the relative change in value of the VA versus that of the physical asset; the effect of leverage of derivatives on the VA; terms that may affect the value of the VA, such as whether there are any limitations on and/ or approval required by VA holders for issuing new VAs; and associated legal risks with the potential collapse of the VATP/ VA etc.). Standard terms emphasising how retail investors will be protected should be included in the marketing materials of the VA before it is allowed to be traded by retail investors.

However, if the current proposal proceeds, i.e., to make individual operators responsible for assessing VAs before offering them to retail investors, we would suggest that, as a minimum, the SFC should provide a list of acceptable indices and independent index providers for operators to refer to when conducting their assessments.

The position regarding non-fungible tokens ("NFTs") may need further clarification. Is it the case that NFTs will not be classified as "VAs" that may be offered to retail investors for trading, on the basis that they would not generally fulfil the SFC's proposed criteria (e.g. normally, they are not actively traded in the market and, therefore, are not liquid assets)?

Q3 - 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 VATPs?

The SFC should consider whether investors of VAs who suffer losses due to the default of a VATP operator could be eligible to claim compensation under the existing Investor Compensation Fund, as for investors of securities, according to the investor compensation regime under the SFO, subject to the existing compensation limit of HK$500,000 per investor.

In addition, the CP mentions in paragraph 26 that "*the dynamics of the virtual asset market have changed significantly. More global financial institutions and service providers such as traditional custodians have entered the space and are establishing institutional-grade infrastructure for it*." However, there are no requirements regarding custodians in the proposals. We would suggest that serious consideration be given to requiring that independent SFC-regulated custodians be engaged to hold VAs for investors to ensure the safe custody of their assets.

Issues such as these are critical from an investor protection perspective. In the collapse of VATP operators, such as Gatecoin, the cryptocurrency exchange incorporated in Hong Kong, which was ordered by the court to be liquidated in 2019, where customers are regarded as unsecured creditors, it could be a decade or more before investors can get back some of their assets, and, even then, eventual distributions may be only a very limited proportion of investors' losses.

We also suggest strengthening the requirements for board members of a VATP operator, including having a requirement for independent non-executive directors ("INEDs") on the board. VATP boards should include professionals with cybersecurity, governance and risk, financial technology, VAs and/ or industry domain knowledge etc., and preferably with relevant qualifications and/or experience. Consideration should also be given to requiring a board level Risk Committee with INED involvement to be established and that the senior management team of a licensed VATP operator should include a qualified accountant.

More generally, VATPs should be required to exercise transparency in their communications with and reporting to investors.

We believe that the above proposals would increase the corporate governance safeguards of licensed VATPs and hence provide greater protection to investors.

Please also refer to our responses to other questions.

Q4 - 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?

While we agree that requiring VATPs to obtain adequate third-party insurance coverage would, in principle, be an effective measure to protect investors, it is pointed out in paragraph 54 of the CP that VATPs face practical difficulties to obtain such insurance, as many insurers are unwilling to provide coverage associated with hot storage and, even if they are, the insurance premiums would not be commercially sustainable. As such, requiring funds to be set aside by licensed VATPs could be an alternative investor protection measure. Please refer to our response to Q5 below.

Q5 - 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.

We believe that the funds should be set aside by the licensed VATP operators under an escrow arrangement rather than under house account of the licensed VATP operator. If practicable, investors' assets should be segregated from the assets of the VATP operators to provide greater protection to investors. We understand that, in Japan for example, it is compulsory to segregate investors' assets from those of the VATP operators, and that Japan investors already obtained their assets back from FTX in February 2023. As explained above, in our response to Question 4, for greater protection, we suggest requiring that independent SFC-regulated custodians be engaged to ensure the safe custody of investors' assets.

It was reported in the case of FTX that customer assets of over US$3.2 billion were channeled to the founders, via an organisation namely Alameda Research, and part of the funds were used to purchase luxury properties in the Bahamas, political and charitable donations (*https://www.prnewswire.com/news-releases/ftx-debtors-file-schedules-and-statements-of-financial-affairs-with-bankruptcy-court-301773613.html*). This could have been avoided had mandatory custodian requirements or, possibly, an escrow arrangement been in place. Such examples reinforce the importance of segregation of investors' assets in protecting the interests of investors (both retail and institutional investors).

At the same time, it is also understood that requiring VATP operators to set aside the funds may significantly increase their working capital requirement, which could affect the viability of the business models of some VATP operators.

We acknowledge that it is not easy to strike an appropriate balance between facilitating market development and optimising investor protection but, certainly in opening up the VA trading market to retail investors when some other market are becoming more cautious, especially in the light of recent events, Hong Kong needs to be aware of the potential impact of any major failures of VATPs where investors are not sufficiently well protected.

Q6 - 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 will leave this question to market practitioners/ experts to comment further. However, we have some doubts about possible technical/ practical difficulties for the operators of VATPs to comply with the rules for custody of VAs of their clients in some cases. For example, FTX User Debt ("FUD") was issued purporting to represent debt claims in FTX; but, in this case, how could a VATP be certain whether it has discharged its safe custody obligations? Would it need hold the FUD token itself, or would it need to check whether the token issuer had claims on FTX assets, which were mostly VAs?

As indicated above, we suggest that preferably a custodian regime, similar to collective investment schemes, could be implemented for licensed VATP operators, i.e., a SFC-regulated custodian should be engaged to hold clients' assets on trust, instead of using an "associated entity" of the operator.

Further, and particularly where there is no licensed custodian arrangement and, if VA derivatives trading is also permitted, we suggest that the SFC should require an exchange to publish whether it has sufficient virtual and fiat assets to match its customers' holdings ("Proof of Reserve") on a frequent and regular basis, and enforce publishing such information on a

live basis, which is similar to the requirements imposed on VATPs in Japan. There should be sound internal controls around the Proof of Reserve system and it should be regularly audited by a qualified accountant/ auditor. Investors should also be allowed to check whether their balances are matched by assets in a trust account/ independent custody and whether covered by an audit. The following overseas exchanges offer examples:

(i) Kraken (https://www.kraken.com/proof-of-reserves); and
(ii) Binance (https://www.binance.com/en/proof-of-reserves)

Q7 - If licensed VATP 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?

Given VAs are highly speculative and volatile assets already, in our view licensed VATPs should offer trading services in VA derivatives only to professional and institutional investors, primarily for risk hedging risks. Retail investors should not be offered such services at this stage in the development of VA trading in Hong Kong.

We note that the CP does not mention regulation of margin trading of VAs, which has proved to be one of the major risk areas for exchanges like FTX. We would like to see the SFC's proposals also covering the regulation of margin trading in future.

Q8 - 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 do not agree with the proposal in paragraph 61(b) of the CP that licensed VATP operators will be required only to disclose to clients how they will handle the voting rights arising out of a client's ownership of a VA. In our view, operators, like securities brokers, should, in principle, be able to assist their clients to exercise their voting rights attaching to VAs, if the latter wish to do so.

Prevention of market manipulative and abusive activities

We are not entirely clear how a VATP operator would be able monitor and prevent market manipulative and abusive activities, in practice, unless this were to be clearly defined and limited to activities on the Hong Kong licensed VATPs. Given that the same VAs may be traded in many different jurisdictions, market manipulation and abusive activities could occur on an overseas exchange and the activities could affect significantly the price of the relevant VAs traded in Hong Kong (e.g. due to arbitraging by global investors). Would such activities constitute "market manipulative or abusive trading activities" referred to in the VATP Guidelines? If yes, what actions would the SFC expect a VATP operator to take in such circumstances?

Q9 - 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.

The proposal under section 12.3 to set HK$8,000 as the threshold for conducting customer due diligence for occasional transactions, whether the transaction is carried out in a single operation, or in several operations that appear to the SFC-licensed VASP to be linked, is potentially quite onerous; particularly since this also extends to a transaction in an equivalent amount in any other currency and which is not a wire transfer or a VA transfer. This compares with the threshold of HK$120,000 for occasional transactions generally (other than wire transfers) conducted by other regulated entities. The reason for setting the threshold at the

low level set for wire transfers only in the case of other regulated entities may need to be explained further.

Q10 - Do you have any comments on the Disciplinary Fining Guidelines? Please explain your views.

We will leave this question for market participants to comment.

Advocacy and Practice Development
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