KING&WOOD MALLESONS
金杜律师事务所

香港中環皇后大道中15號置地廣場告羅士打大廈13樓

13/F, Gloucester Tower, The Landmark
15 Queen's Road Central, Central, Hong Kong

T +852 3443 1000
F +852 3443 1299

www.kwm.com

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

By email: VATP-consultation@sfc.hk

To the Securities and Futures Commission

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

Thank you for the opportunity to respond to the Consultation on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators licensed by the Securities and Futures Commission ("**Consultation Paper**"). This document is a submission of King & Wood Mallesons ("**KWM**") having regard to input from our large Hong Kong and offshore-regulated exchange and traditional finance sector clients and work with other major APAC industry bodies. OSL Digital Securities Limited (an existing Hong Kong licensee and long-established digital economy sector leader) has also contributed to parts of this submission.

We summarise our views, as well as those of the other contributors to this submission, in response to the questions raised by the Securities and Futures Commission ("**SFC**") in the Consultation Paper, as well as our additional comments.

Unless otherwise defined, terms used in this response have the meaning given to them in the Consultation Paper.

1 Introduction

KWM is an international law firm headquartered in Asia, and is proudly one of Hong Kong's largest law firms. With access to a global platform, our team of over 2000 lawyers, in centres of excellence around the world, works with clients to help them understand local challenges, find commercial solutions and support legal and policy initiatives.

We are in the unique position of being a leading legal practice in relation to blockchain, virtual assets ("**VAs**"), financial regulation and anti-money laundering and counter-terrorist financing ("**AML/CTF**"), with one of the largest and most highly respected global teams focussed on fintech and blockchain. We have advised on VAs since 2016.

KWM has been actively providing comments and support throughout the legislative journey of the new licensing regime for centralised VA trading platforms under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) ("**AMLO**"), both in KWM's own capacity as well as for particular clients and large industry associations.

In short, we all have a shared desire to see a vibrant and internationally competitive digital economy for Hong Kong, with trust at its foundation. We ask that all our comments be interpreted in this light.

2 Executive summary

Overall, we commend the SFC's commitment to establishing and formulating a robust but also appropriately balanced regime during this challenging time for the global VA sector. We acknowledge the SFC's significant efforts in engaging with the industry and taking on board industry feedback on a number of key issues.

In this response, we seek to identify specific recommendations to bolster the aims of the Consultation Paper whilst striking an appropriate balance to mitigate potential systemic issues arising from certain proposals, bolstering regulatory certainty, aligning with the AMLO and reflecting principles of technological neutrality and risk-based conduct and supervision.

In summary, we support and welcome the detailed guidance and regulatory framework for licensed VA trading platform operators ("**Licensed Platform Operators**") to protect Hong Kong investors and the integrity of the VA market. However, certain requirements could be fine-tuned.

In summary, our key comments include the following:

(a) **Clarity on application**. The AMLO captures a broad cross-section of VAs, but at the same time captures a reasonably narrow scope of activities. We understand from the AMLO Legislative Council process and dialogue with the SFC that multiple activities are not intended to be caught, including brokerage even if in digital form, with the focus on business models that mirror *traditional* exchanges with *traditional* matching processes. However, the language of the AMLO remains broad and the only guidance on its interpretation that is publicly available is housed in Legislative Council papers and a footnote to the Consultation Paper. Further, VA trading infrastructure is often, by design, different to traditional exchanges. As such, more granular guidance that defines the parameters of the new regime would be welcomed for its consistent application.

(b) **Retail pathways are welcomed and controls should balance the risk of the unregulated "shadow" VA sector flourishing**. We fully support access by retail to the VA sector for various systemic and consumer protection reasons. However, we suggest refinements could be made to the rules for clarity, as well as to avoid unregulated VA markets flourishing – in short, if the retail rules are too restrictive, retail will not be protected but will simply go elsewhere. The risk of regulatory arbitrage remains high on the current proposals, based on our awareness of the products and platforms readily available in the market.

(c) "**Same business, same risks, same rules" principle**. We support the SFC's adoption of this principle. All our comments should be read in support of this principle. We suggest that certain requirements under the draft Guidelines for Virtual Asset Trading Platform Operators set out in Appendix A to the Consultation Paper ("**VATP Guideline**") and the draft Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (For Licensed Corporations

and SFC-licensed Virtual Asset Service Providers) as set out in Appendix B of the Consultation Paper ("**AML Guideline**") could be lightly adjusted to reflect this principle.

(d) **Market integrity and investor protection should continue to be risk-based and proportionate**. The VATP Guideline clearly represents one of the high water marks of global VA regulation. It creates a compelling framework for VA sector regulation in its coverage of market integrity and investor protection requirements. We suggest in our detailed response some options and considerations to ensure these remain risk-based, proportionate and workable. In relation to workability, VAs are a special class in that many of the traditional rules do not translate as easily – for example, some of the disclosure rules in relation to Bitcoin and Ethereum are much more difficult to apply at all, or at least in an *additive* way to investor protection, as compared to the relevance and value they have in relation to a security token issued by a centralised issuer and recorded and validated on a permissioned blockchain.

(e) **Flexibility is welcome, but certainty will be valuable over time**. We welcome multiple new areas of flexibility where particular rules recognise that there could be situations where an alternative approach is merited. However, many of these lack specificity as to how discretions will be exercised and what factors will be taken into account when Licensed Platform Operators pursue exceptions. There is very little time before 1 June 2023, so this may not be possible now, but we suggest this be an area of focus for the next evolution of the VATP Guideline. This also supports Principle A.4 of the International Organization of Securities Commissions ("**IOSCO**") Objectives and Principles of Securities Regulation, which relates to clear and consistent regulatory processes.[1]

(f) **Business models rely on sophisticated services**. We recognise the intent to keep Licensed Platform Operators focussed on their main objective of trading VAs. However, we highlight the need to take into account their need for liquidity and therefore market making, the flexibility required in terms of funding, and the market demand and need for derivatives at least for hedging risk exposures, but also to provide clients with access to exposure to VAs without necessarily holding the VAs themselves.

(g) **Banking dependency remains a significant hurdle and requires a collaborative effort.** We fully support the proposed controls on client money handling, including the value to investor protection of mandating the use of Hong Kong licensed banks in the case of money received in Hong Kong. However, the reality is that Hong Kong licensed banks still require significant regulatory support to consider banking the sector. There is no doubt that banks should be cautious in the wake of significant market scandals and collapses. At the same time, the Legislative Council and SFC have created a framework that will make Licensed Platform Operators not only highly regulated, but also stringently supervised and subject to in-depth external validation. As such, we consider the SFC has an important role to play in liaising with other regulators, including the Hong Kong Monetary Authority ("**HKMA**") and the banking sector more generally, to convey the strength of this regime and to help shape the necessary positive regulatory messaging to banks (within reason) to enable the rules relating to bank accounts be realistically achievable.

(h) **Consistency with the AMLO.** We have raised a small number of points where we consider there could be stronger alignment between the Consultation Paper and the AMLO, such as eligibility for licensing and custody options. We suggest maximising alignment given the

[1] As accessed from https://www.iosco.org/library/pubdocs/pdf/IOSCOPD561.pdf.

AMLO reflects the intent of the Legislative Council of Hong Kong following extensive consultation, deliberation and other procedures.

Our detailed response and recommendations are set out in the schedule to this letter.

We would be pleased to provide further insight and support to the work of the SFC, including in relation to our recommendations. Should there be any queries arising from this submission, please do not hesitate to contact us.

Yours faithfully

Schedule – Responses to specific questions

In this schedule, we provide our responses to the specific questions raised in the Consultation Paper.

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.**

General comments

We welcome the SFC's proposal to allow Licensed Platform Operators to provide services to retail investors. Denying retail access carries a significant risk of pushing retail investors to trade on unregulated VA trading platforms overseas, creating a "shadow" VA sector.

We understand the rationale for enhanced protections for retail investors and agree that protection is valuable and necessary. However, we take the view that the VA-knowledge test and the suitability obligations are too onerous, particularly if the specific token admission criteria, that is, the eligible large-cap VA test described in paragraph 7.6 of the draft VATP Guideline ("**Specific Token Admission Criteria**") remains in place. See our response to Question 2. Having retail investors be required to undertake knowledge testing, along with risk profiling and the requisite supporting information to be provided, may in effect be a barrier to retail investors in Hong Kong.

Put simply, if it is too hard, retail investors will look elsewhere, again leading to a "shadow" VA sector. This undermines the purpose of the proposed protections in the first place. We draw attention to other comparable markets:

(a) Singapore proposes to allow retail access provided that the consumer has been assessed to have sufficient knowledge of the risks of the VA services, which appears to be achievable through provision of adequate disclosure regarding risks. Other proposed protections are restrictions on offering incentives, debt-financing and leveraged VA transactions. There is no in principle suitability and matching requirement.[2]

(b) Dubai allows market participants to engage with risk, so long as they give "informed consent" about their investments and Licensed Platform Operators have provided them with all information necessary for such consent.[3] There is no in principle suitability and matching requirement.

It is our view that a risk-based approach could be adopted. For example, allowing retail investors to trade following receipt of appropriate risk disclosures under daily, weekly, monthly and annual limits without being required to undertake a lengthy knowledge test and without requiring suitability and matching to be conducted. If the Specific Token Admission Criteria remains in place, the risk profile of the VAs will likely be similar in any event.

We also recommend exemption of certain of these requirements for Individual Professional Investors (as referred to in the VATP Guideline and in the Code of Conduct for Persons Licensed or Registered with the SFC ("**SFC Code of Conduct**")). We recommend allowing a risk-based

[2] See chapter 3 - https://www.mas.gov.sg/-/media/MAS/News-and-Publications/Consultation-Papers/2022-Proposed-Regulatory-Measures-for-DPT-Services/Consultation-Paper-on-Proposed-Regulatory-Measures-for-Digital-Payment-Token-Services.pdf

[3] See fundamental principle 2 on page 5, here - https://www.vara.ae/media/Virtual%20Assets%20and%20Related%20Activities%20Regulations%202023.pdf

approach for Licensed Platform Operators to be able to dispense of requirements such as matching if a person meets the Individual Professional Investor test, or, providing guidance such that it would be assumed that such individuals are deemed suitable for all eligible large-cap VAs.

Harmonisation and industry guidance

There is a significant risk of inconsistency in the approach to:

(a) conducting knowledge tests under paragraph 9.4 of the VATP Guideline. We recommend developing industry standard questionnaires that can be adopted by Licensed Platform Operators in assessing knowledge. This will also assist clients that wish to trade with more than one Licensed Platform Operator in Hong Kong, who will not be required to complete multiple questionnaires of different standards;

(b) conducting risk profiling of clients in accordance with paragraphs 9.6 and 9.21(b)(i) of the VATP Guideline. We recommend further industry guidance on the factors to be considered in a risk profiling exercise and sharing information from thematic review of how risk profiling is conducted in practice; and

(c) conducting risk profiling of VAs under paragraph 9.21(b)(ii). We recommend the SFC provides guidance on the features of a VA that it considers enhances risk and considers categorising certain well-known VAs as low risk, medium risk and high risk.

Separately, we strongly recommend that statutory professional investor tests be revisited as a matter of priority as capital markets evolve, the VA sector matures and high net-worth portfolios increasingly include VA components. The professional investor test would also merit expansion to enable those with sufficient knowledge and experience to access products reserved for this class of investors (that is, those who can appreciate the risk and make rational assessments), rather than limiting it to those who can simply demonstrate that they can bear financial loss with a particular portfolio of assets. We acknowledge this is a separate process, but equally recognise the critical role the SFC plays in the evolution of the SFO over time and the SFC's role as the key VA sector regulator for Hong Kong. We do not extrapolate upon that further at this time, but would be eager to hear the SFC's views.

Specific feedback

We set out below recommended edits to the draft VATP Guideline:

(a) Paragraph 9.3(a). We respectfully submit that requiring Licensed Platform Operators to list all jurisdictions that do not permit trading of VAs is overly onerous and not helpful to clients. It is simply not feasible for any Licensed Platform Operators to review over 190 jurisdictions, if that is the intention here. We suggest this requirement be removed, with Licensed Platform Operators having in place controls to prevent unlawful trading instead. This is also consistent with the approach taken in regulating other financial market intermediaries and related "fit and proper" considerations.

(b) Paragraph 9.3(c). There are circumstances in which it may not be unlawful for a person in a jurisdiction to trade (nuanced and specific to the jurisdiction). We suggest adding "unless to do so would not be unlawful". By way of example, while certain jurisdictions have very stringent limitations on VA trading, they do not necessarily capture all activity, wherever it

occurs, and in every context, by a citizen. It should be possible for a Licensed Platform Operator to take legal advice and act in accordance with it.

(c) Paragraph 9.7, note 1. We recommend this refers to overall holdings, with "*in virtual assets"* being deleted. It was unclear to us why holdings in VAs, but not other assets, would be solely relevant here.

(d) Footnote 58. We recommend deleting the first sentence as it is confusing given specific rules are laid down. It also introduces uncertainty. Paragraph 5 already provides the direction to comply with the spirit of the general principles in the VATP Guideline. The rest of the footnote still provides the necessary guidance on the SFC's focus.

(e) Paragraph 9.13. We recommend against specifying that the information must be sent by email and instead use a phrase such as "written form" to allow for flexibility on mode of communication.

(f) Paragraph 9.18. This appears to be overly onerous; a Licensed Platform Operator should be entitled to market its services. It is unclear why VAs would be in a different category to other capital market products that may be subject to general offer and marketing restrictions and controls, but not comprehensive bans in all cases. If retained, we recommend further guidance on what forms of marketing are prohibited, for example, whether this refers to an advertisement in the MTR or also website statements, social media and even private communications.

(g) Paragraph 9.26. Not all items (a) to (l) will always be applicable. We recommend adding "as applicable" to the end of the first paragraph, prior to the list. We also recommend the SFC to develop standardised risk disclosures similar to those in schedule 1 of the SFC Code of Conduct in respect of typical major risks relating to trading VAs including cybersecurity and technology-related risks, explaining forks and various types of common cyberattacks and the consequences of loss of private keys.

(h) Paragraph 9.33(f). It is unclear what the intended difference between "market price" and "market value" is. We understand the first relates to the actual price of a trade (as traded) whereas the value relates to a prevailing market price as at a certain date. We suggest clarification.

Clarification

Finally, we also recommend paragraph 5.1(d) be revisited to ensure it does not suggest that rules applicable to retail and Individual Professional Investor clients apply to all. For example, a footnote could be used to make clear the application of this principle.

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

Overview

Echoing our response to Question 1, we support the pathway for retail access to VA exchanges operated by Licensed Platform Operators, and we acknowledge the importance of appropriate token admission criteria and token due diligence requirements in protecting the investing public.

However, we respectfully submit the following:

(a) The Specific Token Admission Criteria set out in paragraph 7.6 of the draft VATP Guideline may not be an effective solution to address the risks faced by retail investors. Our key reasons are set out in sub-paragraphs (a) to (c) below.

We suggest that a set of principles-based admission criteria, coupled with the general requirement to keep the SFC informed, is more appropriate. Further details are set out in sub-paragraph (d).

(b) To enable effective implementation, we seek the SFC's clarifications on some parts of paragraph 7.5 of the draft VATP Guideline ("**General Token Admission Criteria**") and paragraphs 7.7 to 7.10 of the draft VATP Guideline ("**Additional Token Due Diligence Requirements**"). These clarification requests are in sub-paragraph (e)

Additional details

(a) **Specific Token Admission Criteria**

Our comments in this paragraph are subject to the SFC's expectation on what amounts to an "acceptable index" issued by an "*index provider which has experience in publishing indices for the conventional securities market*" under paragraph 7.6 of the draft VATP Guideline. To illustrate the practical difficulties, we have tried to apply the Specific Token Admission Criteria using three VA indices that are widely employed in the market, namely:

(i) **Bloomberg Galaxy Crypto Index**, which covers 11 constituents (ie BTC, ETH, ADA, MATIC, SOL, DOT, LTC, AVAX, UNI, ATOM and LINK) based on its latest factsheet.[4]

(ii) **MSCI Global Digital Assets Index**, which covers 30 VAs from the eligible universe. The "Final Universe" includes the top 30 VAs ranked in descending order of their full market capitalisation.[5]

(iii) **S&P Cryptocurrency LargeCap Index.** While there was a news report dated 21 July 2021[6] noting that "243 digital assets" were covered by the S&P Cryptocurrency Broad Digital Market Index, the full list of constituents of the S&P Cryptocurrency LargeCap Index does not appear to be available to the public free of charge.[7]

Based on publicly available information, it appears:

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4 March 2023 version available at https://assets.bbhub.io/professional/sites/10/BGCI-Factsheet-Mar-23.pdf.

5 "Eligible universe" consists of all individual digital assets benchmarks (herein, "Crypto Reference Indexes") published by Compass Financial Technologies, available at https://www.compassft.com/indices/.

The list of VAs in the "Final Universe" does not appear to be available to public free of charge. See MSCI Global Digital Assets Indexfact sheet (up to 31 January 2023) at https://www.msci.com/documents/10199/15674506-2bd3-ccc4-a53d-06fddc40f58c

6 Available at https://www.coindesk.com/business/2021/07/20/sp-crypto-index-has-243-coins-doge-is-not-one-of-them/

7 See S&P Cryptocurrency LargeCap Index factsheet available at https://www.spglobal.com/spdji/en/idsenhancedfactsheet/file.pdf?calcFrequency=M&force_download=true&hostIdentifier=48190c8c-42c4-46af-8d1a-0cd5db894797&languageId=1&indexId=92411309.

(i) not all of the example indices make available the index constituents and their respective weightings accessible and free of charge to retail investors;

(ii) realistically and having regard to footnote 19 of the Consultation Paper, Licensed Platform Operators may be comfortable to categorise up to 7 to 8 VAs as "eligible large-cap VAs". This number may be further reduced depending on whether Licensed Platform Operators can obtain legal opinions confirming that the VAs do not fall within the definition of "securities"; and

(iii) the example indices contain strong disclaimer wording on their publicly available factsheets along the lines that:

(A) the index providers do not guarantee the timeliness, accuracy or completeness;

(B) the index providers do not make any warranty as to the indices or any related data; and

(C) the index providers expressly disclaim all warranties of merchantability and fitness for a particular purpose with respect thereto.

The above may vary subject to whether a Licensed Platform Operator enters into a licensing agreement with the index provider, and the terms of such licensing agreement.

Sub-paragraphs (b) and (c) below contain the key reasons why the Specific Token Admission Criteria may not be the best approach in determining whether a VA can be an eligible large-cap VA.

(b) **Non-reliance disclaimers and lack of transparency**

Unlike the requirement in respect of unlisted index funds and index tracking exchange traded funds[8], the SFC does not expressly provide its expectation *"that the index constituents together with their respective weightings should be easily accessible, free of charge, by investors*". Two of the three example indices do not provide such information to the public free of charge.

This means that a Licensed Platform Operator may need to incur substantial and, in substance, unnecessary cost to conduct an initial assessment on which indices to employ and which VAs may satisfy the Specific Token Admission Criteria. The Licensed Platform Operator may also need to engage multiple index providers to confirm whether its proposed eligible large-cap VAs fulfill the Specific Token Admission Criteria.

Further, the factsheets or other materials relating to the indices contain strong non-reliance disclaimer wording. This means that each Licensed Platform Operator will need to enter into a licensing agreement with each index provider in respect of (at least two of) the indices they intend to rely on, to enable Licensed Platform Operator to:

[8] These are requirements are contained in paragraph 8.6 of Section II (Code on Unit Trusts and Mutual Funds) of the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products.

(i) access the necessary information to confirm compliance with the Specific Token Admission Criteria, eg to confirm the list of constituent VAs and the other requirements set out in Note 1 of paragraph 7.6 of the draft VATP Guideline; and

(ii) be informed of any changes to the list of constituent VAs, the methodology or rules of the index to ensure compliance with paragraph 7.6 and 7.10 of the draft VATP Guideline on an ongoing basis.

Some institutional investors may have better access than retail investors to information relating to the major indices relied upon by the Licensed Platform Operators. This may result in information imbalance and may be unfair to retail investors if several major indices exert an excessively large impact on the Hong Kong market.

(c) **Not an indicator of low risk**

We respectfully submit that being included in an index in itself:

(i) does not address any key risks involved in any particular VA (eg the VA is in fact a fraudulent scheme); and

(ii) does not guarantee of price stability, low volatility or low risks,

and may indeed exacerbate risk by providing a false impression of safety.

We further submit that being included in at least two indices "*which [have] a clearly defined objective to measure the performance of the* ***largest VAs in the market***" is useful in ascertaining the popularity of a VA at the time of assessment. However, it cannot confirm that a VA has consistently high market capital and strong liquidity.

We refer to the note under paragraph 7.10 of the VATP Guideline which anticipates the situation where a VA may fall outside the constituent VAs of an acceptable index. By way of example, the Crypto200 ex BTC Index by Solactive includes "*the top 200 cryptocurrencies except for Bitcoin and stablecoins, by market capitalization, in USD*" and is "*based on Pricing data for the index is provided by CoinMarketCap*".[9] Its constituents are constantly changing. While we appreciate the flexibility provided to the Licensed Platform Operators to evaluate whether to continue allow trading of such VA by retail clients, we respectfully submit that a VA may cease to be a constituent of an index (eg fall out of the top 10) for natural market reasons, rather than any adverse news or liquidity issues. In such case, we strongly suggest that the Licensed Platform Operator should **not** halt or restrict trading of such VA as this would unduly impact the price of the VA.

It is unlikely that the Specific Token Admission Criteria would provide an additional layer of protection for retail investors. By way of example, and having regard to prevailing market conditions at material times, we cannot see that the Specific Token Admission Criteria would have necessarily protected the market from most (if not all) of the most recent major blow-ups.

Further, there can be underlying questions as to data quality and independence. In this respect, we understand index providers do not generally provide, and are unlikely to

[9] See https://www.solactive.com/Indices/?index=DE000SLA7P17.

provide, *actionable* assurances in respect of factors such as accuracy, timeliness, completeness or integrity of data relating to a constituent VA, consistent with our initial observations in paragraph (b) above.

Ultimately, we consider the Specific Token Admission Criteria may give retail investors a false sense of security, or at least a false impression of where true risks lie, with a better approach being for Licensed Platform Operators to make appropriate risk-based assessments based on all the facts available to them, or for there to be published lists.

Additional market manipulation risks

While an index has to fulfil certain criteria[10] to become an "acceptable index", we understand that the index providers do not necessarily have to be regulated in Hong Kong (or in other comparable jurisdictions). There is no real control to address the risks relating market manipulative and abusive activities involving index providers.

There is also a risk that an index provider may specifically create an index for the disguised purpose of supporting retail trading of certain VAs by selectively choosing (or even manipulating) the data that goes into the calculation or assessment of whether a VA is eligible to be a constituent of an index, or whether it makes to, for example, the top 10 VAs amongst other eligible constituents. This may also happen if the index provider relies on inaccurate data provided by other third parties.

Further, the involvement of the index providers in the process of determining whether a VA is an eligible large-cap VA (ie whether it can be tradable by retail investors in Hong Kong) will result in more people gaining access to the "inside information" relating to the listing of a VA on a licensed platform. As mentioned above, if the index providers are unregulated in Hong Kong, their employees or personnel are also likely unregulated in Hong Kong. They may not be subject to the same market misconduct regulations as those in Hong Kong, and may make use of such information to manipulate price or benefit from trading the relevant VAs.

Concentration risks

As mentioned above, we expect a Licensed Platform Operators may categorise around 7 or 8 eligible large-cap VAs based on the three example indices. The SFC's regulatory expectations regarding the "acceptable indices" will have a significant impact on the actual number of eligible large-cap VAs in the Hong Kong market. To this end, we strongly recommend the SFC provide a list of the "acceptable indices" and "index providers which has experience in publishing indices for the conventional securities market" to provide more regulatory certainty.

On the above basis, we raise some further risks we have identified that may flow from a such restrictive Specific Token Admission Criteria:

(i) This may result in severe concentration risk in the whole Hong Kong VA retail market.

[10] Set out in paragraph 7.6 of the draft VATP Guideline.

(ii) This may reduce competition leading to a less efficient and diverse market in financial innovations.

(iii) Retail investors may choose to access ineligible VAs through back channels and unregulated platforms.

(iv) This may reduce the competitiveness of the Licensed Platform Operators, and impact the commercial feasibility of the whole Hong Kong VASP licensing regime due to the restrictions and associated compliance costs.

(v) Where there is a flaw in an index, or simply an asset fails, there is a compounding of risk as a result of so many entities relying on few sources.

(d) **Principle-based admission criteria**

We respectfully suggest that:

(i) the list of eligible large-cap VAs available for retail investors should form part of a Licensed Platform Operator's business plan; and

(ii) the SFC should provide a set of principles-based admission criteria to enable a Licensed Platform Operator to determine what assets can be considered eligible large-cap VAs. These principle-based admission criteria should have regard to the underlying characteristics and nature of a VA.

Coupled with the general requirement to keep the SFC informed of any material changes to the Licensed Platform Operator's business plans[11], we respectfully submit that this is a more appropriate and balanced approach.

It is of course possible that the SFC could then flag the index-based test as a "deemed compliant" approach to admitting a VA. However, we suggest the principles-based approach should be first option and not simply housed in Note 3 as a fall-back that requires approval.

(e) **Specific feedback and clarifications regarding the General Token Admission Criteria and Additional Token Due Diligence Requirements**

We also seek clarification of the following points in respect of the draft VATP Guideline:

(i) Paragraph 7.4. To enable the Licensed Platform Operators to understand regulatory expectations, we recommend that the SFC provide a template monthly report in respect of the eligible large-cap VAs to be submitted by the token admission and review committee to the board of directors.

(ii) Paragraph 7.5 (generally). A number of the General Token Admission Criteria are dependent upon the accuracy of the factual matters provided by the issuers. To ensure the requirement to "*perform reasonable due diligence requirements*" are

[11] Paragraph 3.6 of the draft VATP Guideline and paragraph B(1)(8) to schedule 3 of the draft VATP Guideline.

operationally feasible, we recommend the SFC consider expressly providing the following flexibility, to the extent feasible and reasonably practicable:

(A) Allowing Licensed Platform Operators to rely on an issuer's confirmation in respect of factual matters such as "background of the management or development team" and "the accuracy of the marketing materials for a virtual asset issued by the issuer".

(B) If the SFC does not consider (i) sufficient, allowing Licensed Platform Operators to rely on third party assessments or audited reports provided by issuers to the Licensed Platform Operators.

Note: (A) and (B) would only be relevant in situations where a Licensed Platform Operators establishes a direct relationship with the issuer.

(C) Separately, certain VA issuers will be regulated under the European Commission's Markets in Crypto-Assets Regulation ("**MiCA**") which comes into effect early next year. They will be subject to a number of requirements including transparency and disclosure requirements in respect of VAs. We suggest the SFC allow Licensed Platform Operators to rely on:

(I) the due diligence results conducted by its MiCA or other appropriately regulated group company; and/or

(II) the information published and provided by the issuer pursuant to MiCA or another appropriate regime,

such that the Licensed Platform Operator does not need to conduct additional due diligence (in reliance on (I)) or confirm the validity and accuracy of any such information (in reliance on (II)).

Separate sponsor regime as a potential pathway

In certain cases:

(A) a Licensed Platform Operators may not be the most appropriate person to conduct certain aspects of due diligence, particularly in relation to factual matters;

(B) the operational costs involved in the due diligence process to ensure compliance with the General Token Admission Criteria, the Specific Token Admission Criteria and the Additional Token Due Diligence Requirements can be very high; and

(C) it may be appropriate to involve specialist licensed entities in the due diligence process.

An option is to develop a sponsor-based regime in the long run for the purpose of the due diligence on VAs. This could support the sustainability of the industry's growth, particularly in respect of security tokens with purported returns and multiple

lifecycle events. In developing such a sponsor regime, the SFC could have regard to the existing sponsor regime with respect to the listing of securities on The Stock Exchange of Hong Kong Limited, for example. This is likely to be a long-term effort, given our understanding that existing traditional licensed sponsors are largely neither ready nor willing to take on a new role as a VA sponsor having regard to the additional resources required to build relevant due diligence capabilities. It would likely require support, resources, guidance and potentially subsidies or tax concessions to make such an expansion feasible. In any event, we do not advocate for a regime that *mandates* sponsors.

(iii) Paragraph 7.5(b). We are of the view that there is unnecessary overlap with paragraph 3.7(g)(vii) and this can be deleted. Paragraph 7.5 relates to important matters relevant to Hong Kong compliance and does not, in general, extend to compliance with other market requirements. It may also be the case that jurisdictional nexus or other considerations make it unnecessary to pinpoint the exact regulatory status of a given asset in a market (for example, if the tests relevant to all regulated activities all relate to local carrying on business). If the SFC considers something here is still merited, we suggest the more appropriate and straightforward test is:

> "*whether the Platform Operator requires any regulatory licences or approvals to provide trading services in a virtual asset in the markets in which it operates.* "

(iv) Paragraph 7.5 (c). We suggest the SFC consider amending the provision as below to enhance clarity:

> *"(c) the supply, demand, maturity and liquidity of a virtual asset, including its market capitalisation, average daily trading volume, track record ~~(for example, issued for at least 12 months except for security tokens)~~, whether other ~~P~~platform ~~O~~operators also provide trading for the virtual asset, the availability of trading pairs (for example, fiat currency to virtual asset), and the jurisdictions where the virtual assets have been made available for trading;*

Having regard to paragraph 61(a) of the Consultation Paper, we understand that the SFC's intention is to remove the "post-issuance track record of 12 months" requirement along with the other requirements which were previously applicable to "security tokens".[12] We believe the inclusion of an example at paragraph 7.5(c) creates confusion. We also submit that Licensed Platform Operators should be able to make available newly issued VAs (at least to professional investors) on their platforms, provided that other due diligence requirements have been satisfied. This is crucial to the development of Hong Kong VA sector and ecosystem.

(v) Paragraphs 7.5 (e) and (f). We recommend the SFC consider restricting the scope of these requirements. As currently drafted, a Licensed Platform Operator is required to consider "*the marketing materials for a virtual asset issued by the issuer, which should be accurate and not misleading*" and "*the development of a virtual asset including the outcomes of any projects associated with it as set out in its*

[12] See paragraph 4.3 of the existing VATP Terms and Conditions.

Whitepaper (if any) and any previous major incidents associated with its history and development" in order to fulfil its due diligence obligation with respect to each VA.

We respectfully submit that, depending on the history of each VA, this may prove to be excessively costly for the Licensed Platform Operators, and may not be effective in identifying and addressing any current and genuine risks.

(vi) Paragraphs 7.5 (g) and (h). We recommend the SFC consider restricting the scope of these requirements to publicly known risks only.

(vii) Paragraph 7.5 (i). We respectfully submit that the term "scandalous" is too ambiguous and could be interpreted in multiple ways with very little prospect of certainty or consistency, resulting in unnecessary consumer and market risk. Therefore, we suggest replacing it with "otherwise illegal". We suggest legality is a more appropriate standard for financial services regulation and can be far more clearly ascertained and consistently applied.

(viii) Paragraph 7.8. We submit that Licensed Platform Operators may encounter practical difficulties complying with this requirement, depending on the nature and characteristic of a VA. We suggest the SFC could consider providing more guidance on:

(A) the situation where the VA is on a private / permissioned chain;

(B) what audit criteria should be used and what the standard should be adopted; and

(C) how to select an appropriate independent auditor. To this end, we suggest the SFC provide a non-exhaustive list of acceptable independent auditors or some objective criteria in the selection of smart contract auditor.

(ix) Paragraph 7.10. In line with sub-paragraph (b) above, we recommend the SFC consider expressly allow Licensed Platform Operators to rely on an undertaking from issuers (where they are relevant and identifiable) to keep Licensed Platform Operators informed of any subsequent changes in order to satisfy its ongoing monitoring obligations.

(x) Note under paragraph 7.10. In addition to our comments on this note above, we suggest the SFC consider amending the provision as below to enhance clarity:

> *"Note: As an example, where an admitted virtual asset falls outside the constituent virtual assets of an acceptable index as provided in paragraph 7.6 above, the Platform Operator should evaluate whether to continue to allow trading of this virtual asset by retail clients. Factors which the Platform Operator may consider include whether there are any material adverse news (~~or~~ including those relating to underlying liquidity issues) for the virtual asset. Where such factors would unlikely be resolved in the near future, the Platform Operator should consider whether the trading of the virtual asset should be halted or whether retail clients should be restricted to the selling of their positions only."*

We generally agree with the need to monitor any material adverse news with respect to each eligible large-cap VA. However, the drafting appears to contemplate a deeper level of insight or investigation. We therefore recommend the above changes. If deeper enquiry is indeed the expectation, we suggest further clarity.

In addition, we respectfully ask the SFC to consider more generally the negative impact of halting or restricting trading of a listed VA to retail investors, and to reconsider and provide further guidance on the threshold for halting or restrict trading of a listed VA.

A decision to halt or restrict trading may have significant and unforeseeable impacts on the price of the VA. Retail investors may suffer significant losses when attempting to close their positions.

We submit that this should be a last resort for any Licensed Platform Operator. We suggest updating this note under paragraph 7.10 to make clear the impact halting or restricting trading may have on a listed VA, and that a Licensed Platform Operator should not be required or expected to halt or restrict trading of a listed VA immediately, merely because the listed VA has failed to meet the Specific Token Admission Criteria based on a Licensed Platform Operator's own assessment.

(xi) Paragraph 7.11(b). We suggest deleting all the words after "under Part IV of the SFO" or simply replacing that text with "as applicable", to match the style of the other sub-paragraphs in paragraph 7.11 and to avoid confusion. In particular, this paragraph 7.11(b) as drafted could be read to exclude all security tokens from the statutory exemptions, and not just unauthorised collective investment schemes and structured products. On such a reading, no security token could utilise, for example, the established statutory exemption in section 103(2)(a). If that is indeed the intention (which we assume it is not), we suggest it would be more appropriate that this be undertaken via legislative amendment. Otherwise, we think the simplification we have suggested will suffice.

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 VA trading platforms?

We do not recommend any additional requirements per se. However, we raise that certain requirements under paragraph 9.28 of the VATP Guideline will not be possible or appropriate in all circumstances. For example, it will not be possible to provide background information on the management team or developer of Bitcoin.

Furthermore, we have broader concerns regarding the re-posting of the information for each VA ("**VA-related Information**"). Licensed Platform Operators are not generally in a position to ascertain and/or stand behind the timeliness, accuracy and completeness of the VA-related information. This is because Licensed Platform Operators often do not have a direct relationship with the issuer of a VA. They may not have any additional or more reliable information beyond what is publicly accessible. Requiring the Licensed Platform Operators simply to re-post publicly available VA-related information may create a false impression to clients about the timeliness, accuracy and completeness of such information.

Therefore, we recommend considering a harmonised approach to certain of the disclosure requirements to ensure consumers receive a consistent and understandable explanation of the major VAs that will be available to retail.

Having a standard disclosure on common VAs will enhance protection by ensuring appropriate and consistent explanations are being provided, thus avoiding consumer confusion. Please also refer to our comments on Question 2.

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?**

We welcome the SFC's proposed approach to allow for greater flexibility for Licensed Platform Operators to determine the compensation arrangements that best suit their needs and operations.

We make the following comments in respect of the proposed compensation arrangements:

(a) We recommend that the SFC set out the non-exhaustive factors it will consider as part of its approval process. This will help give the industry certainty on the subject, and also result in Licensed Platform Operators proposing compensation arrangements that are better aligned to the SFC's expectations. In short, this will be beneficial to the SFC and the industry alike.

(b) We recommend a Licensed Platform Operator be permitted to hold reserve amounts in the same form as the VA client asset.

A key benefit of this is there will less market volatility risk, which can be significant in the VA industry. It also gives the Licensed Platform Operator flexibility having regard to the asset base that it holds. This approach would also be consistent with the requirement in paragraph 10.6(a) of the VATP Guideline that VAs should be held in the same type and amount as those owing to clients.

(c) We recommend that the SFC provide greater clarity to the phrase "provide an appropriate level of coverage". We understand that the term is a reference to the types of risk that will be covered by the compensation arrangements, as opposed to the level or amount of funds the subject of the compensation arrangements.

Connected to this, we also suggest that the SFC sets out the minimum types of risks that should be covered by the compensation arrangements. For example, MiCA sets the minimum areas of the cover the insurance policy should address.[13]

(d) In respect of the amount of compensation that must be retained, we suggest greater flexibility be granted, such that the test moves away from the total amount of assets under custody. This is because the total value of assets under custody will always be fluctuating, and may be difficult to monitor. Further, the precise trigger of when the compensation amount "persists" below the requisite value is a threshold that is hard to gauge with certainty. Instead, we suggest a framework similar to MiCA (see below for details) or an arrangement whereby the Licensed Platform Operator assesses key applicable risks, and

[13] See Article 60(5), MiCA.

likelihood of loss, and ensures that these areas are appropriately protected to deal with such risks.

We also invite the SFC to consider the implications of the requirements under paragraphs 10.22 to 10.25 on Licensed Platform Operators which are unable to obtain full insurance coverage. As currently drafted, a Licensed Platform Operator is required to set aside and hold on trust on a dollar-for-dollar basis the total value of client VAs not covered by third party insurance. This effectively means that if a Licensed Platform Operator becomes more successful (ie the total value of client VA goes up), the necessary amount of capital and related capital costs also go up.

(e) We recommend that the SFC draw from and considers adopting a similar approach to the Hong Kong stored value facility regime ("**SVF Regime**") and/or MiCA.

For example, the SVF Regime includes greater flexibility for the types of compensation arrangements that are permitted, since it includes bank guarantees. It also includes further guidance to prospective applicants on what the HKMA is looking for, and how to achieve adequate protections to stored value facility related money. This is consistent with our recommendations in paragraphs (a) and (c) above.

MiCA similarly provides for greater flexibility in terms of the types of compensation arrangements permitted, since it too includes the ability to rely on bank guarantees. Further, MiCA does not seek to protect the totality of VAs under custody, but rather requires crypto-asset service providers to have in place prudential safeguards equal to an amount of minimum capital requirements, or one quarter of the fixed overheads of the preceding year, whichever is higher. This represents a more practical and commercially viable option. It will also ensure uniformity in global regulation, which eases compliance burden of having differing standards globally.

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 understand that trust arrangements give an added layer of consumer protection since the funds are required to be segregated and will not form part of the VA exchange's general pool of assets in the event of insolvency. However, a trust arrangement gives clients a beneficial and proprietary interest in the reserve amounts from the moment the trust is created. We understand a client's interest in the reserve amounts is only intended to crystalise upon a compensation event occurs. The overall effect is that the clients are provided with additional proprietary interests that do not reflect their holdings. We also suspect that there will be limited providers who are willing to provide such trust services.

Accordingly, we suggest that Licensed Platform Operators be given a degree of flexibility to determine how and with whom reserve amounts be set aside. We suggest an arrangement whereby the Licensed Platform Operator is given the flexibility to choose an appropriate arrangement, subject to the reserve amounts being adequately safeguarded (a concept used in the SVF Regime). We describe a variety of options below that we suggest be permitted:

(a) **Option A**: funds be permitted to be kept under a house bank account with an "authorized institution" (as defined under the Banking Ordinance (Cap. 155)) ("**AI**") or foreign licensed

bank, to hold the reserve amounts. The money in the bank account will only be permitted to be kept as cash, or low-risk investments (eg time deposits or money market funds). The Licensed Platform Operator will then provide an undertaking to the SFC that it will only access and use the funds upon a prescribed compensation event, evidence of which must be provide to the SFC upon such an event. The Licensed Platform Operator would also undertake not to use the funds for its own purposes (eg on-lend or re-hypothecate the assets).

(b) **Option B**: the Licensed Platform Operator declares a trust over the reserve amounts for the benefit of clients. This reserve amounts can be held with either:

(i) in the case of VAs or fiat currency, a Hong Kong licensed trust or company service provider, an AI or a licensed custodian or bank in a foreign jurisdiction; or

(ii) in the case of VAs only, in a Licensed Platform Operator's own wallet. If this option is chosen, the Licensed Platform Operator needs to ensure an escrow-type arrangement is in place whereby transactions cannot be carried out without authorisation from a third party. This is to prevent the Licensed Platform Operator gaining unauthorised access to such reserve amounts.

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?**

Reconsider the approach to Associated Entities

We understand that the AMLO does not prohibit a Licensed Platform Operator from holding client assets and indeed contemplates custody by either an Associated Entity or the Licensed Platform Operator themselves. In this respect:

(a) we ask the SFC to reconsider hard-wiring mandatory custody by an Associated Entity in the Guideline, to ensure alignment with the legislative intent expressed in the AMLO. We also consider this is appropriate given the stringent segregation and other obligations already imposed on custody and the reality that an Associated Entity is, by its shareholding, controlled by the Licensed Platform Operator. This could be by exception if preferred – that is, self-custody only if the Licensed Platform Operator is able to demonstrate to the SFC that sufficient controls are in place; and

(b) ensuring it is clear that third party solutions are also permitted in relation to custody either by the Licensed Platform Operator or the Associated Entity, by clarifying paragraph 12.6 – we expand on this further below.

Hot and cold wallet storage

Overall, we support the structured approach to imposing control measures on hot and cold wallet storage. We have received feedback from some exchanges that paragraphs 10.6(c) and (d) of the draft VATP Guideline could be refined, having regard to emerging trends in comparable jurisdictions. For example, we understand certain jurisdictions adopt a principles-based regulatory approach rather than a mandatory percentage of assets to be stored in cold wallet storage. On the other

hand, we understand that the Korean Financial Service Commission intends to impose a lower minimum threshold for the cold wallet storage and cited 70% as an example.[14]

Ultimately, our recommendations here are to prioritise a principles- and risk-based approach and to ensure Hong Kong continues to take into account both the approach in other markets, to reduce the risk of regulatory arbitrage, and the practical realities of exchange operation. In this respect, we understand that the higher the percentage of assets in cold storage, the more expensive and operationally intensive, and therefore less attractive the service. Of course, this must always be balanced with client protection considerations and we acknowledge that other markets are starting to implement cold storage requirements to help level out the international playing field.

Fora such as IOSCO could be appropriate to enable ongoing dialogue between markets. The following paragraphs also articulate feedback we have received in relation to other hot wallet protection measures.

Technologies and other solutions to mitigate risks associated with hot storage

We understand that various technologies and solutions may be adopted as a means to protect client assets in hot wallet. Some examples include the following:

(a) **Multi-Party Computation ("MPC") technology** - Some existing VA trading platforms may use MPC technology such that each party will only have access to a portion of the private key, and all parties have to collaborate in order to derive the full private key to sign a transaction.

(b) **Multi-signature access** - Multi-signature access requires multiple authorised persons to sign off on a transaction before it can be executed. Multi-signature access is commonly used among existing VA trading platforms as it can be customised to suit the specific operational and business needs having regard to the risks identified.

(c) **Key sharding** - A private key can be divided into multiple fragments or "key shards", which can be stored on different tech stacks. This addresses the issues of a single point of weakness – that is, even if an attacker gains access to one storage location or one key shard, the attacker would be unable to access wallet. We understand this is becoming a key standard to mitigate risks of unauthorised access to a wallet so as to minimise risks of theft or loss of VA.

(d) **Physical backup of key shards and private key** - To further enhance the level of security, key shards can be split up and distributed across multiple devices.

Some of these devices can be offline physical devices. They can also be stored in different locations. All physical devices used should satisfy the security standards developed by the industry bodies or regulators in a comparable jurisdiction, such as the Federal Information Processing Standards ("**FIPS**") developed by the National Institute of Standards and Technology in the United States.

(e) **Hardware Security Modules ("HSMs") or Trusted Platform Modules ("TPMs") or both** - These provide additional layers of security and protection to the storage of private keys and

[14] See Korea Financial Services Commission's press release dated 28 May 2021 available at https://www.fsc.go.kr/eng/pr010101/75998.

related data. HSMs provide a secure hardware environment that is resistant to physical and software-based attacks, while TPMs can be implemented as a part of the infrastructure to further enhance security.

(f) **Implementing an effective custody policy** – A Licensed Platform Operator's custody policy is essential to protecting and safekeeping client VAs. The custody policy should describe in detail the mechanism for the transfer of VAs between hot, cold and other storage. These mechanisms are not prescribed in the VATP Guideline as such, but we are aware of highly sophisticated approaches by certain exchanges that should be factored into the overall equation.

(g) **Confidential compute** – This ensures important data is always encrypted in transit (ie when being processed) and at rest.

Use of local and offshore third party custodial service providers

We refer to paragraph 12.6 of the draft VATP Guideline which expressly anticipates that Licensed Platform Operators may outsource any activities associated with the VA trading platform to a third party service provider. On this basis, we understand that the custody of client assets (including client VAs) can be outsourced to a third party custodial service provider. For clarity, we invite the SFC to consider updating:

(a) Paragraph 10.5 of the draft VATP Guideline as below:

> *"A Platform Operator should ensure that all client virtual assets are properly safeguarded and held in wallet address(es) which are established by its Associated Entity and are designated for the purpose of holding client virtual assets. The Platform Operator should ensure that client virtual assets are segregated from the assets of the Platform Operator or its Associated Entity. The Platform Operator should ensure the Associated Entity's compliance with this requirement. Nothing in these Guidelines prohibits the Associated Entity from outsourcing any of its functions to a third party service provider, provided that it has obtained the consent of the Platform Operator."*

(b) Paragraph 12.6 of the draft VATP Guideline as below:

> *"Where the platform or any activities associated with the platform is provided by or outsourced to a third party service provider, a Platform Operator should perform (or procure its Associated Entity to perform) appropriate due diligence, conduct ongoing monitoring and make appropriate arrangements to ensure that the Platform Operator meets the requirements in this Part and Part XIV (Record Keeping) below. In particular, the Platform Operator or Associated Entity (as appropriate) should enter into a formal service-level agreement with the service provider which specifies the terms of services and responsibilities of the provider. This service-level agreement should be regularly reviewed and revised, where appropriate, to reflect any changes to the services provided, outsourcing arrangements or regulatory developments. Whenever possible, such agreements should provide sufficient levels of maintenance and technical assistance with quantitative details."*

We also refer to paragraph 10.8(e) of the draft VATP Guideline. We invite the SFC to reconsider the strict requirement to store seeds and private keys in Hong Kong. Our key reasons are set out below:

(a) Some existing VA trading platforms with a global presence are using reputable third party custodial service providers based outside Hong Kong. Some of these custodial service providers with a global presence are often key market players with a proven track record. They may be able to provide better protection and security for the safe custody of client VAs.

(b) The adoption of the MPC or key-sharding technologies may result in parts of the seeds or private keys and their backups being stored in multiple jurisdictions which may be outside Hong Kong. A strict requirement to store any and all parts of seeds or private keys in Hong Kong will exacerbate the risk of single point of failure.

We suggest these could be further clarified.

Q7	**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?**

Overview

We appreciate the SFC's recognition of the importance of derivatives to the development of the VA market, and we welcome the SFC's initiative to consider relaxing the existing prohibition on offering, trading or dealing in VA futures contracts or related derivatives ("**VA Derivatives**") by Licensed Platform Operators under paragraph 7.23 of the draft VATP Guideline.

From an investor perspective, VA Derivatives can play a crucial role in risk mitigation by hedging. They can also provide exposure to the asset class while eliminating the need for holding VAs directly With the introduction of VA-specific documentation by the International Swaps and Derivatives Association, Inc ("**ISDA**"), VA derivatives are often structured in a manner that is similar to and easily understood by investors who are accustomed to dealing with derivatives that have traditional securities as underlying assets.[15]

Retail clients

Price volatility of VAs is a major concern of the SFC, and rightfully so. VA Derivatives are amongst the most direct tools to hedge volatility risks. We respectfully submit that these tools should be available to all clients, including retail clients ("**Retail Tradable VA Derivatives**").

(a) **Structure and licensing requirements**

Since the Retail Tradable VA Derivatives will be offered by a Licensed Platform Operator to the public and are likely "securities", this means that, unless a statutory exemption applies, Retail Tradable VA Derivatives should be:

[15] See the ISDA Digital Asset Derivatives Definition issued on 26 January 2023, available at https://protect-au.mimecast.com/s/0TUkCP7LnETL3Qyh7Udaf?domain=isda.informz.net.

(i) subject to the SFC's authorisation or registration regime; and

(ii) offered only by a corporation licensed for conducting Type 1 and Type 7 regulated activities - that is, an SFO-licensed Platform Operator or a Licensed Platform Operator holding dual licences.

(b) **"Same business, same risks, same rules" principle**

As noted above, Retail Tradable VA Derivatives are generally required to be authorised by the SFC. That being the case, we respectfully submit that the risk level of these VA trading platforms' products may not be higher than those "limited suite of products" referred to in paragraph 8 of the SFC-HKMA joint circular on intermediaries' virtual asset-related activities dated 28 January 2022 ("**Joint Circular**")[16].

We respectfully submit that retail investors protection measures described in the Joint Circular are sufficient.

(i) **VA-knowledge test** – Similar to other licensed corporations, the Licensed Platform Operator can assess whether a retail client has knowledge of investing in VA Derivatives prior to placing an order on or effecting a transaction in VA Derivatives. If a retail client does not possess such knowledge, the Licensed Platform Operator should first provide training to the retail client on the nature and risks of VA Derivatives.

Relevantly, we recommend the SFC prepare training materials to promote general awareness of how to effectively use VA Derivatives to hedge risks as well as the nature and risks of VA Derivatives. The Licensed Platform Operators may include the link or the educational materials in the screen flow when the retail client is entering into a VA Derivative contract on the platform. Please also see our comment at paragraph 1.2 of this submission.

(ii) **Warning statements** - The Licensed Platform Operators should also be required to disclose the relevant risks to retail clients before they can enter into any VA Derivative contract, including but not limited to, the standardised risk disclosures and the additional risk disclosures relating trading futures and options (as set out in Schedule 1 to the SFC Code of Conduct) and the warning statements in Appendix 5 to the Joint Circular.[17]

(c) **Additional protection**

(i) **One-on-one bilateral form** - To provide an additional layer of protection to retail investors, the SFC may consider requiring Licensed Platform Operators to enter into derivatives transactions with retail investors on a one-on-one bilateral basis and document the arrangements using the widely adopted ISDA Master Agreement and the ISDA Digital Asset Derivatives Definitions.

[16] Available at https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/suitability/doc?refNo=22EC10.

[17] Available at https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/suitability/doc?refNo=22EC10.

Insurance fund and other existing protections - Some VA trading platforms may also offer an "insurance fund" or similar service or arrangement as a stop loss mechanism to further protect their clients.

Professional investor clients

In line with the Joint Circular, we respectfully submit that Licensed Platform Operators should be allowed to offer, trade or deal in VA Derivatives with professional investors, as is the case for other SFC-regulated intermediaries subject to applicable controls. The VA-knowledge test requirement should apply to apply to professional investors, except Institutional Professional Investors and qualified Corporate Professional Investors (as referred to in the VATP Guideline and in the SFC Code of Conduct).

We add that this is particularly important as some Corporate Professional Investors and Institutional Professional Investors may be prohibited from directly holding VAs due to regulatory or prudential requirements. VA Derivatives will allow them to gain exposure to VAs without directly holding underlying VAs.

Financial accommodation

Relevantly, we submit that it is important for the Licensed Platform Operators (or their group companies) to provide financial accommodation to their clients to enable efficient funding for the purpose of VA Derivatives trading and to ensure there is sufficient liquidity on the trading platform to support the VA Derivatives transactions.

More generally, we submit that an outright ban of VA Derivatives may result in some Hong Kong investors accessing VA Derivatives on unregulated platforms which are not subject to the SFC's oversight. This may harm Hong Kong investors and the Hong Kong VA market as a whole. Please also see our response to Question 11(e).

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 Guideline?

Overall, we welcome the additional enhancements made to the existing VATP Terms and Conditions, as they provide more flexibility. We however make the following observations and suggested amendments:

(a) **Notification of plans to list, suspend or remove VAs for retail clients**

We recommend that Licensed Platform Operators need only notify the SFC, and not necessarily obtain SFC approval, where they propose to include any new VAs, or suspend or remove any VA. The SFC already requires:

(i) Licensed Platform Operators to conduct thorough due diligence, including obtain legal advice in respect of such VAs;

(ii) listed VAs to have sufficient liquidity; and

(iii) Licensed Platform Operators to ensure VAs are suitable to retail clients if the suitability requirement is triggered.

The above measures are sufficient such that it is not necessary to seek SFC approval. The suggested approach is consistent with other Hong Kong licensing regimes – for example, the securities regime does not require pre-approval for each security that is added to an online trading platform, although updates to business plans and controls generally do need to be updated.

(b) **Submission of legal opinions**

In respect of the paragraph 7.9, we submit that a Licensed Platform Operator should not have to submit its legal advice to the SFC. It should be enough that the Licensed Platform Operator has obtained legal advice from a reputable and capable law firm with experience in the area.

To require disclosure of confidential and privileged legal advice is to impinge on the rights that Article 35 of The Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China confers – that is, that Hong Kong residents have the right to confidential legal advice. Accordingly, paragraph 7.9 should be adjusted to simply obtain such legal advice from qualified and competent laws firms in respect of the matters described. If required, the SFC may request an outline of the scope of the advice, without the need to disclose the advice or waive any legal professional privilege. It may also set out minimum criteria for the selection of Hong Kong legal counsel if that is considered necessary.

These will help ensure that Basic Law principles relating to privilege that are also protected in the SFO in several circumstances are appropriate respected, while still delivering the outcome that is necessary – that is, clarity by the Licensed Platform Operator on the regulatory status of the asset, based on professional advice.

We would welcome further dialogue with the SFC if, for example, it requires an opinion on certain assets for its own supervisory purposes, or considers a standardised industry opinion approach is needed.

(c) **Clarity and confirmation as to the position in respect of other SFC related guidelines, codes, and circulars**

The existing VATP Terms and Conditions stated that other SFC related rules apply – these were set out in Schedule 1 of the existing VATP Terms and Conditions. This has been deleted in the VATP Guideline. We recommend that that the following be included to provide clarity and comfort as to the scope of the regulatory requirements licensees that apply to them:

(i) **For SFO licensees**: confirmation that all other SFC rules apply to such licensees to the extent relevant, however if there is any inconsistency, the more stringent requirements apply.

On the subject, what is more stringent may not be the same for each SFC licensee, and may not be an objective reference of every occasion. For example, due to specific operational or technologic configurations, certain requirements may be harder for one Licensed Platform Operator than another.

(ii) **For AMLO licensees**: confirmation that other SFC rules do not apply in respect of non-security-related trading and activities.

For example, there is no legislative or SFC-issued instrument that states that the manager-in-charge regime ("**MIC regime**"), and associated requirements, apply to Licensed Platform Operators. However, we understand from industry consultations that the SFC anticipates the MIC regime will apply to Licensed Platform Operators. For AMLO licensees, we submit there should be an express reference that the SFC's circular titled "Circular to Licensed Corporations Regarding Measures for Augmenting the Accountability of Senior Management" applies to Licensed Platform Operators who hold an applicable licence under the AMLO. We recommend this is especially the case in light of our view that it is possible for platform operators to only hold a licensed under the AMLO (and not licences under the AMLO). See the response to question 11, paragraph (b) for further details.

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.

Thank you for providing the in-depth proposed drafting. We have several comments and suggested refinements which are grounded in our work on the AMLO and related guidelines since 2011, as well as our understanding of current on-chain analytics tools.

Paragraph numbers listed below refer to Chapter 12 of the AML Guideline.

Paragraph	Comment
12.1.2	We recommend providing licensed corporations ("**LCs**") with guidance on regulatory expectations of them when dealing with VASPs, including due diligence and clear guidance that the VASP industry is not deemed "high risk" in general and should be provided with access to LC provided services on a risk based approach. In addition, we recommend ensuring the SFC and HKMA have fully aligned the sector AML guidelines such that VASPs are able to access the Hong Kong banking sector with more ease than the current position. This will also greatly assist LCs that are also authorised institutions ("**AIs**"). Specifically, we suggest, at the bank industry level, a presumption that a Licensed Platform Operator be "bankable" given this robust new regulatory regime, its supervision for compliance with AML/CTF by the SFC and the External Assessment Report ("**EAR**") requirements that effectively validate the adequacy of systems and compliance.
12.1.3	We recommend developing industry guidance or FAQs on features of VAs that would suggest it may be a security, in addition to the requirement for VASPs to obtain legal advice on this matter as required under paragraph 7.9 of the VATP Guideline.
12.1.4	The current drafting suggests that all VAs are inherently high risk and in general, anonymity enhanced. This is not strictly accurate. We recommend developing industry guidance that provides detailed advice on the types of feature that enhance the ML/TF risks associated with a VA.

Paragraph	Comment
	As a general observation, there have been significant changes in approach to risk assessments relating to ML/TF (both in terms of institutional assessments and customer assessments) over the last 10-15 years. Our experience is of approaches that differ quite significantly between financial institutions. Further, risk assessment approaches are now far more sophisticated than after the AMLO was first enacted. We suggest early regulatory intervention to accelerate the adoption of strong risk assessment methodologies and consistency. Thematic reviews and education seminars by the SFC would be of significant benefit. Whilst risk indicators have been alluded to in the AML Guideline, we suggest more specific direction would assist the industry.
12.4.1	If the additional identity information examples are in fact mandatory for collection, we recommend this is made clear.
12.3.3 Footnote 107	Clarification is required on the meaning of footnote 107 which states that "occasional transactions" do not apply to FIs that are LCs or SFC-licensed VAS Providers. This appears to contradict 12.3.2 that directly provides for occasional transactions for SFC-licensed VAS Providers (consistent with the AMLO).
12.3.6 12.7	**Transaction monitoring** We understand the SFC expectation to identify linked transactions to avoid structuring and those connected to tainted sources. We strongly recommend a transaction monitoring guidance paper specific to VASPs be developed, with input from vendors that provide transaction monitoring solutions as well as VASPs themselves. Different technology solutions are available. Whilst we support the technology neutral stance adopted by the SFC, certain differences within the solutions may significantly alter the effectiveness of the screening. It would enhance protection against ML/TF for the SFC to provide guidance on certain of its expectations for solutions. Further, providing a list of solutions (potentially with minimum settings) that are deemed acceptable would ensure a consistent approach and also provide comfort to the banking sector such that banks may be more willing to offer accounts to licensed Licensed Platform Operators. We suggest that guidance considers matters such as whether a solution offers: • real time screening; • the ability to screens the chain looking backwards and forwards (ie, deposit and withdrawal screening) through to a sensible stop point rather than being based on a set number of hops; • multi-asset screening;

Paragraph	Comment
	• cross-asset and cross-chain tracing; • the ability to adjust the detection triggers and risk scoring methodologies; and • the ability to screen transactions and wallets. The data flows used within the solution should also be considered, for example looking at whether financial crime related information from across the network (ie, that reported by exchanges as well as the transaction history) is used to strengthen algorithms and benefit the wider community. This should be considered against the backdrop of safe data and data privacy. There are other factors of transaction monitoring outside of the solution space that would benefit from guidance, particularly whether there are expectations around using quarantine, cold wallets and blocklists. We strongly recommend education for exchanges on this issue.
12.11 and 12.12	**"The Travel Rule"** The SFC is no doubt aware of the sufficient challenges that VASPs face in implementing the travel rule, both in Hong Kong and overseas. The technology and infrastructure is not currently in place to provide for harmonised exchange of information. Whilst the requirement exists under the AMLO, we recommend the SFC considers providing assurance that enforcement action will not be taken in relation to failure to comply with the Travel Rule pending the availability of such technology, with a long-stop date such that the industry remain committed to solving the problem.
12.13	**Counterparty due diligence** The requirements to conduct counterparty due diligence appear to be overly onerous. In particular, the requirement to understand the adequacy and efficiency of another VASP's AML controls and compliance with the travel rule will require significant time to obtain and review information. VASPs may not wish to share information, many may have developed their own technology that would be commercially sensitive. Whilst it is clear that the requirements are aligned with traditional correspondent banking requirements, we suggest that the difference with VASPs is the ability, through on-chain analytics, to see where the VAs have been and are going to. Strengthening transaction monitoring guidance and requirements as per our comments on 12.3.6 and 12.7 above, may achieve better mitigation to ML/TF risk than requiring this level of counterparty due diligence. The technology for this is already available. Further, there is no current standard Wolfsberg Correspondent Banking Due Diligence Questionnaire, which the banking industry heavily relies on to give practical effect to similar requirements that the HKMA imposes. If the requirements are to

Paragraph	Comment
	remain, we suggest time is provided to the industry to agree a similar counterparty due diligence questionnaire, at least as between the VASPs in Hong Kong. Global initiatives are also underway – for example, we have been a part of a similar initiative spearheaded by Global Digital Finance. We suggest this could be effected locally with relative ease, but does require time.
12.13	We recommend specifying that licensed VASPs are standard due diligence ("**SDD**") entities to put them on an equal footing to how other licensed or regulated financial institutions are treated under the AMLO and regulatory guidance. This should apply to VASPs licensed by the SFC and to VASPs licensed in an equivalent jurisdiction. We acknowledge this may require statutory amendment for formal SDD recognition. However, in the meantime, we consider that guidance from the HKMA or FAQs from the Hong Kong Association of Banks ("**HKAB**") could be valuable to articulate the risk-based diligence measures required in light of the exceptionally high degree of regulation involved.
12.13.10	If the purpose of this paragraph is to prohibit VASPs operating with unlicensed or unregistered VASPs, whether because the regime does not exist in the VASPs jurisdiction or otherwise, we suggest that is clearly stated.
12.14	The requirements for transactions with unhosted wallets are far less stringent than under counterparty due diligence. This may encourage transactions with unhosted wallets, which we anticipate is not the intention. The phrase "exercise extra care" in paragraph 12.14.1 would benefit from guidance on what extra steps are expected.

Industry body

Finally, we wish to raise the value that HKAB brings in relation to developing guidance for the banking industry on AML/CTF issues, in close collaboration with the HKMA. We have been a part of that process since 2011, with an ongoing role on FAQs and other industry guidance. However, this does not exist for the VA sector, to our knowledge. We suggest this would be a valuable time to consider the possibility of supporting a similar association, particularly in light of the particular technical and operational idiosyncrasies of VAs.

This need not be in statutory form like HKAB. Alternatively, the SFC could issue such guidance but with a structured process for taking input from an AML/CTF-focussed group comprised of financial crime specialists from each Licensed Platform Operator.

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

We generally support the Disciplinary Fining Guidelines.

However, we request that the SFC clarify how disciplinary actions are attributed to individuals and corporations *in practice*. The Disciplinary Fining Guidelines and AMLO make clear that the SFC's disciplinary powers apply to all "regulated persons", which include both individuals and corporations.

Nevertheless, in practice, we have observed that there are significantly more SFC enforcement cases against individuals rather than corporations. The rationale for this is not clear.

As such, we suggest that the SFC provide clear guidance on how it determines whether to pursue a corporation rather than an individual, and vice versa. We suggest setting out a list of specific factors that the SFC may consider when determining this. For example, it may that where a company has compliant and comprehensive policies and procedures, adequate trainings for staff etc in place, the SFC may be less likely to pursue the corporation and instead focus on individual prosecution.

Q11 Other items

We raise below various additional items grouped thematically:

(a) **Transition arrangements**

(i) **"Meaningful and substantial presence"**. The requirement that the platform operator must be in Hong Kong "with meaningful and substantial presence" should not be a requirement when assessing if a platform operator meets the eligibility criteria for the transition arrangements. At best, it should only be a factor in assessing whether a platform operator has been operating in Hong Kong.

This is because the eligibility criteria for the transition arrangement, which is set out in the AMLO, does not refer to this phrase. The introduction of this phrase *changes* the statutory requirements, and imposes additional requirements not present in the legislation. The intent expressed in the AMLO should be maintained, without change. To add or modify that criteria is to change the statutory position which was put forward by LegCo.

At best, we suggest that a "genuine presence in Hong Kong" may be considered a factor when interpreting and assessing whether a person is "operating in Hong Kong".

The key reason is that if the SFC takes the view that a "meaningful and substantial presence" is required, then it is also implicitly saying that small scale exchanges are not caught by the AMLO, which is not, in our view, legally correct. This places them in the invidious position of risking criminal prosecution if a Court takes a different view to the SFC, with no viable licensing alternative. We do not consider this was the intent of the Legislative Council.

We do not have any other concerns about the other factors listed by the SFC, noting our understanding that these are not all necessary – for example, offshore incorporated exchanges are still eligible, per the AMLO.

(ii) **Responsible Officer** ("**RO**") **locality**. There remains uncertainty about the locality of ROs at various points during the transition period. We submit the industry would greatly benefit from further guidance and certainty on this, given the importance of satisfying the transition arrangements.

In short, we understand that in order for ROs to be eligible for the transition arrangements, the proposed ROs must be:

(A) performing a regulated function in Hong Kong for a VA trading platform (whether operating in Hong Kong or elsewhere) immediately before 1 June 2023; and

(B) performing regulated function in Hong Kong for the Company (as the principal of the proposed RO) at the time of the application.[18]

We also submit that so long at the above requirements are satisfied, it is still possible to have one of the two ROs based abroad, subject to being able to fulfil their duties and responsibilities from abroad, and any licensing conditions that may be imposed on them. We recommend that the SFC confirm this point in its consultation conclusions.

(iii) **Timing related considerations**. We recommend that the SFC provide industry guidance on the following:

(A) **Roadmap to 1 June 2023.** We suggest the SFC provide a timeline on when the finalised VATP Guidelines, AML Guidelines and other guidelines are expected to be released. Finalised VATP Guidelines and regulatory requirements are critically important for all types of platform operators, to allow them to assess whether they can comply with the regulatory requirements, and ultimately decide on whether to apply for a licence, wind-down Hong Kong operations or make changes to ensure they comply with the transition arrangements.

(B) **Timing to submit licensing application.** The AMLO requires an applicant to submit their application by 29 February 2024.[19] We recommend that the SFC confirm that the applicant need only *submit* their application by that date, as opposed to have their application *accepted* by that date. If the latter were to apply, the applicant will need to submit their application several weeks earlier, based on past experience working on SFC applications, where applications are not acknowledged and accepted immediately, but may require one or more rounds of Q&A.

(C) **When AMLO and SFC requirements must be met.** We understand that a platform operator seeking to rely on the transition arrangements will be required to comply with the applicable regulatory requirements from 1 June 2024,[20] assuming they meet the other transition related requirements. This is clear from the AMLO and paragraph 79(c)(ii) and 80 of the Consultation Paper.

We further understand that Phase 1 EARs be provided when submitting the licence application. These two separate requirements have the potential to

[18] It is not a requirement that the RO perform regulated functions for the Company as at 1 June 2023 – it can be for another VA exchange. This means that the Company (as a pre-existing VA trading platform) may propose to employ or appoint an RO who were performing a regulation function in Hong Kong for another VA trading platform immediately before 1 June 2023, and such proposed RO may still be eligible for the transition arrangements. See paragraph 77 of the SFC Consultation Paper on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the Securities and Futures Commission dated 20 February 2023 ("**Consultation Paper**").

[19] See section 3 of Schedule 3G, AMLO.

[20] See section 3, subsection 1(b)(iii) and section 4(2) of Schedule 3G, AMLO.

conflict and confuse the industry. Accordingly, the industry will greatly benefit from SFC confirmation that:

(aa) a platform operator does not need to comply with all applicable regulatory requirements on 1 June 2023 or the date it submits its application (assuming it before 29 February 2024), subject to subparagraph (bb); and

(bb) the platform operator, as at the date of submitting its application, must also submit the Phase I in respect of finalised policies. While the policies must be finalised and ready for implementation, they do not need to have commenced until the earlier of 1 June 2024 (when deemed licensed) or issuance of the Phase 2 EAR.

In this respect, while Parts II and III are stated as the minimum requirements for an application per paragraph 1.4 of the VATP Guidelines, and not the full gamut of the VATP Guidelines, many of the requirements embedded in Parts II and III appear to draw in all those requirements (such as paragraph 3.7(d) of the VATP Guidelines. Our understanding is that it is *not* the intention to require actual compliance with Parts IV onwards until licensing. We suggest this could be clarified.

We also raise that it may be appropriate to grant applicants a grace period (eg 3 months) from the date the licence application is submitted obtain the Phase 1 EAR. This is consistent with existing SFC licensed corporation applications which allow for flexibility to satisfy other key requirements closer to the grant of the licence.

(D) **Timing of RO and licensed representative** ("**LR**") **exams.** We suggest that consistent with the approach in SFC licensed corporation applications, the SFC permit that RO and LR applicants complete their applicable examination closer to approval of their respective licences. The AMLO currently requires that as 1 June 2024, the Company must satisfy all SFC regulatory requirements, which would include that all licensed persons are competent (and therefore satisfy examinations).

Given the importance of these timings, we recommend that the SFC confirm the applicable timing of the above as a matter of urgency. Licensed Platform Operators and proposed ROs and LRs need time to understand what is required and by when – for example, ROs and LRs will need time to study, book and attend examinations, which require forward planning. This upfront guidance will greatly assist the industry to understand the path ahead for them. There are also limited examination appointments currently available.

(b) **Whether all Licensed Platform Operators must be licensed under the SFO**

We respectfully disagree with the SFC's stance that applicants "should" apply for licensing under the SFO and AMLO. Instead, we suggest, "may" or even "are encouraged to consider". Our reasons are set out below.

We understand that the SFC will request that applicants to obtain a licence under the AMLO (as a VASP) and SFO (in respect of financial products). This is despite the fact that the Licensed Platform Operator may not make available securities or futures products on their VA exchange.

We understand the SFC's rationale for this is for this because product features may change such that an VA that is not a security, may through product changes, become one. We further understand justification is made on the basis that the regulatory requirements across both licensing regimes are substantially the same, so there is no material uplift or practical difference.

We suggest that applicants be able to pursue a AMLO / VASP licence only, without the need for any SFO licences, if their business model does not involve security tokens. Our reasons are as follows:

(i) Licensed Platform Operators under the AMLO regime are required to undertake due diligence on all VAs on their platform. Therefore they will know the regulatory treatment of all supported VAs. Their due diligence extends to reviewing changes, such that the Licensed Platform Operators will know if and when a VA becomes a "security" or regulated product. In the case of Licensed Platform Operators that provide services to retail clients, it is an express requirement to obtain such an advice.

(ii) There are practical and material implications from such a requirement. There are specific requirements that apply to securities related businesses. The Licensed Platform Operator will need to comply with all SFC guidelines, codes and circulars. Further, it imposes ongoing compliance burden for Licensed Platform Operators to ascertain if any Type 1 or 7 regulatory changes affect their business.

(iii) Such an approach is inconsistent with our understanding that SFC licensees should either use their SFC licence to perform their regulated activities, or return the licence. This is consistent with the requirement in section 195(1)(c) of the SFO.

(c) **Proprietary trading and market-making**

We refer to paragraphs 13.2 and 13.3 of the draft VATP Guideline.

We welcome the introduction of a limited carve out to the general prohibition on Licensed Platform Operators and their group companies ("**Affiliates**") to engage in proprietary trading subject to the SFC's permission on a case-by-case basis.

Liquidity is crucial to the stability of the VA market

Liquidity is a critical factor in reducing VA price volatility and improving the overall VA market stability, but the reality is that liquidity continues to be a challenge to a number of VA trading platforms in Hong Kong.

We understand from a number of large exchanges that it is important to allow Affiliates to engage in market making activities on the platform operated by the Licensed Platform Operator ("**Affiliated Platform**"). The key reasons are as follows:

(i) **Day-to-day operational purposes** - An Affiliate may need to engage in proprietary trading in order to re-balance VAs between different trading pairs on an Affiliated Platform to ensure the smooth operation of the platform.

Subject to the terms of the agreements with third party market makers with respect of each VA, the willingness and appetite of the third party market makers to trade a specific VA may change from time to time, depending on their own internal financial conditions and outlook for a**ny** particular VA. As a result, Licensed Platform Operators may need to suspend trading of a VA more frequently due to lack of liquidity. This can have a significant adverse impact on:

(A) Licensed Platform Operators' financial performance and ability to operate as an ongoing concern; and

(B) investors' confidence in Hong Kong's VA trading platforms as a whole.

(ii) **Ensure liquidity at all time** – The adverse impacts noted above can be aggravated in the event of extreme market conditions. In such cases, there may be a sudden shortage of liquidity in one or more VAs on Licensed Platform Operators' platforms. Subject to the terms of the agreements with third party market makers, third party market makers may not be willing or able to provide liquidity in those circumstances. This may result in the Licensed Platform Operators being forced to suspend trading due to lack of liquidity which may further worsen the market in respect of one or more VAs.

The interest of Affiliates is more aligned with the Licensed Platform Operators (compared to third party market makers), and they are more willing to provide liquidity consistently and reliably to the Affiliated Platform for each VA. This would enhance market stability and be beneficial for Hong Kong investors overall.

"Same business, same risks, same rules" principle

We appreciate that the SFC is concerned about the potential for conflict of interests resulting from any market making activities conducted by Licensed Platform Operators or Affiliates. However, these similar conflicts can arise in the securities trading space between the client-facing businesses and the affiliated proprietary trading businesses within the same group. Such conflicts are managed in practice through a number of control measures detailed in various SFC codes, guidelines and FAQs, including the SFC Code of Conduct and the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC ("**Internal Control Guidelines**"). Some of the concepts or requirements under the SFC Corporate Finance Adviser Code of Conduct may also be helpful.

We invite the SFC to consider permitting Affiliates and/or the Licensed Platform Operator to engage in market making activities, provided that conflicts of interest are appropriately managed through appropriate control measures, including the following:

(iii) **Segregation between the Affiliate and the Licensed Platform Operator (and the Associated Entity)**. Such segregation can include:

(A) Segregation of personnel – This means that the decision-making, day-to-day management and front-line functions of the Licensed Platform Operator and the Affiliate should be performed by different people; and

(B) Segregation of premises and information access management – the Affiliate's staff members who may be involved in the market making activities or proprietary trading should not have access to the physical premises and certain confidential information of the Licensed Platform Operator and *vice versa*, unless specifically approved by the Licensed Platform Operator's Compliance Officer in exceptional circumstances. Confidential information that is price sensitive, may result in actual or perceived conflict of interests or would otherwise lead to market abuse or be adverse to the interests of the Licensed Platform Operator's clients if disclosed should not be shared with the Affiliate.

(iv) **Effective information barriers** - Licensed Platform Operators should have in place effective policies and procedures to identify information that may be confidential and price sensitive. Staff members of the Licensed Platform Operator should be warned that unauthorised disclosure of such information to the Affiliate, may lead to a conflict of interest, market abuse or otherwise adversely affect the interest of its clients. Licensed Platform Operators should have in place control measure to ensure such information is not accessible by the Affiliates.

(v) **Appropriate disclosure** - Licensed Platform Operators should specifically disclose to their clients if their Affiliates engage in market making activities on the Affiliated Platform.

In particular, we submit that the transparency of the Licensed Platform Operator may be able to mitigate some key concerns regarding the impact an Affiliate's market making or proprietary trading activities may have on the pricing of VAs. This can include the following disclosures:

(A) the calculation of the price presented or displayed on the price chart on the VA trading platform; and

(B) the matching and execution processes.

In fact, we understand many VA trading platforms make publicly available the above information (including their order books), with real-time updates of prices and price charts in respect of each VA or trading pair.

(vi) **Internal controls** – Before engaging in any market making activity on the Affiliated Platform, Licensed Platform Operators should have in place and should ensure their Affiliates have effective policies and procedures and controls to implement the above, manage conflict of interest and prevent market manipulative and abusive activities.

In line with the "same business, same risks, same rules" principle, we submit that the nature and the extent of the risks involved are similar to those faced by licensed corporations which possesses confidential or price sensitive information. Therefore, we invite the SFC to consider imposing the relevant requirements under the SFC

Code of Conduct, the Internal Control Guidelines and the Corporate Finance Adviser Code of Conduct relating to control measure such as:

(A) preventing the flow of information which may be confidential or price sensitive:

(I) between the Licensed Platform Operators and their Affiliates; and

(II) between staff performing different activities and to prevent and manage any conflicts of interest; and

(B) detecting improper activities, eg having in place a staff personal dealing policy to ensure that the Licensed Platform Operators, the Affiliates or their staff cannot take advantage of confidential price sensitive information, or execute transactions as or on behalf of insiders.

Based on the above, and on the basis that the Licensed Platform Operator and the Affiliate have in place effective and clear policies to address the above and to comply with the general requirements under paragraphs 13.1 and 13.4 of the draft VATP Guideline, we suggest the SFC consider the following:

Proprietary trading by a Licensed Platform Operator on an Unaffiliated Platform	(i)	A Licensed Platform Operator can trade as principal on another platform which is not operated by a company within the same group of companies as the Licensed Platform Operator ("**Unaffiliated Platform**").
Proprietary trading by an Affiliate	(ii)	An Affiliate can trade as principal on an Unaffiliated Platform.
	(iii)	An Affiliate can trade as principal on the platform operated by the Licensed Platform Operator, provided that the Licensed Platform Operator does not have any interest or involvement in the transaction other than being the exchange platform operator.
Market marketing activities conducted by an Affiliate	(iv)	An Affiliate can engage in market making activities on a proprietary basis on an Affiliated Platform.
	(v)	An Affiliate can engage in market making activities on a proprietary basis on an Unaffiliated Platform.

(d) **Algorithmic trading**

We refer to paragraph 7.24(a) of the draft VATP Guideline.

We recommend that the SFC provide clarity on the following:

(i) The algorithmic trading-related restriction does not prohibit any Licensed Platform Operator's clients from using their own algorithmic trading systems in connection with the VA trading platform.

We understand that the restriction is only intended to prevent the Licensed Platform Operator from providing "algorithmic trading systems" (as defined in paragraph 18.2 of the SFC Code of Conduct) to its clients as a service in connection with the VA exchange.

(ii) The definition of "algorithmic trading" at footnote 57 of the draft VATP Guideline is too broad, and may cover some risk-mitigation functionalities provided by VA trading platform, such as permutations of contingent orders (eg stop-loss or stop-limit orders) placed by the clients. In view of the price volatility of VAs, these functionalities are crucial for VA investors, who are accustomed to trading with these functionalities.

We recommend restricting the definition "algorithmic trading" by amending footnote 57 such that it reads:

> *"For the purpose of this paragraph, algorithmic trading refers to computer generated trading activities created by a predetermined set of rules aimed at delivering specific execution outcomes. Algorithmic trading does not cover the situation where a client places contingent orders or instructions to buy and/or sell within a specific price range designated by the client."*

(e) **Financial accommodation**

We refer to paragraph 7.22 of the draft VATP Guideline.

We invite the SFC to consider how investor protection could still be managed while recognising certain benefits for the Hong Kong VA market that could flow from allowing financial accommodation, such as improving the liquidity and increasing trade volumes and thereby lowering risks associated with low liquidity and enhancing market stability.

Investor risks associated with financial accommodation or leveraged trading may be mitigated by additional investor protection measures which are already available in the market, such as suitability, compensation mechanisms, effective stop loss order options, etc.

Similar to VA Derivatives, we understand that financial accommodation can also be an effective tool for hedging, and it may be crucial for some Corporate Professional Investor and Institutional Professional Investors to ensure a well-balanced portfolio in line with their mandate.

As such, we invite the SFC to consider permitting Licensed Platform Operators and/or their Affiliates to provide financial accommodation to their clients provided that risk mitigation measures such as suitability and credit risk assessments (as applicable) and appropriate limits are applied, in line with the same business, same risks, same rules" principle as further described below.

Applying the "same business, same risks, same rules" principle

The Joint Circular requires intermediaries to "*be cautious in providing any financial accommodation for investing in VA-related products to clients*" and "*assure itself the client has the financial capacity to meet the obligations*"[21], rather than outright banning the provision of any financial accommodation.

It is understandable that SFC may wish to prohibit the Licensed Platform Operators from providing financial accommodation to retail investors given the high-risk nature of the VA trading. However, professional investors should be able to understand the additional risks involved in financial accommodation (eg margin trading). It is also not clear to us what conceptual distinction applies to VAs as opposed to other instruments more generally. The securities margin financing regime, for example, offers a model for controls that could be applied. Similarly, the Money Lenders Ordinance (Cap. 163) contains significant protections for borrowers generally.

In line with the "same business, same risks, same rules" principle, we recommend the SFC update paragraph 7.22 of the draft VATP Guideline, and address the risks by imposing substantially the same the Joint Circular requirement and other requirements similar to the SFC's existing extensive regulatory requirements regarding margin lending under schedule 5 of the SFC Code of Conduct.

(f) **Legal opinions and EARs**

We raise the following comments with respect to the requirement to obtain legal opinions ahead of admitting any VA for retail trading, and to obtain EARs in two phases:

(i) **Disclosure of legal opinions to the SFC**

While we agree with the requirement for Platform Operators to obtain legal opinions ahead of admitting any VA for retail trading, we strongly disagree that these opinions must be disclosed to the SFC in light of the principles of legal professional privilege. Please see our response to Question 8 in this regard.

(ii) **Ongoing monitoring of VAs**

We understand that the ongoing requirement to monitor VAs admitted for trading[22] applies to Platform Operators internally only – that is, Platform Operators are not required to obtain legal opinions from external legal counsel on a periodical basis to meet this ongoing requirement. We request the SFC to confirm our understanding.

(iii) **External assessors' independence**

We understand that an external assessors' independence is measured only against advising and assessing the *same system*.[23] As such:

[21] Paragraph 13 of the Joint Circular.

[22] Under paragraph 7.10 of the VATP Guidelines.

[23] Under paragraph 96(c) of the Consultation Paper and paragraph 5 of Appendix F to the Consultation Paper.

(A) where an external assessor has been involved in building a Platform Operator's system A, it is still able to independently assess the Platform Operator's system B;

(B) where an external assessor has assisted with drafting the Platform Operator's written policies, it is still able to independently assess the implementation of those policies and associated systems and procedures in practice; and

(C) consistent with paragraph (B) above, there are no barriers for law firms to act as external assessors in both phases of the EARs. This is because we understand that this requirement is intended for a vendor of particular systems – it does not apply to a firm which looks at the Platform Operator's existing rulebook and identifies and supplements with areas for uplift.

We kindly ask the SFC to confirm our understanding.

We also wished to check whether it would be useful for Platform Operators to have a written policy in place to ensure all external assessors are acting independently.

(iv) **Walk-through and system demonstrations**

We understand that as part of the assessment process of a licence application, the Platform Operator may be required to conduct process walk-throughs and system demonstrations with respect to each key risk area.[24] We request the SFC provide guidance on what it envisages this process and demonstration to look like. For example, whether this will be virtual or on site, over several rounds or in a single round, what will be involved etc. Understanding this early on will assist Platform Operators with preparing ahead of time to ensure it is able to properly demonstrate and explain its processes and systems as part of the licensing application.

(v) **Timing of EARs**

Our view is that it is not necessary for Phase 1 EARs to be submitted as at the application date. Please refer to our comments under Question 11(a) of this submission for more detail.

(g) **Financial resources and soundness**

We raise the following for clarification:

(i) **VAs should be considered "assets"**

We submit that VAs should be considered "assets" under paragraph 6.1 of the VATP Guideline where such VAs are well known and widely circulated. Where the Platform Operator's business focuses on VAs, the value of VAs is naturally important and will be a substantial form of "assets" for the Platform Operator. This

[24] Under paragraph 3 of Appendix F to the Consultation Paper.

is consistent with our comments on compensation arrangements under Question 4 of this submission.

(ii) **Prescribed forms**

We understand that the Platform Operator must submit to the SFC a return in the "form specified by the SFC", and signed "in a manner specified by the SFC".[25] We wished to confirm with the SFC when this form, as well as other prescribed forms, may be made available. If such forms are already publicly available, we request the SFC indicate where these are located. We raise this point given that, based on our experience, we understand that such forms generally set out detailed expectations on how forms must be completed and on what requirements must be met.

(iii) **Capital requirements**

Under paragraph 6.8(a) and (b) of the VATP Guideline, the Platform Operator must notify the SFC where it becomes aware that its liquid capital falls below 120% of the required liquid capital, and where its liquid capital falls below 50% of the liquid capital stated in its last return submitted to the SFC.

As such, we understand that in practice, Platform Operators are expected to maintain 120% of the required liquid capital. This can be confusing to Platform Operators, given that the statutory minimum is lower than what the SFC expects in practice. We strongly recommend the SFC make this point clearer upfront – that is, to say that the minimum capital requirement is different from what the SFC expects in practice. We also request the SFC provide a rationale for this approach.

In addition, we also ask for guidance on what the implication is for Platform Operators who fall under the 120% mark (but remain above the minimum required capital mark). We understand that this involves a Q&A process with the SFC, in which the Platform Operator will be required to demonstrate that it can manage expenses and keep its capital above 120% of the required capital. We understand this goes to fitness and properness. We request the SFC confirm this understanding.

(iv) **Drafting suggestion**

We also respectfully suggest that paragraph 6.6 of the VATP Guideline be redrafted to plain English. As currently drafted, it is not clear what the proposed timings are.

(h) **Scope of application of the regime**

We understand that the AMLO licensing regime is not intended to apply extra-territorially, with the exception of the "active marketing" requirement. This is consistent with the general

[25] Under paragraph 6.5 of the VATP Guidelines.

position under Hong Kong law that legislation should not apply extra-territorially, unless made express or the context requires such an application.[26]

More specifically, we understand that the SFC's supervisory jurisdiction will be focussed on Hong Kong operations in respect of Hong Kong clients, and the SFC will only consider offshore activities insofar it affects the fitness and properness of the licensed trading platform, its licensed persons and Hong Kong specific operations and activities. This is again consistent with the SFC's supervisory approach and jurisdiction in respect of licensed corporations and registered institutions.[27]

We recommend that the SFC should make this more express in its VATP Guideline or alternatively provide confirmation that SFC requirements do not expect to offshore activities. This is particularly important to the industry given platform operators have global business models and client bases. Licensed Platform Operators should be able to provide other services and products to clients if so permitted under the local laws, such that they should not be constrained by Hong Kong requirements in this regard. For example, the requirement for a Licensed Platform Operator not to provide derivatives related services should not apply to the Platform Operator insofar as it provides such services from offshore, to offshore clients. This is subject to providing such a service in a legally compliant manner in that jurisdiction.

[26] See the "Main Proposed Revisions to a draft for a composite Securities and Futures Bill" ("**Bill**") (dated December 1996)", available here: https://www.sfc.hk/en/Rules-and-standards/Laws/Legislative-history/SFO-and-related-ordinances/derivation-table-and-transitional-materials/Main-Proposed-Revisions-to-a-draft-for-a-composite-Securities-and-Futures-Bill

[27] This is consistent with the SFC's circular titled "Circular clarifying the licensing obligation of corporations and individuals more particularly those conducting business outside Hong Kong" dated 1 April 2010.