31 March 2023

Securities and Futures Commission

54/F, One Island East

18 Westlands Road, Quarry Bay

Hong Kong

Dear Sir/Madam,

Response to Consultation Paper on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the Securities and Futures Commission ("the Consultation Paper")

Introduction

1. Matrixport welcomes the opportunity to provide our views and thanks the Securities and Futures Commission ("SFC") for the opportunity. The following commentary outlines our responses to three major issues in the Consultation Paper, namely:
   a. Scope of "*Centralised VA Trading Platforms*" under the AMLO VASP Regime (in paragraph 12);
   b. Safe Custody of Assets (in paragraph 19(a)); and
   c. Trading in VA Derivatives (in paragraph 58 - 60) & Financial Accommodation (in paragraph 19(h)).

Scope of "*Centralised VA Trading Platforms*" under the AMLO VASP Regime

2. It is ambiguous whether a pure wallet or custody service platform (the "Custodian") with peer-to-peer trading function (which is offered by a third party service provider via means of electronic facilities, i.e. Application programming interface or API) available to the users of the Custodian would fall within the scope of the AMLO VASP Regime.

3. Pursuant to section 1(a)(ii) and (b) of Part 1 under Schedule 3B to the Anti-Money Laundering and Counter-Terrorist Financing (Amendment) Ordinance 2022 (the "Amended AMLO"), "*VA Service*" refers to (1) "*providing services through means of electronic facilities whereby persons are regularly introduced, or identified to other persons in order that they may negotiate or conclude, or with the reasonable expectation that they will negotiate or conclude sales or purchases of virtual assets in a way that forms or results in a binding transaction*", and (2) "*where client money or client virtual assets comes into direct or indirect possession of the person providing such service*".

4. Accordingly, if (1) the users of the Custodian are regularly introduced, or identified to the third party service provider via an API in order that they may negotiate or conclude sales or purchases of virtual assets, and (2) these users' money and virtual assets comes into possession of the Custodian, then the Custodian is likely to provide "*VA Service*" under the Amended AMLO.

5. However, pursuant to the footnote 9 of paragraph 12 in the Consultation Paper, "*the AMLO VASP regime will cover VA trading platforms which are centralised and operate in a manner similar to traditional automated trading venues. Such platforms typically provide virtual asset trading services to their clients using an automated trading engine and provide custody services as an ancillary service to their trading services. Accordingly, in business models whereby a platform provides virtual asset trading services without the use of an automated trading engine, for instance, a platform which operates as an order routing facility or a simple bulletin board, the business activities of the platform would not fall under the scope of the AMLO VASP regime*".

6. Given that the aforementioned Custodian does not provide VA trading services to its users using an "*automated trading engine*" (despite that it may be considered routing the users' trade orders to the third party service provider for trade execution), such Custodian is unlikely to be a "*centralised VA trading platform*" defined in paragraph 5 above.

7. As a result, the SFC is asked to clarify whether the aforementioned Custodian with a third party peer-to-peer trading function available to its users via an API would be considered as "*centralised VA trading platform*" under the AMLO VASP regime and therefore is required to apply for the relevant licence.

Safe Custody of Assets

8. To safeguard the client assets, pursuant to paragraph 19(a) in the Consultation Paper, the VATPs licensed under the AMLO VASP regime (the "Licensed VATP") should:
    a. hold client money and client virtual assets on trust through a wholly-owned subsidiary, i.e., "associated entity";
    b. ensure that not more than 2% of the client virtual assets are stored in hot wallets;
    c. establish and implement written internal policies and governance procedures for private key management to ensure all cryptographic seeds and keys are securely generated, stored and backed up;
    d. not deposit, transfer, lend, pledge, repledge or otherwise deal with or create any encumbrance over client virtual assets; and
    e. maintain an insurance policy to cover risks associated with the custody of client virtual assets.

9. While it is agreed to impose the strict requirements on (c) the private key governance, (d) the client virtual asset disposals and (e) the insurance policy in the paragraph 8 above, the SFC is asked to contemplate the following recommendations on (a) the self-custody arrangement and (b) the threshold requirements on hot and cold wallet storages.

10. For the self-custody arrangement in paragraph 8(a) above, the Licensed VATPs are unlikely in possession of the in-house expertise in developing the custody infrastructure from scratch. SFC is urged to let the Licensed VATPs appoint third party custodians, which are subject to the same requirements as the self-custody arrangement under the AMLO VASP regime and an independent third party due diligence before the appointment. The Licensed VATPs are therefore able to focus on the risk management over their trading platforms while reducing its risks in custody of its client assets by appointing a competent third party custodian.

11. Despite the Consultation Paper's proposed regulatory framework being focused on VATPs only, the Government of Hong Kong and the Legislative Council are urged to extend "VA Services" under Part 1 under Schedule 3B to the Amended AMLO to include VA custody services, whereby the Licensed VATPs can appoint VA custodians, specifically licensed in Hong Kong, for custody of their client's virtual assets.

12. For the threshold requirements on hot and cold wallet storages in paragraph 8(b) above, not more than 2% of the client virtual assets stored in the Licensed VATP's hot wallets means 98% of them stored in its cold wallets, which would result in inconvenience against the clients' withdrawals and unnecessary operational costs and risks against the Licensed VATPs when executing clients' withdrawal instructions. To strike a balance between the security of the client virtual assets and the operational resilience, the Licensed VATPs should, instead of simply complying with the fixed percentages of hot and cold storages, adopt robust security measures in both hot (e.g. 2FA, withdrawal limits, etc.) and cold (e.g. multi-signature, physical access restrictions, etc.) wallet storages, and sufficient insurance and compensation arrangement in regard to the client assets.

Trading in VA Derivatives & Financial Accommodation

13. The Licensed VATPs offering VAs only are not sustainable even if some VAs may be available to the retail investors subject to specific token admission criteria. The investors, no matter retail or professional, can easily source other channels, e.g. peer-to-peer trading platforms and VA automated teller machines ("ATM"), to buy or sell VAs while those channels are far lower operating and regulatory costs than the Licensed VATPs.

14. Nowadays, most VATPs are of an advantage in offering VA derivatives while ATM cannot offer VA derivatives and peer-to-peer trading platforms may offer VA derivatives at relatively higher costs.

15. It is inevitable for professional trading houses, asset management firms or hedge funds to utilize VA derivatives either for hedging purposes or getting the return more than the market benchmark, i.e. so-called "Alpha", from margin trading. Without a regulated market, these professional investors need to use an OTC derivative market which lacks transparency, increases counterparty risk and reduces fund efficiency.

16. The traditional finance options volume is 35x times of the equity spot market notional value. There is huge demand for VA derivatives markets as the VA spot market matures.

17. As a result, the SFC is urged to allow the Licensed VATPs offering VA derivatives on their platforms.

Proposed Type of Business Model

18. With regard to the business model of those VATPs offering VA derivatives, they generally operate an order matching engine whereby the market makers and takers can long and short futures and options contracts on their platform.

19. To maintain the liquidity, they may offer lower trading fees to some designated market makers to ongoingly open the contracts.

20. The investors can then hedge their positions on BTC or ETH against the BTC or ETH futures and options contracts thereon. It would be extremely costly for those investors to source the futures and options issuers to open the tailor-made contracts for hedging.

21. As a result, for the Licensed VATPs to offer VA derivatives with relatively lower costs would maintain the liquidity in the market and be beneficial to the VA ecosystem.

Proposed Types of VA derivatives

22. Despite the aforementioned advantages, the risks associated with VA derivatives are definitely higher than the risks in VAs as VA derivatives are more complex than VAs in terms of profitability and risk modeling.

23. Therefore, it is recommended to first allow perpetual futures on BTC and ETH and then European options on BTC and ETH, which are two most common types of VA derivatives available to the investors in the market.

24. For other VA derivatives, the Licensed VATPs may be subject to the SFC's prior approval on a case-by-case basis.

Financial Accommodation

25. By using VA derivatives for hedging, it is not cost effective if the investors are required to hedge against their positions with full costs of the particular futures and/or options contracts. It is common for them to deposit margin (e.g. BTC, ETH or even USD) as collateral in the VATPs to open the futures contracts, so even if the price of BTC goes for one side and hence the margin has been used up and the futures contracts have been closed, the investors have just lost their margin on the futures contracts but earned the profit at their own positions on the other side. For hedging, 100% margin deposit would be costly, especially the investors may hedge their positions with multiple futures contracts.

26. To strike the balance between the risk of leverage and the cost effectiveness, it is recommended to replace the restriction on the financial accommodation by a robust credit risk management system (e.g. assessing the investors' financial positions before accepting the margin trading) adopted by Licensed VATPs.

<u>Conclusion</u>

27. In submitting our commentary, we draw upon Matrixport's global experience and expertise as an active participant in virtual asset space globally. Should you have any questions concerning our commentary above, we would be delighted to make ourselves available to discuss in more detail.

Yours faithfully,

Matrixport