

PwC's and T&P's Joint Response – SFC's Consultation on the Proposed Regulatory Requirements for VATPs Licensed by the SFC

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| <u>Guidelines for Virtual Asset Trading Platform Operators</u> | | |
| A. Proposal to allow retail access to licensed VA trading platforms | 1. Do you agree that licensed platform operators should be allowed to provide their services to retail investors, subject to the robust investor protection measures proposed? Please explain your views. | <p>Yes.</p> <p>We expect global retail customer demand (including Hong Kong) for VA services will continue to increase. If it is not already the case, we expect that access to VAs in other jurisdictions will gradually open up to retail customers too. As such, for Hong Kong to maintain its status as an international financial centre (and establish itself as a VA hub), Hong Kong regulations need to evolve. Provided that sufficient and robust investor protection measures are in place there is no reason why access to VAs should not be made available to retail customers in Hong Kong. Furthermore, if access to VAs is not made available to retail customers in Hong Kong, these customers will increasingly use offshore VATPs.</p> |
| | 2. Do you have any comments on the proposals regarding the general token admission criteria and specific token admission criteria? | <p><u>General token admission</u></p> <ul style="list-style-type: none"> We note that VATPs are required to consider the liquidity of a VA, including its market capitalisation. We suggest the SFC provides clear guidelines on how to measure liquidity and market capitalisation. Given the duplication of time, effort and cost required with the proposed approach for token admissions, we suggest the SFC consider setting up an “industry level” token admission and review committee. This would have input from each VATP as well as other stakeholders (e.g., regulators, auditors, lawyers etc.) with relevant technical expertise. Without this, there is a risk of inconsistency in application of the criteria, monitoring of the VA as well as duplication of efforts and time. If the stated objective is to ensure customer protection, an industry level committee with pooled expertise could be a more efficient mechanism. This would allow each VATP to focus on risks specific to their business and customers, such as KYC, cybersecurity, and market manipulation. We expect this would reduce barriers to entry, improve competition and encourage more global VATPs to choose Hong Kong as a destination. <p><u>Specific token admission – large-cap virtual asset</u></p> <ul style="list-style-type: none"> To provide greater certainty, reduce time and cost for individual applicants to research and prepare submissions regarding the acceptability of a proposed index, we suggest that the SFC provides a list of acceptable indices (subject to update from time to time). Given that liquidity and market capitalisation requirements are already being imposed on tokens for retail access (in addition to general token admission criteria), we do not see how the requirement for tokens to also be included in two independent and separate indices will add to their suitability for retail access. With a limited selection of tokens available for retail access, retail |

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| | | <p>customers may increasingly use offshore VATPs for trading tokens not listed in the indices. We would urge the Commission to reconsider this as part of the specific token admission criteria for retail access.</p> <p>We understand that a VATP is required to submit a proposal to the SFC if it wishes to make retail trading available to those VAs which fulfil the general token admission criteria but fall outside the specific token admission criteria. Please clarify if, in the situation where one VATP clears eligibility of a VA with the SFC, such VA will be deemed “clear” for other VATPs as well. It will be quite inefficient if the eligibility of the same VA needs to be repeatedly assessed.</p> |
| | <p>3. What other requirements do you think should be implemented from an investor protection perspective if the SFC is minded to allow retail access to licensed VA trading platforms?</p> | <p><u>Product risk profiling</u> In light of the features and risks of VAs, we suggest that the product risk profiling and assessment criteria is further clarified in respect of the different risks and features that VAs expose investors to, as compared to traditional asset classes.</p> <p><u>Concentration risk assessments</u> We suggest providing further guidance to calculate and assess customers’ net worth / assets under management and asset concentration risks where they are exposed to VAs on a standalone basis, and if their investment portfolio includes a mix of VA and traditional assets.</p> <p><u>Knowledge assessment</u> We suggest that the knowledge assessment of customers should be tailored to address the nature of key risks of VA products including the following areas:</p> <ul style="list-style-type: none"> ○ drivers of price volatility; ○ private key management; ○ potential loss of all investments in VAs; ○ intrinsic value of VAs; ○ inability to sell VAs, such as during illiquid market conditions or system outages; ○ losing access to VAs due to unforeseeable events (e.g., technological or operational issue, cyber-attack, private keys are lost or irretrievable, fraud, theft, sabotage) <p><u>Investor Compensation Arrangement</u> We suggest VAs be considered under the existing investor compensation arrangement (under the SFO), to compensate investors who suffer pecuniary losses because of defaults of VASPs, to give extra protection to retail investors in particular.</p> <p><u>Measures for customers requiring extra care</u> Additional measures for the protection of customers requiring extra care may be imposed (e.g., vulnerable customers (VCs)). Examples of measures could include restricting the trading services offered to VCs and imposing</p> |

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| | | <p>more conservative concentration limits for VCs and requiring post-sales confirmations on VAs offered to VCs through recommendation/solicitation.</p> <p><u>Trading VAs on margin</u> In view of the high price volatility of VAs, the SFC may wish to consider imposing VA trading limitations on margin for long positions or requiring more prudent margin levels.</p> <p><u>Additional security protocols and education</u> We suggest the SFC mandates a minimum level of security protocols that each VATP must introduce and implement for its clients. This could be determined based on industry consultation and operational feasibility. However, there are certain best practice security protocols which should also be considered, such as Multi-Factor Authentication and controls on external withdrawals.</p> <p><u>Additional requirements to ensure appropriate governance and risk management</u> We suggest the SFC considers providing additional guidance on expected governance and risk management measures for VATPs, similar to, and possibly more stringent than, those applied to banks and securities firms given the heightened risk in VA markets. There may not be an immediate need for this, but we suggest consideration be given to this as the sector continues to mature. Some examples of these include more specific minimum standards on risk management, governance, liquidity, operational resilience, cybersecurity, and mandatory reporting of internal controls to clients and regulators.</p> |
| B. Proposed requirements for insurance / compensation arrangement | 4. Do you have any comments on the proposal to allow a combination of third-party insurance and funds set aside by the licensed platform operator or a corporation within its same group of companies? Do you propose other options? | No comment. |
| | 5. Do you have any suggestions as to how funds should be set aside by the licensed platform operators (for instance, under house account of the licensed platform operator or under an escrow arrangement)? Please | No comment. |

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| | explain in detail the proposed arrangement and how it may provide the same level of comfort as third-party insurance | |
| | 6. Do you have any suggestions for technical solutions which could effectively mitigate risks associated with the custody of client virtual assets, particularly in hot storage? | Please refer to “Other questions/suggestions”. |
| C. Trading in virtual asset derivatives | 7. If licensed platform operators could provide trading services in VA derivatives, what type of business model would you propose to adopt? What type of VA derivatives would you propose to offer for trading? What types of investors would be targeted? | <p><u>Types of VA derivatives offered</u></p> <p>The main types of VA derivatives products currently offered by trading platforms are options and futures (i.e., dated and perpetual futures). Some platforms even offer structured products (options contracts with a complex payoff profile). Putting a blanket prohibition on one type of derivative based on the product type may lead to making arbitrary and artificial distinctions. However, linking this issue to the type of investor targeted may be a sensible approach.</p> <p><u>Types of investors targeted</u></p> <p>Given the VA market is susceptible to high volatility, price manipulation, cyberattacks and requires complex understanding of derivatives products, there are an array of risks which derivatives traders are exposed to. We suggest distinguishing between retail and institutional access, as the two investor types will often have different levels of understanding of the market, and their risk management understanding will generally differ.</p> <p>It is well understood that there are several legitimate use cases for derivatives in the business dealings of professional investors. While counterparties may enter a derivatives contract to mitigate exposure to price movements of a related investment, another reason is to seek to profit from volatility in the price of an underlying variable without significant capital investment. Many retail investors have used margin trading with high leverage and have subsequently suffered from liquidations. This has become a consumer protection issue in some cases. As such, we suggest that as a first step, access to derivatives be limited to professional investors.</p> <p>We recognize that retail investors who still want to trade VA derivatives may be pushed to unregulated offshore exchanges if there is no regulated derivative platform offering in HK. Therefore, despite the risks flagged above, we suggest that at a later stage the SFC looks at the pros and cons of allowing VA derivatives trading to retail investors. If derivatives are to be permitted, the SFC could consider limiting the leverage taken by users when purchasing a derivative.</p> |

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| D. Other adaptations to existing requirements to be incorporated into the VATP Guidelines | 8. Do you have any comments on how to enhance the other requirements in the VATP Terms and Conditions when they are incorporated into the VATP Guidelines? | Please refer to "Other questions/suggestions". |
| Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (For Licensed Corporations and SFC-licensed Virtual Asset Service Providers) | | |
| A. Virtual asset transfers | 9. Do you have any comments on the requirements for virtual asset transfers or any other requirements in Chapter 12 of the AML Guideline for LCs and SFC-licensed VASPs? Please explain your views. | <p>We do not have any comments on the scope of the requirements in Ch. 12 of the AML Guideline; However, there are two specific areas where we suggest the SFC could provide further guidance and clarity.</p> <p>1. Terrorist Financing, financial sanctions, and proliferation financing – Database maintenance screening and enhanced checking (para. 12.8.3) <i>Where a virtual asset transfer can be completed prior to or without the said screening or when any of the required originator and recipient information is missing (which renders the FI unable to conduct screening), the FI should take appropriate risk mitigating measures, having regard to its business practices.</i></p> <p>We suggest providing more guidance at para. 12.8.3 to avoid confusion. Please consider rephrasing para. 12.8.3 with suggested wording (see the underlined text) below: <i>Where a virtual asset transfer can be completed prior to or without the said screening or when any of the required originator and recipient information is <u>not available due to the fact that the relevant parties did not comply with the following requirements under s.13A of Schedule 2 of the AMLO:</u></i></p> <ul style="list-style-type: none"> <i><u>The ordering institution must obtain, record and submit the required originator and recipient information;</u></i> <i><u>The beneficiary institution must obtain and record the required originator and recipient information submitted to; and</u></i> <i><u>The intermediary institution must ensure that all the required originator and recipient information is retained and transmitted to the institution to which it passes on the transfer instruction.</u></i> <p><i>which renders the FI unable to conduct screening, the FI should take appropriate risk mitigating measures, having regard to its business practices.</i></p> <p>2. Virtual Asset Transfers ("VATs") – Intermediary Institutions (para. 12.11 – 12.14) <i>We noted that both section 13A of Schedule 2 to the AML (Amendment) Ordinance and the SFC's revised Guideline on AML/CFT (for LCs and SFC-Licensed VASPs) prescribe the obligation of</i></p> |

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| | | <p><i>intermediary institutions when the intermediary participates in completion of the transfer of virtual assets in a number of sections (i.e., para. 12.11 “Virtual asset transfers”, 12.12, “VATs – Technological solution for travel rule compliance”, 12.13 – “VA transfer counterparty due diligence and additional measures”, 12.14 “VATs to or from Unhosted Wallets”)</i></p> <p>We suggest clarifying and/or providing specific examples under which circumstances the virtual asset transfer would involve intermediary institutions. It would be beneficial for the SFC to provide illustrated examples to help regulated entities understand the role of intermediary institutions.</p> |
| <u>Disciplinary Fining Guidelines</u> | | |
| Disciplinary Fining Guidelines | 10. Do you have any comments on the Disciplinary Fining Guidelines? Please explain your views. | No comment. |
| <u>Miscellaneous</u> | | |
| Other questions / suggestions | <p><u>Consideration on Independent Custodian</u></p> <p>Under the current and proposed regulatory framework on VA custody, VASPs can only hold client money and client VAs on trust through a wholly-owned subsidiary i.e., associated entity.</p> <p>Generally, in Financial Services, international leading practice would suggest that custody of client money and assets would best be maintained by an independent, third party licenced and well-regulated custodian. We acknowledge the limitations in Hong Kong because currently, the SFC does not have the statutory powers to regulate independent custodians. Therefore, a logical solution is to allow VATPs to use a wholly owned subsidiary in Hong Kong (as per the consultation paper). However, we would encourage the SFC to permit – and perhaps prefer – a model whereby an independent third-party custodian be used which is appropriately licenced and regulated. This could include an overseas custodian (if the relevant jurisdiction and regulator is deemed acceptable / appropriate by the SFC) that is audited and has appropriate third-party internal controls reports (e.g., ISAE3402/SOC1 etc)</p> <p>Alternatively, the SFC may consider imposing additional T&Cs on the VATP in relation to the use of independent third party custodians such that (a) any proposed engagement must be with the consent of the SFC (and the primary criterion for this consent may be, among other things, that an independent assessment report is provided in respect of the proposed custodian relating to things such as its operations, framework, wallet protocols, cybersecurity protocols, regulatory status, insurance, audits etc); and (b) that there are regular, periodic reviews/reports submitted by the VATP in relation to the operations/finances/status of the proposed custodian to the SFC, failing which, the SFC would not approve, or would revoke its consent to, the use of such custodian. In our view, even if the SFC cannot directly regulate such a custodian, it would still be able to exert a degree of control by proxy (through the imposition of T&Cs on the VATP licence). Ultimately, the</p> | |

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| | | <p>requisite degree of investor protection should still be able to be achieved, albeit indirectly through this proxy mechanism. If this is of interest to the SFC we would be happy to discuss the framework for such an assessment report (both for (a) and (b)) mentioned above.</p> <p>In the longer term, we would strongly recommend that a new law / regulation is introduced in Hong Kong to facilitate the use of a third-party custodian based in Hong Kong which is licensed and regulated. Any custodian should also be subject to appropriate audits and be required to commission third party internal controls reports (e.g., ISAE3402, ISAE3000 etc.) to be made available to clients and regulators - as are frequently used in the traditional securities industry.</p> <p><u>Dual Licenses</u></p> <p>When reading the consultation paper, we note that the SFC “prefers” VATPs to have both Type 1/7 and an AMLO licence – but it is not mandated. Based on our industry discussions, we understand that the reason why such situation is indeed “preferable” is because it will help in the event that a VATP only has an AMLO licence, but then discovers that one or more tokens on the platform change characteristics and becomes deemed a “security”. In such an event, a platform without a Type 1/7 licence would have to cease operations until the Type 1/7 licence is obtained which would be very disruptive to clients. Please could the SFC clarify this rationale for all readers when finalising the rules.</p> <p><u>External Assessment</u></p> <p>Historically the SFC has adopted an approach for most (if not all) external assessments to be performed by an independent reviewer – and in some cases by an independent auditor. This approach has served the SFC and the industry well because there has been no threat of a reviewer or auditor “reviewing their own work”. The topic of “independence” could be clearer in the proposed rules.</p> <p>Specifically, we encourage the provision of further guidance and greater clarity with respect to the “independence” consideration outlining the selection and appointment of an external assessor for the Phase 1 and Phase 2 external assessment reports. An example of this could include whether a consulting firm which has already provided implementation advisory work for a VASP (e.g., P&P, T&C drafting, system implementation support) would still be eligible to act as a Phase 1 and / or Phase 2 external assessor having considered the relevant “self-review” threats that would be applicable.</p> <p>We also suggest providing guidance as to whether an external assessment (in particular Phase 2 assessment) would also be applicable for existing VASPs that already have a Type 1/7 licence. By doing so, this would help ensure consistency - with both the approach and the application of supervisory standards - to all VASPs across the board.</p> |