

## Part I: Executive Summary

We warmly welcome the SFC's initiative to regulate virtual asset ("VA") trading platform operators ("Platform Operators"). We are of the view that the recent rapid expansion and development of VA trading emphasise the need for stringent and robust regulations and oversight, and a sound regulatory framework for Platform Operators can allow Hong Kong to develop a vibrant sector and ecosystem for VA. We therefore appreciate the opportunity to comment on the Consultation Paper.

We broadly agree with the proposals ("Proposals") set out in the Consultation Paper and we appreciate the SFC's endeavour to strike an appropriate balance between the promotion of the growth of the VA industry in Hong Kong and the need for investor protection and market integrity. Whilst we welcome the SFC's effort in establishing a commercially viable adaptive regulatory framework to accommodate investors' market needs (both professional and retail), more guidance should be provided to virtual asset service providers ("VASPs") as to compliance with the new regulations and considerations should be given in respect of the practicability of the regulations to be imposed. In summary, we have the following comments or concerns on the Proposals:

- **Retail access to VA trading:** We recognise the retail access is essential to support the robust development of VA trading ecosystem. Given the relatively less experience and industry insights of retail investors, we have proposed various additional protection measures, which includes (i) restricting trading limit; (ii) restricting types of VAs that are available to be invested; (iii) assessing an investor's risk tolerance level before allowing a retail investor to invest in a specific VA product; and (iv) providing compulsory education programs and portfolio analysis to retail investors. On token admission criteria, we have further provided some aspects that VA trading platforms may consider to ensure technical stability of VAs.
- **Insurance, compensation and escrow arrangement:** Considering the actual circumstances of the market, we suggest that the SFC should be more flexible in providing the alternative for managing risks and transitional frameworks should be available before a complete transformation. More guidance should also be given on the selection of escrow agent and the terms and conditions of the escrow arrangement.
- **AML/CFT requirements and Disciplinary Fining Guidelines:** We generally agree with the proposed AML/CFT measures subject to the review on their practicability by the VASPs. On Disciplinary Fining Guidelines, we suggest the SFC to include more elaboration and examples as to the situation that the relevant fine would be imposed to avoid confusion.

## Part II: Key proposed regulatory requirements for licensed virtual asset trading platform operators

### Guidelines for Virtual Asset Trading Platform Operators

#### A. Proposal to allow retail access to licensed VA trading platforms

**Question 1:** *Do you agree that licensed platform operators should be allowed to provide their services to retail investors, subject to the robust investor protection measures proposed? Please give reasons for your views.*

## **Reply**

We in general agree that licensed VA Platform Operators should be allowed to provide their services to retail investors, subject to appropriate investor protection measures. The reasons include the following:

- VA platforms can provide retail investors with access to a wider range of investment opportunities, including VAs that may have strong growth potential and higher potential returns.
- With the rapid development of VA market over the past few years, retail investors can invest in VAs through different platforms or channels. The crux of the matter is that many of such platforms or channels may not be regulated, untested or even fraudulent.
- We note that the SFC's previous approach of "professional investors only" on VAs. It can be put that such approach is not insensible. Indeed, it can be thought that, with some exceptions, the Hong Kong retail participation in the recent Terra/Luna and FTX debacles were kept to a minimum due to such policy.
- However, in view of the rapid evolution towards Web3 and fintech, Hong Kong as the top international finance centre is in a unique position to leverage its finance expertise to capture the Web3 opportunity whilst striking a balance between retail participation and investor protection.

For the investor protection measures, we agree with the "same activity, same risks, same regulation" principle as discussed in FSTB's policy statement last year. The level of regulation should correlate to the nature of the VAs in question. Given that retail investors tend to be less experienced and informed about VA investments, we can consider restricting (i) the trading limit; (ii) the categories of assets and derivatives; and (iii) the risk level of the VA product a retail investor can invest in, based on the platform operator's assessment on the knowledge and risk tolerance level and risk profile of the corresponding retail investor. Regarding our comments on the other proposed robust investor protections (e.g. token admission criteria), please refer to our responses to Questions 2 and 3 below.

**Question 2:** *Do you have any comments on the proposals regarding the general token admission criteria and specific token admission criteria?*

## **Reply**

We generally agree with the proposed general token admission criteria. Furthermore, the underlying technology of a VA is a critical factor in its long-term viability and stability that makes it relatively suitable for retail investors to invest in; while VAs that have been tested and proven to have reliable and secure technology could also be given preference in the selection. In order to ensure the technical stability of VAs, here are some aspects that the trading platform operator may look into as well:

- (i) Updates and maintenance: Whether the developers and founders/issuers of the VAs regularly update and maintain the software to ensure that it remains secure and stable, while updates are being regularly released to address any potential bugs and vulnerabilities;



- (ii) Security measures: Whether the developers and founders/issuers of the VAs implement adequate security measures to protect the VA from hacks and other security threats, e.g. multi-factor authentication, encryption, cold storage and other security protocols; and
- (iii) Scalability: Whether the underlying system on which the operation of VAs is based is able to handle the increased demand and large volume transactions without sacrificing performance or security.

For specific token admission criteria, as mentioned in the Consultation Paper, it is possible that an eligible large-cap VA may cease to be a constituent of an acceptable index. In other words, such criterion can be too restrictive, thereby warranting the SFC to consider other alternative criteria, such as, stipulating a specified market capitalisation requirements regarding VAs.

The approach of limiting retail access to large-cap VAs at this stage appears to be sensible, thereby allowing us to adjust and iterate our regulatory approach over time. We also note that ultimately, issuers should be allowed to conduct STOs in Hong Kong, and retail investors should be allowed to invest in issuers' token regardless of whether such tokens are classified as securities or otherwise.

**Question 3:** *What other requirements do you think should be implemented from an investor protection perspective if the SFC is minded to allow retail access to licensed VA trading platforms?*

#### **Reply**

We note that investor education is important. Compulsory investor education programs can be implemented on top of the "suitability obligations" to help retail investors better understand the risks and potential returns associated with VA investments. For example, educational webinars and information session should be made compulsory to retail investors before setting up account and making investments; real-time risk alert and alike notifications should be made available to explain the consequences of certain market reactions when triggered by events such as sudden price drop and changes in trading volumes; the general education of the blockchain technology, the importance of safeguarding e-wallets and private keys would also be useful.

Provision of portfolio analysis by personalised investment counsels and investment recommendations based on a retail investor's risk tolerance and investment goals by the licensed platform operator may also be required to allow access of the retail investors.

#### **B. Proposed requirements for insurance / compensation arrangement**

**Question 4:** *Do you have any comments on the proposal to allow a combination of third-party insurance and funds set aside by the licensed platform operator or a corporation within its same group of companies? Do you propose other options?*

#### **Reply**

As VAs are relatively less regulated, the "market value" of the same are often susceptible to extreme volatility and market force. A combination of third-party insurance and segregated funds is a way to start, but of course it would lead to higher expenses for such operators. As such, the SFC should

be flexible to consider including other liquid assets (e.g. well-recognised stable coins (see HKMA's Conclusion of Discussion Paper on Crypto-assets and Stablecoins published in January 2023) as part of the combination as well. As e-HKD and CBDC discussion has gone underway, e-HKD (see HKMA's paper on e-HKD - Charting the Next Steps) and/or even e-CNY may be considered for capitalisation requirements and settlement purposes. This in turn requires analysis on how it impacts the Government's monetary policy.

On the other hand, traditional frameworks and corporate structures can be utilised to navigate retail investors in transitioning from Web2 to Web3. For instance, retail investors are very familiar with the traditional Hong Kong exchange system, whereby clients' fund segregation achieved by way of holding clients' assets via intermediaries and not by the Hong Kong Stock Exchange itself. It can be considered that the same can be adopted in the context of crypto exchanges with adjustments. Furthermore, the offshore bond trustee structure under which the investor's bonds are held by the trustee for the benefit of the investor can be utilised, at least during these transitional stages. This in turn calls for the need for intermediaries, trustees and custodians who are Web3 literals and the education thereof. While such arrangements may not be the norm for Web3 exchanges, these Web2 solutions (with Web2.x adjustments) can still serve as an option or alternative for managing risks.

**Question 5:** *Do you have any suggestions as to how funds should be set aside by the licensed platform operators (for instance, under house account of the licensed platform operator or under an escrow arrangement)? Please explain in detail the proposed arrangement and how it may provide the same level of comfort as third-party insurance.*

### **Reply**

We are of the view that house account and escrow arrangement should both be appropriate and be able to provide similar level of comfort as third-party insurance.

First of all, the value of the VA may vary time to time while the amount covered under the third-party insurance may not be able to timely increase if needed. On the other hand, by setting certain amount of funds aside, it is guaranteed that such amount is solely for compensation arrangement and the amount can be easily increased as long as the licensed platform operator or its associated corporation has additional funds.

The licensed platform operator should report daily on the balance of the house account or escrow account to make sure the amount of funds exceeds the total value of the VAs under custody. For escrow arrangement, the SFC may provide more guidelines on the selection of the escrow agent and the terms and conditions of the escrow agreement, for example:

- (i) The escrow agent should be an independent third-party escrow service provider with over certain period of relevant experience; and
- (ii) The terms and conditions of the escrow agreement must include that the licensed platform operator does not have right to withdraw any funds from the escrow account and the funds in the escrow account can only be released under certain circumstances. If possible, the SFC may propose certain terms and conditions which are compulsory to be included in the escrow agreement to avoid confusion.



We also add that the discussion of the role and need of professional trustee, custodians and intermediaries are relevant in this question.

**Question 6:** *Do you have any suggestions for technical solutions which could effectively mitigate risks associated with the custody of client virtual assets, particularly in hot storage?*

**Reply**

As the market evolves, would it be possible that smart-contract embedded segregate-ability can be developed by building a layer on top on Ethereum and/or Bitcoin blockchains? We shall defer to the technical experts in this topic to comment on this question.

**C. Trading in virtual asset derivatives**

**Question 7:** *If licensed platform operators could provide trading services in VA derivatives, what type of business model would you propose to adopt? What type of VA derivatives would you propose to offer for trading? What types of investors would be targeted?*

**Reply**

We shall defer to the VA traders or related intermediaries on this question. Nevertheless, we note that the Hong Kong Stock Exchange have listed BTC and ETH futures ETFs in December last year.

**D. Other adaptations to existing requirements to be incorporated into the VATP Guidelines**

**Question 8:** *Do you have any comments on how to enhance the other requirements in the VATP Terms and Conditions when they are incorporated into the VATP Guidelines?*

**Reply**

According to the VATP Terms and Conditions, an SFO-licensed platform operator is not allowed to provide any financial accommodation for its clients to acquire assets (paragraph 4.8). Financial accommodation, as defined in the SFO, means, among others a loan or other arrangement under which a person is or is to be provided with credit, to secure a relevant payment. It is noted that there are a number of exchanges offering margin lending in cryptocurrency trading, such as ByBit, Binance and Huobi, etc. and there is certain market need for margin trading in cryptocurrency. Margin trading would also be a good investment tool for sophisticated investors to magnify gains, conduct hedging and short selling, etc.

In order to truly open the market and regulate the cryptocurrency trading market at a later stage, it is proposed that the SFC may consider including margin lending in cryptocurrency trading, and in that case, the licensed platform operator should also be subject to the Schedule 5 (Additional requirements for licensed persons providing margin lending) (with proper modifications according to the circumstances), and that relevant provision, i.e. paragraph 7.22 of the VATP Guidelines, should be modified.

It is understood that margin trading is a very high-risk investment, therefore, this investment model is suggested to be open to professional investors only.

**Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (For Licensed Corporations and SFC-licensed Virtual Asset Service Providers)**

**(i) Virtual asset transfers**

**Question 9:** *Do you have any comments on the requirements for virtual asset transfers or any other requirements in Chapter 12 of the AML Guideline for LCs and SFC-licensed VASPs? Please explain your views.*

**Reply**

We understand that the requirements in Chapter 12 of the AML Guideline for LCs and SFC-licensed VASPs are made reference to the AMLO and the latest standards and guidance promulgated by the FATF. Subject to the comments from potential licensed platform operators on the practicality of the proposed requirements on the customer due diligence and record-keeping requirements (which appear to be rather complicated), we generally agree with the proposed requirements.

**Disciplinary Fining Guidelines**

**Question 10:** *Do you have any comments on the Disciplinary Fining Guidelines? Please explain your views.*

**Reply**

The Disciplinary Fining Guidelines provide further guidelines to the AMLO. We generally agree with the Disciplinary Fining Guidelines, but the SFC may also consider the following:

- (i) Section 53ZSP(3)(c)(ii) of AMLO mentions that the maximum level of fine that can be imposed is HK\$10 million or 3 times profit gained or loss avoided. The Disciplinary Fining Guidelines further states that SFC will not automatically linked the fine imposed with profit gained or loss avoided, without mentioning when the SFC will do so. Therefore, we suggest the SFC should provide examples or circumstances to avoid confusion.
- (ii) For the specific considerations, we suggest the SFC may further elaborate and include more circumstances, such as:
  - (a) the roles and positions of the individuals involved; The more senior the individual involved, the more likely he/she will be presumed taking more responsibility and involvement in relation to the conduct;
  - (b) the level of sophistication of the market participants affected by the conduct: Misconduct that involves institutional investors may be viewed as less serious than those effecting retail investors; and
  - (c) mitigating factors, such as the remedial actions taken by the persons involved to reduce the severity of the conduct.