Response to SFC's Consultation Paper dated 28 February 2023 - Consultation Paper on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the SFC (the "Consultation Paper")

This response is co-submitted on behalf of the Victory Securities Group, including its licensed subsidiaries (Victory Securities Company Limited), its to-be licensed VATP operator (Victory Fintech Company Limited) and Hong Kong Digital Assets Group in Deloitte Touche Tohmatsu.

As a starting point, we agree that virtual assets should be regulated, as far as possible, under the "*same business, same risk, same rules*" approach advocated by the SFC.

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.

We welcome the SFC's proposal to allow licensed virtual asset trading platform operators (VATPs) to offer their services to retail investors. The current prevention of retail access to SFC-licensed VATPs leaves retail investors to trade on unregulated overseas cryptocurrency exchanges, which offer little to no investor protection. However, we suggest the SFC clarify the interaction and linkage between the proposed requirements of virtual asset knowledge test, suitability assessment, and trading limit to ensure that retail investors' exposure to risks relating to trading of virtual assets does not exceed their ability to bear such risks. We recommend that the SFC allow more flexibility for VATPs to determine what combination and extent of measures to adopt, subject to the SFC's review and approval of their internal policies and controls. We would welcome further guidance from the SFC on its expectations regarding the practical implementation of the above investor protection requirements.

Furthermore, we would like to seek the SFC's views on the onboarding requirements in the case where the client deals with the VATP through an intermediary licensed for Type 1 regulated activity. We suggest that the onboarding and investor protection requirements applicable to both licensed VATPs and Type 1 licensed intermediaries be synchronised, and a licensed VATP be permitted to rely on the investor protection measures already carried out by the Type 1 licensed intermediary where it deals with retail investors through a Type 1 licensed intermediary.

Lastly, in addition to the general guidance provided under the 9.4 of the proposed Guideline for Virtual Asset Trading Platform Operators, we suggest the development of a standard rating test to assess retail clients' knowledge with the aim of facilitating consistent application of the investor assessment across the industry, and permitting comparison and benchmarking of the retail investors against other standard risk ratings they may have undertaken prior to investing

in other securities. As the technical and operational characteristics of the asset class evolve, knowledge tests and examinations would need to adapt as well. We would welcome the SFC, the HKSI, or a similarly well-placed public body to take the lead in ensuring that examination requirements are kept up-to-date.

We also recommend that the SFC consider permitting licensed VATPs to take into account a client's holdings of digital assets in assessing whether the client is suitable to participate in virtual asset trading and the appropriate trading limits to be established for that client. Such investors may possess better knowledge and experience in virtual assets and have substantial wealth to withstand the risks of investing in virtual assets, or of trading between virtual assets.

On a separate note, we recommend the SFC to take on a more active role in promulgating investment education resources to the public. Other industry players should also contribute to the education of the public to assure that that the retail customers are well-aware of the stringent requirements that Licensed Platform operators must fulfil and effective way to protect their assets. If appropriate, we would be very interested in participating, and taking an active role, in a combined approach to improve the knowledge in virtual assets of the Hong Kong public.

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

We agree with the general token admission criteria in the Consultation Paper and VATP Guidelines but find the proposed specific token admission criteria for retail investors too restrictive. The "eligible large-cap virtual asset" requirement could limit retail investors to only a few mainstream tokens, and the "non-security" requirement could exclude certain popular tokens. This could leave retail investors with limited choices and hinder Hong Kong's goals of being inclusive to innovative virtual asset businesses. We suggest that the specific token admission criteria be relaxed or adjusted with appropriate limits for retail clients in place, set by the VATP operator. The SFC could allow licensed VATPs to permit their retail clients to trade virtual assets that do not meet the proposed requirements, with adequate measures in place to limit risk exposure. The SFC should also clarify whether larger unregulated indices would be accepted as "acceptable indices", and whether this includes synthetic instruments traded on large exchanges.

If retail investors are subject to high levels of restrictions, we believe many will continue choosing to trade on unregulated overseas exchanges, ultimately reducing investor protections for Hong Kong retail investors. Enabling virtual assets and indices with good liquidity on third-party exchanges would allow for more options for retail investors to include smaller tokens from innovative projects without subjecting them to disproportionate risk levels,

and allowing them to trade through a regulated Hong Kong entity subject to supervision by the SFC.

To assist in the flexible application of this policy against such a fast-developing technology, we would recommend that the SFC also retain the current case-by-case approval mechanism for VATPs and VASPs if certain tokens do not meet the proposed requirements.

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?

We think the SFC's investor protection requirements are already comprehensive. Rather than proposing new restrictions, we suggest the SFC could clarify how licensed VATPs should adapt and tailor their investor protection measures, including virtual asset knowledge test, suitability assessment, trading limits, token admission criteria, product due diligence, and risk disclosures. This would enable greater and more meaningful retail access while maintaining adequate investor protection.

We would also recommend introducing a cooling off mechanism for retail clients e.g., for the first 24 hours upon signing up for the trading platform, no marketing to invite for purchase/sale should be offered to retail clients.

In additional to the standardized risk disclosure requirement under the paragraph 9.26 of the draft VATP Guideline, a personalized risk warning on the trading cap of a particular investor should be displayed to the clients based on the KYC information provided by the client.

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?

We are supportive of measures which reduce the high capital requirements associated with the present virtual asset operations. The requirements to have available (i) 12 months of operational expenditure (as unproductive capital reserves), (ii) expensive insurance premiums, and (iii) sufficient regulatory capital to meet traditional Financial Resources Rules which apply only incompletely to virtual assets, all combine to cause significant operational drag. Whilst we appreciate the risks which are being addressed, we would encourage further guidance from the SFC on the proposed ratio of funds vs insurance, as well as whether coverage of assets through either avenue will continue to remain at 100% given the technological progress

and investments made in cold-only wallets which are less susceptible to risks of loss due to hacking.

By way of example, we note that there are limits on investor compensation through the Investor Compensation Company, as well as limits on fiat currency through the Deposit Protection Scheme administered by the HKMA (where currently each of ICC and DPS compensation are limited to $500,000 HKD per claimant). We would submit that a similar threshold for clients who hold assets through the licensed operator's custody may be appropriate investor protection and would significantly reduce the amount of capital required to self-insure, as well as the premium required for third-party insurance.

Again, we welcome the "*same business, same risk, same rules*" approach, and the rightsizing of the approach to the unique (but mitigable) risks associated with virtual assets by regulated entities.

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.

Where funds are set aside by the licensed operator, or within a group of companies, it would seem to be appropriate to keep such funds within an escrow account held by an appropriate deposit-taking institution[1], with appropriate operational controls such that withdrawals from the funds are (i) authorised by the Board of Directors of the licensed operator and (ii) notified to the SFC as to any withdrawals along with the reasons for doing so.

We would also suggest the following alternative be developed over time, as the market matures:

A mechanism similar to that for the deposit protection scheme. The licensed platform will pay contribution to SFC, or any other entity set up by the SFC for this purpose and any investor who suffers losses may file a claim against the scheme; and/or

A sale surcharge on virtual asset transactions and custody to make up a compensation fund. Where a client elects to purchase their own particular insurance to cover their VAs stored on the exchange, the sales tax can be reduced or waived.

[1] As far as the funds held for compensation comprise virtual assets, a respective escrow mechanism is suggested.

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?

As we intend to only utilise cold storage at this point in time, our suggestions on this question have already been incorporated into our proposed custody solution including multiple non-overlapping roles to prevent collusion, strict automation of withdrawal procedures with built-in cryptographic signatures at each stage to avoid tampering by external or internal parties, and routine penetration testing by independent assessors to ensure industry best practices are being adhered to.

However, if in the future retail trading of virtual assets were to become commonplace, it may become necessary to facilitate withdrawals via hot wallets. Whilst we do not have a specific workflow to support such withdrawals in the current business model, we would anticipate including the same considerations as the cold-only infrastructure in order to mitigate hot wallet risks. Additional factors which may be considered could include:

a) Permitting the use of third-party custodians, independent of the licensed operator. By permitting the separation of custody and trading/exchanges, each can manage their own specific risks, and separation between the two reduces contagion if either experiences a breach.

b) Consider whether to permit end-of-day net settlement of virtual assets for licensed counterparty clients, such that they do NOT have to prefund all trading. This would reduce unnecessary and potentially large transfers between licensed entities which may result in operational risks to hot wallets.

c) Continuously assess and embrace new developments (whether technical or otherwise) in this rapidly evolving asset class. Some might improve the safe custody of virtual assets. Prior to adoption these should be thoroughly tested, should in general apply to all, rather than a subset, of blockchains, and should be globally accepted.

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?

Several types of VA derivatives that we recommend the SFC consider:

a) Delta-one other synthetic products: Traditional financial institutions may be reluctant to transact or hold virtual assets due to unfamiliarity with the asset class. However, where institutions may obtain the economic return profile of virtual assets through a synthetic instrument, they are more likely to be familiar with counterparty risk assessments

against another institution. Access to the underlying via delta-one products also reduce the amount of capital deployed, which is attractive to institutional investors.

b) Options: The prudent and professional use of options and other higher-delta instruments are standard tools for pro-active risk management, which allow, for example, to hedge market and/or idiosyncratic risk with little capital exposure. Certain options trading strategies can potentially provide a way for sophisticated investors to limit the risk of loss and protect their investments against market volatility.

c) Prime Brokerage: Borrowing and lending of beneficially owned spot products should be permitted to Professional Investors. This introduces credit risks to and from investors, which Professional Investors are well placed to assess utilising traditional risk assessment techniques. Borrowing / lending services are very common Prime Brokerage offerings, which are regularly accessed by institutional investors and play an important role in the seamless interaction of traditional financial markets.

   Futures: It is very common for sophisticated investors to hedge or offset their exposure to certain types of risk by entering into futures contracts. Providing access to these instruments to professional investors would allow them to prudently manage their risk and realize a better risk-adjusted return.

We submit, as with other financial products, the risks which are being regulated primarily relate to the institutional counterparty risk of the product issuer being able to return the economic benefit to the product-holder at expiry or redemption of the product. These risks are well-understood at the institutional level, and capable of falling within the traditional SFO definitions and risk controls.

In line with the "*same business, same risk, same rules*" approach, We submit that where an investor can demonstrate suitable investment knowledge of the risks associated with the product, and provided the investor has the financial ability to absorb any losses associated, the product should not be treated differently to e.g. warrants which are available to all investors who meet the relevant requirements.

In any event however, Professional Investors (and especially Institutional Professional Investors) would greatly benefit from access to derivative products in order to manage downside risk associated with virtual asset spot positions. Additionally, as noted above, traditional financial institutions which are still obtaining experience in virtual assets may be reluctant to hold the underlying virtual assets, due to concerns by their risk and compliance teams as to various aspects of the investment. However, such institutions are much more likely to be familiar with the counterparty risks associated with e.g. delta-one synthetic products in which the underlying asset is never beneficially owned by the institution.

Derivatives are standard and important tools for institutional investors to proactively manage risk. Access to these instruments on a licensed and regulated platform is indeed a prerequisite for some institutional investor before being able and willing to enter this asset class.

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?

We make the following observations on the VATP Terms and Conditions:

10.10(b) - "*The Platform Operator and its Associated Entity should ensure that client IP addresses as well as wallet addresses used for deposit and withdrawal are whitelisted, using appropriate confirmation methods (such as two-factor authentication and separate email confirmation)*": Given the prevalence of dynamic IP addresses, IP address whitelisting no longer represents best practice from a technical point of view, and may indeed decrease security by whitelisting e.g. a large corporate IP address which may be shared by several thousand people. We submit the preferred technological control is by device fingerprinting, so that logins by a user from a device which is unknown to the Platform requires additional multi-factor authentication (which should not simply be limited to Email). The authentication factor to be used should be the strongest available for the account, ideally using hardware based authentication such as a Yubikey (best) or Time based One Time Password (better). Email could be used as a factor in bootstrapping trust situations, such as first time registration, but should not be used if stronger factors are available.

10,6(e) – "*The Platform Operator and its Associated Entity should have detailed specifications for how access to cryptographic devices or applications is to be authorised and validated, covering key generation, distribution, storage, use and destruction.*"

We would request the SFC provide some clarification of the circumstances under which 'destruction' of keys or cryptographic devices is permitted, given record keeping requirements. Is the destruction of keys or cryptographic devices contemplated only where it is part of an operational process to ensuring appropriate backup keys and devices are available at another location?

12.12(e) - "*prompt notification to clients after certain client activities have taken place in*

their accounts."

For user experience and operational efficiencies, would the SFC please clarify whether "prompt" means "immediate" i.e. a notification email is sent to the client upon these actions occurring, or whether it is intended that such notifications could be sent with an end-of-day statement or similar notification.

7.21 - "*A Platform Operator should execute a trade for a client only if there are sufficient fiat currencies or virtual assets in the client's account with the Platform Operator to cover that trade except for any off-platform transaction to be conducted by institutional professional investors which are settled intra-day.*" – We would recommend that paragraph 7.21 be modified such that both institutional and qualified corporate professional investors may (subject to appropriate operational and financial controls by the Platform Operator) to settle on an intra-day or end-of-day settlement cycle for both on and off-platform trades. We submit this is both appropriate and commensurate with traditional financial risk management principles, specifically in that:

a. Institutional and qualified corporate professional investors understand the risks associated with these proposed arrangements, which are similar to other omnibus or securities accounts terms and conditions;
b. The proposed change does not impact the risk faced by retail investors;
c. The current draft is viewed by institutional and corporate professional investors as unduly burdensome from an operational perspective, and inconsistent with their expectations of virtual assets being regulated in a manner similar to traditional securities. We believe our proposed change will help attract larger offshore investors to participate in the Hong Kong virtual asset industry.

7.22 – "*A Platform Operator should not provide any financial accommodation for its clients to acquire virtual assets. It should ensure, to the extent possible, that no corporation within the same group of companies as the Platform Operator does so unless for exceptional circumstances which are approved by the SFC on a case-by-case basis*." – We believe that this restriction may need significant amendment in due course, particularly as the development of prime brokerage products in the virtual asset space, and the proposed end-of-day settlement mechanism proposed in 7.21 above may entail at least some technical financial accommodation which contravenes the language in 7.22.

13.2 – "*A Platform Operator should not engage in proprietary trading except for off-platform back-to-back transactions entered into by the Platform Operator and other limited circumstances permitted by the SFC on a case-by-case basis.*" - We propose the introduction of a requirement to disclose the trading profit made from a back-to-back transaction, similar to the paragraph 8.3 under the SFC Code of Conduct. Such a requirement will address possible conflicts of interest between the platform operators and clients, and enhance investor transparency on execution arrangements.

The SFC expressed in paragraph 90 of the Consultation Paper that:

> *"Given that the terms and features of virtual assets may evolve over time, a virtual asset's classification may change from a non-security token to a security token (or vice versa). To avoid contravening any of the licensing regimes and ensure business continuity, VA trading platforms (together with their proposed responsible officers and licensed representatives) should apply for*

approvals under both the existing SFO regime and the AMLO VASP regime and become dually licensed and approved."

We would recommend that the SFC clarify the approach in this paragraph of the Consultation Paper, as to whether platform operators who do not intend to offer securities are required to seek licensing under the existing SFO regime notwithstanding their lack of securities offerings. If the SFO regime does indeed remain opt-in, we have some doubts as to whether the AMLO regime alone provides sufficient investor protection to facilitate retail investors participating in the virtual asset space. If the intent is that platform operators must apply for approvals under both the SFO regime and the AMLO regime, we would suggest substituting the word "should" for the word "must" in this paragraph to remove ambiguity.

Additionally, we would greatly appreciate guidance from the SFC regarding the issuance of STOs and the monopoly of the Hong Kong Stock Exchange ("HKEX"). In 1986, the then four exchanges were merged, under strong pressure from Government, to form the Unified Exchange. The exchange was given a statutory monopoly in order to prevent fragmentation of the market and to create a body with the critical mass to develop HK's equity market more effectively. The monopoly's main significance nowadays is in relation to the listing function, since there is ample potential and actual competition to HKEX's trading platform from exchanges and alternative trading systems located outside HK. Notwithstanding the intention of the monopoly, we feel that the active development of the virtual asset class, and of Hong Kong into a "crypto-hub", would require allowing licensed and regulated VATP operators to list tokenized real assets, including securities.

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.

We generally agree with the requirements for virtual asset transfers in Chapter 12 of the AML Guidelines. We are cognizant of the sunrise issue, but believes the industry is urgently working towards interoperable protocols which mitigate the risks substantially, particularly as more platforms seek licensing within their domestic regimes.

We do observe that the requirement to "*obtain and record the required information from its customer who may be the originator or recipient*" from unhosted wallets appears to be a higher standard than applied by other jurisdictions, which may result in operational frictions when interacting with clients overseas who are not subject to the same requirements with their domestic operators. Further, if client wallet whitelisting is intended to be applied to VATPs and VASPs, this control appears somewhat redundant. If the intent is that the client makes a declaration that they are the originator of such virtual assets in the transfer, we have no comment or objection to this.

Additionally, the proposed date for the commencement of travel rule compliance is proposed as 1 June 2023. Whilst We remain firmly committed to travel rule compliance, the industry response is presently fragmented based on somewhat inconsistent and rapidly evolving jurisdictional requirements which is exacerbating the sunrise issue and hampering implementation efforts. We would submit that VASPs and VATPs should implement the travel rule on a 'best efforts' basis, with formal travel rule compliance to be required in a further 18 months i.e. by 1 January 2025.

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

We note the contents of the Disciplinary Fining Guidelines, and believe they appear to be broadly consistent with the SFAT and High Court cases' judgments on related issues.

The SFC may consider clarifying the following points under the Specific Considerations listed in the Guidelines:

a) "*whether the conduct is widespread in the relevant industry (and if so, for how long) or there are reasonable grounds for believing it to be so widespread*": conduct may be widespread within unregulated VASPs (whether in Hong Kong or overseas) which is nevertheless entirely inappropriate, such as wash trading or front-running. The SFC may consider clarifying whether such conduct that is widespread in unregulated entities would represent a mitigant in relation to the conduct of a regulated individual or firm.

b) "*whether the SFC has issued any guidance in relation to the conduct in question*": As a practical matter, given the fast-paced nature of the industry, we make the observation that SFC guidance on specific conduct may require substantial internal SFC resources to compile. The SFC may consider whether other specified Hong Kong industry bodies' guidance may also be helpful to consider in this context, to augment the SFC's internal capabilities.