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** In cooperation with
Trench, Rossi e Watanabe
Advogados

31 March 2023

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

Dear Sirs,

By email
VATP-consultation@sfc.hk

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

1. Introduction

- 1.1 We thank the Commission for the opportunity to provide feedback on the proposals in the Consultation.
- 1.2 Unless otherwise defined herein, terms defined in the Consultation or the VATP Guidelines (as the case may be) shall have the same meaning when used in this submission.
- 1.3 We set out below our responses to those questions in the Consultation to which we would like to provide feedback.

Responses

2. 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 explain your views.

- 2.1 We agree that it is important for Hong Kong, as an international financial centre with substantial cross border business and fund flow activities, to adopt a risk-

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based and pragmatic approach to implementing a regulatory system that meets international standards. We are supportive of the proposal to allow access by retail investors to virtual assets ("VA"), provided that suitable and proportionate investor protection measures are adopted consistent with the "*same business, same risks, same rules*" approach as advocated by the Commission in paragraph 8 of the Consultation.

- 2.2 We further submit that it is important to plan in a holistic and forward-looking manner as to how the regulatory regime will operate in practice. We consider that there should be level-playing fields for SFC licensed platform operators and other SFC intermediaries in providing VA or VA-related services; and also, there should not be overly heavy regulatory compliance burdens on market players.

<p>VA dealing services and VA advisory services</p>	<p>Under the existing <i>Licensing or registration conditions and terms and conditions for licensed corporations or registered institutions providing virtual asset dealing services and virtual asset advisory services</i> (January 2022) (the "VA Dealer/Advisor Conditions"):</p> <ul style="list-style-type: none"> • With respect to providing virtual asset dealing services, the licensee or registered institution shall only provide such services to "professional investors". • With respect to providing virtual asset advisory services, the licensee or registered institution shall only provide such services to "professional investors". <p>If an SFC licensed platform operator will be allowed to provide their VA services to retail investors, we submit that corresponding relaxations should be made available for other SFC intermediaries providing virtual asset dealing or virtual asset advisory services.</p>
<p>Distribution services in relation to VA-related products</p>	<p>We would like to seek clarifications as to whether there will be any corresponding relaxations to the "professional investor" restriction for</p>

	distribution of VA-related products under the <i>Joint circular on intermediaries' virtual asset-related activities</i> dated 28 January 2022.
Eligibility criteria of VA / VA-related products that are available to retail clients	Based on the Consultation, there will be eligibility criteria (including general and special admission criteria, etc.) under the VATP Guidelines for an SFC licensed platform operator to make VA available to retail clients. If VA and VA-related products will also be made available by other SFC intermediaries to retail clients in connection with VA dealing, VA advisory and/or VA-related distribution services, we hope that the Commission can also provide guidance on the relevant eligibility criteria.
Compliance standards for retail clients in providing VA or VA-related services	As a general comment, in view that the compliance requirements for SFC licensed platform operators and other SFC intermediaries which conduct VA / VA-related business are embedded in different sets of regulations (including the VATP Guidelines, VA Dealer / Advisor Conditions, etc.), it would be helpful for the industry to have easy access to the information on the common standards that may apply to them in one consolidated place.

2.3 We make the following submissions with respect to the proposed investor protection measures:

(a) **Retail Client/Retail Investor Definition**

- (i) The VATP Guidelines define "*retail client*" or "*retail investor*" as not including any person who is a "*professional investor*". The term "*professional investor*" has the meaning as defined in section 1 of Part 1 of Schedule 1 to the SFO. In order to be a "*professional investor*" under the Securities and Futures (Professional Investor) Rules ("**PI Rules**"), the monetary threshold component must be satisfied. Based on the definition of "portfolio" under the PI Rules, a "*portfolio*" may only comprise any of the following:

- (a) *securities;*
- (b) *a certificate of deposit issued by—*
 - (i) *an authorized financial institution; or*
 - (ii) *a bank which is not an authorized financial institution but is regulated under the law of any place outside Hong Kong;*
- (c) *in relation to an individual, corporation or partnership, money held by a custodian for the individual, corporation or partnership;*

This means that any holdings of VA which are not "*securities*" (as defined in the SFO) cannot be included in the "*portfolio*" calculation. This will result in potentially inconsistent treatment between (A) individual investors (with large holdings of VA which constitutes "*securities*") who are qualified as "professional investors" whilst (B) the other individual investors (with large holdings of VA which is not "*securities*") who are not qualified as "professional investors".

We submit that consideration should be given to expanding the definition of "*portfolio*" (for the purpose of the "professional investor" definition as far as the VATP Guidelines are concerned) to also include VA which are not "*securities*" to provide a more consistent treatment. We further submit that such exclusion of the non-securities VA from the "*portfolio*" calculation seems to be inconsistent with the requirements in Note 1 under paragraph 9.7 of the VATP Guidelines for the SFC licensed platform operator to take into account the client's overall holdings in VA (which *includes non-securities VA*) on a best efforts basis when setting the exposure limit.

(b) **On-Boarding, KYC and Suitability**

- (i) We submit that further guidance is required to enable an SFC licensed platform operator to comply with the proposed requirements under paragraphs 9.3 to 9.7 of the VATP Guidelines. In particular, we submit that guidance should be provided in the following areas thereby facilitating standardisation amongst different SFC licensed platform operators and clarity for retail clients:

(A) **Client on-boarding assessment**

It is noted that under the proposals, during the onboarding of investors, an SFC licensed platform operator should ensure that the provision of its services is suitable for that client. Since the suitability assessment at the "service-

level" is a new concept that is built into the VATP Guidelines, we would be grateful for more guidance on how the suitability should be assessed.

(B) Steps to take if the client has exceeded the exposure limits (e.g., due to fluctuation in the price of the VA)

We would like to seek more clarity on the steps to take. Under the current proposal, it is not entirely clear whether an SFC licensed platform operator is required, for example, to mandate a client to immediately divest such VA and/or return to the prescribed exposure limit or simply prevent the client from purchasing further VA of the same type / nature.

(c) Disclosure

- (i) Paragraph 9.26 of the VATP Guidelines provides the disclosure should "fully disclose the nature and risks" of a VA and that such disclosure should "*amongst other things, include:...*". Whilst we agree that the categories listed therein are common potential risks associated with VA, the open-ended nature of the disclosure obligation under the proposal would lead to real substantive difficulties for an SFC licensed platform operator to meet the relevant standard. It may not be feasible for an SFC licensed platform operator to determine the "full" nature and extent of risks that a VA may present. As a general matter, in preparing the disclosures required, the SFC licensed platform operator would normally need to rely upon the publicly available information and the VA issuer's own disclosures and representation.

We suggest that the baseline due diligence standard be limited to only require an SFC licensed platform operator to take "reasonable" steps to consider the publicly available information and such other information that an SFC licensed platform operator has in possession when determining the nature of any risks. We also submit that in general, a "reasonable" steps standard should apply in complying with paragraph 9.26. Such an approach would allow SFC licensed platform operators to more readily tailor disclosures and make the disclosures more relevant / meaningful to clients.

- (ii) Paragraph 9.28 of the VATP Guidelines provides for certain types of information that are considered "relevant and material" to be included in the disclosures in order to meet the requirements under paragraph 9.27(d). These include, amongst other things:

(b) *Background information about the management team or developer of the virtual asset;*

(c) *Issuance date of the virtual asset;*

In some cases, for example Bitcoin, this information may not be known or is the subject of conjecture. As these are not subject to the same "(if any)" qualification as some of the other items in paragraph 9.28 of the VATP Guidelines, we would like to ask if "(if applicable)" or alike can be included in the relevant items under paragraph 9.28.

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

- 3.1 We understand from our discussions with licensed security token exchange operators in other jurisdictions that the exchange operators determine which security tokens to admit for trading based on their listing rules, due diligence and other assessment criteria. In general, we are supportive of the proposals to align with the market and international developments. However, we would like to make the following points.

General Admission Criteria

- 3.2 Whilst we agree it is appropriate to require some form of due diligence on VA, we note that the admission criteria in paragraph 40 of the Consultation and in paragraph 7.5 of the VATP Guidelines are described as being "*non-exhaustive factors*" and SFC licensed platform operators must "*ensure they satisfy the token admission criteria*" before admitting VA for trading and ensure that "*they continue to satisfy the criteria at all times*". The open-ended nature of the proposed due diligence required by an SFC licensed platform operator could prove very difficult to satisfy, which may lead to potential regulatory ambiguity. It is also not entirely clear whether a VA which fails to satisfy one or more of the listed criteria must be rejected for admission in all cases or halted / suspended / withdrawn from trading after it has been admitted.
- 3.3 We submit that several of the criteria in the VATP Guidelines would prove difficult for an SFC licensed platform operator to confirm despite performing "*all reasonable due diligence*" including the following:
- (a) **Paragraph 7.5(a) - the background of the management or development team of a VA.** As already noted above in regard to the disclosure requirements, in some cases, for example Bitcoin, this information may not be known or is the subject of conjecture. We submit that it should be sufficient for an SFC licensed platform operator to include language noting and/or explaining this to be the situation.
 - (b) **Paragraph 7.5(e) - whether the marketing materials for a VA issued by the issuer are accurate and not misleading.** Consistent with marketing materials issued by, amongst others, funds or listed companies, an SFC licensed platform operator would normally only be able to access publicly available information and/or seek information from the issuer. It

is not possible for SFC licensed platform operators to undertake independent in-depth assessment and deep-dive due diligence on the materials provided by the issuers. As such, any inaccuracies or misleading statements may not be able to be identified / verified by the relevant SFC licensed platform operators.

- (c) **Paragraph 7.5(h) - the extent and nature of any legal risks associated with the VA, including any pending or potential civil, regulatory, criminal, or enforcement action relating to its issuance, distribution or use.** These could require the SFC licensed platform operator to obtain extensive legal advice on a regular basis and it could also necessitate ongoing / regular searches of court and other records - both of which will involve significant time and costs (in particular for VAs with global presence) for rather limited likely benefits for clients. As court and other proceedings would normally only become known once issued, served and publicly documented, we submit that the SFC licensed platform operator's obligation should be limited to considering those publicly available information and other information that would otherwise come to the SFC licensed platform operator's actual knowledge.
- (d) **Paragraph 7.5(i) - whether the utility offered, the novel use cases facilitated, or technical, structural or crypto economic innovation exhibited by the virtual asset appears to be fraudulent or scandalous.** We consider that similar concerns would arise for an SFC licensed platform operator as those expressed in response to paragraph 7.5(e) above. Accordingly, we submit that the basis for assessment should again be limited to publicly available information and other information which the SFC licensed platform operator has actual knowledge.

We also note that the term "*scandalous*" may be subject to different interpretations (as this would likely involve certain subjective elements). This will give rise to ambiguity and thereby difficulty for an SFC licensed platform operator to comply. We submit that this term ought to be removed.

Specific Token Admission Criteria

- 3.4 With respect to Note 1 to paragraph 7.6 of the VATP Guidelines, the proposed requirements include that: (c) the index provider should possess the necessary expertise and technical resources to construct, maintain and review the methodology and rules of the index. It is likely that the SFC licensed platform operators will rely on the publicly available information on the index provider and materials issued by the index provider. It is not feasible for them to conduct extensive due diligence on the index provider. Accordingly, we submit that any due diligence requirement should be limited to those publicly available information and other information which the SFC licensed platform operator has actual knowledge.

Other Token Due Diligence

- 3.5 With respect to paragraph 7.8 of the VATP Guidelines, we submit that it is important to provide greater clarity as to the nature, scope and content requirements for the proposed smart contract audit report. It is unclear what are considered "*contract vulnerabilities*". It is also unclear as a practical matter how such an audit would be achieved in view of the multiple disciplines / jurisdictions that may be involved.
4. **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?**
- 4.1 We note that several market participants (including fund managers and exchange operators) have commented on the limited availability and prohibitive expense of securing comprehensive insurance coverage for businesses and activities that are related to virtual assets. We note that several prominent exchanges have already publicly acknowledged that they maintain pools of emergency insurance funds for user recovery which are typically funded by allocating a portion of the trading fees that are generated by activities on the exchange.
- 4.2 We consider that the proposed combined insurance and funds approach could be a suitable method to provide greater flexibility to SFC licensed platform operators enabling them to meet their regulatory obligations whilst also balancing protection for investors.
5. **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.**
- 5.1 We note that such Chapter 12 is not included in the latest proposed amendments to the AML Guidelines of the Hong Kong Monetary Authority. In order to align the AML standards for financial institutions, we would seek clarity on the application of the requirements in Chapter 12 of the SFC AML Guideline on registered institutions.

* * *

Please do not hesitate to contact the following people if we can assist with any additional information or to discuss our submissions in further detail:

Yours faithfully,

Baker McKenzie