

5 April 2023

Securities and Futures Commission

**Sent via email:** VATP-consultation@sfc.hk

Dear Sir or Madam,

**Re: Consultation Paper on the Proposed Regulatory Requirements for Virtual Assets Trading Platform Operators licensed by the Securities and Futures Commission**

The Alternative Investment Management Association ("**AIMA**")<sup>1</sup> appreciates the opportunity to provide feedback on the Securities and Futures Commission's ("**SFC**") "*Consultation Paper on the Proposed Regulatory Requirements for Virtual Assets Trading Platform Operators licensed by the Securities and Futures Commission*" ("**VATP Consultation**"). Feedback set out in this response has been collected from AIMA's APAC Digital Asset Working Group and other members, which has been closely monitoring global, regional, and local developments relating to virtual assets ("**VAs**").

While AIMA is an industry body whose membership is predominantly that of private fund managers - we are the largest global body of alternative asset managers - a growing number of our members are taking a keen interest in getting involved in VA-related activities. The SFC-licensed VA trading platforms ("**VATPs**") will form part of the broader VA ecosystem so the standards that they will be held to will be of interest to managers, banks or securities firms who will deal with them. It is with this perspective that we make some additional recommendations for the SFC's consideration as well as our response to the proposals in the VATP Consultation.

**General Comments**

Our members ("**Members**") are generally supportive of the SFC's proposal under the VATP Consultation to establish a unified "*Guidelines for Virtual Asset Trading Platform Operators*" ("**VATP Guidelines**"), which will be applicable to both VA service providers regulated under the Anti-Money Laundering and Counter-Terrorist Financing (Amendment) Bill 2022 ("**VASP Regime**") and the VATPs currently regulated under the existing licensing regime ("**Existing SFO Regime**") under the Securities and Futures Ordinance. This will provide much needed

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<sup>1</sup>The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,100 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than US\$2.5 trillion in hedge fund and private credit assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 250 members that manage US\$800 billion of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors). For further information, please visit AIMA's website, [www.aima.org](http://www.aima.org).

regulatory certainty to VATPs licensed under the Existing SFO Regime and to be licensed under the VASP Regime.

Members also appreciate the SFC's adoption of the overarching "same business, same risks, same rules" principle in the VATP Guidelines, which ensures that requirements that are applicable to securities brokers and automated trading venues will also be applied equally to VATPs (save for adaptations to address the specific risks posed by VAs).

The regulatory framework is generally consistent with international standards, and in certain areas such as investor protection, is more advanced than some other major jurisdictions with similar regimes. We believe that this will help foster the growth of the VA ecosystem and open up the VA industry to provide Hong Kong with a competitive edge as a VA hub in the Asia region, as the Hong Kong government has announced in the Hong Kong Fintech Week 2022.

While Members generally welcome the proposals under the VATP Consultation, some Members have raised particular feedbacks on certain areas of the proposal from a fund manager's perspective:

*(a) Product range, admission criteria and listing procedure*

The scope of VA products which can be traded on VATPs are of particular interests to fund managers. Members are appreciative of the streamlined procedure for the admission of new VAs for trading on the VATPs, which removes the requirements in the *"Terms and Conditions for VA Trading Platform Operators"* ("**VATP T&Cs**") including vetting by the SFC, submission of written legal advice for VAs if they are made available only to professional investors, and that security tokens must be asset backed and have post-issuance track records of 12 months.

This not only increases the VA product range available to be traded on the VATPs, but also reduces the time required for a VA to be admitted to a VATP which may be time sensitive as investors using the VATPs may not be able to capture the gains from the rising price of a VA if its admission is delayed.

We are strongly supportive of allowing VATPs to offer, trade or deal in VA futures contracts or related derivatives ("**VA Derivatives**"). Using derivatives for hedging and shorting purposes plays an important part of fund management, as the SFC acknowledged in the VATP Consultation. Members are therefore of the view that it is important for licensed VATPs to be able to provide VA Derivatives-related services, whether listed or over-the-counter ("**OTC**"). Being able to engage in VA Derivatives-related activities on appropriately regulated platforms (instead of using unregulated or under-regulated platforms) would help fund managers hedge risks and effectively employ their funds' investment strategies in a safer and regulatory-compliant manner, which is beneficial from an investor protection perspective.

This would also help foster the healthy development of a wider range of attractive and innovative fund products which will support Hong Kong to be a VA fund hub. Members also note that a lack of availability of VA Derivatives would also reduce the alpha opportunities available to, and making investments riskier for, fund managers, and in this sense cause Hong Kong licensed VA fund managers to be structurally less competitive than their licensed counterparts in other jurisdictions (e.g. Singapore and UAE). This would make it challenging for Hong Kong VA fund managers to raise external capital from allocators and investors, which currently consider strategies such as index arbitration and systematic call overwriting appealing. Without allowing VA Derivatives to be traded on VATPs, Members consider it more difficult to justify onboarding with Hong Kong licensed VATPs at this stage.

We suggest that, at this initial stage, VATPs should be allowed to offer, trade or deal in VA Derivatives with professional investors, with these VA Derivatives being classified as "complex products". We appreciate the SFC's preference to narrow the product range available at the inception of the VATP regime, but we respectfully submit that at least listed VA futures and options, with terms and features similar to those available on the Chicago Mercantile Exchange, should be available for clients, including fund managers, for hedging and investment

purposes. The underlying asset of these VA futures and options should not be restricted to Bitcoin and Ethereum, but should be extended to all other types of VAs listed on the VATPs, in order for fund managers to properly hedge their risks or employ their investment strategies.

The SFC is encouraged to conduct a further consultation on the viability of VATPs providing VA Derivatives-related services to retail investors (including suitability and investor protection, which we consider should be similar to the existing requirements under the SFC's regulatory regimes for traditional securities), and to explore the possibility of VATPs providing more sophisticated VA Derivatives products (such as those currently available on VA exchanges in other jurisdictions, such as perpetual contracts and OTC derivatives) at a later stage.

#### *(b) Provision of algorithmic trading services*

Under the current draft of the VATP Guidelines, VATPs are not allowed to "provide algorithmic trading services" to clients. Members are aware that industry participants are diverged in their understanding of the scope of this restriction, with some understanding it to mean that VATP cannot provide, allow or facilitate algorithmic trading at all, while others understanding it as VATP clients can plug in their own algorithmic trading programs for their quant strategies but the VATPs themselves cannot provide the algorithmic trading services.

As the SFC may be aware, there is a growing number of quant funds in the market, in particular in the APAC region.

With this competitive fund management environment, the investment strategies of a growing class of hedge funds are increasingly dominated by algorithmic trading, and many fund managers which are not quant funds may employ some form of algorithmic trading strategies when managing their funds for efficiency and cost-effectiveness. Algorithmic trading is especially important for digital asset fund managers as the prices of VAs are generally more volatile than traditional securities and financial instruments. Without the ability to use algorithmic trading, VA fund managers will find it difficult to employ their strategies.

Members therefore urge the SFC to clarify its proposal on restricting the provision of algorithmic trading services, and in any case, consider allowing VATPs themselves to provide algorithmic trading services to customers, in particular professional investors.

#### *(c) Transfer of VAs*

The current proposals under the VATP Consultation lifted the restriction of transferring client VAs under VATP T&Cs, and proposed the amended "*Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (For Licensed Corporations and SFC-licensed Virtual Asset Service Providers)*" ("**Amended AML Guidelines**") with a new Chapter 12 applicable to VATPs. Members welcome this proposal, which is generally in line with those applicable to SFC licensed corporations with respect to traditional asset classes and funds, as it would facilitate fund managers with existing VA positions to deposit the VAs of the funds that they manage into the VATPs without the inconvenience of converting VAs into fiat.

While this is outside the scope of this VATP Consultation, we would suggest that the SFC consider expanding the applicability of the new Chapter 12 of the Amended AML Guidelines to other licensed corporations as well, in order to facilitate subscription and redemption in VAs. Subscription and redemption in kind is very popular in the VA fund industry globally, and is often requested by investors of VA funds who themselves often have positions in VAs. With the safeguards of the requirements under the new Chapter 12 of the Amended AML Guidelines, we consider that SFC-licensed fund managers will be able to benefit from the flexibility to accept VAs into their funds with minimized money laundering and terrorist financing risks.

#### *(d) Pre-trade control*

Paragraph 7.21 of the VATP Guidelines provides that a VATP should only execute a trade for a client if there are sufficient fiat currencies or VAs in the client's account with the VATP to cover that trade, except for any off-platform transaction to be conducted by institutional professional investors which are settled intra-day, and no financial accommodation should be provided to its client to acquire VAs.

As the SFC may be aware, this is not in-line with the arrangements with traditional securities, with brokers often providing securities lending and financial accommodation to clients when such clients do not have sufficient cash or securities in the client's account. Bearing in mind SFC's "same business, same risks, same rules" approach, Members urge the SFC to reconsider this restriction.

Separately, while we note that the SFC proposed that the above restriction will not be applicable to off-platform transactions conducted by institutional professional investors, it is not entirely clear to Members why any off-platform transactions would be within the scope of this VATP Guidelines as these transactions are conducted outside of the VATPs on an as-principal basis between the relevant parties. We would appreciate SFC's clarification on this.

#### *(e) Custodial requirements*

Members agree with the SFC's objective with respect to the custodial requirements as set out in the VATP Guidelines to minimize exposure to losses arising from a compromise or hacking of VATPs. Naturally, custodial arrangement is an important concern for fund managers, in particular in relation to VAs. However, we note that the strict requirement of requiring VATPs to store 98% of client VAs in cold storage (with limited exception permitted by the SFC on a case-by-case basis) may not be practical for VATPs, and by extension, fund managers.

The transfer of client VAs out of cold storage are likely driven and directed by VATP clients' liquidity needs, and not by the VATPs or their associated entities. This requirement would hamper fund managers' ability to trade on behalf of their funds in a timely and cost-effective manner, in particular where there is a large trading volume as there may be delays and additional costs involved for VATPs to move VAs from cold storage to hot storage for trading. Another problem which may arise is when a VATP operate on an omnibus account basis, certain clients' trading may use up the 2% hot wallet "quota" and the VATP will have to subsequently transfer VAs from its cold wallet to its hot wallet for other clients to trade on the VATP. This may result in additional gas fees and delays which may ultimately be disadvantageous to VATP clients (and their clients or investors) as a whole. We therefore support a proposal that will provide more flexibilities to VATPs in relation to custodial arrangements, in particular in cold and hot storage allocation.

Further, we would like to request clarification that VATP clients are not prohibited to appoint third party custodians to safekeep VAs. Without the ability to appoint third party custodians that can be connected to all the VA exchanges used by the manager (including the Hong Kong licensed VATPs), a VA fund manager will need to undergo multiple settlement processes and arrangements with different VA-related intermediaries and VATPs. There may be increased operational challenges and risks to VA fund managers. Clients should be allowed to appoint and utilize third party custodians to enable secure storage of private keys and mitigate risks.

#### *(f) Raising regulatory expectations*

While Members are supportive of the SFC's proposal to lift many requirements from the SFC's existing guidance for VATPs under the VATP T&Cs, they are concerned that some of the requirements in the VATP Guidelines are not entirely consistent with existing regulatory requirements for other licensed corporations, which appears to be incompatible with the "same business, same risks, same rules" principle adopted by the SFC. For instance, the onboarding requirements for VATPs under the VATP Guidelines are different to those applicable to Type 1 licensed

entities providing VA dealing services under the *"Joint circular on intermediaries' virtual asset-related activities"* issued jointly by the SFC and the Hong Kong Monetary Authority ("**HKMA**").

Further, paragraph 1.7 of the VATP Guideline provides that where there are inconsistencies between the existing legal and regulatory requirements and those under the VATP Guidelines, the more stringent requirement should prevail. While this is not directly applicable to VATPs, considering this from a broader context, in the case where a licensed corporation provides services relating to both traditional securities and VAs, such licensed corporation would likely apply the higher regulatory standards across the board from a practicality standpoint even if the concerned activity does not relate to VAs specifically.

Members are of the view that this approach may result in unintended regulatory creep and raised regulatory expectations which may have sweeping implications to the financial services industry in Hong Kong at large, including fund managers. Members urge the SFC to review the VATP Guidelines so there are no unintended read-across implications from a regulatory expectation perspective for Hong Kong licensed corporations.

#### *(g) Competence requirements*

Members is supportive of the SFC's proposal that VATPs should apply for approvals under both the Existing SFO Regime and the VASP Regime to become dually licensed, as the SFC correctly pointed out that the features and terms of VAs may evolve overtime and a VA's classification may change from a non-security token to a security token (or vice versa).

However, as the SFC may appreciate, the talent pool for experienced individuals for this new industry and both regulated activities is limited, and it may be difficult for VATPs to employ appropriate personnel who are suitable to be licensed for operating VATPs, especially responsible officers ("**ROs**"). VATPs will need to employ individuals who has experience and expertise from both the traditional market and the new market, and this is not always available from the same individual.

We therefore encourage the SFC to provide more flexibility when assessing an individual's competence when such individual applies to be an RO of a VATP, in particular in relation to academic or professional qualifications and relevant industry experience. Specifically, we would be grateful if the SFC may refer to its circulars, *"SFC Adopts a Pragmatic Approach to Licensing Fund Managers"* dated 11 June 2007 and *"Circular to clarify competence requirements for existing licensed persons intending to provide asset management services"* dated 23 June 2017, and take a pragmatic approach in assessing the competence of ROs for VATPs.

#### *(h) Engagement with local and global regulators, standard setting bodies and industry*

Members also encourage the SFC's continued engagement with regulators locally (including with the HKMA in respect of stablecoins) and globally, as well as standard-setting bodies (such as the FATF), to develop a more consistent approach to the regulations of VATPs to minimize regulatory arbitrage and to create a certain and effective regulatory framework.

Finally, it would be helpful for market participants to understand the SFC's and other Hong Kong regulators' overall plan for VA-related activities holistically, and specifically how VATPs, VA intermediaries (such as Types 1, 2, 4 and 5 SFC licensed entities and other service providers) and VA fund manager regulatory frameworks will overlap and interact with each other. Members are of the view that a general road map will help market participants in considering and determining their regulatory and licensing strategies with respect to VA-related activities.

We appreciate the opportunity to provide our comments on the foregoing matters and hope that the SFC will find these useful and will take these into account in formulating its consultation conclusions.

We would be pleased to provide further explanation or to meet to discuss our response to the VATP Consultation.

Yours faithfully,

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The Alternative Investment Management Association Ltd (Hong Kong Branch)