APPENDIX

Q1: 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.

Yes, we believe that VATPs should be permitted to provide VA trading services to retail investors. As noted by the SFC, permitting retail access will help to prevent such investors from using unregulated, offshore VA trading platforms. It is preferable to allow retail investors to have access to VA trading on Hong Kong regulated platforms which will be supervised by the SFC.

We agree that there should be robust investor protection measures adopted to ensure that VATPs and their employees are fit and proper to carry on such business, and the assets held on the platform are safe. It will be necessary to find a proper balance between investor protection and customer experience so that it will be appealing for retail clients to use licensed VATPs and for local and global exchanges to establish operations in Hong Kong rather than move or continue to operate on an offshore, unlicensed basis (*e.g.*, without active marketing to the Hong Kong public).

Our comments on specific aspects of the investor protection measures are set out below.

Q2: Do you have any comments on the proposals regarding the general token admission criteria and specific token admission criteria?

General token admission criteria

We agree that VATPs have ultimate responsibility for ensuring that the tokens listed on their platform are suitable to be traded. VATPs should have a clear and transparent listing process for admission of a VA to trading and have due regard towards key matters such as the background of the issuer and management team, liquidity of the token, its code design and infrastructure security.

It is important that VATPs conduct rigorous due diligence on VAs admitted for trading. That said, since some tokens already constitute the underlying of products approved to be listed for public offering on the Stock Exchange of Hong Kong or selected approved overseas jurisdictions and exchanges, we recommend the SFC permit VATPs to conduct simplified due diligence on such tokens.

Specific token admission criteria

In respect of the specific token admission criteria for retail trading proposed by the SFC, we have concern that the requirement for a VA to be included in at least two "acceptable indices" issued by at least two "index providers" may be too restrictive. In particular, it appears from footnote 20 of the Consultation Paper that the SFC is suggesting VATPs should only be permitted to list the top 10 largest VA (or such other similar number).

While we believe market capitalization should be an important factor in selecting whether a token should be permitted to be traded by retail clients, it should not be the determinative factor for the following reasons:

- Firstly, as mentioned, permitting VATPs to provide services to retail clients will help to discourage their use of unregulated, overseas VA trading platforms. However, if the restrictions imposed are too high – such as by only providing a very limited selection of tokens – then the retail clients may continue to turn to unregulated platforms in order to have wider access to smaller tokens.

- Secondly, we note that VAs can be purchased for a variety of use cases, including as a utility token to be used in the Metaverse and other projects (including certain ecosystems developed in Hong Kong). Such VAs may not have the market capitalization to constitute a "large cap" token globally for trading purposes under the SFC's proposal, but may be popular in Hong Kong and elsewhere for its use cases.
- Thirdly, many tokens which may not be "large-cap" VAs under the proposed definition still have a large market capitalization and sufficient liquidity globally (and indeed more than many small cap stocks seen on stock exchanges which are permitted to be traded by retail clients).

In addition, requiring VATPs to rely on third-party published indices means that part of a VATP's listing process is not within its control. A change in methodology, periodic re-basing, a large increase in the market capitalization of another token and/or cessation of publication by an external index provider could result in different tokens being accessible to retail clients depending on when a VATP obtains a licence and/or reviews a particular token.

We note many exchanges have developed robust token listing procedures that take a more well-rounded approach. Instead of the specific token admission criteria currently proposed, we suggest that VATPs be required to adopt a more rigorous, holistic listing procedure to determine whether tokens should be accessible by retail clients (as compared to professional investor-only tokens), taking into account factors such as sufficient and adequate market capitalization, liquidity and utility for retail use.

While we appreciate that the SFC has left discretion under the VATP Guidelines to approve tokens which do not meet the large-cap VA criteria, we believe this does not provide enough certainty for many stakeholders to proceed – particularly for exchanges deciding whether to set up a VATP in Hong Kong, and who will consider restrictions placed on retail clients.

Q3: 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 broadly agree with the investor protection measures set out by the SFC. Our comments on specific aspects of the investor protection regime in the VATP Guidelines are below:

- Paragraph 9.7 of the VATP Guidelines provides that, except for institutional and qualified corporate professional investors, VATPs should set a limit for each client to ensure that the client's exposure to VA is reasonable, as determined by the VATP, with reference to the client's financial situation and personal circumstances.

  The SFC should provide more guidance on how this limit is intended to be established on an individual client basis, when no solicitation or recommendation is provided. For example, if the client already has a majority of investable assets in VAs at the time of onboarding, then the question would arise whether VATPs need to restrict the client's trading activity from the start and require the client to sell-only (which may be taken as a recommendation to sell).

  In addition, when calculating the client's exposure, the SFC should clarify whether VATPs can distinguish between risk profile and holdings in fiat-linked stablecoins with reserve assets (noting these should be treated as closer to cash-equivalents) and non-stablecoins when assessing the VAs.
- Paragraph 9.18 of the VATP Guidelines provides that VATPs should not post any advertisement in connection with a specific VA.

Since the suitability requirements are dis-applied for institutional and qualified corporate professional investors, and some VATPs may set up special landing pages or services designed for such investors, it would be helpful to dis-apply this requirement at least for these investors since "advertisement" is a very broad term.

- Paragraph 9.30 of the VATP Guidelines provides that VATPs should, upon request, disclose the financial condition of its business to a client by providing a copy of the latest audited balance sheet and profit and loss account required to be filed with the SFC, and disclose any material changes which adversely affect the VATP's financial condition after the date of the accounts.

  This requirement does not exist in the securities regime. Given that VATPs are already subject to rigorous capital requirements – and client assets are held on trust – we do not think this disclosure obligation is necessary. Such information is commercially sensitive and, depending on the background of the VATP, could be material non-public or inside information.

  If in fact a VATP has run into financial difficulties – and has breached certain financial resources rules – then we would expect the VATP to cease and wind-down operations in any case, rather than simply make selective disclosure about adverse financial conditions to certain clients who have requested such information.

Q4: 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?

It is currently commercially difficult to obtain insurance in view of the lack of insurers willing to provide such coverage (or if such coverage is offered, then the scope is narrow or the premiums required are high). Therefore, we welcome the SFC's proposal to allow a combination of third-party insurance and own funds to be used.

The SFC should set out further guidance on its expectations around the type of own "funds" which are permitted to be used. For example, in many cases, exchanges have established insurance funds which hold major tokens (*e.g.*, Bitcoin and Ether) traded on the platform and/or major stablecoins (rather than fiat currency). Since loss of the VAs, for example as a result of hacking, could result in compensation for clients in VAs rather than fiat currency, the SFC should clarify that own funds can be denominated in VAs as well.

Also, the SFC should clarify the ratio (or range) of own funds to client virtual assets it may approve in order to give an indication to interested parties on how much capital they may need to prepare when considering to apply for a licence.

We also understand that some larger exchanges are considering to set up captive insurers in light of the difficulty in obtaining third-party insurance. We suggest leaving flexibility in the VATP Guidelines for the SFC to permit non-third party insurance arrangements where the VATP demonstrates to the satisfaction of the SFC that such arrangements are appropriate.

Q5: 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.

In addition to the examples provided by the SFC, we think the SFC can consider requiring the own funds to be held with an appropriate third-party custodian – holding on trust for the VATP's clients – to be paid out upon certain specified circumstances.

We note that an increasing number of leading banks and custodians are providing VA custody services. This wider acceptance should be embraced and integrated into the regulatory regime, where appropriate, as a way to increase the number of checks and balances and increase client confidence.

Q6: 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?

We believe that in practice the requirement to store 98% of client VAs in cold storage is too high and operationally impractical. The process to move VAs from cold storage into hot storage is intentionally complex to ensure the security of the VAs. At the same time, platforms usually permit customers to withdraw assets at any time. In times of market volatility and stress, an extremely high percentage in cold storage could be overly burdensome as well as delay customer withdrawals, and this could contribute to, or amplify, client anxiety.

Therefore, we welcome the added discretion in Paragraph 10.6(c) of the VATP Guidelines for the SFC to lower the percentage of VAs held in cold storage and suggest that the word "*limited*" be removed to demonstrate that the SFC will approve a broader category of circumstances as long as the VATP can demonstrate that client VAs will be properly protected.

As noted above, the SFC could also consider permitting the flexibility to use a licensed and reputable third-party custodian (including those based outside Hong Kong) to hold client VAs. This could offer increased protections for Hong Kong users, and promote protections similar to existing arrangements in the securities context.

Q7: 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?

We welcome the SFC's intention to look into permitting VATPs to offer trading services in VA derivatives. As noted by the SFC, VA derivatives are an important tool used by institutional, corporate and other investors to hedge their activities and manage risk.

There are a number of popular VA derivative products currently traded, including perpetual and delivery futures contracts and European-style options which we believe institutional and other investors would be interested in trading on VATPs.

Noting that VA derivatives trading can be more risky than spot VA products, the SFC can consider introducing additional safeguards such as restricting certain futures and options products (*e.g.*, where the user could lose more than the original investment) to institutional and qualified corporate professional investors, as well as restricting the leverage which can be used by clients depending on their classification.

If the SFC can provide an outline as to when it will consider permitting VATPs to offer trading services in VA derivatives as part of the conclusions to the Consultation Paper, we believe this will be a strong encouragement for platforms to consider establishing operations in Hong Kong and support Hong Kong's efforts to establish itself as a leading VA hub.

Recognising that this would be a new type of trading activity currently not overseen by the SFC, we think the SFC could consider, at the initial stage, a further "opt-in" approach for VATPs looking to

offering VA derivatives trading so that the SFC can have the opportunity to assess and understand such activities and VATPs can demonstrate they can comply with the SFC's high regulatory expectations.

Q8: 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?

Access to liquidity and conflicts of interest

Given that VAs trade on a global basis, it is important for platforms to be able to access global order books in order to reach the deepest pools of liquidity. High liquidity means better execution and prices, tighter bid-ask spreads and lower slippage, which in turn reduces liquidations and opportunities for market manipulation. A deep pool of liquidity is especially important during periods of high market volatility when consumers may want to quickly exit their VA positions.

For global platforms looking to set up a VATP in Hong Kong, the SFC should make clear that VATPs can use order routing to access the global order book of their global affiliates, if any.

In addition, the SFC should clarify that VATPs can accept broker-dealers (including affiliates) onto the platform to submit orders which can be matched against other global order books. Such broker-dealers would be an ordinary user on the platform, and therefore would be under the same trading rules as other Hong Kong users.

In the case of broker-dealers who are affiliates of the VATP, we understand the SFC's concerns about potential conflicts of interest where the VATP (or its affiliates) may be seen as trading against its users. However, we believe that appropriate internal controls and procedures can be put in place to ensure that these risks are properly disclosed and mitigated, and such controls and procedures would be subject to the SFC's oversight. For example, the SFC could require VATPs to have audit trails to demonstrate that the orders being submitted on the trading platform by the affiliated broker-dealer are non-proprietary back-to-back transactions.

The SFC has proposed certain amendments to the "Conflicts of Interest" section of the VATP Guidelines regarding off-platform back-to-back transactions, but should further clarify that VATPs are permitted to have affiliates entering into back-to-back transactions on the platform, trading as principal, where no market risk is taken by the affiliate.

Other non-spot trading services

Many platforms offer a range of VA services other than spot trading, such as staking-as-a-service, futures, options and derivatives trading. As noted under Paragraphs 7.23 – 24 of the VATP Guidelines, VATPs should not:

(a) conduct any offering, trading or dealing activities in virtual asset futures contracts or related derivatives;

(b) provide algorithmic trading services to its clients;

(c) make any arrangements with its clients on using the client virtual assets held by the Platform Operator or its Associated Entity for the purpose of generating returns for the clients or any other parties.

Depending on the structure and nature of the arrangements, these activities may not be licensable under the amended Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) ("**AMLO**") or Securities and Futures Ordinance (Cap. 571) ("**SFO**") regimes. While under the VATP

Guidelines, the SFC does not intend to permit VATPs to provide such services, they may have local or global affiliates who can offer such services in Hong Kong lawfully.

The SFC should clarify whether a VATP will be permitted to introduce clients to affiliates and/or third parties providing these services, assuming (i) such activities are lawfully conducted in Hong Kong and (ii) the VATP makes clear that such services are not provided by the VATP and therefore not protected under the AMLO or SFO regimes.

Other Comments

Dual licensing

Paragraphs 89 – 92 of the Consultation Paper note that VA trading platforms "*should*" apply for approvals under both the AMLO and SFO regimes to become dually-licensed and approved, in order to avoid contravening the licensing regimes and ensure business continuity in case a VA's classification changes. The SFC should confirm that it is *not* a mandatory requirement to be dually-licensed.

We do not think that VASPs should be required to obtain a securities licence unless they expressly intend to conduct securities activities by facilitating the offering, issuance and/or trading of security tokens for the following reasons:

- Firstly, many global platforms are not licensed for securities activities in other jurisdictions and this is a deliberate part of the platforms' global regulatory strategies. As part of many global platforms' listing procedures, they will obtain opinions confirming that the tokens traded on their platform are not securities. For these exchanges, in the unlikely event that a VA is conclusively re-characterized as falling within a category of "securities", the global platforms will delist such token from their offering. In such circumstances, the Hong Kong VASP likely will also delist the token in order to align with their global platform's order book and trading strategies (*e.g.*, as they may stop covering and conducting due diligence on that token).
- Secondly, we note that under the proposed token admission criteria for security tokens, VATPs would not be permitted to offer security tokens to retail investors. Therefore, any tokens which are found to be "securities" would need to be withdrawn from trading for all retail customers in any case. In practice, token holders will be allowed a certain time frame to withdraw delisted tokens from the platform. This is not dissimilar to delisting in the traditional securities market, which is not uncommon.
- Lastly, we think that the risk of a token being subsequently re-characterized as "securities" should be quite low in practice. Before listing a VA, VATPs may (or in the case of proposed retail-eligible tokens, will be required to) obtain a legal opinion opining that the token is not "securities". If a VATP only intends to offering non-security tokens to be traded, by applying for a licence under the SFO regime, they would be representing that they intend to conduct securities activity, which is contrary to the legal opinions they have obtained.