

**Consultation Response to the Hong Kong
Securities and Futures Commission (SFC)**

Date: 31 March 2023

welcomes the

opportunity to provide a response to the SFC with respect to the Consultation Paper on the Proposed Regulatory Requirements for Virtual Asset (VA) Trading Platform Operators Licensed by the SFC of 20 February 2023.

Hong Kong is widely recognized as a leading financial services market that is underpinned by a highly respected regulatory regime. A well considered regime for virtual assets will continue to position it as a global leader and innovator. We look forward to working with the SFC and the wider industry to develop a regulatory framework that protects consumers, provides certainty and fosters innovation.

Board and Senior Management recognize the value and importance of fit-for-purpose regulatory frameworks being in place that enable continued development and growth of this emerging technology. Such initiatives bring structure to industry participants and confidence to consumers. We acknowledge Hong Kong's progress on crypto asset regulation and its intent to license all centralised VA trading platforms carrying on their businesses in Hong Kong or actively marketing their services to Hong Kong.

There are a number of regulatory requirements in the existing draft that we believe will benefit from further regulatory guidance or may need updating to cover potential gaps in regulatory protection for customers. We strongly believe that regulation must be fit-for-purpose, take into account the impact on customers' willingness to access the crypto industry, and follow a framework that is clearly defined for all participants. We have attempted to provide constructive responses to the following questions in light of the Consultation Paper's emphasis on centralized VA trading platform providers.

Responses to Consultation Paper's Questions

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.

Large-Cap VAs - We would question how the SFC defines Large-Cap VAs. As currently worded, it will deprive many retail customers from trading in virtual assets that they have been able to trade to date. We are unsure of the rationale for requiring a Large-Cap VA to be listed on at least 2 separate index providers, one of whom needs to have experience in publishing indices for conventional securities. There are limited options for conventional securities and of those that do, they only provide indices for a limited number of virtual assets. The industry uses many of its own index reference points (such as CoinMarketCap and CoinGecko) and so we suggest the SFC consider the appropriateness of not allowing these industry standard indices to be used. Another metric could be where the Virtual Asset is traded on at least [x] exchanges.

Limits on Retail Customers - There is a requirement for a Platform Operator to set a limit for each customer to ensure that the customer's exposure to virtual assets is reasonable, as determined by the Platform Operator, with reference to the customer's financial situation and personal circumstances. We interpret this as the customer's exposure being relative to their overall net worth, experience, and risk tolerance.

We note that Platform Operators will be required on a best efforts basis to understand a customer's overall exposure to digital assets, but this may be difficult to execute in practice - customers often have multiple accounts on numerous VASPs and so we will be reliant on the applicable customers disclosing this information to us. Customers may also continue to maintain accounts with multiple VASPs precisely in order to, in aggregate, have greater exposure to virtual assets than if they were using just one VASP.

We would suggest that Platform Operators be able to take a risk based approach based on the information available but also based on customer activity on the platform, and that there is allowance that this is subject to a customer providing full disclosure to the Platform Operator. Notwithstanding there is not a requirement to verify the customer net worth and therefore this requirement will only provide limited protection to consumers given they may look to access the services of multiple VASPs at the same time in order to bypass the limits a single VASP imposes.

Customer Concentration Risk - There is currently an obligation for the Platform Operator to have in place appropriate tools for assessing a customer's concentration risk and such an assessment should be based on the information about the customer obtained by the Platform Operator through its know your customer process and any virtual assets held with the Platform Operator.

However, there is limited guidance as to what outcome this seeks to effect and expected actions on such circumstances. It is also not unusual for customers to concentrate their investment in only a small number of major crypto assets (ie BTC and ETH only). This requirement would be more applicable in the instance where high risk virtual assets are being offered, and Platform Operators are obligated to provide guidance to customers of the risks associated with concentrating their investment in assets that have been assessed to be higher risk.

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

Exchange Proprietary Tokens - Many platforms have proprietary tokens that are available for customers to hold and trade, and where such tokens deliver benefits such as reduced trading fees. The Large-Cap VA requirement will likely mean these tokens cannot be traded by HK customers, meaning in many cases that HK customers will be at a disadvantage from a customer experience perspective from customers of exchanges in other jurisdictions who can still avail themselves of the benefits of holding an exchange proprietary token. We would suggest that the SFC considers an allowance for the listing of exchange proprietary tokens where they provide benefits to the customers of the relevant VA trading platform, even if such tokens may not fulfill the Large-Cap VA requirement.

Change in a VA classification - Current requirements require VA trading platforms that do not hold a securities license to address the risk of a virtual asset's classification changing from a non-security token to a security token. Guidance from regulators is increasingly required to aid in determining how an asset meets the definition of a security in order to monitor for any changes that may occur that result in a virtual asset moving from a non-security to being a security, or vice-versa. We would suggest that the SFC considers providing additional guidance on Hong Kong's definition of securities as it relates to virtual assets, so that VA trading platforms

do not rely on interpretations by regulators in foreign jurisdictions given the differing views currently being applied for a single virtual asset, often within the same foreign jurisdiction.

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?

Insurance requirements - We would highlight there are very limited insurance options available for the industry at present, with those providing such services only providing a minor level of coverage compared to the assets held by the VA trading platform. We would recommend the SFC considers providing clarity in respect of what it believes would be an appropriate level of coverage, and that this be assessed based not solely on compensation measures, but also on the systems and controls that the Platform Operator deploys to protect its customers' virtual assets, as well as its own.

For example, many Platform Operators deploy a mixture of cold and hot wallet structures to hold customer funds, with cold wallet structures by their nature affording a high level of protection to the customer. We would hope the SFC would reconsider the position implied under Section 10.24 that there must be 1:1 compensation coverage by giving allowance to cold wallet structures and security controls maintained by Platform Operators such that a 1:1 compensation requirement is not always needed.

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?

Hot Wallet requirements - Currently, it is prescribed in the proposed regulations that only 2% of assets are stored in a hot wallet. We would highlight this seems very low given the need for assets to be available during times of market volatility so would recommend consideration of the relevant business model to give allowance to operate at a level closer to 10% provided requisite controls are in place. We would also highlight that VA trading platforms may have different business focuses that may alter how their users need to access their virtual assets. For example, a platform that focuses on custody may be fine to operate with a 2% hot wallet threshold on the basis that users are not accessing their assets regularly, whereas for a platform with a higher focus on trading it would be appropriate to assess based on funds not being used by users to trade. We would also suggest the SFC considers assessing the user risk based on volume of virtual assets held on a particular VA trading platform as part of a risk-based approach to hot vs cold requirements. Considering the operating nature of VA trading platforms in general, we would suggest the SFC considers either (i) a less-prescriptive principles based requirement that includes factors such as nature of customer use of the platform, element of virtual assets that are unused, and aggregate volume of assets held, or (ii) a higher prescriptive

threshold of around 10% of customer virtual assets being held in hot wallets is permitted given the liquidity required during times of market volatility.

Custody - Where a licensed platform operator sets aside its own funds or the funds of a corporation within its same group of companies to satisfy the requirements, can the SFC clarify if the associated entity has to be a subsidiary of the licensed VA provider? If this is the case then query where the protection is if the associated entity has to be a subsidiary of the licenced entity. If the licensed entity is subject to insolvency proceedings, its subsidiaries may also be captured or restricted, preventing customers from accessing their funds. We would propose consideration of support for a separate structure to be permitted that creates separation between the legal entities. An example may be the use of a foundation or trust that is not held under the licensed VA provider, and then having that structure (whose objects are solely to provide custody services to that VA trading platform's customers) be the corporate structure that customers contract with for the provision of custody services.

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?

Virtual Asset Derivatives Trading - We would recommend the SFC give consideration to inclusion of virtual asset derivatives in the regulatory framework similar to the approach adopted in other progressive regions. This enables institutions in particular to both trade the crypto markets whilst being able to hedge their risk on the same trading venue. Inclusion of derivatives would make it a more complete regime that is attractive to more major global industry participants and be a differentiator in the APAC market.

We would propose the offering of virtual asset futures and swaps are permitted in that they enable customers to hedge their risk whilst minimizing risk to the broader market. This is achieved through operating a purpose built platform that requires prefunding of a customer's account for the purposes of hedging their trading positions. Positions could be allocated on a riskless principal model whereby the risk for the platform and the consumer is limited only to assets available on the platform. Please note that the virtual asset industry manages margin for derivatives positions without the need for customers to incur separate margin loans that they need to cover should their position move against them. This benefits the customer as they can ring fence their exposure to the margin that they have posted for the trade, without worrying about a margin lender/broker having a claim against them for the leveraged portion of the trade.

In turn, the VA trading platform providing the service can be obligated to validate the funds deposited by the customers are only being used by the relevant customer for the intended purpose (i.e. assets cannot be rehypothecated or reused elsewhere). Comingling of assets for any other purpose is strictly prohibited in order to maintain a sustainable business model.

It would be reasonable to require the exchange to give undertakings that the collateral used for trading is not subject to any other use than the intended purpose, with this achievable via regular Proof of Reserves reporting that actually prove (and document) their assets and liabilities. These can be made available to customers, the public and the regulator directly (see for example

In addition, independent third party validation reports conducted periodically and made available to the SFC can provide further comfort.

Virtual asset derivative products are popular amongst institutional and professional traders, and experienced retail traders that have experience in the virtual asset industry. Global average 24 hour volumes and open interest for virtual asset derivatives products are now in the 100s and 10s of billions USD¹ respectively, and similar to traditional markets virtual asset derivatives volume is much larger than average daily volumes for global spot markets². The virtual asset derivatives markets have also shown continual growth - for example, Bitcoin derivatives 24 hour open interest has grown from approx USD 4 billion to USD 9 billion since November 2020, and even following the fall of FTX in November 2022 open interest has recovered³. It is expected to continue to grow further with the increased adoption of virtual assets and the development of on-chain real world assets furthering the need for advanced trading and risk management solutions.

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.

Travel Rule - Based on the current requirements the industry will be actively seeking guidance on the SFC's expectations for handling of VA transfers and exchange of information. This is particularly so in relation to the timing of the transfer, data involved, and handling of mismatching data or counterparties that are not subject to Travel Rule requirements. We suggest the SFC considers requiring vendor solutions to be interoperable given a key issue currently faced by the industry is the lack of interoperability between available commercial solutions.

It is recommended Travel Rule implementation is considered on an iterative approach as has been adopted in other regions. Special consideration should also be given to the handling for transfers to/from unhosted wallets, particularly in light of the current technical limitations in identifying such transfers. Furthermore, clarification will be sought on the counterparty VASP

¹ Please see

<https://www.coingecko.com/en/exchanges/derivatives#:~:text=The%20total%20derivatives%20volume%20is,in%20the%20top%203%20rankings> and <https://coinmarketcap.com/rankings/exchanges/derivatives/>.

² Please see <https://www.coingecko.com/en/all-cryptocurrencies> and <https://coinmarketcap.com/>.

³ Please see

<https://www.theblock.co/data/crypto-markets/futures/aggregated-open-interest-of-bitcoin-futures-daily>

due diligence requirements in terms of how this is applied at a group level or an individual legal entity level given the differing structures of global VASPs depending on factors, such as jurisdiction of structure and operations.

Additional Observations

External Assessment Reports - To streamline the application process, we noted the SFC proposes to require a VA trading platform applicant to engage an external assessor to assess its business going forward, and submit the assessor's reports to the SFC (i) when submitting the licence application (Phase 1 Report) and (ii) after approval-in-principle is granted (Phase 2 Report). There may be benefit for the industry if the SFC could provide a list of external assessors who would be able to prepare the Phase 1 and Phase 2 reports given the unique nature of risk management and control frameworks for managing a VASP, or alternatively issue such guidance to external assessors in order to set an industry standard.

Industry Associations - There are a variety of virtual asset and blockchain-focused associations in Hong Kong. It would be informative for the industry as a whole if the SFC would consider publicly confirming if it already had engaged, or is planning to engage, with one or more of such associations. This would hopefully provide a continual dialogue with the industry, and for the industry to continue to support the SFC and the broader financial system in Hong Kong.

Conclusion

We thank the SFC for the opportunity for the industry to provide comment and input to the proposed regulatory framework. We believe the current consultative approach being taken by the SFC will prove to be a benefit for the virtual asset industry and Hong Kong's financial industry more broadly.

Please note that we respectfully request that our name not be published when the SFC publishes the results of the consultation, but the content of this submission can be published.