

Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators

SFC consultation paper answers:

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.

Yes, we agree to allow retail investors to access crypto via VATP.

Given many retail investors already have found avenue to access virtual assets often via platforms that do not hold relevant licenses, where no transparency or reporting are obligated to be shared with the investors, even without the insurance requirements imposed, the fact that regulated VATP needs to do regular filing of its financial resources status, having third party audits and sufficient security expertise to manage virtual asset custody etc, already offers a better option compared to platforms that are not subject to these requirements.

VATP could also impose various investor protection measures including investor knowledge tests.

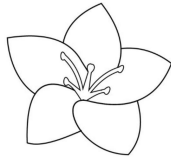
2. Do you have any comments on the proposals regarding the general token admission criteria and specific token admission criteria?

The proposed procedure via internal committee to assess target token prior to listing, covered many grounds and are well thought out.

However the requirement (suggested on Guideline for VATP 7.5C) of only possible to list tokens that have been issued at least for 12 months, meaning the VATP won't be able to do initial token listings for new projects, which in terms of scope of business, might impact its attractiveness for investors who are keen to participate in any such initial exchange offerings of new tokens.

Also the requirements for VATP to conduct audit or demonstrate 3rd party audit is reliable and review for security flaws for smart contracts from the token issuers, is a rather high expectation placed on VATP's capabilities, in essence VATP is a centralized trading platform where it operates similarly to other type of orderbook based trading venues, it may not even have sufficient in house smart contract develop resources or auditor expertise to conduct such audits, actually smart contract audit in itself has been a bottleneck/high growth industry over the past few years which made the smart contract auditors a scarce resource and very highly sought after.

We would suggest VATP to evaluate the smart contract risk by referring to the historical audit record from third party auditors, the respective auditors' auditing track record as well as historical bug reporting/hacking records for the project as minimal requirements.



As to specific token admission criteria, the requirement of only including virtual assets in at least 2 “acceptable indices” issued by at least two “independent index providers”, and that required those index should be sufficiently liquid, rules-based of which provider should possess the necessary expertise and technical resources, may create confusion and inconsistency for listing. VATPs may inconsistently provide documentary evidence in proving the above criteria, and retail investors may have a difficult time to understand and assess such requirements. Although not without its limitations, we do think that the Japan FSA approach where top ranked liquid virtual assets get approved, the method itself is more easier to implement and understand. For instance VATP could be allowed to trade top 20 assets, then allowing VATP to exclude any if the VATP has strong reasons to disqualify the asset based on its Due diligence efforts as required in the guidelines.

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?

Avenues where retail investors themselves are able to hedge/insure against their VA exposure if needed to. See answers to the next question.

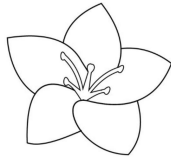
Investor protection could also be implemented by way of knowledge test and to assess investor’s risk appetite.

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?

Regarding Insurance requirements: where 98% of client VA assets should be hold in cold storage; where hot storage should be fully covered by insurance policy, and cold stored assets should have substantial coverage such as 95%, where if not possible to get such policies from insurers, then the LC needs to set capital/financial resource from its own books or from group companies aside in a designated account as reserves against hacking/default risks, to cover 100% of client assets on platform.

This requirement puts a heavy financial burden on competitiveness of the VATP compared to other peers, given other regulated/unregulated trading platforms are not subject to the same standard.

Insurance policy for VA service providers are hard to procure, very costly and often do not cover hot wallets; and setting aside the amount of capital as large as the client asset base from LC’s own balance sheet rendering only large financial conglomerate able to operate the VASP and smaller sized LC incapable to grow its business as it would lack the sufficient financial resources to put aside to subsidize the LC’s activities.



For clients of such VATPs, if the trading/custody fees charged on aggregate (given the cost of this full insurance coverage plus other regulatory reporting/compliance duties) is quite high, double or triple level of fee charged compared to that of a comparable platform elsewhere say coinbase (which is also regulated and by the SEC), then clients (end customers) may elect to open accounts elsewhere use such VATPs from other jurisdictions instead of the HK VATPs.

We would suggest to consider a more open approach, where the VATP must sufficiently disclose the risks of possible security incidents the client might be exposed to, then provide a dual fee charging tier services for its clientbase, whereby the insured fee charging option includes the insurance coverage and the plain fee charging option excludes the insurance option, for clients themselves to determine if they want to pay extra for the insured solution vs a plain access to trading without the insurance but cost a lot less in fees.

For specific risks types where a regular insurance policy does not cover, the VATP should be allowed to cooperate with 3rd party insurtech providers to offer dedicated insurance solutions where if clients are keen to hedge such risks, clients can individually pay for such insurances and get guaranteed payouts if the hacking/default incident does occur.

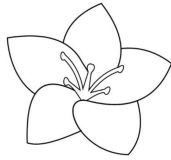
In this instance the VATP could use the financial resource set aside for this purpose to act as underwriting capital for such coverage policies, HK government VA task force or any other funding source can also contribute initial funding to enlarge this underwriting capital base, whereby clients of such VATP should be paying premiums to get coverage for their VA assets.

The government related funding can exit later when the traditional insurance industry gets familiar with how to model and underwrite the risk for VA assets; or if possible, allowing a web3 model to crowd-source from any interested participants in attracting the underwriting capital if these participants find such returns to be attractive.

On one hand the solution addresses a real issue, on the other hand it lessens the burden of competitiveness for licensed VATPs and meanwhile it can be a business opportunity to earn returns from VA investors who are willing to pay the premiums.

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.

bearing the comment for question4 where we do find the overall insurance requirements is rather stringent, however if the requirements holds, funds better be held in escrow accounts instead of house accounts.



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?

For centralized VATP, a lot of the trading unless it needs to leave the exchange, is orderbook management, only when it settles and in&outflows, it requires assets on hot-wallet to facilitate.

A lot of the times, attacks to hot wallets is either direct access to the server device where the seed phrase of the hot wallet is stored or via social engineering activities to gain access to user authorization details; in house overall IT operational security standards where proper password manager in combination of hardware 2FA such as Ubikey etc is adopted that renders access to devices impossible on remote basis, combined with continuous training and awareness to employees about risks of phishing attacks and social engineering, can go along in defending many common attack factors.

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?

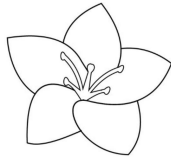
For VATP to operate competitively with other crypto exchanges, derivatives should be allowed to be offered. It is also important for licensed type9 that are subject to VA conditions to be able to effectively hedge their spot positions or adopt future vs spot arbitrage strategies.

As the specific type of products, futures and options, especially futures where the market size and depth is already larger than the spot market, is more suitable. In order to control risks of over leverage, the SFC can put restrictions on the maximum amount of leverage allowed for the future products, for instance it could limit any futures offered be it termed or perpetual products on VATP to have a maximum of 3-5x leverage. The SFC may at the same time also implement limit for leverage on asset manager level, whereby depending on strategies, max leverage per fund level can be applied, such as 3-5x for hedge funds and multi-strategies, and 2-3x for long only biased funds, where VATP can also require clients to maintain sufficient/over collateral against such leveraged positions.

We suggest that Such derivatives products should be offered to PI only with sufficient knowledge about risks associated with trading crypto derivatives.

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?
N/A

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.



Mulana

Investment Management

Implementing travel rules as recommended by FATF may be difficult when there are not many of VATP from other countries have already imposed such rules. We could use Korea market as an example. In Korea, several organizations have invited different VATPs to become members and they agree to share members' clients' information for VA transfer between members, and such information sharing is conducted via API. On a later stage Hong Kong may impose such membership mechanism for VA transfer.

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

We think disciplinary Fining should be the same as the existing guidelines under SFC.