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.

Our Comments:

We agree that the licensed platform operators should be allowed to provide services to the retail investors given the proposed robust investor protection measures. In the light of the keen demand from retail investors towards the investments in virtual assets, and the inherent volatile nature and high propensity to market manipulation, denying their access to the regulated VATP regime would merely push them to the unregulated trading platforms where they are more vulnerable to those malpractice of market manipulations or fraudulent platforms, and suffer even huge losses with no protection at all.

It cannot be denied that no matter what protection measures for retail investors are in place, it is in no means implied that they are, to any extent, less vulnerable to incurring any or even material losses in their investment of virtual assets, given the inherent volatile and highly risky attributes of the market.

Question 2:

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

Our Comments:

Having in mind that the Commission has proposed to setup those measures with token due diligence, ongoing monitoring of the traded token if it continues to fulfil the admission criteria as specified by the review committee of the licensed VATP, as well as the additional requirements for legal opinion to be sought regarding categorization of the traded token that it would not amount to the definition of "securities" under the SFO. We would like to express our comments as shown below.

One crucial point of consideration here is that given the intricate peculiarities of the VA tokens, the criteria applied to justify the eligibility of a said token for retail level may themselves change over time and the underlying factors inducing to the resultant changes may not be practically or precisely detected. Furthermore, provided that once detected, legal opinions may be required again if the changes detected would actually render the token not to be eligible for retail level or should be withdrawn instead.

Further that the VATP should have a token admission and review committee in place, and regular reports submitted to the committee with regard to any material changes in relation to the admitted token which would affect the eligibility of the token available to retail investors. These requirements are conducive and recommended as it makes it a routine review and/or update of the tokens' characteristics offered for trading in the platform.

Question 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?

Our Comments:

Given that where a VATP intends to make a specific virtual asset available for trading by retail clients, the very first thing is to ensure that the VA should satisfy the requirements of an "eligible large-cap virtual asset", which is referred to as a virtual asset from at least two "acceptable indices" issued by two independent index providers (details in para 7.6 of the Guideline for VATP), the requirements are stated in onerous details to formulate a rather stringent set of criteria where a practical example in compliance is still yet to be discovered.

Apart from the above, the VATP should also comply with the requirements imposed by the Commission to ensure that it is capable to provide trading of the virtual asset to be made available to retails; not to mention the additional smart contract audit requirements stated in para 7.7 to 7.8 of the Guideline for VATP.

With the restriction on proprietary trading for VATPs already in place, to further safeguard the interests of the investors, we propose that the virtual assets under custody of the VATP or its associate entities should be prohibited from pledging as collateral for acquiring any sort of financial facilities.

In the light of the prevailing licensing conditions, the proposed paid-up capital requirement of HKD 5 million is disproportionately not commensurable with the expected turnover value of the traded tokens taking into consideration the mandatory requirement to provide the compensation arrangement (para 10.22 to 10.24 of the Guideline for VATP).

As in its nascent stage, we are of the view that the proposed requirements should be revised in order that the VATP thus licensed is able to operate in a regulatory regime where it can nurture and continue to survive and develop instead of being strangled by the tight grid of regulatory formalities.

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?

Our Comments:

It depends very much on the coverage of the insurance policy and the amount of compensation arrangement the VATP or its associate entities (the "**Operator**") are capable to set aside for such purpose.

In case where the coverage offered by the insurance company is not enough to offer sufficient protection and is relatively fixed in amount in its very nature in the interim of the review period, and that the Operator has a relatively high total value of client virtual assets under its custody which exceeds on a continual basis the covered amount offered by the insurance policy, the Operator would have a liquidity problem of filling the "gap" by the amount of compensation arrangement.

Let's illustrative this problem though a scenario below.

A Bull Market Scenario

If an Operator purchased an insurance policy with, say with coverage of USD100 million, of the coverage at the beginning of the year. If value of the virtual assets under its custody exhibits a yearlong bullish trend, then the amount covered by the insurance policy will become less and less during the year before the insurance policy is subject to next review; and that the Operator will have to set aside more and more funds in order to fully cover the risk of the virtual assets under its custody according to the mandatory requirement under para 10.24 of the Guideline.

Proposed Solution:

A threshold coverage ratio of 1.5X (1.5 multiple) be adopted to cater for the ever-changing market prices of the virtual assets traded under the Operator which allows higher level of flexibility. As far as the total value of virtual assets is less than 1.5X of the amount covered by "third party insurance + funds set aside on trust", no action of further funding is required. In case 1.5X threshold is exceeded, the Operator has to take immediate remedial action for additional fundings in order to keep the leverage under 1.5X.

Furthermore, as it is stated that the licensed Operator has to mandatorily maintain at all times that the amount of "third party insurance plus the compensation arrangement" should be sufficient to fully cover the total value of client virtual assets under its custody, and any incidence of shortfalls necessitates immediate notification to the Commission, which poses a regulatory burden to the licensed VATP or its subsidiary in providing the accommodative compensation arrangements.

It should be particularly noted that there are reported difficulties of obtaining an appropriate insurance policy providing sufficient coverage for risks associated with "hot storage" which is more vulnerable to hacker risk owing to its connection through the internet.

Additional points to consider:

It is stated in para 10.6 (c) of the Guidelines on VATP (and para 7.5 (c) in the Terms and Conditions for VATP) that:

"The Platform Operator and its Associated Entity should store 98% of client virtual assets in cold storage" except under limited circumstances permitted by the SFC on a case-by-case basis to minimize exposure to losses arising from a compromise or hacking of the platform."

Subject to stipulations as above, it is plausible to negotiate with the third party insurance provider to revise the coverage upward as risk from hacking of the trading platform has been substantially reduced, if not minimized at all!

It cannot be denied that it is the business decision of the insurers on the extent of coverage they are willing to undertake, or the amount of premium charged if they are to offer, on condition that the premium should be on a reasonable basis which allows flexibility for viability of the Operator per se.

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?

Our Comments:

It is stated in para 10.6 (c) of the Guidelines on VATP that:

"The Platform Operator and its Associated Entity should store 98% of client virtual assets in cold storage except under limited circumstances permitted by the SFC on a case-by-case basis to minimize exposure to losses arising from a compromise or hacking of the platform"

It is obvious that the Commission has already made use of the regulatory requirement to reduce the risk of using hot storage apart from adopting any technical remedial solutions beforehand.

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?

Our Comments:

The current SFO Licensing Regime does not allow SFO-licensed VATPs to offer, trade or deal in virtual asset futures contracts or related derivatives. And that the Commission also restricts the VATPs to offer any facilities to its clients, thus no margins trading is available.

Yet, in the light of the buoyant demand for VA derivatives products, especially from the institutional investors who deploy derivative contracts as an effective hedging and/or leverage strategies to monitor their portfolio exposure to virtual assets which are inherently volatile, the introduction of VA derivative product should be a matter of time indeed.

Whether the VA derivatives contracts are deliverable to actual underlying virtual assets, or merely serve as a strategic or hedging tool which is financially settled in cash only upon expiry, remains an issue to be considered thoroughly since physical delivery entails more technical arrangements across the spot market and the derivative market.

Actually, it is appreciated that the Commission has made an aggressive and innovative leap forward in authorizing the virtual asset futures exchange-traded funds (the VA futures ETF) where retail investors can participate with limited indirect access to virtual assets under a regulated trading environment.

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.

Our Comments:

As it is noted that the Commission has prepared a draft of a stand-alone Chapter 12 of Virtual Assets in the existing Guideline on AML-CFT, and it has been renamed as the *Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (For Licensed Corporations and SFC-licensed Virtual Asset Service Providers) (AML Guideline for LCs and SFC-licensed VASPs).*

We would like to pinpoint a few areas for our comments.

Travel Rule (Section 12.12.2 and footnote 130)

Travel rule refers to the application of the wire transfer requirements set out in FATF Recommendation 16 in a modified form in the context of virtual asset transfers (in particular, the requirements to obtain, hold, and submit required and accurate originator and required recipient information immediately and securely when conducting virtual asset transfers), recognizing the unique technological properties of virtual assets.

In particular when a Financial Institution (FI) deploys a technological solution for ensuring travel rule compliance (Section 12.12.2) with focus on the interoperability of the solution to capture all the required information from the transfer itself as well as the relevant counterparties which may be the ordering institution, intermediary institution or beneficiary institution involved in the virtual asset transfer.

This solution in place is deployed to serve other purposes like as a monitoring device for any suspicious transactions (which is analogous to a monitoring and detection device of a trading system in ordinary brokerage). The concern here is that the VATP has to ensure itself the solution such deployed fulfills the requirements and compliance of the travel rule; due diligence on the solution device itself plays a crucial part in complying with the Guideline as well!

Unhosted wallets (Section 12.14)

Unhosted wallets (as stated in Section 12.1.8) refer to any decentralized virtual asset

exchanges, peer-to-peer platforms, or virtual asset businesses that are unregulated or with lax AML/CFT controls are particularly attractive to illicit actors or money launderers.

As popularly known that unhosted wallets are merely addresses on a blockchain which is difficult to determine who really owns and controls them, creating opportunities for the illicit actors to abuse this heightened anonymity. It poses a serious shortcoming in fulfilling the KYC requirements as identities of the originators or recipients are not known. In case of peer-to-peer transactions through unhosted wallets, there typically involves no intermediary to carry our any CDD at all.

The requirements in section 12.14.2 and 12.14.3 are rather comprehensive in satisfying the KYC requirements provided that no delayed CDD is accepted for any anonymous transfer through unhosted wallets.

[The End]