



28 March 2023  
Securities and Futures Commission  
53/F, One Island East,  
18 Westlands Road, Quarry Bay  
Hong Kong

Dear Director,

**Submission on a Consultation Paper on the Proposed Regulatory Requirements for  
Virtual Asset Trading Platform Operations Licensed by the Securities and Futures  
Commission**

HKVAEX welcomes the opportunity to comment on the Consultation Paper on Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the Securities and Futures Commission.

HKVAEX supports Hong Kong's regulatory efforts to formulate a virtual asset ("VA") service provider licensing regime to enhance the investor protection, and provide more clarity on the regulatory requirements, as well as transitional arrangements.

We believe that a VA regulatory regime should be proportionate and clear. We support the principle of "same business, same risks, same rules" whilst also taking into account the specific risks posed by VAs.

Questions regarding our submission or comments can be directed to  
via email and/or to

**HKVAEX Team**

**About HKVAEX**

[www.hkvaex.hk](http://www.hkvaex.hk)

HKVAEX established in 2022, we are a Hong Kong based virtual asset exchange with an aim to provide a compliant, reliable, and high-performance trading platform to our users.

**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.**

HKVAEX's response

HKVAEX strongly supports the inclusion of retail investors under the proposed regulatory regime, and considers that robust investor protection measures will bring a number of additional benefits including regulatory certainty, and improving the quality of services by establishing a high standard for licensed VA platform operators. We think that it is appropriate to manage risk in a similar way through the use of existing financial product regulatory infrastructure, with some enhancements to address the absence of known issues in the case of virtual assets.

Other than the token admission criteria for retail investors, we generally agree with the investor protection measures proposed by the SFC. The tokens which would be available for trading by retail investors will be very limited and we believe this will force retail investors to trade on unregulated VA trading platforms. We would therefore strongly encourage the SFC to reconsider the admission criteria for making virtual assets available to retail investors. We are of the view that introducing additional measures during onboarding to bring investors' awareness to the risks of virtual assets rather than restricting the tokens availability. The recommended additional measures are detailed in question 3.

**Question 2:**

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

HKVAEX's response

HKVAEX generally agrees with the general token admission criteria for professional investors, the general token admission criteria recognises how the token admission criteria may enhance investor protection and the consideration behind admitting a token. However, we are of the view that tokens made available to retail investors should not be restricted to specific token admission criteria.

We recognise that a more comprehensive token admission criteria is needed to protect retail investors. However, we do not support the view that retail investors should be entirely exempt from trading virtual assets unless such tokens are "eligible large-cap virtual assets". Such a stringent criteria is likely to create a profound hindrance and force retail

investors to unregulated VA trading platforms. Instead of restricting retail investors to “eligible large-cap virtual assets”, we would recommend the SFC to require VA platform operators to design a detailed VA admission process specifying both admission criteria and rejection criteria. Listing out rejection criteria can ensure VA platform operators would not admit VAs that fall under the rejection criteria. Most importantly, we think that having an adaptive approach is more useful than a fixed requirement.

As for the general token admission, we think that having a track record of at least 12 months is too restrictive. This criteria is inconsistent with similar virtual asset regulatory regimes in other jurisdictions. We believe that a track record of at least 12 months should not be a mandatory criteria, yet considered as part of a holistic admission criteria. If the track record is not available, VA platform operators should use the historical record of similar projects to form a projection. VA platform operators should set out criteria such as capital requirement, liquidity, for evaluating the historical record and determine whether or not to admit the VA. VA platform operators should also request past projects of the management or development team for enhanced assessment.

HKVAEX understands that it is imperative to require a prudent mechanism for token admission whilst at the same time remaining flexible and adaptable and appreciating the nuances to different tokens. We recommend the followings:-

- Inadmissible token criteria

Formulate a clear criteria of inadmissible characteristics of a token. We believe that the SFC should clearly define the characteristics of tokens that should be inadmissible for trading as this would help the VA trading platforms to draw a clear line between admissible and inadmissible tokens. The inadmissible token criteria should be reviewed from time to time to ensure that this captures the latest market development. This would also filter out scam tokens.

- Eligible jurisdictions for token admission

Set out the eligible jurisdictions for token admission. Jurisdictions such as the UK, Australia, have recently released consultation papers<sup>1</sup> on proposals for a more rigorous regulatory framework to regulate virtual asset activities. The virtual assets regulatory framework between these jurisdictions and Hong Kong are very similar. We suggest that the SFC sets out the eligible jurisdictions taking into account the virtual assets regulatory framework and the result of the FATF’s mutual evaluation. Tokens admitted on the regulated VA trading platforms in the eligible jurisdictions should be exempted from the large-cap specific token admission criteria.

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<sup>1</sup> *Future financial services regulatory regime for cryptoassets: Consultation and call for evidence* by HM Treasury of the UK Government, and *Crypto asset secondary service providers: Licensing and custody requirements* by The Treasury of the Australian Government

This approach has been used for remote onboarding of overseas individual clients, we recommend applying a similar logic for token admission, this would also foster the regulatory exchange and strengthen investors confidence.

Lastly, we do not agree with the prohibition of retail investors to trade security tokens. This is because retail investors can trade securities in traditional financial markets, retail investors will expect consistent treatment of similar products. Hence, it is logical to allow retail investors to trade security tokens provided that the kind of security token mirrors a security that retail investors are allowed to trade in traditional financial markets. We understand that the SFC may be concerned with the risks of security tokens as they may not be subject to the same or similar robust regulatory assessment as the traditional financial markets. To this end, we would recommend the SFC to require VA platform operators to formulate a robust assessment framework to evaluate the underlying assets of the security tokens and the kind of security tokens. Additionally, the SFC can consider limiting certain sectors for tokenising their assets.

**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?**

HKVAEX's response

HKVAEX strongly believes that having retail investors understand the risks of virtual assets trading is much more beneficial to investor protection in the long term rather than limiting access to such products. We have expressed our stance in question 1.

We would encourage the SFC to consider the following requirements for retail investors protection instead of restricting retail access to large cap tokens only:-

- Investor appropriateness training

Retail investors are more vulnerable to volatility in the virtual asset market as they may not fully understand the risks associated with the ecosystem and cybersecurity weaknesses. We see some VA trading platforms provide training covering some fundamental concepts on how virtual assets work. Such training may not always be sufficiently robust and reflective of the risk associated with virtual assets trading in reality. We suggest that the appropriateness training should be focused on market fluctuations and anti-scam education.

Further, we suggest that the appropriateness training should be refreshed on an annual basis.

- Appropriateness assessment

The objective of knowledge assessment is to assess whether an investor has prior knowledge in virtual assets. As mentioned above, we think that general training may not be sufficient and reflective of the risk associated with virtual asset trading in reality. Hence, the knowledge assessment may not be fully reflective of retail investors' knowledge and risk appetite. There are a number of recommendations in relation to the knowledge assessment. We understand that the SFC may not intend to implement granular requirements on the knowledge assessment, however, we think that the following would help to increase retail investors' risk awareness.

- *Replace the term "knowledge assessment" with "appropriateness assessment"*

The goal is to ensure that retail investors understand the associated risks of virtual asset trading and determine their risk profile. The term "appropriateness assessment" is more reflective of the intent. This is also to draw retail investors' attention as to whether virtual asset trading is appropriate for them.

- *A diverse question bank*

This is to encourage retail investors to do further research to educate themselves rather than "gaming" the appropriateness assessment to pass.

- *Cool-off period between assessments*

This is similar to above, encouraging retail investors to do further research to educate themselves. This would give them some time to rethink whether they are suitable for participating in virtual asset trading. We also suggest that the VA trading platform operators should not encourage retail investors to retake the test multiple times after failure, and retake attempts should be limited.

- Risk disclosure and risk warnings

We do not agree that risk disclosure alone can address the associated risks that retail investors face. We therefore think that it would be useful to display the risk warnings and must be forcibly closed by the investors. Other risk warnings requirements include differing degrees of risk warning for more volatile tokens, re-displaying risk warnings after a certain period of time.

**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?**

HKVAEX's response

HKVAEX strongly supports the modification of existing insurance requirements by introducing a combination of compensation arrangements. We agree that investor protection is of paramount importance and we appreciate that the SFC has taken into consideration the industry's feedback and is able to strike a balance between investor protection and market development. We support the arrangement of funds set aside within the licensed VA platform operator or a corporation within its same group of companies.

In addition to the proposed compensation arrangement, we recommend the SFC to consider extending investor protection specifically for retail investors. The Investor Compensation Regime ("IC Regime") was established with an aim to pay compensation to investors who suffer pecuniary losses as a result of default of a licensed intermediary in relation to exchange-traded products in Hong Kong and securities traded on a stock market operated by the Shanghai Stock Exchange or the Shenzhen Stock Exchange.

We believe that the IC Regime can provide a certain level of security to retail investors. At present, the compensation limit is HK\$500,000 for trading securities and futures contracts respectively. We suggest that the SFC extends the compensation coverage to virtual asset trading.

**Question 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.**

HKVAEX's response

HKVAEX suggests holding the funds under the house account of the licensed VA platform operator. The trust or company service provider ("TCSP") licence exempt the followings from applying for a TCSP licence:-

- An authorised institution (as defined in the Banking Ordinance (Cap. 155))
- An licensed corporation (as defined in the Securities and Futures Ordinance (Cap. 571))
- An accounting professional (i.e., Certified Public Accountant as defined in the Professional Accountants Ordinance (Cap. 50))



- A legal professional (i.e., a solicitor or a foreign lawyer as defined in the Legal Practitioner Ordinance (Cap. 159))

In this context, we believe that it may not be necessary to apply for a TCSP licence for the licenced entity. However, the compensation funds, whether they are held in fiat or virtual assets, should be kept in segregated accounts or segregated wallets. The funds should be kept in a cold wallet as we do not anticipate any need to access the funds on a regular basis. Further, we suggest that the private keys accessing the compensation funds should be assigned to signers who are not signers involved with maintaining daily wallet operations. We would also recommend that the private keys are kept under escrow arrangement. Under this arrangement, the risks associated with cybersecurity and collusion are reduced to minimal.

The reason we do not advocate escrow arrangement for compensation funds is that it may not necessarily provide the same level of comfort. Under escrow arrangement, the funds will be kept under third party custodian, as well as the private keys. The custodian may not be subject to the same level of security requirements in relation to the wallet infrastructure and cybersecurity measures as licensed VA platform operators. We are concerned that the third party custodian may not be capable of providing the same level of comfort as third party insurance.

#### **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?**

#### HKVAEX's response

HKVAEX recommends the use of the Threshold Signature Scheme ("TSS") solution for hot storage. TSS is an advanced form of multiparty computation ("MPC") that provides a greater resilience and security level to mitigate single point of failure. TSS enables a group of participants to jointly sign a message without any one of them having complete access to the signing key. In TSS, the signing key is divided into multiple shares, and each share is distributed among the participants. A predefined threshold of participants is required to cooperate in order to produce the signature. This ensures that no individual participant can sign a message on their own, and also provides fault tolerance in case some members are unavailable or compromised.

In short, the advantages of TSS are summarised as follows:-

- Greater security - it is significantly harder for attackers to gain access to TSS-based virtual asset wallets because there is no single point of failure. Multiple parties must be compromised to gain access to the private key.

- Tolerance to failure - Since the threshold number of participants required to sign a transaction can be smaller than the total number of secret share holders, the system can sustain multiple participants failing while still being able to generate signatures and approve transactions.
- Privacy - the nature of participants are not required to reveal their secret share to others meaning that every participant's input is kept private.

We think that the characteristics that TSS provides are more advantageous than other current technical solutions such as multisign.

#### **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?**

#### HKVAEX's response

HKVAEX would be interested in providing perpetual contracts. Perpetual contracts enable traders to hedge the underlying virtual assets' future price movements. They are similar to futures contracts in nature, except that they do not have an expiration date. Perpetual contracts are relatively simple in comparison to other derivatives products while serving the purpose of hedging risks. Investors do not have to worry about rolling over the expiry date, and each underlying will only have one corresponding contract, making it simpler for the platform to maintain as well.

The VA platform operator should monitor clients' margin level in real-time, and have well-defined mechanisms in place, to automatically liquidate the position should the maintenance margin fall below the required threshold.

The business model we would be interested in is to act as a platform operator matching orders from different traders. This would be performed under the same trading platform as spot trading. We would facilitate the liquidation process should the maintenance margin fall below the required threshold. Additionally, the funding rate would be collected every 8 hours. This is in line with the current industry practice.

We understand the potential risks the VA platform operator exposed by providing VA derivatives, hence, we propose the following investor protection measures:-

- Settlement entity  
Investors' margin will be held under a separate entity designated for settlement purposes. The settlement entity is responsible for settling trading accounts, clearing



trades, collecting and maintaining account margin, and facilitating the liquidation process.

- Insurance fund

In a volatile market, it may be difficult to ensure that the losing positions are liquidated precisely at the liquidation price. In cases where a VA platform operator is unable to liquidate position before an account reaches negative equity, the VA platform operator should have an insurance fund in place to ensure that profitable investors receive their profit in full and cover any excess losses incurred by a bankrupt investor.

- Set position limits

Impose position limits on the maximum amount of contract each account can hold. Alternatively, margin requirement per contract can be increased for accounts that have concentrated positions.

- Margin call prior to liquidation

If investors' accounts fail to meet the threshold of maintenance margin, the VA platform operator should notify the investors as soon as possible. This is to inform investors that they can either add funds to their accounts or reduce the position until the minimum maintenance margin requirement is satisfied.

- Leverage ratio

Apply different leverage ratios for investors who have different risk profiles. For example, allow higher leverage ratios for investors who have higher risk appetite or are professional investors, and vice versa.

#### **Question 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?**

#### HKVAEX's response

HKVAEX largely supports the regulatory requirements of the VATP Guidelines. Overall they are proportionate and clear.

We understand that the management of risk and the sensible protection of client virtual assets are key considerations. However, we strongly encourage the SFC to reconsider the requirement of storing 98% of client virtual assets in cold storage. Such a requirement is very restrictive and it is even stricter than the global market standard.

We recommend the SFC allowing VA trading platforms to lower the threshold of cold storage if the VA trading platform is able to demonstrate to the SFC their robust security and strong internal control mechanisms by obtaining industry certifications such as ISO270001 and SOC2. This provides incentives to the VA trading platform operators while ensuring that the VA trading platforms can satisfy the highest international security standards.

**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.**

HKVAEX's response

HKVAEX is supportive of the formulation of the Chapter 12 for virtual asset activities; it provides more clarity on the virtual asset transfer (i.e., travel rule) requirements. The practice of travel rules is in line with the FATF standard.

We note that there is a sunrise issue regarding the implementation of travel rules across jurisdictions. The FATF has published the *Targeted update on implementation of the FATF standards on virtual assets and virtual asset services providers* in June 2022, which indicates that as of March 2022, about a quarter of jurisdictions have started passing relevant laws and regulations and expected to implement them by the end of 2023. Around a third (about 37%) have not yet started introducing the travel rule. It was also indicated that temporary flexibility should be introduced to address delays in global implementation.

In Chapter 12, it specifies that the VA platform operators should perform counterparty due diligence before effecting a VA transfer. The VA platform operators are required to put in place corresponding measures to the risks presented by the VA counterparty. We generally agree with this approach because it addresses the sunrise issue. We would like to recommend the SFC to put in place a VA counterparty due diligence checklist that is akin to the current AML self assessment checklist. This is because the VASP regulatory framework varies in different jurisdictions, so having a VA counterparty due diligence checklist would enable VA platform operators to better align on the criteria for performing VA counterparty due diligence.

**Question 10:**

**Do you have any comments on the Disciplinary Fining Guidelines? Please explain your Views.**

HKVAEX's response

HKVAEX do not have any further comment on this.

**Other comments:**

HKVAEX's response

It would be helpful if the SFC would provide more clarity on the “pre-existing” requirements of a VATP to be eligible for the transitional arrangement. We think that the factors taken into account in assessing whether a VATP has a meaningful and substantial presence in Hong Kong are generally reasonable. However, it is not clear what is meant by “considerable number of clients and volume of trading activities”.

VATP businesses vary in scale, meaningful and substantial presence is relative. A VATP with a small customer base but a large volume of transactions should have equivalent potential as a VATP with a large customer base but small volume of transactions.

We think that clarity on this point is important to enable existing VATP to assess their eligibility of the transitional arrangement.