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<b>The Securities and Futures Commission</b>	Email	:
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Hong Kong	Your ref.	:

By Email ([VATP-consultation@sfc.hk](mailto:VATP-consultation@sfc.hk)) and Online Submission

**March 31, 2023**

Dear Commission,

**Re: Consultation Paper on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators licensed by the Securities and Futures Commission (Consultation Paper)**

We refer to the Consultation Paper published on 20 February 2023.

We appreciate the SFC's efforts in providing comprehensive guidance to licensed virtual asset trading platforms regarding the expected regulatory standards.

We are pleased to provide our detailed responses below. We will adopt the defined terms in the Consultation Paper for the purpose of this submission.

***Response to 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.***

1. We support that licensed platform operators should be allowed to provide their services to retail investors, subject to the proposed investor protection measures. The "serving professional investors only" restriction has put all Hong Kong VA trading platforms at a notable disadvantage, causing them to lose competitiveness compared to other overseas regulated platforms in major jurisdictions and unregulated platforms that can serve retail investors. This restriction may also inadvertently push investors to use overseas or unregulated platforms. We previously submitted our views on this matter to the Hong Kong Legislative Council during the legislative process in July 2022 and will not repeat them here.

2. As such, we agree that licensed VA trading platforms in Hong Kong should have the flexibility to offer their services to retail investors, provided that there are some appropriate investors protection measures and safeguards.

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

3. We agree that investor protection is very important, and we support that there should be some token admission criteria for tokens accessible by retail investors listed on HK licensed VA trading platforms.
4. We note from the Consultation Paper that in addition to the existing “knowledge assessment” requirement during onboarding, it is proposed that the platform operator should conduct an assessment of the risk profile of the client and establish limits for each client to ensure that the client’s exposure to virtual assets is reasonable, with reference to the client’s financial situation and circumstances. We consider that the enhanced safeguards are adequate for offering robust protection to retail investors.
5. The proposed specific token admission criteria in the Consultation Paper may be too restrictive, which ultimately may result in only a handful of tokens being available for trading by retail investors. The number of crypto indices providers and “eligible large-cap virtual assets” fulfilling the SFC’s proposed requirements (including the requirement that at least one of the index providers shall have experience in publishing indices for traditional non-virtual asset financial market) will be very small.
6. Since the SFC has already weaved in the above-mentioned enhanced protection measures, it may be appropriate considering allowing a wider range of factors to be included in the specific token admission criteria so that retail investors could have more token choices. We understand that the industry has submitted many different proposals for the SFC to consider and we urge the SFC to seriously consider the suggestions.
7. An overly restrictive token admission criteria which result in limited product types accessible by retail investors will reduce the attractiveness of licensed platforms to retail investors who are not prevented from trading on overseas and unlicensed platforms. Investors may continue to gravitate toward other overseas platforms which provide a more expansive range of products.
8. We also observe that stablecoins would unlikely meet the specific token admission criteria for inclusion. In practice, a few stablecoins have become the widely used virtual assets in the virtual assets ecosystem, acting as a bridge between fiat currency and virtual assets. While we acknowledge that the regulatory classification of stablecoins remains subject to the forthcoming framework to be introduced by the HKMA, their exclusion would again compromise the competitiveness of licensed VA trading platforms in Hong Kong in the interim.

***Response to 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 virtual assets trading platforms?***

9. We consider that the proposed requirements are already adequate to offer investor protection to retail clients to licensed VA trading platforms.

***Response to 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?***

10. We support the proposal to allow a combination of third-party insurance and funds set aside by the licensed platform operator to cover risks associated with custody of client virtual assets. We believe this approach adequately safeguards client interests while enabling flexible structuring of compensation arrangements by platform operators.
11. We suggest the SFC provide comprehensive guidance on the expected coverage and confirm whether such standard will apply uniformly across platforms. If not, we suggest the SFC clarifying in detail the key principles and factors which it may consider in approving the compensation arrangement so that platform operators can prudently account for these factors when arranging for coverage and structuring the custodial arrangements.
12. In particular, with regard to the requirement that compensation arrangements need to be reviewed and reconciled daily to ensure that the total value of client virtual assets under the licensed platform's custody are covered, this may impose operational difficulties to platform operators given the volatility of virtual assets. It is suggested that the frequency and practicality of conducting such reconciliation be revisited.

***Response to 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.***

13. We do not have a strong view on this issue.

***Response to 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?***

14. We will leave it to the industry players to provide suggestions on technical solutions on custody.
15. Separately, we note from paragraph 10.6(c) of the VATP Guidelines that platform operators should store 98% of client virtual assets in cold storage "except under limited circumstances permitted by the SFC on a case-by-case basis". We suggest

that the SFC should provide more clarifications as to circumstances which the SFC would allow for an exception.

16. In practice, the hard limit may be difficult to comply with as clients may, from time to time, have large withdrawals and the 2% limit on the hot storage may be exceeded. Where there are instances which the limit may have been inadvertently exceeded, platform operators may require time to rectify and transfer client virtual assets from hot storage to cold storage.
17. Accordingly, we propose the SFC to adopt a more practical and flexible approach that focuses on the underlying objective of safeguarding clients' assets rather than the strict compliance with an arbitrary figure. As long as platform operators have demonstrated that they have implemented adequate controls and procedures to monitor client virtual asset levels and promptly rectify any issues, we consider any temporary technical breach should be acceptable in such circumstance. In this regard, we suggest some adjustments to the current wording of the requirement so that it is not a strict 2% limit and would allow for more nuanced risk management that better reflects the realities of operating a VA trading platform.

***Response to 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?***

18. We would suggest the SFC take a more risk-based approach in considering whether VA derivatives should be allowed. For instance, it could be a starting point for VA derivatives to be offered to professional investors by HK licensed VA trading platforms. Some VA derivatives which are not particular high risk or difficult for investors to understand could also be accessible to investors.
19. Each VA derivative may have different terms and features, and a blanket ban may not be the most appropriate. VA derivatives in fact could serve as a tool to help investors gain exposure to VAs without having to hold the assets directly, and also enable more sophisticated hedging and portfolio management strategies.
20. With appropriate safeguards and risk management practices in place, we strongly support opening the VA derivatives market development in Hong Kong which will be in line with the vision of developing Hong Kong as an international virtual asset hub.

***Response to 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?***

21. According to paragraph 10.10(b) of the VATP Guidelines, the "Platform Operator and its Associated Entity should ensure that client IP addresses... are whitelisted." While IP whitelisting provides significant security benefits, it may prevent platform users/investors from accessing their own accounts when traveling overseas, as their IP addresses will not be whitelisted. We therefore request further guidance from the SFC on this matter.

***Response to 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.***

22. We note that the “travel rule” requirements have now been codified under the new section 13A of the AMLO which will take effect on 1 June 2023. However, we also note from paragraph 69 of the Consultation Paper that the SFC proposes to provide a 12-month transitional period for compliance with the requirements in relation to existing clients or virtual assets currently made available by licensed platform operators. In this regard, we would like to clarify whether such transitional arrangement will also apply to the compliance with the “travel rule” requirements as stipulated in the AMLO and the AML Guideline for LCs and SFC-licensed VASPs.
23. In any case, given the current status of developing trusted travel rule solutions, there may still be practical challenges for platform operators to strictly adhere to the “travel rule” requirements. Requiring strict conformity may compel clients to utilize unhosted wallets, counteracting the original objective of preventing money laundering. The SFC may wish to consider whether a phased approach to compliance would be deemed acceptable.

***Response to Question 10: Do you have any comments on the Disciplinary Fining Guidelines? Please explain your views.***

24. We do not have any comments.

***Other Specific Comments: -***

25. As the SFC is aware, it is common practice for Hong Kong licensed banks to require non-licensed corporations to provide proof of the SFC's grant of approval-in-principle in order to open a segregated bank account.
26. However, under the transitional arrangements, the "approval-in-principle" process may come after a pre-existing VA trading platform has been "deemed licensed" as of 1 June 2024. This means that the platform may not be able to open a segregated bank account before or upon being deemed licensed. Despite this, they are still required, under current regulations, to have a segregated bank account upon being deemed licensed. This requirement appears unworkable in reality.
27. Therefore, we urge the SFC to re-consider and clarify the approval process and steps, and to work with the HKMA if necessary in order to address the potential gaps as identified above.

We look forward to continuing our support and contribution in shaping Hong Kong's regulatory framework for virtual assets.

Yours sincerely,

**QReg Advisory Limited**