



BY EMAIL

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Securities and Futures Commission
Email: VATP-consultation@sfc.hk

Dear Sir/Madam

Consultation on Proposed Requirements for Operators of Virtual Assets Trading Platform

We thank the Securities and Futures Commission for the opportunity to participate in the consultation on the proposed requirements for operators of virtual assets trading platform.

We would also like to take this opportunity to applaud the initiatives taken by Hong Kong, in particular, the Securities and Futures Commission and Hong Kong Monetary Authority, to embrace the adoption and development of web3 and crypto and supporting the web3 community through useful engagement to develop regulations that promote the safe use and adoption of crypto.

Overall, we find the proposed regulatory requirements to be imposed on licensed VA trading platforms to be detailed and balanced to achieve the necessary protection for users of the platforms and to enforce safe guards required to operate a VA trading platform.

We enclose our responses on some of the questions raised for the consultation for your consideration.

As always, please do not hesitate to contact

should you have any questions in relation to our responses to the consultation.

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**PROPOSED REGULATORY REQUIREMENTS FOR VIRTUAL ASSET TRADING PLATFORM OPERATORS
LICENCED BY THE SECURITIES AND FUTURES COMMISSION**

SFC CONSULTATION

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.

We believe that the licensed platform operators should be allowed to provide services to retail investors.

As the SFC has acknowledged, restricting retail access to VA trading platforms does not stop retail investors from buying or trading crypto; instead, such restrictions inevitably lead retail investors to either (i) use overseas VA trading platforms; and/or (ii) use some form of peer-to-peer trading, which may lack proper regulations and retail protections. Further, legal recourse against these overseas VA trading platforms and/or peer-to-peer trading would be difficult for retail investors to access and pursue.

Of the investor protection measures described in paragraphs 28 to 52 in the Consultation Paper, we would ask the SFC to reconsider the following measures for the reasons given below:

- (A) Assessing a client's risk tolerance and risk profile to determine his/her suitability to participate in trading virtual assets – Whilst we acknowledge that this is a traditional and typical form of determining suitability of a product for an investor, in reality, such assessment is somewhat inconclusive because such assessment can be manipulated to achieve the desired result by the investor such that he or she is given access to the product. Instead, it would be more relevant and useful to focus on the investor's knowledge and experience of, and exposure to, virtual assets as described in paragraph 9.4 of the VATP Guidelines.
- (B) Imposing a face-to-face requirement for opening account as set out in paragraph 9.5 of the VATP Guidelines – This is not a necessary requirement and should be removed entirely. With technology advancement, there are many ways for licensed platform operator to verify the identities of the clients. By way of example, Hong Kong's virtual banks have been able to open bank accounts for users without the need for a face-to-face meeting for years.
- (C) Hard-limits - We agree that setting across-the-board hard limits for retail investors' maximum exposure is not necessary. Any such limit would only be arbitrary, impractical and makes the trading platform less attractive to use.
- (D) Virtual assets offer - We do not believe that it is necessary to distinguish virtual assets to be offered to institutional, professional or retail clients. Virtual assets are inherently volatile in nature, and experience and exposure would be a better indicator to ability to trade in these virtual assets than capacity/status. Whilst professional investors may have better financial status to absorb losses arising from virtual asset trading, they do not usually have greater knowledge or exposure to virtual assets than retail clients. The goal should be to allow open access to virtual assets to the market that has the proper experience and exposure.

Further, the SFC should balance the level of investor protections against the attractiveness of using such trading platforms, otherwise the efforts by the SFC and implementation of these requirements by VA trading platforms will be futile in opening up access to virtual asset trading to the Hong Kong market.

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

We have comments on the following admission criteria:

- (A) Background of the management or development team – It is not uncommon that many management or development teams of a virtual asset act anonymously or pseudonymously. The motivations behind such practice vary, but one commonly cited reason is that the anonymity and pseudonymity affords the management or development teams with additional personal security. As recent events have shown, having a “doxed” management or development team does not necessarily have any bearing on the safety of a virtual asset. That said, as a balanced approach, we suggest that the requirement should be that the management or development team of a virtual asset must dox to the licensed VA trading platform, but is not required to reveal their full identities to the public.
- (B) Requirements for the virtual assets to have supply, demand, maturity and liquidity, including a track record (such as at least 12 months trading record) – In crypto, the market moves relatively fast which means new players continuously enter the market to launch their virtual assets. In our view, requiring that a virtual asset needs a track record prior to listing on the licensed platform operator means the market in Hong Kong would potentially miss out on supporting and participating in new entrants to the crypto market; it should merely be a consideration and lacking a track record should not automatically disqualify virtual assets from being admitted for trading. In addition, it also means that the licensed platform operator cannot support new projects that may have originated from Hong Kong, resulting in such projects listing their virtual assets overseas. The implications of this is that Hong Kong is not promoting innovation and creative in crypto projects and the Hong Kong market will still need to use overseas VA platform if it wishes to support a new crypto project.
- (C) Marketing material – the onus should not be placed on the virtual asset platform to underwrite the accuracy of marketing produced by the virtual asset provider. This will shift the responsibility from the virtual asset provider to the platform, and therefore should be removed as an admission criteria. Instead, marketing for virtual assets should be prohibited as the disclosure requirements for the virtual asset would be a better source of information for the investors. Alternatively, the onus on the virtual asset platform should only be to take reasonable steps to ensure that the marketing materials are accurate and not misleading.
- (D) Legal risk – we support that the virtual asset platform needs to take a view on the legal risks of the virtual asset, however, this should not be satisfied by virtue of the virtual asset provider producing legal opinions. Whilst a level of comfort could be derived from the fact that a law firm has reviewed and assessed the nature of the virtual asset, it is often the case that legal opinions could be tailored to desired results of the client that engaged the law firm. The licensed platform operator should have in-house legal specialist that could determine the legal risk of a virtual asset based on certain objective criteria.
- (E) Eligible large-cap virtual assets – similar to the arguments above relating to the virtual assets having a track record, reliance on the virtual assets having already been listed on two independent index providers is not necessary. The virtual asset platform should have sufficient process and procedures to assess whether the virtual assets meet the relevant

criteria to satisfy listing as opposed to imposing this additional large-cap standard, which rely on admission standards of other platforms/index providers.

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?

We support the requirement for the licensed platform operator to provide disclosure of the virtual assets. In addition to the list set out in paragraph 51 of the SFC Consultation, disclosure should also cover what the protocol/project do in terms of utilities, services, features, governance, etc. The SFC should provide a standardised template for the licensed platform operator to provide these information so that it is easy for the retail investors to understand and compare the different virtual assets.

In addition to the requirements already prescribed by the SFC, we feel that it is also critical, either as part of the SFC Fintech division or the licensed platform operator platform, short videos or courses should be made available on virtual assets to encourage, guide and enhance the learning and knowledge of investors and the general market of virtual assets, and more broadly Web 3. For example, various overseas centralised exchanges have a section on their website which provides a short explanation on various concepts ranging from setting up a wallet to tokenomics of a virtual asset.

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?

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.

We support the proposal to allow a combination of third party insurance and funds set aside by the licensed platform. Based on our experience, it is exceedingly difficult and expensive to obtain third party insurance coverage in respect of virtual assets. Even when such third party insurance is obtained, the coverage is often restricted only to a small universe of virtual assets. As such, requiring third party insurance alone would be unfeasible. In our view, it would be preferable to place more of an emphasis on requiring a trading platform to set aside funds for disaster recovery purposes. The origin of these funds could vary, but can include a certain percentage of the fees earned on each transaction conducted by a user.

An alternative to the proposal of a combination of third-party insurance and funds set aside by the licensed platform operator is to require each licensed platform operator to contribute a percentage of funds to one centralised regulated authority or body, which holds the pool of funds from all licensed platform operators. This pool of funds would only be accessible to licensed platform operator in certain prescribed circumstances, such as security hack suffered by a licensed platform operator resulting in losses to its clients ("**Prescribed Incidents**"), after thorough review of the situation by the relevant authority or body and the SFC and approval of the release of funds. Further, the relevant authority or body or the SFC should have discretion as to when to use these funds for certain circumstances which calls for compensation to investors.

This would reduce the burden of securing required insurance and lower the funds required to be set aside by licensed platform operators on an individual basis. This also allows licensed platform operator to have full compensation protection for virtual assets investors because a large pool of assets is available to cover the Prescribed Incidents.

In the event a licensed platform operator has been approved to access this pooled fund, that licensed platform operator should then be required to compensate the drawdown over a period of time of an amount which is at an amount that is a certain percentage higher than the drawdown (similar to paying an excess for making an insurance claim).

In addition, such funds could be held in a multi-sig wallet which can be monitored and tracked on-chain by everyone.

Question 6: Do you have any suggestions for technical solutions which could effectively mitigate risk associated with the custody of client virtual assets, particularly in hot storage?

In regards to hot storage custody, this exposes the private keys of client assets to potential attackers, raising cybersecurity concerns that can lead to a loss of client virtual assets. Instead, we suggest using “warm” storage solutions that combine the convenience of online transactions seen with hot storage, while maintaining security seen with cold storage.

Some suggested technical solutions that aim to mitigate risks are solutions that offer multi-signature wallets and hardware security modules (HSMs), both of which improve security and reduce the danger of any oncoming threats.

Recommended solutions include Fireblocks, Ledger Enterprise and Coinbase Custody. All of which utilize multi-signature wallets built with HSMs.

Further aspects which can minimize risks aside from the aforementioned solutions is the diversity of warm and cold storage solutions, creating strict role-based access control policies for wallet management, regular security audits, insurance and proper employee training.

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?

For platforms that seek to offer trading in VA derivatives, the business model should be based on a fee structure where the platform should act like an "exchange" that matches buy-sell orders while charging transaction fees. Certain eligible market makers can enjoy fee rebates while providing liquidity on such exchanges.

VA derivatives should start with simple ones like quarterly futures offered on CME, perpetual futures and gradually expand to OTC options for eligible investors.

Types of investors that seek to engage in VA derivatives should be PI(Professional Investors), a high-net-worth investor who is considered to have a depth of experience and market knowledge that makes them eligible for certain benefits.

Question 9: Do you have any comments on the requirements for virtual asset transfers or any other requirements in Chapter 12 of the AML Guidelines for LCs and SFC-licensed VASPs? Please explain your views.

Whilst we support the need for LCs and SFC-licensed VASPs to maintain and implement rigorous AML/KYC policies and procedures, especially in relation to virtual asset transfers given the pseudonymity and anonymity of wallets, we consider that the SFC needs to provide certain guidelines as to suspension, delays or withholding of virtual asset transfer transactions. Unlike traditional securities market, the crypto market is extremely volatile and fast-paced which results in prices of virtual assets moving rapidly. In instances where virtual asset transfers from an exchange to a wallet has been suspended, delayed or withheld by an exchange, due to reasons of ensuring AML/sanction formalities are satisfied, this has in the past resulted in losses to users, disputes and even litigation in certain other jurisdictions.

Whilst being mindful of the need for LCs and SFC-licensed VASPs to carry out proper AML/KYC due diligence, unless there is reasonable doubt or concerns raised from the action of an investor/client such as numerous transfers to multiple different wallets within a short period of time or red flags raised by a third-party blockchain analytics company, LCs and SFC-licensed VASPs should be guided not to suspend, delay or withhold asset transfers without plausible reasons or certain objective guidelines.