



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

We write to the Securities and Futures Commission (the “**SFC**”) in response to the Consultation Paper to provide our feedback on key issues raised by the SFC in relation to the proposed regulatory requirements for licensed virtual asset trading platform operations (“**VATPs**”) under the new licensing regime to commence on 1 June 2023.

Venture Smart Financial Holdings Limited (the “**VSFG**”), incorporated in Hong Kong and whose registered office is situated at 23/F, Lee Garden Five, 18 Hysan Avenue, Causeway Bay, Hong Kong, and is licensed by the Securities and Futures Commission of Hong Kong to carry on Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management) regulated activities with CE Number BCO0369. We would therefore like to take the present opportunity to submit our views on the SFC’s proposed regulatory requirements for licensed VATPs.

As a licensed Virtual Asset Manager, we welcome the SFC to publish our comments and are willing to have our organization's name publicly disclosed. However, we request that individual replies remain anonymous. We value open and transparent communication and believe that our comments can contribute to the development of regulatory policies. However, we also wish to protect the privacy and confidentiality of our representatives who may have provided the comments.

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 welcome the SFC’s proposal to allow licensed virtual asset trading platform operators (“**VATPs**”) to offer their services to retail investors, as prohibiting retail access could leave investors to trade on unregulated cryptocurrency exchanges with limited investor protection. Alternatively, we believe spot ETF could be a good starting point for retail investors to start tapping into the virtual asset (VA) market.

Besides the VATPs’ direct service offering to retail investors, we notice that some licensed Type 1 intermediaries are now allowed to offer VA dealing services, either by acting as an introducing agent for its existing professional investor clients or by opening an omnibus account with the VATP for its professional investor clients.

We hereby respectfully request the SFC's guidance on the onboarding requirements for professional and retail clients who do not deal with licensed VATP directly, but instead use an intermediary licensed Type 1 regulated activity:

- 1) Firstly, we would like to seek the SFC's clarification on whether Type 1 intermediaries would be permitted to provide VA dealing services to retail clients upon the commencement of the new licensing regime for virtual asset service providers (the "**VASP Licensing Regime**") under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Chapter 615 of the Laws of Hong Kong) (the "**AMLO**") on 1 June 2023, given the SFC's proposal to allow retail investors to trade on VATPs as set out in the Consultation Paper.
- 2) Secondly, if Type 1 licensed intermediaries are allowed to provide VA dealing services to retail investors through partnering with a licensed VATP, then we suggest that the SFC should consider to what extent a VATP can rely on the onboarding measures carried out by the Type 1 licensed intermediary:
 - a. In order to ensure smooth cooperation between licensed VATPs and Type 1 licensed intermediaries, the onboarding and investor protection requirements for both should be synchronized. Additionally, a licensed VATP should be allowed to rely on the investor protection measures already carried out by the Type 1 licensed intermediary when dealing with retail investors through them.
- 3) Thirdly, the treatment of different investors based on whether they are professional or retail investors may not be the most appropriate for the purposes of investor protection, as currently virtual assets are not included in the calculation of a client's net worth for the purpose of the definition of "professional investors".
 - a. As the trend shifts towards digital assets, many investors now hold a substantial portion of their assets in virtual assets. However, despite their significant wealth and knowledge of VAs, these investors may not qualify as professional investors under the current rules due to the exclusion of virtual assets from net worth calculations.

- b. Whilst amending the Professional Investor Rules may take time, we suggest that the SFC should consider permitting licensed VATPs and VASPs to take into account a client's wealth in virtual assets in assessing whether the client is suitable to participate in virtual asset trading.
 - c. In the longer term, it is also hoped that the SFC and other financial regulators will consider revising the rules for the calculation of an investor's portfolio and net worth by amending the relevant provisions in the Professional Investor Rules.
- 4) Furthermore, we suggest that the SFC collaborate with the Hong Kong Exchange to introduce VA spot ETFs to cater to retail investors in the near future and should also encourage EFT issuers to collaborate with licensed virtual asset managers with experience and track records to create spot ETFs. This can provide some obvious benefits to the overall VA markets and investors:
 - a. Lower barrier to entry: a spot ETF would provide investors with greater VA market exposure without the inconvenience and complexity of managing digital assets in digital wallets or extra platforms (VATPs), reducing the risks of identity theft, financial fraud, and other issues stemming from a lack of consumer protection.
 - b. Enhances Liquidity: by providing a readily accessible and regulated investment vehicle for VA exposure, a spot VA ETF can also enhance the liquidity of the market, resulting in a more stable market with reduced price volatility.
 - c. Additionally, the introduction of a spot ETF would make it easier for financial institutions to gain exposure to the VA market for their clients, as there is a growing demand. This would increase the accessibility and efficiency of investing in virtual assets, while again providing investors with greater liquidity and a reduced risk of price volatility
 - d. Lastly, a spot ETF can help address the potential issues raised by future-based ETFs, such as deviations from the net asset value due to management fees and fees induced by contract rollover. By providing direct exposure to actual tokens, a spot ETF can provide a more

transparent and efficient investment mechanism for investors seeking virtual asset exposure.

We believe this collaboration between the SFC and the Hong Kong Exchange would be a significant step forward in expanding access to virtual asset investment opportunities while ensuring investor protection.

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

We largely agree with the general token admission criteria outlined in the Consultation Paper and the VATP Guidelines. However, we believe that the proposed specific token admission criteria for VAs to be admitted for trading by retail investors could be overly restrictive, potentially limiting retail investors to only Bitcoin and perhaps a few other tokens as their only choices.

To promote an open and inclusive VA market for Hong Kong, licensed VATPs should broaden their offerings to include more utility and security tokens. This approach would provide investors with greater access to the market while driving technology adoption. To achieve this and maintain adequate investor protection measures, we propose implementing the following measures:

- 1) We suggest relaxing these specific token admission criteria and restrictions for retail investors while instructing VATPs to impose limits for tokens which do not meet either or both of the “eligible large-cap virtual asset” and the non-security requirement.
 - a. Concentration limits on a retail client for trades in VAs which do not meet either or both of requirements, effectively mitigating the heightened risks to the client of trading in such virtual assets.
 - b. Trades limits could further be subject to certain prerequisites, including passing virtual asset knowledge tests, suitability assessments, and KYC/AML procedures.
- 2) Also, if the SFC decides to impose the “eligible large-cap virtual asset” requirement, we suggest that the SFC consider accepting an index that tracks the top 50 or 100 tokens by market capitalization as an acceptable index.
 - a. This approach includes relatively smaller tokens issued by newly launched innovative projects, and retail investors could benefit from

greater market access without being subjected to disproportionate risk levels.

- b. The current example of an index tracking the performance of the 10 largest tokens provided by the SFC in the Consultation Paper may suggest that an index with a larger constituent base may not be accepted by the SFC, which could limit market access for retail investors seeking to invest in innovative projects and homegrown fintech businesses in Hong Kong.

While we suggest measures to facilitate the inclusion of more tokens, we agree that each VATP should set up a "Token Committee" that would be responsible for reviewing and approving VAs for trading. Meanwhile, we suggest more measures to improve the governance:

- 1) Based on the current model of the Listing Committee and Listing Review Committee for stock market, we propose the establishment of an external Listing Review Committee as an independent entity to handle reviews of the Token Committee's decisions on new token listing. This committee should comprise independent members who can ensure objectivity and transparency during the selection process and oversee the exchange's listing policies and practices.
- 2) Also, the listing committee may consider establishing criteria for auto-listing approval for certain virtual assets like Bitcoin and Ether, which are widely accepted and have proven track records in "eligible large-cap virtual asset", and an auto-delisting mechanism for certain tokens that fail to meet specified criteria.
- 3) In addition, engaging third-party licensed brokers or underwriters (Type 1 and Type 9 holders) for further independent assessment and due diligence could help mitigate fraud risk and enhance investor protection.

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?

As mentioned above, we believe the investor protection requirements being proposed by the SFC are already very comprehensive and stringent, and perhaps more so than is necessary.

It is suggested to allow retail investors to open accounts through licensed Type 1 broker/ dealer with licensed VATPs under an omnibus account model according to the Joint circular on intermediaries' virtual asset-related activities, as this could provide them with additional protection and guidance from a licensed intermediary.

Also, licensed VASPs could also offer personalized investment advice and guidance to investors, based on their financial goals and risk tolerance, enabling them to tailor their investment strategies to their specific needs and objectives. This approach could enhance access and inclusivity in the virtual asset market while ensuring that investors are well-informed and protected.

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?

We welcome the SFC's proposed move to allow VATPs to adopt a combination of third-party insurance and funds of the VATP itself and/or its affiliated group companies in its risk compensation arrangement, as exorbitant premiums charged by the few insurance companies willing to offer insurance policies covering virtual assets held in hot storage are a huge burden on the finances of licensed VATPs, making it even harder for VATPs to sustain their operations, much less make a profit.

Besides, we suggest referring to some existing insurance schemes in the financial market like The License Holders Insurance Scheme for Exchange Participants, which was published in April 2021. Although the Circular provides information on the insurance scheme that applies to intermediaries licensed for Type 1 & Type 2 instead, this could be a reference for VATPs in the future, especially when there is more participants.

To establish an appropriate insurance scheme for the VATPs, a new Industry Working Group (IWG) for VA could be formed by comprising representatives from various brokers associations and brokerage houses, with secretariat support from the SFC, to focus on policy development for insurance, risk coverage, indemnity levels, deductible amounts, and other terms and conditions.

Lastly, an insurance pool could be established, consisting of, for example, 0.1 base point of each trading fee and premiums paid by participants for the regulated activities.

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 are of the view that different options should be allowed to VATPs, so long as the funds are set aside on trust and designated for the purpose of the VATP's risk compensation arrangement.

In particular, VATPs should be allowed to place the funds in a fixed deposit bank account (from which it cannot withdraw funds for a specified period of time) without necessarily depositing those funds with a third-party escrow agent or custodian, which would incur additional fees and expenses and diminish the benefit of allowing a combination of third-party insurance and the VATP and/or its affiliated group companies' own funds in the first place.

Alternatively, the SFC could consider simply increasing the financial resources requirements (including the minimum share capital and liquid asset requirements) as a means to ensure there are sufficient funds for risk compensation purposes, whilst adjusting the required insurance coverage to appropriate levels which are reasonably affordable by VATPs.

For example, the liquid asset requirement could be raised from the current 12 to 18 months of operational expenses calculated on a rolling basis and to be maintained by the VATP at all times, whereas the required insurance coverage for client virtual assets held in hot and cold storage could be lowered to a corresponding extent. This would be a simple, cost-effective way to achieve the aims of affording adequate protection to investors in the event of loss to client virtual assets held by the VATP (through its wholly-owned subsidiary acting as custodian) and other contingencies and, at the same time, alleviating the financial burden and practical difficulties faced by VATPs in maintaining 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?

- 1) In relation to VATPs operating in Hong Kong, a consortium Central Clearing and Settlement System ("CCASS") for virtual assets could serve as a crucial depository and settlement system for listed virtual assets in Hong Kong.

- a. The CCASS for virtual assets could serve as a crucial depository and settlement system for listed virtual assets in Hong Kong, providing safekeeping and depository services similar to CCASS for listed securities. This could also constitute an essential part of Hong Kong's VA market infrastructure, facilitating the efficient operation of the market by providing a centralized clearing and settlement system for transactions. Meanwhile, CCASS also provides ongoing monitoring and supervision of participants to ensure that they maintain the necessary level of security and compliance with rules and procedures related to virtual asset custody.
 - b. Under the consortium CCASS model, licensed VATP operators can collaborate and pool their resources to develop a centralized and shared custody solution. This involves the development of a shared infrastructure, such as a network of servers, that can be used to store and manage client virtual assets. To ensure the safety and integrity of the system, CCASS's custodian participants must meet specific requirements related to virtual asset custody, such as having a certain level of experience and expertise, a specific amount of capital or insurance coverage, or a proven track record of compliance with virtual asset-related laws and regulations.
 - c. Additionally, the SFC could establish guidelines and standards for the operation and governance of the consortium CCASS, ensuring that it operates in a fair, transparent, and secure manner.
- 2) To further enhance market liquidity, we recommend that the SFC collaborate with VATPs to introduce market maker participation. Market makers play a crucial role in facilitating liquidity on the platforms and can help to stabilize prices and reduce volatility. In selecting market makers, the SFC should ensure that they are suitably qualified in terms of financial standing, risk management capabilities, trading record, computer equipment, and internal security procedures. By introducing market makers, the SFC can promote a more efficient and stable market for virtual assets in Hong Kong.
 - 3) To enhance rules that facilitate monitoring VASPs in accordance with the SFO and AMLO, we recommend that VASPs collaborate with blockchain data solution service providers, for example, Chainalysis, which is a leading provider of blockchain data analytics tools and services that help monitor and investigate cryptocurrency transactions.

- a. Regulators could leverage their expertise in blockchain analytics to develop more effective tools to monitor both on-chain and off-chain interactions between all VA CCASS participants, as well as between participants and external parties. We may also consider Flowdesk as a point of reference. Flowdesk is a prominent, fully compliant infrastructure solution that encompasses all aspects of crypto trading, custody, and market making. It provides exceptional low-latency technology with continuous availability, along with top-notch crypto asset custody services.
- b. The real-time data tracking solution is key for blockchain participants to identify suspicious activities and prevent money laundering and terrorist financing in the virtual asset market.
- c. Blockchain data solution service providers with an in-depth database can be a solution to challenges associated with monitoring virtual asset transactions, such as the pseudonymous nature of blockchain transactions. Many service providers in the market have developed tools to help identify the real-world identities of individuals and organizations involved in cryptocurrency transactions, which can improve the effectiveness of monitoring and regulatory enforcement.

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?

We would propose to offer at the initial stage virtual asset derivatives with relatively familiar product structures similar to futures and options in the traditional financial market.

In this connection, we would also like to seek the SFC's preliminary views on whether it would be prepared to permit the trading of VA derivatives and futures products similar to Bitcoin futures and Bitcoin options, which have been in existence in the market for several year since 2017. Given the SFC's recognition of the important role played by VA derivatives in the interface between traditional finance and the virtual asset space and their value in enabling institutional investors to hedge risks more effectively, we

are of the view that the SFC should consider allowing at least professional investors to trade VA derivatives on licensed VATPs initially and gradually opening up retail access to improve the competitiveness of locally licensed VATPs vis-à-vis overseas crypto exchanges and encourage more virtual asset businesses to come to Hong Kong.

To ensure investor protection, we suggest VATPs working with specific VASPs to adapt and tailor investor protection measures for VA derivatives, such as KYC, virtual asset knowledge tests, suitability assessments, trading limits, token admission criteria, product due diligence, and risk disclosures, that effectively mitigate risks associated with VA derivatives trading.

Last but not least, we believe an appropriate gearing limit and monitoring could also help manage risk for investors and licensed VATPs. VA derivatives are typically traded on a margin basis, which increases investors' exposure to the volatility of the underlying investment. Gearing limits and monitoring would involve setting a certain level of leverage or minimum percentage of the gross principal value as initial and maintenance margin levels that investors can use when trading virtual asset derivatives. This would prevent investors from taking on excessive risk and potentially suffering significant losses.

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?

[No input so far.]

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.

Whilst we agree that appropriate amendments should be made to the existing AML/CTF requirements to address virtual asset transactions, we are of the view that the immediate implementation of the “travel rule” in relation to virtual asset transfers (as provided by Chapter 12 of the AML Guideline for LCs and SFC-licensed VASPs) (the “**Travel Rule**”) with effect from 1 June 2023 would be impracticable.

As there are currently no commonly accepted standards and systems for the collection, handling, disclosure, retention and record-keeping of originator and recipient

information as provided by Chapter 12 of the AML Guideline for LCs and SFC-licensed VASPs, it will take time for licensed VATPs and other licensed corporations (“**LCs**”) to prepare and develop adequate systems and procedures to comply with the new AML/CTF requirements in respect of virtual asset transfers.

Additionally, given that in many cases the ordering institution, the beneficiary institution and/or the intermediary institution will be located outside Hong Kong and that to date the Travel Rule has yet to be implemented or to take effect in a number of jurisdictions (including the United Kingdom, Australia, South Africa and parts of the European Union), requiring licensed VATPs and LCs in Hong Kong to comply with the Travel Rule with effect from 1 June 2023 would put them in a situation where it would be impossible for them to process and execute virtual asset transactions involving a number of their existing partner institutions and other counterparties overseas.

Further, if the licensed VATP or LC being the ordering institution in Hong Kong submitted the originator and recipient information to the intermediary institution or beneficiary institution located in a jurisdiction which has not implemented or enforced the Travel Rule, it is uncertain how such information would be handled by the overseas intermediary institution or beneficiary institution, thus posing risks to the security and privacy of client data. In view of the above concerns, we would recommend that the implementation of the Travel Rule in Hong Kong be postponed by a period of 12 to 18 months to enable licensed VATPs and other LCs to develop the necessary systems and procedures and to coordinate viable arrangements with overseas institutions.

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

[No input so far.]