



The Capital Markets Company Ltd.
Level 16
28 Hennessy Road
Wan Chai
Hong Kong
T +852 2245 3252
capco.com

Securities and Futures Commission
54/F, One Island East
18 Westlands Road, Quarry Bay
Hong Kong

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

To whom it may concern

As an interested party on the subject consultation, please find our viewpoints on the questions presented.

Yours faithfully

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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.

There is clear public interest in, and appetite for, crypto currencies and other digital assets. Our recent Capco survey of APAC retail banking customers found that 30% of Hong Kong respondents said it would be 'very interesting' to access virtual assets (VA). Limiting licensed exchanges to professional investors could lead retail traders and other members of the public to seek out unlicensed and unregulated platforms offering high risk and highly volatile products.

Retail investors are attracted to VA by the success stories circulated in media outlets and on social community platforms, highlighting low to zero transaction fees and yields that are uncommon in the traditional finance ecosystem.

In order to build a sustainable and responsible virtual asset ecosystem in Hong Kong, it would be best to allow retail investors to engage with products and services via regulated platforms, while improving financial literacy, raising awareness of regulated platforms, and provide adequate warnings in using unregulated platforms of unknown origin.

Question 2:

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

The existing general token admission criteria looks at the supply and demand and trade data of a token for admission, and currently does not take into account the background and the creation of the token. Given that general tokens can often be community driven projects, basing the admission criteria solely on trading statistics may not be adequate – the social or community aspect of the token should also be considered.

The licensed platforms should have the responsibility to perform due diligence and evaluation before admitting tokens. A comprehensive list of factors should be considered such as the management team, size of token community, token utilities, liquidity, and security.

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?

HK consumers' conventional deposits held with financial institutions are protected up to the set limit under 'Deposit Protection Scheme', institutions may choose from purchasing third-party insurance or maintaining their own reserve fund or a combination of both methods. The same set up could be applied to VA operators with a guarantee of \$500,000 as an example, to provide the confidence into virtual asset trading for retail investors, so not to be regarded or treated as any other speculative assets.

Aside from retail investors being subject to Know Your Customer (KYC) and anti-money laundering (AML) measures when they sign up to a trading platform, implementation of sensible limitations set on the trading services and functions should also be considered. Platform functionalities could be unlocked based on an individual's risk profile and completion of relevant educational content or assessment provided by the VA platform.

As with traditional trading functions such as bonds, where only professional traders have access to higher risk options, retail VA investors should only be able to access basic spot trading from the onset. Functions such as leverage trading should be limited, and the fiat currencies available for retail investors to invest in could also be limited.

In addition, rather than adopting the practice of fiat on-ramp/off-ramp to VA platforms seen in other jurisdictions, the utility of e-HKD should also be considered as one way to drive adoption and to enhance AML measures.

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?

The independent third-party insurance could protect the customer in case of the insolvency of the operators, while maintaining the flexibility for the operators to compensate customers in a more cost-effective way. SFC should give clear requirements to the VA operators regarding mandatory insurance coverage and reserve funds in the event of security incidents, platform failure or other losses. The compensation arrangements, and disclosures of such, should be supervised and regularly reviewed and inspected.

Since the cost of obtaining third-party insurance is high, VA operators might be discouraged from providing adequate insurance coverage to customers. SFC could collaborate with insurance companies to set up insurance schemes for the licensed platform operators, providing a risk assessment that would help insurers offer appropriate products based on the VA operator's risk profile, and ultimately maintaining a standardized level of insurance protection across all licensed platforms.

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.

No comment

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?

Hot storage is connected to the internet and more vulnerable to security risks (hacking, cyber attacks, insider threats, data breaches). A combination of security measures should be considered offering the right balance of safety and usability, for example:

- (i) Access controls (e.g. MFA, RBAC) and (ii) time-locks (e.g. delayed and escrow transactions require a specified waiting period to complete the transaction) could be implemented with timely notifications of transaction to the VA holder, reducing the risk of unauthorized access and transactions.
 - (iii) Redundancy and traffic control should be catered for in the trading platform architectural design to ensure high service availability and prevent overloaded traffic (e.g. multiple hot storages or servers in different geographic regions, load balancing).
 - (iv) Regular data backup and recovery plan for restoring access to VA in case of system failure, including testing of this plan to identify potential data loss issues.
 - (v) End-to-end data encryption to protect against breaches of sensitive data, private keys and user credentials, e.g. adopt industry encryption standards.
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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.

No comment

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?

Other jurisdictions require the operator to provide a whitepaper for any VA being offered to the public, and do not need prior approval for the VA from the regulatory bodies before admitting for trading (with the condition that they can prove they are complying with the related AML & CFT or other protection/reporting requirements). This allows more flexibility for the operators and reduces their regulatory burden, while helping to ensure that investors are sufficiently protected. The lower barrier to market entry can then support the growth of the industry, in terms of increasing the number of new entrants, more diversified VA offerings and foster innovation.

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.

Although the nature of blockchain is that all transactions are anonymous, VATP should be required to always conduct KYC on their users, with a recommendation that they conduct enhanced customer due diligence (CDD) when customers sign up to open an account on the platform.

With this in mind, when a suspicious activity is captured in the system, even if the transaction is anonymous on the blockchain, the platform should be able to trace the user via the platform's transaction records and the user's KYC information. To further mitigate risks associated with suspicious activity, VATP should be required to implement coin purity measures on their platforms so that virtual assets that pass through can also be held for further investigation when needed.

With regard to the level of KYC required for users to sign up to the platform to begin trading, VATP platforms can refer to the standard used by digital stock exchange platforms and virtual banks. In addition, AML standards regarding the locale and type of users that can be accepted by VATPs should also follow a standard set by the SFC.

Question 10:

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

The current fines and reprimand actions proposed range may not be realistic if one considers the recent collapse of a cryptocurrency exchange in Nov-22.

The fining approach of Hong Kong is quite similar to the US, China, and Japan, which also set a limit on the size of fine (plus other penalties depending on the nature and severity of the incident). The SFC could also refer to Europe, where the penalty is assessed up to a certain percentage of the total annual turnover of the VATP.

Apart from imposing disciplinary actions to deter violation, sustainable and accountable practices can be promoted by reinvesting the fines collected into ecosystem initiatives to accelerate the growth of the VA ecosystem in Hong Kong. They could be used as the fundings for R&D on tools/technologies that would enhance efficiency and security of the VA ecosystem, as well as investments to operators that have contributed or adopted such practices as reward/incentive.
