HKDAS
香港數碼資產學會
Hong Kong Digital Asset Society

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

Date: 31 March 2023

To whom it may concern:

Re: Seeking comments from the public and the industry on the proposals in the "Consultation Paper on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the Securities and Futures Commission" published at 20 February 2023.

Introduction

Hong Kong Digital Asset Society (HKDAS) is a not-for-profit organization established in 2021, leading by a volunteer group of members who care about the future of Financial Technology in Hong Kong, Greater China and Asia. This March, HKDAS initiated a survey to collect feedbacks to the SFC VA licensing regime from our members as well as general public (the "Survey") [1]. The Survey was successfully conducted by the HKU Blockchain Club, our survey partner. A 13,674 valid responses were collected. The answers to the questions below consolidated comments from our members, and the Survey findings. We hope the feedbacks will help in finalising the proposed regulatory requirements applicable to licensed VA trading platform operators.

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 support the proposal to allow retail investors to gain limited exposure to VA.

Banning retail investors from trading VA will cause Hong Kong to lose competitiveness in the global VA market. This is not in accordance with the policy statement published by the Hong Kong Government last October to support the development of VA ecosystem in Hong Kong (the "Policy Statement").

Furthermore, the Survey result shows positive feedback that (1) 39.2% of respondents support the licensing regime, while 24.3% are against, others have no comments; (2) 53.2% supports investment limits on retail investors; (3) 61.7% of respondents are inclined to transfer investments to licensed exchanges; and (4) 43.0% respondents want their frequently-used exchange to be licensed, but many have no comments.

In this regard, preventing retail investors from switching to unregulated exchanges, a regulated channel for retail investors to trade VA should be allowed. The proposed robust investor protection measures could serve as an extra-level of investor protection.

Comparing to a few years ago, VA related knowledge become more organized and accessible. Hong Kong Digital Asset Society is one example. We provide free lectures, mentoring services, workshops, and necessary training to educate the local general public and students on the latest development in digital assets and block-chain technology. By our observation, young investor who is interested in trading VA need a platform to gain necessary trainings and experiences. Majority of the young investors in Hong Kong are retail investors. Allowing them to access VA could also open more space for innovation and entrepreneurship that can eventually facilitate the development of VA in Hong Kong.

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

We support the proposal that VATP Operators should set up a token admission and review committee. This committee could provide a framework for the VATP Operators to perform relevant duties and make decisions.

We think expecting the VATP Operators to conduct in-house smart contract audit is not suitable and practicable. This could impose large operational and financial burden to the platform. Reviewing whether the smart contract layer is subject to any security flaws or vulnerabilities involves extended knowledge that VATP may not have sufficient in-house expertise with auditor quality. Similar to the credit rating system, brokers can rely on the 3rd party credit rating report. VATP should be allowed to rely on 3rd party audit by reputable smart contract audit service providers.

The proposed definition of "Eligible Large-Cap Virtual Assets" is built on the definition of "acceptable indices". Subject to other criteria set out in the clause 44, the foot note 20 "For instance, an index which captures the top 10 largest virtual assets may be considered an acceptable index." Indicates that "largest virtual assets" plays a key role in the definition. However, explicit and quantitative approach to measure the ranking of such "largest virtual assets" is not concluded. In this regard, we think a more direct and straight forward definition should be considered.

Although the token admission requirements will inevitably limit the types of cryptocurrencies/tokens that investors can trade on the licensed platform, the Survey results that 57.6% respondents support sales of major crypto only. Considering "Suitable investment products" is the second top factors that respondents consider when choosing crypto exchange, we propose the definition of "Eligible Large-Cap Virtual Assets" is the top 50 virtual assets in terms of market capitalization in major crypto exchanges, with semi-annually rebalancing.

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?

The Survey result shows more than 78.5% of respondents support a compensation mechanism in case of attacks/accidents in exchanges.

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 agree VATP should ensure that not more than 2% of the client virtual assets are stored in hot storage, and hot storage should be fully covered by insurance policy or funds set aside. Considering an insurance policy fully covers hot storage for VA service providers is hard to obtain or over wise very costly. Most likely, many small VATPs would choose to meet the requirement by funds set aside. This already put a financial burden on the operations and competitiveness of those platforms. Given that the hot storage is fully covered, introducing some flexibility on the insurance policy for cold storage could provide more space to VATPs (and give more space to start-up platforms to grow). We suggest allowing investors to make their own decisions on the level of insurance coverage for cold storage and absorb the relevant insurance cost. The VATP provides the infrastructure for investors to obtain insurance coverage from 3rd party insurance companies.

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.

N.A.

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?

As VA trading platforms hold clients' private keys which makes the platform an attractive target for hackers. Cybersecurity measures like whitelisting, Two-Factor Authentication (2FA), and stringent password mechanism should be required for any VA movement. Introducing an extra layer of security using hardware like Yubikey security keys is encouraged.

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?

Letting Hong Kong be competitive enough to other crypto regulation-friendly jurisdictions, we should be inclusive regarding VA derivations. If VATPs are not allowed to offer trading services of VA derivatives, could make institutional crypto investors lose their interest in Hong Kong. At least, traditional and perpetual crypto futures should be offered for trading. Given this, we think VA derivatives should be accessible to all types of investors including both retail investors and professional investors.

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?

We support the proposed measures stated in the session "Publication of VA trading platform lists" in the consultation paper.

Since many VA trading platform operates in various jurisdictions using separate legal entity with similar name. Also, the Survey shows the 9 crypto exchanges the respondents currently trading with are all multinational companies. Suitable measures should be incorporated in the list to help investors to distinguish the licensed branch of a multinational exchange.

Using FTX as an example, there are 29 legal entities with their name starting with "FTX" (number 32 to 60 in the public list of debtor*). It is hard for general public to know which "FTX" they are dealing with. Trading platform may attract clients by promoting it is a SFC licensed VATP, but eventually direct or transfer their clients to unlicensed platforms under the same group, with similar trading name, to avoid their compliance and regulatory obligations.

On top of the existing information in the "List of licensed virtual asset trading platforms", we suggest to also include (1) the official website address of the licensed VA trading platform to distinguish it from similar website address, (2) approved trade names, and (3) names of related unlicensed VA trading platform.

*https://restructuring.ra.kroll.com/FTX/Home-DownloadPDF?id1=MTQ0NDMzMA%3D%3D&id2=0

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.

N.A.

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

We think the disciplinary fining regarding VA should be the same as SFC's current guidelines.

For an on behalf of
Hong Kong Digital Asset Society

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[1] SFC VA licensing regime support rating survey by HKDAS

SFC VA licensing regime support rating survey by HKDAS Survey Period: March, 2023 Valid responses: 13,674 Target respondents: retail and individual investors Survey organizer: HKU Blockchain Club

Survey Results
 	
Finalised data after rebalancing:
1. 39.2% of respondents support the licensing regime, while 24.3% are against, others have no comments.
2. 61.7% of respondents are inclined to transfer investments to licensed exchanges.
3. Details on proposed frameworks:
    1. 53.2% supports investment limits on retail investors
    2. 57.6% supports sales of major crypto only
    3. 67.8% supports no-margin trading
    4. 78.5% supports compensation mechanism

4. Respondents rank the following factors when choosing crypto exchange (1 being most important):
    1. Popularity
    2. Suitable investment products
    3. User interface
    4. Ease of fiat money transfer
    5. Licensed
5. Our respondents are trading on many crypto exchanges, here is the list ranked in alphabetical order:
    1. BINANCE
    2. BITGET
    3. BYBIT
    4. COINBASE
    5. Crypto.com
    6. HUOBI
    7. JPEX
    8. KUCOIN
    9. OKX
6. Generally, retail investors wants their frequently-used exchange to be licensed, but many have no comments.
    1. 50.7% no comments
    2. 43.0% support
    3. 6.3% against