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.

Licensed platform operators should be permitted to offer their services to retail investors, subject to the SFC's proposed stringent investor protection measures. While granting retail investors access to the virtual asset market, these measures can help ensure their safety.

The SFC's proposed onboarding requirements, governance measures, token due diligence requirements, and admission criteria are intended to provide additional protections for retail investors. By requiring platform operators to evaluate clients' risk tolerance, risk profile, and financial situation, these measures aim to prevent retail investors from being excessively exposed to risks related to virtual assets.

In addition, the establishment of a token admission and review committee, which is responsible for establishing and enforcing trading criteria for virtual assets, contributes to the maintenance of a high standard for the assets available on the platform. This, in turn, can help protect retail investors.

The proposed due diligence measures and token admission criteria emphasize further the responsibility of licensed platform operators to ensure that all tradable virtual assets meet specific standards. This can reduce the likelihood that retail investors will be exposed to fraudulent or poorly-managed virtual assets.

If retail clients are not given the option to access the market via licensed operators that are under the supervision of the SFC, this may have the unintended result of pushing them towards unregulated platforms, which exposes them to the very risks regulators want to protect investors from.

Overall, the proposed investor protection measures strike a balance between granting retail investors access to the market for virtual assets and protecting them. Under these conditions, allowing licensed platform operators to serve retail investors can contribute to a more inclusive and well-regulated virtual asset market.

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

While the concept of eligible large-cap virtual assets intends to offer retail investors a curated selection of virtual assets to trade, there is a potential drawback to this approach. The specific token admission criteria may result in a very limited selection of virtual assets being made available to retail investors on regulated Hong Kong platforms. This limited selection may inadvertently prompt retail investors to seek access to a broader range of virtual assets on unregulated platforms, where investor protection measures may be insufficient.

If retail investors migrate to unregulated platforms, the SFC's goal of investor protection may

be compromised, as these platforms may not adhere to the same stringent standards and requirements as licensed platform operators. As a result, retail investors may be exposed to increased levels of risk, such as fraud, market manipulation, and unreliable virtual asset quality.

To address this issue, the SFC may need to consider refining the token admission criteria to permit a broader range of virtual assets on regulated platforms while preserving robust investor protections. By encouraging retail investors to remain within the regulated environment, the SFC would be better able to protect their interests.

The proposal to allow platform operators to submit proposals for non-categorized virtual assets is a positive step towards accommodating a broader range of virtual assets. This case-by-case approach provides flexibility for the SFC to assess the suitability of specific virtual assets for retail trading, potentially leading to a more diverse offering for retail investors within the regulated environment.

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?

In addition to the disclosure obligations listed in the document, the following requirements could further strengthen investor protection if the SFC allows retail access to licensed VA trading platforms:

1) Risk Disclosures: Licensed platform operators should provide clear, prominent, and accessible risk disclosures outlining the specific risks associated with trading virtual assets. These disclosures should cover market, liquidity, cybersecurity, regulatory, and operational risks, among others. It should be presented in a form that is easy for investors to evaluate and compare to make well-informed decisions.

2) Educational Resources: Platform operators should be required to provide comprehensive educational resources to help retail investors understand the complexities of virtual assets, their underlying technology, and the trading process. This could include guides, articles, videos, and interactive tools.

3) Transparent Fee Structures: Platform operators should disclose their fee structures upfront, detailing any trading fees, withdrawal fees, or other charges that may apply. This transparency will allow retail investors to make informed decisions about the cost of trading on the platform.

4) Ongoing Monitoring and Reporting: Platforms should have a robust system in place for monitoring and reporting suspicious activities, such as market manipulation or fraudulent transactions, to the SFC. This will help maintain the integrity of the platform and protect retail investors.

5) Clear Communication: All platform-related communication, including terms and conditions, privacy policies, and other legal documents, should be written in plain

language that is easily understandable by retail investors.

6) Wallet Security: Licensed platform operators should implement stringent security measures to protect investors' virtual asset wallets, such as multi-factor authentication, cold wallet, and regular security audits.

7) Investment Limits: Consider implementing investment limits for retail investors based on their experience, risk tolerance, or financial situation. This could help prevent inexperienced investors from taking on excessive risk.

8) Regular Updates: Platforms should be required to provide regular updates on the virtual assets listed on their platform, including any significant developments, changes in management, or updates to the underlying technology.

9) Grievance Redressal Mechanism: Establish a clear and transparent grievance redressal mechanism for retail investors to report issues, seek assistance, and resolve disputes.

While implementing these additional investor protection measures, it is important for the SFC to strike a balance between safeguarding investor interests and maintaining a conducive environment for the growth of virtual asset trading platforms. The measures should be carefully designed and proportionate so as not to create undue burden on VA operators, which may otherwise result in regulatory arbitrage as businesses shift to more lenient jurisdictions.

By adopting a balanced approach that is both protective and pragmatic, the SFC can foster a healthy ecosystem for virtual asset trading platforms in Hong Kong, ensuring investor protection without stifling innovation or hindering the industry's growth. This, in turn, will help maintain Hong Kong's position as a leading global financial center, while also promoting the responsible development and use of virtual assets.

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?

Allowing a combination of third-party insurance and funds set aside by the licensed platform operator or a corporation within its same group of companies can be a practical approach to ensure that sufficient financial resources are available to cover losses in case of any operational or security incidents. This proposal can provide flexibility for VA trading platforms to manage their risk exposure while ensuring client protection. However, it is crucial to establish clear guidelines and criteria for the proportion of third-party insurance and self-insurance to maintain transparency and consistency across the industry.

It is important to note that there are currently limited providers for insurance in the virtual asset space. When insurance is available, it is often very expensive, which may add significant costs to the platform operator that may not be justifiable. Additionally, insurers may choose to provide coverage only for cold wallets, leaving hot wallets unprotected. As a result,

even if third-party insurance is allowed, it may not be a viable option for many platform operators due to the lack of availability and the high costs associated with such insurance.

In light of these challenges, it is essential to explore alternative risk management solutions that can provide adequate protection for both platform operators and clients without being overly burdensome.

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.

One potential issue with using escrow arrangements for funds set aside by licensed platform operators is the difficulty in identifying suitable escrow agents. Currently, banks in Hong Kong are hesitant to serve crypto companies, particularly those that have not obtained a license. This creates a chicken and egg problem, where companies need to have an escrow arrangement in place to be eligible for a license, but banks require clients to have a license before agreeing to act as escrow agents.

To address this issue, it is essential for the SFC to collaborate with the Hong Kong Monetary Authority (HKMA) to clarify matters and encourage banks to act as escrow agents for parties applying for SFC licenses. Establishing clear guidelines and providing necessary support can help facilitate a more efficient and secure process for licensed platform operators to set aside funds and ensure investor protection. This would also enable companies to navigate the licensing process more smoothly and promote the growth of the virtual asset industry in Hong Kong.

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?

To effectively mitigate risks associated with the custody of client virtual assets, particularly in hot wallet, licensed platform operators can consider adopting the following technical solutions:

1) Multi-signature wallets: Implementing multi-signature wallets can provide an additional layer of security, as it requires multiple private keys to authorize transactions. This reduces the risk of a single point of failure and makes it more difficult for unauthorized access or malicious activities.

2) Regular security audits: Conducting regular security audits, both internal and external, can help identify vulnerabilities and weaknesses in the platform's security infrastructure. This enables the platform operator to address and mitigate risks proactively.

3) Real-time monitoring and alerts: Implementing real-time monitoring and alert systems

can help detect and prevent unauthorized access or suspicious activities, allowing platform operators to respond promptly to potential threats.

4) Employee training and access controls: Ensuring that employees with access to hot wallet systems have proper training and are subject to strict access controls can help minimize the risk of insider threats or human error.

By incorporating these technical solutions, licensed platform operators can enhance the security of their hot wallet systems, effectively mitigating risks associated with the custody of client virtual assets. Utilizing multiple custodians can also help diversify risks for the VA operators and enhance the eligibility for insurance coverage through the custodians.

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 licensed platform operators offering virtual asset derivatives, the proposed business model should focus on secure, conservative, and transparent risk management, with an emphasis on pre-funded collateral requirements and real-time de-risking of positions to reduce systemic risks. Virtual asset derivatives such as futures and options on cryptocurrencies like Bitcoin and Ethereum could be offered to a wide range of investors, including institutional investors, high-net-worth individuals, and knowledgeable individuals.

To ensure investor protection, the model should incorporate robust eligibility checks, KYC and AML procedures, and require investors to demonstrate their understanding of the products they want to trade through educational resources.

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?

These changes would reduce operational difficulties for platform operators, and maintain transparency and protection for clients.

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.

Effective ongoing monitoring of virtual asset transactions and activities is critical for mitigating the risks associated with money laundering and terrorist financing. This necessitates the implementation of suitable KYC measures.

We see two main challenges in the KYC space with respect to VAs.

First, traditional KYC methods tend to be centralized and fragmented, which may impede the immediate collection of information and risk assessment. Moreover, the market currently lacks a strong supply of reliable KYC service providers that have sufficient experience in the VA ecosystem and are trustworthy; licensed exchanges in Hong Kong will naturally gravitate to these one or two providers at the outset. However, concentration of market power in only a small number of KYC service providers that do have the requisite expertise in the VA space may increase risks in the system (e.g. the effect of data breaches and other cybersecurity incidents would be magnified).

Second, the rapid growth of decentralized finance (DeFi) has meant that KYC processes and monitoring by centralized entities and exchanges may not be sufficient. Requiring licensed exchanges to conduct robust KYC measures on customers is certainly a good start but those exchanges can and should also still address ways in which transfers to decentralized wallets and exchanges can be continually monitored.

A possible solution to the two issues discussed above is to utilize the very technology behind VAs: blockchain. Blockchain technology can be used to enhance real-time transaction monitoring and risk evaluation.

It is important to acknowledge that transactions in the DeFi space are not entirely pseudonymous when wallets can be tied to an identity through a robust KYC process and a soulbound token. By connecting a digital token to a user's verifiable credentials, VA operators and regulators can monitor transactions and activities linked to specific individuals, allowing them to identify suspicious patterns in real-time. This also results in a transparent audit trail, enabling VA operators and regulators to more effectively detect, manage, and mitigate potential money laundering activities, particularly when data is standardized across platforms.

Moreover, on-chain KYC deters bad actors from exploiting virtual assets for illicit activities, as their actions can be more readily traced back to them. In sum, the adoption of on-chain KYC and the utilization of blockchain technology can significantly improve the monitoring and management of virtual asset transactions, thereby reducing the risks associated with money laundering and terrorist financing.

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

N/A