

Dear SFC,

I am writing to provide feedback on the consultation Paper on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators. As an industry participant, I appreciate the opportunity to contribute my thoughts and suggestions on this matter. I hope that my suggestions will contribute to the continued growth and development of the virtual asset industry in a safe and responsible manner.

Thank you for considering my feedback, and I look forward to the opportunity to discuss these matters further.

Sincerely,

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.

Based on the experience of the two currently licensed platforms (OSL and Haskey), the licensing process can be lengthy, with approval taking up to a year after the initial application. OSL, whose parent company is a listed entity (863 HK), has already undertaken at least two rounds of fundraising/share placement in 2021. It suggests that operational costs are high, particularly given the need to retain digital asset talent and implement robust investor protection measures. Additionally, there is a limited pool of such talent in Hong Kong, and compliance with new regulatory frameworks can be costly, given the emerging nature of these technologies.

Allowing licensed platforms to provide services to retail investors could increase expected revenue and incentivize potential licensees to enter the market. Without this, the sector's profitability may be limited, which could lead to a decline in interest from potential licensees, ultimately pushing them to seek similar licenses in other countries.

The UK's Financial Conduct Authority (FCA) recently (Feb 2023) has also launched a consultation and call for evidence on creating a future regulatory regime for cryptoassets, focusing on bringing key cryptoasset activities into the regulatory

perimeter for financial services. The consultation aims to protect the interests of the public and retail investors rather than limiting the scope of professional investors. In light of what other countries are doing, it may not be productive for Hong Kong to continue debating whether or not to roll out these services to retail investors, as it would be a waste of time and resources. Instead, Hong Kong should take the first-mover advantage in Asia in developing robust regulatory frameworks that promote innovation while ensuring the protection of all investors.

Question 2:

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

I concur with the SFC's stance on token admission criteria, as adopting a more cautious approach is advisable. It is crucial that licensed platforms do not offer any virtual assets that are classified as "securities" under the SFO. However, it is concerning that each platform would need to engage legal counsel to review each token to determine whether they are deemed "securities.". It would create a high financial and time cost for the entire industry and impede its development. It would be advantageous if the SFC could establish a mechanism to identify which tokens fall under the category of securities, thereby facilitating the industry's progress.

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 consultation 9.21(c) (page 80 of the consultation), The Platform Operator should have in place appropriate tools for assessing a client's concentration risk, and such an assessment should be based on the information about the client obtained by the Platform Operator through its know your client process and any virtual assets held with the Platform Operator.

If there are limits on the amount retail investors can invest in virtual assets, the concentration risk becomes less significant. This is because some retail investors may not be experienced in selecting altcoins and may invest all their funds in Bitcoin. Therefore, rather than focusing on the client's concentration risk, it would be beneficial to prioritize the imposition of limits on the amount of money that investors can invest. It would help prevent investors from investing more than they can afford to lose and alleviate concerns about concentration risk.

Separately, it is crucial to inform retail investors about the ownership of the crypto assets associated with each product. The recent Celsius Network case serves as a reminder that customers of interest-bearing products may unintentionally turn over control of their assets to the platform provider in case of bankruptcy. While customers may not always thoroughly review the terms and conditions, platform operators must clearly disclose the crypto assets' ownership status and provide adequate warnings about potential risks in case of bankruptcy. This would help ensure transparency and protect retail investors' interests in case of a platform's insolvency.

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.

In consultation Part III Section B Proposed requirements for insurance /compensation arrangement (page 18 of the consultation), a licensed platform operator should monitor the total value of client virtual assets under its custody on a daily basis. Where a licensed platform operator becomes aware that the total value of client virtual assets under custody exceeds the covered amount under the compensation arrangement approved by the SFC and the operator anticipates such a situation will persist, the operator should notify the SFC and take prompt remedial measures to ensure compliance with the compensation requirements.

I think there may be some ambiguity regarding when a licensed platform operator should notify the SFC because the operator may not accurately anticipate how long the situation will persist due to the volatile nature of the crypto market. To provide greater clarity, it may be more appropriate to establish a specific rule stating that if the total value of client virtual assets under custody exceeds the covered amount approved by the SFC for a fixed number of calendar days, then the operator will be required to inform the SFC and take prompt remedial measures to ensure compliance with the compensation requirements.

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.

Keeping funds in the operator's account may be more convenient and provide greater control over the funds, but it also exposes the funds to the risks of the operator's financial situation. In the event of financial difficulties or bankruptcy, the funds may be at risk of being used to pay off creditors or lost entirely.

Alternatively, using an external party with an escrow arrangement may provide more protection for the funds, as they would be held separately from the operator's assets and only released for the specified purpose of compensating clients. However, this arrangement may also be more complex and involve additional fees or administrative requirements.

Ultimately, the best approach for setting aside funds as reserves will depend on the specific circumstances of the operator. It may be a combination of both approaches, and the operator should be given the flexibility to decide on the best way forward.

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?

Overall, the custody requirements proposed in the consultation (such as segregation of client assets / independent audit, insurance, cold storage) are aimed at ensuring that VA platform operators have adequate measures to protect client assets from loss, theft, or misappropriation.

After FTX went bankrupt, actually most good market operators have already voluntarily engaged an external auditor to perform proof of reserve to support the exchanges' on-chain holding of cryptocurrency corresponds with users' balances. I suggest that the SFC consider making proof of reserve audits a compulsory requirement for operators, with a frequency of at least twice a year. This would ensure that the custody requirements proposed in the consultation are being properly implemented and that client assets are adequately protected from loss, theft, or misappropriation.

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?

Virtual asset derivatives, such as futures and options contracts, are typically traded by a range of investors, including institutional investors, professional traders, and

sophisticated retail investors. Institutional investors, such as hedge funds and asset managers, may use virtual asset derivatives to hedge their exposure to virtual asset markets or to gain exposure to specific virtual assets or market segments. They may also use derivatives to generate additional returns through leveraged positions or by taking advantage of market inefficiencies.

Professional traders and sophisticated retail investors may use virtual asset derivatives for speculative purposes, taking positions on the direction of virtual asset prices and attempting to profit from market movements. They may also use derivatives to manage risk, such as by hedging a long position with a short futures contract.

Given the high volatility of cryptocurrencies, it is important to acknowledge the demand from retail investors for options to hedge their investment portfolios. I suggest that operators selling virtual asset derivatives can limit the default leverage level for retail clients, with the option to adjust the leverage level and trading limits based on evidence of the client's derivative trading experience, such as the number of years they have been trading and the number of executed trades.

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?

I do not have any suggestions for enhancing the other requirements in the VATP Terms and Conditions, as they are quite similar to those in the VATP Guidelines.

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.

Chapter 12 of the AML guidelines has been thoroughly updated, aligning with FATF Recommendation 15 and Recommendation 16, which addresses the travel rule. This provides a clear direction for VASPs on how to interact with unlicensed/unregistered foreign VASPs and how to mitigate risks in such situations. The guidelines have also made significant strides in addressing virtual asset transfer and the necessary due diligence required for VA transfer counterparties, along with additional measures.

The "Targeted Update Implementation FATF Standards on Virtual Assets and Virtual Asset Service Providers - Jun 2022" document from FATF (<https://www.fatf-gafi.org/en/publications/Fatfrecommendations/Targeted-update-virtual-assets-vasps.html>)

) includes some useful guiding questions for selecting Travel Rule Technological Solutions vendors. Incorporating these question examples from FATF document into the existing guidelines could enhance the section 12.12.3, because the current section 12.12.3 doesn't mention record-keeping and transaction monitoring requirements on the Solution vendor. By incorporating these guiding questions, the guidelines could provide more comprehensive information on how VASPs can select appropriate technological solutions to comply with the Travel Rule requirements.

Question 10:

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

While fines for non-compliance are a significant aspect of regulation, it's important to note that the virtual asset industry is relatively new, and there may not be enough enforcement cases to directly compare with traditional finance. Therefore, it's crucial for both enforcement authorities and market participants to engage in more frequent communication and mutual understanding. This approach will help foster a cooperative environment where both parties can work towards developing solutions

that benefit the entire industry. Ultimately, this will help ensure the continued growth and development of the virtual asset industry while maintaining regulatory compliance.