From:
Sent: 20, February, 2023 7:19 PM
To: VATP-consultation
Subject: Re: Consultation Paper on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators licensed by the Securities and Futures Commission

I am an active retail investor in the virtual asset market and former Help Desk Technician and Community Manager for a cryptocurrency mining pool. My responses to selected questions in the consultation paper are as follows:

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

I believe that the initial proposals constitute a reasonable set of criteria by which licensed platform operators can judge the eligibility of virtual asset tokens for trading. One suggestion I would like to add is that the requirement for a specific token to be included in two indices issued by at least two independent index providers should additionally require that at least one of the indices be issued by a provider incorporated in Hong Kong, in order to ensure that the SFC is able to monitor and oversee the inclusion of virtual assets in these tokens. Otherwise, licensed platform operators might seek to launch indices containing otherwise ineligible virtual assets in other jurisdictions and markets, specifically to satisfy this requirement before the SFC is able to enforce the rules on acceptable indices.

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 proposed requirements, I would like to suggest that the Circulating Supply and Total Supply of the virtual asset (if applicable) should also be disclosed. This should also be accompanied by a link to the official website of the virtual asset outlining the virtual asset's ownership distribution on initial issuance and token unlock schedule ("tokenomics"), where available.

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?

For virtual assets where multisignature wallet technology is available, all wallets custodying client virtual assets should be required to utilize a minimum of a 3-of-5 multisig when technically possible, whereby 3 of 5 parties are required to approve transactions before they are executed. This can mitigate the likelihood of a single compromised individual key from leading to loss of virtual assets. Similar incidents have happened to dozens of previous and existing virtual asset platform operators in recent years due to the lack of proper security measures.

Additionally, operators should be required to institute maximum asset transfer limits in their internal systems. This is to help limit the potential losses incurred by unintended or unauthorized transfer of assets, such as the supposed accidental transfer of $416 million worth of Ethereum by the Crypto.com exchange deposited to a different exchange, an incident that was disclosed last November following public scrutiny of the unexplained transfers.

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?

There are a large variety of VA derivatives currently available on the market. Other jurisdictions have attempted to limit access to many types of VA derivatives, but legal enforcement has been unable to prevent investors from accessing unlicensed platforms secretly offering similar derivatives, notably platform K in the USA and platform B in the European Union. As such, I believe that attempting to restrict retail access to derivatives would merely push retail investors to seek unlicensed platforms despite the higher risks that that would entail.

I believe that a VA derivatives licensing regime should be developed to give specific guidance on the requirements for derivative products offered by licensed platform operators. Derivatives should also only be made available for VAs that already satisfy the general and specific token admission criteria, with fair disclosure of the trading fees involved. (Some existing platform operators globally display a discounted trading fee only applicable to certain trading pairs and/or when paid using a specific token, instead of the regular trading fee applicable to the selected product being traded.)

The following derivative products I believe could reasonably be offered for trading by retail investors:

- Spot market margin trading, subject to disclosure of the method by which margin interest funding fees are calculated and charged;
- USD-margined perpetual futures contracts, which have prices that trade freely against the spot market price, but either pay out or charge funding fees from the margin balance of holders, depending on the direction of the contract and the difference between the contract price and spot market indices. This is the most popular VA derivatives product sought by retail investors in the VA market at present. Platform operators wishing to offer USD-margined perpetual futures contracts should be required to do the following (non-exhaustive list):

- Explain the pricing mechanism of perpetual contracts, including how the price of perpetual contracts may diverge significantly from the spot market price depending on market demand and supply;
- Outline the method used to calculate the funding fees (including how the level of leverage affects funding fees);
- Outline the method used to calculate the spot indices, including disclosure of the name, price and volume of the individual constituent markets within the indices;
- Limit the amount of leverage available to mitigate investor losses arising from the highly volatile price movements seen in the VA market; I would suggest 10x as a maximum limit;
- Only offer Isolated Margin; As opposed to the inherently more risky Cross Margin, whereby the unrealized gain of one position can be used to provide margin for a different position;
- Create and maintain an insurance fund of a specified percentage of typical derivatives volume, with a publicly disclosed figure held in the same manner as the proposed insurance arrangement for platform operators;
- Offer relevant educational materials for investors to learn about these products.

The following derivative products I believe could reasonably be offered for trading by professional investors:
- European options with settlement dates;
- Coin-margined perpetual futures contracts, which carry greater risks than USD-margined contracts due to the volatile value of the margin balance;
- Leveraged tokens and "ETFs", which have complex pricing and funding fee mechanisms that are poorly understood by most retail investors, even where educational materials are currently provided.
- OTC loan markets where the platform operator serves only as an intermediary between third-parties.

The following derivative products I believe should be restricted entirely (non-exhaustive list):
- Prediction games where payout is determined by correctly guessing whether the price of a VA is above or below a strike price. These are effectively short duration options with poor liquidity that can only be exercised at expiry, and gamify the experience to attract retail investors. This derivative is unlikely to be useful to professional investors.
- Platform-offered copy trading of derivative products, only used to appeal to retail investors and often faked and traded against by unlicensed platform operators with trading arms.
- Trading bots offered by platform operators; There is an inherent conflict of interest present, as the platform operator benefits from the trading bots making more trades and paying more trading fees to the platform operator
- Fractionalized NFTs, "ETFs", and leveraged "ETFs" for NFT collections, which have unclear market pricing mechanisms given the non-fungible nature of NFTs.

Regards,
Vincent Tam