

# **Submission to the SFC Consultation Paper on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the Securities and Futures Commission**

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## **Introduction**

This submission responds to the questions raised by the Consultation Paper issued by the Securities and Futures Commission on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the Securities and Futures Commission on 20 February 2023 (the “Consultation Paper”).

Unless stated otherwise, terms used in this submission are the same as those terms as defined in the Consultation Paper.

Please also find in the Appendix some of our comments relating to the Proposed Guidelines for Virtual Asset Trading Platform Operators.

## **Consultation Questions**

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 agree in principle that licensed platform operators should be allowed to provide their services to retail investors, subject to the robust investor protection measures proposed as this represents an important milestone in the development of the virtual asset framework in Hong Kong.

Although there are currently investor protection measures outlined in the proposal, the SFC may consider having a set of guidelines or codes specific to virtual assets so retail investors can be more readily informed of such protection measures. This would also clear up ambiguity between certain terms that may be used interchangeably when referring to virtual assets, despite having nuanced meanings, such as “wallet” and “account”.

In particular, additional requirements licensed platform operators and licensed firms should comply with when providing services related to virtual assets to investors. For instance, enhanced suitability assessment to ensure investors are fully aware of the risks involved with the virtual asset products they intend to invest in.

Additionally, to enhance the safeguarding of the custody of virtual assets, we suggest a mechanism which will allow licensed platforms to segregate investor assets via multiple custodians so that if one key is breached, investor assets held under other keys will not be affected.

Once retail investors are allowed to use the services provided by licensed platform operators, they may likely engage in the transfer of virtual assets across hot and cold wallets. In this case, the SFC should consider robust policies and procedures whereby the transfer of such assets into hot wallets would not breach the 2% threshold as stipulated under paragraph 19 of the Consultation Paper.

On another note, given that licensed platforms may also be allowed to provide their services to retail investors, we would also like to clarify whether firms conducting regulated activities such as Type 4 (advising on securities) and Type 9 (asset management) will also be allowed to provide their services to retail investors in relation to virtual assets to ensure a fair level playing field. We note that some Type 9 asset managers are interested in increasing their exposure to virtual assets and are planning to launch virtual assets funds. However, under the current regime, their virtual asset products can only be offered to professional investors.

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

Due to the rapidly changing nature of the virtual asset market, the eligibility of “large-cap virtual assets” may fluctuate. We suggest that the evaluation conducted by the licensed platform operator in accordance with paragraph 46 of the Consultation Paper should be a transparent process, whereby the SFC and investors are sufficiently informed about the licensed platform operator’s considerations and subsequent conclusion. It would also be helpful to establish a register or index of available tokens admitted by licensed platform operators.

Additionally, given the wide breadth of virtual asset products in the market, we suggest that licensed platform operators have an approval mechanism in place for product approval which may draw reference from the present internal product approval process for SFC-authorized unit trusts and mutual funds, investment-linked assurance schemes and unlisted structured investment products.

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?*

If the SFC is minded to allow retail access to licensed VA trading platforms, we are of the view that other requirements to be implemented from an investor protection perspective should also include:

- Disclosure of any change in the admission of a virtual asset, such as an addition or removal of a virtual asset;
- Issuance information in regard to the virtual asset to be made available to investors such as the name of issuer, a brief description of the issuer’s background, the trading volume for the first 24 hours, and initial price;

- Disclosure of policies and procedures surrounding the custody of investor virtual assets, such as the percentage of hot and cold wallet allocation;
- Sufficient risk management monitoring of virtual assets to detect potential or actual market and price manipulation, such as alerts for abnormal trading volume, unusual trade/cash movement, and spoofing;
- Disclosure of investor complaints and a log of complaints received by the licensed VA trading platform;
- Stop loss agreement between retail investors and the licensed VA trading platform;
- Transaction limits of the virtual asset to be imposed on retail investors;
- Disclosure on the weighting of virtual asset products provided to retail investors compared to professional investors; and
- Disclosure of any repledging or margin financing activities of virtual asset products by the VA trading platform.

The list above is not exhaustive and we note that the SFC shall update and review such requirements from time to time accordingly with input from the industry and other regulators.

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?*

Given the conservative approach of insurers in regard to virtual assets, we agree with the SFC's proposal to allow for a combination of third-party insurance and funds set aside by the VA licensed platform operator or a corporation within its same group of companies to satisfy insurance requirements.

We also suggest that any significant and/or material change in the proportion of third-party insurance and funds set aside by the licensed VA platform operator should be disclosed to the SFC and/or investors.

The SFC may provide additional guidance on the selection of third-party insurance to assist licensed platform operators in ensuring that the third-party insurance obtained will best protect investors. Investors should also be made aware of how they will be protected in material events, such as when an eligible large-cap virtual assets experiences significant loss exceeding the insured amount, or during system blackout.

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.

For funds to be set aside by the licensed VA platform operators, we suggest using an escrow arrangement as this helps ensure insurance requirements can be met. This arrangement also improves ease of monitoring, to ensure that funds are being used as they are intended.

As insurance requirements may change from time to time, the level of funds set aside in the escrow account can be reviewed regularly and altered according to the licensed VA platform operator's needs.

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?

Several solutions to mitigate the risks associated with the custody of client virtual assets (e.g. hacking incidents or default on the part of the licensed VA platform operator or its associated entity) include:

- Segregation of client virtual assets into multiple accounts to reduce concentration risk and custodian counterparty risks that may arise; and
- Regular independent audit of the licensed VA platform operator's blockchain technology to ensure it is robust and up to industry standards.

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?

The business model to be adopted by licensed platform operators may be determined by its size, investors, as well as the different VA products and services provided. This may be subject to further revision and continuous assessment based on the licensed platform operators' needs and business. For instance, if licensed platform operators provide trading services in VA derivatives, platform operators may incentivize investors to be informed and kept up-to-date on information about such derivatives, including the risks involved through mini-award systems whereby the licensed platform operator may waive certain handling charges after the investor has completed training courses on the derivative product.

In our opinion, VA derivatives play a crucial role in the virtual asset trading market by providing a range of benefits. On one hand, they allow for effective portfolio risk management by offering a means to hedge against price fluctuations. On the other hand, licensed platform operators may increase trading volume and liquidity,

making it easier for investors to trade VA derivatives at a more equitable market value.

If VA derivatives are to be offered in the market, we suggest that the licensed platform operators may consider offering VA derivatives to retail and professional investors on a risk-based approach. Hence, higher-risk financial instruments, such as contracts for difference and exchange-traded notes which allow investors to speculate on the price movement of a VA without owning the underlying asset, should be made available to professional investors only.

Given that VA derivatives are complex and pose a higher risk compared to other investment products, we suggest that investors should be subject to more stringent knowledge tests and/or provide sufficient training to investors so they understand the nature and risks of the VA derivatives they intend to invest in. Licensed platform operators should also be reminded to provide sufficient disclaimers and warning statements to investors, particularly to retail investors, informing of the risks involved.

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?*

To provide greater investor protection, we propose additional requirements in respect of this be added to such under 4.10 of the VATP Terms and Conditions. This includes greater transparency over investor communication with the platform operator, including complaints handling and reporting of suspicious activity (e.g. suspected occurrence of prohibited trading activities).

Given that the SFC has proposed to allow retail access to licensed VA trading platforms, we suggest that platform operators should also ensure its website (paragraph 6.15 of the VATP Terms and Conditions) clearly indicates which of its services are available for professional investors only, and which are also available to retail investors.

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.*

We appreciate the SFC's work done in vamping up the AML Guideline for LCs and SFC-licensed VASPs and note that many of FATF's recommendations (as mentioned in the Updated Guidance for a Risk-Based Approach to Virtual Assets and VASPs published in October 2021) have been taken into consideration.

Given the distinct characteristics of virtual assets and the subsequent ML/TF risks associated, platform operators should ensure specific training on virtual assets is provided to staff in light of the fact that money laundering risks in virtual assets areas may be different from that of traditional banking or asset management businesses. This will help facilitate licensed platform operators' compliance with additional virtual asset-specific AML/CFT requirements.

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

We do not have further comments on this.

**Conclusion**

We appreciate the SFC's effort in formulating the Regulatory Requirements for Virtual Asset Trading Platform Operators. In light of the ever-evolving landscape of virtual assets, it is important to balance robust investor protection whilst at the same time allowing room for innovation. Particularly in the face of the recent collapse of FTX, the call for investor protection is greater than ever, and much work will be needed to regain investor trust. We believe that the steps taken by the SFC will work on consolidating this.

Generally, we agree with the measures proposed by the SFC. Such measures will, as mentioned by others, help legitimize the virtual asset regime in Hong Kong, attract investors, and solidify Hong Kong's reputation as an international financial center.

However, given that this is relatively uncharted territory, it would be prudent to continuously monitor and assess the effectiveness of the proposed measures.

**Appendix – Comments relating to the Proposed Guidelines for Virtual Asset Trading Platform Operators**

Paragraph Reference	Comments
3.16 Responsible Officers (“RO”)	The ROs will be required to take HKSI LE Paper 1 and 2 exams as they are required to comply with the LRP requirement. We note that the contents of the Papers 1 and 2 exams may not cover virtual assets. Given that it may be impractical for the industry to design another exam Paper for this, the SFC may consider imposing additional CPT requirements that relate to virtual assets to ensure their knowledge and ongoing competence in this area.
3.33 LRP Conditional Exemption 1(a)(i)	We note that the majority of virtual assets are unlikely to be listed in any specified exchanges outlined in the relevant Schedule. As a result, this may not be particularly relevant in demonstrating substantial related experience.
VI. Financial Resources and Soundness	<p>With reference to the SFC’s current minimum paid-up capital and minimum liquid capital requirements for licensed corporations under various circumstances, a risk-based approach may be considered by the SFC when assessing the financial resources requirements for VA Platform Operators.</p> <p>In situations where VA derivatives, which involve higher risks such as margin trading and leverage, are introduced, the minimum paid-up capital and liquid capital requirements of at least HK\$5,000,000 and HK\$3,000,000 respectively may be insufficient in offering a cushion against potential losses or liabilities arising from the Platform Operator’s activities.</p> <p>Therefore, we suggest that VA Platform Operators who invests in VA derivatives be subject to higher minimum paid-up and liquid capital requirements compared to VA Platform Operators who only invest in spots and/or stablecoins.</p>



<p>X. Custody of Client Assets – Insurance/compensation Arrangement</p>	<p>As insurance coverage is one of the key protective measures for investors in this context, we suggest that Platform Operators should also disclose the name of the insurer on their website.</p>
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