FINTECH ASSOCIATION OF HONG KONG

Response to the SFC's Consultation Paper on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators

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The FinTech Association of Hong Kong (FTAHK) is a **member-driven, independent, not-for-profit, & diverse** organisation that is the voice of the FinTech community in Hong Kong. It is organised and led by the community, for the community, through a series of committees and working groups.

Our objective is to promote Advocacy, Communication and Education in the wider FinTech ecosystem.

Build the community.

Be the connector.

A. FOREWORD

In February 2023, the SFC announced a new licensing regime for centralised VA trading platforms ("**VATPs**") that trade non-security tokens, which will come into effect from June 01, 2023. The intention is to update the present regime to take into account the various changes that have occurred within the VA ("**VA**") sector, and to reconsider the balance between investor protection vis-à-vis market development with the aim of fulfilling the Hong Kong government's stated policy agenda of "working towards providing a facilitating environment for promoting sustainable and responsible development of the VA sector in Hong Kong"[1] as well as Hong Kong as an "international innovation and technology centre"[2].

Upon commencement of the new regime, all centralised VATPs carrying on their business within Hong Kong, or actively marketing their services to HKSAR-based investors, will need to be licensed and regulated by the SFC, irrespective of whether a token would be deemed a security under the Securities and Futures Ordinance ("**SFO**").

The FTAHK has prepared a collective response from its members with a view to assist the SFC in finalising the proposed regulatory requirements applicable to VATPs.

Please note, that while we have consulted widely, any views expressed in this submission are the views of FTAHK and do not necessarily represent the views of individual contributors or members.

The FTAHK welcomes the opportunity to discuss any of the feedback provided in future follow-up sessions with the SFC.

FTAHK

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[1] Hong Kong Financial Services and Treasury Bureau, "Policy Statement on Development of Virtual Assets in Hong Kong" (31 October, 2022): https://gia.info.gov.hk/general/202210/31/P2022103000454_404805_1_1667173469522.pdf

[2] See Hong Kong Innovation and Technology Bureau, "Hong Kong Innovation and Technology Blueprint" (December 22, 2022): https://www.itib.gov.hk/en/publications/I&T%20Blueprint%20Book_EN_single_Digital.pdf; Financial Secretary Paul Chan, "Virtual asset sector to thrive in Hong Kong" (March 1, 2023): https://www.news.gov.hk/eng/2023/03/20230301/20230301_173757_894.html

B. SUMMARY

The FTAHK is supportive of licensed VATP operators being permitted to provide their services to retail investors, provided that robust protection measures are implemented to protect such investors. In particular, sufficient product information on the nature of those VAs offered, as well as details as to the risks of any such investment should be clearly addressed. We are also in favour of the imposition of a suitability/ risk assessment framework for any retail investors looking to trade in VAs.

The FTAHK is aligned with the SFC's intention to adopt the concept of "*same business, same risks, same rules*" to govern VATPs, putting VATPs within the scope of the existing SFO regime and subject to those requirements presently applicable to securities brokers and automated trading venues. Relatedly, we would welcome initiatives from the SFC to facilitate the operations of VATPs, including outreach and engagement with the insurance industry, and the reported roundtable to be co-hosted by the HKMA and SFC on the issue of banking services for companies operating within the VA sector.

While the FTAHK is generally supportive of greater investor protection and the various measures proposed, we would like to highlight to the SFC that several of the proposed measures are likely to impose a significant barrier to entry to new firms who are looking to establish themselves in the Hong Kong market and may cause such firms to consider other jurisdictions for their operations.

Our responses to each specific question posed by the SFC will highlight our specific areas of concern and suggestions.

The FTAHK welcomes the opportunity to discuss any of the feedback provided in future follow-up sessions with the SFC.

C. FEEDBACK TO QUESTIONS

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.

The FTAHK is supportive of licensed VATP operators being permitted to provide their services to retail investors, provided that robust protection measures are implemented to protect such investors. In particular, sufficient product information on the nature of those VAs offered, as well as details as to the risks of any such investment should be clearly addressed. We are also in favour of the imposition of a suitability/ risk assessment framework for any retail investors looking to trade in VAs.

The FTAHK is aligned with the SFC's intention to adopt the concept of "*same business, same risks, same rules*" to govern VATPs, putting VATPs within the scope of the existing SFO regime and subject to those requirements presently applicable to securities brokers and automated trading venues.

Notwithstanding the foregoing, we note that the practical cost to the industry participants of these proposals may be large: it is likely that a number of the VATPs to be regulated will be newly licensed, and therefore would not be applying existing systems and frameworks for suitability requirements and associated controls. We therefore suggest the SFC adopt a risk-based approach, having regard to an investor's circumstances (trading pattern, level of sophistication and investment experience), alongside the complexity and risk associated with a particular product.

In addition, we note that in comparing the proposed measures against similar regulation from Singapore, the European Union, the United Kingdom and Dubai, the timing and applicability of the suitability requirements appears the most stringent of our peer jurisdictions. For example, neither Singapore nor Dubai have imposed mandatory suitability and matching requirements, but rather rely on disclosure requirements: Singapore requires sufficient knowledge of a VA, but we note this appears easily satisfied via sufficient disclosure; Dubai permits participants to "engage with risk", provided that there is informed consent on the part of the customer. In comparison, the proposed new regime will impose knowledge testing, suitability, and substantial disclosure requirements on VATPs.

Whilst we are generally supportive of greater investor protection and the various measures proposed, we would like to highlight to the SFC that the proposed measures are likely to impose a significant barrier to entry to new firms who are looking to establish themselves in the Hong Kong market and may push such firms to consider other jurisdictions for their operations.

As to specific proposals:

- It is our view that the VA knowledge test and the suitability obligations are onerous to VATP operators, particularly if the eligible large-cap VA test as described in paragraph 7.6 of the VATP Guideline remains. Having such onerous testing

requirements in place may serve to create a barrier within the retail market, with likely consequences being the creation of a shadow market, or retail investors looking for investment opportunities on offshore platforms.

One way of addressing this would be for the SFC to consider an exemption of certain of these requirements for individual professional investors. Whilst the approach does match that in the SFC Code of Conduct for Individual Professional Investors, given the small pool of assets available for investment, the measures seem unnecessary. In addition, we would welcome adoption of a risk-based approach, for example, establishing trading limits where suitability has not been reviewed.

As a side note, we also query whether considerations such as, "*5 transactions within a period of 3 years*" is an appropriate means of demonstrating adequate knowledge of VA transactions.

- On the issue of exclusion of hard limits in favour of client-specific limits, the FTAHK would appreciate clarity from the SFC as to what this approach would look like, and the level of complexity and modelling expected on the part of the VATP. Please note that individual limits set by licensed platform operators may result in different operators setting different limits for the same retail investor. Alternatively, based on the approach in other jurisdictions, the FTAHK would welcome the adoption of an industry-wide common standard and guidelines to address suitability and the determination of what constitutes a "complex" product. Such common standards and guidelines should meet SFC expectations while limiting the impact on firms to develop bespoke criteria.

  This would avoid the significant risk of inconsistency in approach in relation to knowledge testing, risk profiling of clients and risk profiling of VAs. In addition, industry standard questionnaires and SFC guidance on risk profiling would allow well known VAs to be consistently categorised by the SFC.

- In relation to concentration risk, the FTAHK is cognisant that there may not be a single threshold that is suitable for the various circumstances presented by the differing types of VAs that may be tradeable. As such, we suggest that the SFC consider the issuance of a series of "FAQs" or industry guidance on how different limits should be established, taking into account various relevant factors including a product's risk rating, or a customer's risk tolerance, e.g., lower thresholds for higher risk products and lower risk tolerance on the part of the customer.

QUESTION 2 - DO YOU HAVE ANY COMMENTS ON THE PROPOSALS REGARDING THE GENERAL TOKEN ADMISSION CRITERIA AND SPECIFIC TOKEN ADMISSION CRITERIA?

The FTAHK is supportive of the SFC's approach to allowing Hong Kong-based retail investors invest and trade in VAs. However, we are of the view that the limitation on suitable assets (namely those which are classified as "large cap" and have been determined to have sufficient liquidity) is unduly restrictive and does not adequately address concerns related to protecting Hong Kong retail investors who may otherwise continue to trade VAs offshore. Moreover, we believe that the limitation to "large cap" VAs does not serve to foster responsible innovation in Hong Kong as an international VA hub. This maybe an area to consider in the context of broader initiatives, for example those in Hong Kong related to Science Park and/or Cyberport.

The FTAHK is in favour of the adoption of an objective test that is premised upon an analysis of market cap, liquidity, track record and fundamental research, as supported by written documentation In addition, to encourage greater tokenisation, we believe consideration should be given to the nature of tokens, specifically where there is a physical asset underpinning them. In these instances, the market price of the physical assets could be used as a reference price and be tracked – this should be considered when looking at the liquidity of an asset.

Looking at the proposed token admission criteria against that of comparable jurisdiction, we note that many of our peer financial markets have already adopted guidelines/ standards around token admission, and we would encourage the SFC to align any future approach with already existing standards. As an example, Hong Kong's VATP eligibility listing rules could be based on the New York Department of Financial Services ("**NYDFS**") BitLicense rules, which were first introduced in 2015. We see two facets of the BitLcense program are particularly relevant to a discussion on token admission criteria: (i) the BitLicense program allows exchanges the opportunity to self-certify that a token to be listed is consistent with the consumer protection standards associated with such license; and (ii) there is an opportunity for certain tokens to be "green listed", i.e., designated by the regulator as being safe for trading. We note also that the NYDFS specifically exempts self-certification for privacy coins, or any coins that are "*designed or substantially used to circumvent laws and regulations*."

The FTAHK also queries the significance placed on whether a token has been included in an index by a third-party provider. We note that a degree of importance has been attributed to the inclusion in an index of a token. However, we would like to highlight that inclusion in an index does not necessarily address some of the key risks associated with a particular VA and is also no guarantee of price stability of a token, low volatility, or a lower set of risks. If the SFC would like to continue to adopt the index inclusion approach, we recommend that the SFC create and publish a non-exclusive list of acceptable indices or index providers as a means of providing regulatory certainty to VATP operators, or in the alternative, provide a channel of communication

for VATP operators to verify with the SFC whether an index would be deemed acceptable.

Should the SFC look to move forward with the large-cap VA admission requirement, we are of the view that VATP operators will require additional clarity on the specific requirements to preclude any breach of the future guidelines. As an example, from a reading of the proposals, it appears that the large cap assessment is only to be performed once -- at the point of admission of the VA to the platform. Thereafter, once admitted, so long as a token does not suffer a material adverse news event, or liquidity issues, then it is able to remain an investment option, despite no longer satisfying the large cap assessment. We assume that this is not the intention of the SFC and would appreciate clarity on this issue.

In addition, when applying "*index provider which has experience in publishing indices for the conventional securities market*" under paragraph 7.6 of the VATP Guideline to the Bloomberg Galaxy Crypto Index, MSCI Global Digital Assets Index and S&P Cryptocurrency LargeCap Index, we note, based on publicly available information:

- having regard to footnote 19 of the Consultation Paper, VATPS may be comfortable to categorise up to 7 to 8 VAs as "eligible large-cap VAs". This number may be further reduced depending on whether VATPs can obtain a legal opinion confirming that the VAs do not fall within the definition of "securities";

- the SFC does not expressly provide its expectation "*that the index constituents together with their respective weightings should be easily accessible, free of charge, by investors*". Two of the three example indices do not provide such information free of charge to the public;

- the indices factsheets contain strong non-reliance disclaimer wording. This means that each VASP is required to enter into a licensing agreement with each index provider in relation to access the information necessary to confirm compliance with the Specific Token Admission Criteria and be informed of any changes to the list of constituent VAs; and

- Institutional investors may have better access than retail investors to information relating to the major indices relied upon by the Licensed Platform Operators, which would result in an information imbalance.

In addition to the above, more guidance is required on how to deal with VAs that, for various reasons, no longer form part of the constituent VAs of an index. The current VATP Guidelines seem to suggest that the only circumstances in which a VA is to be removed from a platform's offerings is where there is material adverse news, or there are underlying liquidity issues impacting the VA. Is the SFC able to clarify whether there are any other considerations VATP operators should be cognisant of?

The FTAHK would also appreciate additional guidance from the SFC as to the factors it would consider when determining whether a Platform Operator is permitted to admit VAs that do not satisfy the large cap requirement. Also, would the admission by one VATP operator of a token that does not meet the large-cap requirement be considered a green light for all other VATPs to admit such VA? Clarity on these and the issues set out above would be appreciated.

As a final point to note, we would like to highlight to the SFC that VATPs should not permit admission of "anonymity-enhanced" VAs that obfuscate transactions and impede the tracing of transactions (as required by 12.7.3 of the Guideline on AML and CFT) whilst the blockchain analytic providers have yet to advance technology to be able to monitor then elevated level of AML/Sanctions risk. Relatedly, consideration should also be given to how VATPs are to address changes to a token's governance post-admission, e.g., the subsequent adding of a privacy feature. These amendments are likely to happen without knowledge of the VATP, and an understanding of the implications to a VATP in these instances would be beneficial for market certainty.

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 VIRTUAL ASSET TRADING PLATFORMS?

In addition to the insurance requirements, to which our views are set out in our response to Question 4 below, the FTAHK is also of the opinion that the SFC should consider adoption of a risk-based approach when determining whether retail investors should be permitted access to licensed VATPs, i.e., we would recommend that operators conduct a risk assessment/ engage in a risk-profiling exercise when dealing with a retail investor, similar to what is done for retail investors in the course of recommending investment products.

In addition we believe that investor education is a key element in risk mitigation – retail investors should be required to undergo some form of education as a means of ensuring awareness of VAs and the associated risks. It is open as to who would provide these courses (whether the VATPs themselves, or by authorised service providers) or through SFC-sponsored general education. We think it would be beneficial to the industry if the SFC stipulate a minimum knowledge standard to ensure that there is an appropriate level of knowledge available in public fora as reference for retail investors. The FTAHK would be pleased to explore with the SFC how it might support a similar cross-industry initiative for the crypto sector.

In addition we note that the proposed requirements as set out in paragraph 9.28 of the consultation paper may not be achievable in all cases. Taking Bitcoin as an example, it would not be possible to provide the background information on Bitcoin's management team or developer – there is no central management team associated with Bitcoin, but designated developers; and as a result of such, disagreements between this developer group can lead to forks in the blockchain. Rather, we would suggest adoption of a minimum standard for disclosure on commonly traded VAs as a means of enhancing retail investor protection and ensuring investors receive a consistent and understandable explanation of those assets that will be available for retail investment.

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 order to make Hong Kong a globally competitive and sustainable VA Market, the FTAHK is of the view that regulatory certainty and commercial feasibility are required to be addressed in the first instance. When looking at commercial feasibility, the risk management practices of a VATP plays a critical role; insurance capital will flow into a risk segment, so long as risk carriers/ financiers are able to forecast long-term stability. To facilitate this, the establishment of an initial fundamental framework would be useful. For example,:

- Only policies insured by an insurer with a credit rating of A- or above can be admitted as contingent capital (we note that this is consistent with the practices within the EU). If there is no credit rating, a policy limit should be 100% collateralised.

- Proven claims capabilities (credit ratings) need to be demonstrated to ensure not only claim payment ability, but also claim adjustment capabilities.

The FTAHK understands the SFC's inclination to allow a combination of segregated funds and insurance as a means of providing dual protection to customer funds that are under custody, especially in light of the extreme challenges that VATPs face in obtaining sufficient and appropriate insurance – that would allow for protection of 100% of client assets – in a commercially viable way. Notwithstanding this understandable desire for consumer protection, we believe this option to be feasible only in the short term – the requirement would place additional financial burdens on VATP operators (as they must put aside a certain amount of additional capital), but additionally does not allow for risk diversification as the segregated funds assume all the risk in a single basket (i.e., the VATPs).

Given the policy objective of the SFC that VATPs are to gain confidence from different stakeholders within the digital asset ecosystem, the FTAHK believes it to be vital to involve insurers in any discussions on determination as risk – insurers will only be willing to take on the risk of insuring VAs against their own balance sheets when they are comfortable and confident in their understanding of the risk(s) entailed. Any offer of insurance would then serve to endorse the risk management, internal control framework and governance demonstrated by a VATP.

We see the risk exposure encountered by VATPs as a mix of short-tail risk, e.g., hacking, theft, and long-tail risk, e.g., financial distress of VATPs, legal liability arising from mismanagement or poor corporate governance, etc. It is our view that a long-term goal of regulators is to bridge the gap between VATPs and the insurance sector, by addressing the primary issue of how to attract insurance capital to write insurance for crypto-related risks.

We set out below some currently available insurance products which can be considered as a means of mitigating the related exposure of VATPs:

Type of Insurance	***Primary Objective***	***Who may be interested?***	***Benefits***
Directors' and Officers' (D&O) Liability Insurance	Protect the D&Os from lawsuits for innocent management wrongful acts (i.e. financial difficulty, mismanagement)	All companies, including start-ups and listed companies	Attract qualified members to join the board Attract investment capital
Professional Indemnity (PI) Insurance	Protects the company and senior management from innocent professional wrongful act	VATPs, technology companies, custodians, financial institutions and professional service providers etc	Secure the commercial contracts by demonstrating professionalism Offer extra layer of confidence to the customers/ retail users
Crime/ Specie Insurance	Protect the company from loss of intentional acts (i.e. theft)	Custodians, VATPs etc	Differentiate over competitors Additional layer of protection
Cyber Insurance	Protect the company from cyber-attack (i.e. hacking)	Every company with internet exposure (i.e. data aggregators), technology companies,	Reputational protection Alternative capital to fund remedial costs

As an initial requirement, the FTAHK would recommend the SFC make it a mandatory requirement for VATPs to obtain D&O insurance. This would allow regulators to leverage the insurance companies' capabilities in assessing a VATP's corporate governance structure, as well as the professional skills and ability of their appointed directors and officers. The industry collectively would benefit from solid corporate governance and the professional expertise of qualified directors. We note that this a requirement for listed companies in Hong Kong for similar reasons.

In terms of insurance relating to wallets, we believe that the proposed solution of combining insurance and segregated funds represents a good starting point for the industry. Given the limited capacity available to the VA sector, and to avoid this requirement from being prohibitive to market participants, the FTAHK recommends the establishment of a pool to cover all licensed VATPs and suggest a limit of US$500m as a starting point for cold wallets, and US$50m for hot wallets. In line with the approach taken by insurance providers, premiums should be proportional to the AUM at the beginning of a year and adjusted at the year-end. We believe these

proposed limits have taken into account the insurance capacity available in the global market.

In summary, whilst sufficient self, pooled or third-party coverage of the risks associated with VATPs is the aim of the regulator (and, consequently, the industry), we recommend adoption of an approach that avoids mandating prohibitive requirements. We urge the SFC to engage with the insurance industry to ensure they have the required knowledge to gain comfort with – and be confident in – the associated risks. This may be in the form of a working group to assess the obstacles to a competitive offering in the Hong Kong market, and a clear streamlined approach to any approvals necessary to offer such policies in Hong Kong to VATP applicants and/or license holders. The FTAHK would welcome such initiatives and offers its support to the SFC in furthering such dialogue with the relevant players.

On the proposals more specifically, we consider these to be an improvement on the current regulations. Specifically, the FTAHK would like to share the following comments:

No absolute requirement of coverage at all times

The FTAHK is of the view that the words "at all times" should be deleted from the Proposed Requirements. Rather, we suggest that a VATP is required to report to the SFC if,

- It becomes aware the total value of clients' VAs under custody exceeds the covered amount under the approved compensation arrangement; and
- The platform operator anticipates that such a situation shall persist.

In these instances, the platform operator would then be required to take prompt measures to remediate.

Guidance is needed on the interpretation of the appropriate level of cover

The new SFC standard is that platform operators must have an appropriate level of coverage, as approved by the SFC – no guidance is given on what would constitute an appropriate level of cover, nor what considerations will be taken into account by the SFC in determining whether to grant approval. Whilst we acknowledge that this allows for flexibility to make decisions on a case-by-case basis, we believe that this is at the cost of providing guidance to the market to minimise uncertainty. Additionally, the proposed requirements do not specify whether coverage standards for hot and cold storage, respectively, will remain the same, whether any limits will be applied to the different combination of elements, or what other factors are material and relevant for approval to be given.

We would recommend that the SFC set out non-exhaustive factors that are to be considered as part of the approval process for proposed compensation process as this would allow the industry to propose compensation arrangements that are in-line with the SFC's expectations.

Reserve funds and financial resources rules

Our comments on the option for a platform operator to hold segregated reserve funds as an alternative to insurance are set out above. Should the SFC not be minded to establish a pool fund in the manner we have described, the FTAHK is of the view that some consideration should be given to aligning the amount of segregated reserve funds to the lesser risks associated with VAs that are held in cold storage and subject to the appropriate controls. We note that the SFC has proposed a Liquidity Requirement on VATPs that will be in addition to the requirement for segregated reserve funds and believe that this combination will result in a significant financial burden and capital management constraints on VATP operators – in the absence of sufficient insurance coverage, the situation suggested by the proposals is for a VATP to, in effect, be self-insured.

By way of comparison, under the proposed Markets in Crypto-Assets ("**MiCA**") Regulation[3], crypto-asset service providers will be required to have in place prudential safeguards equal to an amount of minimum capital requirements, or one quarter of the fixed overheads of the preceding year, whichever is higher (See Article 60). The prudential safeguards under MiCA can take any or combination of the service provider's own funds, an insurance policy, or a comparable guarantee. For instance, for a trading platform with capital requirement of EUR 150,000, the required prudential safeguard will be EUR 150,000 or one quarter of the fixed overheads of the preceding year, whichever is higher.

Whilst we understand the SFC's intention to adopt a stringent approach to ensure sufficient protection for retail investors, we are concerned that the cost of the proposed protection will stifle market development. The proposed level of protection is beyond a reasonable risk-based approach to appropriate prudential safeguard, even for the sensitive case of custody for retail client VAs and we respectfully ask the SFC to consider adoption of a more balanced framework.

[33] https://data.consilium.europa.eu/doc/document/ST-13198-2022-INIT/en/pdf

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.

Our substantive comments on the proposal that VATPs set funds aside is set out in our response to Question 4 above. That being said, we would appreciate clarification from the SFC on the preferred means of storing any such funds that are set aside, as well as what levels of access by the VATP operator, if any, the SFC would consider appropriate to such funds.

Of the two options referenced in the question (i.e., a house account or an escrow arrangement), the FTAHK is of the view that adoption of an escrow arrangement may be more appropriate, given the additional level of protection offered – the funds are required to be segregated and will not form part of a VATP's general pool of assets in the event of insolvency, and as such, VATP operators would not be able to transfer money out of the account. Moreover, the escrow arrangement would provide retail investors with a beneficial and proprietary interest in the reserve amounts from the moment of inception of the trust. In the event of an insolvency, any claim made by customers would be paid directly out of the escrow account. We note, however, that the overall effect of such an arrangement is that VATP clients are provided with additional proprietary interests that do not reflect their actual holdings with an operator.

Practically, the FTAHK believes that mandatory adoption of such an arrangement may be cost-prohibitive for VATPs, and that there are likely to be a limited number of service providers who would be willing to provide services of this nature. Were the SFC to consider imposition of such a requirement, we request that consideration also be given to establishment of a pooled trust for the use of VATP operators.

In addition, if the funds to be set aside by VATPs are required to be on a matched (i.e., dollar-to-dollar) basis, with restricted usage, we foresee practical implementation issues, for example, in the capital cost of such arrangement to VATP operators, where such costs may be shifted to end users.

As such, we suggest that VATPs be given a degree of flexibility in determining how and with whom reserve amounts are to be set aside, subject to the proviso that the reserved amounts are considered adequately safeguarded (a concept that is currently used in the Stored Value Facility regime). This could be effected, for example, as follows:

- Option A: segregated funds be permitted to be kept under a house bank account with an "authorised institution" (as defined under the SFO) or foreign licensed bank, to hold the reserve amounts. The money in the bank account will only be permitted to be kept as cash, or low-risk investments (e.g., time deposits or money market

funds), or such other use permitted by the SFC. The VATP then provides an undertaking to the SFC that it will only access and use the funds upon a prescribed compensation event, evidence of which must be provided to the SFC upon such an event. The VATP would additionally undertake not to use the funds for its own purposes (e.g., on-lend or re-hypothecate the assets).

- Option B: the VATP declares a trust over the reserve amounts for the benefit of clients. This reserve amounts can be held with either:

  - a Hong Kong licensed trust or company service provider;
  - an authorised institution;
  - a licensed custodian or bank in a foreign jurisdiction; or
  - in the case for VAs, in a Licensed Platform Operator's own wallet. If this option is chosen, the Licensed Platform Operator would need to ensure an escrow-type arrangement is in place whereby transactions cannot be carried out without authorisation from a third party; this is to prevent the VATP gaining unauthorised access to such reserve amounts.

QUESTION 6 - DO YOU HAVE SUGGESTIONS FOR TECHNICAL SOLUTIONS WHICH COULD EFFECTIVELY MITIGATE RISKS ASSOCIATED WITH THE CUSTODY OF VIRTUAL ASSETS, PARTICULARLY IN HOT STORAGE?

FTAHK is of the view that the general principle to be adopted in respect of technical solutions to mitigate the risks associated with the custody of VAs should focus on the intended outcomes, e.g., a fit-for-purpose management of risks, in preference to being overly prescriptive – whether in terms of setting rules or developments of technology – as new and innovative technical solutions continue to be developed.

Against this general principle, the FTAHK recommends an approach that focuses on identification of threats and fit-for-purpose layering of multiple levels of prevent-detect-contain-recovery risk management methods suited to the particular VATP's business and current/ future operating conditions.

Concerns that the 2% hot ratio creates additional risks as too prescriptive

In the case of the 2% hot to cold ratio, whilst this may appear to manage a group of risks, the FTAHK views this level as being set too low and being prescriptive in nature. As such, there are concerns that the industry would be exposed to increased liquidity and transition risks as the air-gap nature of the hot to cold transition will usually involves humans, thereby introducing another category of threats/ risks.

Allowing only 2% of storage of assets in a hot wallet may also create a significant risk of a run "on the bank" that could lead to breaking the platform operator. The FTAHK is of the view that regular stress testing would be a more favourable means of determining an appropriate level of assets stored in hot wallets rather than adoption of a fixed percentage.

An additional risk that such a strict rule may limit the ability for customers to rapidly trade, depriving the platform operator of sources of income that could impact the overall profitability of the exchange, and also potentially depriving the customers of any trading gains.

We note that in our peer jurisdictions, regulators have adopted a position that allow for ratios that are determined in accordance with a risk management approach adopted by the VATP, and so avoid a fixed perspective. Such a 'fit-for-purpose' risk management approach that can be adjusted based on the environment would also feed into the assessment process a VATP would undergo when seeking insurance. As we have set out in our response to Question 4 above, ensuring an adequate risk and governance framework, and leveraging off the skills and capabilities of the insurance industry in conducting these assessments is a vital tool in establishing a regulatory compliant, and investor-protective, environment. A general average of 95% cold and 5% warm/ hot may be found to be a more suitable threshold to be adopted, however we note that this can range from 85% and 95% depending on market conditions, as well as the need to support liquidity for operations.

Hardware Security Modules (HSMs)

For awareness (as these are already widely used by VATPs) one of the technology solutions that enables mitigation of risks is Hardware Security Modules ("**HSMs**") – these have been integral to the current operations of highly sensitive systems, such as payment systems, and have increased prominence given the integral nature of sensitive keys in VA systems.

In terms of the management of risks of transition between hot and cold wallets, and the inherent risks associated with each wallet:

- Cold wallets are offline storage devices that provide a high level of security for VAs, while hot wallets are connected to the internet and can be more vulnerable to security breaches. Many organisations use a combination of cold and hot wallets to balance security and accessibility for VAs.

- However, transitioning VAs from cold to hot wallets can be a time-consuming and cumbersome process that can increase the risk of human error and potential security breaches. Through the use of HSMs with multi-signature capabilities, the process of transferring VAs between cold and hot wallets can be simplified and made more secure.

- HSMs, whether on-cloud or on-premise, can be configured to require multiple signatures from authorised personnel before approving the transfer of VAs. This ensures that the transfer is authorised by multiple individuals and that the VAs remain secure during the transfer process. Additionally, HSMs can be programmed to automatically move VAs between cold and hot wallets based on predefined criteria, such as transaction volume or frequency.

- By using HSMs with multi-signature capabilities, organisations can ensure that the transfer of VAs between cold and hot wallets is secure, streamlined, and efficient. This can help reduce the risk of human error, increase security, and provide clients with greater peace of mind regarding the custody of their VAs.

For these reasons SFC should anticipate the use of HSMs as part of the risk mitigation approaches adopted by VATPs.

Existing Examples of Technology Risk Management

Other elements of existing technology risk management are expected. The FTAHK notes that these are likely to change over time and reiterate our view that the regulations not be too prescriptive. For reference we include a list of current means of technology risk management solutions:

- Distributed Denial of Service (DDoS) protection of the hot storage
- Multi-signature and multi-party computation (MPC) wallets reduce the risk of single custodial keys
- Protection of sensitive data in a HSM (as noted above), confidential compute, trusted platform modules (TPMs)

- Careful management of disaster recovery to protect against catastrophic loss of online keys, however the segregation, sharding, storage and encryption all need specialist design and execution.
- Recognition that the systems, especially those on cloud and DR should be accessible from Hong Kong but may not be located in Hong Kong.
- 2FA / MFA authentication to access or action any change for the exchange and for the client
- Wallet operating policies that terminate withdrawals if these prevent controls are breached, will depend on the operations but may include positive-listing withdrawal addresses, which can narrow and control the destination where assets may be transferred to, setting transaction size limits and hourly/daily velocity limits which would require human administrators to approve and process transactions

The FTAHK notes that none of the above are 'technological innovations', but rather a layering of multiple levels of prevent, detect, contain and recovery risk management methods developed over decades to protect sensitive information and funds. The SFC should anticipate the improving risk mitigation approaches to be adopted by VATPs over time.

QUESTION 7 - IF LICENSED PLATFORM OPERATORS COULD PROVIDE TRADING SERVICES IN VIRTUAL ASSET DERIVATIVES, WHAT TYPE OF BUSINESS MODEL WOULD YOU PROPOSE TO ADOPT? WHAT TYPE OF VIRTUAL ASSET DERIVATIVES WOULD YOU PROPOSE TO OFFER FOR TRADING? WHAT TYPES OF INVESTORS WOULD BE TARGETED?

Types of Business Model

The FTAHK believes that the licensing regime regarding trading services in VA derivatives should be analogous to those of existing VA derivative models in peer jurisdictions. We believe a similar approach to that taken by the Monetary Authority of Singapore, whereby crypto derivative products are listed and traded on approved exchange would be suitable in the Hong Kong market.

Given the high statistical correlations of this young market, with a view to extend into the future and exclusive of the various underlying idiosyncratic risks (e.g., 51% attack/ hack, network failure or community fork), having access to a basket of 'major' derivatives would be initially sufficient to beta adjust/ delta hedge significant market events. The FTAHK believes that the initial types of derivatives would primarily be perpetual futures, following-up with short-dated options. One additional consideration for the SFC is whether to limit (or disallow) derivatives that involve fiat currencies (e.g., BTC/ USD), and to only permit derivatives on pairs in which both sides (the underlying and accounting currency) are denominated in a VA (e.g., BTC/ ETH). This would reduce the possibility of systemic risk of contagion to the fiat financial system in case of losses incurred by a VATP.

The FTAHK believes that these derivative products should be limited to institutional and professional investors to minimise the risk to the broader industry. If derivative products were to be offered to retail investors, we would recommend that such interested retail participants undergo extensive knowledge testing, and there be an obligation on the part of the VATP operator to clearly display the funding cost of any leveraged position in an easily understood manner.

Further, it is our view that the licensing regime should encourage the development of specific use cases for derivatives for risk management (i.e., hedging against market risk of underlying assets, or treasury management). We believe that critical market functions and products such as derivatives are vital to the furtherance and development of the VA industry.

As a matter of clarification, we would be grateful if the SFC would confirm that Ether Futures are considered Futures for the purposes of the SFO (Type 2 license). We note that presently only Bitcoin Futures is defined as a “Future” in the 2017 SFC circular.

QUESTION 8 - DO YOU HAVE ANY COMMENTS ON HOW TO ENHANCE THE OTHER COMMENTS IN THE VIRTUAL ASSET TRADING PLATFORM TERMS AND CONDITIONS WHEN THEY ARE ADOPTED INTO THE VIRTUAL ASSET TRADING PLATFORM GUIDELINES?

The FTAHK would like to make the following comments on the proposed Virtual Asset Trading Platforms Terms and Conditions:

- We would appreciate the SFC can clarify whether, in the scenario of a bank acting as a broker and connecting to a VATP via API, it would be possible for brokers to provide an assurance that their end-clients have sufficient funds, rather than to provide pre-funding to a VATP operator? Does the SFC envisage any exclusions to the pre-funding requirements?

- We are broadly in agreeance with the SFC's removal of specific admission criteria relating to security tokens, and the move towards compliance with general token admission criteria. We would also like to suggest that the SFC consider adoption of a white-listing framework for eligible Hong Kong-based projects, such as those stablecoins that are to be regulated under the HKMA's framework (or otherwise regulated by the SFC). We believe that this would serve to further cultivate and enhance Hong Kong's Web 3/ VA ecosystem and will serve to support the early-stage development of Hong Kong based projects, or future HKD-backed stablecoins.

- On the SFC's inclusion of an exception to proprietary trading requirements, whereby licensed platform operators will be allowed to conduct off-platform back-to-back transactions in limited circumstances, or on a case-by-case basis, is the SFC able to provide more guidance as to the circumstances in which it would consider granting exceptions?

- We note that there is presently no definition of "senior management" within the Guidelines and would suggest reference be made to the SFC Frequently Asked Questions. Relatedly, when finalising the guidelines for determination of competence (paragraph 3.13), the FTAHK recommends that the SFC reference paragraph 4.19 of the Guidelines on Competence, which includes a non-exhaustive list of industry experience. FTAHK believes that aligning these requirements against what licensed individuals may already be familiar with from the traditional finance industry would bring greater certainty to the market.

- We feel that additional guidance as to (i) financial accommodations (e.g., margin or leveraged trading); and (ii) algorithmic trading services would be beneficial to the market.

- We believe that VATPs need only to notify – and not obtain SFC approval – for any plan to include any new VAs, or suspend or remove any VA. This is on the basis that the SFC already requires:

  - VATPs to conduct thorough due diligence, including obtain legal advice in respect of such VAs;
  - any listed VA is to have sufficient liquidity (this is pre-determined prior to admission on an exchange); and
  - where the suitability requirement is triggered, there is an obligation on VATPs to ensure that VAs are suitable to retail investors.

We believe that the above measures are sufficient such that it is not necessary to seek SFC pre-approval.

- The existing VATP Terms and Conditions state that other SFC related rules apply – these were set out in Schedule 1 of the existing VATP Terms and Conditions. We note that this has been deleted in the VATP Guideline. The FTAHK recommends that that the following clarification be included to provide clarity and comfort as to the scope of the regulatory requirements that apply to different licensees:

  - For SFO licensees: confirmation that all other SFC rules apply to such licensees to the extent relevant, however if there is any inconsistency, the more stringent requirements apply.
  - For AMLO licensees: confirmation that other SFC rules do not apply in respect of non-security -related trading and activities.

QUESTION 9 - DO YOU HAVE ANY COMMENTS ON THE REQUIREMENTS FOR VIRTUAL ASSET TRANSFERS OR ANY OTHER REQUIREMENTS IN CHAPTER 12 OF THE AML GUIDELINES FOR LCS AND SFC-LICENSED VASPS? PLEASE EXPLAIN YOUR VIEWS.

The FTAHK believes that the requirements contained in Chapter 12 of the AML Guidelines are likely to place significant burden (both financial and administrative) on VATP operators. In response, we recommend developing industry guidance or a series of Frequently Asked Questions on features of VAs that would suggest it may be a security. This would be in addition to the requirement for VATPs to obtain legal advice on this matter as required under paragraph 7.9 of the Guidelines.

Transaction Monitoring

The current drafting of Chapter 12 appears to suggest that all VAs are inherently high risk, and in general, anonymity enhanced. The FTAHK does not consider this to be a strictly accurate representation and suggests the SFC develop industry guidance, in consultation with the industry, that would provide detailed advice on the types of features that the SFC considers enhances the money laundering/ terrorist financing risks associated with a VA.

Relatedly, to enhance protection against money laundering/ terrorist financing risks, the SFC should consider issuing transaction monitoring guidance specific to VATPs in consultation from the industry and solution providers. The FTAHK notes that a range of technological solutions are presently available and, whilst we support the technology-neutral stance adopted by the SFC, certain differences within the solutions may significantly alter the effectiveness of the screening. Providing a list of solutions or features deemed acceptable to, or advisable by, the SFC would ensure a consistent approach, and may also provide comfort to the banking sector, such that banks would be more open to the idea of offering services to licensed VATPs, an important issue to resolve in order for Hong Kong to develop as an international VA hub. In creating such guidance, we would suggest consideration of the following criteria:

- whether a solution offers real-time screening;
- whether a solution can screen a chain looking backwards and forwards, i.e., deposit and withdrawal screening through to a sensible stop, rather than being based on a pre-set number of hops;
- whether a solution can perform cross-asset and cross-chain tracing;
- whether a solution can adjust the detection triggers and risk scoring methodologies; and
- whether a solution can screen both transactions and wallets.

Data flows used within the solution should also be considered, e.g., looking at whether financial crime-related information from across the network (i.e., that reported by VATPs, as well as the transaction history) is used to strengthen algorithms and benefit the wider community. This should be considered against the backdrop of safe data and data privacy.

The FTAHK also notes that there are other factors of transaction monitoring outside of the solution space that would benefit from guidance, particularly whether there are

expectations around using quarantine, cold wallets and blocklists. In addition, as a means of enhancing the protection against money laundering/ terrorist financing, the SFC could also consider providing guidance on its expectations of any technological solutions.

Counterparty Due Diligence

The FTAHK believes that the requirements to conduct counterparty due diligence appear to be overly onerous. In particular, the requirement to understand the adequacy and efficiency of another VATP's AML controls and compliance with the Travel Rule may prove to be administratively burdensome as they will require significant time to obtain and review information. While some Travel Rule solution providers will be able to facilitate connecting counterparties with platform operators, the implication is that VATP operators would need to reach out individually to all counterparties. It is likely that a part of any due diligence to be conducted would require a review of each counterparty's AML policies and other internal information which would need to be shared directly with the platform operator. Not only would this create significant administrative overhead, some VATPs may not wish to share information as many may have developed their own technology that would be commercially sensitive. The FTAHK asks that the SFC reconsider this requirement or look to alternatives. One option to ease this overhead could include a list of Travel Rule providers or solution features that the SFC views as "low risk" that could be commonly adopted by VATP operators.

We also note that different jurisdictions are in different phases of Travel Rule implementation, and there appears an implication within the proposals that licensed operators are limited to entering into transactions with counterparties situated in jurisdictions which are already currently compliant with the Travel Rule. The FTAHK believes that if the SFC is able to share a list of jurisdictions it views as being fully compliant, it would facilitate better understanding of the SFC expectations to avoid transactions connected to tainted sources.

Whilst it is clear the requirements are aligned with traditional correspondent banking requirements, the FTAHK suggests that the difference with VATPs from correspondent banks is the ability, through on-chain analytics, to see which wallets VAs have historically been stored in and are going to. In addition, unlike traditional banking structures which use branches and subsidiaries, VATPs typically utilise global shared services and shared technology structures, e.g., an investor may be onboarded by a counterparty entity in country X, but the wallet associated with the investor's VAs are associated with an platform operator operated out of country Y. The platform operator and onboarding entity of the investor may be affiliates as opposed to a subsidiary/ branch/ parent company. We query the SFC's expectations of counterparty due diligence in this scenario, and would recommend that counterparty due diligence be performed on the platform operator entity rather than the onboarded entity of the investor.

In addition, the FTAHK believes that strengthening transaction monitoring guidance and requirements as per our comments above may achieve better mitigation to money laundering/ terrorist financing risk than requiring this level of counterparty due diligence, and as we state above, available technology already exists. . If the requirements are to remain, the FTAHK suggests sufficient transition time be provided

to the industry to agree a counterparty due diligence questionnaire analogous to the Wolfsberg Corresponding Banking Due Diligence Questionnaire, at least as between the VATPs in Hong Kong.

We note that global initiatives to address this are also underway, and the FTAHK recommends that the SFC consider providing some assurance that recognition will be given to good faith and reasonable efforts to address the important issue of money laundering/ terrorist financing, and that enforcement action will not be taken in relation to failure to comply with the Travel Rule pending a broader consensus and adoption of the requisite global infrastructure, with a long-stop date such that the industry remains motivated to solve the problem.

In addition to the views above, the FTAHK has the following specific comments on the requirements set out in Chapter 12:

- If the additional identity information examples in paragraph 12.4.1 are in fact mandatory for collection, we suggest that the SFC makes it clear to VATPs from the outset.

- The majority of the risk-based policies suggested in paragraph 12.11.21.b) are examples of best practice. It should be noted, however, that owing to the underlying mechanics of blockchain technology that it will not be possible to "*return the relevant VAs to the originator's account.*" It is for this reason that other jurisdictions have stopped short of making this specific recommendation. FTAHK welcomes other suggestions from the SFC on what to do with frozen assets or follow-up action.

- We note that some of the current technology providers with the largest coverage explicitly state that they are not, and will not become, interoperable with other providers. To be fully compliant, most platform operators will likely need to integrate with more than one provider, which will not only have a not insignificant financial cost, but impact resources in engineering and custodial teams. The impacts will be felt the most significantly by smaller [firms] wishing to enter the market.

- If the purpose of paragraph 12.13.10 is to prohibit HK licensed VATPs from operating with unlicensed or unregistered VATPs, whether because a licensing regime does not exist in the VATPs jurisdiction or otherwise, we suggest this be clearly stated.

- The phrase "*exercise extra care*" in paragraph 12.14.1 would benefit from guidance on what extra steps are expected.

- Paragraphs 12.10.6 and 12.14.3.b) state that VATP operators are expected to assess the ownership of individual accounts and later to review the assessment results of the ownership or control of each unhosted wallet. The FTAHK interprets ownership in this context as meaning that the user has ownership of the private keys associated with the unhosted wallet.

Several assessment options have been put forward or adopted by other jurisdictions for unhosted wallets, including:

- Self-declaration
- Transaction patterns between centralised trading platforms and unhosted wallets
- Satoshi testing

We would welcome clarification from the SFC of its expectation of which (if any) of these options would meet its expectations. Finally, an ownership assessment is performed at a set point in time and we note that ownership of a wallet may change, either through legal ownership transfer, or through illicit means such as cybersecurity hacks. Given that unhosted wallets represent high risk transactions, the FTAHK recommends that an enhanced due diligence approach be adopted with regular, periodic monitoring of unhosted wallets to confirm ownership for the duration of the relationship with the investor.

- We welcome clarification of footnote 107, as it is unclear what is meant by its reference that occasional transactions do not apply to licensed corporations or SFC-licensed VATPs. This appears to contradict with paragraph 12.3.2 which directly provides for occasional transactions for SFC-licensed VATPs.

QUESTION 10 - DO YOU HAVE ANY COMMENTS ON THE DISCIPLINARY FINING GUIDELINES? PLEASE EXPLAIN YOUR VIEWS.

The FTAHK is supportive of the position of establishing equivalency between traditional and centralised VATPs and encourages the development of a fair and equal playing field. We note that the proposed guidelines are almost identical to the disciplinary fining guidelines for traditional financial services and, looking at the broader international context, largely in line with the provisions of Article 113 of MiCA, which provides considerations relevant to disciplinary fines in the context of VATPs.

In determining the level of fines, the FTAHK is of the view that fines should be proportionate to the action and also recognise the intent of the perpetrator. Given that the possibilities for market volatility, we would also suggest that any fines imposed should be based on the value of the VA(s) at the time of the event, i.e., any gain or loss in the period between the loss and the imposition of a fine is not considered as this would avoid instances of significant uncertainty and detriment to VATPs given the volatility of VAs prices.

When finalising the Disciplinary Fining Guidelines, it would be helpful if the SFC would clarify how disciplinary actions are to be attributed to individuals and corporations in practice. The Disciplinary Fining Guidelines and AMLO make it clear that the SFC's disciplinary powers apply to all "*regulated persons*", which includes both individuals and corporations. However, in practice, we have observed that there are significantly more enforcement actions brought by the SFC against individuals, rather than against corporations, and we are unclear as to the basis for this. As such, we feel it would be useful for the market to be provided with clear guidance as to the factors that the SFC takes into consideration when determining whether to pursue a corporation or an individual. As an example, it may be that where a company has comprehensive

compliance policies and procedures, coupled with adequate training for staff and other measures in place, would this be an instance of where the SFC would focus on individual prosecution rather than pursuit of action against a corporation? While we appreciate that a certain degree of discretion is available to the regulators in determining its course of action, the FTAHK believes that such guidance will assist in creating a more robust VA ecosystem in Hong Kong.