

The Hong Kong Chartered Governance Institute

Submission

Securities and Futures Commission (SFC)

Consultation Paper on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the Securities and Futures Commission

30 March 2023

Re: Consultation Paper on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the Securities and Futures Commission

[Unless the context requires otherwise, the terms and expressions used in this submission shall have the meanings set out under the Consultation Paper.]

About HKCGI

The Hong Kong Chartered Governance Institute (HKCGI), formerly known as The Hong Kong Institute of Chartered Secretaries, is the only qualifying institution in Hong Kong and the Mainland of China for the internationally recognised Chartered Secretary and Chartered Governance Professional qualifications.

With over 70 years of history and as the Hong Kong/China Division of The Chartered Governance Institute (CGI), the Institute's reach and professional recognition extend to all of CGI's nine divisions, with about 40,000 members and students worldwide. The Institute is one of the fastest growing divisions of CGI, with a current membership of over 7,000, 300 graduates and 2,600 students with significant representations within listed companies and other cross industry governance functions.

Believing that better governance leads to a better future, HKCGI's mission is to promote good governance in an increasingly complex world and to advance leadership in the effective governance and efficient administration of commerce, industry and public affairs. As recognised thought leaders in our field, the Institute educates and advocates for the highest standards in governance and promotes an expansive approach which takes account of the interests of all stakeholders.

Manage and not de-risk

From the applied governance perspective, the primary issue for the consultation is whether Hong Kong should de-risk retail participation in VAs, given events, including the collapse of FTX with the stranding of billions of dollars of customer assets, demonstrate risks. The alternative is to seek to educate retail investors and other market participants on the underlying risks and manage them through effective and robust regulations, supervision and enforcement against VA trading platforms and their product offerings.

From the applied governance perspective, we support the latter approach, where the risks of product offerings are managed for market integrity, which will also promote Hong Kong as an International Financial Centre. In line with the position advocated by IOSCO, which is spurring a transition from an anti-money laundering/counter-financing of terrorism AML/CFT-focused approach to more comprehensive regulations.

In this connection, our Institute recognises that the SFC is a forerunner in having introduced the opt-in regulatory framework in 2019 covering areas such as safe custody of assets, Know-Your-Client (KYC), AML/CFT, prevention of market manipulative and abusive activities, criteria for admitting virtual assets for trading, accounting and auditing, risk management, avoidance of conflicts of interest and cybersecurity. For a centralised VA trading platform. The AMLO VASP regime will also come into effect in June 2023. Upon commencement of the AMLO VASP regime, all centralised VA trading platforms carrying on their businesses in Hong Kong or actively marketing their services to Hong Kong investors will need to be licensed and regulated by the SFC, irrespective of whether they provide trading services in security tokens.

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.

We agree.

As set out in paragraph 16 of the Consultation Paper, the virtual asset landscape has changed significantly, and it is opportune to review the SFO requirements and consider potential modifications, to strike a better balance between investor protection and market development.

We agree with paragraph 26 of the Consultation Paper that the dynamics of the virtual asset market have changed significantly. More global financial institutions and service providers, such as traditional custodians, have entered the space and are establishing institutional-grade infrastructure.

In this context, we are not opposed to allowing, from the applied governance perspective, retail investor access to VA. This would be subject to robust investor protection, including under the VATP Guidelines. We agree with the safe custody provisions where no more than 2% of client assets are in hot wallets, and other matters, including KYC and AML/CFT requirements, managing of conflict of interests, and proper risk management, etc., referred under paragraph 19 of the Consultation Paper.

We must emphasise that issues relating to mis-selling and adequacy of disclosures, including the risk of loss of the entire investments, must be addressed and made clear to retail investors. There can be a significant market impact on Hong Kong's reputation from VA-related failures, and the supervision and enforcement by the SFC must be adequate. There should also be an element of surprise, for example, with random audits and/or mystery shoppers of VA platform operators.

Question 2:

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

As noted under paragraph 38, virtual assets are not SFC regulated. The SFC may reconsider the US-style accreditation and set a general amount. As noted, this was suggested by some respondents under soft consultations. It is essential that retail investors know they are buying into risky products and could potentially lose all their investments.

If a suitability regime is employed, will there be any element of independence for the token admission and review committee? This is a governance issue, and the proposal under paragraph 34 is that there should be senior management representation and board oversight.

Regarding general token admission, under the Consultation Paper, this is left to the platform operators. Again, the governance issue is that there should be enhanced investor education and clarity that investors are buying into unregulated products not authorised by the SFC and could lose their entire investments. As to specific tokens with at least two independent index providers, the volatile nature of tokens and the evolving nature of acceptable indexes mean that we are unsure if this represents sufficient comfort from the governance perspective. Rather the focus should be adequacy and transparency of disclosures to the retail investors that they might lose their investments.

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?

The SFC could consider requiring disclosures as to which other jurisdictions, if any, will there be potential recourse and related regulation. The feasibility of a levy for compensation funds may be considered, but the losses might exceed the fund amount.

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?

The real risk relates to the underlying volatility. The enhancement will presumably cover employee fraud and other defined matters. Thus, we are not opposed to any credit enhancements provided they are appropriately ring-fenced and can be managed by, for example, licensed TCSPs or other independent professionals.

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.

Please see our answer to Q4.

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?

Please see our answer to Q4.

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?

This is a question for Platform Operators, and in case there are governance issues, we will be pleased to comment further.

Question 8:

Do you have any comments on how to enhance the other requirements in the VATP Terms and Conditions when incorporated into the VATP Guidelines?

We have no specific comments on the operational model proposed by the SFC, which is best left for comments from Platform Operators.

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.

We do not have any specific comments, as AML/CFT issues are covered internationally. The regulatory model proposed by the SFC will no doubt be acceptable under emerging international best practice.

Question 10:

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

We do not have any specific comments as this is part of the SFC's regulatory model.

If there are any questions, please feel free to reach out to Ellie Pang FCG HKFCG(PE), Chief Executive, HKCGI or Mohan Datwani FCG HKFCG(PE), Deputy Chief Executive, HKCGI at 2881 6177 or research@hkcgj.org.hk.

Yours sincerely,

For and on behalf of
The Hong Kong Chartered Governance Institute



Ernest Lee FCG HKFCG(PE)
President