Hong Kong Securities and Futures Exchange  
54/F, One Island East  
18 Westlands Road, Quarry Bay,  
Hong Kong  

31 March 2023  

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

Dear Sir/Madam,  

Binance understands the responsibility we, and every other major platform, have in collaborating with policymakers and regulators to contribute to the development of a regulatory framework with consumer protection and market integrity at its heart.  

We hope you find our response to the consultation helpful. We are keen to continue the discussion on this important issue, and look forward to discussing our response in further detail.  

Thank you for taking the time to engage with us.  

Yours faithfully,  

Binance.
Responses as submitted via on-line link:

**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.

**Retail access**: We understand that the HKSFC intends to limit retail access to tokens which are large-cap and liquid (e.g. virtual assets which are listed on acceptable indices such as Bloomberg).

We do not believe that it is appropriate to distinguish between tokens that can be traded by retail clients compared to those that can be traded by professional clients. This is because any token that is listed on a VA trading platform should go through a comprehensive listing assessment before being made available to the investing public (whether retail or professional). Differentiating retail and professional clients by reference to token type is not in line with similar global regimes. We think that there are other more appropriate ways to protect retail clients including:

- Different standards of risk warnings
- Applying a suitability test / questionnaire for retail clients
- Restricting leverage

In addition, liquidity of a token is only one of the aspects that should be considered as part of a holistic listing process.

Instead of restricting retail access to certain large cap tokens, we would instead encourage the HKSFC to require that VA trading platforms design a clear and transparent application process for admission of a virtual asset to trading. This should be approved and reviewed by the HKSFC. The VA trading platform should take into consideration key matters such as the background of the issuer of the virtual asset, legal classification, liquidity of the token, its code design and infrastructure security. We believe that these considerations are important irrespective of whether a token is traded by retail or professional clients.

In respect of the listing of new tokens (which have not previously been publicly traded) (“New Tokens”) VA trading platforms should apply enhanced due diligence before and after the listing process. For example:

- With the absence of past trading volume and pricing data, the VA trading platform should have a well-defined and transparent methodology to forecast trading volume, listing price, and market cap of the New Token on day-one of trading. These estimated liquidity metrics should be taken into account during the listing evaluation process for New Tokens, similar to historical trading data used for existing tokens. New Tokens that cannot meet the liquidity requirements should not be listed.
A post-listing review should be carried out by the listing committee within the first week of the New Token listing to ensure that the New Token meets the initial pre-listing expectation, and as applicable, feedback should be provided to improve the process for future listings of New Tokens.

In circumstances where a New Token transacts materially below the initial liquidity estimates, the committee should report the event to the HKSFC.

Existing requirements such as pledging/lending (paragraph 19a): It may be helpful to consider the different aspects of the crypto ecosystem to ensure that services and activities can be made available to retail customers proportionate to the overall benefits and risk the industry presents to the HKSFC and Hong Kong. For example, activities such as yield farming, staking, and saving have different characteristics, risk profiles and utility within the crypto ecosystem and should be considered separately. The levels of risk and reward, complexity and impermanent loss also differs across the activities with saving and staking simpler than higher risk yield farming.

In particular, staking is the process of supporting a blockchain network and participating in transaction validation by committing crypto assets to that network on-chain. It is used by blockchain networks which use the proof of stake consensus mechanism and is integral to the functioning of the blockchain network.

Through appropriate regulation, including the use of disclosure and customer consent, it is feasible that simple, lower risk, saving and lending activities can be made available to retail consumers safely. Importantly, this should include staking products that support the blockchain network.

Safe custody of assets (paragraph 19a): we would suggest that the proportion and mix of client virtual assets in hot and cold wallets is dependent on the licensed VA trading platform operator’s business model and should be managed in line with, for example, its liquidity risk management policy and processes to ensure good operational resilience. This proportion and mix should be managed operationally and not mandated by HKSFC. For example, mandating a small upper limit on the overall volume of client virtual assets that are able to be stored in a licensed VA trading platform operator’s hot wallet (e.g. 10 percent) could (i) impact the speed at which customer withdrawals can take place; (ii) compromise security systems of the licensed VA trading platform operator as it will require more sweeping from the cold to the hot wallet.

Knowledge assessments (paragraphs 28 and 29): Any assessment of customer knowledge should aim to be proportionate to the nature, scale, and complexity of the risks posed. To achieve the outcome required the knowledge assessment should be operated by industry and be flexible enough to reflect the individual services and activities being accessed by each customer. To ensure consistency in approach, and a fair and reasonable assessment of customer knowledge, an industry working group with representatives from HKSFC should agree the principles expected, including desired outcomes to be achieved. Industry should then design
solutions to assess knowledge based on this framework to enable the right balance to be struck between the responsibilities of the regulator, regulated and retail customer. This should help ensure that knowledge tests are practical and fair, in support of the policy objective, whilst allowing retail customers to exercise individual choice in respect of crypto.

Where a retail customer does not have the required standard of knowledge this should be based on an assessment specific to the service or activity being accessed. Customers should be allowed to take the knowledge test again and be provided with support and materials to support them. Any interim restrictions applied to individual services or activities, based on the customer’s lack of knowledge, should be flexible and consistent with this approach.

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

**General token admission:** In respect of the general token admission criteria we would suggest that it may be worth formalising the criteria in a whitepaper submitted to VA trading platforms or regulators as part of the admission process. Whitepapers are important documents and provide a level of information that is helpful to VA trading platform operators and regulators when meeting their own obligations. We would also suggest that the information submitted should not be restricted to the general token admission criteria set out in the consultation, or the use of a specific template. This is relevant to managing internal operational processes, the whitepaper providers who operate globally, and for future proofing where a whitepaper may contain other information that has not been mandated.

**Specific token admission:** On the specific token admission criteria we believe this is overly restrictive and likely to be operationally impractical, as per our response to Q1.

In addition to our answer in Q1, whilst there has been an increase in the number of virtual asset index providers, these tend to be providers from traditional finance and we query whether such providers have sufficient skills and experience in the digital asset space. Further, this proposal may also lead to index providers pulling away from the sector if a stamp of approval from them is taken into consideration.

**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?

We agree with the sentiment expressed by the HKSFC at paragraph 27 of the consultation document that retail investors should be permitted access to trading services provided by licensed VA trading platform operators. We highlight for information MAS’s view at 2.10 of their digital payment token consultation document that “regulation does not shield consumers from the risk of their cryptocurrency holdings losing value, or if DPT service providers collapse due to unsustainable business models, fraud or excessive risk taking. As with all financial decisions,
consumers must take primary responsibility to understand the choices they wish to make, obtain the needed information, and exercise utmost caution before deciding where to put their money.”

As regulation matures globally, and crypto service providers better understand the regulatory standards expected of them, we expect that speculation and volatility observed in some markets should reduce. Current regulatory concerns may change as a result, and flexibility should exist to allow appropriate access so that the wider opportunities of crypto innovation can occur proportionate to the overall benefits and risk the industry presents to HKSFC and Hong Kong.

**Reconciliation and disclosure of retail account information:** For firms licensed as VA trading platform operators we would suggest that timely reconciliation of customers’ assets, together with the ability to make a customer statement of account available to the customer, is important. We suggest that for licensed VA trading platform operators best practice for customer reconciliation is ‘real time’.

Operationally, including for security reasons, we would suggest that as long as the information required is available to the customer, on at least a monthly basis, the licensed VA trading platform operator should not be mandated to send the information to the customer uninitiated. Where the licensed VA trading platform operator’s functionality enables the customer to log-in and self-serve to access the information in their account directly, and in which there is a log of all their transaction data enabling them to view a statement of their account, then this should suffice in meeting reconciliation and disclosure requirements.

**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?

It is commercially difficult to obtain insurance to the standard currently expected by the HKSFC which is consistent with other areas important to technology such as cyber insurance. There are many reasons for this, including lack of historical data to help price and write insurance, the evolving nature of the industry and threat landscape, determining the scale and scope of the insurance required and the lack of legal precedent. In the short term responsible companies such as Binance take IT security extremely seriously and provide support and self-funded insurance schemes such as our Secure Asset Fund for Users (SAFU) to their users. In the longer term we believe the virtual asset industry, with appropriate guardrails and encouragement from regulators, will present opportunities for the insurance industry to capitalise on. We believe this will be a win-win for all parties involved.

We would emphasise that Binance’s cold storage is, by design, extremely secure and Binance is fully supportive of high IT security standards designed to safeguard its platform and users such as the Binance Custody solution.

Binance utilises commonly accepted international standards (e.g. externally audited and certified ISO27000, SOC2 TypeI/II) relevant to the provision of IT services, including in its
approach to business resilience, data and cyber security and customer information protection. This includes designing, implementing and operating the platform with built-in high availability across different availability zones, and data durability with a greater than 99.99% service level agreement (SLA). Business resilience standard operating procedures and SLAs have been clearly defined for the failure of critical system components with regular revisits and failover practices. Data security and customer information protection includes classifying and managing data based on sensitivity. All internal and external facing systems have clearly defined permission and role based access controls. We also monitor critical system components, user devices and endpoints for potential hacking or exposures to security vulnerabilities.

Instead of mandating the specifics of wallet insurance, we would instead propose:

- Requiring VA trading platforms to “self insure” on terms agreed by the HKSFC with published materials providing information and assurance relating to cyber security practices and operational resilience.

- VA trading platforms could establish one or more separate captive insurers within their global group that provide an insurance solution on a group wide basis.

- Applying a similar approach used for traditional financial services, where there is typically a maximum limit on how much protection can be offered to each customer. For example, bank deposit insurance is capped at HKD 500,000. We recommend applying a similar logic, such that each investor's virtual assets are insured but up to a notional limit. The level should be applied to ensure that most retail investors are fully protected, to allow limited resources going to the most vulnerable set of investors.

**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.

The Financial Stability Board’s recent consultation on “Regulation, Supervision and Oversight of Crypto-Asset Activities and Markets” identified in its Annex 1 “Essential functions, risks and relevant international standards” that Function 2: Wallets and custody are operational risks (please refer to Annex I of the FSB paper)

Through consultations such as those published by the FSB and HKSFC we expect that the regulation of crypto will introduce robust governance, effective risk procedures and adequate internal control mechanisms proportionate to the nature, scale and complexity of the risks inherent in the business model and the firm’s activities. This will include disclosures relating to the risks and arrangements in customers having their assets held by VA trading platforms, and the effective management of conflicts of interests by e.g. appropriate asset segregation, supported by internal systems and controls and external audit.
Due to the inherent characteristics of VA trading platform businesses, and the underlying technology used, as compared with traditional financial services, it may be necessary to regulate them on a more bespoke basis. For example, depending on the business or customers of the VA trading platforms:

- it may not always be operationally feasible and may in fact increase security risk where a third party custodian is required to hold customers’ assets,
- they may list a wide range of tokens, some of which third party custodians may not be capable of holding, and;
- involving a third party custodian may require on-chain transfers which may compromise security, timeliness of transfer and increase cost to users.

Binance proposes that, within regulatory guardrails, there should be flexibility to enable different risks to be managed appropriately by the VA trading platforms.

**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?

We recommend the use of the Threshold Signature Scheme (“TSS”) solution for hot storage. TSS is an advanced form of multiparty computation (“MPC”) that provides a greater resilience and security level to mitigate single point of failure. TSS enables a group of participants to jointly sign a message without any one of them having complete access to the signing key. In TSS, the signing key is divided into multiple shares, and each share is distributed among the participants. A predefined threshold of participants is required to cooperate in order to produce the signature. This ensures that no individual participant can sign a message on their own, and also provides fault tolerance in case some members are unavailable or compromised.

There are a number of advantages of TSS, including:

- **Greater security** - it is significantly harder for attackers to gain access to TSS-based virtual asset wallets, because there is no single point of failure. Multiple parties must be compromised to gain access to the private key.
- **Tolerance to failure** - Since the threshold number of participants required to sign a transaction can be smaller than the total number of secret shareholders, the system can sustain multiple participants failing while still being able to generate signatures and approve transactions.
- **Privacy** - the nature of - participants are not required to reveal their secret share to others meaning that every participant’s input is kept private.

**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?

Derivatives:
Binance would be interested in providing certain Futures and Options products of the nature described below to professional, institutional and retail clients in HK. The following are intended to be illustrative examples:

Futures: perpetual and delivery futures contracts that are quoted, settled and margined in either stablecoins (i.e. such as USDT or BUSD, known as “USDS-M Futures”) or certain cryptocurrencies (i.e. such as ETH, BTC, know as “Coin-M Futures”). Users would need to provide a certain amount of “initial margin” in order to open a position in Futures and would need to meet ongoing “maintenance margin” requirements in order to maintain open positions. Futures are therefore “leveraged” - the amount of leverage permitted will depend on the product and the particular user. If users fail to meet applicable margin requirements, their positions will be subject to automatic liquidation.

Options: European-style options that are quoted and settled in stablecoins, with expiries ranging from 1 day to weekly, monthly or quarterly. Exercise will be on expiry only (and will be automatic if the option is “in the money” in favour of the Buyer at expiry). An option buyer will need to pay a premium (in USDT) in order to open a position in an option contract - margin requirements will only be applicable to certain users whom Binance would permit to write/issue options and therefore take short positions in options (i.e. certain market makers). Failure to meet margin requirements where applicable will result in positions being liquidated.

Business Models:

Binance would be interested in the following business models:

Platform operator/matching engine: Binance would act as platform provider and match orders from different participants. Binance would essentially operate a financial market in the relevant products.

OTC /principal activity: Binance would offer Futures and Options as principal and would face all clients on resultant trades. Risk would be hedged back to the global Binance platform.

Leverage third party licence: Binance would offer Futures and Options products through a third party licensed entity in HK, leveraging the licence held by such third party - which could be a platform operator licence or a principal trading licence.

Investor protection safeguards:

VA derivative trading should be permitted provided that VA trading platforms implement investor protection safeguards.

For example at Binance, as part of our French AML registration, we have first-hand experience differentiating sophisticated/non-sophisticated investors with respect to derivative products. In
this regard, the AMF granted Binance France an exemption to make derivative products available to institutional investors as defined under MiFID.

Another risk mitigant with respect to derivative products (rather than an outright ban) is to impose leverage restrictions per client classification. For example, in Japan, a regulated Type I FIBO is prohibited from (i) handling crypto asset derivative transactions for customers without requiring their customers to deposit sufficient margin and (ii) continuing to engage in a Crypto Asset Derivative Transaction without requiring their customers to deposit margin to fill any shortfall in the required deposit, at a certain time on each business day.

The amount of margin to be deposited by a customer will be, if the customer is an individual, 50% of the value of the crypto asset derivative transactions (i.e. the leverage ratio will be up to 2 times) or if the customer is a corporation, the value of the relevant Crypto Asset Derivative Transactions, multiplied by the crypto asset risk assumption ratio specified in the relevant public notice. This ratio is expected to be based on the calculation by using historical volatilities. In this regard it should be acknowledged that where the customer is a corporation or sophisticated individual, we would propose to offer accredited tiers of margin, higher than what would be available to retail clients. The rationale behind such suggestion is that Binance utilises a client classification process during which we collect various information and supporting documents to help assess and evidence the following: the client’s regulated status (where applicable, e.g. regulated and licensed institution/individual), financial literacy and competence, availability of financial resources, understanding of the risks involved in trading derivatives, and ability to bear financial losses.

**Question 8:** Do you have any comments on how to enhance the other requirements in the VATP Terms and Conditions when they are incorporated into the VATP Guidelines?

No further comments.

**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 welcome the efforts that HKSFC have implemented to achieve compliance with relevant AML obligations for VA trading platforms, including the “sunrise issue”.

The Financial Action Task Force (FATF) is also aware of the sunrise issue, and has allowed for some flexibility for member countries to decide how to tackle the delays in the global implementation of the Travel Rule.

The HKSFC requires a risk-based due diligence assessment on all VA counterparties before affecting VA transfer and has set out some criteria to be considered for due diligence assessment.
We would suggest that the HKSFC also consider a "self assessment checklist" for due diligence assessments similar to the current AML self-assessment checklist. This would help to support consistency amongst local VA trading platforms and avoid polarised assessment results.

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

No comments.

**Question 11:** Seeking comments. The SFC welcomes comments from the public and the industry on the proposals in this consultation paper. The feedback received will help us finalise the proposed regulatory requirements applicable to licensed VA trading platform operators. Please submit comments to the SFC in writing no later than 31 March 2023.

**Dual Licences (Para 89 - 90):** This proposal is inconsistent with similar virtual asset regimes globally, where regulators have created a standalone licence and registration regime for “virtual asset” services, recognising that virtual assets should be categorised differently to financial products/services.

We believe that the HKSFC’s existing “opt-in” regime is sufficient, and there is no need to create a new dual-licensing regime for the VA trading platform.

In particular, before listing a token, the VA trading platform can obtain legal advice clarifying whether the token is likely to be a virtual asset or a security. Based on this the VA trading platform can ensure it has the correct regulatory permissions.