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Re: Public Comment on CR/04/2023 - Policy Recommendations for Decentralized Finance (DeFi)

Consultation Report

Greetings:

I am writing in response to the request for public consultation CR/04/2032 issued on September 2023 regarding Policy Recommendations for Decentralized Finance (DeFi) Consultation Report. My comments are on behalf of Twofish Enterprise (Asia) Limited, a company is a small fintech company in the Hong Kong Special Administration Region of the People's Republic of China. We are a fintech laboratory whose goal is to promote technology transfer between the realms of high-energy physics and finance.

We note with pride that, Ms. Julia LEUNG, the Chief Executive Officer of the Securities and Futures Commission is chairing the Board of Directors of IOSCO, and wish to thank the staff and members of the SFC for their efforts implementing securities regulation in Hong Kong. We wish to emphasize that our extremely negative views toward the state of virtual asset regulation in Hong Kong are not the fault of the SFC staff and leadership, but rather with the standards and policies that

they are asked to implement, including, the standards and guidelines that IOSCO has proposed in the current public consultation.

Regarding Questions 1, 6 and 7, we strongly disagree with the recommendations and guidance in this report and that we believe that efforts to create a globally consistent framework for virtual asset

regulations have severely damaged Hong Kong's role as an international financial centre and its efforts to become a virtual asset hub. We further believe that efforts to standardize virtual asset regulation are unworkable given the existing geopolitical environment. In fact, we would strongly recommend to the Hong Kong regulators, that given the extremely negative impact that the IOSCO project of standardization has had on the virtual asset market, that the Hong Kong regulators refrain from introducing any new regulations based on IOSCO recommendations.

Regarding Question 4, we feel that IOSCO has not considered the role of geopolitical risks and conflict in securities regulation, and consideration of those risks make the recommendations in the public consultation untenable. We understand the difficulties and sensitivity of considering geopolitical risks and conflict in discussions of securities regulation, but failure to discuss these

matters will not lead to good public policy.

Regarding Question 10, As we disagree with the entire approach IOSCO has taken toward global securities' governance, we naturally interoperability between this report and the IOSCO CDA Report is not an overall effective framework.

Regarding Questions 3 and 5, we believe that fundamental misunderstandings of the virtual asset and decentralized markets have led Hong Kong regulators to adopt regulations based on IOSCO regulations that have done extreme damage to Hong Kong's status as an international financial centre, and that this lack of research has contributed to the negative development of financial regulation in Hong Kong.

Specifically regarding Question 5, we have identified several data gaps within the public consultation. First, IOSCO has been focusing on the illicit uses of DeFi rather than its positive, beneficial uses. Second, IOSCO has does not give sufficient focus to the users of DeFi rather than to the operators of the system. Third, IOSCO does not give sufficient focus to the business aspects of DeFi. Who are the actors, how do they make their money, what are their jurisdictional needs?

However, while we fully support IOSCO’s efforts to better understand the DeFi market, we strongly oppose the efforts by IOSCO to standardize global regulations and to attempt to encourage member jurisdictions to extend regulations from traditional financial regulation to the virtual assets space, and we shall now elaborate the basis for our position.

**Implementing IOSCO recommendations has had a severe negative impact on securities regulations in Hong Kong**

Our extreme negative reaction to the recommendations and guidance in the IOSCO public consultation arises from our extreme frustration and dissatisfaction with the outcome of virtual asset regulation in Hong Kong. In the early 2010s, Hong Kong was a world leader in the area

of virtual assets and decentralized finance, and this was due to the favourable regulatory environment offered to the virtual asset industry at the time. However, as Hong Kong has moved away from its original light touch approach to virtual asset regulation and implemented the regulations of IOSCO and other international standard organizations such as FATF, this has had an extreme negative impact on Hong Kong's role as an international finance centre without improving

investor protection or creating any social benefit.

Specifically, we believe that then effort to create global consistency using a "same activity, same risk, same outcome" philosophy behind these guidelines and recommendations in the IOSCO public consultation has and will continue to have a negative impact on Hong Kong as an international financial centre and its efforts to become a virtual asset hub. To create consistency with the recommendations of international standards bodies such as IOSCO and FATF, the Hong Kong

regulators have introduced a virtual asset service provider licensing system and have mandated standards and practices on virtual asset providers that have created an absolutely devastating impact on Hong Kong's role as an international financial centre.

Hong Kong drives on the left of the road, whereas the mainland of China drives on the right of the road. Both systems can be the basis for proper traffic regulation. However, a misguided effort to ensure global regulatory consistency and standardization under the principle of "same activity, same risk, same outcome" would result in regulations that result in everyone driving in the middle of the road, and we believe that this is the outcome of virtual asset regulation in Hong Kong.

Although the Hong Kong government has stated its intention to transform Hong Kong into a virtual asset hub, these efforts are failing due to the flawed regulatory approach which the Hong Kong

government has taken. The virtual asset service provider licensing system that Hong Kong implemented has created extreme difficulty on the ability of honest companies such as ours to innovate and to attract talent and capital to Hong Kong, while doing nothing to protect investors against fraud or dishonest activity.

**Implementing IOSCO recommendations has made Hong Kong an unattractive location for virtual asset capital and talent**

In early 2023, there was a flurry of interest in virtual asset providers to come to Hong Kong. However, this excitement was based on the hope that Hong Kong would use its new virtual asset regulations to create a system which would be inviting to both talent and capital in the virtual asset space. However, much of this excitement and interest was based on "wishful thinking" that the Hong Kong regulators would reverse the failed policies of recent years and return to the light touch approach which characterized Hong Kong policy in the 2010s. As it has become clear that this was not the case, and that in fact the SFC would be implementing Hong Kong's new virtual asset regulations in accordance with IOSCO recommendations, this excitement has turned to

disappointment, and companies in the global virtual asset industry now find Hong Kong to be an unattractive destination to set up operations because of its flawed virtual asset regulatory system.

We have noted that no global virtual asset service provider has submitted a licensing application under the new system, and our extremely negative experiences in our efforts to secure a licence and

to assist other small local companies in Hong Kong to secure a licence has convinced us that the current virtual licensing system is completely unworkable for small local companies. We note that no company that is licensed or has submitted a licensing application has publicly reported themselves to be profitable, and we therefore question the long-term viability of the licensing system.

Specifically we believe that the licensing system imposes massive and untenable compliance costs of virtual asset service providers in Hong Kong. Although one may think that a licensed company can recover costs by excluding competition, we believe that the nature of DeFi makes it impossible to create a captive market for investors in Hong Kong, while the barriers produces by licensing prevents outside companies from setting up in Hong Kong thereby hurting the local virtual asset ecosystem.

Part of the failure to attract interesting from global virtual asset companies has been due to fundamental misunderstandings by the Hong Kong regulations as to the needs of virtual asset companies. Most of the interactions between the Hong Kong regulators and financial institutions are with large multinational companies, which benefit from the IOSCO project of consistent cross-border regulations. A large multinational company benefits from dealing with one set of consistent

regulations, regardless of whether those regulations are favourable or not. Furthermore, by subjecting virtual assets to the same rules as traditional assets such as stated in Recommendation 3, a traditional financial company can use the same processes and procedures that it uses for traditional assets for virtual assets.

However, as DeFi, companies do their operations online and remotely and can easily move operations from jurisdiction to jurisdiction. This being the case, companies in the virtual asset space are less interested in consistent regulation and more interested in friendly regulations than consistent ones. The interest that virtual asset companies had in Hong Kong in early-2023 was based on Hong Kong's previous "caveat emptor" and light touch regulation, with the belief that the new virtual asset service provider regulatory regime would allow Hong Kong

to hit the "reset button" and return to its traditional regulatory approach. As it has become clear that this is not the case, DeFi companies have chosen to focus their attention elsewhere.

Although one may seem that implementing IOSCO recommendations would attract large traditional companies, this is not the case. Big whales are attracted by small fish, and as the small fish swim to other locations, the big whales will follow. As small DeFi companies have moved to other jurisdictions, the large multinationals have been deploying their resources to follow this capital and talent.

Our company has noted with frustration these developments and the inability of our company to bring talent, capital, and innovation to Hong Kong due to its broken virtual asset regulatory system. Time and again, we have seen talent, capital, and innovation go to other parts of the world rather than come to Hong Kong. We have been very active in bringing virtual asset talent and capital to Hong Kong, but our efforts have been focused on attempting to convince talent and capital that “Hong Kong is less bad than it appears.” We would rather be in a situation we are working with Hong Kong’s regulatory framework rather than against it.

**Implementing IOSCO recommendations has not protected the investor and has inadvertently increased opportunities for fraud**

While making Hong Kong an extremely unattractive destination for virtual asset development, the regulatory regime has not succeeded in protecting the investor, and has in fact has done the reverse. Hong Kong is currently dealing with a massive scandal involving JPEX as thousands of investors have been defrauded out of hundreds of millions of dollars, and we believe that its broken virtual asset regulatory system contributed to this outcome. JPEX was able to defraud investors in Hong Kong by making false and misleading statements about its licensing status, and JPEX would not have been able to make false and misleading statements about its licensing status if the Hong Kong

had no licensing.

We strongly believe that the JPEX scandal would not have happened if Hong Kong taken its traditional light-touch "caveat emptor" approach toward virtual asset regulation, and focused its efforts on investor education rather than to creating a flawed licensing system which we believe to be worse than no licensing system at all.

We note that Hong Kong had previously avoided any major scandal at the level of JPEX, and in fact, previous cryptocurrency scandals such as FTX and 3 Arrow Capital did not strongly impact Hong Kong to the degree that JPEX. We believe that the lack of these scandals were not despite a licensing system, but rather because Hong Kong lacked a licensing system. Because Hong Kong had no licensing system and a "caveat emptor" approach, investors and market actors were aware that they were unprotected and therefore bad actors were less able to raise funds from the investing public.

The successful "caveat emptor" approach that Hong Kong took in the early-2010's may be completely unsuitable for jurisdictions other than Hong Kong, but this merely illustrates the dangers of attempting to create global consistency and standardization. The introduction of licensing was part of a well-intended but misguided effort to standardize Hong Kong regulatory practices to the standards set by IOSCO without thinking through the special characteristics of the Hong Kong

market and the likely social impact of such regulation.

We are hopeful that the JPEX scandal and the difficulties that Hong Kong has had in attracting virtual asset capital, talent, and innovation to Hong Kong will force a rapid reevaluation of Hong Kong's virtual asset policies. However, we strongly believe that the virtual asset regulatory system of Hong Kong should not and cannot be based on the IOSCO principles of global consistency and standardization outlined in this public consultation for several reasons.

**IOSCO recommendations ignore the impact of technology on market stability and investor production**

The underlying philosophy of the IOSCO recommendations and guidelines assumes that consistency and standardization under a “same risk, same activity, same regulation” philosophy will result in greater public benefit. This is, in fact, not the situation as new technologies fundamentally change the investing environment. One can react to these changed circumstances by attempting to make the new system work like the old system, but this removes any public benefit from the new system.

Hong Kong's failed efforts at achieving investor protection through licensing has provided an excellent example of how new technology makes old regulatory methods obsolete. In a centralized finance system, settlement of securities can be centralized into a single exchange. Any person who wishes to buy Hong Kong listed shares must do so through a regulated monopoly overseen by the Securities and Futures Commission. However, decentralized finance and blockchain makes it possible for investors in Hong Kong to transfer financial instruments by bypassing centralized exchanges and to trade financial instruments offshore, and the ability for local Hong Kong investors to trade on markets outside of Hong Kong cannot be restricted without conflicting with the Basic Law. This makes it impossible in Hong Kong to achieve investor protection through a local licensing system, and the JPEX scandal shows the futility of attempting to do so.

One could argue that the issues with investor protection lie with the fact that the regulatory system is incomplete, and that after several years of public consultations and white papers that we will have a regulatory system that deals with decentralized finance. However, this ignores the speed at which technology chances. By the time we have finished with a consultation process, the technology has made the measures being discussed obsolete.

One may think that the IOSCO recommendations can resolve these problems by creating a standardized and consistent regulatory system that is global, and that all the securities regulators of the world will cooperate to create a single regulatory system for investor protection. However, by making the new decentralized systems similar to the old systems, one not only removes the social benefit of decentralized technology, but in the case of Hong Kong, this approach is geopolitically and constitutionally impossible.

**IOSCO recommendations ignore the implications of geopolitical risk**

First, we believe that the principle of global standardization and consistency simply cannot be applied in the current geopolitical situation. The most important risk which financial

institutions are concerned with at the current moment is geopolitical risk, which is not addressed at all in the recommendations. Put simply, attempting to create a consistent global approach to

securities regulation assumes that the member jurisdictions have common interests and common objectives, when in fact this is simply not the case.

We note that certain member jurisdictions of IOSCO are attempting to limit the acquisition of technology by the People's Republic of China through the use of financial sanctions, and are attempting to use securities regulation and financial regulation to do so. We believe that as a part of the People's Republic of China, it is necessary for Hong Kong to oppose these measures, not only to

advance the national security and economic development of the People's Republic of China, but to promote technological and economic development for all mankind.

As such, we believe that the Hong Kong regulators must set up a regulatory system that may actively contravene the recommendations which have been proposed by IOSCO in the current consultation. For example, we believe that Hong Kong should actively promote the use of

technologies and regulations which would limit the ability of certain member jurisdictions to undertake a financial or technological sanction's regime against the People's Republic of China, and to do so the Hong Kong regulators must contravene some IOSCO recommendations.

For example, Recommendation 3 is to achieve common standards of regulatory outcomes. Since it is the desired regulatory outcome of certain IOSCO members is to deny technology to the People's Republic of China, while it is necessary for Hong Kong to circumvent such restrictions, common standards of regulatory outcomes are obviously impossible. As it is in the interest of Hong Kong to develop new markets and systems to circumvent the technological and financial controls that certain IOSCO members have on traditional markets, those new markets can and should be subject to different rules and outcomes so that these new markets cannot be used to block Chinese access to

capital and technology.

Similarly, Recommendation 2 which involves identifying responsible persons, Recommendation 6 requiring clear, accurate disclosures, and Recommendation 8 to promote cross-border cooperation and information sharing may not be in the national interest of the People's Republic of China where those recommendations facilitate the ability of other IOSCO members to impose limits on technology and financial access to the People's Republic of China and limit the People's Republic of

China's ability to maintain an independent foreign policy.

**The IOSCO objective of global standards and consistency fundamentally conflicts with the one country, two systems policy**

Second, Hong Kong operates under the one country, two systems principle, which is fundamentally incompatible with the "same activity, same risk, same outcome" principle, as this seeks to standardize securities regulation not only between the mainland of China and Hong Kong but throughout the entire world. Hong Kong maintains a capitalist political and economic system that is different from than the socialist system practised in mainland China and in the area of decentralized finance, Hong Kong naturally has created a regulatory system based on capitalism that is very different from the system used in mainland China which is based on socialism. These differences are undertaken with the full support of the central government of the People's Republic of China

and contribute to the national security and economic prosperity of the Chinese nation.

One example of how the regulatory system in mainland China and Hong Kong differ relies on how the systems deal with technological change. Because mainland China has a socialist state-driven system with high state capacity, the regulations regarding decentralized finance are set up so that they can change instantly and dramatically in response to technological changes, whereas the regulatory system in Hong Kong is based on a capitalist market-driven system in which a limited state is set up to respond slowly and deliberately, and that the responsibility for dealing with technological changes lies with the market.

Both systems have advantages and limitations, but the national security and economic prosperity of the Chinese nation involves trying to craft one country out of two very different systems. The Central Government of the People’s Republic of China has placed huge responsibilities on the government and residents of Hong Kong to aid in the cause of national development within the capitalist system. This places a special responsibility on local small businesses such as ours to lead in the vision and policy development and to recommend policies to the regulators in Hong Kong.

However, just as it would be inappropriate for Hong Kong to standardize its decentralized finance regulations with that of the socialist system used in the mainland of China, we also believe that it would be equally inappropriate for Hong Kong to standardize its regulations with jurisdictions outside of China, and we believe that it would be inappropriate for IOSCO to issue guidelines and policy that would assume and mandate this standardization.

**IOSCO should abandon its objectives of global regulatory consistency and focus on promoting dialogue and information gathering**

We believe that dialogue and communications is a good thing, and IOSCO plays a valuable role in allowing regulators to share experiences. However, while it is a good thing for Hong Kong regulators to talk to regulators in Dubai, Singapore, Shenzhen, London and New York City, it must be realized that Hong Kong are not these places, and Hong Kong simply cannot and should not regulate its markets by blindly copying the practices of other jurisdictions. To paraphrase the Funeral Oration of Pericles, our city should not merely copy the our neighbours but should be an example to them.

In closing, we are against the very principle of global standardization and regulatory consistency and the "same activity, same risk, same outcome" approach. We will therefore oppose any efforts by regulators in Hong Kong to implement regulatory practices and procedures which seek to implement the Recommendations 2, 3, 6, 8 in the public consultation or to attempt to create standardization and consistency for the sake of consistency.

Given the negative experiences that Hong Kong has had with its virtual licensing system, we will strongly argue to the Hong Kong regulators that Hong Kong return to a light-touch regulatory system, and that there should be no new regulatory restrictions in Hong Kong concerning DeFi. This places us in direct opposition to Recommendations 2, 3, 6, and 8 of the consultation document.

Nevertheless, although we believe that Hong Kong and other member jurisdictions should undertake regulations that are appropriate for their own situation and resist IOSCO's efforts at standardization and global consistency, we support the IOSCO's efforts in research in

decentralized finance and believe that increased dialogue between different members is a worthy goal. We therefore support Recommendations 1 and 9 in that we believe that securities regulators

would benefit from greater dialogue and interaction with the DeFi community.

Regarding Recommendations 4 and 5, we believe that the risks mentioned in those Recommendations are small in comparison to the issue of geopolitical risks. As far as Recommendation 7 to enforce applicable laws, this must also been seen in the context of geopolitical risks as the laws of different member jurisdictions fundamentally conflict with each other.

The unfortunate geopolitical situation which we find ourselves in makes the fostering of dialogue even more important, and by soliciting comments from actors which are not government bodies, we hope that IOSCO can moderate the level of geopolitical conflict and contribute to

global peace and harmony. Furthermore, because conversations regarding regulation are often dominated by large well-establishment multinational companies, we appreciate the opportunities for small start-up companies such as ours to be involved in the policymaking process.

We therefore greatly appreciate IOSCO's public consultation and hope that IOSCO and the SFC find our comments to be of use.

Faithfully yours,



Joseph Chen-Yu WANG

Principal Investigator

Twofish Enterprises (Asia) Limited