

RE: SFC GIVES GREENLIGHT FOR VIRTUAL ASSET SPOT EXCHANGE-TRADED FUNDS**Background and Overview**

On 22 December 2023, the Securities and Futures Commission (the “SFC”) published the “Circular on SFC-authorised funds with exposure to virtual assets” (the “Circular”),¹ in which, amongst other things, the SFC has signalled its readiness to: (A) accept applications for the authorisation of virtual asset (“VA”) spot exchange-traded funds (the “ETFs”) for offering to the public under sections 104 and 105 of the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) (the “SFO”); and (B) extend the types of financial instruments in which SFC-authorised VA funds (the “VA Funds”) may invest indirectly in VAs. In this Client Alert, we summarise and discuss the key regulatory changes introduced by the Circular and share our views and observations.

Updates on Regulation of SFC-Authorised Funds with Exposure to VAs*(A) Authorisation of VA spot ETFs*

So far, only VA futures ETFs have been authorised by the SFC for offering to the public.² However, in the Circular, the SFC has for the first time indicated its willingness to accept applications for the authorisation of VA Funds which invest directly in spot VAs which are made available to the Hong Kong public (i.e. to both professional investors³ and retail investors) for trading on VA trading platforms (“VATPs”) licensed by the SFC (the “Eligible VAs”).⁴ SFC-authorised ETFs may conduct in-kind or in-cash transactions in Eligible VAs in the spot market through SFC-licensed VATPs or authorised financial institutions (i.e. licensed banks) (“AIs”) which meet the regulatory requirements of the Hong Kong Monetary Authority (the “HKMA”). Other requirements in relation to the authorisation of VA spot ETFs include, without limitation, the following:

- (a) **Management company:** The management company should have: (i) a good track record of regulatory compliance; and (ii) at least one (1) competent staff member possessing relevant experience in the management of VAs or VA-related products;
- (b) **Custody:** The trustee or custodian of the VA Fund may only delegate its VA custody function to either a SFC-licensed VATP or an AI which meets the expected standards of VA custody issued by the HKMA from time to time, and should ensure, amongst other things, that most of the VA holdings of the VA Fund are stored in cold wallet and minimise the duration of storage in hot wallet;
- (c) **Disclosure:** The product key fact statements and other offering documents of the VA Fund should disclose the investment objectives, investment limits and key risks relating to the fund’s VA exposures, such as price risk, custody risk, cybersecurity risk and fork risk for investments in spot VAs;
- (d) **Investor education:** The management company should carry out investor education in accordance with the requirements of the Code on Unit Trusts and Mutual Funds (the “UT Code”)⁵ prior to the launch of the VA Fund;
- (e) **Distribution:** Intermediaries distributing SFC-authorised VA Funds are required to comply with the

¹ The Circular supersedes the previous circular on the subject issued by the SFC dated 31 October 2022.

² For instances, CSOP Bitcoin Futures ETF (Stock code: 3066) and CSOP Ether Futures ETF (Stock code: 3068), both of which managed by CSOP Asset Management Limited, were authorised to be listed and traded on The Stock Exchange of Hong Kong Limited (the “Hong Kong Stock Exchange”) in December 2022.

³ “Professional investor” is defined in Part 1 of Schedule 1 to the SFO.

⁴ As of the date of this Client Alert, only two (2) VATPs, namely OSL Digital Securities Limited (“OSL”) and Hash Blockchain Limited (“HashKey”), have obtained the Type 1 (dealing in securities) and Type 7 (providing automated trading services) licences granted by the SFC.

⁵ The UT Code was last updated on 1 January 2019 and can be accessed on the SFC’s website at <https://www.sfc.hk/en/Rules-and-standards/Codes-and-guidelines/Codes>.

requirements set out in the joint circular of the SFC and the HKMA on VA-related activities of intermediaries (the “**Joint Circular**”),⁶ including conducting a VA knowledge test on their clients (other than institutional professional investor⁷ and qualified corporate professional investor⁸ clients) prior to effecting a transaction in VA Funds on their behalves. In addition, except in the case that the VA Fund is listed and traded on the Hong Kong Stock Exchange and that there has been no solicitation or recommendation, intermediaries are required to comply with the suitability obligations⁹ and include clear and easily comprehensible information and warning statements to clients in relation to the VA Fund and the underlying VA investments;

- (f) **Valuation:** Spot VAs should be valued based on a benchmark index published by a reputable provider which reflects a significant share of trading activities in the underlying spot VA; and
- (g) **Service providers:** The management company is required to confirm that all necessary service providers (including fund administrators, participating dealers, market makers and index providers) are competent, available and ready to support the SFC-authorised VA Fund.

(B) Extension of types of permitted financial instruments for indirect investments in VAs

Previously, SFC-authorised VA Funds were only permitted to invest indirectly in VAs through Bitcoin futures and Ether futures traded on the Chicago Mercantile Exchange. However, SFC-authorised VA Funds may now acquire indirect exposure to VAs through VA futures traded on other conventional regulated futures exchanges, subject to conditions including but not limited to the following:

- (a) the underlying VA must be an Eligible VA;
- (b) the relevant VA futures have adequate liquidity;
- (c) the management company satisfactorily demonstrates to the SFC that the roll costs of the relevant VA futures are manageable and effective means will be adopted to manage such roll costs; and
- (d) the VA Fund should have sufficient flexibility in portfolio composition, rolling strategy and handling of market disruption events for risk management purposes.

SFC-authorised VA Funds may also invest in exchange-traded products other than VA futures provided that the applicable requirements in the UT Code are met.

Prior consultation and approval

Funds with VA exposure amounting to more than 10% of their net asset value (“**NAV**”) which seek authorisation by the SFC and existing SFC-authorised funds which intend to obtain VA exposure of over 10% of their NAV are required to carry out prior consultation with and obtain the approval of the SFC.

⁶ “Joint circular on intermediaries’ virtual asset-related activities” issued by the SFC and the HKMA, which was last updated on 22 December 2023.

⁷ “Institutional professional investor” is defined in paragraph 15.2 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (the “**Code of Conduct**”) as a person falling under paragraphs (a) to (i) of the definition of “professional investor” in Section 1 of Part 1 of Schedule 1 to the SFO. This includes recognised exchanges and clearing houses, licensed corporations and registered institutions (and their wholly-owned subsidiaries and holding companies), authorised financial institutions (and their wholly-owned subsidiaries and holding companies), authorised insurers, authorised collective investment schemes, registered provident fund schemes, registered occupational retirement schemes, governments and central banks, as well as the overseas equivalents of such institutions and entities.

⁸ “Qualified corporate professional investors” refers to corporate professional investors which have passed the assessment requirements under paragraph 15.3A of the Code of Conduct and gone through the consent and annual confirmation procedures under paragraph 15.3B of the Code of Conduct.

⁹ Please refer to paragraph 5.2 of the Code of Conduct and the Frequently Asked Questions issued by the SFC on suitability requirements, which are accessible at <https://www.sfc.hk/en/Rules-and-standards/Suitability-requirement/FAQs>.

Our Observations

The Circular marks a significant milestone in the development of Hong Kong's regulation of VA-related products amidst growing market interest and increasing demands of intermediaries for product innovation since the first VA futures ETFs¹⁰ were listed on the Hong Kong Stock Exchange in December 2022. In particular, the SFC's signalling of its readiness to authorise VA spot ETFs is an indication of the SFC's and the Hong Kong government's determination to stay abreast of international developments in the VA space, including the eagerly anticipated approval by the Securities and Exchange Commission of the United States' first batch of spot Bitcoin ETFs (including an application by BlackRock, in which JP Morgan has been named as an "authorized participant"),¹¹ which is expected to be granted in early 2024, and the huge Bitcoin uptake expected to be brought by the Bitcoin "halving" event scheduled to take place in April 2024.

However, whilst the SFC has been taking active steps to promote Hong Kong's development as a global VA hub, the approach of the SFC remains a consistently cautious one. Specifically, in line with the SFC's regulatory approach towards licensed VATPs and the VA-related activities of intermediaries,¹² the SFC has maintained a tight control over the types of VAs which may be directly or indirectly accessed by retail investors by limiting the same to Eligible VAs, which must meet stringent requirements as to liquidity, market capitalisation and other criteria.¹³ As a matter of fact, as at the date of this Client Alert, Bitcoin and Ether still remain the only two (2) VAs permitted to be offered for trading by retail investors on the only two (2) SFC-licensed VATPs (i.e. OSL and HashKey). Additionally, the requirement that transactions in spot VAs by SFC-authorised ETFs must be conducted through SFC-licensed VATPs and AIs will continue to restrict the opportunity of intermediaries to collaborate with overseas VA exchanges and financial institutions to offer more competitive and diverse products that appeal to the market.

Nevertheless, despite these limitations, the latest updates to the regulation of SFC-authorised VA Funds introduced by the Circular are to be welcomed as a positive development favourable to Hong Kong's VA industry. It can be expected that, following the greenlight given by the SFC, a greater variety of VA Funds, including VA spot ETFs, will become available to investors in Hong Kong.

If you have any views or questions on the issues raised in this Client Alert or the Circular or are interested in establishing or distributing a SFC-authorised VA Fund, please do not hesitate to get in touch with our team members at ly@lylawoffice.com or at (+852) 2115-9525.

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¹⁰ Please refer to footnote 2 above.

¹¹ See <https://www.reuters.com/business/finance/blackrock-vaneck-among-asset-managers-that-submitted-updated-filings-spot-2023-12-30/> and <https://www.thestreet.com/crypto/markets/jpmorgan-set-to-push-bitcoin-through-key-role-in-blackrock-etf>.

¹² Please refer to our previous client alert on the Joint Circular dated 7 November 2023.

¹³ Including, amongst other things, the requirement that VAs to be made available for trading by retail investors must be included in at least two (2) independent indices tracking the largest VAs. For details, please refer to our previous client alert relating to the regulatory requirements under the new VA service provider licensing regime dated 29 May 2023.