SFC is prepared to authorise VA funds for retail investors (including VA Spot ETFs)

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Background

On 22 December 2023, the Securities and Futures Commission of Hong Kong ('**SFC**') issued a circular on SFC-authorised funds with exposure to virtual assets ('**VA**') ('**Circular**')[1] to set out requirements on authorising investment funds with direct[2] and indirect[3] exposure to VA of more than 10% of their net asset value ('**NAV**') for public offerings in Hong Kong ('**SFC-authorised VA Funds**').[4] The Circular represents a welcome and fundamental shift in the regulator's attitude to the VA ecosystem by opening up access to the retail investor class.

Essentially, the SFC will now (i) accept applications for the authorisation of VA spot exchange-traded funds ('**VA Spot ETFs**') and (ii) permit SFC-authorised VA Funds to invest in, in addition to BTC futures and ETH futures, spot VA, other VA futures and VA exchange-traded products ('**VA Futures/ETP Funds**').

In this News Flash, we provide a summary of the new requirements on SFC-authorised VA Funds and share some insights into what it means for market participants.

General requirements on SFC-authorised VA Funds

As a basic requirement, all funds seeking to acquire VA exposure of more than 10% of NAV must undertake prior consultation with and obtain approval from the SFC.

In addition to the requirements set out in the joint circular on intermediaries' VA-related activities ('**Joint Circular**') (for a summary of such requirements, please refer to our News Flashes issued in November 2023 and January 2024), SFC-authorised VA Funds are subject to the following conditions:

(1) Managers
Managers of SFC-authorised VA Funds should (i) have a good track record of regulatory compliance; (ii) have at least one competent staff member with relevant VA or VA-related products management experience; and (iii) comply with the additional terms and conditions ('**T&Cs**') under Appendix 7 of the Joint Circular.

[1] The Circular supersedes the Circular on Virtual Asset Futures Exchange Traded Funds issued on 31 October 2022.
[2] Funds investing directly in spot VA tokens.
[3] Funds acquiring indirect investment exposure to such VA, for example, through futures traded on conventional regulated futures exchanges and other exchange-traded products.
[4] Under sections 104 and 105 of the Securities and Futures Ordinance.

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(2) Custodian
The trustee/custodian of an SFC-authorised VA Fund should only delegate its VA custody function (where applicable) to an SFC-licensed VATP[5]. The trustee/custodian and any delegate responsible for taking custody of VA holdings of an SFC-authorised VA Fund should:

(a) ensure that the VA holdings are segregated from its own assets and the assets it holds for its other clients[6];
(b) store most of the VA holdings in the cold wallet and minimise the amount and duration of VA holdings stored in the hot wallet as much as possible[7]; and
(c) ensure the seeds and private keys are
  (i) securely stored in Hong Kong;
  (ii) tightly restricted to authorised personnel;
  (iii) sufficiently resistant to speculation[8] or collusion[9]; and
  (iv) properly backed up to mitigate any single point of failure.

(3) VA tokens
Only VA tokens listed on SFC-licensed VA trading platforms ('**VATPs**') that are also available to the Hong Kong public for trading should be invested in ('**Eligible VA**').

(4) Investment Strategy
Exposure to VA should not be leveraged at the fund level.

(5) Service providers
Managers of SFC-authorised VA Funds should confirm that all necessary service providers[10] are competent, available and ready to support the SFC-authorised VA Funds.

(6) Disclosure
The offering documents, including the product key facts statements ('**KFS**'), of SFC-authorised VA Funds should disclose the investment limits and key risks related to the funds' VA exposures.

(7) Investor Education
Investor education should be carried out before the launch of any SFC-authorised VA Funds in accordance with the existing requirements under the UT Code.

(8) Distribution
Lastly, intermediaries distributing SFC-authorised VA Funds should comply with the requirements set out in the Joint Circular. For a summary of such requirements, please refer to our News Flashes issued in November 2023 and January 2024.

Specific requirements on VA Spot ETFs

For VA Spot ETFs, the SFC has, in addition to the requirements above, imposed the following specific requirements:

(1) Valuation
Valuation of spot VA should be conducted based on a benchmark index published by a reputable provider that reflects a significant share of trading activities in the underlying spot VA.

(2) Transactions and direct acquisitions of spot VA
Transactions and acquisitions of spot VA should be conducted through SFC-licensed VATPs[11]. In particular, spot VA should be:

[5] Or an authorised financial institution ('**AI**') (or subsidiary of a locally incorporated AI) which meets the expected standards of VA custody issued by Hong Kong Monetary Authority ('**HKMA**') from time to time.
[6] Unless client assets are held in an omnibus account, in that case, it should adhere to the standards as set out in 4.5(a)(iv)(3) of the Code on Unit Trusts and Mutual Funds ('**UT Code**').
[7] Save for meeting the needs of subscriptions and redemptions.
[8] Eg, through generation in a non-deterministic manner.
[9] Eg, through measures such as multi-signature and key sharing.
[10] Such as fund administrators, participating dealers, market makers and index providers.
[11] Or AIs (or subsidiaries of locally incorporated AIs) in compliance with HKMA's regulatory requirements.

(a) for in-cash subscriptions and redemptions, acquired and disposed of through SFC-licensed VATPs[12]; and

(b) for in-kind subscriptions and redemptions, transferred by and/or to SFC-licensed or registered participating dealers ('**PDs**')[13] that are subject to the additional T&Cs under Appendix 6 of the Joint Circular, to and/or by VA Spot ETFs' custody accounts with SFC-licensed VATPs[14].

(3) Disclosure
In particular, the KFS of VA Spot ETFs should contain specific key risks associated with the funds' spot VA exposures, such as price risk, custody risk, cybersecurity risk and fork risk.

Specific requirements on VA Futures/ETP Funds

In addition to BTC futures and ETH futures traded on the Chicago Mercantile Exchange, the SFC now permits SFC-authorised VA Funds to invest into VA futures traded on other conventional regulated futures exchanges and other VA ETPs (subject to applicable requirements in the UT Code). Apart from the requirements applicable to SFC-authorised VA Funds, VA Futures/ETP Funds should also comply with the following conditions:

(1) VA futures
Only VA futures traded on conventional regulated futures exchanges should be invested in. In addition, managers of VA Futures/ETP Funds should be able to demonstrate to the SFC (i) that the VA futures have adequate liquidity (ii) that the roll-over costs of the VA futures are manageable, and (iii) how such roll-over costs will be managed.

(2) Investment Strategy
An active investment strategy should be adopted to allow flexibility in portfolio composition[15], rolling strategy, and handling of any market disruption events.

(3) Disclosure
In particular, the KFS of VA Futures/ETP Funds should contain upfront disclosure of the specific key risks associated with the funds' VA Futures/ETP exposures, including the potentially large roll costs and operational risks, such as margin risk and risk associated with mandatory measures imposed by relevant parties.

What this means for market participants

Although the conditions on authorising VA funds are still rigid, the Circular is certainly welcome news for market participants, especially those looking to increase the scope of access to the VA investment ecosystem. The SFC's green light to VA Spot ETFs marks a significant step in the opening up of Hong Kong's VA regulatory landscape, and is a timely development following close on the heels of events in the USA (with the SEC giving the go-ahead to the same products). In addition, the expansion of the type of VA futures and ETPs in which SFC-authorised VA Funds are allowed to invest is another important move in further liberalising the VA Funds market in Hong Kong.

[12] Acquisitions and dispositions may be performed either on-platform or off-platform.
[13] Spot VA may be held locally or overseas.
[14] Or AIs (or subsidiaries of locally incorporated AIs).
[15] Eg, diversification of futures positions with multiple expiry dates.

Let’s talk

For a deeper discussion of how this impacts your business, please contact us.

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