

Oversight

Offer of spot virtual asset funds to retail investors in Hong Kong

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Introduction

Responding to the growing interest globally in investment products which provide exposure to virtual assets (**VA**), the Securities and Futures Commission of Hong Kong (**SFC**) has already introduced regimes that allow the offering of certain VA products to the Hong Kong public with appropriate investor protection safeguards. On **22 December 2023**, the SFC published a circular titled "*Circular on SFC-authorized funds with exposure to virtual assets*" (**Circular**), which allows SFC-authorized funds to invest in spot VA tokens.

This update has met with the watershed for the world's largest cryptocurrency and possibly the broader crypto industry - shortly after the Circular being published, the Securities and Exchange Commission of the US (**SEC**) approved the first US-listed exchange traded funds to track bitcoin.

The issuance of the Circular is the SFC's third attempt in defining Hong Kong's regulatory framework applicable to virtual assets. In October 2022, the SFC started accepting applications for ETFs that obtain exposure to VA primarily through futures contracts, while in June 2023, its licensing regime of virtual asset trading platforms (**VATPs**) became effective, enabling Hong Kong investors to directly access large-cap spot VA, subject to certain eligibility requirements and robust investor protection safeguards.

The Circular builds on these reforms by setting out requirements for SFC-authorized funds when:

- investing **directly** in the same spot VA tokens accessible to the Hong Kong public for trading on SFC-licensed VATPs (i.e. direct exposure); and/or
- acquiring **indirect** investment exposure to such VA (for example, through futures traded on conventional regulated futures exchanges and other exchange-traded products).

The SFC would consider authorising investment funds with exposure to VA of more than 10% of their net asset value (**NAV**) for public offerings in Hong Kong (**SFC-authorized VA Funds**) under such requirements.

This Oversight gives an introduction to the Circular's requirements relating to SFC-authorized VA Funds and their application.

Requirements for SFC-authorized VA Funds

Regulatory Framework

SFC-authorized VA Funds are expected to meet the requirements set out in the Circular, as well as all other applicable requirements provided in the existing rules and regulations governing SFC-authorized funds and VA related regulated activities, namely:

- the Overarching Principles Section and the *Code on Unit Trusts and Mutual Funds (UT Code)* in the SFC [Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products](#); and
- the SFC and Hong Kong Monetary Authority (HKMA) [joint circular on intermediaries' virtual asset-related activities \(Joint Circular\)](#), more specifically on (i) distribution, (ii) dealing, (iii) asset management and (iv) advisory services relating to VA investment products.

Management Companies

According to the Circular, the Management Company of an SFC-authorized VA Fund (**Virtual Asset Fund Manager**) is required to (i) demonstrate a good track record of regulatory compliance, (ii) have at least one competent staff member with relevant experience in the management of VA or related products and (iii) comply with additional requirements set out in the *Proforma terms and conditions for licensed corporations or registered institutions which managed portfolios that invest in virtual assets (RA9 Terms and conditions)* to be imposed by the Licensing Department (where applicable).

In this regard, the SFC refers to RA9 Terms and conditions as of October 2023 which has streamlined the regulatory requirements with other SFC's codes and guidelines, including the *Fund Manager Code of Conduct* and the *Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission*.

In other words, Virtual Asset Fund Managers are expected to be equipped with both retail fund management and virtual asset management capabilities. So far we still see a gap between these two capabilities – asset managers in Hong Kong are either (i) currently acting as retail fund managers who lack virtual asset management experience and license coverage, or (ii) managing virtual asset related collective investment schemes that are offered on a private placement basis in Hong Kong i.e. lack retail fund management experience. We therefore expect there to be some sort of partnership between these two types of asset managers through delegation or co-management arrangements, but these arrangements still present regulatory challenges. For example, asset manager which has obtained SFC approval of the uplift of type 9 license would still be required to satisfy the key personnel requirements under Chapter 5.5(a) of the UT Code (namely having at least two key personnel each with not less than 5 years investment experience in managing public funds) if it wishes to be appointed as the investment delegate by a retail fund manager.

Eligible Underlying VA

One distinct feature or investment restriction in respect of the SFC-authorized VA Funds with direct investment in spot VA tokens is that such SFC-authorized VA Funds can only invest in VA tokens that are accessible to the Hong Kong public for trading on SFC-licensed VATPs.

There are currently two VATPs licensed by the SFC (please click [here](#) for the list of SFC-licensed VATPs) and various applicants pending approval. We expect there to be a surging number of VATPs which will help stimulate the trading of VA tokens locally and hence the development of SFC-authorized VA Funds. Such restriction is considered to be a move to provide investor protection given the operation of the underlying assets (i.e. VA tokens) is subject to SFC's supervision.

VA Futures

The SFC has started accepting applications for ETFs that obtain exposure to VA primarily through futures contracts back in 2022 and there are existing SFC authorized ETFs that focus on such investment strategy. The Circular clarifies that for VA futures, only futures traded on conventional regulated futures exchanges are allowed on the basis that the Virtual Asset Fund Manager is able to demonstrate that these have adequate liquidity, that the roll costs of the relevant VA futures are manageable and how these costs will be managed.

Indirect exposures to eligible VA through other exchange-traded products will be subject to any applicable requirements in the UT Code, together with other requirements which the SFC may impose.

Where an SFC-authorized fund adopts an investment strategy that is primarily VA futures-based, it should adopt an active investment strategy which allows flexibility in portfolio composition (by way of example, the Circular notes diversifying futures positions with multiple expiry dates), a rolling strategy and handling of any market disruption events.

In this connection, it is notable that the Circular supersedes the SFC's Circular on Virtual Asset Futures Exchange Traded Funds issued on 31 October 2022 (**2022 Circular**). Notwithstanding that, insofar as the requirements set out in the 2022 Circular relating to the VA futures and SFC-authorized funds which adopt an investment strategy that is primarily VA futures-based, there is no change as a result of the issue of the Circular.

Spot VA - Transactions and Direct Acquisitions

Where an SFC-authorized VA Fund enters a transaction in, or acquisition of, spot VA, this should be conducted through either an SFC-licensed VATP, an authorised financial institution (**AI**) or a subsidiary of a locally incorporated AI and should comply with relevant HKMA requirements.

In particular, SFC-authorized spot VA ETFs may engage in both in-cash and in-kind subscriptions and redemptions as follows:

- For in-cash subscriptions and redemptions, an SFC-authorized spot VA ETF should acquire and dispose of spot VA through an SFC-licensed VATP (either on-platform or off-platform).
- In the case of in-kind subscriptions, a participating dealer (**PD**) is expected to transfer spot VA (which may be held locally or overseas) to an SFC-authorized spot VA ETF custody account with an SFC-licensed VATP, AI or subsidiary of a locally incorporated AI (or vice versa in the case of in-kind redemptions).

Where an ETF invests in spot VA, its PD should be both (i) an SFC-licensed corporation or registered institution and (ii) subject to any applicable additional terms and conditions set out in *Licensing or registration conditions and terms and conditions for licensed corporations or registered institutions providing virtual asset dealing services and virtual asset advisory service* as of October 2023 imposed by the Licensing Department of the SFC. The standards set out therein align with the requirements under the SFC's regulatory framework for VATPs to the extent that they relate to the performance of the dealing function carried out by intermediaries.

Custody

The Circular also sets out the requirements expected of the trustee or custodian of an SFC-authorized VA Fund. Where a trustee or custodian undertakes a VA custody function, it should only delegate this to an SFC-licensed VATP, AI (or subsidiary of a locally incorporated AI) which meets the HKMA's VA custody standards.

The trustee, custodian or any delegate responsible for taking custody of an SFC-authorized VA Fund's VA holdings (**Delegate**) should also ensure segregation of the VA holdings from its own assets and from assets held for other clients (where client assets are held in an omnibus account, the standards set out in 4.5(a)(iv)(3) of the UT Code must be adhered to) and store most of the VA holdings in the cold wallet.

The trustee, custodian or Delegate should ensure that most of the VA holdings in the cold wallet. The amount of VA holdings stored in the hot wallet (and how long they are stored) should be minimised as far as possible, except to meet subscription and redemption needs.

Finally, the trustee, custodian or Delegate should ensure the seeds and private keys are (i) securely stored in Hong Kong; (ii) strictly restricted to authorised personnel; (iii) sufficiently resistant to speculation or collusion; and (iv) properly backed up to mitigate any single point of failure. In terms of measures to combat collusion, the SFC suggests multi-signature and key sharing.

Valuation of spot VA

When calculating the value of spot VA, the Virtual Asset Fund Manager of SFC-authorized VA Funds should adopt an indexing approach based on VA trade volume across major VA trading platforms (namely, a benchmark index published by a reputable provider reflective of a significant share of trading activities in the underlying spot VA).

Service Providers

Aligned with SFC's expectation of any SFC authorized funds, a Virtual Asset Fund Manager should confirm that all necessary service providers (such as fund administrators, PDs, market makers and index providers) are competent, available and ready to support the SFC-authorized VA Fund.

Disclosure and Investor Education

An SFC-authorized VA Fund's offering documents, including the product key facts statement (**KFS**), should disclose the investment limits and key risks relevant to the fund's VA exposures and the KFS should, in particular, contain an upfront disclosure of the investment objectives and key risks associated with the fund's VA exposures.

Risks to be included could include price risk, custody risk, cybersecurity risk and fork risk for investments in spot VA, as well as potentially large roll costs and operational risks for investments in VA futures.

As a new product available in the Hong Kong market, a Virtual Asset Fund Manager should carry out investor education relating to SFC-authorized VA Fund prior to launch.

US Spot Bitcoin ETFs

It is noteworthy that the requirements set out in the Circular do not apply to Recognised Jurisdiction Schemes (including UCITS) and those under mutual recognition of funds arrangements. Therefore, one may wonder if there could be a fast track for the spot bitcoin ETFs currently traded publicly in the US to be listed and offered in Hong Kong.

Under the current Hong Kong regulatory framework, it is impossible to cross-list SEC approved spot bitcoin ETFs in Hong Kong, as they are not registered investment companies pursuant to Investment Company Act 1940 (as amended), and therefore not qualified as Recognised Jurisdiction Schemes by the SFC. That would mean the US spot bitcoin ETFs will need to comply with the requirements in the Circular in full, which is not practicable from an operational perspective, because as explained above, the SFC's Circular provides, amongst other things, that an SFC-authorized VA Fund can only enter a transaction in, or acquisition of, spot VAs through either an SFC-licensed VATP, an authorized AI or a subsidiary of a locally incorporated AI and should comply with relevant HKMA's requirements. (Read more: [The SFC's Circulars on tokenised securities-related activities and on tokenisation of investment products](#))

Therefore establishing a local bitcoin ETF seems to be a more plausible option for ETF issuers.

Conclusion

We have advised clients on investment products with exposure to VA futures since the 2022 Circular. It is now a breakthrough in the Hong Kong VA regulatory regimes as SFC-authorized funds that provide exposure to spot VA will be available to retail clients. Further to that, the SEC approval of 11 spot bitcoin ETFs in the US which came out shortly after the Circular has stimulated the sentiment of setting up SFC-authorized VA Funds in Hong Kong.

In order to keep up the current momentum brought by the US-listed bitcoin ETFs, we hope the SFC will provide more guidance on the eligibility of Virtual Asset Fund Managers, and the possibility of a dual-manager arrangement, given the scarcity of fund managers which are equipped with both retail fund management and virtual asset management capabilities.

Contact us

To find out more, we invite you to connect with Eva Chan, recently honoured as one of [The A-List 2023-24: Growth Drivers | China | Law.asia](#) by [China Business Law Journal](#). Eva's expertise has also earned her the distinction of being a leading individual in investment funds by Legal 500 Hong Kong and [50 Leading Women in Hedge Funds](#). Contact Eva for a deeper dive into this analysis:

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