January 2024

Greenlight for retail investors – SFC-authorised virtual asset funds

Background

In October 2022, the Hong Kong Securities and Futures Commission (the "**SFC**") published a circular setting out its readiness to accept applications for authorisation of virtual asset futures ETFs and the SFC's requirements in authorising such ETFs (which we covered in an earlier client alert). Since then, the market and regulatory landscape of virtual assets ("**VA**") in Hong Kong has evolved rapidly, including the introduction of a new licensing regime for virtual asset trading platforms ("**VATPs**")(please refer to our earlier client alert for more detail), and the SFC sees a broader range of investment products with exposure to VA being offered in major overseas markets.

The SFC has therefore decided to expand the scope of the existing requirements, and have published a new circular on 22 December 2023 which supersedes the previous circular in October 2022. The SFC will now be accepting applications for authorisation of funds that: (i) invest directly in the same spot VA tokens accessible to the Hong Kong public for trading on SFC-licensed VATPs, and/or (ii) acquire indirect investment exposure to such VA (for example, through futures traded on conventional regulated futures exchanges and other exchange-traded products)(a VA fund authorised by the SFC is collectively referred to herein as the "**VA Funds**"), and the new circular sets out the new requirements that the SFC will impose.

This client alert summarises the SFC's new requirements when authorising VA Funds.

What are the changes

In summary, the following is a list of new requirements that the SFC will impose when considering an application to authorise a VA Fund:

Management companies

- The management company of a VA Fund must have at least one competent staff member with relevant experience in the management of VA or related products, and will be subject to the Terms and conditions for licensed corporations or registered institutions which manage portfolios that invest in virtual assets. It is no longer required for the management company to demonstrate that it has at least three years' proven track record in managing ETFs.

Eligible underlying VA

- The VA Fund should only invest (directly or indirectly) in VA tokens that are accessible to the HK public for trading on SFC-licensed VATPs, meaning the VA tokens must be eligible large-cap VAs as set out in the Guidelines for VATP Operators.

Investment strategy

- VA Funds may invest directly or indirectly in eligible VA tokens in accordance with the following requirements:
  - For VA futures, only those traded on conventional regulated futures exchanges, but no longer limited to Bitcoin futures and Ether futures traded on Chicago Mercantile Exchange;
  - Indirect exposure to eligible VA via other exchange-traded products is subject to the UT Code and other requirements of the SFC;
  - VA Funds should not have leveraged exposure to VA at the fund level.

Transactions and direct acquisitions of spot VA

- VA Funds doing spot VA trading should only do so on SFC-licensed VATPs, or through HKMA-authorised financial institutions ("**AI**") in accordance with HKMA's requirements.

Custody

- The trustee/custodian of a VA Fund must be a VATP or an AI (or its subsidiary if it is a locally incorporated AI), and they must: (1) hold client assets on a segregated basis; (2) ensure most of the VAs are stored in cold storage. If a hot wallet is used, they must minimise amount and duration as much as possible; and (3) ensure seeds and private keys are securely stored in HK, tightly restricted to authorised personnel, sufficiently resistant to speculation or collusion, and properly backed up to mitigate any single point of failure.

Valuation

- For valuation of spot VA, the management company should adopt an indexing approach based on VA trade volume across major VA trading platforms.

Disclosure

- The offering documents, including product key facts statements ("**KFS**"), should disclose investment limits and key risks related to the funds' VA exposures. The KFS Should also have risk disclosure regarding price risk, custody risk, cybersecurity risk and fork risk.

Furthermore, a VA Fund is not long subject to the requirement of having a net derivative exposure of a VA futures ETF that is less than the ETF's total NAV.

The above requirements are not applicable to Recognised Jurisdiction Schemes (including UCITS funds) and those under mutual recognition of funds arrangements.

Joint Circular

In addition to the above, the SFC also made consequential changes to the Joint circular on intermediaries' virtual asset-related activities (which superseded the former joint circular published on 22 October 2023)("**Joint Circular**"), so that the Joint Circular also covers VA Funds. In particular, a VA Fund will not be restricted to "professional investors" only and:

- in respect of the distribution of VA Funds that are listed and traded on the Stock Exchange of Hong Kong and that there has been no solicitation or recommendation, the distribution of which will not be subject to the suitability requirement, the minimum information requirement and the warning statements requirement, but there should be a VA knowledge test on the client concerned;

- in respect of the distribution of VA Funds that are not listed, or listed but with trading in their fund units conducted off exchange, the distribution of which will be subject to the suitability requirement, the minimum information requirement and the warning statements requirement. There must also be a VA knowledge test on the client concerned; and

- in respect of VA derivative funds, the intermediaries must also observe the relevant requirements for derivative products.

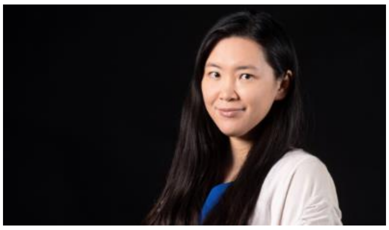
The flowchart appended to the Joint Circular was also updated to assist intermediaries in determining whether certain requirements are applicable when distributing a VA Fund.

How we can help?

VA regulation is rapidly evolving in Hong Kong, especially as regulators are starting to have a better understanding of how risks associated with VA can be addressed. We expect there to be more upcoming changes to the existing regulatory framework in light of the regulators' effort to build a safe and active market for VA investors. Interested parties should continue to monitor the development in this area or seek legal advice if they wish to carry out businesses or make investments in relation to VA.

We advise many clients in the financial sector on matters involving investment fund distributions and virtual asset regulation. Please get in touch if you are interested in discussing any of the above.

Contact us



Katherine Liu
Partner, Head of finance and financial services regulation
T: +852 2533 2717
E: katherine.liu@shlegal.com

James Wong
Associate
T: +852 3166 6933
E: james.wong@shlegal.com

Alan Wong
Associate
T: +852 2533 2719
E: alan.wong@shlegal.com

Monica Jia
Associate
T: +852 2533 2795
E: monica.jia@shlegal.com

Stephenson Harwood is a law firm of over 1300 people worldwide, including 200 partners. Our people are committed to achieving the goals of our clients – listed and private companies, institutions and individuals.

We assemble teams of bright thinkers to match our clients' needs and give the right advice from the right person at the right time. Dedicating the highest calibre of legal talent to overcome the most complex issues, we deliver pragmatic, expert advice that is set squarely in the real world.

Our headquarters are in London, with eight offices across Asia, Europe and the Middle East. In addition, we have forged close ties with other high quality law firms. This diverse mix of expertise and culture results in a combination of deep local insight and the capability to provide a seamless international service.

STEPHENSON HARWOOD
WEI TU CHINA ASSOCIATION
罗夏信-伟途 联营