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31 October 2022

## Circular on Virtual Asset Futures Exchange Traded Funds

1. This circular sets out the requirements under which the Securities and Futures Commission (SFC) would consider authorising exchange traded funds (ETFs) that obtain exposure to virtual assets (VAs)<sup>1</sup> primarily through futures contracts (VA Futures ETFs) for public offering in Hong Kong under sections 104 and 105 of the Securities and Futures Ordinance (SFO).

### Background

2. In November 2018<sup>2</sup>, when the SFC formulated its regulatory approach for VAs, the SFC noted with concern the significant risks associated with investing in VAs, which were inherent in the nature and characteristics of VAs or stemmed from the operations of less regulated platforms or managers of VA products. As such, the SFC decided that only professional investors<sup>3</sup> should be allowed to invest in VA funds that are offered in Hong Kong.
3. Since then, the VA landscape has evolved rapidly. A broad range and larger number of investment products providing exposure to VAs, including VA-related ETFs offered in various markets globally, are now available to both retail and professional investors and have become increasingly popular. Similarly, demand for such products has increased in Hong Kong. This led to the issue of the “Joint circular on intermediaries’ virtual asset-related activities”<sup>4</sup> (Joint Circular) by the SFC and the Hong Kong Monetary Authority in January 2022 which allows SFC-licensed and registered intermediaries to offer trading of eligible VA Futures ETFs to retail investors in Hong Kong.
4. In light of these developments, the SFC has been actively looking into a regime that would enable the authorisation of investment products providing exposure to VAs and would meet investor demands with appropriate safeguards from an investor protection perspective.
5. It has been observed that there are meaningful developments in the VA ecosystem recently and some of the initial concerns over VA Futures ETFs have become increasingly manageable and could be adequately addressed with proper safeguards, disclosure and investor education. However, as a good part of the VA ecosystem (e.g., VA trading platforms) is still not subject to the same robust regulation as service providers or products in traditional financial markets, investment products that invest directly in spot VAs may continue to present investor protection issues.

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<sup>1</sup> “Virtual assets” refers to digital representations of value which may be in the form of digital tokens (such as utility tokens, stablecoins or security- or asset-backed tokens) or any other virtual commodities, crypto assets or other assets of essentially the same nature, irrespective of whether or not they amount to “securities” or “futures contracts” as defined under the Securities and Futures Ordinance (SFO), but excludes digital representations of fiat currencies issued by central banks.

<sup>2</sup> Available via: <https://www.sfc.hk/en/News-and-announcements/Policy-statements-and-announcements/Statement-on-regulatory-framework-for-virtual-asset-portfolios-managers>

<sup>3</sup> As defined in section 1 of Part 1 of Schedule 1 to the SFO.

<sup>4</sup> Available via: <https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/doc?refNo=22EC10>

6. In view of the above, the SFC is prepared to accept applications for authorization of VA Futures ETFs.
7. The SFC will keep in view and closely monitor the development of the VA market and its regulatory landscape regarding the appropriateness of authorization of ETFs that invest directly in spot VAs.

### **Requirements on VA Futures ETFs**

8. VA Futures ETFs seeking SFC authorization for public offering in Hong Kong should meet the applicable requirements in the Overarching Principles Section (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 (SFC Handbook).
9. VA Futures ETFs that are seeking SFC authorization for public offering in Hong Kong should meet the additional requirements set out in this circular.

### **Management companies**

10. The management company of a VA Futures ETF is required to (i) have a good track record of regulatory compliance; and (ii) demonstrate at least three years' proven track record in managing ETFs. The relevant experiences in managing the same or similar type of products from the group of companies to which the management company belongs will be taken into account.<sup>5</sup>

### **Eligible futures**

11. Only VA futures traded on conventional regulated futures exchanges are allowed, subject to the management company demonstrating that (i) the relevant VA futures have adequate liquidity for the operation of the VA Futures ETF and (ii) the roll costs of the relevant VA futures contracts are manageable and how such roll costs will be managed.
12. Initially, only Bitcoin futures and Ether futures traded on Chicago Mercantile Exchange are allowed. The SFC will keep this in view and consider expanding the scope of eligible VA futures markets as appropriate.

### **Investment strategy**

13. The management company of a VA Futures ETF is expected to adopt an active investment strategy to allow flexibility in portfolio composition (e.g., diversification of futures positions with multiple expiry dates), rolling strategy, and handling of any market disruption events.
14. The net derivative exposure (as defined under the UT Code) of a VA Futures ETF shall not exceed 100% of the ETF's total net asset value.

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<sup>5</sup> The SFC may consider accepting delegation or co-management of a VA Futures ETF in appropriate cases, provided that the management company (in the case of delegation) or at least one of the management companies (in the case of co-management) complies with the requirements set out in this paragraph 10.

### Disclosure

15. The product key facts statement of a VA Futures ETF shall contain upfront disclosure of the investment objective and key risks associated with investment in VA futures such as:
- a) potentially large roll costs of VA futures; and
  - b) operational risks related to VA futures (such as margin risk and risk associated with mandatory measures imposed by relevant parties).

### Distribution

16. As VA Futures ETFs are derivatives products and VA-related products, intermediaries are subject to the applicable requirements under the “Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission” (Code of Conduct) and related guidelines including the Joint Circular when they provide services to clients with respect to VA Futures ETFs. For the avoidance of doubt, intermediaries should comply with the existing conduct requirements for derivative products<sup>6</sup> and must also comply with the VA-knowledge test requirement.

### Investor education

17. The management company of a VA Futures ETF is expected to carry out extensive investor education before launching the VA Futures ETF in Hong Kong.

### Others

18. The SFC may consider introducing additional requirements or conditions as deemed necessary or appropriate in the discharge of its functions.

### **Application**

19. The SFC understands that this is the first time that VA Futures ETFs may seek authorization from the SFC. If you wish to seek clarification of any aspects of this circular, please contact the team supervisor or case officer of the Investment Products Division who is responsible for overseeing the SFC-authorized funds of your fund group or client.

Investment Products Division  
Securities and Futures Commission

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<sup>6</sup> Paragraphs 5.1A and 5.3 of the Code of Conduct