

Circular on SFC-authorized funds with exposure to virtual assets and Joint circular on intermediaries' virtual asset-related activities


January 2024



On 22 December 2023, the Securities and Futures Commission (SFC) published two circulars superseding previous issued circulars: [Circular on SFC-authorized funds with exposure to virtual assets \(First Circular\)](#) and [Joint circular on intermediaries' virtual asset-related activities \(Second Circular\)](#). The updates align the regulatory requirements in Hong Kong to global developments. In the Second Circular, the SFC noted that the Commission is prepared to accept applications for the authorisation of other funds with exposure to virtual assets, including virtual asset spot exchange traded funds (VA spot ETFs).

In this brief, KPMG outlines the updated regulatory requirements, and key expectations for licensed financial intermediaries.

Introduction



In light of the global development of the virtual asset landscape, including VA-related exchange traded funds (ETFs) being offered to both retail and professional investors in major overseas markets, the SFC issued [Circular on SFC-authorized funds with exposure to virtual assets](#) on 22 December 2023. This supersedes the Circular on Virtual Asset Futures Exchange Traded Funds issued on 31 October 2022.

Key updates in the First Circular:

- I. Highlights the fact that the SFC's licensing department may impose additional terms and conditions on management companies and custodians;
- II. Allows a fund to invest in VA tokens on top of VA futures;
- III. Removes the restriction where only Bitcoin futures and Ether futures traded on the Chicago Mercantile Exchange are allowed to be traded by the funds; and
- IV. Includes guidelines on area including transactions and direct acquisitions of spot VA, custody, valuation and service providers.

Also, since the SFC has authorised VA futures ETFs and is prepared to accept applications for the authorisation of other funds with exposure to virtual assets, including VA spot ETFs, the HKMA and SFC issued the [Joint circular on intermediaries' virtual asset-related activities](#) on 22 December 2023, superseding the joint circulars on intermediaries' VA-related activities issued on 20 October 2023 and 28 January 2022.

Key updates in the Second Circular:

- I. clearly specifies the requirements applicable to intermediaries when they distribute VA-related products; and
- II. sets out the standards of conduct expected of intermediaries when distributing VA funds authorised by the SFC.

Circular on SFC-authorized funds with exposure to virtual assets

Revised scope of application

- Instead of ETFs that obtain exposure to VAs primarily through futures contracts for public offering in Hong Kong, SFC has put a specific limitation on the percentage of net asset value (NAV) for the fund to be regulated.
- Investment funds with exposure to VA of more than 10% of their NAV for public offerings in Hong Kong (SFC-authorized VA Funds) are now subject to the requirement set out in the circular.
- For funds having or intending to have VA exposure of more than 10% of NAV that wish to seek the SFC's authorisation or existing SFC-authorized funds that plan to obtain VA exposure of more than 10% of their NAV, prior consultation with and approval of the SFC are required. Other than that, the requirements set out in the circular are not applicable to Recognised Jurisdiction Schemes (including Undertakings for Collective Investment in Transferable Securities funds) or those under mutual recognition of funds arrangements.

Key revised requirements of the circular

A. Management companies

- Management companies of SFC-authorized VA Funds should have a good track record of regulatory compliance and at least one competent staff member with relevant experience in the management of VA or related products. *(This replaces that requirement that management companies need to demonstrate at least three years' proven track record in managing ETFs)*
- The management companies of SFC-authorized VA Funds may be subject to additional terms and conditions to be imposed by the Licensing Department. *(Newly added)*

B. Eligible underlying VA

- SFC-authorized VA Funds should only invest (directly or indirectly) in VA tokens that are accessible to the Hong Kong public for trading on SFC-licensed virtual asset trading platforms (VATP). *(Instead of just VA futures)*

C. Investment strategy

- For VA **futures**, only those traded on **conventional regulated futures exchanges** are allowed. The management company must also demonstrate that the relevant VA futures have adequate liquidity and that the roll costs of the relevant VA futures are manageable and how such roll costs will be managed. *(This update removes the restriction of only Bitcoin futures and Ether futures traded on Chicago Mercantile Exchange being allowed)*
- Indirect exposures to eligible VAs via other exchange-traded products are subject to applicable requirements in the Unit Trust Code and other requirements which may be imposed by the SFC.
- SFC-authorized VA Funds should **not** have **leveraged** exposure to VA at the fund level. *(Instead of just the net derivative exposure of a VA Futures ETF shall not exceed 100% of the ETF's total net asset value.)*

D. Distribution

- Please refer to the relevant requirements for intermediaries and distribution of SFC-authorized VA funds as set out in the Joint circular on intermediaries' virtual asset-related activities issued by HKMA and SFC. *(Updated in response to the joint circular issued)*

Circular on SFC-authorized funds with exposure to virtual assets

Key revised requirements of the circular

E. Transactions and direct acquisitions of spot VAs (*New section*)

- Transactions and acquisitions of spot VAs by SFC-authorized VA Funds should be conducted through **SFC-licensed VATPs** or **authorized financial institutions** (AIs) in compliance with the Hong Kong Monetary Authority's (HKMA) regulatory requirements. In particular:
 - (a) For in-cash subscriptions and redemptions, SFC-authorized spot VA ETFs are expected to acquire and dispose of spot VAs through SFC-licensed VATPs, either on-platform or off-platform.
 - (b) For in-kind subscriptions, participating dealers are expected to transfer spot VAs, which may be held locally or overseas, to SFC-authorized spot VA ETFs' custody accounts with SFC-licensed VATPs, or AIs (or subsidiaries of locally incorporated AIs). The process is vice-versa for in-kind redemptions.
- Both in-kind and in-cash subscription and redemption are allowed for SFC-authorized spot VA ETFs.
- For ETFs that invest in spot VAs, their participating dealers should be SFC-licensed corporations or registered institutions; and subject to additional terms and conditions to be imposed by the Licensing Department where applicable.

F. Custody (*New section*)

- The trustee/custodian of an SFC-authorized VA Fund should only delegate its VA custody function (where applicable) to an **SFC-licensed VATP**, or an **AI** which meets the expected standards of VA custody issued by the HKMA.
- The trustee/custodian and any delegate responsible for taking custody of VA holdings of an SFC-authorized VA Fund should comply with the following:
 - a) it should ensure that the VA holdings are segregated from its own assets and the assets it holds for its other clients;
 - b) it should store most of the VA holdings in the cold wallet. The amount and duration of VA holdings stored in the hot wallet should be minimised as much as possible, save for meeting the needs of subscriptions and redemptions; and
 - c) it should ensure the seeds and private keys are: securely stored in Hong Kong; tightly restricted to authorised personnel; sufficiently resistant to speculation (eg, through generation in a non-deterministic manner) or collusion (through measures such as multi-signature and key sharding); properly backed up to mitigate any single point of failure.

G. Valuation (*New section*)

- For the valuation of spot VAs, the management companies of SFC-authorized VA Funds should adopt an indexing approach based on VA trade volume across major VA trading platforms. That is, a benchmark index published by a reputable provider that reflects a significant share of trading activities in the underlying spot VA.


H. Service providers (*New section*)

- The management companies should confirm that all necessary service providers, such as fund administrators, participating dealers, market makers and index providers, are competent, available and ready to support the SFC-authorized VA Funds.

I. Disclosure and investor education

- The offering documents, including the product key facts statements, of SFC-authorized VA Funds should **disclose the investment limits and key risks related to the funds' VA exposures** (*instead of just operational risks related to VA futures*).

Joint circular on intermediaries' virtual asset-related activities



The SFC has authorised VA futures ETFs and is prepared to accept applications for the authorisation of other funds with exposure to virtual assets, including VA spot ETFs, HKMA and SFC have issued [Joint circular on intermediaries' virtual asset-related activities](#) on 22 December 2023, superseding the joint circulars on intermediaries' VA-related activities issued on 20 October 2023 and 28 January 2022.

Key updates in the circular:

- I. clearly specifies the requirements applicable to intermediaries when they distribute VA-related products; and
- II. sets out the standards of conduct expected of intermediaries when distributing VA funds authorised by the SFC.

Key revised requirements of the circular

A. VA-related products definition

Virtual asset-related products are now defined as products which:

- (a) have a principal investment objective or strategy to invest in virtual assets;
- (b) derive their value principally from the value and characteristics of virtual assets; or
- (c) track or replicate the investment results or returns which closely match or correspond to virtual assets.

B. Complex products

Intermediaries distributing VA-related products considered to be “complex products” should comply with the SFC’s requirements on the sale of complex products, including ensuring the suitability of VA-related products, irrespective of whether there has been a solicitation or recommendation.

There are exemptions for VA-related products considered to be complex exchange-traded derivatives and complex exchange-traded SFC-authorized non-derivative VA funds.

C. VA funds authorised by the SFC for public offering

For VA funds authorised by the SFC for public offering, they will not be restricted to “professional investors only”. Nevertheless, the following requirements will apply in their distribution:

1. for those listed and traded on the Stock Exchange of Hong Kong, where there has been no solicitation or recommendation, intermediaries may execute client orders in them on exchange without the need to comply with the suitability requirement or the minimum information and warning statements requirements. However, intermediaries should still conduct a virtual asset-knowledge test on the clients concerned; and
2. for those not listed, or those listed but with trading in their fund units conducted off exchange, intermediaries should comply with the suitability requirements and the minimum information and warning statements requirements, and conduct a virtual asset-knowledge test on the clients concerned.

If these funds are also VA derivative funds, intermediaries also need to comply with the existing requirements for derivative products.

How KPMG can help

KPMG is a market leader in supporting licensed corporations and virtual assets companies in various capacities including audit and advisory. A team of seasoned experts with deep knowledge of the VA space is ready to support you on the new SFC requirements.



Pre-Implementation

- Understanding the rules and managing rule ownership assignment
- Perform a gap analysis and readiness assessment of your controls and processes against requirements and industry practices
- Assist you to perform the due diligence requirements as set out by the SFC on your partnered VA platforms and vendors



Implementation Support

- Support firms in implementing the SFC requirements in light of the regulated activity or activities you wish to carry out
- Perform regular assessments and health checks to ensure continued compliance with regulatory requirements, including cybersecurity and technology assessment, AML assessment and custody assessment



Business Support

- Business roadmap support and target operating model support under the new VA related activities framework
- Product and capabilities review and assessment against business objectives
- Notification and licensing support to the SFC
- IT and cybersecurity services in relation to VA business
- AML and KYC services

Contact us



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