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Bitcoin fund

A Discussion on Bitcoin fund and its regulatory issues

Introduction to Bitcoin fund

What is Bitcoin Fund

The broad definition of Bitcoin fund includes all collective investment schemes with majority of the asset under management invested in Bitcoin assets, derivatives and indices; and venture capital funds that invests in shareholder equity of startups engaging in the issuance or provision of ancillary services to Bitcoin (such as Bitcoin wallets, mining and blockchains). Some industry practitioners prefer a narrower scope and exclude the venture capital funds, which do not directly invest in Bitcoin products, from the definition.

Fund on Mining Technology Firms

After identifying different types of bitcoin fund, we now turn to look at some fund examples that are of the abovementioned type. Bitcoin Growth Fund is an example of Indian bitcoin fund that invest in companies affiliated with cryptocurrencies. As part of the Bitcoin Growth Fund, Mining and ICO Fund (“MCAP”) invests mainly in vertical forward bitcoin business (i.e. investing in mining technology firms).

Such investment has lower volatility than other bitcoin funds that invest in cryptocurrencies itself as purchasing stocks in a blockchain startup or a listed mining technology firms can avoid direct exposure to the volatility of cryptocurrencies. On the other hand, the liquidity of such fund may not be as high as funds that directly invest in cryptocurrency because the fund liquidity will depend largely on the performance of the mining companies.

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Fund on Bitcoin

Crypto Assets Fund and Bitcoin Investment Trust are two funds that invest in bitcoin and derive its value solely from the bitcoin price. Fund of such kind are of higher volatility because of the volatile nature of bitcoin. Provided that the degree of acceptance of bitcoin can be easily hampered by bad news, its exchanges are exposed to high risks of being hacked and the relevant regulations are primitive, the bitcoin price can have a dynamic movement in a short period of time and hence pose a greater volatility risk to fund investing in it. Since the daily trading volume of bitcoin is massive, the liquidity of such fund is higher when compared to MCAP likewise fund.

Fund on Bitcoin Derivatives

Bitcoin futures, bitcoin forward, bitcoin swap are some common types of bitcoin derivatives that are traded in bitcoin exchanges. By far, there is no bitcoin fund that solely invests in bitcoin derivatives. Bitcoin derivatives are speculative and are leverage-based. Since the derivatives are often leveraged, it magnifies the volatility of its underlying asset, Bitcoin, and hence having an even higher volatility than Bitcoin itself. As the concept of bitcoin derivative departs from conventional economics, these products are currently having a number of drawbacks, such as absence of regulated exchanges, absence of uniform and standardize contract, etc. To better incentivize fund managers to invest into these products, these undesirable features are to be addressed.

Compliance issues of Bitcoin Fund in Hong Kong

As the current legislation and regulations were drafted without the presence of cryptocurrencies, the legal position of cryptocurrencies is uncertain in Hong Kong. Following SFC's clarification in the statement on initial coin offerings dated 5 September 2017, it is possible that dealing or advising on digital tokens regarded as securities under the SFO, or managing or marketing a fund investing in such digital tokens may constitute a "regulated activity". This means a license may be required for engaging these regulated activities and hence compliance with the relevant SFC codes and guidelines is mandatory. Yet, the SFC remained ambiguous on her stance towards regulating investing activities relating to cryptocurrencies and to-date, there is no clear guidance addressing the regulatory requirement for cryptocurrencies-related activities.

Custody

With reference to the Fund Manager Code of Conduct ("the Code"), a fund manager of bitcoin fund should ensure that the assets entrusted to it are properly safeguarded. The custodian appointed should satisfy the requirements set out in the Code. The fund manager should also take all reasonable steps to ensure that the custodian is properly qualified and suitable on an ongoing basis. Given the nature of digital assets, cybersecurity is the most threatening issue confronting both fund managers and custodians. The regulators have not yet clarified the requirement on the custody of bitcoin fund.

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Brokers and Electronic Trading

Many online exchange platforms for Bitcoin nowadays are unregulated. There are no specific regulations on the system's reliability and security to ensure its capability of handling mammoth transaction volume. With more bitcoin funds launching into the market, electronic trading system for bitcoin funds may easily be overloaded. It is also doubtful as to the fund manager's sufficiency of experience in using such trading system.

Portfolio Valuation

Earlier this year, Deloitte announced that it has successfully completed auditing permitted blockchain systems and applications with professional auditing and assurance standards. However, it remains unclear whether portfolio valuation of funds can also be properly performed under the existing accounting standards and SFC regulations. It is stipulated in the Code that all assets held by a Fund Manager on behalf of clients should be valued on a regular basis and the basis of valuation should be disclosed to clients.

The major difficulty with bitcoin assets and derivatives valuation is the lack of authoritative and statutory body or exchange for independent and reliable price quotes. Furthermore, as mentioned in our previous issue of CP Insights on Bitcoin regulatory issues (September 2017), there has not been a consensus from regulatory bodies, domestically and worldwide, to the nature of cryptocurrencies.

As a result, the applicable Hong Kong laws and regulations to Bitcoin assets and derivatives remains unclear. Without clear guidelines and instructions from the HKMA, the SFC and/or the Government, fund administrators are hesitant in acting as a pioneer, or worse, a precedent case for future reference.

Conclusion

Except funds investing in mining technology firms, which is similar to investment in securities of listed corporations or private equity, the legal and regulatory landscape for funds investing in bitcoin and bitcoin derivatives is largely undeveloped.

The volatile nature of bitcoin makes it an extremely risky asset class that it is easy to touch the nerve of regulators and result in stringent regulations. Also, as bitcoin fund is new to the market, supporting infrastructure is primitive.

Therefore, for the sake of protecting investor interest, giving the green light to the setup of funds investing in bitcoin or bitcoin derivatives at this moment is imprudent. Fund managers are also not encouraged to step into this uncharted area with no corresponding updates on the relevant codes and guidelines by the regulators.

If you have any further questions regarding this issue of CP insights or have any topic you would like us to cover, please submit your response here <https://goo.gl/forms/gDLVThTmxGvMI4r12>.

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