Weekly Hot Take

Hong Kong's BTC Spot ETF:
Trigger for China's institutional flow?

Presto Research

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Summary

- Hong Kong Exchange(HKEX) is reportedly set to list its own Bitcoin spot ETFs soon - perhaps as early as this month. The applicants cited in the media include Harvest Global Investments, VSFG, Value Partners, and CSOP, among others.
- Hong Kong's spot Bitcoin ETFs are trying to distinguish themselves from their US counterparts by adopting in-kind creation/redemption, thereby enhancing market efficiency and addressing liquidity concerns.
- Factors favoring the successful launch of HK-listed Bitcoin spot ETFs include 1) the demand for 24-hour liquidity from US-listed ETF investors, and 2) the Chinese investors' strong appetite for politically neutral global monetary assets, as seen in the relatively large AUMs of the HKEX-listed gold ETFs.
- We conservatively estimate the HKEX-listed Bitcoin spot ETF to attract US$10-20bn inflow in the first 12 months upon listing.

Figure 1: HK's BTC spot ETFs set to repeat the gold spot ETFs' success?

	US	China (sandbox regions)	Diff.	Source
Financial Hub	US Equities Market Cap: US$50tn	HKEX Market Cap: US$5tn	10x	Bloomberg
Wealth Under Mgmt	US$115tn (2022)	US$4tn (HK, 2022)	29x	PwC, SFC
Gambling Revenue	US$9bn (Las Vegas, 2023)	US$23bn (Macau, 2023)	0.4x	The Nevada Independent Macao News
Gold ETF AUM	US$122bn+	US$70bn+ (HK-listed only)	1.7x	Bloomberg
BTC Futures ETF AUM	US$5bn+	US$140mn	35x	Bloomberg
BTC spot ETF AUM	US$59bn	?	?	ETF.com

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The talks are gaining momentum that the Hong Kong Exchange (HKEX) is about to list its own Bitcoin spot ETFs soon—perhaps as early as this month. Taking a cue from the Bitcoin spot ETFs listing in the US, expectations are building that it could kickstart another wave of institutional fund flow into BTC, this time led by the East. We examine related facts, narratives, and the outlook in this report.

What we know so far

While details remain speculative, reports have indicated that up to 10 financial institutions are poised to apply for Hong Kong's spot Bitcoin ETFs. Harvest Global Investments led the way by submitting the first application in January, with Hong Kong-based asset managers Venture Smart Financial Holdings(VSFG) and Value Partners following suit a few weeks ago. The media has previously mentioned the anticipated launch date for Hong Kong's spot Bitcoin ETFs is in the second quarter, while last week Reuters reported it could be as soon as in April.

Figure 2: Known bitcoin spot ETF applicants, as reported by media

Source: Presto Research

Asset Managers (Sponsors)	AUM	HQ	Source
Harvest Global Investments	US$230bn	Beijing, China	CoinDesk
Venture Smart Financial Holdings (VSFG)	N/A	Hong Kong	CoinDesk
Value Partners	US$5.9bn	Hong Kong	CoinDesk
China Southern Asset Mgmt (CSOP)	US$284bn	Shenzhen, China	Bitcoin.com
China AMC	US$271bn	Beijing, China	Nikkei Asia
Bosera Asset Mgmt.	US$237bn	Shenzhen, China	Nikkei Asia

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With Beijing's blessing

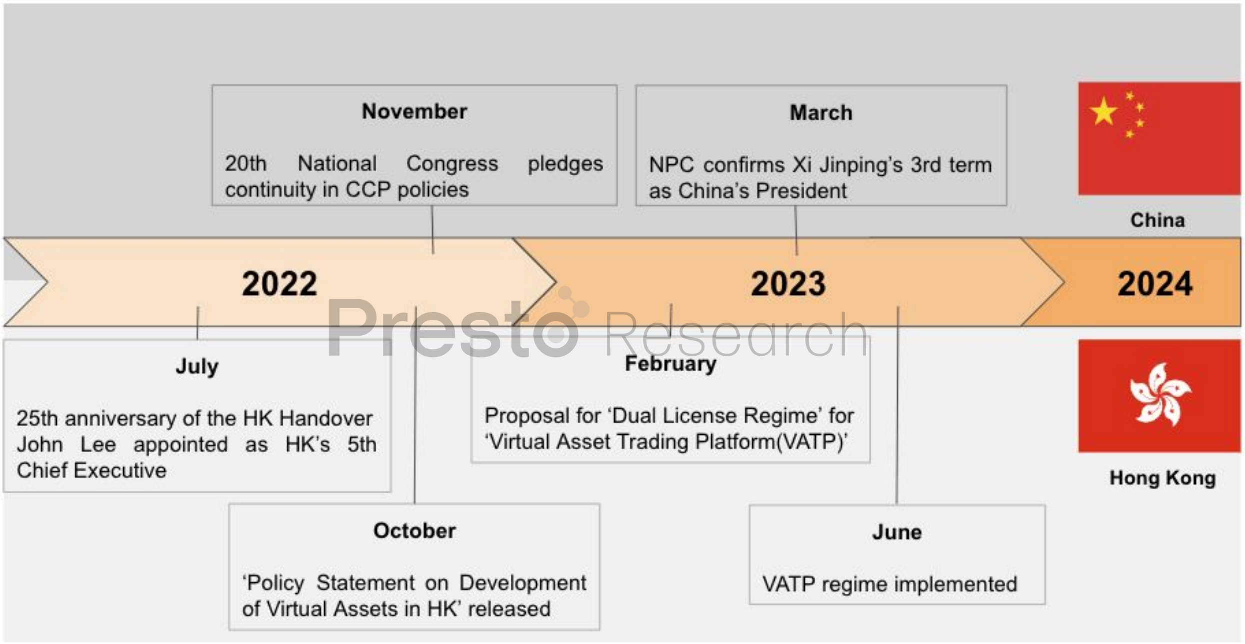
To contextualize Hong Kong's interest in Bitcoin spot ETFs, it helps to zoom out and understand how the political and economic landscapes surrounding Hong Kong have evolved over the last few years. On the 25th anniversary of Hong Kong's handover to China, President Xi Jinping visited the territory and reiterated China's commitment to the 'One Country Two System (一国两制)' principle under which Hong Kong has been governed since 1997. The President's speech emphasized that the principle has brought mutual prosperity to China and Hong Kong, and therefore will ensure Hong Kong continues to flourish under the principle.

Immediately thereafter, the Hong Kong government quickly announced a slew of policies aimed at bolstering Hong Kong as a cutting-edge global financial hub. The government was fully aware that it urgently needed to restore the city's competitiveness, which have diminished against rivals such as New York and Singapore during COVID-19, and incorporating digital assets became a key component of the strategy.

In October 2022, Hong Kong's then-freshly appointed Chief Executive John Lee announced 'Policy Statement on Development of Virtual Assets in Hong Kong', a de facto manifesto and high-level blueprint on why and how the Hong Kong government plans to embrace digital assets into the territory's mainstream financial system. From early 2023, Hong Kong government started to announce a series of regulatory initiatives streamlining and/or providing regulatory clarity on digital assets and related business activities, paving way for qualified entities to legitimately enter the industry(Figure 3). Along with establishing regulated crypto trading venues and framework for tokenization and stablecoin issuance, listing digital asset spot ETFs emerged as one of the pillars of the Hong Kong government's initiatives.

Figure 3: In sync with China's policy

Source: Presto Research



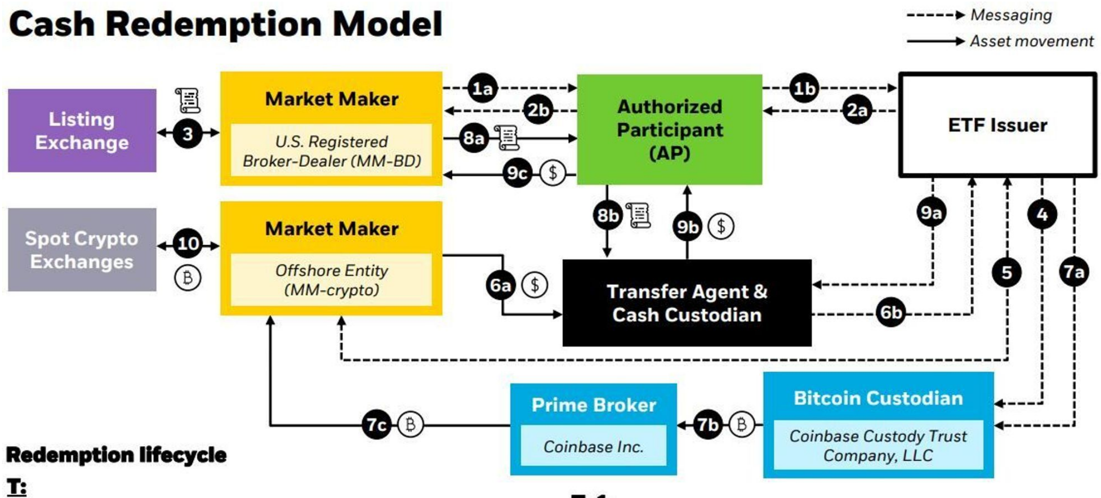
Rivalry between Hong Kong and New York

Media has reported that the Security & Futures Commission(SFC), Hong Kong's financial regulatory agency, is open to allowing in-kind creation/redemption for the territory's ETFs. In-kind creation/redemption allows for the direct exchange of assets ($BTC for Bitcoin ETFs) for ETF shares, contrasting with cash redemption processes, where ETF shares are exchanged for cash only. Compared to cash redemption, in-kind redemption is recognized for its better tax efficiency and reduced trading costs (with fewer steps as seen in Figure 3). The share of the two types in the ETF marketplace likely reflects these benefits; 22% of the ETFs around the world are cash-only, while the figure is even smaller when broken down by asset at a mere 7.4%.

Figure 4: In-kind vs cash creation/redemption model

Source: Bitmex Research

Cash Redemption Model



Redemption lifecycle

T:

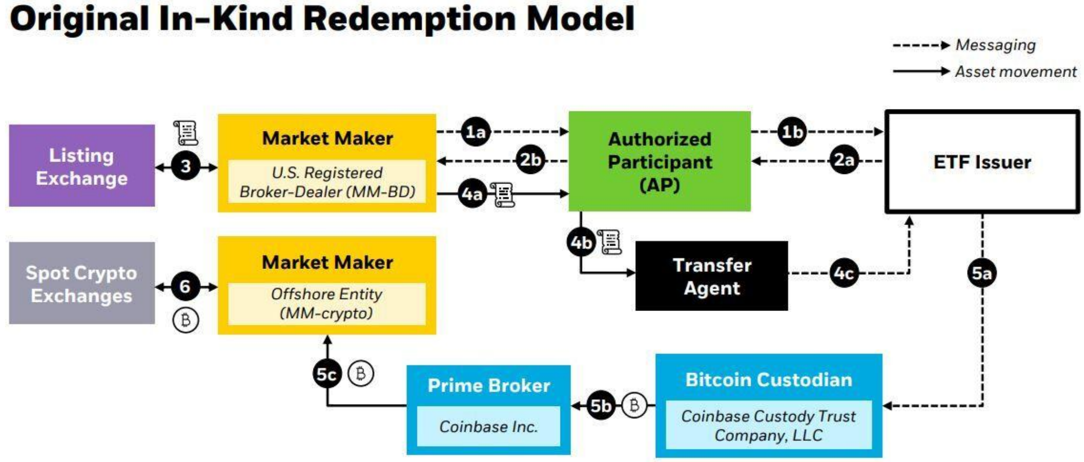
1. Market Maker (MM-BD) places redemption order via Authorized Participant (AP) in response to ETF dislocation from NAV
2. ETF Issuer approves redemption order
3. MM-BD buys ETF shares via Listing Exchange
4. ETF Issuer instructs Bitcoin Custodian to move bitcoin out of cold storage so it can be sold
5. ETF Issuer enters trade with MM-crypto to sell bitcoin for USD

T+1:

6. MM-crypto delivers cash to Transfer Agent
7. Bitcoin Custodian delivers bitcoin to MM-crypto via transfer through Prime Broker
8. MM-BD delivers shares to Transfer Agent via AP
9. ETF Issuer instructs Cash Custodian to release cash to MM-crypto via AP
10. MM-crypto may unwind bitcoin position

For illustrative purposes only. May not reflect all steps involved in process by all parties. Reflects only one possible Cash model; the number of possible approaches to Cash are significantly more varied, with more complex distinctions, than the number of possible approaches to In-kind. Other Cash models may reflect significant differences.

Original In-Kind Redemption Model



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5. ETF Issuer instructs Bitcoin Custodian to release bitcoin to MM-crypto via transfer through Prime Broker
6. MM-crypto may unwind bitcoin position

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In the US, despite preferences from major players like Blackrock for in-kind creation/redemption, the Securities and Exchange Commission(SEC) has shown a firm stance toward the cash-only type for spot Bitcoin ETFs. The reasons are not clear, but many assume this is due to a focus on regulatory caution and simplified oversight that the cash-only type provide. The SEC may be taking a view that, under the in-kind type, there are too many complexities and potential risks associated with the direct handling of BTC by the APs.

Some view the SFC's willingness to approve in-kind type as a move to outmaneuver its US counterparts in its quest to catch up with the competition. For its part, the SFC may be motivated by factors beyond superior product design. Specifically, in-kind type could address market functionality challenges, particularly those related to liquidity.

Hong Kong's current regulatory regime restricts crypto trading to the licensed exchanges, officially referred to as 'Virtual Asset Trading Platforms (VATPs)'. While over a dozen platforms await the SFC's VATP license approval, only two - OSL Exchange and HashKey Exchange - hold the license currently. This raises concerns about potential insufficiencies in trading volume, which is critical for the well-functioning ETF market(Coinbase's BTC/USD trading volume is at least 10x larger than HashKey's on average, according to CoinGecko). In-kind creation/redemption could help solve this.

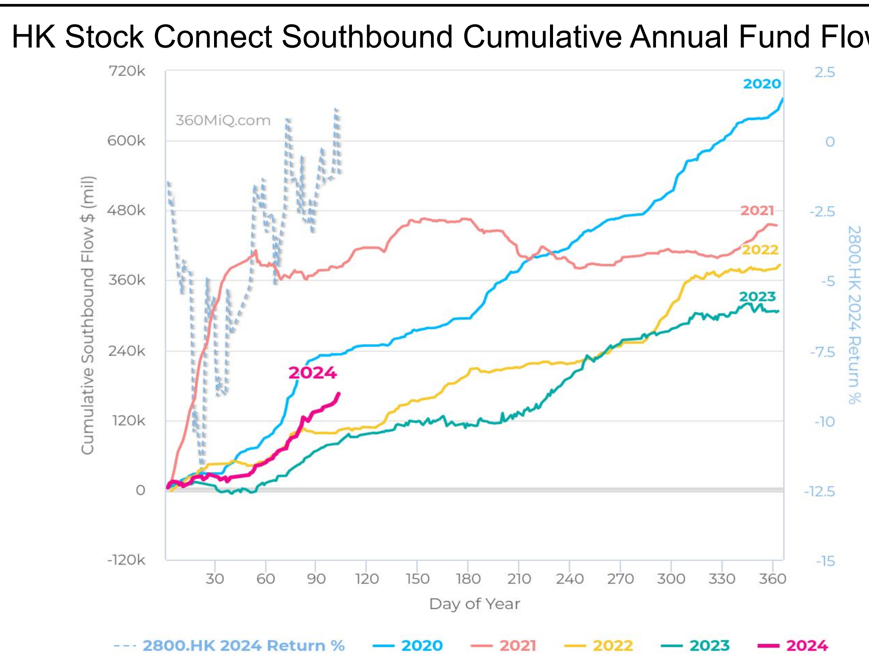
Can HK Bitcoin ETFs outgrow US-counterparts?
Estimating how much funds will flow into Hong Kong's spot ETFs is made extra difficult by the so-called 'second mover disadvantage.' Generally speaking, in non-US jurisdictions with relatively open financial regimes where local investors can easily access US-listed instruments, there isn't a strong incentive to direct the funds into a locally-listed ETF with the same investment exposure. This is because it often trades thinly and at a wider spread than its US counterparts, lacking

network effect and first mover advantage. Local ETF listings are therefore usually targeted at investors with strict local mandates (e.g., restrictions on investing outside their jurisdictions), those averse to FX transactions, or those who want access to liquidity in non-US time zones.

That said, there are a couple of factors in favor of the HK-listed Bitcoin spot ETFs. First, the US-listed ETF investors who want to trade 24 hours can consider allocating to the HK-listed vehicles, especially given the underlying asset trades 24/7. Second, HK-listed gold ETFs have done well historically(Figure 1), implying the Chinese investors' strong appetite for politically neutral global monetary assets. The bitcoin's 'digital gold' narrative therefore could attract equally strong interest from the Chinese investors, especially if HKEX-listed Bitcoin spot ETFs are added to the universe of stocks eligible for the mainland investors as part of the Southbound Stock Connect program. We conservatively estimate the HKEX-listed Bitcoin spot ETF will attract US$10-20bn inflow in the first 12 months upon listing. The estimate is based on taking 20-30% of the YTD inflow (not AUM) into the 10 US-listed ETFs and annualizing it.

Figure 5: Off to a good start

Source: 360miq.com



Sandbox's good track record

Longer-term, how HK Bitcoin spot ETFs fare can have an implication for the Hong Kong government's pro-crypto initiatives. The market's response to the launch will be taken as a barometer for the digital asset's potential and can seal its position as a much-needed growth driver for Hong Kong's financial industry. Its success can also generate greater political will to push through adoption that the legacy players reflexively resist. Above all, if successful, it will go a long way toward clearing skepticism about whether China is serious about nurturing the digital asset industry in Hong Kong.

Even if all else fails, it's worthwhile to remember that China's growth strategy through the combination of the mainland's huge capital base and sandbox policies have worked well in the past. Let's not forget that Hong Kong in essence is China's sandbox for the free financial market, just as Macau is for the gaming/leisure industry.

About Presto

Presto is a Singapore-based algorithmic trading and financial services firm founded in 2014. Presto focuses on delivering exceptional value for clients through rigorous research-driven approach to investment and trade execution. With more than a 100 million trade executions in a day, Presto is a leading financial services firm in both digital assets and traditional finance markets.

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