

May 21, 2024

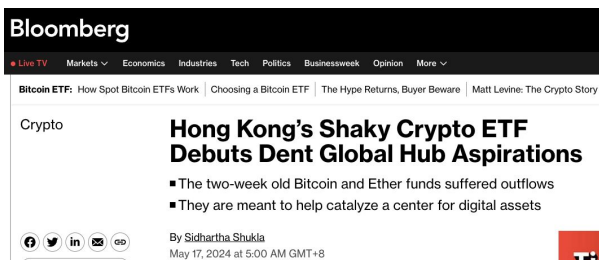
Peter Chung | Research Head
peterchung@prestolabs.io

Summary

- The Hong Kong spot crypto ETFs are unique in two respects. They are the only legitimate vehicles that can 1) accept BTC/ETH via in-kind creation, and 2) convert BTC/ETH into an asset recognized by the Hong Kong banking system as collateral. This appeals to large BTC/ETH holders, who now have a means to be included in the banking system.
- Incentivised by its desire to grow Hong Kong into a global financial hub rivaling New York, Beijing can utilize various policy tools to support Hong Kong government's crypto-hub initiatives. Stock Connect is one of them.
- Although the three crypto ETFs are not currently eligible for the Southbound Stock Connect program, the fact that the rules around eligibility have evolved in the past to accommodate changing policy needs suggests that the possibility of crypto ETF eligibility is real.

Figure 1: HK ETFs deserve more than a one-dimensional take

Source: Bloomberg, South China Morning Post, Coindesk



Since its debut four weeks ago, mainstream media has been quick to label Hong Kong's spot crypto ETF launch as 'disappointing' or 'a failures.' The negative headlines are often based on the ETF's much lower initial fund flow data compared to the US ETFs. However, given the significance of the Hong Kong ETFs' listing and their unique positioning, the topic deserves more than a cursory examination. This report aims to do precisely that by examining alternative perspectives and less conspicuous but important developments in recent weeks.

Bitcoin Asia Takeaways

Han Tongli, the CEO/CIO of Harvest Global Investments and one of the three sponsors for the HKEX-listed spot crypto ETFs, shared interesting insights during a panel discussion at [the Bitcoin Asia](#) (May 9-10, Hong Kong). His key points can be summarized as below.

- The Hong Kong ETFs may become eligible for Stock Connect in future.
- The in-kind creation/redemption feature in the HK's spot ETFs is important for two reasons.
 - It is an official channel to bring BTC/ETH into the TradFi system, bringing them out of the underground to legitimacy. Once converted into ETF shares via the in-kind creation process, the BTC/ETH wrapped in legally recognized vehicles can be accepted as collateral by the Hong Kong banking system.
 - Furthermore, this process is performed without going through the US-controlled financial system, which appeals to sovereign states outside the US-sphere of influence (e.g. China, India, some Arabic nations, etc.)

While there is a lot to unpack in these comments, this report will focus on the first point, given its more direct relevance to the investors.

Figure 2: “Empowering Hong Kong: Bitcoin Spot ETF” @ Bitcoin Asia

Source: SCMP



Stock Connect 101

Stock Connect refers to a cross-boundary investment channel that connects the stock exchanges in mainland China and the Hong Kong Stock Exchange (HKEX). Launched in 2014, the program allows investors on both sides of the border to trade shares on the exchanges of the other side using their local brokers and clearing houses. The two bourses in China (Shanghai Stock Exchange and Shenzhen Stock Exchange) each have separate channels to HKEX, referred to as Shanghai-HK Stock Connect (沪港通) and Shenzhen-HK Stock Connect (深港通) respectively. Depending on the direction of the fund flow, the program is categorized as Northbound (from HK to Mainland) or Southbound (from Mainland to HK) Connect.

China officially maintains capital controls, restricting FX trading only for current account transactions (e.g., export/import of goods and services) in principle. Over the years, however, China has experimented with a limited amount of FX trading for capital account transactions (e.g., investment/divestment in assets) in a controlled setting. As one such experiment, the Stock Connect program is subject to various rules regarding both asset types and investment quotas, whereby the number of stocks eligible for the program and the total investment amount is tightly monitored and controlled by the government.

Figure 3: Birds' eye-view on Chinese equity market

Source: Bloomberg, HKEX, Presto Research

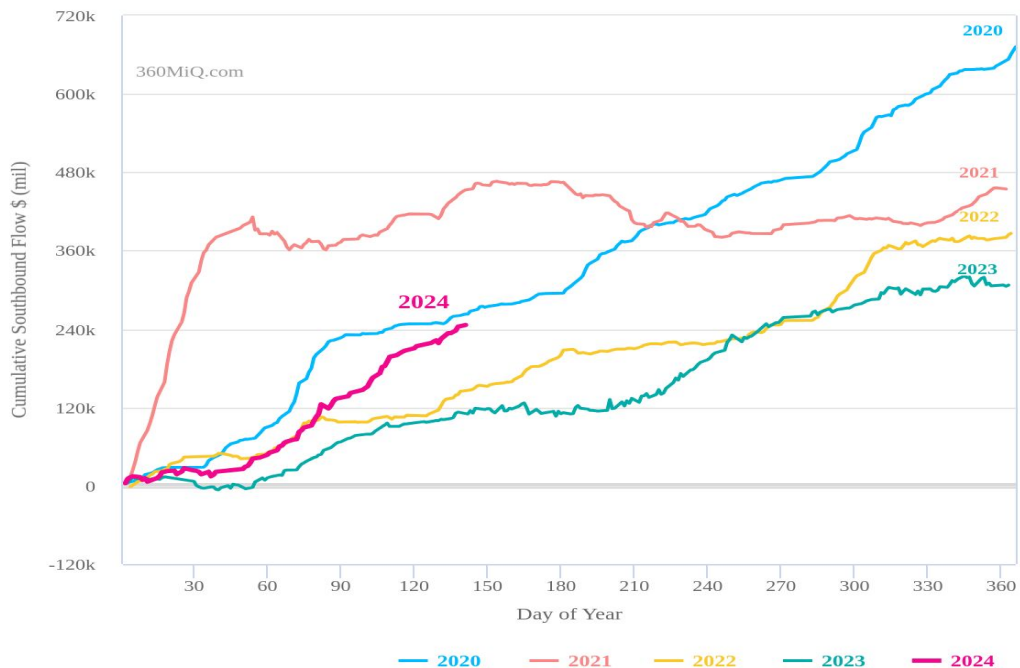
Chinese Equity: Market Cap by Exchanges

(US\$ billion, as of April-end '24)



Figure 4: Stock Connect Southbound Cumulative Annual Fund Flow

Source: 360imq.com



Expanding the universe

In 2022, Stock Connect program was expanded to include 'eligible' ETFs. To be eligible for Southbound connect, an ETF needs to meet all of the following criteria (Figure 5, 6).

Figure 5: Open for business...

Source: HKEX



HKEX's Stock Connect programme is expanding to include ETFs. This new milestone underlines Hong Kong's role as a superconnector facilitating the vital flow of capital between East and West and represents a significant step in HKEX's mission to connect China and the World and build the Marketplace of the Future.

2014	2016	2021
Launch of Hong Kong-Shanghai Stock Connect	Launch of Hong Kong-Shenzhen Stock Connect	Inclusion of ETFs into Stock Connect

Why list in Hong Kong?

Tap into China's wealth

>HK\$26.6bn Southbound Stock Connect average daily trading activity¹, April 2022

Mainland Chinese investors are increasingly diversifying portfolios overseas, with Hong Kong as the preferred destination.

Supported by liquidity providers

34 International market makers

Market makers contribute to a deep pool of liquidity in Hong Kong's ETF market, offering strong support to ETF issuers.

Deep pool of liquidity

HK\$7.7bn Hong Kong ETF market average daily turnover 2021

Hong Kong's ETF market is growing rapidly with average daily turnover up 20% y-o-y in 2021. HKEX is committed to further market enhancements and new products.

Access Asian investor base

As Asia's ETF marketplace, Hong Kong remains a top ETF trading destination for investors across the region, especially from Singapore, South Korea and Taiwan.



¹ Calculation based on average daily total trade value (buy and sell trades) in Shanghai and Shenzhen Southbound Stock Connect.



Figure 6: ...but not to everyone

Source: HKEX

Regular Review for Inclusion of ETFs in Stock Connect (Southbound)¹**Eligibility Criteria:**

ETFs primarily regulated by SFC and listed on SEHK that satisfy all of the following criteria at any regular review will be accepted as eligible ETFs for Southbound trading:

1. The ETF must be traded in HKD and have a daily average Assets Under Management (AUM) in the last six months of no less than HKD 1.7 billion;
2. The ETF must be listed for no less than six months;
3. The benchmark index must be launched for no less than one year;
4. The ETF must not be synthetic ETFs or Leveraged and Inverse Products;
5. The total weighting of SEHK-listed stocks in the benchmark index must not be less than 90%;
6. The total weighting of Stock Connect Southbound eligible constituents in Hang Seng Index (HSI), Hang Seng China Enterprises Index (HSCEI), Hang Seng TECH Index (HSTECH) and Hang Seng Hong Kong-Listed Biotech Index (HSHKBIO) must not be less than 70% and the total weighting of Stock Connect Southbound eligible constituents in other benchmark indices must not be less than 80%; and
7. The benchmark index or the index methodology of the benchmark index must fulfil either of the below criteria:
 - (a) Applicable to broad-based indices²:
 - A constituent stock must not be more than 30% of the index's weighting.
 - (b) Applicable to non-broad-based indices:
 - The number of index constituent stocks must not be less than 30;
 - A constituent must not be more than 15% of the index's weighting and the total weighting of the top five weighted constituents must not be more than 60%; and
 - The constituent stocks comprising no less than 90% of the index's weighting must be the top 80% shares by Average Daily Turnover (ADT) ranking in the relevant stock exchange in the past 12 months.

Eligible ETFs that subsequently meet any of the following criteria upon regular review will be designated as sell-only securities and will be restricted from buying:

1. The ETF's daily average AUM in the last six months falls under HKD 1.2 billion;
2. The ETF becomes a synthetic ETF or Leveraged and Inverse Product;
3. The total weighting of SEHK-listed stocks in the benchmark index falls under 85%;
4. The total weighting of Stock Connect Southbound eligible constituents in HSI, HSCEI, HSTECH, HSHKBIO falls under 65% or the total weighting of Stock Connect Southbound eligible constituents in other benchmark indices falls under 70%; or
5. The benchmark index and the index methodology of the benchmark index fulfil either of the below criteria:
 - (a) Applicable to broad-based indices:
 - A constituent stock exceeds 30% of the index's weighting.
 - (b) Applicable to non-broad-based indices:
 - The number of index constituent stocks falls under 30;
 - A constituent exceeds 15% of the index's weighting or the total weighting of the top five weighted constituents exceeds 60%; or
 - The constituent stocks which are the top 80% shares by ADT ranking in the relevant stock exchange in the past 12 months falls under 90% of the index's weighting.

¹ Subject to regulatory approval

² Broad-based index refers to an index whose constituent selection is not limited to a specific industry or investment theme but reflects the performance of a certain market or a certain size of stocks

Note that the criteria shown above effectively rules out the possibility of the crypto spot ETF inclusion, as only ETFs whose underlying assets consist of an equity basket can qualify. Currently, out of the total 287 HKEX-listed ETFs, only 10 ETFs meet the criteria (Figure 7).

Figure 7: Privileged Ten

Source: Bloomberg

Ticker	Name	Mkt Cap	Listing Date	Leverage	Fd Bnch Prim	Last Price	%1D
ETF Eligible for Stock Connect 2							
2800 HK	d TRACKER FUND OF HONG KONG-B	145,573	11/12/1999	N	HSI	19.72c	+0.97%
3033 HK	d CSOP HANG SENG TECH INDE-HKD	32,922	08/28/2020	N	HSTECHN	4.0400c	+1.30%
2828 HK	d HANGSENG CHINA ENT INDEX-HKD	26,402	12/10/2003	N	HSI21N	70.30c	+1.15%
3067 HK	d ISHARES HANG SENG TECH E-HKD	11,037	09/17/2020	N	HSTECHN	8.6500c	+1.23%
3403 HK	d CHINAAMC HSI ESG ETF-HKD	8,089	11/10/2022	N	HSIESGSN	41.48c	+1.37%
2837 HK	d GLOBAL X HANG SENG TECH ETF	3,547	03/30/2023	N	HSTECHN	5.0300c	+1.25%
3032 HK	d HANG SENG TECH INDEX ETF-H	3,159	09/04/2020	N	HSTECHN	4.0900c	+1.44%
3110 HK	d GLOBAL X HS HIGH DIV YIE-HKD	2,274	06/17/2013	N	HSI52N	22.92c	+0.97%
3088 HK	d CHINAAMC HANG SENG TECH -HKD	2,007	09/03/2020	N	HSTECHN	5.2000c	+1.56%
3037 HK	d CSOP HANG SENG INDEX ETF-HKD	1,533	05/06/2021	N	HSINH	19.9900c	+1.16%

China's toolbox

On April 19th, HKEX and the Shanghai/Shenzhen Stock Exchanges quietly proposed the expansion of eligible ETFs under Stock Connect. The proposal for the Southbound are shown in Figure 8 and 9.

Figure 8: Lowering entry barrier

Source: HKEX



香港聯合交易所有限公司
(香港交易及結算所有限公司全資附屬公司)

THE STOCK EXCHANGE OF HONG KONG LIMITED
(A wholly-owned subsidiary of Hong Kong Exchanges and Clearing Limited)

通告 CIRCULAR

Subject: **Expansion of Eligible ETFs under Stock Connect**
Enquiry: **Participant General Enquiry Hotline¹ (Tel: 2840 3626 E-mail: trd@hkex.com.hk)**

The Stock Exchange of Hong Kong Limited, Shanghai Stock Exchange and Shenzhen Stock Exchange have agreed on the expansion of eligible Exchange Traded Funds (ETFs) under Stock Connect (the Expansion). Subject to regulatory approval, the eligibility criteria for ETFs under Stock Connect will be updated.

編號 Ref. No.:	CT/042/24
日期 Date:	19/04/2024

Figure 9: Before and After

Source: HKEX

Eligibility Criteria for ETFs (Southbound trading):

Both buy and sell	Existing criteria	After the Expansion
1. Daily average AUM in the last six months	No less than HK\$1.7 billion	No less than HK\$550 million
2. Total weighting of SEHK-listed shares in benchmark index	No less than 90%	No less than 60%
3. Total weighting of Stock Connect Southbound eligible constituents in benchmark index	No less than 70% for HSI/HSCEI/HSTECH/H SHKBIO ² and 80% for other benchmark indices	No less than 60% for all benchmark indices

Sell only	Existing criteria	After the Expansion
1. Daily average AUM in the last six months	Falls under HK\$1.2 billion	Falls under HK\$450 million
2. Total weighting of SEHK-listed shares in benchmark index	Falls under 85%	Falls under 55%
3. Total weighting of Stock Connect Southbound eligible constituents in benchmark index	Falls under 65% for HSI/HSCEI/ HSTECH/HSHKBIO and 70% for other benchmark indices	Falls under 55% for all benchmark indices

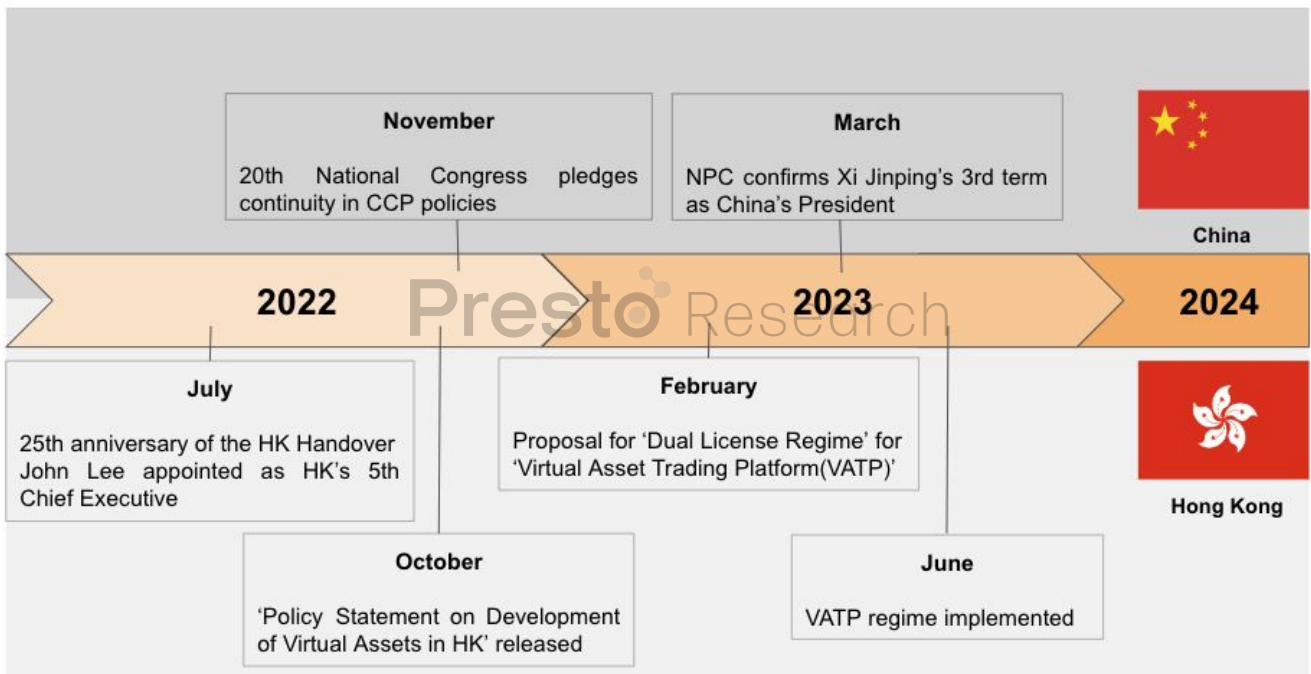
The proposal is subject to regulatory approval and the implementation can take up to three months. Once approved, we estimate the number of eligible ETFs is likely to expand to around 50.

Admittedly, neither the motivation for the proposal nor the reason for the timing of the announcement is clear. Nor does the proposed change allow for the inclusion of commodity-backed ETFs like the three spot crypto ETFs. However, this announcement, when viewed more broadly in the context of how Stock Connect program has evolved over the last few years, is a reminder that the rules around the program are rather flexible and can be adjusted to incorporate the government’s changing policy needs.

Consequently, this means, when assessing the outlook for Hong Kong spot crypto ETFs, myopically focusing on the initial fund inflow or the existing rules will not get you too far. Rather, understanding Beijing's intention behind supporting Hong Kong's pro-crypto policy is a more effective approach. We have argued that Beijing wants to see Hong Kong strengthen its position as a cutting-edge financial hub rivaling New York, not least driven by geopolitical considerations, and recognizes the role digital assets can play in such endeavors. For more, refer to the April 15th publication of Presto Research's Weekly Hot Take, [Hong Kong's BTC Spot ETF: Trigger for China's Institutional Flow](#).

Figure 10: China's plan for stronger Hong Kong

Source: Presto Research



Conclusion

For people with memories of China's crackdowns on crypto industry, it could be challenging to overcome scepticism on Beijing's intention and acknowledge nuances. This partly explains the current mainstream narratives on the Hong Kong's digital asset initiatives, which often fails to go beyond one-dimensional take. Understanding historical context and reading the tea leaves in this part of the world is essential, but it's not for everyone.

That said, given the global nature of the asset class, China's role in BTC mining, and the evolving geopolitical landscape, investors are better served by having a more holistic perspective. Remember, there is a reason why China in 2022 suddenly shifted its tone on the digital asset industry. Just like any other government, Beijing is treading carefully in this new field, and just like anywhere else, it ain't always going to be smooth sailing. But one thing is certain: Beijing has a lot in its toolbox to get the desired outcome.

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.

Find out more at <https://www.prestolabs.io>.

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Authors

Peter Chung, Head of Research : [X](#), [Telegram](#), [LinkedIn](#)

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