Use of external electronic data storage by SFC licensed corporations

Joanna Fung

The Securities and Futures Commission (SFC) issued a circular on 31 October 2019 (Circular) setting out the applicable requirements for a licensed corporation (an LC) to use external electronic data storage providers (EDSPs) for keeping regulatory records exclusively, i.e. without keeping a duplicate set of records at SFC approved premises. Regulatory records are records or documents which LCs are required to keep under the Securities and Futures Ordinance (SFO) and/or the Anti-Money Laundering and Counter-Terrorist Financing Ordinance.

(i) Prior SFC approval

An LC needs to apply for SFC approval of the premises where it keeps its regulatory records. The Circular clarifies that such premises include the relevant data centre(s) used by the EDSP if contemporaneous copies are not kept at the LC’s approved premises.

The EDSP should be (a) a company incorporated in Hong Kong or a non-Hong Kong company registered under the Companies Ordinance; and (b) its data centre needs to be located in Hong Kong (HK EDSP). If the EDSP is not a HK EDSP, the LC must obtain an undertaking from the EDSP to provide regulatory records and assistance as may be requested by the SFC.

(ii) Managers-in-Charge (MICs)

The LC should designate at least two MICs of core functions to access the regulatory records kept with an EDSP at any time. The two MICs must ensure that the SFC has effective access to such records upon demand without undue delay.
(iii) **Other requirements**

As with any outsourcing arrangement, the SFC expects an LC to

- **conduct proper due diligence** on the EDSP and **regular monitoring of service delivery** to ensure the EDSP is suitable and reliable (having regard to its operational capabilities, technical expertise and financial soundness);

- **maintain an effective governance process** and implement comprehensive information security policy to prevent unauthorized access and disclosure;

- assess the level of dependence and **consider using more than one EDSP**;

- **develop an exit strategy** to transition to an alternative storage solution; and

- **have a legally binding service agreement with the EDSP** that provides for contractual termination and provision requiring the EDSP to assist in the transition.

(iv) **Ongoing notification to the SFC**

An LC is required to notify the SFC of any proposed transition arrangement at least 30 calendar days prior to any termination, expiration, novation or assignment of the service agreement with the EDSP.

As is so often the case, the devil is in the detail: many LCs may have unknowingly stored data with one or more EDSPs, whether in or outside Hong Kong, without maintaining contemporaneous duplicate records on their own servers. For example, they may use the cloud for email storage; they may use web-based operational or portfolio management tools in their management functions. EDSPs, particularly non-HK EDSPs, may be unwilling to incorporate the necessary terms into their contractual arrangements with LCs, or to provide the necessary undertaking.

LCs are expected to review their use of external electronic data storage to ensure compliance with the Circular.

If an LC is already keeping regulatory records exclusively with an EDSP, it should notify the SFC without undue delay and apply for approval under the SFO.

If any data centre of an EDSP used by the LC has already been approved by the SFC, the LC should provide the SFC with the names of the two designated MICs and other required confirmations no later than 30 June 2020.

**Opt-in regulation of virtual asset trading platforms**

**Scott Carnachan and Isabella Wong**

The Securities and Futures Commission (SFC) has announced a regulatory regime that virtual asset trading platforms operating in Hong Kong can opt into, provided that at least one of the virtual assets traded on the platform falls within the definition of “securities” under the Securities and Futures Ordinance (SFO).

The new regulatory regime was announced by the SFC CEO Mr. Ashely Alder at Hong Kong Fintech Week 2019, with the details set out in the SFC’s **position paper of 6 November 2019 on the regulation of virtual asset trading platforms** (**Position Paper**).

The Position Paper is an extension of the SFC’s statement of 1 November 2018 on the **conceptual framework for the potential regulation of virtual asset trading platform operators**. This year, the SFC announced a holistic
approach in licensing and regulating eligible virtual asset trading platforms, together with detailed terms and conditions applicable to the licensed platforms. Through an opt-in licensing mechanism, the SFC wishes to help investors distinguish regulated platforms (which must have investor protection measures in place to maintain their SFC licences) from unregulated platforms.

Each virtual asset trading platform operating in Hong Kong should review the Position Paper carefully to determine whether it would benefit from regulated status and to make an assessment of the changes it would need to make to its business to satisfy the SFC’s requirements.

Legislative backdrop to the regulation of virtual asset trading platforms

The SFC derives its powers from the SFO. The SFO does not regulate virtual assets or the activities of virtual asset trading platforms, unless the virtual assets fall within the definition of "securities" (referred to in this article as securities tokens) or "futures contracts" under the SFO. Accordingly, unless and until the SFO is amended, the SFC can only operate an opt-in regulatory regime for virtual asset trading platforms that elect to include one or more securities tokens on the platforms. Trading of virtual assets that are not securities tokens will not be subject to the insider dealing, market misconduct or other provisions of the SFO, even if the relevant platform is licensed by the SFC.

SFC approach to virtual asset trading platforms

From 6 November 2019, a centralized virtual asset trading platform that offers trading of not less than one security token in Hong Kong can apply for a Type 1 (Dealing in Securities) and Type 7 (Providing Automated Trading Services) licence. Eligible platform operators will be licensed and placed in the SFC’s regulatory sandbox. Where the platform operator is part of a group of companies and wishes to apply for an SFC licence, all virtual asset trading business activities of the group in Hong Kong and the active marketing of such trading services to Hong Kong investors must be conducted by one group entity only and it is that group entity that must apply for the SFC licence.

Once a platform operator is licensed with the SFC, its entire business operations (covering trading of both security tokens and non-security tokens) will be subject to the SFC’s oversight. A licensed platform operator will need to comply with specific licensing conditions and additional terms and conditions, as further discussed below. Although the SFC does not have enforcement power over the licensed platform’s activities relating to non-security tokens, the SFC will take disciplinary action against licensed platform operators for breaches of the specific licensing conditions relating to the entire activities of the platform. Non-security tokens traded on a licensed platform will not be authorized by the SFC nor will their offering documents require registration under the Companies (Winding Up and Miscellaneous Provision) Ordinance.

The SFC will focus its resources on licensing and regulating centralized platforms providing trading, clearing and settlement services of virtual assets. At this stage, the SFC is not prepared to accept licensing applications from operators of (i) decentralized platforms which provide a direct peer-to-peer marketplace for investors, or (ii) order routing systems for virtual asset trades.

Operators of unlicensed virtual asset trading platforms in Hong Kong need to ensure that no “securities” or “futures contracts” as defined in the SFO will be traded on their platforms.

Regulatory requirements for licensed platforms

An SFC licensed virtual asset platform operator (Licensed Operator) will be subject to:

- Specific licensing conditions (which are set out in Part III B of the Position Paper); and
- Terms and conditions (which are set out in Appendix I of the Position Paper).
The proposed licensing conditions will require a Licensed Operator to:

- obtain the SFC’s prior written approval to offer new services (including incidental activities) and to offer new products on its platform (both securities tokens and non-securities tokens);
- provide monthly business reports (and additional information, upon request) to the SFC by end of the second week of each calendar month; and
- engage an independent professional firm to conduct an annual review of the Licensed Operator’s business operations and submit a review report to the SFC by the end of the fourth month of every year.

The terms and conditions are largely based on the existing framework for the regulation of securities and futures contracts under the SFO and its subsidiary legislation, the Code of Conduct for Persons Licensed by or Registered with the SFC, guidelines and circulars issued by the SFC, with additional requirements applicable specifically to virtual asset trading activities.

We set out below the key requirements under the terms and conditions:

- **Financial resources**: A Licensed Operator needs to maintain sufficiently liquid assets of at least 12 months of its actual operating expenses on a rolling basis.

- **Due diligence**: A Licensed Operator needs to conduct due diligence on each virtual asset (both securities tokens and non-securities tokens) before admitting the virtual asset to the platform for trading. The due diligence covers specific areas including but not limited to the background of the virtual asset issuer and the virtual asset itself (including its marketing materials, market capitalization and average daily trading volume etc.). For each virtual asset traded on the platform, the Licensed Operator should also submit to the SFC written legal advice as to whether the virtual asset constitutes securities under the SFO and the implications on the platform of admitting the virtual asset for trading.

- **Custody of virtual assets**:
  - A Licensed Operator should hold virtual assets and client money on trust for its clients by itself or through its wholly-owned subsidiary which is incorporated in Hong Kong and holds a trust or company service provider licence under the Anti-money Laundering and Counter-Terrorist Financing Ordinance (Qualified Associated Entity). The Licensed Operator should disclose to its clients the legal uncertainties over clients’ claims to the virtual assets. In addition, not more than 2% of the virtual assets can be stored in hot (online) wallets, whilst at least 98% of the virtual assets must be kept in cold (offline) wallets, maintained by the Licensed Operator or its Qualified Associated Entity.
  - A Licensed Operator must maintain full insurance coverage for the value of virtual assets held in the hot wallets and a substantial coverage (e.g. 95%) for the value of the virtual assets in the cold wallets.
  - A Licensed Operator and its Qualified Associated Entity need to ensure that all cryptographic seeds and keys are securely generated, stored and backed up.

- **Know-Your-Client**:
  - Other than institutional professional investors and qualified corporate professional investors, a Licensed Operator needs to ensure that clients have sufficient knowledge (including of the associated risks) of virtual assets, before providing services to them. A client who has executed five or more transactions in virtual assets within the past three years will be considered as having sufficient knowledge.
A Licensed Operator should also assess and manage the concentration risks for each client account by setting trading limits, position limits based on the client’s financial situation and sufficiency of the client’s net worth to satisfy trading obligations.

- **Anti-money laundering and counter-financing of terrorism (AML/CFT):** A Licensed Operator needs to have policies and procedures in place to manage AML/CFT risks. A Licensed Operator may deploy virtual asset tracking tools to enable its platform to trace the on-chain history of specific virtual assets. A Licensed Operator should not take on suspicious clients (e.g. with a history of ransomware attacks, money laundering or dark web transactions).

- **Prevention of market misconduct:** A Licensed Operator needs to have controls for surveillance of platform activities so that it can identify, prevent and report market manipulative and abusive activities. It should only adopt surveillance systems provided by reputable and independent service providers.

- **Accounting and auditing:** A Licensed Operator should carefully select its auditor and appoint a firm that has experience in auditing virtual asset related business activities.

- **Risk management:** A Licensed Operator should require clients to pre-fund their accounts before trading. No margin can be provided to clients. For institutional professional investors, however, a Licensed Operator may trade for the clients off-the-platform provided an intra-day settlement will be provided for that trade.

- **Conflicts of interest:** A Licensed Operator should not conduct proprietary trading or market making activities. Where market making activities are conducted to enhance the liquidity of a virtual asset, such activities need to be conducted by an independent third party at arm’s length.

### Warnings on virtual asset futures contracts

When issuing the Position Paper, the SFC also warned investors of the risks of trading virtual asset futures contracts. The SFC noted that “virtual asset futures contracts” typically include instruments that allow investors to speculate on the prices of the underlying virtual assets at a future date and have similar features to a “contract for differences” under the Gambling Ordinance. Unless an exemption applies, authorization for conducting gambling activity in Hong Kong may be required for entering into a virtual asset futures contract that is a contract for differences. The SFC has neither licensed nor authorized any platforms in Hong Kong to offer or provide trading services in virtual asset futures contracts, and has indicated it is unlikely to grant such licence or authorization due to the risks associated with these instruments.

Asset managers investing in or trading over-the-counter derivative instruments, where the underlying are virtual assets, need to be aware of the SFC’s warnings and consider the implications on their investment and trading activities. On 1 June 2018, the SFC issued a circular to intermediaries on compliance with notification requirements, in which it asked licensed intermediaries to notify the SFC before engaging in virtual asset activities. If an asset manager manages a fund that invests more than 10% of its gross asset value in virtual assets, the asset manager will be subject to separate terms and conditions (as discussed in our article of 22 October 2019).

### The UK FCA finds three asset management firms in violation of competition laws

Sharon Pang

The UK’s Financial Conduct Authority (FCA) issued its first formal ruling under its competition enforcement powers on 22 May 2019 against three asset management companies. Hargreave Hale Limited (Hargreave
Hale), Newton Investment Management Limited (Newton), and River and Mercantile Asset Management LLP (RAMAM) were found to have contravened the competition laws through the sharing of “strategic information” during the book building process in relation to an IPO by On the Beach Group plc (On the Beach) and a placing by Market Tech Holdings Limited (Market Tech), shortly before the books closed and the share prices were set. Newton was granted immunity for reporting the infringement to the FCA, and thus avoided a pecuniary penalty. Antitrust fines of £306,300 and £108,600 were imposed on Hargreave Hale and RAMAM, respectively.

What constitutes “strategic information”? Asset managers participating in an IPO or a placing are direct competitors of each other. Each asset manager needs to consider rival asset managers’ likely demand for the shares, and decides what bid he needs to submit in order to ensure he will be allocated the desired amount of shares in the face of such competition. Although each individual asset manager has an incentive to bid less in the hope of obtaining shares at a lower price, he also needs to weigh this incentive against the risk of missing out or being allocated fewer shares than he desires if rival asset managers bid for sufficient volume at higher prices.

In a competitive book building process during an IPO or a placing, rival asset managers independently and confidentially determine the volume and value of their respective bids based on their own assessment of the investment opportunity. Any information that enables one asset manager to know the intention of another during the IPO or placing, when they should have been competing for shares, is considered “strategic information”. Examples of “strategic information” include: an asset manager’s own assessment of the value of the issuing firm, the number of shares and the price at which he intends to bid, and whether or not he plans to submit a bid. The sharing of such information during the book building process in an IPO or a placing can eliminate, or at the minimum substantially reduce the uncertainty among the asset managers regarding each other’s intention.

What “strategic information” was shared among Newton, Hargreave Hale and RAMAM? The FCA ruled that Newton, Hargreave Hale and RAMAM disclosed and/or accepted “strategic information” by sharing information on their valuation of the issuing firms, their bidding intention, including the volume and/or share price of the bid they intended to submit, in connection with the On the Beach IPO and the Market Tech placing.

On the Beach IPO. In the morning on the day of the book closing, a fund manager at Newton (Mr. Paul Stephany) blind-copy emailed asset fund managers at 12 rival firms, including Hargreave Hale and RAMAM. Mr. Stephany disclosed his own valuation of the issuing company in the email (“£260 million pre [new] money”), and encouraged the other asset fund managers to move their respective valuation at the same level. Mr. Stephany also disclosed in the email that he had placed an order of a specific amount at the £260 million limit the same morning.

The direct recipients of Mr. Stephany’s email at Hargreave Hale forwarded the email internally to the asset managers who were responsible for the firm’s ultimate decision with respect to the On the Beach IPO. Moreover, Hargreave Hale tried to get in touch with Newton after receiving the email, and the two companies had at least one telephone conference prior to the book closing. In its reply to Newton’s email, RAMAM offered its own valuation of the On the Beach IPO, to which Newton responded with its own view of RAMAM’s valuation.

Market Tech placing. In the morning on the day of the book closing, Mr. Stephany of Newton telephoned Hargreave Hale and RAMAM separately to discuss the valuation of Market Tech. During these calls, Mr. Stephany disclosed to his counterparts at Hargreave Hale and RAMAM the amount of shares he intended to buy, and at what price. Mr. Stephany also attempted to persuade his counterparts to submit their own orders at the same low price as Newton’s. Hargreave Hale had already submitted its bid in the Market Tech placing prior to its conversation with Newton, and did not change its submission subsequent to the phone call. RAMAM submitted its bid at the same price as Newton’s shortly after its call with Mr. Stephany.
The fact that the disclosures took place on the day the respective book was due to close rendered the information exchanged among the asset management firms even more “strategic”. Generally, the shorter the time period between the disclosure of information on a bid and the time the book closes, the less likely the disclosing firm will change its bid or depart from its stated intention. Hence, as the deadline for bid submission approaches, uncertainty as to the discloser’s intention regarding the IPO or placing is likely substantially reduced. Thus, the recipient can also place greater reliance on the disclosed information.

**Why is the exchange of “strategic information” anti-competitive?**

In a properly functioning competitive market, every bid submitted by an asset manager should be independent of the “strategic information” of rival asset managers. Sharing of “strategic information” can distort and restrict competition because it reduces the parties’ decision making independence by lowering their incentives to compete. As rival asset managers compete less vigorously during book building, each asset manager may end up submitting a lower bid than he might have otherwise. As a result, the issuing company may achieve a lower strike price than it would have in the absence of “strategic information” sharing among competing asset managers, which in turn leads to an increase in the cost of capital for the issuing firm. The higher capital cost raises the cost of the related investments that the issuing firm plans to undertake. In some cases, some investments may become non-viable because of higher capital costs.

Further, the anti-competitive conduct among asset managers, which leads to lower bid prices and hence higher capital costs, could reduce the attractiveness of IPOs and placings as a means of raising capital for firms, thus distorting the efficient allocation of capital. It can also undermine the credibility of the book building process as a means of raising capital for companies.

**How should (and shouldn’t) an asset manager respond to the disclosure of “strategic information” by a competitor?**

Hargreave Hale and RAMAM were two of 12 asset management firms who received the same email from Newton which contained “strategic information” on the On the Beach IPO on the day of the book closing. Only Hargreave Hale and RAMAM (as well as Newton) were implicated. The reactions of three of the remaining ten recipients of the Newton email (who were not implicated in this matter) illustrate how “well advised” firms should react when they receive “strategic information” from a competitor:

- Old Mutual Global Investors (UK) Ltd. (**Old Mutual**) attempted to block the discloser’s email address in order to avoid any future contact; the problematic email from Newton was forwarded internally to Old Mutual’s Head of Compliance.
- BlackRock Investment Management (UK) Ltd. (**BlackRock**) emailed the discloser at Newton (Mr. Stephany) to explain that his emails were not in line with BlackRock’s protocol.
- Henderson Volantis (**Henderson**) withdrew from participating in the On the Beach IPO.

The FCA’s decision also highlights what an asset manager should not do when he finds himself on the receiving end of “strategic information” from a competitor – thanking the discloser for the information, continuing the discussion with the discloser (and therefore endorsing or encouraging the disclosure), agreeing to consider the information, or providing information to the discloser in return. Competition law enforcers may consider such responses to the disclosure of “strategic information” by a competitor as evidence of the recipient’s participation in an anti-competitive “concerted practice” in violation of the competition law.

Notably, by not proactively rejecting the “strategic information”, the recipient may also be deemed to have “accepted” the information from the discloser, and thus be considered a party to a “concerted practice” and be found in violation of the competition law. According to the FCA decision, evidence of the recipient not distancing itself from the “strategic information”, not rejecting the information, or not reporting its receipt to regulators or internal compliance officers can all be indicative of the recipient’s acceptance of the information.
**Why is this FCA decision relevant to asset managers in Hong Kong?**

Since the Hong Kong Competition Ordinance came into full effect in December 2015, the Hong Kong Competition Commission (HKCC) has launched over a hundred investigations of allegedly anti-competitive conduct committed by businesses and individuals in a wide range of industries. Among the conduct that the HKCC focuses on is the sharing of commercially sensitive information between competitors, which the HKCC considers highly problematic under the Competition Ordinance. Hence, asset managers should be vigilant in their interactions with their competitors. Specifically, the exchanges of “strategic information” among competing asset managers during book building, which the FCA found to be in breach of the competition laws in the UK, may also run afoul of the Competition Ordinance if committed in Hong Kong.

**SFC reprimands and fines bank HK$400 million**

*Rory Gallaher*

The Securities and Futures Commission (SFC) has publicly reprimanded and fined a bank HK$400 million in relation to overcharging practices and related internal control failures.

The bank overcharged its clients by increasing the spread after execution of trades without their knowledge and charging them fees in excess of standard disclosures or rates. The bank increased the spread charged to clients following the execution of trades in bonds and structured notes.

Where the execution price achieved in the market was better than the limit order price placed by the client in buy or sell trades, the bank’s staff would increase the spread within the bank’s order processing system, the difference being retained for the bank’s benefit.

On some occasions, bank staff misreported the execution price or spread to clients; and in some other cases, bank staff falsified quarterly statements issued to intermediaries authorized to trade for clients.

Such conduct clearly falls short of the standards expected of a regulated entity (and indeed the bank’s own marketing materials). The SFC’s statement of disciplinary action specifies in detail the various regulatory requirements held to be breached by such conduct, including the requirements to:

(a) act honestly, fairly, with due skill, care and diligence, and in the best interests of clients;
(b) make adequate disclosure to clients of the monetary benefits received and relevant material information;
(c) avoid conflicts of interest and ensure fair treatment of clients;
(d) ensure that any representations made and information provided to clients are accurate and not misleading;
(e) ensure that the charges, mark-ups or fees affecting clients are fair and reasonable and characterized by good faith;
(f) execute client orders on the best available terms; and
(g) ensure that clients are provided with adequate information about the services provided including the nature and scope of fees, penalties and other charges.

It seems that in many instances it was unclear whether the bank was acting as principal or agent in the relevant transaction, which raised serious concerns about how it could ensure compliance with relevant regulatory requirements.
The SFC found that the overcharging malpractices involved a combination of serious systemic failures for a prolonged period of time, including inadequate policies, procedures and system controls, lack of staff training and supervision, and failures of the bank’s first and second lines of defence functions.

These failures in turn provided grounds for claims of other regulatory failures by the bank including failures to:

(a) ensure that any person it employs or appoints to conduct business is fit and proper and otherwise qualified to act;

(b) ensure that it has adequate resources to supervise persons employed or appointed by it to conduct business on its behalf;

(c) ensure that it has internal control procedures and financial and operational capabilities to protect its operations, its clients and other licensed or registered persons from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions;

(d) implement and maintain measures appropriate to ensuring compliance with all regulatory requirements applicable to the conduct of its business activities so as to promote the best interests of clients and the integrity of the market;

(e) (i) establish and maintain an appropriate and effective independent compliance function, (ii) ensure staff performing the compliance function possess the necessary skills, qualifications and experience to enable them to effectively execute their duties, (iii) enforce clear policies to ensure that the compliance function covers all relevant aspects of the bank’s operations, including the unfettered access to necessary records and documentation, and (iv) ensure staff performing the compliance function, in conjunction with management, establish, maintain and enforce effective compliance procedures; and

(f) establish and maintain effective policies and operational procedures and controls in relation to the bank’s day-to-day business operations, to ensure (i) the compliance by the bank and its staff with relevant legal and regulatory requirements, and (ii) that client orders are handled in a fair and equitable manner.

To compound its failings, the bank failed to report the breaches promptly: the SFC found evidence that the bank had identified the relevant issue in 2014, but failed to report it until 2016.

The bank has agreed to compensate clients with interest, which is likely to cost a further HK$180 - 200 million, and to engage independent reviewers to (i) identify the root causes of the relevant conduct and assess the magnitude of its spread overcharge practices, (ii) validate the relevant overcharge and compensation arising, and (iii) review the adequacy and effectiveness of the bank’s remediation measures.

It does not appear that the staff involved benefitted directly from the overcharging, but it seems likely that their remuneration was impacted by it. Remuneration structures commonly adopted in the financial services industry often form the motivation for misconduct. Regulators have highlighted this as a concern, but the lesson has yet to be learned.

Mainland China briefing: foreign ownership limits

Shanshan Liu

On 11 October 2019, the China Securities Regulatory Commission (CSRC) released in a press conference the time frame for removal of limits on foreign stakes in financial services entities.
This announcement was a follow-up from an earlier CSRC announcement in April 2018, which stated that the CSRC would accept applications from securities companies, fund management companies (FMCs) and futures brokers to increase their foreign ownership by up to 51%. The CSRC further proposed to bring forward the timeline to allow these entities to apply for up to 100% wholly foreign ownership from 2021 to 2020. This plan would grant foreign companies full ownership to domestic securities companies, FMCs and futures brokers in Mainland China.

The specific timetable to remove limits on foreign ownership set by the CSRC is as follows:

1) Futures brokers – 1 January 2020;
2) FMCs – 1 April 2020; and
3) Securities companies – 1 December 2020.

This announcement is a strong sign of the Chinese government’s willingness to further open up its financial industry and attract more foreign capital to the markets in the Mainland. The increase in foreign ownership and foreign players in the Mainland Chinese market should also boost the growth of the local financial industry through competition with the foreign owned companies. This announcement should help promote the internationalization of Chinese financial markets for asset management and commodities futures.

For foreign asset managers who are seeking to acquire wholly foreign ownership of a domestic FMC, securities company or futures broker in China, there are several factors that they should take into consideration. For instance, they should assess if they are fully prepared to move to 100% ownership and make such a commitment to China’s market, taking into consideration the relevant market conditions and their relevant experience. Furthermore, given the time lag between making a CSRC application and receiving final CSRC approval, it is advisable that foreign asset managers seeking to acquire 100% ownership prepare and submit their applications as early as possible, either by way of increasing their equity in their existing joint venture, or by setting up a new wholly foreign-owned entity.

SFC licensing and compliance hints

Michelle Ma

You will need a new licence if the activity is not “incidental” anymore!

There are various situations in which a firm can be exempted from having to have an SFC licence and one of them is where the “incidental exemption” applies. The way this exemption works is that a firm is not required to also be specifically licensed for a regulated activity if the firm is only conducting that activity wholly incidentally to the main activity for which it is licensed. This means that a firm must have a licence in the first place to be able to rely on this exemption (unlike the “wholly owned group exemption”).

It is important of course to understand the scope of permitted “incidental” activities when the licence is first granted; but it is almost more important to consider the scope of this exemption prior to giving up one of several licences (and remaining licensed to conduct other regulated activities).

For example if a firm decides to terminate all the sub-advisory arrangements between a Hong Kong Type 9 asset manager and its parent company (the manager of the fund), and move its portfolio managers back to the parent, the Hong Kong firm will need to give up its Type 9 licence (unless it has any of its own funds or managed accounts). But if the firm wants to keep the trading desk in Hong Kong in order to continue to handle securities or futures contracts trades for those portfolio managers (who have moved to the parent company), the Hong Kong company would also need to apply for a Type 1 (securities) and a Type 2 (futures contracts) licence (and its minimum liquid capital and paid-up share capital requirements would both go up even though the level of activity had been reduced).
This is because the placing of securities / futures contracts orders by an asset management firm for funds / portfolios managed by the firm itself (although technically a Type 1/2 regulated activity) does not require an actual Type 1/2 licence for the reason that the activity is wholly incidental to its Type 9 asset management activity. On the other hand, the placing of orders for funds / portfolios managed by a group company or an affiliate is not considered incidental to any of the other activities conducted by the Hong Kong firm, which means that to do so the asset management firm would also need a Type 1/2 licence.

This concept is also relevant in a fund specific context. If the asset manager does not need to give up its Type 9 licence, but ceases to manage one of the group funds, it will automatically lose its entitlement to continue placing trades for that fund under the “incidental exemption”. Therefore it would need to get a Type 1/2 licence to continue providing the trading function.

Care therefore needs to be taken even before reducing a business line just in case the reduction triggers the need for a new licence, as illogical as this may sound.

You can find more information about the “incidental exemption” in paragraphs 1.3.3 to 1.3.6 of the SFC’s Licensing Handbook, or speak to us if you wish to know more.

Recent publications

New rules regarding entitlement to treaty benefits for non-resident taxpayers in China

An important lesson on settlement negotiations

Revised Departmental Interpretation and Practice Note No. 28 on the deductibility of foreign tax

Court rules on meaning of “default” in construction contract

Court refuses to remit case back to arbitral tribunal for second time

Court held that arbitration clause in head contract was not incorporated into sub-contract

The importance of monitoring time limits when enforcing arbitral awards

The 2019 Hague Convention on the Recognition and Enforcement of Foreign Judgments

So what if I ignore a Calderbank offer regardless of case merits?

Hong Kong – Mainland interim relief arrangement in aid of arbitration effective on 1 October 2019

Want to know more?

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Whilst every effort has been made to ensure the accuracy of this publication, it is for general guidance only and should not be treated as a substitute for specific advice. If you would like advice on any of the issues raised, please speak to any of the contacts listed.