

Newsletter

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Hong Kong consults on detailed requirements for virtual asset exchanges

Scott Carnachan

The Securities and Futures Commission (**SFC**) is consulting on the detailed requirements that will apply to virtual asset exchanges licensed under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (**AMLO**). The same requirements will also apply to virtual asset exchanges that list securities tokens and so are required to be licensed under the Securities and Futures Ordinance (**SFO**). The consultation paper is available [here](#). The deadline to submit comments to the SFC is 31 March 2023. Our article on the licensing regime under the AMLO is available [here](#).

The licence regime comes into effect on 1 June 2023. Given the limited time between the end of the consultation and the commencement of the licensing regime, it would be prudent for virtual asset exchanges operating or considering operating in Hong Kong to assume virtual asset exchanges licensed under the AMLO will be subject to requirements in substantially the form set out in the consultation paper.

Securities regulation plus

Virtual asset exchanges operating in Hong Kong will move from a largely unregulated environment (now) to a highly regulated environment (from 1 June 2023).

The detailed requirements in the consultation paper indicate that the regulatory environment for licensed virtual asset exchanges will be equivalent to the requirements that currently apply to licensed corporations under the SFO, with modifications, additional requirements and additional restrictions specific to virtual assets. The SFC has indicated in the consultation paper that, in designing the regulatory requirements, it has sought to strike a balance between investor protection and market development.

Steps that existing virtual asset exchanges operating in Hong Kong should consider are set out below under "What existing operators should do next".

Overview of regulatory requirements

The detailed requirements set out in the consultation paper consist of:

1. Guidelines for Virtual Asset Trading Platform Operators (**VATP Guidelines**) – the VATP Guidelines set out the requirements for establishment and ongoing operation of licensed virtual asset exchanges, including in relation to:
 - (a) Minimum requirements to be considered “fit and proper”, competency requirements and continuous professional training requirements;
 - (b) Financial resources;
 - (c) Corporate governance and operations, including processes for admitting tokens for listing and processes to prevent market manipulative and abusive activities;
 - (d) Client take-on procedures and ongoing disclosures to clients;
 - (e) Custody of client assets;
 - (f) Cybersecurity;
 - (g) Conflicts of interest;
 - (h) Recordkeeping;
 - (i) Audits; and
 - (j) Ongoing reporting and notification obligations;
2. Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (For Licensed Corporations and SFC-licensed Virtual Asset Service Providers) (**AML Guideline for LCs and SFC-licensed VASPs**) – the AML Guideline for LCs and SFC-licensed VASPs apply the existing anti-money laundering requirements for licensed corporations under the SFO to virtual asset exchanges licensed under the AMLO and include a new chapter 12 specifically relating to the anti-money laundering risks of virtual assets and the steps that need to be taken when assessing and managing such risks;
3. Prevention of Money Laundering and Terrorist Financing Guideline issued by the Securities and Futures Commission for Associated Entities of Licensed Corporations and SFC-licensed Virtual Asset Service Providers (**Associated Entity AML Guideline**) – the Associated Entity AML Guideline applies the AML Guideline for LCs and SFC-licensed VASPs to associated entities as if they were licensed as a virtual asset exchange under the AMLO (see “Custody requirements – need for a TCSP” below for more detail on associated entities and their role);
4. Disciplinary Fining Guidelines – these Guidelines set out the basis on which the SFC intends to exercise its power to impose fines under section 53ZSP(3)(c) of the AMLO and are consistent with how the SFC exercises its existing power to impose fines under the SFO.

Various requirements of the VATP Guidelines are discussed in more detail below.

Requirement for dual licences under both the SFO and the AMLO

The SFC proposes that virtual asset exchanges must be licensed under both the AMLO and the SFO, even if the intention of a virtual asset exchange is only to list tokens that are not “securities” under the SFO. This proposal is a change from the longstanding approach that a licence will only be granted under the SFO where an applicant will engage in “regulated activities”, as defined under the SFO.

The SFC rationale for proposing a dual licence requirement is that the terms and features of virtual assets may evolve over time and a virtual asset’s classification may change from a non-security token to a security token (or vice versa). The SFC notes that, by obtaining licences under both the AMLO and the SFO, any change in the nature of a token listed on a virtual asset exchange would not result in the exchange breaching either licensing regime.

To the extent that there are differences in the requirements under the SFO and the AMLO, a dual-licensed virtual asset exchange would need to comply with the more stringent requirement.

Custody requirements – need for a TCSP

Licensed virtual asset exchanges will need to establish an “associated entity” to hold client assets. The associated entity must:

1. Be a company incorporated in Hong Kong;
2. Be a wholly-owned subsidiary of the exchange;
3. Be licensed by the Registrar of Companies as a trust or company services provider (**TCSP**) under the AMLO;
4. Hold client assets on trust; and
5. Not conduct any business other than that of receiving or holding client assets on behalf of the exchange.

Requirement for external assessment reports to support licence applications

The SFC proposes to require that a licence applicant engages an external assessor to assess its business going forward, and submit the assessor’s reports to the SFC (i) when submitting the licence application (**Phase 1 Report**) and (ii) after the SFC has granted approval-in-principle of the application (but before final approval) (**Phase 2 Report**). Separate external assessors may be appointed to review different areas of the applicant’s business. The assessor(s) must be independent and should have the necessary expertise and technical knowledge to conduct the required assessment. The SFC reserves the right to oppose the appointment of any external assessor.

The Phase 1 Report should cover the design effectiveness of the virtual asset exchange’s proposed structure, governance, operations, systems and controls, with a focus on key areas such as governance and staffing, token admission, custody of virtual assets, know your client, anti-money laundering, market surveillance, risk management and cybersecurity. The assessor should review and assess whether the platform operator’s policies and procedures are clearly written and in compliance with the applicable legal and regulatory requirements. The Phase 2 Report should be the assessor’s assessment of the implementation and effectiveness of the actual adoption of the planned policies, procedures, systems and controls.

The SFC will grant final approval of a licence application only if it is satisfied with the findings of the Phase 2 Report.

The purpose of the requirement for external assessment reports is to streamline the SFC application process. It will mean an additional up-front commitment of time and costs for licence applicants, both in identifying and appointing an external assessor and in liaising with the external assessor on review of the virtual asset exchange’s proposed structure, governance, operations, systems and controls and the external assessor’s final reports.

Permitted scope of activities

A licensed virtual asset exchange will be able to offer trading in virtual assets to “professional investors” (as defined in the SFO). The SFC also proposes that virtual asset exchanges be permitted to offer trading in certain virtual assets to retail investors.

Prohibited activities

Licensed virtual asset exchanges will not be permitted to:

- provide financial accommodation for their clients to acquire virtual assets (i.e. margin trading is not permitted);
- offer, trade or deal in virtual asset futures contracts or related derivatives;
- provide algorithmic trading services for their clients; or
- make any arrangements with their clients to use client virtual assets held by the exchange for the purpose of generating returns for the clients or any other parties (i.e. lending, staking etc.).

Ability to offer virtual assets to retail investors

The SFC proposes that a licensed virtual asset exchange be permitted to offer trading in eligible large-cap virtual assets to retail investors.

“Eligible large-cap virtual assets” refer to virtual assets which are included in at least two “acceptable indices” issued by at least two independent index providers. An index provider may only be considered independent if it does not belong to the same entity or is not within the same group of companies as the licensed virtual asset exchange.

An “acceptable index” is an index which has a clearly defined objective to measure the performance of the largest virtual assets in the market and fulfils the following criteria:

- a) The index should be investible, meaning the constituent virtual assets should be sufficiently liquid;
- b) The index should be objectively calculated and rules-based;
- c) The index provider should possess the necessary expertise and technical resources to construct, maintain and review the methodology and rules of the index; and
- d) The methodology and rules of the index should be well documented, consistent and transparent.

At least one of the indices must be issued by an index provider which has experience in publishing indices for the traditional non-virtual asset financial market. An example of such an index provider is one which has issued an index tracked by an SFC-authorized index fund.

What existing operators should do next

If you are a virtual asset exchange that is currently operating in Hong Kong, you should:

1. Review the detailed regulatory requirements and decide whether you wish to apply for a licence under the AMLO transitional provisions;
2. If you wish to apply for a licence under the AMLO transitional provisions:
 - (a) Confirm you are eligible to apply (see “Eligibility for AMLO transitional provisions” below);
 - (b) Conduct a gap analysis of your existing structure, governance, operations, systems and controls to identify areas that need enhancement to comply with the detailed regulatory requirements;
 - (c) Implement any necessary enhancements, including any changes required to financial resources, custody arrangements, personnel, policies, documentation etc.;
 - (d) Incorporate a wholly-owned subsidiary to act as the exchange’s associated entity and apply to the Registrar of Companies to licence such associated entity as a TCSP;
 - (e) Engage an external assessor to prepare a Phase 1 Report;
 - (f) Submit an application to the SFC for a licence no later than **29 February 2024**.

Note: At the time a virtual asset exchange submits its application, it is required to give the SFC a confirmation that it complies with and has arrangements to ensure compliance with the regulatory requirements applicable to licensed virtual asset exchanges. As a result, the virtual asset exchange needs to be in full compliance with the detailed regulatory requirements no later than **29 February 2024**.

3. If you do not wish to apply for a licence under the AMLO transitional provisions, you should put in place a plan to either:
 - (a) So far as possible, restructure your operations so that the services you provide do not trigger a licence obligation under the AMLO; or

- (b) Wind down your business in Hong Kong on or before **31 May 2024**.

Eligibility for AMLO transitional provisions

The AMLO contains transitional provisions for existing virtual asset exchanges that have been carrying on business of providing VA services (as defined in the AMLO) in Hong Kong immediately before 1 June 2023. The SFC has indicated it will apply a high threshold for this purpose and will only accept virtual asset exchanges that have been in operation in Hong Kong prior to 1 June 2023 and with meaningful and substantial presence as eligible for the transitional provisions.

In determining whether an existing virtual asset exchange has a meaningful and substantial presence, the SFC has indicated that it will take into account the following factors, amongst others:

- a) whether the exchange is incorporated in Hong Kong;
- b) whether the exchange has a physical office in Hong Kong;
- c) whether the exchange's Hong Kong staff have central management and control over the exchange;
- d) whether the exchange's key personnel (for example, those responsible for the operation of the trading system) are based in Hong Kong; and
- e) whether the exchange's operation is live with a considerable number of clients and volume of trading activities in Hong Kong.

Regulatory updates on SFDR template information for Hong Kong-authorized ESG funds

[Alwyn Li and Raymond Cheng](#)

On 15 March 2023, Hong Kong's Securities and Futures Commission (**SFC**) updated their [presentation materials on Industry Workshops for ESG funds](#) to provide further guidance on whether it is mandatory for UCITS SFDR Article 8 and 9 funds that are authorised by the SFC in Hong Kong to include the pre-contractual disclosures template in their Hong Kong offering documents (**SFDR Template Information**).

According to the SFC's circular to management companies of SFC-authorized unit trusts and mutual funds on ESG funds dated 29 June 2021, the overarching principle is that the Hong Kong offering documents must contain the information that is necessary for investors to make an informed judgement of the investment.

The additional disclosures included in the SFDR Template Information do not in general require the SFC's prior approval as these are typically treated as disclosure enhancements. The updated bilingual Hong Kong offering documents are post-filed with the SFC pursuant to 11.1B of the Code on Unit Trusts and Mutual Funds. However, there have been some industry concerns as to the volume and the size of the Hong Kong offering document after adding the SFDR Template Information (especially for umbrellas with a large number of sub-funds authorised in Hong Kong). According to the latest SFC guidelines, fund managers can now decide whether they would like to include such information in the Hong Kong offering documents of the relevant UCITS. If the fund manager decides not to include the SFDR Template Information in the Hong Kong offering documents, the information should be made available to investors upon request. The Hong Kong offering documents must also disclose how investors may request the SFDR Template Information and in which language it will be available. For example, the SFDR Template Information can be made available for inspection at the Hong Kong Representative's office, or on the fund's website.

Suspension of responsible officer's licence for investment advisory failures

Scott Carnachan and Jennifer Baccanello

The Securities and Futures Commission (**SFC**) imposed a fine of HK\$1.5 million on a licensed corporation (**LC**) and suspended the licence of its responsible officer (**RO**) for seven months for investment advisory failures. Following an appeal by the LC and RO to the Securities and Futures Appeals Tribunal (**SFAT**), SFAT upheld the SFC's decision and **increased** the suspension period for the RO to nine months.

This case highlights several important considerations for financial services firms and individuals, including (i) managing liquidity of funds, (ii) cross trades, and (iii) disclosures to investors, and the responsibility of responsible officers to ensure compliance by licensed corporations.

In commenting on SFAT's decision, Mr Christopher Wilson, the SFC's Executive Director of Enforcement, said "The SFC is determined to crack down on asset management misconduct and will impose harsher penalties going forward to deter such misconduct".

Background

During the relevant period, the LC was licensed by the SFC to carry on type 4 (advising on securities) and type 9 (asset management) regulated activities. The LC was appointed as the principal investment adviser to a Cayman Islands investment manager in respect of five Cayman-domiciled funds (each a **Fund**). Each Fund invested in small and medium enterprise stocks and employed an aggressive investment strategy. The offering memoranda for the Funds described how each Fund placed reliance on its management team which included the investor advisor, i.e. the LC. The RO was primarily responsible for providing investment management and advisory services to the Funds.

After investigation, the SFC determined that both the LC and RO had failed to give appropriate advice to the Cayman-Islands based manager of each Fund in respect of two principle matters:

- (a) a series of loan arrangements entered into between the Funds to deal with liquidity problems – the SFC found that seven loan agreements entered into amongst the Funds were for the sole purpose of addressing the borrowing Funds' liquidity needs, with little regard paid to the lending Fund's interests; and
- (b) a series of cross trades of listed stocks entered into between the Funds to undertake rebalancing of the Funds' investment portfolios at a significant discount to the relevant stocks' most recent closing prices.

The LC and the RO, in their application for review to the SFAT, sought to do two things:

- (1) set aside the SFC's findings of culpability; and
- (2) in the event that culpability was still found by the SFC, to challenge the reasonableness of the SFC's sanctions.

Key issues

The SFAT referred to, among other matters, the SFC's key findings that:

- the LC and RO had acted culpably and failed to ensure that the loan arrangements were fair to and in the best interests of both the borrowing and lending funds;
- the RO, being part of the senior management of the LC, had breached General Principle 9 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**Code of Conduct**), which stipulates that senior management bear primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper principles; and
- the RO attempted to rely on the fact that his duties as investment adviser had been set out in private unwritten arrangements between the RO and one of his business counterparts and therefore the RO argued that his duties were not precisely those that were stated in the written terms and conditions of the investment advisory agreements.

Sanctions imposed

Monetary fine

SFAT agreed that the SFC's sanction orders were fair and reasonable, including the imposition of a HK\$1.5 million fine on the LC.

Suspension of RO's licence

In order to ensure that industry participants properly appreciate the role that an investment advisor has, SFAT decided in this case that the RO required a heavier suspension than the SFC had originally decided upon and increased the suspension of the RO's licence from seven months to nine months.

Key takeaway points

1. **Compliance with regulatory requirements is essential:** Firms and individuals must comply with regulatory requirements and take appropriate measures to prevent and detect potential breaches. Failure to do so can result in regulatory enforcement actions and significant financial penalties. Key regulatory requirements from the SFC's Code of Conduct that SFAT referred to in this case include:
 - a. **General Principle 1 – Honesty and fairness:** In conducting its business activities, a licensed person should act honestly, fairly, and in the best interests of its clients and the integrity of the market.
 - b. **Paragraph 11.1 – Handling of client assets:** Client positions in the market or assets should be adequately safeguarded.
 - c. **General Principle 6 – Conflicts of interest:** Licensed persons must seek to avoid such conflicts but, if they cannot be avoided, they must ensure that their clients are fairly treated.
2. **Ethical responsibilities for licensed persons:** Persons who hold themselves out to be experts in finance and fund management are expected to exhibit professionalism and integrity. The inability to act ethically and in accordance with the regulatory requirements for licensed persons will cast doubt on one's fitness and properness to be licensed by the SFC.
3. **Licensed persons need to understand their fiduciary obligations:** Individuals are expected to be able to understand the fiduciary obligations owed to clients, namely, the obligation to act in the best interests of clients. In this case, the LC and RO were both under a fiduciary obligation to ensure that the interests of investors were protected at all times. Putting in place certain measures just "for the time being" or "not having sufficient time" to properly carry out a task are not reasonable excuses for not upholding fiduciary obligations owed to clients.
4. **Ensure the accuracy of fund documentation provided to investors:** Potential investors that read offering memoranda should be given correct information on all matters. In this case, the investors should not have been misled as to the true role of the investment adviser.
5. **Record keeping and internal controls are critical:** Firms and individuals must maintain adequate records and internal controls to ensure compliance with regulatory requirements and to prevent and detect potential breaches. Inadequate record keeping and internal controls can expose firms and individuals to regulatory enforcement actions and significant financial penalties. In this case, the LC's argument that it needed to deal with specific matters by way of urgency were not a reasonable excuse for the LC failing to maintain succinct and relevant records.
6. **Engage an independent reviewer to assess remedial measures:** Engaging an independent reviewer can provide valuable insight and assurance that remedial measures are effective and address the root causes of any deficiencies. In this case, the LC was required by the SFC to engage an independent reviewer to assess the LC's remedial measures.

Hong Kong SFC licensing and compliance hints – March 2023

Rebecca Yip

SFC in-person on-site inspections are back

The Securities and Futures Commission (SFC) commenced 54 on-site inspections on licensed corporations during October to December 2022 according to the latest [Quarterly Report](#) (October to December 2022), which was slightly lower than 61 in the same quarter ended 31 December 2021.

For nine months ended 31 December 2022, the SFC found fewer breaches during on-site inspections (974) compared to the same period in 2021 (1056) according to the Quarterly Report. Having said that the SFC found more breaches in areas like failure to comply with the Financial Resources Rules, failure to make filing/notification and breaches of the Code of Conduct compared to the same period in 2021.

Separately, we understand that the SFC has resumed conducting in-person on-site inspections. We can assist licensed companies to prepare in advance of an SFC inspection and provide guidance to senior management during such inspections.

Asset and Wealth Management Activities Survey

The SFC commenced its Asset and Wealth Management Activities Survey 2022 on 17 February 2023 ([link](#)). The purpose of this annual exercise is to collect information on the state of the Hong Kong asset and wealth management industry for regulatory and market facilitation purposes.

Licensed companies are recommended to participate in the survey to assist the SFC in better understanding the industry. Licensed companies which had gross operating income derived from asset management, giving advice on funds / portfolios and / or private banking / private wealth management during 2022 should complete the whole survey. For licensed companies that did not engage in any of these activities throughout 2022, they should still complete the General Information section of the survey. The deadline for submitting the survey through WINGS is 21 April 2023.

CPT 2023

The first quarter of 2023 will end shortly. It is time to remind all licensed individuals to start planning their 2023 CPT requirements, especially for those who found it challenging to fulfill the “new” CPT requirements towards the end of 2022. A useful reminder that appropriate internal training can be counted as CPT, provided it meets the SFC’s requirements as set out in the Guidelines on Continuous Professional Training.



Deacons welcomes Isabella Wong to the partnership

We are delighted to announce that Isabella Wong has re-joined us as a partner.

Isabella has re-joined Deacons from a global asset manager after acquiring in-house experience by counselling the manager’s investment management and funds distribution business in APAC (ex-Japan) regions. Before moving to an in-house counsel role, Isabella worked at Deacons as a regulatory lawyer for eight years.

As a former regulator, Isabella also gained hands-on experience in dealing with SFC regulatory matters (covering licensing and compliance aspects) for different financial institutions, alongside participating in policy drafting and consultation works in relation to new regulatory regimes.

Jeremy Lam, Partner and Head of Financial Services Group, commented: “We are delighted to have Isabella re-join our team as a partner, to further strengthen our market leading regulatory and compliance practice. Isabella will play a key role in supporting our clients expand their offering in the virtual assets space, where there are significant growth opportunities as Hong Kong’s regulatory environment continues to evolve.”

Isabella joins our highly ranked Financial Services practice which now comprises 10 partners, 1 consultant and more than 30 legal professionals.

Recent publications

[HKMA: FAQs in relation to anti-money laundering and counter-financing of terrorism](#)

[Court of Final Appeal clarifies the rule of construction on loan amendment or extension agreements](#)

[Legislative Council Panel on Constitutional Affairs: Report on the Work of the Office of the Privacy Commissioner for Personal Data in 2022](#)

[Office of the Privacy Commissioner for Personal Data: Investigation Report on the Ransomware Attack on the Servers of the Hong Kong Institute of Bankers](#)

[Too good to be free – legal issues arising from AI image generators](#)

[Standard contract for outbound transfer of personal information from China](#)

[ISDA: Publication of the Digital Asset Derivatives Definitions](#)

[HKMA: HKSAR Government’s inaugural tokenised green bond offering](#)

[SFC Consultation on proposed requirements for operators of virtual asset trading platforms](#)

[HKMA issued consultation conclusion of discussion paper on crypto-assets and stablecoins](#)

[Can you consent to use of your child’s data?](#)

[FamilyFocus@Deacons: Series on Mainland/Hong Kong cross-boundary marriages – Article 4 – Asset dissipation](#)

[FamilyFocus@Deacons: Series on Mainland/Hong Kong cross-boundary marriages – Article 3 – Division of matrimonial assets](#)

[The newly enacted regime for reciprocal enforcement of judgments in Mainland and Hong Kong](#)

[The importance of inclusion of terms to limit bank’s duty of care](#)

[Increasing use of technology in courts](#)

[Exchange proposes Listing Rule amendments relating to PRC issuers in light of recent changes to Mainland China regulations](#)

[HKIAC 2022 statistics](#)

[How does the court decide whether a matter is the subject of an arbitration agreement?](#)

[Are arbitral tribunal decisions re non-compliance with procedural pre-arbitration conditions reviewable by the court?](#)

[Court confirms high threshold for setting aside arbitral awards](#)

[Mirror, mirror on the wall, whether dancers are employees after all?](#)

When will an earlier adjudication decision be binding on a subsequent one?

Court holds that adjudicator's decision breached the principles of natural justice

Court considers interplay between adjudication and arbitration in a dispute resolution clause

The importance of defining the scope of a reference to adjudication

The Hong Kong Companies Ordinance will facilitate the holding of fully virtual or hybrid general meetings with effect from 28 April 2023

Construction Industry Security of Payment Bill will be introduced to the LegCo in the 2nd half of 2023 legislative session

Year 2022 in review: Employment Law

LRC calls for reform: periodical payment orders for future pecuniary loss

Hong Kong finally updates its copyright regime for the digital age

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