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Newsletter

Financial Services

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Hong Kong offering – Hong Kong summary prospectus or global prospectus with Hong Kong covering document

Alwyn Li

In seeking authorisation from the Securities and Futures Commission (**SFC**) to offer an Undertaking for Collective Investment in Transferable Securities (**UCITS**) to the Hong Kong public, an applicant is required to submit the draft offering documents to the SFC for its review and approval. The management company can prepare the offering documents in two ways: extract from the global prospectus all the information relating to the sub-fund(s) intended to offered in Hong Kong and prepare a standalone Hong Kong Prospectus (also known as a Hong Kong Summary Prospectus (**HKSP**)) (Option 1); or adopt the global prospectus and append a Hong Kong Covering Document (**HKCD**) (Option 2). The preferred option depends on the circumstances and this article serves as a guide by providing practical factors to consider, with a table summarising the pros and cons of each option at the end.

Option 1

The number of sub-funds under the umbrella and the number of sub-funds chosen to apply for the SFC's authorisation have a great bearing – if among the many sub-funds only one or two sub-funds are to be offered in Hong Kong, Option 1 may be the preferred route as it allows information relating to the other sub-funds to be omitted entirely. This may significantly reduce the volume of documents, providing a more centralised location for information and a lower Chinese translation cost.

In addition, with this option, any future changes to the non-SFC-authorised funds in the global prospectus would not affect the HKSP and so no follow up action is required in Hong Kong, meaning a lighter ongoing compliance burden. A HKSP is also usually preferred by the sales team due to its all-in-one format, containing only information relevant to Hong Kong investors in a concise manner.

Option 2

Conversely, if the fund manager wishes to start off with offering a small number of sub-funds in Hong Kong and eventually expand the product offerings (i.e. most of the sub-funds under the umbrella are intended to be offered in Hong Kong), it may be more cost effective to adopt Option 2 taking into account the future product offerings. In terms of compliance, Option 2 is more convenient because Hong Kong-specific disclosures and additional disclosures required by the SFC can all be dealt with together in the HKCD.

Another upside when dealing with future changes to the fund is that this option avoids the need to amend the HKSP piecemeal, which reduces complexities in ongoing document maintenance and compliance monitoring. As a matter of fact, we have observed this option become increasingly common among our clients.

Other observations

Please note that the foregoing is not meant to be exhaustive and fund houses should take into account their own circumstances and preferences when deciding on the format/structure of the Hong Kong offering documents.

A global prospectus can come in different formats. The most common one is either a master document listing out all the information of a sub-fund one-by-one, or a base document followed by supplements specific to each of the sub-funds. For the latter format, Chinese translation for the sub-fund(s) not being offered in Hong Kong would not be necessary, and the fund manager may consider this reduced translation cost an incentive. A switch between these two formats is usually coined as a "re-write", and a mapping exercise should be conducted to evaluate the substance and the nature of those changes, which in turn determines whether the SFC's authorisation is needed.

If the manager wishes to change the format/structure of the Hong Kong offering documents (from Option 1 to Option 2 or *vice versa*), approval from the SFC may be required. According to the SFC's Code on Unit Trusts and Mutual Funds, further authorisation is not required if the content and format of the Hong Kong offering documents remain fundamentally the same as the version previously authorised. As such, if a mapping exercise reveals that there are substantial changes in the format and layout, then the SFC's authorisation is likely to be necessary. We would suggest consulting the change in formatting with the SFC before proceeding.

The manager should consider the long-term operation of the fund because switching between the options above might involve substantial administrative work and wasted time costs. It is also prudent to have sight of the global prospectus and conduct a feasibility study to facilitate making a choice.

Table summarising the pros and cons of Option 1 and Option 2

	Option 1	**Option 2**
Volume of documents	Generally lower, especially when in a big umbrella, only one or two sub-funds are to be authorised by the SFC	Higher
Translation costs	Generally lower since it is in proportion to the volume of documents	Higher
Location of information/ disclosures	Centralised (preferred by the sales team)	Spread across the global prospectus and the HKCD

	Option 1	Option 2
Follow up action required if there are changes to non-SFC-authorised sub-funds	Lighter compliance burden and monitoring Lighter document maintenance	Heavier compliance burden and monitoring Heavier document maintenance
Compliance (SFC-specific)	Less convenient	More convenient: Hong Kong-specific disclosures and additional disclosures addressing the SFC's comments can be dealt altogether

Hong Kong proposes to regulate over-the-counter trading of virtual assets

Isabella Wong

On 8 February 2024, the Financial Services and the Treasury Bureau (**FSTB**) proposed to expand the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (**AMLO**) to regulate providers of virtual asset (**VA**) over-the-counter (**OTC**) trading services: any person or entity that (i) operates a business through a physical outlet or a digital platform for servicing spot trading of VA (**VA OTC Business**) in Hong Kong or (ii) actively markets VA OTC services to the Hong Kong public, within or outside of Hong Kong, will need to be licensed for the VA OTC Business under the expanded AMLO.

This proposal responds to the various fraud scandals associated with unregulated OTC trading of VA in the second half of 2023, and will align the AMLO with the VA regulatory requirements of the Securities and Futures Commission (**SFC**) and the Hong Kong Monetary Authority (**HKMA**) by limiting retail investor access to VAs that are publicly issued or offered by HKMA and SFC regulated entities only. The public consultation on this legislative proposal will close on 12 April 2024.

In-scope operators

The legislative intent is to license providers of VA automated teller machine or exchange services, market makers of VA, and inter-dealer brokers conducting back-to-back trading on VA as principal. Provision of temporary custody/escrow services for VA during the course of VA OTC trading may also be regulated. The FSTB is considering whether a separate VA custody regulatory regime should be established and is seeking public views on the matter.

The proposed licensing scope will exclude operation of Hong Kong licensed virtual asset trading platform (**VATP**) operators, peer-to-peer proprietary VA trading activities between individuals, and trade facilitation activities by providers who are not counterparties of the facilitated VA trades. Additionally, financial institutions licensed by SFC or HKMA (such as SFC licensed VA dealers and in the future, HKMA licensed stablecoin issuers) will be exempt from licensing under the AMLO for conducting VA OTC Business.

Obtaining a VA OTC Business licence

VA OTC Business operators will need to apply to the Commissioner of Customers and Excise (**CCE**) for licences and satisfy the regulatory requirements set by the CCE.

The CCE will refer to the existing regulatory requirements for money service operators (**MSO**) and SFC licensed VATPs to formulate the final regulatory requirements for VA OTC Business operators. The proposed regulatory requirements include:

- Having suitable operating premises in Hong Kong for a physical VA OTC outlet, or a management office, correspondence address, and books and records storage in Hong Kong for an online digital VA OTC platform;
- Employing at least one competent compliance officer and one money laundering reporting officer;

- Demonstrating competency by having a proper corporate governance structure staffed by experienced and knowledgeable personnel to operate the VA OTC Business;

- Operating the VA OTC Business in a prudent and sound manner for the protection of clients' and the public's interests;

- Conducting the VA OTC Business honestly and fairly with due skill, care, and diligence;

- Implementing proper risk management measures, including appropriate policies and procedures for managing Anti-Money Laundering and Counter-Terrorist Financing (and cybersecurity) risks; and

- Maintaining accessible records of transactions and fund flows, as well as providing a full list of wallets for the VA OTC Business operation to the CCE.

Licence limitation and restrictive services

Licensed VA OTC Business operators will have the following limitations on their services:

- They will not be permitted to convert VA to VA, but they can provide conversion services between VA and fiat currency. To provide fiat-to-fiat currency conversion services, they will also need an MSO licence.

- With respect to services to retail investors, they cannot offer VAs that are neither accessible by the retail investors on SFC licensed VATPs nor issued by HKMA licensed stablecoin issuers. However, these restrictions do not apply to services to professional investors.

- Other prohibited services include VA advisory or referral, offering VA derivatives or financial products, staking, lending, and margin trading (**Prohibited Services**).

The licence period for operating a VA OTC Business will be two years, with the option for renewal upon application.

Transitional arrangements

Existing VA OTC Business operators in Hong Kong will be given a transitional period of six months (**Transitional Period**) before the commencement of the expanded AMLO licensing regime. During the Transitional Period, they can continue to operate their VA OTC Business if they have submitted licence applications to the CCE within the first three months of the Transitional Period.

The operational details of the transitional arrangements are expected to be provided after the public consultation. The FSTB will either:

- require the pre-existing VA OTC Business operators which do not submit licence applications to the CCE within the first three months of the Transitional Period to close down their business by end of the first four months of the Transitional Period; or

- grant a deemed licence for the pre-existing VA OTC Business operators which submit licence applications within the first three months of the Transitional Period and are able to meet the CCE's licensing requirements, to continue their operations beyond the Transitional Period until the CCE's final determination on their licence applications.

Impact

The Hong Kong presence requirement for VA OTC Business operators will deter foreign VA OTC trading platforms from remotely providing services or targeting services to Hong Kong investors, unless they have established meaningful presence in Hong Kong.

Existing VA OTC Business operators in Hong Kong need to plan for restructuring their businesses if they want to continue with their operations in Hong Kong. They will need to remove any Prohibited Services and plan for compliance with the CCE's requirements.

Custodians of VAs should observe the legislative development and provide their views on regulations for VA custody services.

SFC or HKMA regulated entities should assess their VA trading activities and consider the potential AMLO licensing obligations.

SFC's recent enforcement actions against two Hong Kong-based managers for failures to comply with the Fund Manager Code of Conduct

Ming Chiu Li and George Ho

Introduction

Recently, the enforcement arm of the Securities and Futures Commission (**SFC**) took action against two Hong Kong-based fund managers for their failure to fulfill their obligations under the Fund Manager Code of Conduct (**FMCC**). This article will discuss these recent cases, highlighting implications that may arise from non-compliance for asset managers.

Case 1: Hong Kong-based investment manager

The SFC investigated a Hong Kong-based investment manager of a Cayman-incorporated fund (the **Investment Manager**) for failures related to its fund management activities.

The SFC's investigation revealed that, at the material time, the Investment Manager invested approximately 90% of the fund's net asset value into financial instruments linked to a Mainland property developer, despite identifying various downside factors in its own analysis. This contravened paragraph 1.2(d) and paragraph 1.7.1 of the FMCC, which require fund managers to maintain appropriate risk management structures and procedures aligned with the firm's characteristics and investment strategies. Fund managers also have a duty to establish effective policies, procedures, and designated risk management functions to promptly identify, quantify, and manage financial and non-financial risks associated with a fund.

As a result, the SFC reprimanded and fined the Investment Manager HK$5.2 million for, among other things, breaching the relevant FMCC provisions. Furthermore, the licence of the responsible officer of the Investment Manager was suspended for 10 months due to his failure to fulfill his duties.

Case 2: Hong Kong-based asset management arm of a Mainland company

The second case involves a Hong Kong-based asset management arm of a Mainland company (the **Fund Manager**) and its failure to discharge its duties as the manager of a Cayman-incorporated fund.

The SFC found that contrary to the fund's investment objective and strategy, the portfolio of the fund held only a limited number of stocks during the relevant period. Additionally, it held highly concentrated positions in two Hong Kong-listed stocks, one of which was not on the permitted securities list approved by the Fund Manager's senior management. The Fund Manager's internal controls were also inadequate in ensuring compliance with the investment mandate.

The Fund Manager's failures as outlined above are inconsistent with paragraph 3.1 of the FMCC, which provides that fund managers should ensure that all transactions conducted on behalf of each fund align with the fund's stated investment strategy, objectives, and restrictions as specified in the fund's constitutive and relevant documents. To achieve this, fund managers should establish effective and properly-implemented procedures and controls.

Consequently, the SFC publicly reprimanded and fined the Fund Manager HK$2.8 million.

Fund managers' obligations under the FMCC

Fund managers are reminded to pay particular attention to the following obligations under the FMCC, as highlighted in the cases above: -

- **Organisation and Management Structure**

  A fund manager should maintain: -

  - satisfactory internal controls and written compliance procedures which address all applicable legal and regulatory requirements.

  - satisfactory risk management governance structure and procedures commensurate with the nature, size, complexity and risk profile of the firm and the investment strategy adopted by each of the funds under its management.

  (Paragraphs 1.2(c) and 1.2(d) of the FMCC)

- **Risk Management**

  A fund manager should establish and maintain effective policies and procedures as well as a designated risk management function to identify and quantify the risks, whether financial or otherwise, to which the fund manager and, if applicable, the funds are exposed. The fund manager should take appropriate and timely action to contain and otherwise adequately manage such risks.

  (Paragraph 1.7.1 of the FMCC)

- **Fund Management – Investment within Mandate**

  A fund manager should ensure that transactions carried out on behalf of each fund are in accordance with the fund's stated investment strategy, objectives, investment restrictions and guidelines, whether in terms of asset class, geographical spread or risk profile, as set out in the respective constitutive and/or relevant documents of the funds managed by the fund manager. In this connection a fund manager should have in place effective and properly-implemented procedures and controls.

  (Paragraph 3.1 of the FMCC)

- **Fund Management – Liquidity Management**

  A fund manager should establish, implement and maintain appropriate and effective liquidity management policies and procedures to monitor the liquidity risk of the fund, taking into account the investment strategy, liquidity profile, underlying assets and obligations, and redemption policy of the fund.

  (Paragraph 3.14.1(a) of the FMCC)

Furthermore, fund managers and their licenced personnel must also comply with the General Principle 2 of the Code of Conduct for Persons Licenced by or Registered with the Securities and Futures Commission and act with due skill, care and diligence, in the best interest interests of its clients and the integrity of the market in conducting its business activities.

Key take-aways

Our observation is that a fund's holding of concentrated illiquid positions will be scrutinised closely by the SFC, against the fund's stated investment policy and the fund manager's general duty to diversify investments and manage risks for portfolios under their management. It is noteworthy that in a circular issued in 2019 (accessible here), the SFC highlighted the importance of managing liquidity risks, implementing robust risk management systems, and establishing well-documented liquidity risk management policies and procedures.

Through these enforcement cases, we see the SFC has become increasingly active in taking action against non-compliance with the FMCC (and other relevant rules and principles). Non-compliance may result in enforcement actions that will lead to financial penalties as well as reputational risks to fund managers. It is important for managers to adhere to the standards of conduct contained in various SFC codes, as compliance is crucial to demonstrate responsible stewardship of funds and protect investors.

New opportunities for Hong Kong licensed fund managers

Fiona Fong and Sarah Lau

The Hong Kong Government and Hong Kong regulators have recently introduced various new initiatives to support the asset management industry as part of Hong Kong's objective to strengthen its credentials as an asset management hub.

New Capital Investment Entrant Scheme

On 19 December 2023, the Hong Kong Government announced the details of its new Capital Investment Entrant Scheme (**New CIES**) with an aim to incentivise more high-net-worth asset owners to set foot in Hong Kong and boost investment. The New CIES is expected to generate interest amongst hedge funds and private equity fund managers operating in Hong Kong and may facilitate the creation of new local business opportunities.

Unlike Hong Kong's previous scheme, collective investment schemes offered privately via Hong Kong's private placement regime, including the following Hong Kong domiciled structures will qualify as permissible investments under the New CIES:

(1) open-ended fund companies (**OFC**) registered under the Securities and Futures Ordinance (Cap.571) and managed by corporations licensed by or institutions registered with the Securities and Futures Commission (**SFC**) for type 9 regulated activities; and

(2) ownership interest in limited partnership funds registered under the Limited Partnership Fund Ordinance (Cap.637).

Under the New CIES, investors will be required to maintain their committed investments of a minimum of HK$30 million in permissible investment assets while permitted to stay in Hong Kong, but will not be required to top up the value of their investment if its market value falls below the minimum threshold. The minimum investment of HK$30 million will require investing at least HK$27 million in permissible investment assets and HK$3 million into a new CIES investment portfolio which will be set up and managed by the Hong Kong Investment Corporation Limited for investments in companies and projects with a Hong Kong nexus.

The financial assets must be deposited and ring-fenced in a designated investment account operated by a Hong Kong Type 9-licensed fund manager or another eligible financial intermediary. Investors will also be permitted to withdraw cash dividends or interest income derived from the permissible financial assets and may elect to switch investments between different permissible financial assets subject to reporting requirements, proper records and the re-investment of trading proceeds in full.

Invest Hong Kong will be responsible for assessing whether applications for the New CIES fulfils the net asset and investment requirements, and the Immigration Department will be responsible for assessing the applications for visa/entry permits, extensions of stay, etc.

The New CIES is expected to officially launch in mid-2024 and additional guidelines on the scheme are expected to be released in Q1 of 2024.

Tokenisation of OFCs

In line with the SFC's earlier initiatives and guidance issued in November 2023 to intermediaries engaging in tokenised securities-related activities and the tokenisation of SFC-authorised investment products, the SFC has, on 21 February 2024, clarified that OFCs may be offered as a tokenised investment product.

The clarification would mean that interest in privately offered OFCs may also be offered in tokenised form, meaning the creation of blockchain-based tokens that represent or aim to represent ownership in the OFC. The move is in line with the SFC's support to strengthen Hong Kong's fintech industry.

Investment managers who are interested in tokenising an OFC are advised to speak to your contacts at Deacons and consult with the SFC. Deacons has a strong regulatory and financial services practice that supports clients in fintech activities including cryptocurrencies and tokenisation of assets.

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Hong Kong SFC licensing and compliance hints – February 2024

Jennifer Baccanello

SFC unveils strategic priorities 2024-2026: navigating global finance dynamics

In response to the evolving landscape of global finance and the unique challenges facing Hong Kong's financial markets, the Securities and Futures Commission (**SFC**) has released its strategic priorities for the years 2024-2026 (**Strategic Priorities**). The Strategics Priorities focus on bolstering market resilience, enhancing global competitiveness, driving financial market transformation through technology and ESG (environmental, social, and governance), and fortifying institutional resilience and operational efficiency, and are set out as follows:

- Maintaining market resilience and mitigating serious harm

  The SFC stresses the importance of maintaining market resilience posed by geopolitics, cybersecurity and technology risk; and will prioritise prompt risk management, enhanced capabilities and tech-driven investigation and enforcement, with close collaboration with other regulators.

- Enhancing the global competitiveness and appeal of Hong Kong capital markets

  Hong Kong aims to sustain its position as an international financial centre and a financial hub and therefore needs to deepen connections with the mainland's capital markets and expand overseas networks by actively participating in international standard-setting initiatives.

- Leading financial market transformation through technology and ESG

  The SFC recognises the transformative potential of technology and the growing importance of ESG considerations in shaping financial markets, and will continue to embrace financial innovation through its steady flow of guidance in respect of virtual assets.

  On the ESG side, the SFC has been vocal in its support for advancing sustainable finance initiatives such as the development of a code of conduct for voluntary adoption by ESG ratings and data products providers providing products and services in Hong Kong.

- Enhancing institutional resilience and operational efficiency

  The SFC is acting in-line with regulators and financial institutions worldwide that are increasingly investing in digitalisation, automation, and cybersecurity measures to enhance operational efficiency, reduce costs, and mitigate operational risks amidst growing complexities in financial markets.

Concluding remarks and impact on licensed corporations

The Strategic Priorities reflect a transparent and proactive approach to address emerging challenges and capitalise on opportunities in the global financial landscape. By fostering resilience, embracing innovation, and promoting sustainability, Hong Kong aims to reinforce its position as a leading international financial centre poised for sustainable growth and development.

It is clear from the Strategic Priorities that the SFC expects organisations to foster a culture that prioritises regulatory compliance, integrity, and transparency at all levels of operation; this can be achieved through two key measures:

- Establish clear lines of supervision and accountability to mitigate the risks associated with overreliance on individual persons.

- Leverage appropriate technological tools to enhance operational efficiency, risk monitoring, and compliance processes.

April 2024 deadline for submitting BRMQ: applicable to licensed corporations with year-end 31 December

As the deadline approaches on 30 April 2024 for licensed corporations (with a year end of 31 December) to submit their Business Risk Management Questionnaire (**BRMQ**), it is crucial to remember the significant changes mandated by the SFC which we discussed in our newsletter of January 2023. One notable addition in the updated BRMQ is Question 20 of Section A9 (Risk Management), which focuses on the presence of an exit plan within the corporation's framework. This emphasises the necessity for licensed corporations to develop a comprehensive strategy for the orderly closure of business in any regulated activity, regardless of whether an exit is currently anticipated.

4 key tips for completing the BRMQ:

1. Understand the purpose: The BRMQ serves as a tool for licensed corporations to assess their risk management practices. Approach the questionnaire with the understanding that it helps identify and mitigate potential risks within your operations.

2. Engage key stakeholders: Involve key stakeholders from various departments within the organisation, including compliance, risk management, and senior management. This ensures a comprehensive understanding of your organisation's risk profile is captured in the responses.

3. Proactive risk identification and mitigation: Use the BRMQ as an opportunity to identify potential areas of risk within the organisation. Develop strategies to mitigate risks effectively, which may involve implementing new policies, procedures, or controls where necessary.

4. Document, document, document: Proper documentation of risk management practices is essential. Maintain detailed records of your risk management processes, including policies, procedures, risk assessments, and mitigation strategies. This documentation demonstrates compliance and serves as a valuable resource for internal review and routine inspections by the SFC.

Fintech Legal Guide for Hong Kong and Singapore

The bilingual Fintech Legal Guide for Hong Kong and Singapore jointly presented by Deacons and Rajah & Tann is a side-by-side comparative overview of the laws and regulations which are relevant to Fintech businesses planning to operate in either or both jurisdictions.

This comprehensive guide covers various crucial aspects of Fintech, including the regulatory landscape, sales and marketing of digital products, data protection and privacy, intellectual property, anti-money laundering regime, company establishment, and talent utilisation.

As Fintech continues to revolutionise the financial services industry and create new growth opportunities in the global market, this guide will provide valuable insights for businesses considering international expansion through navigating the complexities of Fintech regulations.

Please click here to read the guide.

Recent publications

When is a trust created over retention monies?

New Hong Kong-Mainland reciprocal enforcement of judgments regime comes into effect

Major changes in the 2024 CIETAC Arbitration Rules

Series on Family disputes relating to mental capacity issues – Challenges to Enduring Powers of Attorney

Series on Children Matters – Children Relocation

Adjudicator's decision held unenforceable for apparent bias

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Arbitral award found to have been obtained by fraud

New Declaration Thresholds for Concentration of Undertakings

Year 2023 in review: Employment Law

Greater Bay Area Wealth Management Connect pilot scheme enhanced – opportunities for Hong Kong brokers and fund managers

Do your customers know to spot fakes?

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