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## Use of Generative AI: 3 regulatory steps for licensed corporations

Isabella Wong

The Securities and Futures Commission (**SFC**) has issued a [circular](#) for licensed corporations using generative artificial intelligence language models (**AI LMs**). Effective 12 November 2024, licensed corporations must comply with specific notification, senior management and risk management requirements as set out in the circular when adopting AI LMs for their regulated business activities. These requirements can be distilled into the following steps that licensed corporations need to address for use of AI LMs.

### 1. Identify high-risk use case and notify the SFC

Licensed corporations should consider the use cases for AI LMs before adoption. Utilizing AI LMs to provide investment recommendations, advice, or research to investors or clients is considered a “high-risk use case” by the SFC. This type of usage would be viewed as a significant change to the nature of business and services offered by a licensed corporation, triggering a mandatory notification to the SFC within 7 business days of implementation. The SFC encourages licensed corporations to discuss their plans for high-risk use cases involving AI LMs with the SFC.

### 2. Engage senior management to prepare for the expanded responsibilities

Senior management of a licensed corporation using AI LMs for regulated activities should aware the risks and limitations of the AI LM and its input data, to ensure the deployed model is fit for purpose given those considerations. Senior management responsibilities could expand to the (i) design, implementation, customization, training, testing, and calibration (**Model Development**) and (ii) validation, approval, ongoing review and monitoring, use, and decommissioning (**Model Management**) of the AI LMs. Senior management need to ensure that throughout the lifecycle of Model Development and Model Management, the licensed corporation would implement:

- effective policies, procedures, and internal controls for using AI LMs for proper performance of business activities; and
- adequate oversight (and particularly on high-risk use cases) and governance by qualified and experienced individuals.

An effective governance framework should identify high-risk use cases, considering potential adverse client impact if the AI LM's output is inaccurate or inappropriate. This requires responsible staff from the business, risk, compliance, and technology functions who have relevant knowledge, experience or qualification in AI, data science, model risk management, and domain expertise to manage the licensed corporation's adoption and implementation of AI LMs, along with legal and compliance personnel assessing the legal and compliance risks.

**3. Enhance risk management controls**

Licensed corporations can adopt a risk-based approach to implement controls commensurate with the materiality of the impact and level of risks presented by the specific use cases for AI LMs. Below is a high-level matrix outlining the SFC's risk management expectations for the use of AI LMs across different aspects:

Applicable to licensed corporations that:		
Use off-the-shelf AI LM products to configure essential parameters or integrate such products into other components of a AI LM system architecture	Develop, customize, refine, or enhance AI LMs (including fine-tuning the model, using retrieval augmented generation or content filtering, and integrating external tools like prompt management solutions for a pre-trained AI LMs provided by a third-party)	Adopt AI LMs in high-risk use cases
<p><u>General mitigation measures</u></p> <ul style="list-style-type: none"> <li>Take risk mitigation measures commensurate with the materiality of the impact and risks of the specific use case, particularly to address the AI LM's hallucination risk.</li> <li>Thoroughly assess the reliability of any solutions marketed as eliminating or avoiding hallucination, as they have limitations, and remain accountable for the model's output regardless of risk mitigation measures.</li> <li>Provide prominent disclosures that the output may not be accurate, in the user interface where the AI language model is interacting with clients.</li> </ul> <p><u>Cybersecurity and data risk management</u></p> <ul style="list-style-type: none"> <li>Encompass adversarial attacks against the AI LMs as well as the data used to train or fine-tune it as part of the cybersecurity measures.</li> <li>Conduct adversarial testing periodically, to the extent practicable, on GeanAI LMs to harden and protect them against adversarial attacks.</li> <li>Encrypt non-public data at rest and in transit to ensure their confidentiality and security, and mitigate the risks of using AI LM-based browser extensions to entail privacy and data leakage risks.</li> <li>Ensure the quality of the data used to train AI LMs, including identifying and mitigating biases which may have a material impact on the use case.</li> <li>Implement controls to assess and mitigate the risks of sensitive confidential information.</li> </ul> <p><u>Third-party provider risk management</u></p> <ul style="list-style-type: none"> <li>Perform appropriate due diligence and ongoing monitoring to assess whether the third-party provider possesses the requisite skills, expertise, resources and controls to deliver the product or service to acceptable standards.</li> <li>Assess: Whether the third-party provider has an effective model risk management framework, and whether the model's output and performance are appropriate for the institution's specific use cases, including considering the model risk and adopting mitigation measures as needed when validating a third-party AI language model with limited transparency, the institution should, when validating a third-party AI language model.</li> <li>Subject the open-sourced AI language model to in-house relevant model development and management measures.</li> <li>Consider whether a breach by a third-party provider of data privacy or intellectual property laws could have a material impact, and whether the provider has measures to protect or indemnify the institution against any legal actions related to such a breach, as well as the supply chain vulnerabilities and data leakage risk as well as level of dependence etc.</li> </ul>		

Applicable to licensed corporations that:	
Develop, customize, refine, or enhance AI LMs (including fine-tuning the model, using retrieval augmented generation or content filtering, and integrating external tools like prompt management solutions for a pre-trained AI LMs provided by a third-party)	Adopt AI LMs in high-risk use cases
<p><u>Model development requirements</u></p> <ul style="list-style-type: none"> <li>Separate the Model Development function from Model Management function where feasible and appropriate based on the use case and risk level.</li> <li>Adequately validate AI LMs before approval for use and material changes.</li> <li>Conduct comprehensive end-to-end assessment and on-going monitoring of the model performance.</li> <li>Document results of validation, ongoing monitoring of the model testing and calibration results.</li> </ul>	<p><u>Additional risk mitigation measures</u></p> <ul style="list-style-type: none"> <li>Conduct model validation, ongoing review and monitoring in relation to the performance of the AI LM so as to improve its factual accuracy to a level commensurate with the specific use case.</li> <li>Have a human in the loop to address hallucination risk and review the AI LM's output for factual accuracy before relaying it to the user.</li> <li>Test output robustness to prompt variations, as it has been reported that AI LMs may generate different predictions based on text inputs that have the same meaning.</li> </ul>

## Riding the momentum of virtual assets investment: Insights for asset managers

Joyce Li

Hong Kong Exchanges and Clearing Limited (**HKEX**) launched, on 15 November 2024, the HKEX Virtual Asset Index Series, which offers a single and reliable real-time reference price for Bitcoin and Ether, reinforcing Hong Kong's position as a leading hub for crypto investments in Asia. The introduction of the Index Series comes as the Hong Kong Securities and Futures Commission (**SFC**) is looking to expand Hong Kong's virtual assets (**VA**) licensing regime to regulate new VA service providers. Six spot VA exchange traded funds (**ETFs**) were listed on HKEX earlier in April this year.

With no signs of slowing interest in the establishment of unauthorised VA funds and a boost in momentum in the authorised fund space, our FSPG partners Joyce Li, Pinky Siu and Isabella Wong were joined by industry experts Jessie Huang, Head of Institutional Sales of Hash Blockchain Limited, and Davy Kong, Managing Director of ASCENT Fund Services (Hong Kong) Ltd in our recent client seminar to share insights on the key considerations for asset managers looking to gain VA exposure in their portfolios.

The panellists discussed wide-ranging topics from SFC licensing requirements, fund structuring considerations, service provider selection and public offering of funds which invest in VA.

### ***SFC licensing considerations: 10% is the magic number***

As many would already know, simply being licensed to conduct Type 9 (asset management) regulated activities will not automatically enable a manager to manage funds or portfolios with VA exposure.

Prior approval from the SFC is required if the VA investments of a fund or portfolio are more than 10% of the fund's or portfolio's gross asset value (**GAV**) -- explained Isabella, who specialises in advising financial institutions on licensing and regulatory matters. Type 9 licensed corporations must satisfy the SFC's eligibility requirements, such as having competent personnel with relevant VA experience and appropriate internal controls, in order to obtain the SFC's approval. The approved licensed corporation will be subject to additional terms and conditions relating to the management of VA

investments (see [link](#)).

For Type 9 licensed managers who only intend to introduce up to 10% investments in VAs (in terms of GAV) to their funds or portfolio, Isabella reminded such managers should still notify the SFC of its intention to make VA investments.

A clear upward trajectory has been observed over the years. There are, as of today, 29 Type 9 licensed managers who got their licences uplifted.

### ***Choice of fund vehicle: Hong Kong vs off-shore structures***

While the Hong Kong open-ended fund company (**HK OFC**) has emerged as the fund vehicle of choice for ETFs, offshore fund vehicles, such as the Cayman Islands' exempted open-ended investment companies (including segregated portfolio companies) (**Cayman Corporate Fund Vehicles**), appear to be favoured by managers managing unauthorised funds with VA investments; even though, the HK OFC and the Cayman Corporate Fund Vehicles share plenty of similarities. One of the potential reasons for the slow adoption of the HK OFC as a structure for VA funds, as explained by Joyce, who regularly advises on retail funds and private funds, could be the need for an HK OFC to appoint a custodian that meets the SFC's requirements. While great strides have been made to promote Hong Kong as a fund domicile centre, the popularity of the HK OFC as the fund vehicle of choice for VA funds may be stifled until we see a greater number of VA custodians meeting the SFC's requirements enter the market.

### ***Selecting service providers: the right expertise and ensuring operational resilience***

As one would expect, the administrative needs and support for VA funds and its managers are rather different from those for traditional funds, owing to, amongst other things, the nature of the underlying assets and the increased considerations to safeguard against anti-money laundering. Davy remarked that different methodologies and tools are required for the calculation of net asset value for VA funds and additional measures will also need to be established to support in-kind subscription/redemptions by investors. Extra care should be paid to the design of a VA fund and its investment strategy to ensure operational feasibility, be it on service providers' expertise, system capabilities, or regulatory considerations.

Isabella also shared that finding qualified service providers to support VA fund operations can be challenging and Type 9 licensed managers have on-going oversight obligations on their service providers. She further pointed out the importance of asset managers implementing a robust risk management infrastructure (and in particular, covering cybersecurity risks and counterparty risks), if they intend to manage VA funds.

When it comes to selecting a VA trading platform, Jessie highlighted that trading volume and liquidity of tokens are key, as this will very likely affect the price for the same VA token. However, the technological infrastructure behind the platform should not be overlooked.

### ***Additional considerations for managers of authorised funds venturing into the crypto space***

If a manager wishes to offer a VA fund to the retail public of Hong Kong, the fund will need to be authorised by the SFC. This will naturally attract additional considerations. Pinky, who assisted in the authorisation of one of Hong Kong's first spot VA ETFs, explained that fund managers intending to launch authorised VA funds will need to look into SFC considerations apart from SFC licensing. In particular, the experience requirements for the manager's key investment personnel are different from the experience requirements for a responsible officer. A fund manager looking to launch a VA spot ETF will need to ensure that it can demonstrate to the SFC that it has investment personnel with experience in VA investments as well as investment personnel with proven ETF capability. In addition, the SFC will consider whether the manager has a good track record of regulatory compliance. For a new ETF issuer who wishes to launch VA ETFs, the SFC may require the manager to engage qualified auditors to conduct an internal control review on the manager's operational framework to ensure its compliance with the SFC requirements.

### ***What lies ahead***

Noting that there is little product differentiation between the 6 spot VA ETF, Jessie shared that they are in regular dialogue with the SFC on new product ideas and new initiatives which will enrich Hong Kong's VA offering. Jessie noted that, so far, the SFC has been facilitative, demonstrating a readiness to understand industry needs and share regulatory concerns. Aside from VA funds, Pinky also shared the regulatory willingness to develop Hong Kong's VA ecosystem, as demonstrated by the recent launch of Project Ensemble Sandbox by the Hong Kong Monetary Authority, which aimed at accelerating tokenization adoption including that of investment fund units.

The panellists are cautiously optimistic that this is only the beginning of the growth of the VA investment ecosystem in

Hong Kong. With careful planning, and working with the right partners, joining the VA bandwagon may not be as daunting as it may initially appear.

## SFC prompts asset managers of the emerging opportunities in Saudi Arabia

Pinky Siu

In the wake of increasing capital flow via the China-Middle East Corridor, Hong Kong steps up efforts encouraging investors to take advantage of the emerging opportunities in the region - the Hong Kong Stock Exchange announced plan to open an office in Saudi Arabia next year; the Hong Kong Securities and Futures Commission (**SFC**) published a [guide](#) on its website introducing the Saudi Arabian market landscape and how Hong Kong funds can be offered there.

The SFC's guide was released soon after the cross-listing on the Saudi Exchange of two Hong Kong exchange-traded funds (**ETFs**) in October 2024. We discuss in this article how Hong Kong managers can benefit from the market access regime and distribute their funds in Saudi Arabia.

### Market accessibility

Hong Kong is regarded by the Saudi Arabian Capital Market Authority (**CMA**), the regulatory body responsible for overseeing and regulating the capital markets in Saudi Arabia, as a jurisdiction that employs regulatory standards and requirements equivalent to those of the CMA. As such, a Hong Kong fund manager enjoys the benefits of being recognized as an eligible foreign fund manager both in offering Hong Kong funds in Saudi Arabia and in participating in the domestic funds.

### Offering Hong Kong funds in Saudi Arabia

**Private placement:** No approval is required for fund managers to offer units in a Hong Kong fund (public or private) in Saudi Arabia PROVIDED THAT the offer is:

- conducted by means of a private placement;
- made to institutional and qualified clients (as defined under the CMA's Investment Funds Regulation, the [Regulation](#)) and retail clients that meet the requirements set out in the Regulation; and
- processed through a distributor (a capital market institution licensed to carry out dealing activity or the activity of managing investments and operating funds) which must make the necessary filings with the CMA.

Securities advertisements and promotional materials of the Hong Kong fund that comply with the requirements set out in the relevant Saudi Arabian rules and regulations may be sent to persons to whom the placement is offered.

**Cross listing of ETFs:** Hong Kong fund managers may opt to cross-list a Hong Kong domiciled ETF under a master-feeder structure by partnering with a CMA-licensed fund manager for the latter to form a local feeder ETF for listing on the Saudi Exchange.

At present, there are two Hong Kong ETFs listed on the Saudi Exchange, one tracking an index comprising major Stock Connect eligible Hong Kong-listed stocks and the other tracking the Hong Kong's flagship equity bench.

### Participation in Saudi Arabian domiciled funds

Hong Kong fund manager may be appointed as a sub-manager to manage foreign investments of a Saudi Arabian domiciled fund. As mentioned above, Hong Kong is regarded by the CMA as a jurisdiction that employs regulatory standards and requirements equivalent to those of the CMA. Hence, a Hong Kong fund manager can act as sub-manager to manage the foreign investments of a Saudi Arabian domiciled fund, without the need to obtain a license or approval from the CMA.

**Outlook** - Though the capital cooperation between Hong Kong and Saudi Arabia is still at its infancy, rapid investment growth in the China-Middle East Corridor is expected as driven by strong government-to-government links and policy initiatives. Asset managers are urged to keep pace with the emerging opportunities.

## SFC adopts proposal to enhance REIT regime and SFO market conduct regime for listed collective investment schemes

The Securities and Futures Commission (**SFC**), in its recent consultation conclusion, adopted the proposals to (i) introduce a statutory scheme of arrangement and compulsory acquisition mechanism for real estate investment trusts (**REITs**) and (ii) enhance the Securities and Futures Ordinance (**SFO**) market conduct regime for listed collective investment schemes (**CIS**). Legislative amendments are expected to be in place by 2025-end. Set out below are highlights of the adopted proposals.

**REITs:** a REIT is a listed CIS authorised by SFC under section 104 of the SFO. As REITs are constituted in the form of trusts and not companies under the Companies Ordinance (**CO**), a REIT may only be privatised indirectly through the disposal of all or a substantial part of its assets followed by a delisting and deauthorisation in accordance with the Takeovers and Buy-back Codes and the Code on Real Estate Investment Trusts.

Under the adopted proposal, a new part will be introduced in the SFO to the effect that:

- (a) a REIT will be allowed to implement an arrangement or compromise by a similar mechanism under the CO: due disclosure to unitholders, court sanction and approval thresholds (i.e., at least 75% of unitholders' voting rights approving, and votes casting against the arrangement not exceeding 10% of disinterested unitholders' voting rights).
- (b) the provisions for compulsory acquisition under the CO will be replicated to provide for "squeeze-out" and "sell-out" in a takeover offer or in a general offer for a unit buy-back. In other words, if the bidder has acquired at least 90% of the units, the bidder will be entitled to purchase the remaining minority units subject to the minority unitholders' objection right in court; and at the other end, the minority unitholders will be entitled to compel the bidder to buy them out.

**Listed CIS (including REITs):** under the adopted proposal, the following parts of the SFO will be amended to extend the market conduct regimes to listed CIS:

- Part XIII (Market Misconduct Tribunal (MMT))
- Part XIV (Offences Relating to Dealings in Securities and Futures Contracts, etc.)
- Part XIVA (Disclosure of Inside Information)
- Part XV (Disclosure of Interests)
- Part VIII (Supervision and Investigations)
- Part X (Powers of Intervention and Proceedings)

SFC clarifies that in formulating the various definitions in the market conduct regimes, they would have regard to the differing roles and nature of the management company and the trustee of a listed CIS. For example, on 'inside information', the subject of the inside information under the regime will focus on the listed CIS itself, and its management company which is akin to directors of listed companies in making executive decisions for the listed CIS. While the SFC reiterated that trustees and custodians would not be excluded from the market conduct regimes – where they commit any misconduct under the regimes, they will be liable – the subject of the inside information under the proposed regime would not be referring to the inside information of the trustees, which are typically part of banking groups and exercise an independent oversight function.

Please reach out to Deacons should you any queries on the above.

## Hong Kong SFC licensing and compliance hints – November 2024

Connie Chan

### Managing private funds and discretionary accounts: other common instances of non-compliance

In our last newsletter [article](#), we discussed the areas of regulatory concerns raised by the Securities and Futures Commission (**SFC**) in the circular published on 9 October 2024 (**Circular**). The Circular highlighted deficiencies and substandard conduct identified by the SFC during its supervision of licensed firms that manage private funds and discretionary accounts.

In this article, we discuss some of the other instances of non-compliance that we identified during our recent health checks of managers of private funds and discretionary accounts:

1. Records on suitability assessment not kept. Type 9 licensed asset managers that market funds under their discretionary management (in reliance upon an exemption from having to be licensed for Type 1 regulated activity) are required to comply with the suitability obligations. Whilst we find that most licensed entities undertake some level of suitability assessment, the extent of documentation evidencing compliance varies. Please note that unless you can provide an appropriate audit trail of such a process, the SFC may question your internal compliance and procedures.

The SFC continues to remind licensed companies of the importance of compliance with the suitability obligations. Proper records of suitability assessment for private fund marketing need to be kept for at least 7 years to demonstrate compliance.

2. Records that substantiate the investment decision-making process not kept. Some asset managers do not maintain appropriate records pertaining to their investment decision-making process (for instance, research reports and memos from investment committee meetings) to justify their investment decisions for funds or discretionary accounts under management, despite actually considering various factors before making those decisions.

During inspection, SFC often requests to examine documentation concerning the operation of investment committees and their decision-making process and protocols. Inability to produce adequate documentation risks the SFC questioning whether appropriate investor protection measures are in place in connection with the investment process.

3. Insufficient pre-trade and post-trade controls. Some asset managers do not readily incorporate updates to the investment restrictions into their automated investment restrictions checking system; others do not have sufficient post-trade investment restrictions checks.

Asset managers are expected to put in place effective pre-trade and post-trade controls to ensure that the transactions carried out for the private funds and discretionary accounts are in accordance with their stated investment restrictions and guidelines. Any exception is required to be documented with appropriate justification.

4. Best execution deficiencies. Some asset managers do not keep records evidencing that they periodically evaluate broker performance, whilst others do not allocate trades based on the latest broker evaluation.

Asset managers need to consider both qualitative and quantitative factors when reviewing the performance of their execution brokers. Records of their regular broker evaluations need to be kept so that these can be provided to the SFC upon request.

5. Insufficient monitoring of personal trading activities. Some asset managers do not follow up with relevant staff when personal trading statements are not submitted; others do not regularly review personal trading statements to compare them with approved trades or to verify compliance with the minimum holding period.

Fund managers need to ensure that personal trading activities are adequately monitored so that irregularities can be detected and handled properly.

If you would like to discuss our health check service, please reach out to our team for further information.

## Recent publications

[Regulatory requirements for market sounding finalised](#)

[The Advance Decision on Life-sustaining Treatment Bill](#)

[Former Chairman and CEO found liable for disclosure of false or misleading information and insider trading by Market Misconduct Tribunal](#)

[Revised Practice Direction 30.1 for Applications under Part II of the Mental Health Ordinance \(Cap. 136\)](#)

[Competition Tribunal, for the first time, sanctioned relief sought against respondents in their absence](#)

[FamilyFocus@Deacons – Series on Children Matters](#)

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