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Newsletter

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What's inside?

SFC puts on hold proposed amendments to exemption for advertisements of investment products and enforcement-related provisions of the Securities and Futures Ordinance .... 1 - 3

HK Fintech Promotion Roadmap – how will it impact asset managers? .... 4 - 5

Risk based capital requirements for insurers 5

Hong Kong SFC licensing and compliance hints – September 2023 .... 5 - 6

Recent publications .... 6 - 7

SFC puts on hold proposed amendments to exemption for advertisements of investment products and enforcement-related provisions of the Securities and Futures Ordinance

Pinky Siu and Goofy Chan

Following our article in June 2022 about the Securities and Futures Commission's (**SFC**) Consultation Paper on Proposed Amendments to Enforcement-related Provisions of the Securities and Futures Ordinance, the SFC issued the Consultation Conclusions on Proposed Amendments to Enforcement-related Provisions of the Securities and Futures Ordinance (**Consultation Conclusions**) on 8 August 2023. Taking into account public comments on the proposed amendments regarding the exemption in section 103 of the Securities and Futures Ordinance (**SFO**) relating to the issue of advertisements of investment products to professional investors (**PIs**) and the SFC's power to apply for court orders under section 213 of the SFO, the SFC has decided not to proceed with these amendments at this juncture.

Proposed amendments relating to advertisements of investment products

The SFC noted in the Consultation Conclusions that the major concerns with the proposal to amend the professional investor exemption under section 103(3)(k) (**PI Exemption**) and the consequential amendments to section 103(3)(j) are two-fold:

(i) *Necessity:* Many respondents questioned the necessity of the amendments, as there is no material risk for retail investors to be exposed to unauthorised advertisements of investments products if they are unable to invest in them; and the existing regulatory requirements (e.g. know-your-client (**KYC**), suitability assessments and risk disclosures) already provide sufficient protection for retail investors. Some respondents also take the view that the amendments are disproportionate to the alleged "harm" to investors in light of the existing disciplinary sanctions for intermediaries and the criminal penalties for breaches of section 103.

(ii) *Operational difficulties and impact on business:* There were also concerns relating to operational difficulties and disruption to common marketing activities. As we pointed out in our article in June 2022, the proposal effectively requires intermediaries to only issue unauthorised advertisements to PIs who have already been identified as such through KYC and related procedures, which can be difficult in reality as PIs are generally unwilling to provide their KYC information at the preliminary marketing stage. As such, the majority view is that the proposal would significantly reduce intermediaries' ability to market to prospective investors (including undue restriction on online marketing effects), and may give rise to an unfair advantage to more sizable financial institutions who

already have a large existing client base to which they can market new products without having to conduct KYC again.

In response, the SFC remarked that the proposal aims to enhance investor protection by ensuring that retail investors will not be exposed to unauthorised advertisements of investment products intended only for PIs and to reduce the risk of the PI Exemption being abused by advertisers. The SFC highlighted that they are very concerned about the protection of retail investors in an era of increasingly complex and accessible investment products, particularly in light of multiple instances of products intended for PIs being sold to retail investors in breach of suitability rules. However, the SFC acknowledges that the proposal may give rise to practical difficulties in the marketing process, and has decided not to proceed with the proposal in its current form, but will continue to monitor the need to introduce new policies over the longer term and consult the industry again if necessary.

Even though the proposed amendments will not go ahead, the SFC reminds the industry that, to invoke the PI Exemption, a **clear intention to dispose of the investment product only to PIs** must be demonstrated. To demonstrate and evidence a genuine intention as such, the SFC specifically states that, at a minimum, the issuer of the advertisement should ensure it is plainly apparent from the face of the advertisement that the underlying investment product is intended only for disposal to PIs.

Proposed amendments to the SFC's power to apply for court orders

Respondents raised five major concerns over the proposed amendments to section 213 of SFO to expand the basis on which the SFC may apply for remedial or other orders against a regulated person. The industry comments, and the corresponding responses from the SFC, are summarised below.

Public comments	SFC's responses
(i) *Legal and jurisprudence concerns* • There is doubt whether, as a matter of jurisprudence, the SFC should be empowered to seek legal remedies in the form of court orders for a breach of codes and guidelines which have no force of law, and the formulation of which was not subject to the same scrutiny as legislation. • The proposal may introduce significant legal and regulatory uncertainty for regulated persons. • The legislative intent of the SFO is that breaches of regulatory guidance should be treated differently to breaches of statute (e.g. section 399(6) SFO).	• Current law already allows the SFC to seek section 213 orders for breaches of licensing conditions which do not have the force of law. • The legislative intent of section 213 has always been to allow the court to exercise its discretion and order relief as it considers necessary to protect investors adversely affected by others' misconduct. • Allowing legal consequences to flow from breaches of codes and guidelines does not mean the SFC is changing their legal status.
(ii) *Perceived conflation of the disciplinary regime and section 213* • Implementation issues and concerns arise out of the perceived conflation of the disciplinary regime and section 213, when a disciplinary decision would become a possible ground to institute proceedings under section 213. The court is required to review the merits of the SFC's disciplinary decisions in order to discharge its duties under section 213. • There would be risk of parallel proceedings and contradictory outcomes.	• Prior to the issue of the Consultation Paper, the SFC were aware of the possibility of parallel proceedings (i.e. court proceedings under section 213 and the Securities and Futures Appeals Tribunal proceedings on a review of disciplinary decisions). This could be administratively mitigated if the SFC did not commence section 213 proceedings until the appeal process under the disciplinary regime has been exhausted.

Public comments	SFC's responses
(iii) *Fairness and proportionality concerns* • There were concerns that the proposal would result in all forms of disciplinary action by the SFC potentially triggering an action under section 213. • The court's lack of familiarity with the SFC's non-statutory requirements may result in heavy reliance on the SFC's interpretation of the codes and guidelines, leading to unfair decisions. • There will be a potential extension of the limitation period from the date of the loss or breach to the date of the SFC's decision, which would significantly increase the potential liability of regulated persons. • Regulated persons may be fined and then subjected to a compensatory order based on the same misconduct, which would impose an unduly harsh burden on regulated persons.	• The SFC is confident of the independence and competence of the court in dealing with novel legal and factual issues. • Postponing the commencement of the limitation period is a natural result but not the policy objective of the proposal. The SFC will consider these practical implications in further details. • The fundamental nature of section 213 orders is restitutionary and compensatory in nature. In contrast, regulatory fines serve to deter future non-compliance.
(iv) *Impact on the competitiveness and status of Hong Kong as an international financial centre* • The lack of predictability about the total financial impact of an enforcement action may exacerbate the prevailing trend of relocation of staff and business units. • The significant monetary implications arising from section 213 compensation orders and disciplinary sanctions may dissuade regulated persons from participating in some types of high-risk regulated activities, thus adversely affecting the development of Hong Kong's financial markets.	• Higher regulatory standards and active enforcement of those standards help strengthen investor confidence which in turn makes Hong Kong an attractive market for international investors.
(v) *Need for broader and more holistic review of compensation orders as a remedy* • The current laws already provide adequate legal rights and remedies for investors. Part IX of SFO also provides adequate remedies and safeguards to deal with misconduct by regulated persons through disciplinary proceedings. • There are other existing rights of action beyond the SFO (e.g. consumer protection laws, civil litigation, Financial Dispute Resolution Scheme, complaints handling procedures of regulated persons).	• The SFC disagrees that the existing legal framework already provides adequate protection to ensure aggrieved investors will be compensated for financial losses in all appropriate cases. • In circumstances where multiple regulated persons perpetuated similar misconduct with respect to similar investment products resulting in large numbers of investors suffering losses, it would be more suitable for the SFC to obtain compensation on behalf of the investors. • The SFC appreciates that the amendments will have a far-reaching impact and will re-consider the proposal.

The SFC has decided to put the proposal to amend section 213 on hold to thoroughly consider the implementation issues highlighted in the Consultation Conclusions as well as the other options to achieve the policy objective.

The Consultation Conclusions also cover the proposed amendments to the insider dealing provisions of the SFO, which are supported by most of the respondents and the SFC will proceed with these amendments. Please refer to our legal update for further information on the expanded scope of insider dealing provisions.

HK Fintech Promotion Roadmap – how will it impact asset managers?

Isabella Wong

On 25 August 2023, the Hong Kong Monetary Authority (**HKMA**), the Securities and Futures Commission (**SFC**) and the Insurance Authority (**IA**) jointly published a new roadmap, which sets out their regulatory initiatives over the next 12 months for promoting Fintech adoption in the financial services sector.

Similar to Singapore's collaborative initiative with the financial industry that seeks to test the feasibility of applications in asset tokenisation and decentralised finance (see Project Guardian issued by the Monetary Authority of Singapore in June 2023), Hong Kong's financial services regulators have collaborated to implement various Fintech policies and initiatives including Fintech supporting infrastructure for Hong Kong financial institutions. The roadmap summarises the HKMA's Fintech adoption study, the three regulators' past and existing Fintech facilitation measures and their Fintech promotion initiatives between 25 August 2023 and 24 August 2024.

Below are the key take-aways of the roadmap for SFC licensed asset managers:

1. Wealth / investment services and ESG factors are focus areas for Fintech promotion: the regulators aim to facilitate the application of technology in financial institutions' business operations, covering financial planning, investment management, investment execution, client communication, and the collection of ESG related data. Hyper-personalised and low-cost wealth, investment and/or ESG solutions will become a trend.

2. The adoption of artificial intelligence (**A.I.**) and distribution ledger technology (**DLT**) will continue in Hong Kong:

   - A.I. refers to the simulation of intelligence in machines to enable them to perform tasks typically carried out by humans. In the asset management sector, A.I. has been adopted for a while by some SFC licensed entities to provide services (e.g. robo-advisory or online distribution platforms). The SFC is a member of The International Organization of Securities Commissions (**IOSCO**) and so will follow the regulatory approach recommended in IOSCO's Final Report on the Use of A.I. and Machine Learning by Market Intermediaries and Asset Managers of September 2021.

   - DLT is a decentralised and distributed database system that enables multiple ledgers to maintain a shared record of transactions. DLT can be used to enhance the efficiency of cross-border payments, remittances and securities issuance and settlement by minimising intermediaries' involvement. In the context of funds, DLT can be employed to tokenise fund units. Currently, tokenisation is more beneficial to private funds than public funds. Private fund managers who manage illiquid assets (e.g. private equities or real estate projects) may enhance liquidity for their funds, through listing the tokenised funds on the 24/7 operating virtual asset trading platforms. Whereas, public funds are already available at plenty of distribution venues, and some of the online distribution channels are even offering very low distribution costs for both of the mangers and investors of the public funds. The tokenisation costs (such as the cost of employment of technology) may demotivate public fund managers. As public funds are in the regulated space, their managers may also want more regulatory clarity on fund tokenisation before action. IOSCO issued Policy Recommendations for Crypto and Digital Asset Markets Consultation Report in May 2023, these are relevant to all digital assets and tokens, including tokenised funds. Some of the recommendations relate to retail distribution (and specifically, retail appropriateness and disclosure) and will in due course be followed in Hong Kong.

3. As part of the roadmap, the regulators will issue guidance on Fintech adoption in the financial services sector. First, a best practice guidance will be published by the HKMA covering topics on contract negotiation between financial institutions and Fintech solution providers, financial institutions' on-boarding of technology vendors and cyber-security. With respect to asset managers, the SFC will likely issue a circular on fund tokenisation which we expect will provide some regulatory clarity on the tokenisation of public funds. Other than the best practice guidance, the planned regulatory initiatives aim to bridge the connectivity between financial institutions and Fintech solution providers through:

   - providing a Fintech Knowledge Hub, which will serve as a centralised platform for industry updates and a cross-sectoral directory of Fintech solution providers, financial institutions and associations in order to address sourcing challenges;

- launching Fintech Spotlight, i.e. a showcase of videos highlighting innovative Fintech solutions across wealth / investment technology, green technology, A.I. and DLT;
- conducting knowledge-sharing webinars and seminars;
- hosting Fintech showcase and roundtable events; and
- delivering training sessions for Fintech stakeholders.

Hong Kong's Fintech regulatory landscape continues to evolve. The Fintech Promotion Roadmap (and in particular, the Fintech Knowledge Hub) may assist asset managers in tracking developments in Fintech knowledge and market experience.

Risk based capital requirements for insurers

Scott Carnachan

The Insurance (Amendment) Ordinance 2023 was gazetted on 14 July 2023. It (i) provides the framework for risk based capital requirements for authorized insurers, (ii) amends the existing provisions relating to approval of "controllers" of authorized insurers, and (iii) makes other streamlining changes to the operation of the Insurance Ordinance. The changes are the same as set out in the Insurance (Amendment) Bill 2023. We summarised the changes in our previous newsletter article, available here. The changes will come into effect on a day to be appointed by the Secretary for Financial Services and the Treasury by notice published in the Gazette. The target is to commence the risk based capital regime within 2024.

Hong Kong SFC licensing and compliance hints – September 2023

Lilian Lai

Time to review your cybersecurity

The Securities and Futures Commission (**SFC**) has announced in its circular on 15 September 2023 that it will commence a cybersecurity review of selected licensed corporations (**LCs**) including brokers, traders, global financial firms and online distribution platform operators, focusing on their compliance with the regulatory standards on cybersecurity management and operational resilience. The SFC's review includes requiring the LC to complete a survey with a follow up meeting and on-site inspection.

One of the SFC's focuses in the review is the additional cyber risks associated with advanced technology developments – the use of clouds for data storage, third-party technology vendors for construction and maintenance of front- and back- office operation systems, and remote access solutions etc.

LCs should regularly review their information technology infrastructure to ensure they have sufficient controls to enable effective operations and protection of client information and assets. We regularly assist LCs on compliance 'health checks' or mock inspections covering IT and cyber risk review and advice on suggested measures for enhancement. We look forward to speaking with you if you require any assistance.

Reminder on adequate written policies and effective implementation over employee dealings: recent disciplinary actions

The SFC has recently reprimanded and fined two licensed corporations (**LCs**) (and a responsible officer (**RO**) of one of the LCs) in connection with their failure to have written policies / implement controls governing employee dealings.

An LC must have written policies that are clearly communicated to all employees on whether they are permitted to conduct personal dealing. Such activities must be actively monitored requiring regular employee declarations in respect of relevant account holdings, pre-approvals / reporting of personal trading transactions, ongoing surveillance and record keeping. It is not sufficient to merely have a written manual without effective implementation and regular policy review – in one of the disciplinary actions, the SFC found that the LC failed to, among other things, produce records demonstrating all employees had received and understood its employee dealing policy. Furthermore, senior management and compliance were lacking understanding in their respective roles and duties in monitoring employee

dealings and permitted the RO in charge to approve his own trades which exceeded the trading limit prescribed in its policies.

LCs licensed to conduct regulated businesses such as leveraged foreign exchange trading and/or asset management should also comply with the additional specific regulatory requirements such as those set out in Schedule 6 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission and/or the Fund Manager Code of Conduct.

Recent publications

Court holds arbitrators entitled to immunity

Court finds service of Notice of Arbitration invalid and refuses to enforce award

Court holds arbitration agreement spent and lifts stay of proceedings

Successful trade mark oppositions as Hong Kong's borders re-open

Third draft amendment to China's Company Law released for public opinion

Highlights of the Administrative Measures for the Personal Information Protection Compliance Audit (Comment Draft)

HKMA issues consultation on timeline for implementing Basel III final reform package

Launch of bank-to-bank information sharing platform (FINEST)

Hong Kong Deposit Protection Board consults on enhancements to the Deposit Protection Scheme

HKMA announces major enhancements on protection of payment card customers

HKMA consultation begins on review of three-tier banking system

Digital assets: UK Law Commission publishes final report on crypto-token collateral arrangements and insolvency shortfall rules

Report on "The Digitalisation of Financial Services in Hong Kong: Recent Experience, Regulatory Developments and Considerations for Sustainable Innovation and Growth"

Digital assets: UK Law Commission publishes final report on digital assets being a new kind of "thing in action"

Hong Kong regulator broadens scope of insider dealing

FamilyFocus@Deacons: Crossley Applications: Holding your spouse to your nuptial agreement

FamilyFocus@Deacons: Pension sharing in divorce – How much of my pension will my spouse be entitled to?

Competition Tribunal lays down principles for restricting use and disclosure of confidential information in competition proceedings

Generative AI regulations officially released in China

China passes law to regulate generative AI

Navigating data export regulations: a comparative analysis of GDPR and PIPL standard contract clauses

When will the court grant an anti-arbitration injunction?

Court of Appeal finds dispute resolution procedure in contract too unclear and uncertain to be enforceable

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Court refuses to set aside enforcement order on basis of fully virtual arbitration

Court confirms high threshold for setting aside arbitral award

SCCA revises its Arbitration Rules

CFA holds that whether parties have complied with a pre-arbitration mechanism in a contract is a matter for the arbitral tribunal and not the court

Appointment of multiple custodians possible for public open-ended fund company

Is your business transferring personal data out of China? The Standard Contract Measures for Cross-border Transfers now in force

H-share issuers' domestic shares and H shares are no longer deemed as different classes of shares – Implications under the Hong Kong Listing Rules, the Codes on Takeovers and Mergers and Share Buy-backs and Part XV of the Securities and Futures Ordinance

Hong Kong Competition Commission targets exclusivity provisions in online food delivery platform service agreements

Navigating the legal landscape of keepwell deeds and equity interest purchase undertakings: insights from recent High Court decisions

How China's fast-track examination for Hong Kong patent applicants can benefit you

Mandatory electronic dissemination of listed issuers' corporate communications to their securities holders effective from 31 December 2023

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