

Hong Kong: SFC Releases Consultation Conclusions and Commences further consultation on proposed depositaries (RA 13) regime

In brief

The Securities and Futures Commission ("**SFC**") recently released the **Consultation Conclusions on the Proposed Regulatory Regime for Depositaries of SFC-authorized Collective Investment Schemes ("RA 13") ("Consultation Conclusions")** and the Further Consultation on Proposed Amendments to Subsidiary Legislation and SFC Codes and Guidelines to Implement the Regulatory Regime for Depositaries of SFC-authorized Collective Investment Schemes ("**Further Consultation**"). Whilst many of the proposals from the 2019 original **consultation ("2019 consultation")** will be adopted without change, the SFC has refined its approach in several key areas to provide greater clarity to the industry. We summarise the key requirements that will be applicable to RA 13 licensees, the Consultation Conclusions and the new proposals for consultation in the Further Consultation.

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Key Consultation Conclusions

We summarise the key Consultation Conclusions that provide greater clarity regarding the RA 13 regime below:

<p>Scope of RA 13 regime in general</p>	<p>The SFC has confirmed that the RA 13 regime is only intended to apply to top-level trustees or custodians and delegates (including sub-custodians) will not fall within the regime regardless of whether such delegates operate within or outside of Hong Kong.</p>
<p>Limited Exemptions to RA 13 regime</p>	<ul style="list-style-type: none"> • Pooled Retirement Fund (PRF) trustees will, consistent with the 2019 consultation, not be exempted from licensing or registration as they do not generally fall within the Mandatory Provident Fund Schemes Authority's regulatory remit. • The SFC maintains the view from the 2019 consultation that approved pooled investment funds (APIFs) which are authorised for offering to the retail public (i.e., retail APIFs) should be distinguished from pure Mandatory Provident Fund (MPF) products and therefore will not be exempted.
<p>Scope of RA 13 activities</p>	<p>The SFC has refined its approach to defining RA 13 by reference to the activity of providing depositary services for SFC-authorized collective investment schemes (CIS) under the Securities and Futures Ordinance (SFO) ("relevant CIS") which consist of two core functions of a depositary. It is proposed in the Further Consultation that RA 13 will be defined as an activity of providing depositary services for a relevant CIS i.e.:</p> <ol style="list-style-type: none"> (a) custody and safekeeping of relevant CIS property; and (b) oversight of the operation of the relevant CIS to ensure that it is operated in accordance with the provisions of its constitutive documents.
<p>Licensing/Registration requirements on individuals</p>	<ul style="list-style-type: none"> • Where a depositary delegates custody and safekeeping of scheme property to another entity, the staff of the depositary responsible for monitoring the performance of the delegate will need to be licensed or registered for RA 13. • Where a depositary performs part or all of the custody and safekeeping function within the firm, staff empowered to approve instructions or transactions for custody-related purposes in respect of a relevant CIS and those assuming oversight duties over the performance of this function will need to be licensed or registered for RA 13 (whereas staff who are engaged in custody operations without such approval powers or oversight duties will generally not be subject to the licensing obligations under the RA 13 regime). • Staff of a depositary responsible for performing oversight of scheme operations in respect of a relevant CIS (e.g., monitoring compliance with investment restrictions, fund accounting and valuation, etc.) will



	<p>need to be licensed or registered for RA 13. For depositaries which also act as fund administrator, transfer agent or registrar, staff engaged to provide such services are generally not required to be licensed or registered unless they also have an oversight responsibility in respect of the scheme operations based on the depositary's particular business model and governance structure.</p> <ul style="list-style-type: none"> Individuals who solely perform marketing activities for a depositary will not be subject to the licensing obligations under the RA 13 regime.
Managers-in-Charge (MIC)	<ul style="list-style-type: none"> In line with the approach under the current licensing regime, the MICs of the overall management oversight function and MICs of key business lines should be responsible officers. The MICs of other core functions are generally not required to be licensed.
Anti-Money Laundering and Counter-Financing of Terrorism (AML/CFT)	<ul style="list-style-type: none"> All RA 13 licensees must comply with the SFC AML/CFT requirements even if they are also licensed trust service providers with the Hong Kong Companies Registry. An RA 13 depositary is generally expected to carry out customer due diligence ("CDD") on the relevant CIS to which the depositary services are provided as its customer. There are however alternative ways to comply with such requirements including the below: <ul style="list-style-type: none"> (a) the depositary may carry out CDD on the management company of the CIS instead, provided that the following conditions are met: (i) the management company is licensed or registered with the SFC; (ii) the underlying investors of the CIS have no control over the management of the scheme property and (iii) the management company has put in place measures to carry out CDD on all investors of the relevant CIS; and (b) simplified CDD measures ("SDD") may be applied to the CIS or the management company (as the case may be) provided that the relevant conditions for SDD under the AML regime are met. The SFC will issue FAQs to provide further guidance.

Conduct and Internal Controls - Schedule 11 Changes

The key regulatory obligations that will be applicable to an RA 13 licensee are contained in Schedule 11 to the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("**Schedule 11**"). Following the feedback received as part of the consultation process, the SFC has either confirmed that it is proceeding with its originally proposed approach or is proposing changes including the following:

Scope of Schedule 11	The SFC has considered the comments provided during the consultation process and has determined that the originally proposed scope of obligations pursuant to Schedule 11 is appropriate and reflects the obligations to be expected of RA 13 depositaries.
Definition of "relevant operators"	The SFC has confirmed that, given the board of directors of a CIS has oversight obligations including overseeing the issue of units or shares of the CIS, the board of directors is a "relevant operator".
Communications with management company/pricing error or exception reporting	<ul style="list-style-type: none"> The SFC has confirmed its expectation that management companies and depositaries will coordinate to ensure that breaches or issues are reported to the SFC, regardless to which party the breach is attributable. Paragraph 10 of Schedule 11 has been amended to include the steps that the depositary is expected to carry out when there are pricing errors or exceptions, e.g., inform the management company and work with it to ensure the errors or exceptions are dealt with and report (or ensure the relevant operator(s) has reported) the errors or exceptions to the SFC. Paragraph 5(b) of Schedule 11 has been amended so that a depositary will now only be required to advise the management company of material exceptions to its business continuity plan (BCP) which may have a material adverse impact on the operation of the CIS or the discharge of the depositary's obligations, whereas the 2019 consultation covered any types of material exceptions regardless of whether they have a material adverse impact on CIS or the depositary's obligations.
Delegation	The SFC has included a new note to paragraph 6 of Schedule 11 confirming that, in order to ensure the relevant CIS is operated in accordance with its constitutive documents, depositaries are responsible for monitoring the relevant operational activities whether they are carried out by delegates appointed by the depositary itself or by third parties appointed by other operators (including but not limited to the management company).
Cash flow monitoring	<ul style="list-style-type: none"> The original paragraphs 13(b) and (c) of Schedule 11 in the 2019 consultation have been combined and moved under paragraph 15 of Schedule 11 such that a depositary must ensure relevant operators have effective controls in place to obtain all necessary prior written consent from the depositary for any connected party transactions, including placing deposits with connected parties. The SFC have maintained the requirement to identify all cash flows inconsistent with the operations of the relevant CIS regardless of significance under paragraph 12 of Schedule 11.
Investment monitoring	The SFC has amended the original requirement under the 2019 consultation that a depositary should review the accuracy of the management company's records to instead require a depositary to provide the management company with its reconciled records of relevant CIS property and transactions to facilitate the



	management company's verification of the accuracy of its investment records under paragraph 13(c) of Schedule 11.
Custody and safekeeping of relevant CIS property	<ul style="list-style-type: none"> The SFC has confirmed where the payments or asset transfers need not be authorised by the depositary, the depositary should have proper oversight of the management company to ensure that the management company has properly authorised or has obtained the relevant authorisation, see the note under paragraph 14(j) of Schedule 11 (which was paragraph 15(h) of Schedule 11 in the 2019 consultation). The SFC has also confirmed that in order for a depositary to discharge its obligations, custody risks need to be managed and not just monitored and a depositary should safeguard all assets not only physical assets.
Key operators	Paragraph 8 of Schedule 11 (previously paragraph 9 of Schedule 11 in the 2019 consultation) has been amended to reflect that a depositary should perform independent oversight of the relevant CIS, rather than over the management company, to ensure that the relevant CIS is operated in accordance with the constitutive documents.
REITS	The SFC has taken into account the operational differences between real estate investment trusts (REITS) and other types of CIS in areas including daily cash reconciliation and custody and safekeeping of relevant CIS property and revised Schedule 11 to reflect these differences.

Further Consultation - Subsidiary Legislation

The Further Consultation also covers proposed changes to subsidiary legislation as summarised below:

Securities and Futures (Client Securities) Rules (CSR)	<ul style="list-style-type: none"> CSR set out the requirements on handling client securities and securities collateral (being listed or traded on the Hong Kong Stock Exchange or interests in a CIS) that are received or held in Hong Kong by or on behalf of an SFC intermediary or its associated entities. New Part 2A sets out the manner in which scheme securities should be received or held by an RA 13 depositary. In line with existing requirements on other SFC licensees, scheme securities must be deposited in trust or client accounts established and maintained in Hong Kong with authorised financial institutions, SFC licensed corporations (LCs) licensed for Type 1 (dealing in securities) regulated activities, or other SFC approved custodians. In addition, scheme securities shall be dealt with in accordance with written instructions which do not contravene the constitutive documents of the relevant CIS. Section 4 under CSR on standing authority will not apply to RA 13 depositaries. In line with the existing requirements on other SFC licensees, the new section 10A in Part 3 sets out the limitations on how scheme securities shall be treated by a depositary.
Securities and Futures (Client Money) Rules (CMR)	<ul style="list-style-type: none"> CMR set out the requirements on handling client money that is received or held in Hong Kong by or on behalf of an LC or its associated entities. New Part 3 sets out the manner in which scheme money should be received or held by an RA 13 LC. <ol style="list-style-type: none"> The depositary must establish and maintain segregated accounts (which are designated as trust or client accounts) with authorised financial institutions or other SFC approved persons. Each segregated account must be for only one relevant CIS in general. Where the CIS consists of sub-fund(s), it is acceptable to have one segregated account for scheme money in respect of that CIS and all of its sub-fund(s) or separate accounts in respect of that CIS and each of its sub-funds. In addition, in the case of a CIS which is an open-ended fund company or a CIS which is constituted in other corporate form, the relevant CIS account does not need to be designated as a trust or client account. Scheme money may only be paid out in accordance with the scheme documents for designated purposes which include the below: <ol style="list-style-type: none"> meeting payment, distribution, redemption, settlement or margin requirements on behalf of the relevant CIS; settling proper charges due to any person who has provided a service in respect of the relevant CIS; or settling any other liability incurred by or on behalf of the relevant CIS. Scheme money may also be paid in accordance with a written instruction which satisfies the requirements under the new section 10E.
Securities and Futures (Keeping of Records) Rules (KRR)	<ul style="list-style-type: none"> KRR set out the requirements on keeping of records by an SFC intermediary or its associated entities. Section 3A contains detailed provisions setting out the record keeping requirements for an RA 13 depositary. These are extensive and include, amongst others, keeping sufficient accounting, custody and other records to explain and account for all relevant CIS property in respect of each relevant CIS for which the depositary provides its depositary services. The new Schedule 1A supplements the record keeping requirements under the aforesaid section 3A. Section 4A sets out the record keeping requirements on associated entities of a depositary.



<p>Securities and Futures (Financial Resources) Rules (FRR)</p>	<ul style="list-style-type: none"> FRR set out the requirements on regulatory capital of an LC. An RA 13 LC will be required to have a minimum paid-up share capital of HKD10,000,000 and a minimum required liquid capital of HKD3,000,000. To the extent that any scheme money and certain other money including subscription and redemption proceeds received or held by an RA 13 LC have not been paid into a segregated bank account, such non-segregated amount of money will need to be treated as its ranking liability under the new section 37A.
<p>Securities and Futures (Insurance) Rules</p>	<p>Part 2 of Schedule 2 will specify an amount of "nil" for RA 13.</p>
<p>Securities and Futures (Accounts and Audit) Rules</p>	<p>Consequential amendments will be included under which auditors of an RA 13 LC or associated entities of an SFC intermediary shall form opinions regarding applicable CSR, CMR and KRR requirements.</p>
<p>Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules (Contract Notes Rules)</p>	<p>The SFC proposes that RA 13 depositaries and their associated entities shall be exempt from the Contract Notes Rules.</p>
<p>OTC derivative reporting and clearing regime</p>	<ul style="list-style-type: none"> RA 13 depositaries will, unless otherwise exempted, be subject to the mandatory reporting requirements under the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules. These requirements will be triggered if they are counterparties to a specified OTC derivative transaction or have conducted the transaction in Hong Kong. An exemption will be available where an RA 13 depositary is a counterparty to an OTC derivative in its capacity as a trustee of a relevant CIS, but not to transactions undertaken by it in any other capacity. RA 13 depositaries will also be subject to the Securities and Futures (OTC Derivative Transactions – Clearing and Record Keeping Obligations and Designation of Central Counterparties) Rules. The clearing obligation will be triggered where specified conditions are met, including when the person's applicable total position in relevant OTC derivative transactions reach a prescribed threshold, which currently stands at USD20 billion.

Transitional Arrangements

The SFC has confirmed that a transition period of 18 months will be applicable. The originally proposed two month timeframe for existing entities to make a licensing application once the regime commences has been extended to four months.

Key takeaways

The Further Consultation provides another important opportunity to influence the development of the proposed RA 13 regime. Submissions need to be made to the SFC by 30 April 2022. Existing or potential "top-level" depositaries should ensure that they have reviewed the proposed changes and determined how they may affect them and whether they may wish to make any further submissions. Areas that should be considered, and where preparations should commence, include:

- whether the revised scope and definitions change the extent to which the depositary and the activities of its staff will be impacted;
- which staff will need to be licensed and whether they will meet the revised licensing and competency requirements or may enjoy a grandfathering exemption;
- whether any changes in reporting arrangements between the management company and the depositary may be required to meet the updated expectations of the SFC; and
- the extent to which existing processes and procedures and internal controls, and custody arrangements may need to be implemented or revised to meet the new requirements.

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