ALLEN & OVERY

Regulatory Roadmap for a Bold and Adventurous Year of the Rabbit

In this Year of the Rabbit, we believe that financial institutions will need to be vigilant, quick-minded, and ingenious – all characteristics long associated with people born in the Year of the Rabbit. Following on from some of the regulatory challenges that emerged in the Year of the Tiger, we think that the Year of the Rabbit will be one that calls for a bold and adventurous spirit, tempered by the exercise of due caution.

In this Year of the Rabbit article, we focus on: (i) operational resilience; (ii) environmental, social, and governance (**ESG**); (iii) carbon markets; (iv) crypto-assets (including stablecoins); (v) Hong Kong's continuing efforts to establish itself as a super connecter of the region; (vi) online trading and wealth platforms; (vii) enforcement; and (viii) how to ensure that you remain compliant with regulatory developments introduced in the Year of the Tiger.

Operational Resilience

Risk management remains central to the Hong Kong (and international) regulatory agenda.

The Securities and Futures Commission's (**SFC**) revision and expansion of the Business and Risk Management Questionnaire (**BMRQ**)[1], a supervisory tool it uses to gather data and monitor market trends and identify emerging issues, in December 2022 focuses in particular on **operational resilience**.

The revamp of the BMRQ is intended to enhance the effectiveness of the SFC's risk-based supervision of licensed corporations and associated entities. We would advise them to err on the side of caution and start considering the new questions (and their practical implications on existing policies and controls) sooner rather than later, noting that the revised BMRQ will be used for financial years ending on or after 30 November 2023.

The new questions aim to identify potential weak aspects in a licensed corporation's business operations, which could lead to disruptive events and impact operational resilience. Topics covered include:

1 SFC – Circular to Licensed Corporations and Associated Entities Revised Business and Risk Management Questionnaire (23 December 2022): https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/doc?refNo=22EC68

- **Information technology security**, including: (i) the safekeeping/operation of licensed corporations' online banking accounts; and (ii) the use of internet trading platforms.

  The financial services industry is heavily reliant on the information technology infrastructure on which it is built, a situation that was brought into sharp focus by the Covid-19 pandemic, which forced organisations to rely on remote working technology. As such, licensed corporations should now expect an assessment of the robustness of their information technology infrastructure to be part of the SFC's assessment of their fitness and properness in carrying out regulated activities. We also consider this topic specifically in the context of (and in the section titled) "*Online Platforms*" below.

- Licensed corporations' **exit plans** i.e. planning for an orderly closure of a regulated business.

  The SFC expects all licensed corporations to maintain exit plans setting out the procedures to be followed if that company exits a regulated business. Senior management oversight is especially pertinent – the SFC's expectation of an orderly exit attaches to individuals that are **or were** involved in managing the regulated business, irrespective of whether or when they were licensed. They are expected to safeguard client interests and those of the investing public and uphold market integrity. A failure to meet the SFC's expectations may affect an individual's fitness and properness to be licensed or involved in the management of other licensed corporations in the future.

  For detail, please see the SFC's expectations regarding an exit plan detailed in its March 2022 circular titled *Measures to deal with disruptions caused by financial distress and insufficient responsible officers*[2].

- The need for more granular data on **transaction counterparties**, including execution brokers, backup brokers, exchanges, custodian banks, and settlement banks. Exposure to counterparty risks remains a primary concern of the SFC, especially in light of the extreme market volatility experienced by the financial markets in recent years.

- Managing **credit and liquidity risk.** This should remain a top priority for intermediaries with the BMRQ requiring more data around licensed corporations' **margin activities** and controls around such activities, such as information on the grant of forced liquidation waivers to margin clients.

The revisions to the BMRQ follow on from the SFC's *Consultation Paper on Proposed Risk Management Guidelines for Licensed Persons Dealing in Futures Contracts*[3], issued in November 2022. That consultation seeks to introduce risk management guidelines for futures brokers' dealing activities (i.e. corporations licensed for Type 2 regulated activity (dealing in futures contracts), whether they deal in financial or commodity futures). Some of the key themes in the consultation concern risk management, such as oversight and reporting lines, client risk exposure management, institutionalising margin controls, managing counterparty risk, and stress testing.

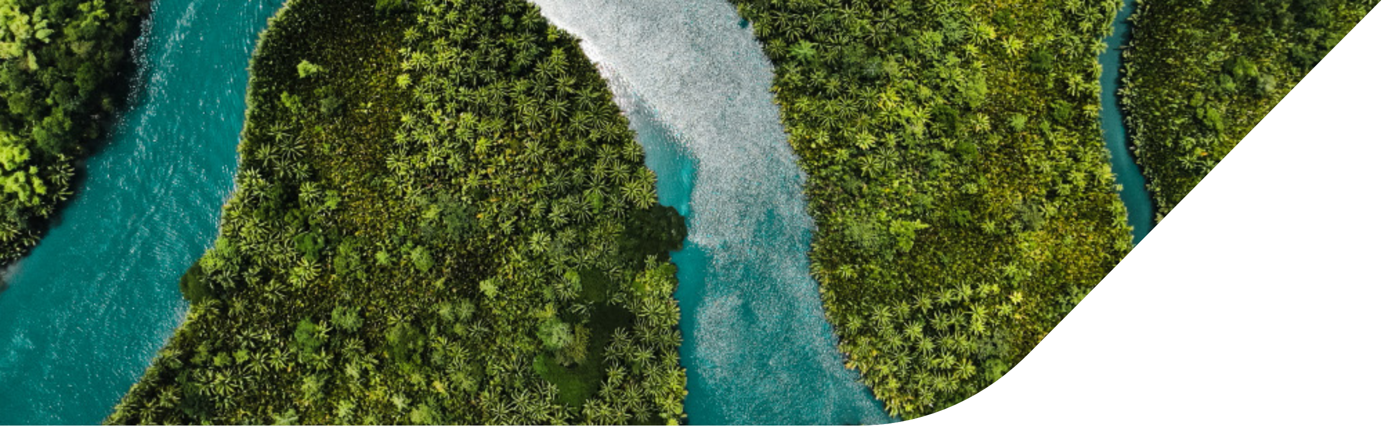
While not new to the regulatory agenda, there were also substantive updates in the BMRQ concerning **money laundering and terrorist financing risk exposures**, with new questions looking at: (i) institutional risk assessment; (ii) senior management oversight; (iii) independent review of AML/CFT systems; (iv) AML/CFT compliance checking; (v) staff training; (vi) outsourcing; (vii) staff integrity; (viii) customer due diligence; (ix) sanctions screening; and (x) transaction monitoring and suspicious transaction reporting. Furthermore, more **client, transaction, and compliance data** will be required from licensed corporations. The introduction of questions that mirror the areas discussed in the SFC's Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (For Licensed Corporations) indicates to us that the SFC remains very invested in closely monitoring market participants' risk exposures.

ESG

The Year of the Rabbit will see developments in both international and domestic ESG frameworks, with climate risk management remaining high on the regulatory agenda. However, numerous challenges exist, including instances of greenwashing (whether in products or carbon markets), the lack of a universal framework for disclosure and reporting and classification systems/an absence of regulations on ESG ratings, concerns regarding data – specifically its reliability and comparability – and relatively nascent (albeit fast evolving) disclosure and reporting regimes, all of which make this a regulatory focus worldwide. There is no doubt that regulators, including in Hong Kong, are focusing on protecting the credibility of this nascent market segment and helping steer private capital into "green" initiatives.

While the "E" of ESG is now relatively mainstream, we anticipate greater regulatory focus on the "S" and the "G" of ESG in the Year of the Rabbit, as social, political and cultural attitudes continue to evolve. There is now greater recognition that **governance** risks and opportunities in decision-making are critical, and regulators have introduced rules and regulations for fund managers and listed companies concerning transparency/disclosure requirements under both the revised Fund Manager Code

2 SFC (4 March 2023): https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/licensing/doc?refNo=22EC18
3 SFC (November 2022): https://apps.sfc.hk/edistributionWeb/api/consultation/openFile?lang=EN&refNo=22CP4



of Conduct[4] and Corporate Governance Code[5], both of which allow investors to screen for appropriate governance practices. In Hong Kong, the Fund Manager Code of Conduct has been amended in order to require certain fund managers (those that manage collective investment schemes) to consider climate-related risks within their own investment and risk management processes, with one of the four key elements being governance[6]. Several baseline requirements in relation to the board and management's roles and responsibilities are expected to be observed by a fund manager, including oversight by the board of progress against goals for addressing issues relating to the climate.

Moreover, the updated Corporate Governance Code (the **CG Code**), which came into effect on 1 January 2022[7], for listed issuers has a number of changes including: (i) requirements that company culture align with the company's purpose, values and strategy; (ii) requirements on board diversity; and (iii) a requirement that the ESG reports are published at the same time as annual reports. The CG Code also emphasises the board's responsibility for oversight and effective governance in relation to ESG risks. Similarly, the HKMA's Supervisory Policy Manual (**SPM**) GS-1 (the **SPM GS-1**)[8], which was implemented in the Year of the Tiger, set out what was expected of senior management and the board of authorized institutions (**AIs**) in relation to climate-related risks. We take the view that a well-planned governance structure will be a good foundation for growth and support organisational purpose, values and strategy, as well as mitigate against greenwashing. It is therefore crucial to consider carefully the role and the makeup of the boards of directors, shareholders' rights and how corporate performance is measured.

Amid the continuing changes in the ESG space, and the recent call to action by the International Organization of Securities Commissions (**IOSCO**) to promote good practices to counter the risk of **greenwashing**[9], we expect that regulators and industry associations will continuously remind the market of the need to adopt the good practices suggested by IOSCO to combat the risk of greenwashing. One example is the recent release[10] by the HKMA of recommendations for AIs in relation to "*the development and ongoing management of [its] green and sustainable products…*" with the aim of ensuring that funds and products are managed in a way that is consistent with the AIs' climate strategy. Furthermore, the SFC has also indicated in its Agenda for Green and Sustainable Finance (published in August 2022) (the **Agenda**)[11] that it will continue to monitor global developments and international regulatory development trends, to engage with stakeholders, and to consider ways to address existing concerns (i.e. on data availability and reliability etc. with respect to disclosure).

The SFC also noted in the Agenda that in respect of corporate **disclosures**, it was strongly aligned with IOSCO's approach – which has been to work closely with the International Financial Reporting Standards Foundation, supporting the launch of International Sustainability Standards Boards **(ISSB)**, and the publication of ISSB's two Exposure Drafts.

The SFC further notes in the Agenda that if the ISSB standards meet the IOSCO Board's expectations, the standards will be endorsed for IOSCO's 130 market regulators. The SFC further expresses that it would continue to support ISSB's work and work on sustainability

4 SFC – Fund Manager Code of Conduct (Fourth Edition) (August 2022): https://www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/codes/fund-manager-code-of-conduct/Fund-Manager-Code-of-Conduct_Eng_20082022.pdf?rev=9aae7a8541054823b7f4626749e56cf8

5 HKEX – Corporate Governance Code: https://www.hkex.com.hk/-/media/hkex-market/listing/rules-and-guidance/listing-rules-contingency/main-board-listing-rules/appendices/appendix_14

6 SFC – Circular to licensed corporations Management and disclosure of climate-related risks by fund managers (20 August 2021): https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/doc?refNo=21EC31

7 HKEX – Exchange Publishes Conclusions on Review of Corporate Governance Code – (10 Dec 2021): https://www.hkex.com.hk/News/Regulatory-Announcements/2021/211210news?sc_lang=en

8 HKMA – SPM GS-1 (30 December 2021): https://www.hkma.gov.hk/media/chi/doc/key-functions/banking-stability/supervisory-policy-manual/GS-1.pdf

9 IOSCO – IOSCO Good Sustainable Finance Practices For Financial Markets Voluntary Standard Setting Bodies and Industry Associations (7 November 2022): https://www.iosco.org/library/pubdocs/pdf/IOSCOPD717.pdf

10 HKMA – Due diligence processes for green and sustainable products (9 December 2022): https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2022/20221209e3.pdf; and

HKMA – Due Diligence Processes for Green and Sustainable Products Annex (9 December 2022): https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2022/20221209e3a1.pdf

11 https://www.sfc.hk/-/media/EN/files/COM/Reports-and-surveys/SFC-Agenda-for-Green-and-Sustainable-Finance_en.pdf

disclosures generally. It furthermore noted it would continue its work with the Stock Exchange of Hong Kong (**SEHK**) on a global baseline standard aligned (i.e. the ISSB) approach to corporate disclosures.

Whilst there is a question about the timing it would be prudent for intermediaries and listed companies to take note that the ISSB will finalise its climate standards during the Year of the Rabbit (potentially by June). As noted by SEHK in November 2022, "*issuers should get familiar with the climate disclosure requirements under the ISSB climate standards and identify gaps in internal policies and practices*." [12]

Moreover, ESG **taxonomies** have been developing in the region and we expect them to play an increasingly central role, as a means by which governments, regulators, financial institutions and other market participants can assess and classify activities and products. Hong Kong does not yet have its own taxonomy, but following the update of the Common Ground Taxonomy (**CGT**) in June 2022, the Green and Sustainable Cross-Agency Steering Group (the **Steering Group**) has indicated[13] that it aims to release for consultation a proposed structure for a Hong Kong taxonomy framework. In particular, there is a desire for a local taxonomy framework to become the focal point of communication when it comes to taxonomy, fragmentation and interoperability issues, by allowing the Mainland and European taxonomies to become more interoperable (focusing specifically on the 70% non-common grounds of the CGT).

We wait to see how such a local taxonomy framework will operate, and how it may help to harmonise the two taxonomies and shape the future discussion on the investments classification. Firms will need to take note of developments during the course of the year and consider how they might impact any existing internal and external taxonomies that are being relied upon.

Carbon Markets: Further Developments and Regulation Ahead?

"Carbon markets have a big role to play in moving us to net zero, but they must be made efficient, liquid and free from conflicts of interests and undue political interference."[14]

IOSCO Chairman Mr Jean-Paul Servais, on stage at COP27

The Year of the Tiger saw significant developments in international financial centres and markets, including Hong Kong, with regard to carbon markets. The Carbon Market Workstream (**CMWS**) (part of the Steering Group) conducted a preliminary feasibility assessment (the **Feasibility Assessment**)[15] of carbon market opportunities for Hong Kong, including exploring the pros and cons of several proposed business models. It concluded that a link with the Mainland markets is needed in order to develop a sizable carbon market locally, which would also facilitate capital flows into the Mainland's carbon markets.

The CMWS further concluded that it would collaborate with relevant authorities and stakeholders to establish the Greater Bay Area (**GBA**) Unified Carbon Market (the **GBA Market**), and explore how international investors can link up with the GBA Market and Mainland China's Emissions Trading Scheme. We expect exciting new developments in the very near future regarding the GBA and Hong Kong's role in facilitating access to Mainland China's carbon markets. Most likely, the CMWS will publish a detailed roadmap, implementation plan and indicative timeline, while the SFC will focus on identifying the appropriate regulatory frameworks for the various proposed business models.

In addition, in July 2022, the Hong Kong Exchanges and Clearing Limited (the **HKEX**) launched the Hong Kong International Carbon Market Council with a view to developing an international carbon market in Hong Kong, and in late October 2022 the HKEX announced the launch of an on-exchange voluntary carbon market (**VCM**) named "Core Climate"[16]. The aim of Core Climate is to facilitate the trading of carbon credits and instruments, acting as a one-stop shop for trading, custody and settlement functions.

12 HKEX – 2022 Analysis of ESG Practice Disclosure (November 2022): https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Environmental-Social-and-Governance/Reports-on-ESGPD/esgreport_2022.pdf

13 HKMA – Cross-Agency Steering Group announces launch of information and data repositories and other progress in advancing Hong Kong's green and sustainable finance development (21 June 2022): https://www.hkma.gov.hk/eng/news-and-media/press-releases/2022/06/20220621-5/

14 IOSCO – IOSCO outlines regulatory priorities for sustainability disclosures, mitigating greenwashing and promoting integrity in carbon markets (9 November 2022): https://www.iosco.org/news/pdf/IOSCONEWS669.pdf

15 HKMA – Carbon Market Opportunities for Hong Kong Preliminary Feasibility Assessment (March 2022): https://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2022/20220330e3a1.pdf

16 HKEX – HKEX Launches Core Climate, Hong Kong's International Carbon Marketplace, supporting Global Transition to Net Zero (28 October 2022): https://www.hkex.com.hk/News/News-Release/2022/221028news?sc_lang=en

It is currently the only carbon marketplace that offers HKD and RMB settlement for the trading of international voluntary carbon credits. In a show of strong market reception, the HKEX announced in late November 2022 that over 400,000 tonnes of carbon credits had been traded since its launch[17].

The Feasibility Assessment suggests that VCMs can be regulated either under the ambit of the Securities and Futures Ordinance[18] (the **SFO**) or under a separate carbon products regime. The Financial Services Development Council (the **FSDC**) recently stated that VCMs should be regulated[19] – comparing them to the stocks and futures trading market. Further studies and consultations on this matter will likely follow and we anticipate greater clarity during the course of the year on whether, how and by whom Core Climate might be regulated. An appropriate regulatory regime would likely be necessary to uphold the integrity of any existing (or future) carbon credit market, though flexibility will likely be required at this nascent stage of market development.

Crypto-assets in 2023 – the end of the Crypto-Winter?

As Ms. Julia Leung (Chief Executive Officer as of 1 January 2023) of the SFC noted in a keynote address[20] during Hong Kong Fintech Week 2022 –

"*The crypto community has long believed that regulation inhibits innovation, limiting Fintech development and thus investor choice. But this belief was shaken by the collapse of Luna and Terra in May, followed by the bankruptcy of Three Arrows and suspended withdrawals by crypto lending platforms… Bringing crypto asset service providers into the regulatory fold is the only pathway to embrace innovation*."

The subsequent collapse of FTX has reinforced this position, with more investors querying the future of crypto-assets and supporting greater regulation of the industry.

Despite these events, we do not expect Hong Kong to abandon its ambition to be a crypto-hub and its openness towards virtual asset (**VA**) businesses, within appropriate regulatory frameworks. We expect the Financial Services and the Treasury Bureau and the Government of the Hong Kong Special Administrative Region of the People's Republic of China (**HKSARG**) (together with the financial regulators) to continue to work towards providing a facilitating environment to promote the VA industry's sustainable and responsible development. The Financial Secretary made this clear in a blog post in November 2022, stating that: "*[t]he policy statement we issued has laid a foundation for cultivating such environment, and has kindled the industry's good hopes for the development of the VA market in Hong Kong*."[21] Three pilot projects were also announced as part of the Policy Statement on Development of VAs in Hong Kong (the **Policy Statement**)[22]: (i) a non-fungible token (commonly known as an NFT) issued to Hong Kong Fintech Week 2022 participants; (ii) the tokenisation of institutional government green bonds (which has, as the HKMA recently announced, culminated in the offering of HKD800 million in tokenised green bond - with a white paper that will be published in due course laying out next steps, a blueprint, and also summarising what was learnt from the experience[23]); and (iii) the potential future launch of the retail central bank digital currency (**rCBDC**) – e-HKD (as discussed below). We have already seen developments in 2023 also, with the Hong Kong Monetary Authority (the **HKMA**) publishing a roadmap for regulating stablecoins – see below.

17 HKEX – Early Momentum for Core Climate, Hong Kong's New International Carbon Marketplace (24 November 2022): https://www.hkex.com.hk/News/News-Release/2022/2211242news?sc_lang=en

18 Cap. 571, Laws of Hong Kong.

19 FSDC – Road to Carbon Neutrality: Hong Kong's Role in Capturing the Rise of Carbon Market Opportunities (2 February 2023): https://www.fsdc.org.hk/en/insights/road-to-carbon-neutrality-hong-kong-s-role-in-capturing-the-rise-of-carbon-market-opportunities

20 Julia Leung (31 October 2022): https://www.sfc.hk/-/media/EN/files/COM/Speech/HKFW-Speech---Eng_20221031.pdf?rev=34b90c7d8dce42ad9215da652cd77dc5&hash=E11F1164D81137053A27C6CEEFACE9D3

21 Financial Secretary of the HKSARG – Taking forward the virtual asset industry development in Hong Kong steadily and prudently (13 November 2022): https://www.fso.gov.hk/eng/blog/blog20221113.htm

22 FSTB – the Policy Statement (31 October 2022): https://gia.info.gov.hk/general/202210/31/P2022103000454_404805_1_1667173469522.pdf

23 HKMA – HKSAR Government's Inaugural Tokenised Green Bond Offering (16 February 2023): https://www.hkma.gov.hk/eng/news-and-media/press-releases/2023/02/20230216-3/#:~:text=Building%20on%20Project%20Genesis%20concluded,and%20realisation%20of%20the%20full

In the Year of the Rabbit, we will see the implementation of the Anti-Money Laundering and Counter-Terrorist Financing (Amendment) Bill 2022 (the **2022 Amendment Bill**), which will introduce, among other things, a licensing regime for virtual asset service providers (**VASP**) (to take effect on 1 June 2023). Interest in the VASP licensing regime is growing rapidly, and as anticipated, the SFC has initiated a consultation on 20 February 2023[24] on the proposed regulatory requirements for VA trading platform operators. Input should be submitted to the SFC on or before 31 March 2023. Most significantly, the SFC indicated that all investors (including retail investors) could access a licensed VA trading platform operator's trading services, if certain investor protection measures are implemented. Some of the investor protection measures include onboarding requirements (i.e. to assess the risk tolerance level and profile of a client, and to determine the client's suitability for the participation in the trading of VAs), governance requirements (i.e. to set up a token admission committee to establish the admission criteria of tokens for trading), disclosure requirements (i.e. disclosing to clients sufficient product information), and insurance/compensation arrangement requirements (which propose that such arrangement could include the use of both third-party insurance and/or funds set aside on trust and designated for said purpose). The SFC is also, among other things, seeking feedback on the transitional arrangements to be implemented for existing VA trading platforms.

The 2022 Amendment Bill also introduced a number of offences that intermediaries that plan to deal in VAs should take note of, some of which come into effect in April, ahead of the licensing regime in June (e.g. to fraudulently or recklessly induce others to invest in VAs). One offence to highlight is the prohibition on issuing advertisements relating to an unlicensed person's provision of a VA service. We expect that this offence will be applied in a similar manner to section 109 of the SFO where advertisements (both the issuance and possession of) would be in scope, regardless of whether targeted at professional investors or the public of Hong Kong.

As in recent years (and noted in our 2022 Christmas update[25] on crypto-assets), the SFC will continue to enhance existing regimes, provide guidance on them, and propose and/or consult on new regimes as crypto-assets become more prevalent, and where regulatory attention is warranted. In October, the SFC released further guidance in a Circular on Virtual Asset Futures Exchange Traded Funds (**VAETFs**)[26], setting out the SFC authorisation requirements for the public offering of VAFETFs. We expect increased availability to be the key to such products during the Year of the Rabbit ahead.

We are cautiously optimistic that crypto-assets, if properly regulated, could thrive in Hong Kong.

Stablecoins – Soon to Be Regulated

A welcome early development in the Year of the Rabbit is the HKMA's conclusions in response to market feedback on its crypto-assets and stablecoins discussion paper (the **Stablecoin Conclusion Paper**) (released 31 January 2023)[27]. The HKMA has published proposed key parameters for a stablecoin licensing regime (the **Proposed Stablecoin Regime**). The common theme of the Proposed Stablecoin Regime is the adoption of a risk-based approach, for example when considering the priority of which stablecoins and which activities to regulate. We believe this would be the right first step in order to properly allocate resources to mitigate the most relevant and significant risks.

Among the things so far concluded have been the: (i) scope of the Proposed Stablecoin Regime; (ii) core regulatory requirements; and (iii) approximate timeline of implementation of the Proposed Stablecoin Regime.

In terms of which stablecoins to regulate, the HKMA's chose to focus on stablecoins that purport to reference one or more fiat currencies. This choice is premised on the specific stablecoins linkage with the traditional financial system and the likely payments use that would, in comparison to other stablecoins or crypto-assets, create a more imminent and higher financial stability and monetary risk.

On which activities to regulate, the initial focus is on critical functions such as: (i) governance; (ii) issuance; (iii) stabilisation; and (iv) wallets. The HKMA further noted that licences would have to be obtained in three main scenarios, where the entity: (i) conducts a regulated activity in Hong Kong; (ii) actively markets a regulated activity to the public of Hong Kong; and, most significantly, (iii) conducts a regulated activity that concerns a stablecoin that purports to reference the value of the Hong Kong dollar[28].

24 SFC – Consultation Paper on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the Securities and Futures Commission (20 February 2023): https://apps.sfc.hk/edistributionWeb/api/consultation/openFile?lang=EN&refNo=23CP1

25 See our recent article on crypto assets – Catching lightning in a bottle: Regulatory developments concerning crypto assets in Hong Kong, Singapore and Australia (20 December 2022): https://www.allenovery.com/en-gb/global/news-and-insights/publications/catching-lightning-in-a-bottle-regulatory-developments-concerning-crypto-assets-in-hong-kong-singapore-and-australia

26 SFC – Circular on Virtual Asset Futures Exchange Traded Funds (31 October 2022): https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/products/product-authorization/doc?refNo=22EC60

27 HKMA – Conclusion of Discussion paper on Crypto-assets and Stablecoins (January 2023): https://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2023/20230131e9a1.pdf

28 This is regardless of whether the regulated activity is conducted in Hong Kong or actively marketed to the public of Hong Kong.

There will be a further consultation on specific regulatory requirements, but the HKMA has already indicated a few crucial elements to the Proposed Stablecoin Regime. Some of these include requirements on ownership, and financial resources, to have the full backing of outstanding stablecoins (through reserve assets), the ability to redeem stablecoins at par, and also a restriction on the deviation of regulated entities from their principal business.

While the Stablecoin Conclusion Paper provides us with much detail of the Proposed Stablecoin Regime, there are still things to be decided, such as whether the changes should be implemented by a standalone law or via amendment to existing legislation, such as the Payment Systems and Stored Valued Facilities Ordinance[29], and whether a local incorporation requirement would be required. The HKMA also proposes to build flexibility into the licensing regime to ensure that other future stablecoin structures and entities, can be brought within the ambit of the Proposed Stablecoin Regime in the future. As the HKMA has indicated, we can expect the Proposed Stablecoin Regime to be implemented by 2023/24, with the regulatory approach to become clearer later this year.

Central Bank Digital Currency (CBDC) – further testing and implementation

The decline in the use of cash and the growth of new forms of money outside the remit of existing regulatory frameworks have led to calls for the introduction of digital versions of traditional paper currency, CBDCs. An article published by the World Economic Forum[30] confirmed the growing trend and calls for the use of CBDCs, setting out three key arguments: (i) that public money plays a special role in financial markets, as the anchor of the monetary system, and that CBDCs (as "public money") would help to ensure the continuation of the monetary system; (ii) that CBDCs help preserve control by the central banks over their currencies, and therefore over monetary policy and financial stability; and (iii) CBDCs help preserve privacy, being a public form of money where private enterprises cannot obtain user data through the use of "private money" digital payments (i.e. compared to the use of credit cards).

There has been significant developments regarding CBDCs in recent years – both with regard to wholesale CBDCs (**wCBDC**) and rCBDCs. On the rCBDC front, the HKSARG and the HKMA take the view that crypto-currencies and VAs cannot serve as legal tender and see the launch of a potential rCBDC (e-HKD) as filling this space[31]. The HKMA has already taken a step towards the potential implementation of an rCBDC in Hong Kong, releasing a positively disposed position paper[32] in September 2022, concluding that there was a necessity for paving the way for the implementation of e-HKD.

Given the ambition for e-HKD to be a "*potential 'backbone' and anchor bridging legal tender and VA*"[33], we expect to see further steps towards the implementation of the HKMA's approach in the Year of the Rabbit.

In Mainland China, as predicted in our Year of the Tiger update, e-CNY has continued to go from strength to strength and is being promoted across the entirety of Mainland China. Use on a trial basis, in December 2022, has been further expanded to other locations also (such as Jinan and Kunming; totaling 26 locations), and has been further promoted on a provincial level. Furthermore, digital payment platforms have also joined the e-CNY acceptance network, with Alipay joining in December 2022 – meaning that Alipay connected platforms (like Taobao) all now accept payments in e-CNY[34]. We expect to see further use of e-CNY locally in the very near future, with more merchants, banks and users adopting e-CNY. As recently as February 2023, Bank of China launched the second phase of its pilot use of e-CNY in Hong Kong, expanding the registration quota for more users after a well-received response to its initial launch in December 2022[35].

On the wCBDC front, between 15 August and 23 September 2022, the HKMA, undertook a trial of mBridge Ledger, a new

29 Cap. 584, Laws of Hong Kong.
30 World Economic Forum – Here's how central bank digital currencies impact the global economy (9 November 2022): https://www.weforum.org/agenda/2022/11/digital-currency-world-bank-cash
31 See Footenote 22 above.
32 HKMA – e-HKD – Charting the Next Steps (September 2022): https://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2022/20220920e4a1.pdf
33 See Footnote 22 above.
34 China Daily – Digital yuan continues domestic march (27 December 2022): https://www.chinadaily.com.cn/a/202212/27/WS63aa2668a31057c47eba6406.html
35 Bank of China (Hong Kong) Limited – BOCHK launches second phase of e-CNY Exclusive Experience by offering a further 1,600 trial quotas (1 February 2023): https://www.bochk.com/dam/bochk/desktop/top/aboutus/pressrelease2/2023/20230201_02_Press_Release_EN.pdf

central bank built blockchain platform, which supports CBDC-based real-time, peer-to-peer and cross-border payments and foreign exchange (**Fx**) transactions. Project mBridge was conducted in collaboration with the Bank for International Settlements Innovation Hub Hong Kong Centre and three other central banks (the Bank of Thailand, the Digital Currency Institute of the People's Bank of China and the Central Bank of the United Arab Emirates).[36]

Project mBridge involved 20 banks in four jurisdictions and HKD171m in payment and Fx transactions (involving multiple CBDCs across different currencies). This was one of the first multi-CBDC projects involving settlement on behalf of corporates, on a real-time basis, of cross-border transactions.[37] These developments are likely to change the landscape of cross-border payments, which have been traditionally been high cost, low efficiency and involved many intermediaries. However, there are still legal questions and challenges to be addressed, given that each jurisdiction has its own rules and regulations, not least concerning the legal categorisation of a CBDC – whether it is a currency, a debt or something else. The conclusions may result in legislative changes, but we expect this will become apparent during the course of the year.

Hong Kong: a Super Connector and a Risk Management Platform

Hong Kong faced strong headwinds in the Year of the Tiger, but it was a year that also saw investments that will come to fruition in the Year of the Rabbit.

With the backing of national policies, Hong Kong remains focused on its role as a super connector for onshore and offshore capital markets. Throughout the Year of the Tiger, Hong Kong continued to prepare diligently for the introduction of various connect schemes. Developments thus far were summarised by Mr. Eddie Yue, Chief Executive of the HKMA, in September 2022:

"First, the suite of mutual market access schemes was expanded in 2021 with the introduction of Southbound Trading under Bond Connect and Wealth Management Connect, and again this year with ETF Connect and Swap Connect. These schemes demonstrate the significant and ever-growing role Hong Kong plays in the two-way opening up of Mainland financial markets. Earlier this month, the China Securities Regulatory Commission announced three new initiatives to strengthen mutual access between Mainland and Hong Kong financial markets. These are, first, broadening the scope of Stock Connect to include foreign companies with primary listings in Hong Kong and more companies listed on the Shanghai and Shenzhen stock exchanges; second, development of an RMB- securities trading counter in Hong Kong and possible inclusion of RMB securities in Southbound Trading via Stock Connect; and third, the introduction of Mainland government bond futures in Hong Kong. These measures will enrich the investment choices for Mainland investors, attract more foreign companies to list in Hong Kong, and provide more offshore risk management tools to meet global investors' hedging needs[38]."

The steady expansion of the connect schemes illustrates the continued importance of Hong Kong and its relationship with Mainland China and how risk management remains of central importance to the operation of the various schemes and their continued success today. Risk management is not limited to considering how the schemes itself would impact respective markets (e.g. by way of quotas, circuit breakers, and scope of products), but includes how the schemes can serve the role of a risk management tool for the market (e.g. the Swap Connect, for the interest rate swap markets).

Enforcement

While we have seen changes in the SFC's senior management – most significantly, Ms. Julia Leung, former Deputy Chief Executive Officer, appointed to Chief Executive Officer from January 2023[39], and the appointment of Mr Christopher Wilson as the Executive Director for Enforcement in November 2022[40] – we expect the SFC's enforcement agenda and approach to remain consistent, with a focus on market risk and investor protection.

36 Bank of International Settlements Innovation Hub – Project mBridge Connecting economies through CBDC (October 2022): https://www.bis.org/publ/othp59.pdf

37 HKMA – Project mBridge: Successful CBDC project for real-value cross-border payment and foreign exchange transactions (26 October 2022): https://www.hkma.gov.hk/eng/news-and-media/press-releases/2022/10/20221026-3/

38 Eddie Yue, Chief Executive, HKMA – New Impetus for Hong Kong (16 September 2022): https://www.hkma.gov.hk/eng/news-and-media/speeches/2022/09/20220916-1/

39 HKSARG – Appointment of Chief Executive Officer of SFC (15 December 2022): https://www.info.gov.hk/gia/general/202212/15/P2022121500447.htm

40 HKSARG – Appointment of Executive Directors to SFC (29 September 2022): https://www.info.gov.hk/gia/general/202209/29/P2022092900339.htm

Greater Enforcement Powers Ahead: the SFC Consultation

We expect that later this year, the SFC will provide a public response to its consultation[41] from mid-2022 on proposed amendments to enforcement-related provisions of the SFO. Market participants should expect that the Consultation Conclusions will be published this year and a proposed bill introduced.

The objective of the proposals is to allow the SFC to take more effective enforcement action and there are three main proposals – (i) expanding the power of the SFC to apply for order and injunctions against people for suspected breach of the SFC's codes and guidelines; (ii) clarifying that the professional investor (**PI**) exemption would only apply to unauthorised advertisements made to PIs and not the general public; and (iii) expanding the scope of insider dealing provisions under the SFO to cover insider dealing perpetrated in Hong Kong in relation to overseas listed securities or their derivatives, and insider dealing perpetrated outside Hong Kong if Hong Kong-listed securities or their derivatives are involved.

In particular, expanding the SFC's right to judicial relief in situations involving the breach of codes and guidelines has raised questions in the market about whether it would effectively give industry codes and guidelines the force of law. We await the SFC's consultation conclusions and potentially further consultations, to see whether and how the proposals will be implemented.

The Use of Technology – the Use of Supervisory Technology (Suptech)

"We believe the use of innovative technology can help make the delivery of financial services more efficient, robust and cost effective."[42]

Deputy Chief Executive, Executive Director, Intermediaries (as she then was), Ms Julia Leung, delivering a keynote speech at ASIFMA Tech & Ops Conference 2022 on 6 October 2022

With the increased availability and sophistication of complex analytical tools, both the SFC and the HKMA have been increasingly using technological solutions to assist their supervisory and enforcement work.

To date, the SFC has used technology to detect illegal activity and to commence investigations – one example being in the detection of ramp and dump schemes. It has also used network analytics to identify relationships between individuals and listed companies during company misconduct investigations and fit and properness enquiries into individuals[43].

New technologies will undoubtedly make it easiest still to detect future misconduct (which is of itself getting more complex), with the SFC strongly advocating the adoption of artificial intelligence and machine learning in the detection of misconduct[44]. The SFC has developed a big-data and AI-driven data analytics platform to analyse data it receives to identify potential misconduct and systematic control deficiencies[45]. To assist with this, the SFC has required certain in-scope brokers (covering 60% of the Hong Kong market's equities trades[46]) to adhere to certain data standards when submitting trading-related data to the SFC.

41 SFC – Consultation Paper on Proposed Amendments to Enforcement-related Provisions of the Securities and Futures Ordinance (June 2022): https://apps.sfc.hk/edistributionWeb/api/consultation/openFile?lang=EN&refNo=21CP3

42 Julia Leung, Deputy Chief Executive Officer and Executive Director, Intermediaries - Resilience and innovation in times of change (6 October 2022): https://www.sfc.hk/-/media/EN/files/COM/Speech/ASIFMA-Tech-Op-Forum-Oct-22---Eng_20221006.pdf?rev=7e608a8937804e0da80b4e6111ea8ab1&hash=5997FC8296043355E3EE1FCAAA925687

43 Ibid.

44 Julia Leung, Deputy Chief Executive Officer and Executive Director, Intermediaries – Resilience, right conduct and integrity of the wholesale market (28 June 2022): https://www.sfc.hk/-/media/files/ER/PDF/Speeches/20220620ASIFMA-Compliance-2022DCEO-speechFinal-Publish-versionEngl.pdf?rev=6d79ee5e715e4e12ac8ba49d2d9a3106&hash=1FBCFAADC100E578270DDC8A55C54FC7

45 SFC – Circular to licensed corporations Thematic review of Data Standards for Order Life Cycles (22 December 2022): https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/doc?refNo=22EC73

46 See Footnote 44 above.

While the implementation by the HKMA of Suptech is still in its infancy, the SFC took the bold step of setting out a three-year roadmap for adopting Suptech solutions in June 2021[47]. It is clear from the roadmap that the HKMA sees great potential in the use of Suptech as a means of enhancing and streamlining supervisory work and regulatory compliance. The HKMA hopes that eventually any HKMA-directed policy changes will be transmitted automatically to regulated entities, and then automatically implemented into internal regulatory systems with little intervention from humans. The HKMA has also indicated[48] that it will use data analytics in its anti-money laundering (**AML**) work, in order to assess sectoral money laundering risks. Instead of merely benchmarking the AML control systems of banks, granular data will be used to create a clear picture of where and how AML risks emerge, as well as their direction of travel in the banking system. This will help the HKMA provide supervisory responses that are timelier, ultimately helping to reduce and prevent serious harm from being done.

The HKMA's view, which we agree with, is that hardware and software upgrades will not be enough on their own, and that complementary efforts will be required to ensure the success of the Regtech and Suptech journey. This includes encouraging an internal culture shift, and developing soft skills of staff. While intermediaries and other market participants may jump at the potential efficiencies that technology will bring to their compliance and surveillance work, it is clear that there must also be buy-in internally by staff, and suitable training to ensure that the technologies are properly implemented.

Online Platforms

The SFC published a multitude of reviews in the Year of the Tiger, but one report we think intermediaries should prioritise in the Year of the Rabbit (if they have not already done so), and consider against their existing set-up, is the *Report on the review of licensed corporations providing online brokerage, distribution and advisory services,* published in August 2022[49].

The SFC's report identifies a wide range of potential compliance deficiencies posed by online services. Three areas of particular note are: (i) client onboarding; (ii) online trading, distribution and marketing; and (iii) cybersecurity. For (i) and (iii), intermediaries are recommended to go through the SFC's specific samples of deficiencies and non-compliance, to ensure existing practices are adequate (and if they are not, rectify them as soon as possible).

For (ii), deficiencies are mainly concerned with **compliance of suitability obligations**. The issues identified by the SFC were:

- Inappropriate clauses and statements under client agreements and acknowledgement of risk disclosure.
- Insufficient product due diligence.
- Failure to observe selling restrictions or additional regulatory requirements applicable to specific products.
- Inadequate client risk profiling.
- Insufficient or improper disclosure of information to clients.

In relation to each of the issues identified by the SFC, intermediaries ask themselves:

- What are the products and/or services being offered online, and how are they offered?
- At what point during the customer process do suitability obligations, if any, arise?
- How are suitability obligations addressed?
- Is current documentation, including client agreements and risk disclosures, reflective of the actual process, policies and controls in place?

Although the SFC only surveyed 50 intermediaries for its report, the SFC's findings nevertheless serve as good grounds for intermediaries to re-evaluate how suitability is approached in the specific context of their online offerings and to be mindful of the potential deficiencies identified from the review.

Ensuring Compliance in Regulatory Developments of the Year of the Tiger

The Year of the Tiger saw the introduction of a number of new regulatory requirements, and the regulators will, as they always do, now test how well market participants have paid attention. Areas of regulatory audit in the Year of the Rabbit are likely to include:

- Requirements around **bookbuilding and placing activities** in equity and debt capital markets that came into effect in late 2022[50], most notably the updated BMRQ, with new questions on fees split between fixed and discretionary fees for IPOs.

47 HKMA – HKMA's Adoption of Supervisory Technology (June 2021): https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2021/20210617e1a1.pdf

48 Carmen Chu, Executive Director (Enforcement and AML), HKMA - Innovative ways of working AML/CFT: Collaboration powered by data, technology and analytics (13 July 2022): https://www.hkma.gov.hk/eng/news-and-media/speeches/2022/07/20220713-1/

49 SFC (August 2022): https://apps.sfc.hk/edistributionWeb/api/circular/openAppendix?lang=EN&refNo=22EC52&appendix=0

50 SFC – Circular to Intermediaries – Frequently Asked Questions (FAQs) on (i) the Code of Conduct on Bookbuilding and Placing Activities in Equity Capital Market and Debt Capital Market Transactions and (ii) "Sponsor Coupling" (6 May 2022): https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/doc?refNo=22EC37

– **Operational resilience**, in particular in relation to business continuity planning – a suite of SFC circulars[51] was issued in the first quarter of 2022. While issued in the light of disruptions caused by COVID-19, the SFC's expectation that a licensed corporation should maintain appropriate and robust contingency planning "*to prepare for, react quickly to and recover from risk events and shocks*" will not subside with COVID-19[52].
– The **investor identification regime**, which will launch on 20 March 2023[53]. By now, market participants should have in place systems to address the various requirements under the new regime, and should have reviewed their privacy policies to address related privacy considerations.
– **Climate risks and management-related** disclosure – the Year of the Tiger saw the implementation of requirements, introduced by way of **revisions to the Fund Manager Code of Conduct**[54], concerning the incorporation of climate-related risks into investment and risk management processes, along with the requirement to make disclosures.[55] Fund managers in Hong Kong should ensure that they comply with any relevant requirements introduced, pay attention to any thematic reviews from regulators, and conduct routine supervision to monitor the implementation of existing measures. For AIs, the SPM GS-1[56] released at the end of 2021 set out guidance on climate-related risk management, climate-related disclosures (the first Task Force on Climate-Related Financial Disclosures aligned disclosures to be made no later than mid-2023), and the HKMA's expectations and supervisory approach concerning an AI's climate risk management. The HKMA's expectation was that AIs would implement the SPM GS-1 by the end of 2022[57]. This year will likely see the HKMA focus on compliance with the SPM GS-1, in particular on governance.

Conclusion

The Year of the Tiger was a year of challenges but also a year of reflection. The market did not sit idle, with industry bodies such as the Alternative Investment Management Association (the **AIMA**) (together with its members) reflecting on *How Hong Kong can extend its leadership in alternative asset management*[58], and the FSDC proposing ideas for *Cementing Hong Kong's Role as a Premier Private Wealth Management Hub in Asia*[59].

Slowly but surely, with the market's strong commitment, Hong Kong, as it has done numerous times in the past, evolves in light of changing global and market dynamics.

Building on the lessons learnt from the risks and turmoil brought by the Year of the Tiger, the Year of the Rabbit will be a year of evolution, and one that will be bold and ambitious.

We, at Allen & Overy, are excited to see what the New Year holds and to be part of this process. We wish our readers a prosperous year ahead.

51 SFC – Circular to licensed corporations Updates to the reminder of business continuity planning in view of COVID-19 Vaccination Programme (18 February 2022): https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/doc?refNo=22EC12;

SFC – Circular to Licensed Corporations Measures to deal with disruptions caused by financial distress and insufficient responsible officers (4 March 2022): https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=22EC18; and

SFC – Circular to licensed corporations Importance of business continuity planning amidst latest COVID-19 situation (7 March 2022): https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/doc?refNo=22EC21

52 For example, see how the International Organization of Securities Commissions framed its May 2022 publication titled "Operational resilience of trading venues and market intermediaries during the COVID-19 pandemic & lessons for future disruptions": *IOSCO published the consultation report on operational resilience before the conflict in Ukraine began. Recent geopolitical tensions, disruptions to supply chains and energy shortages have challenged the operational resilience of trading venues and market intermediaries. In particular, financial and commodity markets have been volatile and cyber risks have increased. The situation will likely evolve further, highlighting the ongoing importance of operational resilience and maintaining an adaptable approach to operational resilience.* ***The observations and lessons learned in this report should also be relevant to new scenarios, particularly the importance of reviewing, updating and testing business continuity plans, information security risks and maintaining good communication channels between regulators, authorities, regulated entities and third-party service providers to help understand any impact on operational resilience.*** [our emphasis]

53 SFC – Circular to Intermediaries Launch of the Hong Kong Investor Identification Regime (12 December 2022): https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=22EC69

54 See Footnote 4 above.

55 See Footnote 6 above.

56 See Footnote 8 above.

57 HKMA – Supervisory Policy Manual (SPM): GS-1 "climate risk management" (30 December 2021): https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2021/20211230e2.pdf

58 AIMA – Alternatives in Hong Kong Building on the City's Strengths (July 2022): https://www.aima.org/educate/aima-research/alternatives-in-hong-kong.html

59 FSDC – Cementing Hong Kong's Role as a Premier Private Wealth Management Hub in Asia (7 September 2022): https://www.fsdc.org.hk/en/insights/cementing-hong-kong-s-role-as-a-premier-private-wealth-management-hub-in-asia

Contacts

Charlotte Robins
Partner – Hong Kong
Tel +852 2974 6986
charlotte.robins@allenovery.com

Bernita Lun
Associate – Hong Kong
Tel +852 2974 7280
bernita.lun@allenovery.com

Hysan Chan
Associate – Hong Kong
Tel +852 2974 6910
hysan.chan@allenovery.com

CN
CA2302064