

HONG KONG INTRODUCES NEW TYPE 13 REGULATED ACTIVITY

To Our Clients and Friends:

On July 27, 2023, Hong Kong's Securities and Futures Commission ("SFC") published a "Circular on Licensing and Registration of Depositories of SFC-authorized Collective Investment Schemes and Related Transitional Arrangements" (the "**Circular**").^[1] Trustees and custodians of SFC-authorized collective investment schemes (the "**relevant CIS**") will have to be licensed or registered with the SFC for the new Type 13 regulated activity ("**RA 13**") from October 2, 2024.

The Circular should be read in tandem with the soon to be enacted Schedule 11 to the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("**Schedule 11**").^[2] Together, the Circular and Schedule 11 provide guidance on the SFC's expectations regarding RA 13 licensing arrangements.

The new RA 13 regulatory regime intends to remedy what the SFC has previously described as a "patchy" approach to the regulation of depositories, whereby the SFC was unable to directly supervise depositories. Instead, the SFC could only exercise indirect oversight through the requirements under the Product Codes.^[3] The RA 13 regulatory framework was proposed by the SFC in September 2019 to fill this void left by a lack of specific, direct supervision mechanism over trustees and custodians of public funds.^[4] In doing so, the new RA 13 regulatory regime will also align Hong Kong's fund custody framework with international standards; most major jurisdictions (such as the United Kingdom and Singapore) have some form of direct regulatory powers over entities providing trustee, custodian or depositary services for public funds (at a minimum). Viewed broadly, the introduction of RA 13 is also consistent with the SFC's focus on regulating entities providing custody services – for instance, its recent decision to regulate virtual assets custody under its new virtual assets trading platform ("**VATP**") regime by requiring custody be undertaken by a wholly owned subsidiary of a licensed VATP operator.

I. Who needs a RA 13 license?

The amendments made to the Securities and Futures Ordinance ("**SFO**") to introduce RA 13 define it as "providing depositary services for relevant CISs".^[5] In essence, what this means is that trustees and custodians (i.e. depositories as defined under the amendments to the SFO) of a relevant CIS at the "top level" of the custodian chain will be required to be licensed or registered for RA 13 in order to provide the following services:

- the custody and safekeeping of the CIS property, including property held on trust by the relevant CIS ("**CIS Property**"); and
- the oversight of the CIS to ensure that it is operated according to scheme documents.^[6]

In practice, many of these depositaries were not previously supervised by the SFC until the introduction of the new RA 13 regime. This suggests that individuals who will now be required to be licensed to undertake RA 13 activities will be subjected to direct SFC supervision for the first time, and may not be accustomed to being licensed.

II. What are the RA 13 regulatory requirements?

In the table below, we highlight the key regulatory requirements applicable to depositaries licensed for RA 13 (“**RA 13 Depositaries**”):

<p>Capital thresholds</p>	<p>RA 13 Depositaries are required to maintain a paid-up share capital of not less than \$10,000,000 and a liquid capital of not less than \$3,000,000.[7]</p>
<p>Treatment of Scheme Money</p>	<p>RA 13 Depositaries that hold or receive scheme money under a relevant CIS (“Scheme Money”) must deposit such Scheme Money into segregated and designated trust accounts or client accounts within three business days after receipt. Each segregated account must be established and maintained for one relevant CIS only.[8]</p> <p>RA 13 Depositaries must not pay Scheme Money out of the segregated account unless such payment is (i) instructed in writing, or (ii) for the purpose of meeting payment, distribution, redemption settlement, or margin requirements, or (iii) to settle any charges or liabilities on behalf of the relevant CIS, as per the scheme documents.[9]</p>
<p>Treatment of Scheme Securities</p>	<p>Similarly, an RA 13 Depositary must deposit client securities which it holds or receives when providing depositary services (“Scheme Securities”) into a segregated and designated trust account or client account. Alternatively, the RA 13 Depositary can register the Scheme Securities in the name of the relevant CIS.[10]</p> <p>An RA 13 Depositary can only deal with Scheme Securities in accordance with written instructions or scheme documents. It must take reasonable steps to ensure that Scheme Securities are not otherwise deposited, transferred, lent or pledged.[11]</p>
<p>Record keeping obligations</p>	<p>In line with the record keeping requirements generally applicable to licensed intermediaries, RA 13 Depositaries are required to keep accounting, custody and other records to sufficiently explain and reflect the financial position and operation of the business, and support accurate profits and loss or income</p>

	statements. Specifically, RA 13 Depositaries must also account for all relevant CIS Property, and make sure that its accounting systems can trace all movements of relevant CIS Property.[12]
OTCD reporting	RA 13 Depositaries are exempted from reporting specified over-the-counter (“ OTC ”) derivative transactions to the Hong Kong Monetary Authority (“ HKMA ”) when acting as a counterparty to the OTC derivative transaction.[13] Similarly, authorized institutions need not report the OTC derivative transaction to the HKMA if the counterparty of the transaction is an RA 13 Depositary acting in its capacity as a trustee of the relevant CIS.[14]

Further, the SFC has previously clarified that the Managers-In-Charge (“**MIC**”) requirements under the current licensing framework extend to RA 13 licensees.[15]

III. Are there any additional requirements applicable to specific classes of RA 13 Depositaries?

Schedule 11 sets out additional requirements applicable to specific classes of RA 13 Depositaries. In the table below, we summarize the key requirements applicable to RA 13 Depositaries authorized under the Code on Unit Trusts and Mutual Funds[16] and Code on Pooled Retirement Funds (“**UT/RF RA 13 Depositaries**”).[17] These are mostly RA 13 Depositaries operating Chapter 7 Funds (i.e. plain vanilla funds investing in equity and/or bonds), specialized schemes (such as hedge funds, listed open-ended funds), and pooled retirement funds.

Appointment and oversight of delegates or third parties	<p>UT/RF RA 13 Depositaries should establish internal control policies and procedures to oversee appointed delegates or third parties. These internal control policies and procedures should cover the following:</p> <ul style="list-style-type: none"> • the selection of a delegate or third party, including assessment procedures and criteria on the delegate or third party’s competence, regulatory and financial status, capabilities and the effectiveness of their internal controls and systems; • ongoing and regular monitoring of the delegate or third party to ensure compliance with regulatory requirements and maintenance of effective internal controls and systems; and • management of actual or potential conflicts of interests arising from the appointment and oversight of delegates or third parties (where applicable).
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	<p>UT/RF RA 13 Depositories should also establish appropriate contingency plans to cater for instances of breaches or insolvency of these delegates or third parties.[18]</p>
<p>Oversight of the relevant CIS</p>	<p>UT/RF RA 13 Depositories should have oversight over the operations of the relevant CIS, and ensure that the CIS is operated or administered in accordance with the relevant constitutive documents.[19]</p>
<p>Subscription and redemption</p>	<p>UT/RF RA 13 Depositories should monitor the relevant operators of each CIS to ensure (among other things):</p> <ul style="list-style-type: none"> • timely processing of subscription and redemption transactions; • execution of subscription and redemption orders in accordance with the constitutive documents of the relevant CIS; • timely deposits of subscription and redemption proceeds into a segregated bank account designated as a trust account or client account holding relevant CIS Property; • reconciliation of subscription and redemption, and that the frequency of such reconciliation is consistent across subscription and redemption; and • proper documentation of reasons for (i) suspension of dealing of unit or shares of the relevant CIS, and (ii) suspension of valuation, price or net asset value calculations of the relevant CIS.[20]
<p>Distribution payments</p>	<p>UT/RF RA 13 Depositories should supervise the relevant operators of each CIS to ensure that:</p> <ul style="list-style-type: none"> • distributions are calculated in accordance with the constitutive documents of the relevant CIS; and • complete and accurate distribution payments are made on a timely basis. <p>With respect to each relevant CIS, UT/RF RA 13 Depositories should ensure that distribution proceeds are transferred according to the operator’s instruction on a timely basis into a designated and segregated or omnibus bank account.[21]</p>

<p>Custody and safekeeping of CIS Property</p>	<p>UT/RF RA 13 Depositories can adopt the safeguards to ensure the safekeeping of CIS Property:</p> <ul style="list-style-type: none"> • assess and manage custody risk by making adequate organisational arrangements to minimise the risks of loss of the CIS Property; • register the CIS Property in the name of the UT/RF RA 13 Depository; • verify ownership of the CIS Property using reliable sources; • maintain updated and comprehensive records of the CIS Property; and • ensure reconciliation is carried out daily for CIS Property in cash form.[22]
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Notwithstanding the above, there are specific requirements applicable to RA 13 Depositories authorized under the Code on Real Estate Investment Trusts (“**REIT RA 13 Depositories**”).[23] These are RA 13 Depositories operating closed-ended funds primarily investing in real estate. REIT RA 13 Depositories are under a fiduciary duty to hold assets of Real Estate Investment Trusts (“**REIT**”) on trust for the benefit of the unitholders of the REIT. While the requirements applicable to UT/RF RA 13 Depositories summarized above are generally applicable to REIT RA 13 Depositories, Schedule 11 tailors some of these requirements to account for the unique features and product structure of REITs. The key modifications are summarized as follows:

<p>Cash flow monitoring and cash reconciliation</p>	<p>Under the Code on Real Estate Investment Trusts (“REIT Code”), the management company of a REIT bears the obligation to manage cash flows. Schedule 11 modifies the custody requirements – which require UT/RF RA 13 Depositories to carry out cash reconciliation of CIS Property daily – to instead require REIT RA 13 Depositories to ensure that the management company has put in place proper cash flow management policies and controls, and supervise the implementation of such policies and controls.</p>
<p>Custody and safekeeping of CIS Property</p>	<p>REIT RA 13 Depositories should ensure that all REIT assets (including the title documents of REIT-owned real estate) are properly segregated and held for the benefit of the unitholders in accordance with the REIT Code and the constitutive document of the REIT.</p> <p>Where the REIT RA 13 Depository considers it in the interests of the REIT for certain assets of the REIT to be held by the management company on behalf of</p>

the REIT, the REIT RA 13 Depository should make sure that the management company has established proper safeguards and controls to properly segregate REIT assets. Additionally, the REIT RA 13 Depository must maintain on-going oversight and control over the relevant assets.

IV. What are the next steps?

The SFC has begun accepting licensing applications for RA 13 since July 27, 2023. Depositories are reminded to submit RA 13 applications on or before November 30, 2023. The RA 13 regime will take effect on October 2, 2024.

[1] “*Circular on Licensing and Registration of Depositories of SFC-authorized Collective Investment Schemes and Related Transitional Arrangements*” (July 27, 2023), published by the SFC, available at <https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=23EC32>

[2] The final text of Schedule 11 can currently be found at Appendix C, “*Consultation Conclusions on Proposed Amendments to Subsidiary Legislation and SFC Codes and Guidelines to Implement the Regulatory Regime for Depositories of SFC-authorized Collective Investment Schemes*” (March 24, 2023), published by the SFC, available at <https://apps.sfc.hk/edistributionWeb/api/consultation/conclusion?lang=EN&refNo=22CP1>

[3] Namely, the Code on Unit Trusts and Mutual Funds, the Code on Open-Ended Fund Companies, the Code on Real Estate Investment Trusts, and the Code on Pooled Retirement Funds.

[4] “*Consultation Paper on the Proposed Regulatory Regime for Depositories of SFC-authorized Collective Investment Schemes*” (September 27, 2019) (“**2019 Consultation Paper**”), published by the SFC, available at <https://apps.sfc.hk/edistributionWeb/api/consultation/openFile?lang=EN&refNo=19CP3>

[5] Section 3, “*Securities and Futures Ordinance (Amendment of Schedule 5) Notice 2023*” (March 20, 2023), available at <https://www.gld.gov.hk/egazette/pdf/20232712/es22023271262.pdf>

[6] “Scheme document” refers to (i) the trust deed constituting or governing the relevant CIS if the CIS is constituted in the form of a trust, (ii) the documents governing the formation or constitution of the relevant CIS if the CIS is constituted in any other form other than a trust, or (iii) other documents setting out the requirements relating to (a) the custody and safekeeping of any CIS Property, or (b) the oversight of the operations of the relevant CIS.

[7] Amended Schedule 1 of the *Securities and Futures (Financial Resources) Rules*, set out under section 10 of the “*Securities and Futures (Financial Resources) (Amendment) Rules 2023*” (March 20, 2023), available at <https://www.gld.gov.hk/egazette/pdf/20232712/es22023271256.pdf>

[8] Amended rule 10B of the *Securities and Futures (Client Money) Rules*, set out under section 7 of the “*Securities and Futures (Client Money) (Amendment) Rules 2023*” (“**CMR Amendment Rules**”) (March 20, 2023), available at <https://www.legco.gov.hk/yr2023/english/subleg/negative/2023ln055-e.pdf>

[9] Amended rule 10C of the of the *Securities and Futures (Client Money) Rules*, set out under section 7 of the CMR Amendment Rules

[10] Amended rule 9B of the *Securities and Futures (Client Securities) Rules*, set out under section 6 of the “*Securities and Futures (Client Securities) (Amendment) Rules 2023*” (“**CSR Amendment Rules**”) (March 20, 2023), available at <https://www.legco.gov.hk/yr2023/english/subleg/negative/2023ln054-e.pdf>

[11] Amended rules 9C and 10A of the *Securities and Futures (Client Securities) Rules*, set out under sections 6 and 7 of the CSR Amendment Rules respectively

[12] Amended rule 3A of the *Securities and Futures (Keeping of Records) Rules*, set out under section 5 of the “*Securities and Futures (Keeping of Records) (Amendment) Rules 2023*” (“**KKR Amendment Rules**”) (March 20, 2023), available at <https://www.legco.gov.hk/yr2023/english/subleg/negative/2023ln057-e.pdf>

[13] Amended rule 10 of the *Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules*, set out under section 4 of the “*Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) (Amendment) Rules 2023*” (“**OTCD Amendment Rules**”) (March 20, 2023), available at <https://www.legco.gov.hk/yr2023/english/subleg/negative/2023ln061-e.pdf>

[14] Amended rule 11 of the *Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules*, set out under section 5 of the OTCD Amendment Rules

[15] Paragraph 26, 2019 Consultation Paper. The SFC’s MIC requirements are listed in the “*Circular to Licensed Corporations Regarding Measures for Augmenting the Accountability of Senior Management*” (December 16, 2016), available at <https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=16EC68>, and the related Frequently Asked Questions published by the SFC (last updated on January 26, 2022), available at <https://www.sfc.hk/en/faqs/intermediaries/licensing/Measures-for-augmenting-senior-management-accountability-in-licensed-corporations>

[16] “*Code on Unit Trusts and Mutual Funds*” (January 1, 2019), published by the SFC, available at <https://www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/codes/section-ii-code-on-unit-trusts-and-mutual-funds/section-ii-code-on-unit-trusts-and-mutual-funds.pdf>

[17] “*Code on Pooled Retirement Funds*” (December 2021), published by the SFC, available at <https://www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/codes/code-on-pooled-retirement-funds/code-on-pooled-retirement-funds.pdf?rev=9badf81950734ee08c799832be6ff92b>

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[18] Section 6, Schedule 11

[19] Section 8, Schedule 11

[20] Section 9, Schedule 11

[21] Section 11, Schedule 11

[22] See section 14, Schedule 11 for the full list of safeguards.

[23] “Code on Real Estate Investment Trusts” (August 2022), published by the SFC, available at https://www.sfc.hk/-/media/EN/files/COM/Reports-and-surveys/REIT-Code_Aug2022_en.pdf?rev=572cff969fc344fe8c375bcaab427f3b



The following Gibson Dunn lawyers prepared this client alert: William Hallatt, Emily Rumble, and Jane Lu.

Gibson Dunn’s lawyers are available to assist in addressing any questions you may have regarding these developments. If you wish to discuss any of the matters set out above, please contact any member of Gibson Dunn’s Global Financial Regulatory team, including the following members in Hong Kong:

William R. Hallatt (+852 2214 3836, whallatt@gibsondunn.com)

Emily Rumble (+852 2214 3839, erumble@gibsondunn.com)

Arnold Pun (+852 2214 3838, apun@gibsondunn.com)

Becky Chung (+852 2214 3837, bchung@gibsondunn.com)

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