

FATF AND APG PUBLISH LONG-AWAITED MUTUAL EVALUATION REPORT ON HONG KONG

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Legal Briefings - By **Kyle Wombolt, William Hallatt, Hannah Cassidy, Jeremy Birch, Joanna Caen and Michael Tan**

Following the Financial Action Task Force (**FATF**) and the Asia/Pacific Group on Money Laundering's inspection of Hong Kong in October and November 2018, their much anticipated [Mutual Evaluation Report \(Report\)](#) on Hong Kong was published on 4 September 2019. Our previous [bulletin](#) on 25 June 2019 gave early insights into the expected findings.

The Report sets out the level of compliance with the [FATF 40 Recommendations \(Recommendations\)](#). It also sets out the level of effectiveness of Hong Kong's anti-money laundering (**AML**) and counter-financing of terrorism (**CFT**) system as against the [FATF 11 Immediate Outcomes \(IOs\)](#) together with recommendations for enhancing and strengthening the system.

This bulletin outlines the key findings and priority actions identified in the Report.

OVERVIEW OF HONG KONG'S PERFORMANCE

Effectiveness of Hong Kong's system

In terms of the effectiveness of Hong Kong’s system in combating money laundering (**ML**) and terrorist financing (**TF**),¹ Hong Kong was found to have a *substantial level of effectiveness* in respect of 6 of the IOs and *moderate level of effectiveness* in respect of 5 of the IOs. Hong Kong did not obtain the highest rating of *high level of effectiveness* for any of the IOs.

Substantial level of effectiveness		Moderate level of effectiveness	
IO.1	Risk, policy and coordination	IO.3	Supervision
IO.2	International cooperation	IO.4	Preventive measures
IO.6	Financial intelligence	IO.5	Legal persons and arrangements
IO.8	Confiscation	IO.7	ML investigation & prosecution
IO.9	TF investigation & prosecution	IO.11	Proliferation financing financial sanctions
IO.10	TF preventive measures & financial sanctions		

Compliance with the Recommendations

Hong Kong was found to be overall compliant with the Recommendations.

Hong Kong was found to be *compliant, or largely compliant* with 36 of the 40 Recommendations.² However, it was only found to be *partially compliant* with the Recommendations concerning the following 4 areas:

• Recommendation 12	Politically exposed persons (PEPs)
• Recommendation 22	Designated non-financial Businesses and Professions (DNFBPs): Customer due diligence
• Recommendation 25	Transparency and beneficial ownership of legal persons
• Recommendation 28	Regulation and supervision of DNFBPs

KEY FINDINGS

ML/TF understanding

Hong Kong has a *reasonably good* level of understanding of its ML and TF risks with the banking sector rightly identified as facing the highest risk. However, the level of understanding for some other higher risk ML areas, such as ML linked to foreign tax and corruption offences, needs further deepening.

There is mixed understanding of ML/TF risks and implementation of mitigating measures in the private sector:

large financial institutions (**FIs**) and those belonging to large international groups, as well as large international DNFBPs tend to have a stronger approach;

the understanding and appreciation of ML/TF risks and the implementation of AML/CFT measures needs improvements among the smaller FIs (particularly in the money service operators and moneylender sectors); and

a significant proportion of DNFBPs do not take a risk-based approach to mitigate their ML/TF risks, mainly as a result of a poorer understanding of their ML/TF risks.

Core supervisors, including the Hong Kong Monetary Authority (**HKMA**), the Securities and Futures Commission and the Insurance Authority, implement appropriate risk sensitive supervision. Other supervisors and self-regulatory bodies need to strengthen their risk understanding and supervisory actions. **Overall, limited sanctions have been applied against the private sector.**

Investigations, prosecutions, convictions and confiscation

Law enforcement agencies (**LEAs**) identify and initiate a significant number of ML investigations. In particular, fraud-related ML is extensively investigated as the highest risk. However, there is a marked drop in the investigation of other major ML risks such as foreign drugs, tax crimes and corruption. **However, the number of prosecutions and convictions is much lower than the number of cases investigated.**

Hong Kong demonstrates an ability to prosecute all forms of ML and has a high conviction rate. However, the low sentences imposed suggest that many ML cases pursued are at the lower end of the scale. **Also, Hong Kong has not yet prosecuted a legal person for ML.**

While confiscation is a high priority for Hong Kong, there remain minor legal gaps and there is a need to enhance the volume of outgoing international requests. The effectiveness of the recently introduced cross-border movement of currency and bearer negotiable instruments disclosure/declaration system is yet to be demonstrated.

Legal persons

Hong Kong's assessment of the ML/TF risks and misuse of legal persons and arrangements needs to be more comprehensive. Authorities currently rely largely on AML/CFT requirements on FIs to ensure transparency.

Recent measures to impose statutory AML/CFT requirements for trust and company service providers, and require companies to collect and maintain beneficial ownership information, will enhance transparency of beneficial ownership requirements over time. **The effectiveness of these measures is however yet to be fully demonstrated due to their recent nature.**

International cooperation

Hong Kong actively responds to formal international co-operation requests for mutual legal assistance and extradition.

There remain legal impediments to formal co-operation with other parts of China.

The low number of outgoing formal requests generally is not consistent with Hong Kong's risk profile.

Terrorist and proliferation financing

Hong Kong has a robust framework for identifying and investigating potential cases of TF. Sanctions for TF are proportionate and dissuasive.

Hong Kong has a sound understanding of the TF risks and vulnerabilities within its non-profit sector, and has applied proportionate measures to mitigate the relatively higher risks faced by international non-profit organisations.

Hong Kong is currently implementing TF and proliferation financing targeted financial sanctions (**TFS**). However, these regimes have only been in place since May 2018, and there were previously delays in implementing TFS, particularly for proliferation financing TFS. Many large/international FIs and DNFBPs have demonstrated a good awareness and understanding of their TFS risks and obligations in practice, although awareness is lower with respect to proliferation financing TFS.

Hong Kong is particularly exposed to potential proliferation financing activities, including through the misuse of legal persons, as well as financial channels. There are concerns in relation to gaps in understanding and implementation of the proliferation financing TFS obligations among smaller entities and newly regulated sectors and in monitoring of compliance with the obligations in those sectors. No proliferation financing TFS case has so far been substantiated.

RECOMMENDED PRIORITY ACTIONS

The Report outlined a significant number of recommendations aimed at strengthening the Hong Kong system.

Set out below are the recommendations that the Report identified as **priority actions** for Hong Kong to take:

continue to review and update the understanding of ML/TF risks and more closely review the ML threats arising from foreign crimes such as corruption, and tax crimes;

clearly prioritise investigating and prosecuting foreign non-fraud ML such as drugs, tax crimes and corruption;

the Customs and Excise Department, the Registrar of Moneylenders, self-regulatory bodies and other DNFBP supervisors should strengthen their understanding of ML/TF risks at the individual institution level to improve their understanding of sectoral risks and develop a robust risk-based supervisory approach;

supervisors and self-regulatory bodies should apply effective, proportionate and dissuasive sanctions for non-compliance with AML/CFT requirements;

take further actions to ensure that beneficial ownership information in relation to legal arrangements, especially for trusts that are not created through professional trustees, is more readily available and is accurate;

closely monitor and ensure compliance with the implementation of the new significant controller register regime, and at an appropriate point assess its effectiveness;

review and put in place the appropriate level of AML/CFT requirements for the dealers in precious metals and stones sector having regard to ML/TF risks;

close the technical gap in relation to the coverage of PEPs from other parts of China;

take further actions to deepen FIs' and DNFBPs' understanding of ML/TF risks and to strengthen AML/CFT implementation by DNFBPs and the smaller FIs (especially in the money service operators and moneylender sectors), particularly with regard to the risks posed by non-resident customers, beneficial ownership requirements, enhanced due diligence requirements in relation to foreign PEPs, and TFS requirements;

closely monitor and manage its exposure to proliferation financing by the Democratic People's Republic of Korea;

conduct targeted outreach to smaller entities in all sectors, and focus in particular on those sectors that demonstrated more systemic gaps in understanding of their TFS obligations;

pursue the identification of proliferation financing-related funds, assets and economic resources and review whether there are impediments to the identification of such assets;

follow and restrain assets that have moved to other jurisdictions and pursue the people involved, including through the use of more outgoing formal requests for mutual legal assistance, extradition and asset recovery in line with its risk profile; and

explore ways to improve its ability to co-operate with other parts of China through formal means.

WHAT TO EXPECT NEXT

Policy and supervision

Hong Kong is likely to see a wave of policy changes and enhancements in the wake of the Report. The Hong Kong government and the supervisors responsible for the various AML and CFT regimes in Hong Kong will no doubt be taking stock of the Report's findings in order to decide what steps to take next. Indeed the HKMA has already issued circulars to [authorised institutions](#) and [stored value facility licensees](#) which focus on the Report and its findings. Clearly, the priority actions identified above will be top of the agenda in terms of legal and regulatory developments.

It is clear from the Report that the AML and CFT approach in relation to DNFBPs and smaller financial institutions are key areas of weakness for Hong Kong and requires significant enhancement and strengthening. The potential for the misuse of legal persons and arrangements, and proliferation financing TFS, are also areas of key concern.

Enforcement

The observations regarding limited sanctions being applied against the private sector and the low number of prosecutions and convictions as compared to the number of cases investigated, may well lead to a shift towards a more aggressive enforcement policy by both LEAs and supervisors.

Furthermore, the Report's recommendation to prioritise the investigation and prosecution of foreign non-fraud ML, such as drugs, tax crimes and corruption, may lead to an expansion of the type of the cases being pursued beyond fraud-related ML.

The trend of increasing numbers of ML and TF related enforcement cases only looks set to continue.

¹Effectiveness ratings can be: high, substantial, moderate, or low, level of effectiveness.

²Technical compliance ratings can be: compliant, largely compliant, partially compliant or non-compliant.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



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