



LOCKED AND LOADED - ONE YEAR INTO THE SFC'S ENHANCED APPROACH TO



While the purpose of enforcement and disciplinary action is to punish those that have misbehaved and deter others from misbehaving in the future, the SFC has recognised that such measures are not the silver bullet to all regulatory issues, as they happen after the fact and it is often too late to undo the damage.

HONG KONG FSR INSIGHTS - 2018 OUTLOOK

That being the case, the SFC adopted a new approach in 2017 and now strives to "front-load" its regulation by identifying emerging risks and taking early targeted intervention to minimise damage to the market. 2017 has seen this being put into action in a number of ways, reflecting a more transparent, upfront and preventative approach to regulation, for example: Legal Briefings - By **Will Hallatt, Hannah Cassidy, John Siu and Jeremy Birch**



- increased thematic reviews of intermediaries, followed by guidance (often with case examples and/or good industry practices) post review to prompt behavioural change, such as the recent SFC and HKMA joint circular regarding their thematic review on potential conflicts of interest in financial groups arising from the sale of in-house products;
- publication of newsletters to provide guidance and to increase transparency of its regulatory approach, such as the launch of the new series *SFC Regulatory Bulletin: Listed Corporations* and the relaunch of the *Enforcement Reporter*;
- ensuring that a transparent and accountable approach is taken where it is minded to object to a listing application or direct the suspension of a listed corporation, by setting out its detailed grounds and providing the listing applicant or the listed corporation with the opportunity to respond (with regards to a listing application, the SFC will deal directly with the listing applicant or its advisers rather than relay its comments via the stock exchange, which was previously the case).

With an increased focus on real-time and preventative regulation and maximising the impact of its actions, the SFC made a concerted effort in 2017 to reduce its enforcement caseload and succeeded in reducing its caseload by one-third as of October 2017. In 2018, we will continue to see its Enforcement Division locked and loaded on those issues that pose the greatest threat to the interests of the Hong Kong public and the integrity of the Hong Kong markets. These include corporate fraud and misfeasance, particularly in the context of IPO sponsor misconduct, together with other key priority areas for which the Enforcement Division has set up specialised teams. By contrast, the SFC may choose not to take action on low impact cases which do not reach the SFC's threshold.

The SFC has indicated that it will shortly be providing more granular guidance on cooperation in disciplinary, civil and Market Misconduct Tribunal proceedings. This will increase transparency over the benefits of cooperating with the SFC, the key factors which the SFC considers in settlement discussions, and the best time for engaging in such discussions.

The SFC has also intimated that it is actively looking at a solution which will partly resolve the challenges it currently faces in cross-border evidence gathering.

CYBERSECURITY CLIMBS THE REGULATORY AGENDA

Cybersecurity has been high on the agenda of Hong Kong regulators in the last few years, with the issue of guidance by the SFC and the HKMA, as well as the introduction of initiatives by the HKMA such as a cyber resilience assessment framework, training and certification programmes and a cyber intelligence sharing platform.

The financial industry in Hong Kong experienced a significant cyber incident in 2016, where cyber attackers used technology to carry out a "pump and dump" scheme. Apart from investigating the crime alongside the police, the SFC separately engaged external IT experts to conduct a thematic review of the systems and controls of firms.

In May 2017, the SFC launched a consultation on enhanced measures for minimising hacking risks in internet trading. This resulted in the issue of a set of guidelines in October 2017 whereby 20 baseline cybersecurity measures (which consolidated and elaborated on existing guidance as well as introduced new guidance) were required to be implemented by firms in two phases. These will come into effect in April and July of 2018. Apart from ensuring compliance with the new requirements, firms should ensure that they are ready to respond to the next cyber incident. This is because when an incident happens, regulators will likely scrutinise how it is handled by the affected firm. As well as systems and control issues, in view of the latest emphasis on individual responsibility, the regulators will not be slow in investigating and interviewing responsible individuals.

In light of the increasing focus of regulators on cyber risk, senior management should prepare by vetting and engaging preferred external IT, legal and other experts, so that they are on hand and cleared to act should an incident arise.

THE LEAD-UP TO THE 2018 FATF AML/CTF MUTUAL EVALUATION

The focus on anti-money laundering and counter-terrorist financing (AML/CTF) compliance shows no signs of abating in 2018.

From March to June 2017, the SFC and the HKMA in Hong Kong collectively took disciplinary actions against five regulated entities and three individuals (senior officers of three of the aforesaid entities) relating to breaches of AML/CTF regulatory requirements. The entities were fined amounts ranging from HK\$2.6 million to HK\$7 million. One individual was banned from re-entering the industry for nine months and the other two individuals were each suspended for six months.

Both the SFC and the HKMA have made it clear that AML and CTF compliance will continue to be a priority, and the recent disciplinary actions demonstrate swift action on their part. The SFC has set up a temporary specialised team within its Enforcement Division to tackle know-your-client and AML/CTF control failings. The raft of disciplinary actions serves as a warning that the SFC and the HKMA are prepared to impose tough sanctions and that regulated entities should take action now to ensure compliance with the relevant requirements.

With Hong Kong's mutual evaluation from the Financial Action Task Force (FATF) due to take place in 2018, we anticipate that the focus by the SFC and the HKMA on AML/CTF issues will continue. There will likely be pressure to wrap up existing enforcement actions prior to the evaluation to show as many concrete results prior to the FATF evaluation, so there could be a flurry of activity in advance. Legislative reforms to enhance the transparency of beneficial ownership of Hong Kong companies and to extend customer due diligence and relevant record-keeping requirements to designated non-financial business and professions are pending before the Legislative Council, and are targeted for implementation in March 2018. The relatively new Insurance Authority will also be placing AML/CTF issues high on its agenda.

The HKMA, like many banking regulators globally, has become concerned with authorised institutions taking a disproportionately stringent approach in relation to customer due diligence, resulting in a decreased access to financial services for a number of legitimate but higher risk customers. The HKMA has issued guidance stressing that customer due diligence involves differentiating the risk levels of individual customers in accordance with their backgrounds/circumstances, and applying risk-mitigating and customer due diligence measures proportionately, rather than simply adopting a "one-size-fits-all" approach. The HKMA has stressed that such approach does not require a "zero failure" outcome. Accordingly, we expect that where failures in compliance measures are identified, the HKMA will be sensitive to any attempt to remedy these predominantly through de-risking.

CONTINUED CRACKDOWN ON CORPORATE FRAUD AND MISFEASANCE - SENIOR MANAGEMENT AND SPONSORS BEWARE

Corporate fraud and misfeasance are a top enforcement priority for the SFC and will likely continue to be so in 2018. They are the subject of two permanent specialised teams set up under the Enforcement Division in late 2016. As of October 2017, there were around 136 active corporate fraud and misfeasance investigations, 28 of which were particularly serious in the SFC's view. Key issues concerned (amongst other things) fraud, misleading financial statements and serious conflict of interests. We expect that the SFC will continue to use all statutory powers available to it to hold listed corporations and their directors and senior executives accountable for their actions.

The IPO sponsor regime is regarded as a risk management tool for preventing corporate fraud and misfeasance, with the sponsor playing a gatekeeping role. The SFC set up a temporary specialised team in late 2016 to handle sponsor-related issues in the Enforcement Division, and was investigating around 15 sponsor firms as of October 2017. Following the implementation of the manager-in-charge regime earlier this year, the SFC will be more focused than ever on individual culpability from the outset of an investigation.

As discussed above, the SFC now takes a front-loaded approach involving greater transparency and preventative action. We have seen this approach being taken in relation to listing matters and listed corporations, such as the issue of guidance on the obligations of directors, financial advisers and valuers in respect of valuations in corporate transactions, guidance relating to the price volatility of Growth Enterprise Market stocks, and the new *SFC Regulatory bulletin: Listed Corporations* this year. We have also seen such approach taken in relation to the SFC's statutory powers to object to a listing application and to direct the suspension of a listed corporation (see above). An "ICE" team, comprising officers from the Intermediaries, Corporate Finance and Enforcement Divisions, has been set up to deal with a number of the above issues. This has resulted in an increased collaboration on an operational level (not just at a policy level) between the three divisions. We will continue to see this front-loaded and collaborative approach in 2018 and going forward.

INCREASED COLLABORATION BETWEEN HONG KONG AND MAINLAND REGULATORS

Over the last few years we have seen a significant increase in collaboration between Hong Kong regulators and their counterparts in the Mainland. In 2014, the first mutual market access scheme, the Shanghai-Hong Kong Stock Connect, was launched. This was followed in 2016 by the addition of a similar scheme, the Shenzhen-Hong Kong Stock Connect. In July 2017, we saw the launch of the first phase of the Bond Connect – Northbound trading – allowing overseas investors from Hong Kong and other regions to invest in the China interbank bond market through mutual access arrangements (Southbound trading will be explored at a later stage). These mutual market access schemes are playing a significant part in opening up the Mainland market to overseas investors and providing Mainland-based investors better access to international investments. In 2018 and beyond, we expect to see an expansion of the scope of the Stock Connect and Bond Connect schemes (such as the trading quota and the range of products covered), together with consideration of a Primary Equity Connect.

Another arrangement entered into between Hong Kong and the Mainland in the recent years is the mutual recognition of funds scheme in 2015, which allows eligible Mainland and Hong Kong funds to be distributed in each other's market through a streamlined vetting process.

The increasing arrangements between Hong Kong and the Mainland, coupled with the growing presence of Mainland financial services firms in Hong Kong, mean that the Hong Kong and Mainland regulators need to rely on each other far more than in the past for supervision and enforcement. On 30 November 2017, the SFC announced that it had reached agreement with the China Securities Regulatory Commission (**CSRC**) on proposals to introduce a new investor identification system for Stock Connect, which would give both regulators direct, real-time line of sight into cross-market trades at the client level. The system is scheduled to be implemented in respect of Northbound trading by the third quarter of 2018, with Southbound trading following shortly afterwards. In the longer term, the SFC has indicated that it intends to implement an investor identification regime covering all trading on the Hong Kong stock exchange.

Both the SFC and the Hong Kong Exchanges and Clearing Limited are very invested in collaborating with the Mainland and have regular meetings, joint training sessions and secondment arrangements with the CSRC. The SFC and the CSRC are currently working on establishing a comprehensive framework for information exchange and cooperation for new Hong Kong futures, options and other derivatives which reference important Mainland asset classes.

HONG KONG INSURANCE REGULATOR PLAYS CATCH UP

On 26 June 2017, we saw a major milestone in insurance regulatory reform in Hong Kong, when the newly established Insurance Authority took over the regulation of insurance companies from the Office of the Commissioner of Insurance. This was Hong Kong's first step in ensuring that its insurance regulatory regime complies with the international requirement that insurance regulators be financially and operationally independent of the government and the industry.

In 2018, the Insurance Authority will focus its efforts on the second part of the reform, being the establishment of a new licensing and regulatory regime for insurance intermediaries, to replace the current self-regulatory system involving three industry bodies. The implementation of this new regime is targeted for mid-2019. The Insurance Authority has recently set up a working group, which will map out the transitional matters with the three industry bodies, and work on the preparation of some 20 sets of rules, codes and guidelines to be issued by the Insurance Authority, covering areas such as licensing, conduct, the selling process and disciplinary measures. The Insurance Authority will be conducting soft consultations, followed by public consultations on these throughout the course of 2018.

In 2018, the Insurance Authority will also continue to promote InsurTech via its Insurtech Facilitation Team, and ensuring the smooth operation of the Insurtech Sandbox recently launched in September 2017. This sandbox will be linked up with those of the SFC and the HKMA to provide a single point of entry for pilot trials of cross-sector FinTech products and services.

In addition, we expect to see further progress in 2018 on the proposed risk-based capital regime (public consultation on the key legislative proposals is expected to take place in late 2017 or early 2018), as well as the proposed insurance policy holders' protection scheme (legislation is being drafted with a view to introducing a bill into the Legislative Council in the second half of 2018).

THE NEW ERA OF EU REGULATION

MiFID II will come into force on 3 January 2018. However, the consensus seems to be that Asian financial institutions and corporates are still assessing the extra-territorial impact on their business models.

The directive has the potential to reshape not just the trading landscape but also affect the way products are developed and clients are serviced. A central theme of the new framework is transparency, which manifests itself in new rules around pre and post-trade and transaction reporting.

Challenges will be proportionate to the complexity of the organisation's trading ecosystem, but market fragmentation in Asia will likely make it difficult for firms to meet best execution requirements where transacting parties must produce documentation by a specific deadline. An Asian broker-dealer trading on an EU trading venue will be subject to requirements imposed by the trading venue in respect of the venue's own compliance with MiFID II requirements. Asian firms may also have to adopt Legal Entity Identifiers to meet transaction reporting requirements.

MiFID II will also likely overhaul the investment research landscape, as banks will now be required to "unbundle" their services, billing clients for research and trading separately. The UK FCA has also warned that the new rules could extend to wider sales and trading roles, whereby advice in the form of highlighting of trends and providing "market colour" would also count as research.

Another key EU regulation proving challenging for Asian benchmark administrators and users is the new EU Benchmark Regulation, whereby Asian administrators will have to register their benchmarks in the EU before 1 January 2020 in order to continue to be accessible to the EU market.

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