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NEWS

EDITORIAL: HONG KONG REGULATORY OUTLOOK FOR 2019— THE RISE OF “SUPTECH”

Regulators are expected to scale up efforts to monitor operational resilience of financial markets in 2019 and adopt enhanced surveillance techniques. In a recent Compliance Bulletin, the Securities and Futures Commission (SFC) announced the establishment of a new Market Intelligence Programme and Data Analytics Group dubbed Suptech (supervisory technology) to support its efforts to more closely monitor risks to financial stability posed by new technologies and the emergence of new business and operational models.

According to the Bulletin, the SFC has “enhanced [its] data analytic capabilities” to ensure that firms are supervised effectively. The Bulletin noted, “not all senior management understand the complex inner workings of their firms’ [IT] systems.” It added that the importance of proper governance structures and hiring suitably qualified and experienced staff as manager-in-charge (MIC) for IT was critical “to ensure that the risks arising from new technologies are properly managed.” The Bulletin also stressed that firms are expected to have in place appropriate procedures to escalate matters to senior management and the board before problems get out of control.

At the same time, the SFC set out its concerns associated with trading virtual assets as well as a host of new measures it regards as vital to protect investors from the inherent risk of investing in this nascent asset class. Firms that invest or distribute virtual asset portfolios or funds¹ will have to agree to licensing conditions and restrict sales to professional investors before they conduct this activity. The SFC also set out a blueprint to explore whether virtual asset trading platforms are suitable for regulation, but there remains much work to do in 2019. For a detailed discussion of the regulatory standards and expectations relating to virtual assets, please see the November 1, 2018, Sidley Update [SFC Announces New Policy to Regulate Digital Assets](#). In this context, two areas likely to be under the spotlight are marketing and sales practices relating to virtual assets, in particular token offerings, given the SFC’s acute concerns.

In addition to the perennial priorities — corporate fraud, intermediary misconduct, sponsor liability, insider dealing and market manipulation — other major themes expected to ramp up include compliance with the Fund Manager Code of Conduct (amended in November 2018) as well as financial resources rules (given the convergence of traditional and nascent asset classes) as firms face tougher market conditions. We also expect a step up in enforcement activity as the first wave of actions following the recent thematic review of the MIC regime are brought and the SFC mines

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1 Where 10 percent or more of the gross asset value of the portfolio is invested in virtual assets.



data obtained from the industry under the revamped statutory returns, such as the new business and risk management questionnaire (BRMQ; see regulatory standards column), to identify irregularities, deficiencies and noncompliance that might otherwise have gone undetected.

Against this background, we hope you find the featured articles in this newsletter to be helpful. If you have any questions or wish to discuss how Sidley can assist your business, please do not hesitate to contact us.

SFC INTRODUCES SIGNIFICANT CHANGES TO THE LICENSING REGIME

Effective February 11, the SFC introduced a series of significant changes to the licensing regime. The changes include redesigned forms, a new Licensing Handbook and mandatory e-filings of all annual returns and notifications.

The measures aim to streamline the licensing process and adopt a risk-based approach to vetting new applicants (or changes to existing licensees) and their substantial shareholders (or associates). Use of the new forms becomes compulsory on April 11 after a two-month transition period.

New applicants will also be required to complete a new business profile and self-assessment questionnaire for specific business activities (including, for example, asset management and electronic trading). The information in the new forms places a particular emphasis on the disclosure of information that will enable the SFC to better assess applicants' licensing requirements as well as their fitness and propriety.

The updated Licensing Handbook includes hyperlinks to relevant circulars and provides guidance on the SFC's expectation for topical licensing issues, including virtual assets classes, private equity or venture capital.

SFC CURBS IMPROPER PRACTICES BY ASSETS MANAGERS AND TIGHTENS RULES FOR MARGIN FINANCING

Following growing concerns about regulatory risks posed from surging margin-financing activities against the backdrop of volatile markets,² the Hong Kong regulator announced a series of initiatives to curb improper practices in the financial sector. The first initiative targets those managing private funds or discretionary accounts and warns that the SFC is ready to take enforcement action against those involved in problematic or shadow margin lending practices. The second initiative took the form of a public consultation aimed at tightening the rules for margin financing in order to create more resilient financial markets. We discuss the principal features of each initiative below.

Asset Managers Risk Enforcement Action if Involved in Shadow Margin Lending Practices

The SFC announced in a [circular](#) to asset managers that it is paying close attention to improper arrangements involving margin-financing activities disguised as investments in private funds or discretionary accounts. The common features identified by the SFC as potentially problematic include these:

- funding arrangements that involve the acquisition of sizable, concentrated positions in one or more securities
- provisions that compel one class of investor to inject top-up capital or collateral when the net asset value of these investments falls below a predetermined level, similar to a margin call

² SFC Report on Review of Securities Margin Financing Activities (August 2018)



- provisions that entitle a different class of investor to receive a guaranteed or predetermined return from the same investment, similar to margin interest

These features alone are not necessarily conclusive that a manager is involved in anything improper and a careful analysis of all relevant factors would be required in each case. However, managers are exposed to a heightened risk in situations where they might be regarded as not having actual discretion in investments made by the fund in one or more securities.

The SFC warned that managers engaged in the management of investments on terms that exhibit similar characteristics without being appropriately licensed will impugn their fitness and propriety. It also urged those involved in such improper activities to cease such arrangements immediately or risk prosecution.

Proposals to Tighten Rules for Margin Financing

On April 4, 2019, the SFC published its [consultation conclusions](#) with regard to guidelines aimed at strengthening the securities margin financing rules and lending practices by addressing high exposure to financial and concentration risks in the industry. Following implementation, the guidelines replace the current generic principles-based requirements under the Code of Conduct with specific qualitative and quantitative benchmarks in critical risk control areas. The guidelines will take effect on October 4, 2019, subject to a six-month transition period. The SFC rejected requests to extend the transition period to 12 months or longer due to increasing market volatility.

The key proposals (as more fully described in the guidelines) include setting hard limits on total margin loans (by reference to liquid capital requirements) as well as margin loans to individual counterparties or groups of related clients (but exclude IPO loans). Further limits are set on total unsettled margin calls and total long-outstanding margin calls, with mandatory triggers for margin calls whenever margin loan balances exceed the margin value of the underlying collateral, with zero tolerance for clients with poor settlement histories. In addition, new requirements will be established for aggregation of credit limits for groups of related clients as well as for inter-connected groups of securities pledged as collateral, with mandatory stress tests to be conducted (at least monthly) based on predefined hypothetical price drops, to monitor credit exposures and concentration risks. A new mandatory self-reporting obligation arises where entities trip stress tests.

These measures will standardize compliance practices, better monitor the adequacy of capital buffers and enhance overall controls. Firms must justify any deviation or establish controls no less prudent than those set out in the guidelines. In extreme cases, the SFC may impose licensing conditions to immediately suspend regulated activities and prevent risks worsening.

REGULATORY STANDARDS/UPDATES

New BRMQ

January 2019: The SFC announced that all licensed corporations (LCs) are required to submit the new BRMQ for financial years ending on or after March 31. The information in the new annual questionnaire places a particular emphasis on the disclosure of information relating to compliance, risk and internal control issues escalated to management or identified during internal audits that will enable the SFC to more closely assess and monitor compliance with relevant legal and regulatory requirements and the Code of Conduct.



Task Force Publishes Anti-Money-Laundering Interpretative Note on Virtual Assets

February 2019: Following concerns about the need to mitigate money-laundering risks associated with virtual assets, the Financial Action Task Force published an interpretative note with detailed requirements for effective regulation and supervision of virtual asset service providers (VASPs). If adopted, VASPs will be required to be licensed or registered in member states and comply with applicable anti-money-laundering regulations.

SFC Delays New Rules Governing Online/Offline Sales of Investment Products

March 2019: The SFC extended the timetable for implementation of the new suitability and disclosure requirements for online and offline sales of complex products to July 6, 2019 (from April 6, 2019). Under the new rules, enhanced disclosure requirements as well as the suitability requirements apply to all unsolicited sales or recommendations of “complex products” online. Further, intermediaries who solicit or recommend a financial product (regardless of complexity) to a client must comply with the suitability requirements.

SFC confirms token offerings are regulated investment products

March 2019: On March 28, the SFC issued a public statement on Security Token Offerings (STOs) utilizing blockchain technology, typically offered to professional investors. The statement confirmed STOs would be regarded as “complex” regulated investment products. Unless an applicable exemption applies, the SFC warned that any person who markets and distributes tokens (whether in Hong Kong or targeting Hong Kong investors) is required to be licensed or registered for Type 1 regulated activity (dealing in securities). Further, licensed intermediaries are expected to notify the SFC prior to engaging in any activities relating to token offerings and comply with the requirements similar to those set out in the SFC’s new policy on virtual assets announced in November 2018 (see [here](#)).

INTERMEDIARIES SUPERVISION

Self-assessment Checklist to Safeguard Client Assets Against Internal Misconduct

December 2018: The SFC issued a new circular with important guidance on best practices that all firms that provide brokerage services to retail investors are expected to adopt to strengthen internal controls and safeguard client assets against the threat of internal misconduct. The circular follows a growing number of serious cases involving unauthorized transactions and misappropriation of client assets. The guidance includes a self-assessment checklist for LCs, their responsible officers (ROs) and MICs to review and improve operational and internal control policies and procedures.

New Risk Mitigation and Conduct Requirements for NCCDs

June 2019: Starting June 14, all LCs are required to manage exposures relating to non-centrally-cleared over-the-counter derivatives (NCCDs) transactions entered into with group affiliates and other connected persons. Other requirements to comply with new risk mitigation measures regarding proper documentation and trade confirmations, portfolio valuations and reconciliations as well as dispute resolution processes will become effective on September 1. These measures apply irrespective of the size of exposure, frequency or the purpose of the transaction, which captures hedging transactions executed by Type 9 advisers managing portfolios that consist of NCCDs (irrespective of whether valuation is performed by a third-party trustee or custodian). Bespoke arrangements for managing risks of discretionary accounts will need to be agreed separately.



KEY PRODUCT DEVELOPMENTS

SFC Amends UT Code

January 2019: Following public consultation, the SFC revised the Code on Unit Trusts and Mutual Funds (UT Code) subject to a 12-month transition period ending December 31, 2019, for existing funds and existing management companies and trustees/custodians. Under the revised UT Code, enhanced disclosures for derivative instruments apply to new funds with immediate effect.

FAQs relating to Open-Ended Fund Companies (OFCs)

January 2019: The SFC updated its frequently asked questions (FAQs) to clarify the requirements for OFCs to be eligible for (i) distribution in other markets under the mutual fund recognition arrangements and (ii) use in setting up structures with close-ended fund features.

SIGNIFICANT ENFORCEMENT ACTIONS

We highlight below several noteworthy enforcement actions this year that may be of interest to fund managers, MICs/ROs, licensed representatives, intermediaries and others operating in the Hong Kong financial markets.

Summary of SFC Enforcement Activity FYE 2018

- The number of breaches noted during on-site inspections fell 13 percent to 1,319 (from 1,512 in 2017). However, internal control weakness and breaches of the Code of Conduct remain prevalent, making up more than 50 percent of total infractions in 2018. While investigations declined to 245 (from 312 in 2017), the number of cases resulting in formal SFC disciplinary action increased, coupled with heftier financial penalties. Although breaches of the Fund Manager Code of Conduct (FMCC) fell 33 percent (from 103 in 2017), we expect the industry to come under closer regulatory scrutiny given the significant changes to the FMCC that took effect in November 2018 (as noted in the editorial above).

Senior Management Accountability

- **December 2018:** Two ROs were banned for nine months for preparing, issuing and approving three equity research reports (and a parallel disciplinary action against the licensed corporation is pending appeal to the Securities and Futures Appeals Tribunal).
- **February 2019:** The SFC revoked the license of a fund manager for breaches of the liquid capital requirements and submission of false and misleading financial returns.

Sponsor Liability

- **March 2019:** A group of four global investment banks agreed to pay a collective fine in excess of US\$100 million to resolve a series of concerns regarding standards of due diligence performed and the level of supervision provided to staff when acting as joint sponsors for a series of initial public offerings in 2009 (under the older sponsor regime) and 2014 (under the new sponsor regime). The SFC also partially suspended the license of one sponsor for 12 months and suspended two former ROs who acted as sponsor principal for two and three years, respectively. As a result of this settlement, two (out of the four) investment banks (as well as the ROs) abandoned their respective pending appeals to review the SFC's disciplinary actions.



Internal Control Failures

- **December 2018:** Two type-9 licensed fund managers were reprimanded and fined HK\$1.5 million and HK\$800,000 respectively for inadvertently short-selling bonus shares (prior to the settlement date) and executing a cross-trade that did not involve any change in beneficial ownership (which was presumed to be a wash trade).
- **January 2019:** A licensed corporation agreed to pay a fine of HK\$2.4 million to resolve its failure to implement adequate controls to monitor compliance with the minimum investment experience requirements for responsible officers under the Mandatory Provident Fund Code and FMCC.

AML/KYC/Product Suitability Failures

- **February 2019:** A licensed corporation agreed to pay a fine of HK\$15.2 million to resolve multiple anti-money-laundering compliance failures associated with third-party deposits.
- **March 2019:** A licensed corporation agreed to pay a fine of HK\$10 million to resolve multiple concerns relating to its selling practices and failures to ensure the suitability of certain derivative products and leverage transactions (including bonds, equity-linked notes, mutual funds, accumulators/decumulators) to noninstitutional clients.

Licensing-Related Issues

- **December 2018:** The SFC updated its FAQs, setting out its views on some common types of supervisory information caught by the statutory secrecy provisions. The SFC confirmed that disclosure by licensed intermediaries of the fact that on-site inspections will be, are being or have been conducted by the SFC and the findings of such inspections (including information requests, letters of deficiencies and other related correspondence with the SFC) to auditors, solicitors or other professional advisers does not breach any statutory secrecy provisions.

CONTACTS

Constance Choy

Managing Partner,
Asia Pacific
+852 2901 3843
cchoy@sidley.com

Effie Vasilopoulos

Partner, Co-leader of Investment
Funds Practice, Asia
+852 2509 7860
evasilopoulos@sidley.com

Dominic James

Counsel, Investment Funds
Practice, Hong Kong
+852 2509 7834
dominic.james@sidley.com

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