



ASIA Funds & Financial Services

NEWSLETTER

FEBRUARY 2020

IN THIS ISSUE

NEWS

Hong Kong regulator sounds the alarm over certain private fund structures..... 1

Licensing requirements for private equity and venture capital firms under Hong Kong's new limited partnership regime 3

Hong Kong regulator imposes new conditions to regulate outsourcing arrangements for cloud storage 3

SFC gives green light to regulation of virtual asset trading platforms in Hong Kong 3

SFC expects firms to maintain "Business as usual" amid coronavirus outbreak..... 4

REGULATORY STANDARDS/UPDATES 4

INTERMEDIARIES/MARKET SUPERVISION 4

KEY PRODUCT DEVELOPMENTS 5

SIGNIFICANT ENFORCEMENT ACTIONS 5

This issue of Sidley's Asia Funds and Financial Services Newsletter discusses important regulatory and enforcement developments affecting entities that conduct regulated activities or trade securities in Hong Kong, with a special focus on those affecting the asset management sector.

The newsletter also notes the SFC's recent enhancements to the investor compensation regime and its plans to extend the licensing regime to apply to trustees and custodians of SFC-authorized collective investment schemes under a newly proposed regulated activity (Type 13).

NEWS

HONG KONG REGULATOR SOUNDS THE ALARM OVER CERTAIN PRIVATE FUND STRUCTURES

As part of its continued drive to curb improper practices by asset managers, the Securities and Futures Commission of Hong Kong (SFC) announced in a special [circular](#) to asset managers and a concurrent [statement](#) to listed issuers that it is paying close attention to improper arrangements involving certain investments in private funds or discretionary accounts, including in respect of their acquisitions, share buybacks and lending practices. This article summarizes the common types of problematic arrangements together with the expected standards of conduct that private fund managers should adhere to and best practices to facilitate the adoption of a more questioning mindset when executing any transaction or accepting a new mandate or capital injections from would-be investors.

Common Problematic Arrangements

The common arrangements identified by the SFC as potentially problematic include these:

- issuers who act as the sole investor in, or provide the vast majority of the capital for, a fund
- issuers who are one of a small number of investors in a fund that invests exclusively in one company (e.g., a single initial public offering) or makes a single investment (e.g., a loan to an individual)
- issuers who subscribe to several funds managed by different managers, but each fund invests all (or the bulk) of its capital in the same investment and, together, the funds hold 100 percent of that investment
- issuers who subscribe to a fund that indirectly, via multiple tiers of other funds, invests in a wholly owned subsidiary of the issuer
- issuers who dispose of an asset to a fund that is in turn majority-owned by the issuer itself

SIDLEY

Visit [sidley.com](https://www.sidley.com) for more information on Sidley's regulatory practice.



These features alone are not necessarily conclusive that issuers and/or managers are involved in an improper arrangement. Careful analysis of all relevant factors (as well as any red flags) 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 or discretionary account, or otherwise fail to detect or adequately review and diligence dubious arrangements that should properly be regarded as dubious or suspicious.

Expected Standards of Conduct

When scrutinizing such arrangements, the SFC urges private fund managers (including their senior management and managers-in-charge) to “observe substance over form throughout the entire process” and offers guidance on the standards of conduct, procedures and controls it expects managers to adhere to when deciding whether to proceed with a proposed arrangement or transaction. This includes

- the need to undertake initial screening of any proposed transaction or arrangement that deviate from generally accepted market practices (e.g., using multiple special-purpose vehicles in private equity funds) and identify potential red flags¹ that may indicate the existence of suspicious transactions or arrangements
- the need to conduct enhanced due diligence and to obtain and document (in writing) senior management approval before accepting a new mandate, executing a transaction or accepting any capital injection from a potential investor
- the need to keep proper records and maintain a complete audit trail of all aspects of a suspicious arrangement (regardless of whether consummated)
- the duty to self-report suspicious arrangements

What Happens Next?

The circular (and statement) underpins the increased level of regulatory scrutiny facing the asset management sector and sends a clear message that those contemplating managing (or making) investments on terms that exhibit similar characteristics run the risk of facilitating illegal or improper transactions that may impugn their fitness and propriety to become or remain licensed if they fail to make adequate or proper inquiries. The close review of transactions that exhibit the characteristics described in the Circular in audit inspections by the regulator is likely to remain a priority area of focus for the foreseeable future.

The circular also warns that the SFC is ready to take enforcement action against firms (and senior management alike) involved in problematic or suspicious practices and urges managers to contact their designated SFC case officers with any questions. Firms should review and assess their current (or proposed) mandates, in conjunction with their written procedures, to ensure they adopt the required level of diligence when executing any transaction or accepting any capital injections from a prospective investor. If you would like to discuss the expected standards of conduct, revamp your written procedures or explore how we may be able to assist you, please do not hesitate to contact us.

¹ For a (nonexhaustive) list of red flags noted during the SFC's supervision of asset managers, including the use of “nominees” and “warehousing” arrangements to hide market misconduct, see Appendix 2 of the circular.



LICENSING REQUIREMENTS FOR PRIVATE EQUITY AND VENTURE CAPITAL FIRMS UNDER HONG KONG'S NEW LIMITED PARTNERSHIP REGIME

Hong Kong is expecting to welcome the long-awaited limited partnership regime designed for private funds (LPF Regime). Significant commercial, legal and taxation advantages are likely to apply to licensed firms that wish to access the new LPF Regime.

Sidley's Update on the [SFC's Licensing Requirements for Private Equity and Venture Capital \(PE&VC\) Firms in Hong Kong](#) (December 3, 2019) summarizes the key licensing requirements in Hong Kong and sets forth the advantages and limitations applicable to private fund managers in relation to each of the relevant licensing options. PE&VC firms that wish to capture these developing market opportunities should understand the licensing regime that will apply to private fund managers in Hong Kong following the introduction of the LPF Regime in 2020.

Sidley has acted as the sole legal adviser in relation to the development of the LPF Regime for private funds and its related licensing considerations. If you would like to understand these requirements or discuss your plans, please contact us.

HONG KONG REGULATOR IMPOSES NEW CONDITIONS TO REGULATE OUTSOURCING ARRANGEMENTS FOR CLOUD STORAGE

The SFC issued new guidance to regulate the use of external electronic data storage providers by licensed firms that intend to keep (or have previously kept) records or documents required to be maintained pursuant to the statutory recordkeeping rules and anti-money-laundering regime in an online environment.

The new guidance and related frequently asked questions (FAQs) released October 31, 2019, while extensive and significant, confirm the Hong Kong regulator's willingness to provide firms with a degree of flexibility in complying with the statutory recordkeeping obligations and clarify the baseline obligations when entering into outsourcing arrangements for the storage of records in electronic format with third-party vendors: See Sidley's Update titled "[Hong Kong Regulator Imposes New Conditions to Regulate Outsourcing Arrangements for Cloud Storage](#)" (November 27, 2019).

If you would like to discuss the approval requirements or plan to adopt cloud storage solutions and would like explore how we may be able to assist you in mapping out the types of regulatory records in scope (i.e., triggering the requirement for SFC approval if stored in the cloud), please do not hesitate to contact us.

SFC GIVES GREEN LIGHT TO REGULATION OF VIRTUAL ASSET TRADING PLATFORMS IN HONG KONG

The SFC issued a position paper on the regulation of virtual asset trading platforms, confirming that it is willing to license and regulate platforms on an opt-in basis. The position paper released November 6, 2019, is the culmination of the SFC's observations of and discussions with platforms in the 12-month period following the release of the SFC's conceptual framework for the potential regulation and licensing of platforms in November 2018.

Sidley's Update titled "[SFC Gives Green Light to Regulation of Virtual Asset Trading Platforms in Hong Kong](#)" (November 12, 2019) summarizes the key features of the framework for the regulation of platforms and explores the effect on the virtual assets market in Hong Kong.



Sidley is at the cutting edge of virtual assets legal work in Hong Kong. Our experience is comprehensive in all core aspects relevant to the virtual assets ecosystem, including advising on the formation of virtual assets funds, advising on regulatory requirements for virtual asset exchange operators and virtual asset fund managers and advising on early-stage financing/merger and acquisition transactions for technology and virtual assets growth companies. Most notably, Sidley is the legal team behind Asia's first (and to date only) tokenized fund.

If you would like to hear some of the insights that we have gained from our groundbreaking work in the virtual asset segment or explore how we may be able to assist you, please contact us.

SFC EXPECTS FIRMS TO MAINTAIN "BUSINESS AS USUAL" AMID CORONAVIRUS OUTBREAK

In anticipation that some licensed corporations may experience operational challenges amid the novel coronavirus outbreak, the SFC reminded all market participants that they are generally expected to continue to make all reasonable efforts to maintain "business as usual" in complying with all regulatory obligations, filing requirements, reporting rules and other deadlines. However, firms faced with specific difficulties or setbacks are encouraged to communicate promptly with their usual SFC contact point.

REGULATORY STANDARDS/UPDATES

FAQS Relating to Securities Margin Financing

September 2019: The SFC published new FAQs to clarify the new requirements aimed at strengthening the securities margin financing rules and lending practices by addressing high exposure to financial and concentration risks in the industry. The new guidelines took 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.

SFC Enhances Investor Compensation Regime

October 2019: The SFC released its consultation conclusions to enhance the investment compensation regime for claims brought by qualifying investors who sustain losses as a result of defaults by intermediaries (i.e., due to insolvency, breach of trust, fraud or malfeasance). Under the enhanced regime, the compensation limits will be increased to HK\$500,000 (more than three times the current limit), and claims for losses relating to northbound trading under Stock Connect will be covered (for the first time). The legislative amendments are expected to take effect in early 2020 (subject to negative vetting by the Hong Kong legislative council).

INTERMEDIARIES/MARKET SUPERVISION

SFC Signs Tripartite MoU with Mainland Chinese Authorities on Audit Working Papers

July 2019: The SFC entered into a memorandum of understanding (MoU) with the Chinese Ministry of Finance and the China Securities Regulatory Commission relating to the disclosure of audit working papers in the Mainland involving Hong Kong-listed Mainland companies. Over the years, timely access to audit working papers and concerns around state secrecy



considerations have often stymied the SFC's ability to investigate Mainland-based issuers and their related persons.

SFC/HKEX Issues Consultation Conclusions to Curb Backdoor Listings and Shell Activities

July 2019: Hong Kong Exchanges and Clearing Limited (HKEX) released its consultation conclusions to (among other things) codify the reverse takeover rules and related guidance letters (subject to modifications) to curb backdoor listings and shell activities and preempt fears about circumvention of the new listing requirements for biotech and prerevenue companies. The amendments took effect on October 1, 2019, subject to a 12-month transitional period.

SFC Signs MoU with ICAC

August 2019: The SFC entered into an MoU with the Independent Commission Against Corruption (ICAC) to combat financial crime in the securities and futures industry in Hong Kong. The MoU, which came into effect on August 19, entitles the regulatory agencies to conduct joint investigations and exchange (or use) information where appropriate.

KEY PRODUCT DEVELOPMENTS

SFC Signals Plans to Regulate Trustees and Custodians of Public Funds

September 2019: The SFC published a consultation paper to (among other things) regulate trustees and custodians of SFC-authorized collective investment schemes (CIS) under a new licensing regime for Type 13 (acting as a depository (trustee/custodian) of an SFC-authorized CIS) regulated activity. The proposals aim to plug perceived gaps in the SFC's ability to bring disciplinary action or take enforcement action against a trustee or custodian. If implemented, the new regime will apply to depositories for SFC-authorized unit trusts, mutual funds, open-ended fund companies, real estate investment trusts and pooled retirement funds, but excludes mandatory provident fund products, and also impose a nonstatutory requirement for RA 13 depositories to maintain professional indemnity insurance.

SIGNIFICANT ENFORCEMENT ACTIONS

We highlight below several noteworthy disciplinary and enforcement actions in the second half of the year that may be of interest to fund managers, managers-in-charge/responsible officers (ROs), licensed representatives, intermediaries and others operating in the Hong Kong financial markets.

Senior Management Accountability

- **July 2019:** Two ROs were suspended for six months (and the licensed corporation fined HK\$1.2 million) for failing to supervise and implement effective controls to ensure compliance with the short-selling regime.

Internal Control Failures

- **July 2019:** The SFC publicly criticized a Type 9 licensed fund manager for failing to properly implement measures to disclose dealings in securities during the offer period, in breach of the Takeover Code. Fund managers who own or control over 5 percent of the securities in a listed issuer are deemed to be associates and must report their share dealings.



- **July 2019:** Two licensed corporations were reprimanded and fined HK\$4.9 million and HK\$1.4 million respectively for improper segregation of client money and misuse of client money to pay monthly commission rebates to account executives.
- **October 2019:** A Type 9 licensed fund manager was reprimanded and fined HK\$6.3 million over failures to detect and prevent illegal short-selling activity and executing cross-trades between staff/client accounts (which resulted in the transactions being executed to the client's detriment).
- **November 2019:** A major financial institution was reprimanded and fined HK\$400 million after self-reporting systemic overcharging practices affecting about 5,000 clients over a 10-year period (and undertook to compensate affected clients approximately HK\$200 million).

Bribery/Anti-Money-Laundering/Life Bans

- Three life bans were imposed on ROs (following criminal conviction) for accepting undisclosed commissions and money-laundering violations.

Licensing-Related Issues

- **October 2019:** A private equity manager was reprimanded and fined HK\$1 million for allowing unlicensed staff to perform regulated activities.

Enforcement Actions for Market Misconduct

- **October 2019:** A licensed representative was banned for 30 months for rigging the price of warrants (netting gains under US\$2,000).
- **November 2019:** A senior regulatory affairs manager who pleaded guilty to insider dealing charges (netting gains over US\$20,000) was jailed for 2.5 months.

CONTACTS

Effie Vasilopoulos

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

Dominic James

Counsel, Investment Funds,
Advisers and Derivatives
+852 2509 7834
dominic.james@sidley.com

SIDLEY

AMERICA • ASIA PACIFIC • EUROPE

sidley.com

Sidley Austin provides this information as a service to clients and other friends for educational purposes only. It should not be construed or relied on as legal advice or to create a lawyer-client relationship. Attorney Advertising - Sidley Austin LLP, One South Dearborn, Chicago, IL 60603. +1 312 853 7000. Sidley and Sidley Austin refer to Sidley Austin LLP and affiliated partnerships as explained at sidley.com/disclaimer.