



ASIA Funds & Financial Services

NEWSLETTER

NOVEMBER 2020

IN THIS ISSUE

NEWS

Post-pandemic Priorities for the Hong Kong Regulator.....	1
Hong Kong Poised to Beef up Regulation of Virtual Assets.....	2
SFC Seeks to Allay Fears Surrounding Compliance with U.S. Sanctions in Hong Kong	3

REGULATORY

STANDARDS/UPDATES	4
-------------------------	---

INTERMEDIARIES/MARKET

SUPERVISION	5
-------------------	---

KEY PRODUCT DEVELOPMENTS	6
--------------------------------	---

SIGNIFICANT

ENFORCEMENT ACTIONS	7
---------------------------	---

This issue of Sidley's Asia Funds and Financial Services Newsletter discusses important regulatory and enforcement developments that impact financial institutions, investment advisers, and investment funds operating in the Asia-Pacific region in a fast-changing regulatory landscape, with a special focus on post-pandemic priorities for the Hong Kong regulator, including increased focus on regulation of virtual assets and compliance with U.S. sanctions in Hong Kong following the enactment of the new National Security Law.

NEWS

POST-PANDEMIC PRIORITIES FOR THE HONG KONG REGULATOR

Prior to the COVID-19 outbreak, the main supervisory and enforcement priorities for the Securities and Futures Commission (SFC), as frontline regulator of Hong Kong's financial services sector, were easy to summarize. Unlike many other agencies, there has been much more continuity than change at the SFC. The SFC has stayed on message and resolute in its focus on adopting a front-loaded regulatory approach to intervene and address all the major problem areas that have historically been a priority in our markets, such as corporate fraud/misconduct, market abuse, senior management accountability, and internal control weaknesses.

To the extent there was a change, the SFC reconfigured its staffing arrangements (adding to its headcount in some areas) in an effort to overcome operational challenges and maintain business as usual during the pandemic. It stepped up its supervisory work and stress tests to monitor financial and operational resilience of licensed firms and address systemic risks in light of heightened market turbulence and volatility across equities, commodities, and fixed income. It also conducted special inspections to ensure compliance with internal control and risk management requirements and, in some instances, offered the industry additional guidance to help comply with regulatory requirements without compromising standards. During the past quarter, according to official SFC statistics, these efforts have resulted in early detection of incidents involving market misconduct, unlicensed activities, boiler room scams, and frauds (which increased 186%).

To aid real-time surveillance capabilities, it increased use of data analytics to track market disruptions and better monitor market irregularities in both Hong Kong and China. In addition, it also deployed artificial intelligence (AI) technology in more areas, including a project launched in June to detect conflicts of interest by extracting and analyzing information from public offering prospectuses (and other corporate news) about listed companies and key stakeholders/controlling shareholders. This means that

SIDLEY

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



erratic price movements in securities of listed companies — that are unaccompanied by announcements to confirm/deny rumors or publicly disseminate price-sensitive information to the market as a whole— can expect to come under close regulatory scrutiny. In tandem, the SFC refined its cross-border protocols with the China Securities Regulatory Commission (CSRC) and also adopted the use of AI to gather evidence for joint SFC/CSRC investigations.

Looking Ahead

This year's thematic inspections covered money laundering, cybersecurity, intermediary misconduct in listed markets, complex and opaque financing arrangements, remote booking, and operational and data risk management as well as book-building activities. In light of heightened volatility and uncertainty in local and international markets, we expect the SFC to pivot away from on-site reviews toward offsite monitoring by analyzing information in regulatory filings, such as financial returns and the revamped business and risk management questionnaires as well as other sources of intelligence. In the asset management sector, the areas many are paying closer attention to are

- Risk management practices (including leverage and liquidity profiles)
- Onshore managers overseeing funds with large redemptions
- Marketing interests of offshore private funds to Hong Kong investors
- Managers handling private fund and discretionary account arrangements or transactions in listed securities

The SFC has repeatedly warned that problematic corporate transactions often involve concealed share ownership or control. In November 2019, it issued a statement voicing concerns over the use of special purpose vehicles and other means (including private funds) to conceal ownership together with a circular to provide guidance to asset managers involved in such arrangements; see [Sidley's Asia Funds & Financial Services Newsletter](#) (February 2020). Again, we expect SFC scrutiny of cases where arrangements are used to conceal ownership or as part of wider schemes to engage in illicit activities or market misconduct.

Licensed intermediaries, including in particular asset managers, should expect to face increased supervision and surveillance in all of these areas and, depending on a firm's line of business, must strive to ensure that trading practices and behavior are reasonably designed and properly supervised amidst the shift away from conducting activities in a traditional office work environment. If you would like to discuss the expected standards of conduct or explore how we may be able to assist you, please do not hesitate to contact us.

HONG KONG POISED TO BEEF UP REGULATION OF VIRTUAL ASSETS

On November 3, 2020, the Financial Services and Treasury Bureau (FSTB), Hong Kong's policy unit on finance and treasury, announced plans to pave the way for a major ruleset shift to expand regulation of virtual asset trading platform operators and exchanges in the coming months while highlighting both anti-money-laundering risks and potential opportunities.

Over the last year, operators of exchanges based in Hong Kong who trade solely in virtual asset classes fell outside regulatory purview (even if they mimicked conventional asset classes). Virtual exchanges/platform operators were therefore left unregulated unless they voluntarily opted into a regulatory "sandbox." This limitation exposed many investors to heightened risks of fraud, security breaches, and market manipulation. The new initiatives, once implemented, will plug this perceived loophole. Any person seeking to operate a virtual asset platform/exchange in Hong Kong (or who target Hong Kong investors) will have to become licensed with the SFC (regardless of whether they conduct regulated activities, i.e., trade regulated financial



instruments). In practice, this will entail the establishment of a permanent place of business in Hong Kong and the requirement for all staff and ultimate owners to meet the fit-and-proper test and other regulatory requirements, to ensure proper governance and continuity.

The term “virtual asset exchange/platform” will be broadly defined to net any trading platform operated for the purposes of allowing an offer or invitation to be made to buy or sell any virtual asset in exchange for any money or any virtual asset (whether of the same or different type) and that comes into custody, control, power, or possession of, or over, any money or any virtual asset at any time during its course of business. However, peer-to-peer trading platforms (i.e., decentralized exchanges) that only provide a forum where buyers and sellers of virtual assets can post their bids and offers, with or without automatic matching mechanisms, for the parties themselves to trade at an outside venue are not covered under the above definition (unless the platform is involved in the underlying transaction concluded outside the platform or otherwise comes into possession or any money of any virtual assets at any time). As such, operators of decentralized platforms/exchanges will continue to remain unregulated (unless they voluntarily opt in to the sandbox).

Once this new statutory regime is in place, said Ashley Alder, SFC Chief Executive in a keynote speech at Hong Kong FinTech Week 2020, “all virtual asset trading platforms in Hong Kong would be regulated, supervised, and monitored under one of two regimes: the existing opt-in framework [the SFC] introduced last year or the proposed new licensing approach [the FSTB] announced.” Existing unlicensed platform operators risk committing a criminal offence if they fail to secure regulatory approvals within 180 days from the date the new regime takes effect. However, given the significant risk involved, the proposal is that successful applicants “should offer their services to professional investors only, at least initially,” added Alder. For an overview of the eligibility and regulatory requirements under the new regime see our update “[Hong Kong Proposes New Licensing Regime for Virtual Asset Service Providers](#)”, dated November 11, 2020, for more details.

SFC SEEKS TO ALLAY FEARS SURROUNDING COMPLIANCE WITH U.S. SANCTIONS IN HONG KONG

Earlier in the year, the SFC released a policy statement to allay widespread industry concerns about the potential ambit and effect of the new National Security Law on businesses in Hong Kong and assured the financial sector that markets will continue to be regulated in the same fashion.

The new security law (full name: Law of People’s Republic of China (PRC) on Safeguarding National Security in the Hong Kong Special Administrative Region) was enacted on July 1 (with immediate effect) by the National People’s Congress Decision on “Establishing and Improving the Legal System and Enforcement Mechanisms for Safeguarding National Security in HK” with a view to (among others) safeguard “national security” as well as to prevent, suppress, and punish new offenses of secession, subversion, terrorist activities, collusion with foreign countries, or “external elements” that endanger national security.

The new security laws, which are ostensibly intended to pave the way for reunification in 2047, criminalizes (among others) activities intended to coerce the PRC Central Government or Hong Kong government in order to pursue a political agenda. It also creates a new offense of collusion with foreign countries or “external elements” and, in particular, criminalizes certain other activities, including those imposing sanctions or blockades or other hostile activities against Hong Kong or China. Offenders face a maximum penalty of life imprisonment of not less than three years, with corporations facing hefty financial penalties/criminal fines.

In response, U.S. President Donald Trump announced mandatory sanctions that ostensibly required financial institutions to sever ties with certain designated Hong Kong and mainland



Chinese government officials. This caused many businesses in the region to worry about their ability to comply with both U.S. sanctions and the New Security Law. While it remains unclear how the New Security Law will be enforced, the deterrent effect and penalties alone have been enough to raise fears that businesses may inadvertently run afoul of the widely framed collusion offense. Since then, on August 8, 2020, the Hong Kong Monetary Authority (the city's banking regulator) publicly stated that it did not recognize unilateral sanctions imposed by foreign governments (which are not part of the United Nations financial sanctions regime) as having any legal effect domestically. As such, it cautioned that financial institutions were under no obligation (as a matter of Hong Kong law) to adhere to the same. More recently, the news media reported that the SFC had privately assured financial institutions that they can implement/comply with U.S. sanctions "without automatically violating" the New Security Law. This was quickly clarified in a brief public statement issued by the SFC on 12 November cautioning intermediaries to "carefully assess any legal, business and commercial risks that they may be exposed to" when considering the implications of U.S. government sanctions.

Notwithstanding the clash in approach adopted by each of Hong Kong's two main frontline regulatory agencies, financial institutions should continue to carefully evaluate the risks and implement appropriate policies having regard to their own circumstances and relevant jurisdictional touchpoints.

REGULATORY STANDARDS/UPDATES

SFC Revamps OFC Regime

September 2020: Following public consultation, the SFC released its consultation conclusions to revamp the open-ended fund companies (OFC) regime to better compete with other overseas private fund structures, including the Variable Capital Company regime in Singapore and the Hong Kong Monetary Authority-sponsored new Limited Partnership Fund (LPF) regime. Two key proposals to expand the custodian eligibility criteria and remove investment restrictions on private OFCs took effect on September 11, 2020 (subject to a six-month grace period for existing private OFC custodians). A further consultation to align customer due diligence requirements for private OFCs with the new LPF regime is pending.

New FAQs on Licensing Requirements for Family Offices

September 2020: The SFC published new FAQs to clarify the factors that trigger the licensing requirements for single and multifamily offices that intend to carry on asset management or other services in Hong Kong.

SFC Further Refines FAQs on Corporate Professional Investors (CPIs)

September 2020: The SFC also updated its FAQs to provide better guidance on the factors intermediaries should take into account when assessing whether CPIs, in particular family trusts and family offices, are exempt from (among others) the suitability requirements under the Code of Conduct.

Proposed Amendments to AML/CFT Guidelines

September 2020: The SFC launched a three-month consultation with revised AML/CFT guidelines for licensed corporations and financial institutions. The proposed changes are intended to reflect the Financial Action Task Force recommendations set out in the recently published sector-specific Guidance for a Risk-based Approach (RBA) for the Securities Sector (released in October 2018). The proposed amendments mandate that firms review institutional risk assessments at least once every two years (or more frequently upon the occurrence of



prescribed trigger events) and expands the list of risk factors for both institutional and customer risk assessments. In the context of the asset management sector, it also requires enhanced due-diligence to be conducted by firms that are (i) engaged in 'cross-border correspondent relationships', which is defined to cover domestic managers who receive or process fund subscription or redemption orders placed by an overseas distributor for and on behalf of underlying investors or (ii) act as delegated asset manager but do not have a contractual relationship with the delegating investment manager's customer (i.e. the fund) to (among others) obtain information about the underlying investors.

INTERMEDIARIES/MARKET SUPERVISION

OTC Derivatives Regime—Update

June 2020: Following public consultation, the SFC released its consultation conclusions to refine the scope of regulated activities under the over-the-counter (OTC) derivatives licensing regime and outline the competence and continuous professional training requirements under the new regime. Notably, the existing exemption for Type 9 asset managers managing OTC derivative portfolios for wholly owned group companies will be extended to cover all OTC derivative products. In addition, Type 3 managers who deal in foreign exchange derivatives solely for the purpose of managing assets will now also be exempt from the new licensing regime.

New FRR Forms

June 2020: The SFC announced plans to revamp all financial returns required to be submitted by licensed firms under the Financial Resources Rules (FRR), which will require disclosure of more detailed/granular information when computing liquid capital, ranking liabilities, and profit and loss. The revised filings take effect for the accounting period starting on or after July 1, 2021. To ensure a smooth transition, licensed firms are expected to evaluate and consider whether their current financial reporting systems adequately capture the required new information/data points (subject to any further "non-substantive" amendments, which the SFC circular indicates could be made at a later stage).

SFC Highlights Cyber Risks for Online Brokerage Accounts

September 2020: Following a recent thematic review, the SFC published a circular with guidance on best practices to plug gaps in cyber security protocols and better protect investors against hacking risks when using online trading accounts in accordance with the baseline requirements set out in the Guidelines for Reducing and Mitigating Hacking Risks Associated with Internet Trading (July 2018).

SFC Signs MoU with IA to Streamline Oversight of Insurance-Related Investment Products

September 2020: The SFC entered into its first memorandum of understanding (MoU) with the Insurance Authority (IA) to streamline supervision and regulation of insurance-related investment products, including investment-linked assurance schemes, approved pooled investment funds under the mandatory provident funds regime and pooled retired funds and other SFC-authorized investment products issued by authorized insurers or distributed by regulated intermediaries.



KEY PRODUCT DEVELOPMENTS

Amendments to REIT Code

June 2020: The SFC announced a two-month consultation to amend the Code on Real Estate Investment Trusts (REITs). If implemented, the proposals will (among others) allow unitholders to consent to investments in projects in excess of the existing sublimit of 10% gross asset value as well as vary other existing investment restrictions and connected party/notifiable transactions.

Chinese Regulatory Agencies Approves Custody Services by Foreign Banks

July 2020: As part of China's efforts to liberalize its financial services sector under the Economic and Trade Agreement with the United States of America signed on January 15, 2020, the China Securities Regulatory Commission (CSRC) and the China Banking and Insurance Regulatory Commission (CBIRC) jointly issued the amended Administrative Measures on Custody Business of Securities Investment Funds (Amended Measures). Under the Amended Measures, local branches of foreign banks operating in China may apply to become licensed to offer securities investment funds custody services with immediate effect.

Inaugural Cross-border ETFs Secure Regulatory Approvals

August 2020: The SFC/CSRC announced the approval of the first two exchange-traded funds (ETFs) to be listed on the Hong Kong and Shenzhen stock markets under a new scheme to facilitate cross-listings of ETFs between the two regions.

SFC Grants First Approval-In-Principle for Virtual Asset Trading Platform

August 2020: The SFC granted licensing approval for the first virtual asset trading platform to conduct Type 1 (dealing in securities) and Type 7 (providing automated trading services) regulated activities in accordance with the conditions outlined in the SFC's policy paper for regulation of virtual asset trading platforms released in November 2019. Upon fulfillment of the licensing conditions, the applicant will become licensed to provide brokerage and automated trading services for digital assets, including securities tokens. This will be Hong Kong's first virtual asset trading platform licensed to trade digital assets that are securities and marks a critical milestone in the development of Hong Kong's burgeoning digital ecosystem.

Chinese Regulators Consolidate QFII/RQFII Regulations

September 2020: The People's Bank of China, State Administration of Foreign Exchange and CSRC jointly announced new Measures for the Administration of Domestic Securities and Futures Investment by Qualified Foreign Institutional Investors (QFII) and RMB Qualified Foreign Institutional Investors (RQFII). Starting November 1, 2020, the new measures consolidate the QFIIs and RQFIIs regulations into a single inbound qualified foreign investor regime. Among other major changes, the new regime allows foreign institutional investors to trade Chinese stocks and bonds under a simplified and unified licensing process and relaxes existing qualification requirements and investment restrictions to facilitate more flexible investment arrangements.

New Guidelines on e-dissemination of Investment Product Documents

September 2020: The SFC issued a circular prescribing minimum standards for investors of SFC-authorized funds that opt to receive documents electronically (including offering documents, notices, announcements, and financial reports). Notably, the circular also extends the standards to non-SFC-authorized investment products/funds.



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.

Summary of SFC Enforcement Activity

- **June 2020:** The SFC released its annual report providing a detailed overview of its enforcement efforts and accomplishments for the fiscal year ending March 31, 2020. This report reveals breaches noted during onsite inspections increased 20% to 1,489 (from 1,236 in 2018-19). Internal control weakness and breaches of the Code of Conduct (making up nearly 50% of total infractions) remained prevalent, with a staggering 65% increase in anti-money-laundering breaches. Although investigations declined to 197 (from 238 in 2018-19), the number of cases resulting in formal SFC disciplinary actions increased and were coupled with heftier financial penalties. In addition, breaches of the Fund Manager Code of Conduct rose 20% (from 67 in 2018-19). We therefore expect the industry to come under closer regulatory scrutiny with a return to heightened market volatility and dislocation.

Senior Management Accountability

- **June 2020:** A RO (acting as director and senior manager) was banned for 12 months (and the licensed corporation fined HK\$25.2 million) for lax anti-money-laundering compliance procedures when screening third-party deposits or withdrawals totalling approximately HK\$37.5 billion. A subsequent appeal to the Securities and Futures Appeals Tribunal was later abandoned.
- **September 2020:** The SFC banned a former RO who acted as sponsor principal for 20 months for due diligence and other shortcomings under the new sponsor regime. Concurrent disciplinary proceedings against the licensed firm is pending appeal to the SFAT.

Internal Control Failures

- **June 2020:** A licensed corporation was reprimanded and fined HK\$800,000 for window-dressing its liquid capital returns over three years by including aged receivables as liquid assets, which if excluded would have resulted in a deficit of HK\$335,000 to HK\$449,000.
- **September 2020:** Two well-known financial institutions were reprimanded and fined HK\$4.2 million and HK\$2.5 million respectively after self-reporting failures to properly segregate clients' securities from proprietary securities held with external custodians and pledging clients securities as collateral to obtain credit lines without valid client authorisation.
- **November 2020:** A well-known financial institution was fined HK\$2.1 million for lax electronic trading controls resulting in inadvertent mismarking errors relating to quotes for stock option positions.

Life Bans

- **August 2020:** A licensed representative was banned for life after being convicted and sentenced to imprisonment for six months (suspended for two years) for seven counts of fraud involving approximately HK\$65,000 (after pocketing fees he falsely represented customers had to pay during the account opening process).

Licensing-Related Issues

- **June 2020:** Two fund managers were convicted and fined for (among others) holding themselves out as carrying on business in asset management without an SFC license.



- **July 2020:** A company and its director were convicted and fined for (among others) advising on corporate finance (i.e., advising on listing applications) without an SFC license.
- **July 2020:** A securities dealer was banned for 20 months for unauthorized trades carried out in the discretionary accounts for four clients and for failing to properly explain the risk disclosure statements during the account opening process.
- **August 2020:** Two securities dealers were banned for eight months and 18 months respectively for unauthorized trades carried out in trust and discretionary account for two clients.

Obstruction

- **September 2020:** A licensed representative was convicted and fined HK\$36,000 for providing false and misleading information to the SFC and concealing that he had been charged with a criminal offense (and was still under criminal investigation) when applying to become licensed.

CONTACTS

Effie Vasilopoulos

Partner, Co-head of Global
Investment Funds Group
+852 2509 7860
evasilopoulos@sidley.com

Dominic James

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

Ling Chen

Senior China Advisor
+86 21 2322 9316
lingchen@sidley.com

SIDLEY

AMERICA • ASIA PACIFIC • EUROPE

[sidley.com](https://www.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](https://www.sidley.com/disclaimer).