# ASIA
# Funds & Financial Services

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## IN THIS ISSUE



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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 the recent proposals to significantly expand the enforcement powers of the Securities and Futures Commission (SFC) to tackle cross-border insider dealing, to give statutory backing to certain breaches of the Code of Conduct, as well as to narrow the well-trafficked private placement exemptions widely used in the industry to market professional investors.

## EDITORIAL

### HONG KONG'S REGULATORY OUTLOOK IN 2022 AND BEYOND

In a recent consultation paper, the SFC has proposed to amend the Securities and Futures Ordinance (Cap. 571) (SFO) in order to significantly enhance its enforcement powers to: (i) tackle cross-border insider dealing; (ii) seek compensation orders and damages in disciplinary cases; as well as (iii) narrow the well-trafficked private placement exemptions widely used in the industry to market professional investors.

According to the consultation paper, the primary objective of the proposed amendments is to "enable the SFC to better protect the interests of the investing public and uphold the reputation of Hong Kong's financial markets through more effective enforcement action." Subject to public feedback over a 60-day comment period, the SFC will proceed with the legislative process. We summarise below all three proposals given the potential for controversy and significant impact on the regulatory and enforcement landscape in Hong Kong in 2022 and beyond.

#### Proposed Amendments to the Insider Dealing Regime

Similar to other major financial markets, Hong Kong adopts a dual criminal and civil regime to deter all forms of market abuse, including insider dealing. However, in accordance with the original intended purpose, the insider dealing provisions under the SFO did not have an extra-territorial effect, i.e., did not cover transactions/trading by persons in Hong Kong on overseas stock markets or persons trading outside Hong Kong. This was because a compromise was struck at the time the SFO was introduced to expressly limit the insider dealing regime to Hong Kong-listed and dually listed stocks. According to the consultation paper, faced with an increasing number of cases with a cross-border dimension, the SFC proposes that the insider dealing regime now be widened to cover:

- insider dealing perpetrated in Hong Kong with respect to securities listed on overseas stock markets or their derivatives
- insider dealing perpetrated outside Hong Kong with respect to any Hong Kong-listed securities or their derivatives.

In doing so, the SFC is poised to introduce a major change to expand the insider dealing regime to give it extra-territorial effect and overcome the perceived jurisdictional roadblocks when tackling cross-border cases involving insider dealing. The SFC also proposes consequential changes or clarifications to some of the defences in the insider dealing provisions. In particular, where a person in Hong Kong is accused of insider dealing in foreign securities or derivatives, the person has a defence unless it is proven that the conduct is also illegal in the relevant overseas jurisdiction. According to the consultation paper, "it is in [Hong Kong's] interests as an international financial centre to deliver a strong deterrent message by punishing this misconduct here."

Nevertheless, the proposals pave the way for a new era of liability, and reinforces the need for caution when handling potentially market-sensitive information whenever trading foreign securities. This is worrying because (unlike the position in the U.S.) there is no requirement for the Hong Kong regulators to demonstrate that the insider owed/breached any duty of confidence, and the Hong Kong courts have confirmed that the starting point is an immediate custodial sentence (irrespective of the amount of any gain or loss avoided).

### Proposed Amendments to the Disciplinary Regime

Where a regulated person is guilty of "misconduct" or the SFC is of the opinion that a regulated person is not "fit and proper" to remain licensed under Section 194 (in respect of licensed persons) or Section 196 (in respect of registered institutions) of the SFO, the SFC may take disciplinary action, including exercising certain powers to revoke or suspend regulatory licenses, or issuing a reprimand or imposing a fine (which is intended to deter non-compliance, rather than be punitive or compensatory in nature).[1]

The power to take disciplinary action against a regulated person for misconduct or where a person is deemed to be unfit to remain licensed is much wider than market misconduct. Typically, where evidence of wrongdoing is less cogent, the SFC often opts to bring disciplinary proceedings, rather than meet the higher burden of proof applicable in civil or criminal proceedings. Disciplinary action is therefore routinely taken in cases where the misconduct in question involves a breach of the Code of Conduct published by the SFC (the Code), rather than a contravention of the SFO.

Unless the "misconduct" also constitutes a breach of one or more of the statutory provisions under the SFO, the SFC does not have free-standing power to seek compensation orders or damages for disciplinary-only infractions. Affected clients/investors who have suffered financial loss, therefore, need to seek redress (at their own expense) before the civil courts. However, according to the consultation paper, the SFC now proposes that Section 213 of the SFO (Injunctions and other orders) be amended to enable the SFC to apply for injunctions and other compensation orders from the Court whenever it exercises any of its disciplinary powers under Sections 194 or 196 of the SFO against a regulated person, without the need for affected clients/investors to have to resort to any private right of action.

In doing so, the SFC is now poised to give statutory backing to the Code and pave the way for compensation orders to be sought without a prior finding by a court or tribunal of a contravention of the statutory provisions of the SFO. This is worrying because the Code, by its terms, does not have the force of law and a breach of Code is not intended to be interpreted in a way that overrides the provision of any law.

1 Any steps taken to identify whether clients or others have suffered loss and any steps to sufficiently compensate those clients are relevant circumstances that would be taken into account in determining whether or not the SFC will impose a fine and, if so, the amount of the fine.

### Proposed Amendments to the Private Placement Regime

A very tight regulatory net has been cast over the marketing of interests in securities or investment funds to Hong Kong investors, which often requires a close analysis. Broadly speaking, unless an offer is authorised by the SFC for sale to the public, two sets of rules require consideration as follows:

- Product offering rules: the offering restrictions, including disclosure requirements, on making offers/invitations to the public under Hong Kong law, unless an applicable offering exemption applies. Most commonly, promoters seek to rely on the 'private placement' exemption. Namely, offers made exclusively to 'professional investors' under Section 103(3)(k) of the SFO, an unlimited number of non-professional investors who invest at least HK$500,000, or no more than 50 offerees in Hong Kong in any 12-month period under Section 103 (3)(a) or (b) of the SFO are exempted from the product offering restrictions.
- Licensing rules: the act of marketing interests in a fund (even when conducted via private placement) is regarded as a regulated activity under Hong Kong law and requires a Type 1 (dealing in securities) license, unless an exemption applies. Most commonly, unlicensed promotors rely on the 'as principal' exemption. This exemption is very limited and narrowly construed. In practice, when marketing to non-professional investors or high-net-worth (HNW) individuals, a promoter will need to appoint a locally licensed intermediary or placement agent to promote the fund.

The term 'professional investor' (PI) generally encompasses SFC-licensed intermediaries, authorised financial institutions, central banks, insurance companies, pension funds, and certain qualified high-net-worth individuals, as defined in the Securities and Futures (Professional Investor) Rules. The issue of advertisements of investment products intended only for PIs is exempt from SFC authorisation because sophisticated PIs do not require statutory protection (unlike retail investors).

The Hong Kong courts had previously ruled that the exemption applies to all offers that are intended to be sold (and had been sold only) to PIs, even if this intention was not clearly stated in the offer documents. The SFC believes this ruling fails to provide adequate protection to retail investors from the risks of direct marketing of inappropriate or risky investment products. Further, the SFC believes that the regime has become far too difficult to enforce because a mere intention to sell products to PIs would qualify for the exemption and the SFC is shackled from taking action until after the sale of the product has taken place. According to the consultation paper, to better protect investors, the SFC proposes that the exemption under Section 103(3)(k) (and its counterpart Section 103(3)(j), which applies to offers to persons outside Hong Kong) be amended to make it clear that it applies in circumstances where the advertisement states on its face that the terms of the offer are limited to professional investors and offers are issued *only* to PIs.

These proposals arguably reinforce the need for promoters to carefully pre-vet PIs prior to disseminating marketing or offering materials, regardless of whether or not disclaimers are included stating that the offer is intended for PIs.

## CSRC ISSUES PROPOSALS TO PROTECT STATE SECRETS IN OVERSEAS AND DOMESTIC LISTINGS

China Securities Regulatory Commission (CSRC) recently published draft *Provisions on Strengthening Confidentiality and Archives Administration of Overseas Securities Offering and Listing by Domestic Enterprises*, which are intended to amend and supersede an earlier version issued in 2009 governing the provision of audit working papers in the context of cross-border regulatory cooperation.

The (revised) provisions mandate (among others) that Chinese domestic companies must obtain approvals from competent state authorities before furnishing documents and materials containing state secrets, governmental work secrets, valuable archives or other sensitive information to designated counterparties (including accounting firms and foreign regulators) in connection with overseas securities offerings or listings. A Chinese domestic company must also enter into a confidentiality agreement with its counterparties in accordance with applicable Chinese laws such as the *Law on Guarding State Secrets* and procure that audit working papers and other sensitive information are stored within China by such counterparties.

Although it is unclear when the (revised) provisions will take effect, as currently drafted, the provisions create new challenges for Chinese companies seeking overseas listings, securities firms, audit firms and other service providers as well as foreign regulators seeking information on Chinese domestic companies for supervisory or other purposes.

## REGULATORY STANDARDS/UPDATE

### Enhanced Measures to Deal With Financial Distress

**March 2022:** The SFC issued a detailed circular to provide guidance for intermediaries to enhance operational resilience in the event of unforeseen disruptions caused by financial distress and the sudden unavailability of key staff. The SFC reiterated the ongoing obligations of all firms to maintain at least two responsible officers to supervise regulated activities and monitor compliance with financial resources. In certain circumstances, firms are also required to provide a business continuity plan and/or an exit plan.

### SFC Proposes Changes to Position Limit Regime

**April 2022:** The SFC published a consultation paper with proposals to refine the position limit regime for listed futures and options contacts. If implemented, the regime will be amended to expand the list of contracts that exchange participants (including unit trusts and sub-funds) may hold in excess of the prescribed position limits and reportable positions, as well as require reporting of positions during public holidays. The proposals also include a mechanism to automatically approve clearing participants who provide clearing services for exchange participants that have been authorised to hold or control contracts in excess of the prescribed limits.

### Regulation of Virtual Assets/Non-Fungible Tokens (NFTs)

**June 2022:** The SFC signalled it is keeping under close scrutiny arrangements involving offers of NFTs to the Hong Kong public, and warned that parties engaged in marketing or distributing NFTs structured to mimic "securities" or interests in "collective investment schemes" will require a license and/or trigger authorisation requirements unless exempted.

Earlier in the year, the SFC and the Hong Kong Monetary Authority issued a joint circular to provide guidance for intermediaries who intend to distribute virtual asset-related products and engage in virtual assets dealing and advisory services. The circular imposes restrictions, including the requirement to undertake suitability assessments (irrespective of whether or not there has been a solicitation or recommendation), and limits offers to professional investors (unless approved for sale to retail investors) subject to a six-month transition period for intermediaries who currently provide virtual asset-related activities.

The Hong Kong government has separately gazetted legislative proposals for a new licensing regime to regulate centralised virtual asset exchanges trading non-security tokens to be licensed and regulated by the SFC. The draft bill is expected to come into effect on March 1, 2023. Once implemented, the new regime will require any person providing a virtual asset service (currently limited to operating a virtual asset exchange) to be licensed by the SFC.

## INTERMEDIARIES/MARKET SUPERVISION

### SFC Migrates to Paperless Licensing Platform (and Waives Annual Licensing Fees)

**April 2022:** All licensing applications, notifications, and regulatory filings were required to be submitted electronically via the fully digitalised licensing platform named WINGS. With the migration towards a paperless environment, the SFC also waived annual licensing fees for all regulated persons / entities for the 2022-23 financial year. Earlier in the year, licensed firms were required to submit the revamped FRR returns through WINGS. The revamped forms collect additional data, including details of proprietary investments, banking information, group company management fees, as well as assets under management, which significantly enhances the SFC's gatekeeping and other regulatory functions.

### New Conduct Requirements for Bookbuilding and Placing Activities

**May 2022:** The SFC published new conduct requirements and related FAQs to provide guidance on the standard of conduct expected of market participants who (i) engage in bookbuilding and placing activities, and (ii) act as sponsor in equity and debt capital market transactions, which become effective on August 5, 2022.

## KEY PRODUCT DEVELOPMENTS

### Re-Domiciliation of Open-ended Fund Companies (OFC)

**April 2022:** The SFC registered the first private Cayman Islands corporate fund as a re-domiciled private OFC in Hong Kong since the new statutory re-domiciliation mechanism took effect on November 1, 2021. The new regime helps overseas corporate funds migrate to Hong Kong using the OFC structure, and funds 70% of eligible expenses (up to HK$1 million per OFC) under a three-year grant scheme.

## SIGNIFICANT ENFORCEMENT ACTIONS

The SFC recently released its annual report providing a detailed overview of its enforcement efforts and accomplishments for the first year ended March 31, 2022. Notably, the SFC ramped up the use of its powers to suspend trading in shares of listed companies in 220 cases (from nil in 2020-21). Internal control weaknesses and breaches of the Code of Conduct (making up nearly 50% of total infractions) remained prevalent, with a staggering 45% increase in anti-money laundering breaches. Market misconduct investigations also climbed 15% to 214 (from 189 in 2020-21) with the number of cases resulting in the formal SFC disciplinary actions increasing 40%, despite the imminent departure of the SFC's Head of Enforcement (Thomas Atkinson). We therefore expect the industry to continue to remain under close regulatory scrutiny as market volatility persists, and have highlighted below recent disciplinary and enforcement actions that may be of interest to managers in charge/responsible officers (ROs), licensed representatives, intermediaries, and others operating in the Hong Kong financial markets.

### Anti-Money-Laundering/Senior Management Accountability

**January 2022:** A licensed corporation was reprimanded and fined HK$5 million (and its responsible officer banned for seven months) over AML/CFT breaches, including failing to implement two-factor authentication, take reasonable steps to know its clients and their ultimate beneficial owners, and have in place an effective monitoring system to detect unusual money movements.

**February 2022:** A licensed corporation was reprimanded and fined HK$4.8 million for AML/CFT breaches, including failing to conduct due diligence, make proper enquiries on deposits, or put in place an effective ongoing monitoring system to detect suspicious trading patterns.

**March 2022:** Two related licensed corporations were reprimanded and fined HK$5.4 million for AML/CFT breaches associated with third-party fund transfers totaling over HK$1 billion.

**June 2022:** A licensed corporation was reprimanded and fined HK$3.8 million for AML/CFT breaches associated with third-party deposits and payments totaling over HK$250 million.

### Internal Control Failures/Breach of FMCC

**January 2022:** A global investment bank was reprimanded and fined nearly HK$350 million for multi-year serious systemic regulatory breaches when conducting client facilitation activities.

**March 2022:** The broker dealer arm of a global bank was reprimanded and fined HK$6.3 million after self-reporting a series of internal control errors, including the failure to correctly name clients who traded A-shares under northbound trading link of Stock Connect, thereby compromising the Shanghai and Shenzhen stock exchanges ability to monitor northbound trading activities.

**June 2022:** Following an SFC audit, a discretionary private fund manager was reprimanded and fined HK$ 3.2 million over breaches of (among others) the Fund Manager Code of Conduct (FMCC), including failures to exercise discretionary investment management authority and undertake satisfactory risk management after 75% drop in the net asset value of the fund (despite the fact that the NAV subsequently rebounded nearly 270%).

### Bribery/Life bans

A former vice president of a global bank was banned for life following his convictions for bribery in accepting gifts in exchange for extending credit facilities, and a life ban was also imposed on a former licensed representative for misappropriating HK$1.8 million after eight cheques to repay the funds were dishonored.

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