

Hong Kong Regulatory Enforcement Trends



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Enforcement trends – 2021 year in review and looking ahead

At the start of each year, we examine important regulatory enforcement events¹ from the previous year in the Hong Kong financial markets and consider what the coming months might hold. This year, Hong Kong is expecting to see a new Executive Director (**ED**) of Enforcement at the SFC², so we thought it would be a good time to consider the SFC's enforcement approach and outcomes since 2016³ before we look ahead at what might be to come.

Executive summary: the headlines

Over the last six years, the SFC's Enforcement Division has focused on pursuing "high impact" cases: those involving the greatest adverse impact for the market. Last year, it continued to do so, in particular focusing on cases involving fraud, whether corporate fraud by those within a listed company or fraud by others against individual investors (e.g. through "ramp-and-dump" schemes). Of course, it did a lot more than that over the year, given the wide range of matters that require assessment from an enforcement perspective. Other aspects of its "staple diet", for example intermediary misconduct, continued to keep it busy. However, in that regard, it is notable that total fines have

been significantly down when compared with total fines last year and the year before. What has caused that? It is not possible to be sure because of the numerous variables involved. However, one thing is clear: the market waits with interest for further colour on how the SFC's new ED of Enforcement (who has not yet been announced) will take the SFC's enforcement efforts forward, and whether there will be any material changes in strategy, approach, direction or emphasis. We offer some thoughts below as to some of the issues with which the new ED will likely need to grapple.

The direction of travel and how we got to where we are

For many, life in general has changed enormously in the six years since 2016. The global financial crisis of 2008/2009 seems like a lifetime ago, and the next crisis is ready to emerge at any time in future. The question is when. In the intervening period the world has become significantly more complex and demanding in countless ways. There's the relentless advance of technology⁴, the increasingly complicated and interconnected financial systems,

international competition, the blurring of boundaries between the old economy and the new, the evolving idea of what constitutes an "asset" or "investment", the growing power of asset managers and "private equity" investors, the impact of fluid and increasingly polarised geopolitics (and corresponding risk of international conflict) and an unprecedented global pandemic that has affected the lives of billions and remains an ongoing threat.

¹ We usually focus on the Securities and Futures Commission's (SFC) enforcement work because it is generally most relevant to those who participate in Hong Kong's financial markets.

² <https://apps.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=21PR117>.

³ The year when the SFC's current ED of Enforcement began his role.

⁴ Think: data, privacy, cyber-security, digital assets and artificial intelligence.

Increasingly, organisations are looking for new ways to prioritise and to achieve efficiency and more effective outcomes, often through using technology; and the SFC is no exception⁵. Since 2016, regulatory enforcement in Hong Kong has changed significantly. It has evolved from a focus on hard-edged enforcement, including common use of criminal prosecutions and penalties, to being increasingly used as a “tool of last resort”, in conjunction with other, less complex and less time-consuming regulatory tools. The aim is to prevent problems and remedy emerging problems early before they become bigger problems instead of relying on punishing and deterring after-the-event. At the same time, crime and misconduct have evolved significantly: like the world more broadly, they are increasingly complex, cross-border and on-line. Why physically rob a High Street bank when there’s potentially much more to be gained at significantly less risk of being identified and caught, by engaging in cybercrime?

Law enforcers have a tough job, and the evolution of the SFC’s approach to enforcement makes sense. Its continued evolution will be critical to the SFC’s effectiveness as a market regulator.

Enforcement – which at its heart involves identifying, investigating and then, when possible, punishing (and therefore ultimately deterring) serious wrongdoing – is immensely complicated. The SFC has described it as a “blunt

regulatory tool”⁶ – a tool that regulators and other law enforcement authorities would prefer not to use but ultimately have no choice about because there will always be “bad actors”, those who are determined not to be law abiding, and those who otherwise do not meet the regulatory standards expected of them.

The targets, particularly those suspected of very serious, deliberate misconduct, can often be uncooperative and even difficult to find⁷. And gathering evidence, which is critical for making informed enforcement decisions, and then taking action to punish and deter, is time-consuming. It must be gathered in accordance with the rule of law and take account of practicalities (for example, leaving to one side search warrants⁸, those from whom evidence is demanded are, as a matter of fairness, generally given a reasonable opportunity to respond⁹) and it can often be complex, particularly, for example, when important evidence may not be in, or directly accessible from, Hong Kong and needs to be gathered with the assistance of an overseas regulator or law enforcer. The result of all of that is that, notwithstanding a regulator’s best efforts with available resources, the enforcement process can sometimes take many years to reach a conclusion¹⁰.

⁵ For example, the SFC: (a) initiated an organisation-wide market surveillance intelligence project to collect and analyse data to identify market conduct risks; and (b) set up a new Data Analytics Group to enhance market surveillance effectiveness and monitor prudential and systemic risks. SFC Annual Report 2017/18 (https://www.sfc.hk/-/media/files/ER/Annual-Report/2017-18/Eng/SFC_Annual_Report_2017-18_Eng_Full.pdf).

⁶ Thomas Atkinson’s speech at the 7th Pan Asian Regulatory Summit, 9 November 2016 (https://www.sfc.hk/-/media/TC/files/ER/PDF/Speeches/Atkinson_20161109.pdf).

⁷ <https://apps.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=21PR37>.

⁸ See footnote 20 below.

⁹ The SFC has broad statutory power to compel assistance from suspects and witnesses when conducting investigations but it inevitably takes time for those powers to elicit the evidence that the SFC seeks. For example, if the SFC requires a recipient of a statutory notice to deliver to the SFC information and materials relevant to the SFC’s investigation, it must give the recipient reasonable time to comply (e.g. potentially relevant records must be identified, extracted from files and archives, and assessed for responsiveness to the SFC’s requests). And because legal professional privilege is protected under Hong Kong’s Basic Law, if the recipient has identified that some of the information and materials required might well be legally privileged, the SFC must afford the recipient a reasonable opportunity to assess what is privileged and what is not, and whether to claim privilege over the privileged information/materials. Similarly, the SFC does not have statutory powers of arrest, unlike the Hong Kong Police and Independent Commission Against Corruption (ICAC). While it can legally compel attendance at interviews as well as answers to its questions in interview, interviews need to be arranged with interviewees, whether they are suspects or witnesses, so timing can depend on their availability and fairness as to how long each individual ought to be given to comply.

¹⁰ Many cases are, of course, resolved much earlier but generally, the more complex the matter, and the greater the volume of relevant evidence and the number of individuals and entities that are involved or from whom evidence is needed, the longer it will take to investigate and for the regulator to reach an informed conclusion.

We use one example to illustrate the enforcement challenges that regulators can face with a particularly complex matter. On 3 December 2009, China Forestry Holdings Company Limited was listed on the Main Board of the Hong Kong Stock Exchange (*Stock Exchange*). It subsequently failed and went into liquidation. On 3 May 2018, following an investigation into matters relating to that company, the SFC commenced proceedings before the Hong Kong Market Misconduct Tribunal (*MMT*) against two individuals who were directors of the company at the relevant time, and an investment vehicle owned by one, on suspicion that they may have engaged in market misconduct in Hong Kong. As of the date of this note, the MMT has not published its report on the matter.

Accordingly, when the enforcement process reaches its conclusion and enforcement action is taken, the wrongdoing that resulted in enforcement may well be long in the past, and the victims of wrongdoing have very likely moved on. In that sense, enforcement, *alone*, may not necessarily be the best way to protect investors' interests. To be most effective, it ought to be used with other, non-enforcement tools, as part of a "suite". For example, targeted supervisory inspections can help to identify, prevent and deter intermediary misconduct; inquiries of listed companies can help to identify, prevent and deter corporate misconduct; and investor education and greater general awareness of when a "scam" might arise can help to reduce instances of on-line fraud, like "ramp-and-dump" schemes.

In the nine years before 2016, the SFC had explored and tested many of the statutory enforcement tools in its armoury¹¹, including more complex tools involving criminal prosecution, and proved that those tools worked by obtaining court judgments and convictions and other positive enforcement outcomes. Having tested (and in many cases proved) the effectiveness of the tools, the SFC then focused on applying them to the problems with the greatest potential to adversely impact investors, the market more generally and Hong Kong's standing as one of the world's leading financial centres. It focused on listed company misconduct, listed company fraud, market misconduct like insider dealing and market manipulation, and intermediary misconduct. And it restructured the teams within its Enforcement Division and tailored its approach around that strategy and a broader strategy involving greater collaboration with the SFC's other teams, aimed at spotting emerging issues and problems and addressing them proactively, with a view to deploying enforcement only when needed. That approach resulted in what the SFC has called "ICE"¹². With respect to corporate misconduct, it has resulted in a "front-loaded", more proactive and sometimes more interventionist, approach¹³.

¹¹ These tools are in the Securities and Futures Ordinance (Cap. 571, Laws of Hong Kong).

¹² A collaboration between the SFC's Intermediaries, Corporate Finance and Enforcement Divisions.

¹³ For example, through share trading suspensions under the Securities and Futures (Stock Market Listing) Rules (Cap. 571V, Laws of Hong Kong).

The statistics

Table 1: Statistical summary of SFC enforcement activities

	2021/22 (Annualised based on Q3 report)	Total (2016/17 – 2020/21)	Total (2011/12 – 2015/16)	2020/21	2019/20	2018/19	2017/18	2016/17
S179 inquiries ¹⁴ commenced	60	150	107	42	31	26	24	27
S181 inquiries ¹⁵ commenced (number of letters sent)	229 (8,448)	1,333 (44,010)	1,150 (32,624)	246 (8,748)	231 (8,767)	294 (9,074)	261 (8,461)	301 (8,960)
Investigations started	237	1,333	2,023	204	197	238	280	414
Investigations completed	121	1,466	1,243	196	182	243	254	591
Individuals/ corporations criminally charged	5	46	141	10	7	5	14	10
Criminal charges laid ¹⁶	37	181	727	29	10	42	54	46
Notices of Proposed Disciplinary Action ¹⁷ issued	43	162	208	27	35	22	29	49
Notices of Decision ¹⁸ issued	44	203	213	35	46	34	32	56
Individuals/ corporations subject to ongoing civil proceedings	173	661	378	179	158	101	97	126
Compliance advice letters ¹⁹ issued	172	1,508	1,662	231	218	234	277	548
Cases with search warrants executed ²⁰	48	131	198	28	17	30	22	34

¹⁴ Section 179 inquiries are typically used to obtain information where the SFC suspects possible corporate misconduct.

¹⁵ Section 181 inquiries are typically used to obtain information where the SFC suspects possible trading or market misconduct.

¹⁶ More than one charge might be laid against an individual or entity.

¹⁷ Notices of Proposed Disciplinary Action (NPDAs) are used where the SFC intends to take disciplinary action against a regulated entity or individual.

¹⁸ The SFC issues Notices of Decision at the end of the disciplinary process which was started through an NPDA, after considering any submissions filed.

¹⁹ Compliance Advice Letters are generally issued where the SFC considers that there is sufficient evidence of a regulatory breach but, in the exercise of its discretion, considers that the breach is not sufficiently serious to warrant enforcement action in the circumstances.

²⁰ Search warrants are court-issued documents that enable the SFC to enter and search specific, identified premises for evidence relevant to an investigation. They can be an effective evidence-gathering tool, using the element of surprise to secure evidence that might otherwise be at risk of being lost if not secured quickly. The SFC has often (but not exclusively) deployed them in investigating matters involving suspected fraud/market misconduct.

There are many ways to interpret statistics, but those statistics raise the following points and questions:

- suspected corporate misconduct appears to be on the rise and/or more of it is on the SFC's radar;
- the civil unrest in Hong Kong in 2019 and the subsequent COVID-19 pandemic seemingly impacted on aspects of the SFC's enforcement work that required search warrants, but the SFC has adapted;
- market misconduct (like insider dealing and market manipulation) remains a consistent problem. For a market the size, complexity and importance of Hong Kong's, how much market misconduct is the SFC realistically able to detect, assess and pursue, given its size and resourcing²¹? Is there much market misconduct that is not caught, where the rewards are so significant such that wrongdoers remain incentivised to pursue it and take a risk notwithstanding the SFC's success in identifying, investigating and pursuing cases with the resources that it has?;
- the SFC is focusing its resources on fewer investigations now than in 2016, and that has resulted in fewer investigations concluded and fewer enforcement outcomes like prosecutions, disciplinary actions and compliance advice letters. As Table 2 below shows, the SFC has focused on larger/more significant cases²² which have generally resulted in larger *total* financial penalties, but have there been significant problems that the SFC has been unable to investigate and pursue because of resource and other constraints²³;
- the SFC has been increasingly using civil tools and remedies (rather than criminal prosecution) to achieve enforcement outcomes. Those tools and remedies might achieve better financial outcomes for investors who have suffered loss as a result of others' wrongdoing, but are they significantly less effective than criminal prosecution in deterring future wrongdoing²⁴?; and
- by focusing on the larger and more impactful cases, might the SFC be missing an opportunity to encourage and engender a broader change in market behaviour that can arise from the market seeing a significant volume of smaller enforcement outcomes in addition to the big cases²⁵?

²¹ The SFC currently has around 1,000 staff. In comparison, the ICAC, which has an arguably narrower regulatory remit than the SFC's (focused on public and private sector corruption and related crimes), currently has around 1,400. Is 1,000 staff sufficient to enable the SFC to do what it must do in a market of Hong Kong's size and complexity?

²² Larger cases, by their nature, are often more complex and therefore more time-consuming to investigate. And if they are pursued in enforcement action, they are more likely to be defended vigorously, because the target(s) has/have more at stake.

²³ For example, difficulties in successfully accessing evidence outside Hong Kong such that it can then be used in Hong Kong.

²⁴ Being caught and then having to pay financial compensation raises a very different cost-benefit incentive equation for determined wrongdoers than being caught and then imprisoned.

²⁵ This type of dynamic has been referred to as part of the "broken windows theory": fix the broken windows in a neighbourhood and that can drastically reduce crime in that neighbourhood. In an Asia-Pacific context, please see: <https://asic.gov.au/about-asic/news-centre/speeches/asic-s-approach-to-enforcement-after-the-royal-commission/> and <https://asic.gov.au/about-asic/news-centre/speeches/parliamentary-joint-committee-on-corporations-and-financial-services-opening-statement-asic-chair-james-shipton-19-october-2018/>.

Table 2: Yearly aggregate SFC enforcement fines

Calendar Year	Number of enforcement actions against individuals	Number of enforcement actions against firms/corporations	Total fines	Average fines across individuals, firms and corporations
2021	46	20	HK\$72,165,000 ²⁶	HK\$1,093,409
2020	56	23	HK\$2,803,724,000	HK\$116,821,833
2019	71	71	HK\$1,287,272,800	HK\$13,992,096
2018	57	38	HK\$194,201,000	HK\$6,696,586
2017	73	24	HK\$497,081,071	HK\$10,144,512
2016	85	25	HK\$67,938,830	HK\$2,717,553

There is a clear trend: total fines are on an upwards trajectory. However, a dive into the detail shows that, consistent with the SFC's apparent "less is more"²⁷ enforcement approach, annual total fines are largely accounted for by a few very large matters²⁸. Will the SFC continue to deliver similar enforcement outcomes in the future if it is investigating fewer matters each year while the Hong Kong financial markets continue to grow and become more complex and fast-moving? This will be one of the key challenges for the SFC's new ED of Enforcement.

Against that background, we look at the key areas of enforcement focus and enforcement outcomes over the last year.

²⁶ This does not include a significant fine of HK\$348.25 million that the SFC announced on 18 January 2022.

²⁷ To avoid any doubt, this is our terminology to describe the SFC's focus on "high impact" cases and the general concept of quality over quantity, and not the SFC's.

²⁸ For example, large fines included the following: HK\$400 million (November 2017), HK\$57 million (May 2018), HK\$24 million (July 2018), HK\$375 million, HK\$59.7 million, HK\$224 million and HK\$128 million (March 2019), HK\$27 million (May 2019), HK\$400 million (November 2019), US\$350 million (HK\$2.73 billion) (October 2020) and HK\$348.25 million (January 2022). Each of those matters took years to reach a conclusion.

Enforcement hotspots

Corporate misconduct/misgovernance

For many years, the Stock Exchange and the SFC have worked to improve Hong Kong listed company corporate governance, because it is critical to investor protection and ultimately the quality of the Hong Kong securities market; and that is critical to maintaining Hong Kong's position as one of the world's great listing venues. It is therefore unsurprising to see this area as a hot topic for the SFC over the last year.

Regulation of Hong Kong listed companies generally comprises two levels. The first rests with the Stock Exchange, as frontline regulator of Hong Kong listed companies. It administers and enforces the Stock Exchange Listing Rules and Directors' Form B undertakings²⁹. But the Stock Exchange does not have statutory enforcement powers. In contrast, the SFC does, so the second level rests with the SFC, which will typically focus its efforts on high-level supervision of corporate activity (through its Corporate Finance Division, as part of its "front-loaded" regulatory approach) and, where enforcement is needed, on the most serious of corporate governance failures.

Good or bad corporate governance ultimately rests in the hands of individuals: listed company directors and senior management. Those individuals are involved in major decisions impacting the company, whether day-to-day, strategic or transformational, and play an important role in implementing mechanisms within the company, like systems, controls, policies and procedures etc., to ensure compliance and reduce the risk of wrongdoing that may be detrimental to shareholders and the market more generally. So that's where the regulators have focused more of their efforts to improve corporate governance: on individuals.

In line with regulators pursuing the benefits of preventing ahead of curing, both the Stock Exchange and the SFC have been paying particular attention to the role of non-executive directors, whether independent or not. The reason is simple: non-executive directors can operate as an important check and balance on executive management, and the regulators expect them to do their jobs properly,

without fear or favour. In practice, of course, that can be particularly challenging for independent non-executive directors who sit on the boards of family-controlled companies, where a strong founder continues to call the shots, and where it might be difficult to disagree with the majority. But that's what the regulators expect: truly independent judgement, professional scepticism and brave questioning and decision-making, even in the face of significant pressure.

In that regard, Hong Kong law is generally on the side of the regulators, in that there is little to distinguish between executive and non-executive directors with respect to the *legal* duties that they owe to the companies of which they are directors³⁰. However, the courts and regulators will take account of each director's specific role within the company when assessing whether he/she has complied with his/her duties.

There are four key points for the market to note in that regard; and three are perhaps more relevant to our clients than the last.

The first is that those who sit on a Hong Kong listed company board as a non-executive director to represent an investor's interests (for example, a senior executive of a private equity investor sitting on the board of a Hong Kong listed portfolio company) must take particular care to ensure that they not only discharge their duties as a director and avoid conflicts of interest, but can also prove that they have done so. We elaborate below on the latter point about proof. The Stock Exchange has been taking, and is likely to continue to take, a tough and uncompromising line with all directors, and will not afford any leeway to directors simply because they are non-executive and sit on the board in a representative capacity.

The second is that regulators expect those who chair a listed company's audit committee or sit on that committee to pay particular attention to the completeness and effectiveness of the company's internal controls framework. This is an area that regulators expect all non-executive directors to focus on, because it is part and parcel of the

²⁹ These are declarations and undertakings that each Hong Kong listed company director gives to the Stock Exchange upon becoming a director of a Hong Kong listed company. Please see Appendix 5 to the Main Board Listing Rules.

³⁰ From a regulatory perspective (and this is potentially important from an enforcement perspective), the duties of Hong Kong listed company directors are enshrined in Rule 3.08 of the Listing Rules and assessed and applied in accordance with Hong Kong law. That means that irrespective of whether a Hong Kong listed company is incorporated in Hong Kong (and many Hong Kong listed companies are incorporated outside Hong Kong), its directors must fulfil Hong Kong directors' duties and meet Hong Kong regulatory obligations and expectations.

independent oversight expected of them, but it is particularly acute for members of the audit committee because of that committee's role and function.

The third is that non-executive directors ought to be meticulous in keeping records of precisely how they have discharged their independent oversight role, and not rely solely on the company secretary keeping good, detailed minutes of board meetings. This is evidence that the Stock Exchange and the SFC will look and ask for when investigating whether a non-executive director has complied with his/her duties, and it is critical for directors to address this proactively ahead of time, so that if they are subsequently quizzed by a regulator, they can proactively present a *positive* case instead of being passive and relying on the regulator to prove its case and then looking to poke holes in that case. The latter is very dangerous, in large part because of the point noted above about equality in law between executive directors' and non-executive directors' duties.

The final point is that with respect to egregious breaches of directors' duties which result in material financial loss to minority shareholders and adversely affect the integrity of the market, the SFC and Hong Kong's civil courts are seemingly increasingly intolerant. In June 2021, the SFC publicised a case where the Hong Kong Court of Appeal ordered three former executive directors of a listed company jointly and severally to pay to that company HK\$622 million as compensation to the company for financial loss that resulted from their failing to act in the company's best interests. That is so far the largest compensation order that the Hong Kong courts have ordered against errant directors following regulatory action initiated by the SFC³¹. The three were found to have failed to conduct proper due diligence before causing or allowing various subsidiaries of the company to conduct transactions that were not genuine commercial transactions. Just pausing here, those who are investment bankers will spot a theme: how much the SFC dislikes due diligence failures. We return to this point later in this note.

Internal control failures

From what we have said above, it will come as no surprise that internal control failures feature heavily (again) in the SFC's enforcement activities against regulated financial institutions over the past year. An examination of regulatory enforcement actions over the last year underlines the continuing regulatory focus on internal controls and on the need to punish and disincentivise internal control failures because they can be at the heart of a wide range of compliance-related problems.

Generally, when a problem occurs, its root cause can often involve one or more of the following: individual wrongdoing³², a failure in internal controls³³ and/or a failure in supervision³⁴. To regulators, strong internal controls and supervision can often help to mitigate the risk of individual wrongdoing and may help bring it to light. Accordingly, for regulated entities and listed corporates, maintaining a strong controls and supervision framework will mitigate regulatory and compliance risk. But it requires concerted, regular, close and thoughtful collaboration between business and the second and third lines of defence.

The SFC's press release about its recent action against a global financial institution³⁵ (over concerns about how that institution had engaged in client facilitation) shows how important the identified gaps in internal controls and supervision were to the SFC's assessment of the matter and, ultimately, to the magnitude of the penalty that the SFC decided to impose, notwithstanding that the matter appears to have been settled between the SFC and the institution in question.

³¹ Under section 214 of the SFO.

³² Whether deliberate, reckless, negligent or innocent.

³³ Broadly, a failure in internal controls can involve one or more of the following: insufficient training, ineffective policies, procedures and guidelines, insufficient documentation, insufficient checks and balances, and insufficient monitoring.

³⁴ Effective supervision can be a good check and balance on individual conduct.

³⁵ <https://apps.sfc.hk/distributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=22PR6>.

Anti-money laundering

Similarly, internal control failures have been at the heart of enforcement action relating to breaches of anti-money laundering laws and regulations (a major focus of Hong Kong market regulators for some years). For example, in November 2021, the Hong Kong Monetary Authority (*HKMA*) fined four banks a total of HK\$44,200,000 for breaching the Anti-Money Laundering and Counter-Terrorist Financing Ordinance by failing to: (i) continuously monitor business relationships through customer due diligence; (ii) promptly investigate suspicious transactions; and (iii) monitor transactions³⁶. One month later, in December 2021, the HKMA took enforcement action³⁷ for the first time under the Payment Systems and Stored Value Facilities Ordinance (*PSSVFO*) when it disciplined an online payment services provider and a prepaid card issuer for failing to establish adequate and appropriate systems of control to ensure compliance with the HKMA's AML Guideline for SVF licensees, and to comply with the *PSSVFO*. The SFC also took disciplinary action against several SFC-regulated entities over the course of the year for similar failures (e.g. inadequate customer due diligence, failure to address the risks from third party fund transfers and, in some cases, failing to conduct sufficient due diligence on customer-supplied systems).

Preserving potentially tainted assets: more hurdles for law enforcers in future?

Hong Kong's anti-money laundering laws criminalise dealing in property known or suspected to be connected with serious crime unless the Hong Kong Police or the Joint Financial Intelligence Unit³⁸ (*JFIU*) is first notified of the existence of that property and of the knowledge or suspicion about that property and then grants consent to deal. The way in which the Police/*JFIU* has used that mechanism over the years to, in effect, freeze the property in question by refusing consent to deal (so that the holder of the property cannot deal in the property without committing a criminal offence) has recently been challenged in court, resulting in a judgment adverse to the Police/*JFIU*. We understand that that judgment is likely to be appealed. If the judgment is not overturned on appeal, enforcement efforts involving early prevention of suspected proceeds of money laundering being dissipated can potentially be materially hindered.

In recent years, the SFC has been creative in using, increasingly, one of its tools of intervention (the restriction notice³⁹) to, in effect, freeze property suspected of being connected with serious misconduct. Query whether that use might also be challenged in future.

³⁶ <https://www.hkma.gov.hk/eng/news-and-media/press-releases/2021/11/20211119-5/>.

³⁷ <https://www.hkma.gov.hk/eng/news-and-media/press-releases/2021/12/20211220-3/>; <https://www.hkma.gov.hk/eng/news-and-media/press-releases/2022/01/20220114-5/>.

³⁸ A clearing house for suspicious transaction reports jointly operated by the Hong Kong Police and Customs & Excise.

³⁹ Under sections 204 and 205 of the SFO.

Online scams

Perhaps one of the biggest challenges for market regulators and law enforcers around the world is cybercrime, a booming industry in large part because of a combination of the ubiquity of the internet and electronic devices, the increase in agile working and the ease with which cybercrime can be perpetrated anonymously across borders.

An examination of the SFC's enforcement activities over the past year shows that the SFC likely spent a significant proportion of its enforcement efforts on dealing with online scams. For example, in early 2021, the SFC conducted a joint operation with the Hong Kong Police on a suspected "ramp-and-dump" scheme⁴⁰, which involved a search of 27 premises, the arrest of 12 individuals, and the SFC freezing approximately HK\$860 million in 63 securities accounts through restriction notices. The number of HKMA press releases⁴¹ warning the public against on-line fraud illustrates the prevalence that activity in today's world.

Insurance Authority

Last year saw several Insurance Authority (IA) enforcement actions. Some involved insurance brokers failing to submit audited financial statements and auditor's reports in a timely manner⁴². Separately, a former insurance agent was reprimanded and prohibited from applying to be licensed for five months for inducing others to travel from China to Hong Kong to escape the pandemic and to take out insurance policies from him⁴³. A recent action focused on AML compliance, where the IA reprimanded and fined two insurers a total of HK\$7 million for failures pertaining to politically exposed persons and high-risk business relationships, among others⁴⁴.

Additionally, the IA appointed managers to manage the business and assets of an insurer, citing concerns over that insurer's operations and solvency⁴⁵. The matter concerned the termination of policy coverage for thousands of taxi owner-operators, and followed previous intervention from the IA.

⁴⁰ According to the SFC, the syndicate's modus operandi was to ramp up the price of targeted listed shares, then induce investors via social media platforms to buy the shares before dumping them at an artificially high price (<https://apps.sfc.hk/ledistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=21PR26>).

⁴¹ <https://www.hkma.gov.hk/eng/news-and-media/press-releases/?t=1646142049327>.

⁴² https://www.ia.org.hk/en/infocenter/press_releases/20210528.html; https://www.ia.org.hk/en/infocenter/press_releases/20211222.html.

⁴³ https://www.ia.org.hk/en/infocenter/press_releases/20210707_1.html.

⁴⁴ https://www.ia.org.hk/en/infocenter/press_releases/20220131.html.

⁴⁵ https://www.ia.org.hk/en/infocenter/press_releases/20220107.html.

What lies ahead?

Because of the typically long timeframes involved in regulatory enforcement, and the fact that regulatory investigations in Hong Kong are usually cloaked in statutory secrecy⁴⁶, it is difficult to predict with precision what enforcement outcomes are likely to arise in the coming months. Those outcomes will very likely be of investigations which are currently in progress. However, it is possible to draw together data points from known regulatory steps and events, to form a view about the likely direction of travel.

For example, we know the baseline is that the SFC Enforcement team's "staple diet" (listed company misconduct, listed company fraud, market misconduct like insider dealing and market manipulation, and intermediary misconduct) will likely continue to keep the SFC's Enforcement team busy for the foreseeable future. And because of indications that the current ED of Enforcement gave during ASIFMA's Compliance Week in September 2021, we know that, within those broad headings, his team's then three top enforcement priorities were anti-money laundering, market soundings and wall-crossing, and the role of sponsors during IPOs.

However, the real question in the coming year is what approach the SFC's new ED of Enforcement is likely to take when he/she takes the helm. For example, will it involve a continuation of the current "less is more" approach, a resumption of the "more is more" approach that we saw pre-2016, or somewhere in-between? Or something quite different altogether? There is not necessarily any clear "right" or "wrong" with those approaches, and we suspect that much will depend on whether the SFC's Enforcement team will receive more resources over time, and on the success of the SFC's efforts to keep enforcement as a weapon of last resort. We expect the new ED of Enforcement to start his/her term with a review of enforcement priorities and processes, just as his/her predecessor did in 2016, and then to formulate a revised strategy. Once that strategy is set, it will take time to implement, and we are unlikely to see its true impact until perhaps 2023 or even 2024.

In the meantime, we believe the areas of regulatory enforcement focus over the coming eighteen months or so are likely to include the following.

Individuals

For the reasons we have discussed above, we expect regulators to continue to hold individuals accountable for misconduct, wherever it is possible to achieve that, whether it is in a listed company or regulated entity context. In particular, supervisors and those who are in charge of particular businesses or functions ought to consider proactively how they can better perform their roles and to reduce the risks that accrue to them from bearing supervisory and management responsibility. Over time, we expect to see the SFC take more action against those who are Managers-in-Charge of relevant control functions, like Compliance and Anti-Money Laundering.

Pandemic-related matters

The COVID-19 pandemic is unlikely to be the last health crisis that the world will see. It is therefore important for regulators to learn from what has happened since 2020, and to identify what market participants did well and what they did not do so well, and how things can be improved ahead of the next crisis. In that regard, contingency arrangements for the pandemic will likely have introduced additional risk into the equation for many market participants. For example, trading from home and multiple locations gives rise to a very different risk profile to trading from a central location, the office (including with respect to supervision, monitoring, compliance and cybersecurity). Similarly, the inability to conduct IPO due diligence face-to-face in mainland China because of travel restrictions gives rise to a very different risk profile for IPO sponsors, particularly with respect to business due diligence and third-party due diligence. We would expect regulators to examine those matters in due course, if they are not already doing so.

Internal controls and risk management

We expect internal controls and control failures to remain a priority for regulators. With respect to risk management, and as an example, the Archegos matter identified a variety of risk management gaps with respect to (in particular) derivatives trading that regulators will expect to be addressed in future, particularly by prime brokers and those who provide financing for such activities.

⁴⁶ Under section 378 of the SFO.

The SFC and the Australian Securities & Investments Commission recently announced⁴⁷ a collaborative thematic review of the foreign exchange activities of global financial groups, focusing on internal controls and compliance with applicable rules and regulations and relevant industry guidelines, like the FX Global Code.

Fundraising

IPO sponsors have remained on the radar for regulators but we have not seen any very large sponsor enforcement outcomes since 2019. There are likely to be more in future, not least because of the regulators' focus on improving corporate governance and the quality of companies that come to Hong Kong to list. In this regard, it is likely that the SFC continues to look for its first test case for determining whether the Hong Kong High Court will grant an order against an IPO sponsor to compensate investors in connection with prospectus disclosure and identified due diligence failings⁴⁸. In respect of other types of fundraising outside of IPOs, the SFC is likely to be scrutinising book-building, pricing, allocation and placing activities, not least because of the new conduct rules governing those activities that will come into force in August 2022.

Online frauds

The SFC's Enforcement team spent a significant proportion of its efforts over the last year on dealing with online frauds, like "ramp-and-dump" schemes, including particularly those where the listed companies in question and various individuals connected with them were suspected of being involved in the potential wrongdoing. As discussed above, given the prevalence of this type of conduct, we would expect the SFC to be similarly engaged in related enforcement activity in future, and to look for effective ways to enforce against those who successfully target Hong Kong investors from abroad.

Anti-money laundering

AML remains high on law enforcers' agendas in the world's major financial markets, not just because, from a regulatory policy perspective, it is important to keep tainted property out of the financial system but also because effective detection, prevention and enforcement are critical to maintaining good outcomes in evaluations that the Financial Action Task Force undertakes, which are important for maintaining market standing and reputation amongst global financial centres. We expect AML to remain a core focus for both the HKMA and the SFC, and other market regulators, like the Stock Exchange and Insurance Authority. This is also an area that, from an internal controls perspective, we consider can benefit from the use of cutting-edge financial and regulatory technology (Fintech and Regtech).

Investment product selling processes

Hong Kong remains one of Asia's and indeed one of the world's foremost private banking centres and its size continues to grow (but it faces stiff competition from Singapore). Unsurprisingly, because of the increasing complexity of financial products and notwithstanding the strides that the market has made since the last financial crisis, regulators remain concerned about the risk of misselling and see that as a key plank to address proactively, for investor protection. The SFC and HKMA recently published a joint circular⁴⁹ about a concurrent SFC-HKMA thematic review of the distribution of non-exchange traded investment products, such as equity-linked structured products (including equity accumulators and decumulators) and corporate bonds. As with all thematic reviews, there is the possibility of subsequent enforcement action if the review elicits evidence of significant compliance problems in any of the institutions inspected.

⁴⁷ <https://apps.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=22PR5>.

⁴⁸ Under section 213 of the SFO.

⁴⁹ <https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/suitability/doc?refNo=22EC17>.

Digital assets

The Hong Kong government has decided⁵⁰ to proceed with a licensing regime for virtual asset services providers (VASPs), under which those seeking to operate a virtual asset exchange must be licensed by the SFC and be subject to anti-money laundering and counter-terrorist financing requirements (in particular customer due diligence and record-keeping requirements) under the Anti-Money Laundering Ordinance.

As SFC-licensed entities, VASPs must meet regulatory requirements for financial resources, knowledge and experience, business soundness, risk management, segregation and management of client assets, financial reporting and disclosure, prevention of market abuse, and avoidance of conflicts of interest. Once the regime comes into force⁵¹, related enforcement actions can be expected to follow in due course.

SFC- and HKMA-regulated financial institutions considering distributing virtual asset-related products, dealing in virtual assets, or providing virtual asset advisory services, should observe the SFC's and HKMA's⁵² updated guidance on selling restrictions, suitability obligations, and terms and conditions that can be imposed on these areas of business⁵³. The HKMA has separately issued a Circular which sets out its expectations with respect to banks' prudential supervision and management of AML and financial crime risks when engaging in virtual asset-related activities. Similarly, the IA has urged insurers to prudently manage business, investment, cyber, conduct and AML/CTF risks that arise from such activities⁵⁴.

Competency and conduct

To achieve effective investor protection, regulators must focus enforcement efforts not just on deliberate misconduct but also on material incompetence. The SFC and the HKMA have continued their drive to raise market competency standards. The HKMA is pushing forward phased implementation of its new mandatory reference checking scheme⁵⁵ applicable to those authorised to conduct regulated activities/functions under the SFO, the Insurance Ordinance, or the Mandatory Provident Fund Schemes Ordinance. The SFC has revised its Guidelines on Competence and Guidelines on Continuous Professional Training⁵⁶, which became effective on 1 January 2022. The revised Guidelines have raised the minimum academic qualification requirements for intermediaries and individual practitioners, while enhancing the competence requirements for individuals advising on Takeovers Code-related matters. In future, regulated individuals will be assessed in accordance with the enhanced standards of competence, with the objective that "bad apples" will find it increasingly difficult to remain in the financial services industry.

Environmental, social and governance matters

Last, but certainly not least, an examination of regulatory pronouncements and areas of focus over the last several years shows how important all three aspects of ESG are to Hong Kong regulators. In those circumstances, we can expect to see regulatory enforcement attention focusing more on ESG-related failures, particularly disclosure failures/ "greenwashing" which can have a direct and profound impact on market integrity.

⁵⁰ Conclusions on the Public Consultation on Legislative Proposals to Enhance Anti-Money Laundering and Counter-Terrorist Financing Regulation in Hong Kong, May 2021 (https://www.fstb.gov.hk/fsb/en/publication/consult/doc/consult_conclu_amlo_e.pdf).

⁵¹ The government is aiming to introduce an AMLO amendment bill into the Legislative Council in the 2021-22 legislative session, whereas the SFC will be consulting on regulatory requirements applicable to VASPs before the licensing regime comes into force.

⁵² Joint circular on intermediaries' virtual asset-related activities, 28 January 2022 (<https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/suitability/doc?refNo=22EC10>).

⁵³ Regulatory approaches to Authorized Institutions' interface with Virtual Assets and Virtual Asset Service Providers, 28 January 2022 (<https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2022/20220128e3.pdf>).

⁵⁴ Regulatory Approaches of the Insurance Authority in Relation to Virtual Assets and Virtual Asset Service Providers, 28 January 2022 (https://www.ia.org.hk/en/legislative_framework/circulars/reg_matters/files/Cir_dd_28.01.2022.pdf).

⁵⁵ Consultation Conclusions Paper on Implementation of Mandatory Reference Checking Scheme to Address the "Rolling Bad Apples" Phenomenon, 3 May 2021 (https://www.hkma.gov.hk/media/eng/regulatory-resources/consultations/Conclusions_Paper_on_MRC_Scheme.pdf).

⁵⁶ Consultation Conclusions on Proposed Enhancements to the Competency Framework for Intermediaries and Individual Practitioners, 18 June 2021 (<https://apps.sfc.hk/edistributionWeb/api/consultation/conclusion?lang=EN&refNo=20CP8>).

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