



Hong Kong Regulatory Enforcement Trends

Less is still more?

This time last year, we examined the Securities and Futures Commission's (*SFC*) enforcement focus in 2018 and saw a continuation of the SFC's "less is more" approach; an approach that the SFC has increasingly pursued since its current Executive Director of Enforcement, Thomas Atkinson, joined the SFC in May 2016.

The rationale behind it is simple: instead of applying enforcement tools over a broad range of matters, with broadly similar degrees of intensity, and looking to increase the number of enforcement investigations and outcomes year-on-year (as had occurred in Hong Kong for a period up to 2016), the SFC's Enforcement Division has instead focused its resources and efforts on fewer, but what it regards as "high impact" cases (i.e. those that deter and prevent wrongdoing damaging to the market).

SFC enforcement – the statistics

Table 1: Statistical summary of SFC enforcement activities

	Nine months ended 31.12.2019	2018/19	2017/18	2016/17	2015/16	2014/15	2013/14
S179 inquiries commenced	26	26	24	27	24	21	23
S181 inquiries commenced (number of letters sent)	186 (7,415)	294 (9,074)	261 (8,461)	301 (8,960)	286 (7,997)	293 (9,752)	220 (5,711)
Investigations started	158	238	280	414	515	553	352
Investigations completed	145	243	254	591	436	362	319
Individuals/corporations charged in criminal proceedings	5	5	14	10	20	15	35
Criminal charges laid	8	42	54	46	107	71	226
Notices of Proposed Disciplinary Action issued	26	22	29	49	35	36	55
Notices of Decision issued	37	34	32	56	42	46	51
Individuals/corporations subject to ongoing civil proceedings	158	101	97	126	100	93	69
Compliance advice letters issued	178	234	277	548	453	302	337
Cases with search warrants executed	14	30	22	34	31	53	59

Table 2: Yearly aggregate SFC enforcement fines¹

Year	Number of enforcement actions against individuals	Number of enforcement actions against firms/corporations	Total fines	Average fines across individuals, firms and corporations
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
2015	55	33	HK\$70,929,500	HK\$4,728,633

What the statistics show

The context

In many respects, 2019 was an atypical year for Hong Kong. News in the second half of the calendar year was dominated by local politics and market disruption relating to public protests. The coronavirus threat emerged shortly afterwards. SFC enforcement activity in 2019 ought to be seen against that background.

Continuing and increasing focus on listed companies and corporate governance

For many years, the Stock Exchange and the SFC have focused their efforts on improving the quality of the Hong Kong securities market and, in particular, on the quality of listed companies. Corporate governance has been top of the agenda. The SFC is armed with various tools which enable it to scrutinise suspected breakdowns in corporate governance. One such tool is the “section 179 inquiry”. The SFC will typically commence a section 179 inquiry if it believes that a Hong Kong listed company’s business has, for example, been conducted for a fraudulent or unlawful purpose, or in a manner that is oppressive to any of its members. The number of section 179 inquiries each year between 2013 and 2019 stayed largely constant. But in the nine months ended 31 December 2019, the SFC commenced as many inquiries as in the twelve months before that period. So for the full 2019 / 2020 year, we might see the SFC having commenced the largest number of such enquiries in the last seven years, on top of an unprecedented level of intervention in the listing process (discussed further below).

Fewer instances of suspected market misconduct in a softer stock market?

As a statistical proposition, greater market turnover can result in more instances of market misconduct, and vice versa. Section 181 of the Securities and Futures Ordinance allows the SFC to inquire into specific market transactions, and who is behind them. The SFC often uses such inquiries to assess whether there may be indicators of potential misconduct that justify commencing a formal investigation into suspected market misconduct. 2019 saw a significant, approximately 37 per cent², fall in the number of section 181 inquiries started and an approximately 18.26 per cent fall³ in section 181 written requests sent. For context, however, it is important to note that in 2019 total stock market turnover and average daily turnover in Hong Kong fell approximately 18.86 per cent compared with 2018⁴.

Significantly fewer new investigations as well as “dawn raids”

The SFC will typically commence an investigation if it has reasonable cause to believe that misconduct within its jurisdiction has occurred; and in those investigations, the SFC will often use its “dawn raid” powers to try and secure, through the advantage afforded by surprise, evidence that it believes might be at risk of being lost. 2019 saw approximately 33.61 per cent fewer new investigations started, approximately 53.33 per cent fewer search warrants executed, and an approximately 40.33 per cent fall in investigations completed, compared with 2018⁵. This illustrates continued use of the “less” aspect of the SFC’s “less is more” approach.

An emerging preference for civil action, remedies and settlements versus criminal prosecution?

For regulators, civil court tools and criminal law tools carry potentially very different utility profiles. Criminal law tools generally carry the greatest deterrent effect because of the potential severity of penalties from a successful prosecution (which, for serious crimes, can include a custodial sentence), but they can

¹ This section has been prepared using data extracted from enforcement news published on the SFC’s website.

² Around 16 per cent if 2019/2020 figures are annualised.

³ If 2019/2020 figures are annualised the level of section 181 written requests sent remains broadly the same.

⁴ <https://www.hkex.com.hk/-/media/HKEX-Market/Market-Data/Statistics/Consolidated-Reports/Annual-Market-Statistics/2019-Market-Statistics.pdf>.

⁵ Annualising 2019/2020 figures shows the same trend: around 11.5 per cent fewer new investigations started, approximately 37.8 per cent fewer search warrants executed, and an approximately 20.5 per cent fall in investigations completed, compared with 2018/2019.

be time consuming to use, not least because of the high standard of proof and exacting rules on evidence that must be met before a conviction can be secured.

Until 2016, the SFC had increasingly sought to pursue wrongdoers criminally (particularly for market misconduct), where the evidence obtained allowed it to do so, principally because of its strong deterrent effect. In the last few years, however, it appears that the SFC has gradually been moving towards greater use of its extensive civil enforcement toolkit.

This is likely to be because of the speed with which interim action can be taken (e.g. through restriction notices and court injunctions), and the greater flexibility afforded by a lower standard of proof when pursuing civil proceedings, whether in SFC disciplinary proceedings, through the civil courts or through the Market Misconduct Tribunal. 2019 saw an increase of approximately 56.44 per cent in individuals/corporations being subject to ongoing civil proceedings, when compared with 2018⁶.

An examination of the SFC's disciplinary actions in 2019 indicates that a significant proportion appears to have been the result of a negotiated settlement between the SFC and the target. From our own caseload, we have seen the SFC being proactive (perhaps increasingly so) in disciplinary cases, in reaching out to regulatees on a "without prejudice" basis, to explore a settlement.

The SFC benefits from early settlements, particularly those with sizeable deterrent fines, because they free up valuable enforcement resources, which can then be redeployed on high-priority/high-impact matters, while enabling the SFC to educate the market and deter similar misconduct. Another benefit of settlements is that in appropriate cases they may secure for investors who have suffered loss a better outcome (e.g. through receiving compensation) than if those investors were left to pursue redress themselves.

A huge increase in regulatory enforcement fines

Despite the statistics showing an overall lower volume of enforcement activity year-on-year, 2019 has been one of the best years on record for the SFC for enforcement fines, with significantly more (approximately 55 per cent more) fines in 2019 than in the previous four years combined! This is a clear illustration of the "more" aspect of the SFC's "less is more" approach.

Those fines have been driven largely by a plethora of IPO sponsor-related enforcement actions in the first half of 2019 and a private banking selling processes-related case in the second half of 2019. Each of those cases was complex and took many years for the SFC to investigate, pursue and bring to a conclusion. Those cases provide a good illustration of the SFC's focus on "higher impact" cases. However, most, if not all, of these cases will have had their genesis before Tom Atkinson's arrival in Hong Kong in May 2016. The obvious question, then, is: when will the market begin to see the "high impact", post-2016 cases (those that the SFC started to investigate in recent years), being brought to a conclusion?

Key areas of enforcement focus in 2019

IPO sponsors – record fines and licence suspensions

In 2019, the SFC settled sponsor enforcement actions relating to at least three IPOs and five sponsors, including some household names, which yielded for the SFC an aggregate of HK\$814 million in fines, principally for due diligence and related issues. Those fines totalled nearly double the SFC's previous record haul for all fines in 2017.

It is notable that the SFC secured tough enforcement outcomes, not just against sponsor banks, but also a number of individual, sponsor principals, thus sending the market a clear signal that, for any future sponsor failings, the SFC will scrutinise the sponsor and its relevant sponsor principal(s). This should act as a strong incentive for sponsor principals to take proactive steps to ensure that they discharge their obligations as principals and, accordingly, best protect themselves from future enforcement action.

Also notable is that the SFC appears willing to give sponsors credit for taking proactive, effective action to remedy identified issues during the course of a suspension⁷. This should also strongly incentivise sponsors which encounter problems to take proactive steps to resolve those problems.

The SFC's press releases and statements of disciplinary action in the matters in question give the market helpful guidance about what the SFC expects of sponsors with respect to certain aspects of due diligence, in particular third-party due diligence and obtaining reliable, independent, verifying evidence.

⁶ If 2019 figures are annualised, the number would be more than double that in 2018.

⁷ Enforcement news – 14 January 2020 (<https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=20PR4>).

Anti-money laundering – largest fine in recent years and a focus on third-party payments

Money laundering and terrorist financing is a global problem, and for some years Hong Kong's financial markets regulators have focused increasing attention on the Hong Kong financial market's anti-money laundering and counter-terrorist financing efforts and taken enforcement action where necessary.

A local brokerage was reprimanded and fined over HK\$15 million in February 2019 for failing to: (i) conduct adequate ongoing monitoring of its business relationship with clients; (ii) implement appropriate internal controls to identify and mitigate the risks of money laundering and terrorist financing associated with third-party deposits (a common concern of regulators); (iii) put in place an effective compliance function; and (iv) file suspicious transaction reports with the Joint Financial Intelligence Unit.

This is the highest fine that has been imposed by the SFC or the Hong Kong Monetary Authority (*HKMA*) for anti-money laundering failings in the last few years. The SFC's findings highlight in particular the importance of timely monitoring of customer transactions, identification and scrutiny of third-party deposits and payments (which have been a particular focus for the SFC)⁸, and of prompt reporting of suspicious transactions.

Members of that brokerage's senior management, including a former Responsible Officer who has since received a 10-month ban from re-entering the industry, were found to have ignored internal control deficiencies reported by its staff.

Corporate misconduct continues to be an area of focus, and the SFC is intervening earlier

Corporate misconduct has been high on the SFC's priority list for some years (2017 and 2018 briefings) and 2019 was no different. Our analysis has found that over 10 per cent of SFC enforcement actions against individuals in 2019 were against directors, executive and non-executive, for misconduct including breaches of directors' duties and alleged fraud.

The SFC has also increasingly used its statutory powers to intervene early in the listing process. Between June 2018 and June 2019, the SFC has directly sought information or expressed concerns in 17 listing applications where it became aware of potentially serious disclosure or public interest issues; as at the end of March 2019, the applicants in just two of these applications had managed to address the SFC's concerns and became listed. Similarly, during the same period, the SFC directly intervened in IPOs and after IPOs 46 times, compared to 32 the year before, and 3 in 2016-17⁹.

Investment product selling practices

Since the 2008 financial crisis, the SFC and HKMA have focused significant effort on enhancing the Hong Kong market's investment product selling practices, focusing on the need to treat customers fairly. In that vein, during the course of 2019, the SFC published several circulars relating to expectations with respect to the sale of complex investment products¹⁰.

In March 2019, the SFC fined a financial institution HK\$10 million for systems and controls failures in investment product selling practices¹¹, particularly relating to suitability.

In November 2019, the SFC fined an international financial institution HK\$400 million¹² for overcharging clients on spread when executing bond and structured note trades, failing to act in clients' best interests and to disclose to clients when a better price might have been achieved in the market (and instead retaining price improvements without disclosure to, and agreement from, clients). This matter highlights the importance of implementing effective checks and balances to prevent staff misconduct, and of appropriate staff supervision and training.

⁸ See <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/aml/doc?refNo=19EC39>. The SFC has made clear its expectations that third-party payments are to be discouraged and should only be accepted with approval from the relevant Manager-In-Charge or Money Laundering Reporting Officer.

⁹ SFC Annual Report 2018/19 pages 56 and 58.

¹⁰ <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/suitability/?year=2019&sortBy=issueDate&sortDir=DESC>.

¹¹ <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=19PR17>.

¹² <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/openAppendix?refNo=19PR111&appendix=0>.

Key takeaway points and what might be on the horizon

Continued “less is more”?

The SFC has been very successful in recent years in securing strong enforcement outcomes in high-impact cases. That has been at the core of the SFC’s recent enforcement strategy. However, given the significant amount of time usually necessary for material matters to be investigated such that the SFC can decide whether to pursue enforcement action, for the SFC to continue to secure similarly high-impact outcomes in 2020 and 2021 will require it to have identified in the last several years other, similar high-impact cases. Have the falling number of new investigations in the last few years inhibited the SFC’s ability to identify more such cases (i.e. dig less, find less)? Time will tell how many high-impact enforcement outcomes emerge in 2020 and 2021.

Corporate misconduct and fraud

The SFC has consistently regarded this as one of its top enforcement priorities. With the SFC’s “ICE”¹³/one-SFC approach yielding positive results¹⁴ and the ongoing close collaboration between the SFC and the Stock Exchange of Hong Kong (*SEHK*) focused on improving corporate and management behaviour¹⁵, it is likely that enforcement activity focused on listed companies and their management, executive and non-executive, will continue.

IPO sponsors

Notwithstanding the record fines against sponsors in 2019, we expect that sponsors will remain targets and that sponsors’ roles in listings will continue to be under scrutiny. Sponsors with a history of returned or rejected listing applications or non-compliance should expect closer scrutiny by regulators¹⁶. We have discussed previously ([here](#)) key areas of sponsor risk and how these risks can be managed. Finally, it remains to be seen whether the SFC continues to look for a test case to determine whether it can secure investor compensation from a sponsor.

Operational resilience

This has been a cross-sector concern across markets over the past few years. With market conditions remaining uncertain and prone to volatility, and the effects of the coronavirus being felt acutely across Hong Kong, operational resilience and risk management will continue to be high on the regulatory agenda. We expect enforcement focus particularly on market activities that span multiple business lines/offices, such as remote booking and transfer pricing. The SFC has noted that its thematic review in this area may expand to include other local and overseas regulators¹⁷.

Senior management and Manager-in-Charge (MIC) accountability

Over two years have passed since the MIC regime came into force, and we expect MIC-related SFC inquiries and investigations to evolve into public enforcement action¹⁸. The SFC’s thematic review¹⁹ of the structure and effectiveness of the management of licensed corporations, including board governance and MIC responsibilities, is also likely to lead to further guidance from the SFC and potential follow-on regulatory action.

Regulatory record-keeping

In October 2019, the SFC published a circular addressing the use of external electronic data storage (*EDSP circular*). That document explains what records a licensed corporation must keep under the Securities and Futures Ordinance (Cap 571) and the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap 615)²⁰ (together, *regulatory records*) with a cloud service provider or in a data centre in Hong Kong. The EDSP circular has given rise to various concerns for the market, various industry associations are working with the SFC to refine the scope of the EDSP circular and to identify applicable standards where affiliates hold regulatory records. We expect the SFC to focus on the arrangements that licensed corporations implement, to ensure that the SFC continues to have access to

¹³ Intermediaries, Corporate Finance, Enforcement.

¹⁴ According to the SFC’s Annual Report 2018-19, after the ICE unit took steps to address price volatility in GEM stocks and GEM placings with a high concentration of shareholders, there was a sharp drop in the average first day price change of GEM listings, from a peak of about 530 per cent in 2016 to around 22 per cent in 2018. There were also fewer instances of high shareholding concentrations in GEM stocks.

¹⁵ According to the SFC’s Annual Report 2018-19, the SFC and the SEHK have been working together on measures to tackle particular problem areas including highly dilutive capital raisings, backdoor listings and shell activities, warehousing of shares, and highly-concentrated shareholding structures.

¹⁶ SFC Regulatory Bulletin – 7 February 2020 (<https://edistributionweb.sfc.hk/t/j-l-ckijtj-dzdrjrs-r/>).

¹⁷ https://www.sfc.hk/web/EN/files/ER/PDF/Speeches/SFC%20Compliance%20Forum%202019_PM%20opening%20remarks_Eng%20.pdf.

¹⁸ Thomas Atkinson announced back in October 2018 that the SFC was already pursuing a number of MIC investigations

(https://www.sfc.hk/web/EN/files/ER/Speech%20-%20TA%20at%202018%20Refinitiv_final.pdf).

¹⁹ SFC Compliance Bulletin: Intermediaries – May 2018

(http://www.sfc.hk/web/EN/files/ER/PDF/SFC%20Compliance%20Bulletin/SFC%20Compliance%20Bulletin%20May%202018_Eng%20final.pdf).

²⁰ <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/doc?refNo=19EC59>.

regulatory records during investigations. In a recent Court of First Instance judgment²¹, the court reconfirmed the breadth and application of the SFC's investigative powers.

Investment product selling practices

The SFC has (once again) identified selling practices, particularly with respect to complex financial products, as one of its top priorities²², and will be reviewing industry compliance with suitability obligations and the new regulatory requirements governing the distribution of complex products.

Asset and wealth management

The SFC continues to focus on facilitating Hong Kong's development as a full-service asset and wealth management centre and a preferred place of fund domicile. Recent regulatory refinements include a new open-ended fund companies regime, the introduction of active exchange-traded funds, and revised conduct requirements on securities lending and repurchase, custody of fund assets, liquidity risk management and disclosure of leverage by fund managers. More recently, the SFC examined the management of environmental, social and governance risks (including climate risks) by the industry and announced that it would clarify regulatory expectations of asset management firms in areas such as governance and oversight, investment management, risk management and disclosure, following the publication of its survey results²³. The opening up of the market, together with enhanced conduct requirements, could lead to additional regulatory scrutiny.

Insurance-related enforcement

The securities and futures and banking markets have seen regulators focus on mis-selling, robust and effective systems and controls, operational/cyber resilience, and anti-money laundering. However, notwithstanding the increasing convergence between insurance and investment and the blurring of the boundaries between them, many of those issues have yet to result in similar focus by insurance regulators. However, that may soon change. The Hong Kong Insurance Authority (**IA**) is now fully-functional; and armed with similar statutory powers to those of the SFC, we may soon see that regulator flex its enforcement muscle. There are indicators that the UK Financial Conduct Authority, for example, has been looking at mis-selling in the insurance sector. We may well see the IA focusing on issues like that too.

²¹ <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=20PR17>.

²² SFC Annual Report 2018-19.

²³ [Survey on Integrating Environmental, Social and Governance Factors and Climate Risks in Asset Management](https://www.sfc.hk/web/EN/files/ER/ENG%20Survey%20Findings%20Report%2016%2012%202019.pdf) – December 2019 (<https://www.sfc.hk/web/EN/files/ER/ENG%20Survey%20Findings%20Report%2016%2012%202019.pdf>).

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