

Financial Services Compliance 2021

Contributing editor
Zachary J Zweihorn
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Financial Services Compliance 2021

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Lexology Getting The Deal Through is delighted to publish the fourth edition of *Financial Services Compliance*, which is available in print and online at www.lexology.com/gtdt.

Lexology Getting The Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique Lexology Getting The Deal Through format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes new chapters on Egypt, Indonesia, Ireland and Italy.

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Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Lexology Getting The Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editor, Zachary J Zweihorn of Davis Polk & Wardwell LLP, for his assistance with this volume.



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REGULATORY FRAMEWORK

Regulatory authorities

1 | What national authorities regulate the provision of financial products and services?

The Hong Kong system of financial regulation reflects a modified institutional approach, with different regulators largely responsible for the oversight of different types of financial institutions.

The two principal authorities responsible for the regulation of banking, securities and derivatives products and services are the:

- the Hong Kong Monetary Authority (HKMA), which regulates banks; and
- the Securities and Futures Commission (SFC), which regulates securities, futures and other contract markets, as well as certain entities that participate in those markets.

There is, however, increasing overlap among and between regulators, particularly as banks expand the range of securities activities in which they are engaged.

2 | What activities does each national financial services authority regulate?

The HKMA oversees all aspects of authorised banking institutions within its jurisdiction, including banks, restricted licence banks (eg, merchant banks) and other deposit-taking companies. It supervises these authorised institutions on a consolidated basis, with the aim of promoting the safety and stability of the banking system, including in respect of local and overseas branches and subsidiaries. The principal areas of HKMA supervision include capital adequacy and liquidity, exposure concentration, resolution, and anti-money laundering and counter-financing of terrorism (AML/CFT) obligations (eg, customer due diligence), with different requirements applicable to locally and foreign incorporated institutions.

The SFC is responsible for the licensing (or registration) and supervision of intermediaries and individuals, including broker-dealers, advisers and funds, engaged in a wide range of securities and futures activities, including:

- dealing in securities;
- dealing in futures contracts;
- leveraged foreign exchange trading;
- advising on securities;
- advising on futures contracts;
- advising on corporate finance;
- providing automated trading services;
- securities margin financing;
- asset management; and
- providing credit rating services.

In 2020, the SFC issued guidelines for family offices intending to carry out asset management or other services in Hong Kong noting that there is no separate licensing regime in Hong Kong for family offices, and SFC regulation of such businesses remains activity-based (ie, dependent on the type of operations and activities undertaken by the family office).

The SFC is also responsible for overseeing market operators, including, among others:

- Hong Kong Exchanges and Clearing Limited (HKEx), which operates:
 - the Stock Exchange of Hong Kong (SEHK);
 - the Hong Kong Futures Exchange;
 - clearing houses; and
 - alternative trading platforms (eg, dark pools);
- overseeing takeovers and mergers of listed companies; and
- the regulation of investment products (including, from April 2019, investment products offered by intermediaries via online platforms).

For example, the SFC and the SEHK work closely together in relation to tackling backdoor listings and shell activities. Backdoor listings involve transactions or arrangements (usually involving listed shell companies) that are structured to achieve a listing of assets while circumventing the requirements that apply to a new listing applicant. Problems with such listings have received widespread attention in Hong Kong.

Authorised banking institutions supervised by the HKMA must register with the SFC as to regulated securities activities undertaken in Hong Kong, but the HKMA is responsible for the day-to-day oversight of any such activities performed by these authorised institutions. The precise role and responsibilities of the HKMA in respect of the securities activities of authorised institutions are set out in a series of memoranda of understanding between the HKMA and the SFC. The Secretary for Financial Services also plays a coordinating role, and helps to set policy for the securities and futures markets generally.

3 | What products does each national financial services authority regulate?

As described above, the HKMA exercises comprehensive supervisory oversight over all of the activities of authorised banking institutions, rather than regulating particular types of products.

The SFC regulates licensed (or registered) institutions on the basis of the activities in which they are engaged, for example, by imposing principles-based business conduct standards. These conduct standards are applicable to all licensed and registered institutions (and individual persons), and include expectations and requirements as to the suitability of products offered or sold to third-party customers.

Through its supervisory and rule-making authority over market operators, the SFC also regulates certain financial products, including securities and futures. It thus has indirect authority over the manner in which these products are transacted, for instance, on exchange or over

the counter. In addition, the SFC directly authorises and regulates investment products, including, among others, closed-end funds, exchange traded funds, leveraged and inverse products, pooled retirement funds, unit trusts and mutual funds, structured investment products, real estate investment trusts, unlisted shares and debentures, and open-ended fund companies.

Authorisation regime

4 What is the registration or authorisation regime applicable to financial services firms and authorised individuals associated with those firms? When is registration or authorisation necessary, and how is it effected?

As to securities and futures activity, financial services firms must be licensed by the SFC before engaging in any of the regulated activities, subject to narrow statutory exemptions. Licensing is necessary when financial services firms carry out a regulated activity, as well as when they hold themselves out as doing so. A licence must be obtained (or a relevant exemption identified) for each type of regulated activity the financial services firm intends to undertake.

Licensing is also necessary if a financial services firm actively markets to the public in Hong Kong any service that would be a regulated activity if performed in Hong Kong. This is true whether the firm is marketing its services from Hong Kong or overseas, including when it does so through a third party. For instance, a US-based asset manager soliciting clients for its US-based services in Hong Kong would need to be licensed for asset management activity in Hong Kong, even if the solicitation was undertaken through its Hong Kong-licensed subsidiary.

Individuals must also be licensed before performing a regulated activity on behalf of their licensed corporation. In addition, any executive directors (ie, senior managers) supervising a licensed corporation's regulated activities must also be licensed as 'responsible officers'.

Temporary licences are available to both firms and individuals if they will undertake regulated activity only on a short-term basis, and it is the SFC's expectation that such licences will be obtained before any regulated activity is undertaken, even in the case of day-long business meeting in Hong Kong, for instance.

To receive a licence, a firm or individual must apply to the SFC. Different requirements apply to each type of regulated activity, but at a minimum, the application process ordinarily requires the submission of extensive materials, including detailed business plans, biographies of senior employees, directors and officers, and other corporate and individual records. All licensed persons – firms or individuals – must also, at a minimum, demonstrate that they are 'fit and proper', in connection with which the SFC evaluates the applicant's financial status, qualifications, competence, honesty, fairness, reputation and character. Licensed firms must also comply with additional requirements, including financial resources rules (eg, rules relating to minimum paid-up share capital and liquid capital) and insurance rules. The application process for temporary licences is less complex, especially for individuals.

With regard to the regulation of virtual assets (eg, digital currencies, crypto assets) and the platforms on which they are traded (virtual asset services platforms or 'VASPs'), in November 2020, the SFC proposed amendments to the AML/CFT statutes that would introduce a mandatory licensing regime for VASPs. Under the proposals, all VASPs operating in Hong Kong would be required to be licensed, regardless of whether or not the virtual assets they trade fall under the definition 'securities'. This represents a change of approach from the more permissive stance announced by the SFC in 2019 (representing an 'opt-in' approach to regulation for VASPs) and is consistent with the recommendations of the Financial Action Task Force that AML/CTF obligations be imposed on VASPs. Depending on the outcome of the consultation, a legislative bill is expected to be introduced into the Hong Kong Legislative Council in

2021. In December 2020, the SFC announced that it had granted the first license to a VASP in Hong Kong (under the existing 'opt in' regime) to carry out Type 1 (dealing in securities) and Type 7 (providing automated trading services) regulated activities, subject to the requirement that the VASP in question will only serve professional investors under the close supervision of the SFC.

Banking organisations are subject to similar authorisation requirements, albeit overseen by the HKMA rather than the SFC. Authorisation is required when banking activities are undertaken in Hong Kong, and also when they are marketed to customers in Hong Kong. Hong Kong has a three-tier banking system that includes banks, restricted licence banks and deposit-taking companies. Different regulations, including different authorisation requirements, apply to locally incorporated banking organisations than to the Hong Kong branches of overseas banks. Otherwise, the application requirements are similar to those applicable to financial services firms licensed by the SFC, and banking entities seeking to engage in securities and futures activities in Hong Kong must also be licensed by the SFC.

The HKMA has also issued licences to virtual banks (ie, banks that deliver retail banking services primarily, if not entirely, through the internet or other electronic channels rather than physical branches). As of 31 January 2021, there are in total eight virtual banks licensed by the HKMA. Virtual banks will be subject to the same set of supervisory principles and key requirements as conventional banks, although some of the requirements may be adapted to suit this new business model.

Legislation

5 What statute or other legal basis is the source of each regulatory authority's jurisdiction?

The importance of financial services to Hong Kong as an international financial centre is recognised in its Basic Law, which also gives the government the authority to 'formulate monetary and financial policies, safeguard the free operation of financial business and financial markets, and regulate and supervise them in accordance with the law'.

Otherwise, the jurisdiction of both the HKMA and the SFC is proscribed by statute: the Banking Ordinance (Cap. 155) in the case of the HKMA, and the Securities and Futures Ordinance (Cap. 571) (SFO) in the case of the SFC.

These ordinances set out the supervisory, examination and enforcement powers of the HKMA and SFC, respectively, in addition to conferring upon each regulator the authority to promulgate more particularised subsidiary legislation (ie, rulemaking with the force of law) and non-binding guidance in respect of defined topics (eg, product suitability).

In relation to AML/CFT, the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) (AMLO) sets out the statutory requirements relating to customer due diligence (CDD) and record-keeping for specified financial institutions, and the powers of the relevant authorities (including the HKMA and SFC) to supervise financial institutions' compliance with the requirements.

6 What principal laws and financial service authority rules apply to the activities of financial services firms and their associated persons?

HKMA

The principal statute applicable to institutions authorised by the HKMA is the Banking Ordinance (Cap. 155).

The Banking Ordinance sets out the requirements for authorisation of financial services firms seeking to provide banking services, the HKMA's powers of direction and examination, restrictions on the ownership and management of authorised institutions, and liquidity

and capital requirements, among others. It also authorises the promulgation by the HKMA of subsidiary legislation addressing a range of topics, from capital and liquidity requirements to disclosure rules, in more particularity.

In addition to the Banking Ordinance and associated subsidiary legislation, institutions authorised by the HKMA must also comply with the minimum expectations and standards set out in the HKMA's Supervisory Policy Manual. The Supervisory Policy Manual codifies the HKMA's supervisory policies and practices, some of which reflect requirements under the Banking Ordinance or AMLD, while others reflect industry best practices. Among the regulatory topics it addresses are corporate governance; internal controls; capital adequacy; credit, interest rate, operational and liquidity risk management; securities activities; and money laundering.

SFC

The principal statute applicable to entities and persons licensed or regulated by the SFC is the SFO. The SFO sets out the licensing requirements for entities conducting regulated activity in Hong Kong; record-keeping, reporting and disclosure requirements; and civil, criminal and disciplinary enforcement regimes in respect of market misconduct. The SFO also confers upon the SFC the authority to promulgate subsidiary legislation addressing a wide range of topics including the treatment of client monies and securities, professional investors, short positions, contract limits, price stabilisation, and investor compensation.

In the case of both the HKMA and SFC, the regulatory requirements reflected in statutes, subsidiary legislation and other binding policy statements are supplemented by a variety of codes of conduct, guidelines and circulars with varying degrees of legal effectiveness.

Scope of regulation

7 | What are the main areas of regulation for each type of regulated financial services provider and product?

Institutions authorised by the HKMA are supervised on a consolidated basis. The main areas of regulation and supervision are registration; safety and soundness; capital and liquidity; internal controls and governance; business conduct; risk management (including AML/CFT), record-keeping, and reporting and disclosure. Pursuant to a memorandum of understanding (MoU) between the HKMA and SFC, the HKMA is also responsible for supervising the securities activities of HKMA-authorised institutions on a day-to-day basis, with the SFC principally responsible for enforcement action in respect of misconduct arising from such activities.

The SFC, unlike the HKMA, only regulates certain defined securities and futures activities. In respect of these activities, it regulates, inter alia, licensing requirements; business conduct (ie, the standard of care afforded customers); market conduct; internal controls, governance and supervision (including AML/CFT); the treatment of client securities and monies; record-keeping, reporting and disclosure obligations; the timing and format of contract notes; and various activity restrictions.

Additional requirements

8 | What additional requirements apply to financial services firms and authorised persons, such as those imposed by self-regulatory bodies, designated professional bodies or other financial services organisations?

The SFC is responsible for licensing market operators, most notably the SEHK, the Hong Kong Futures Exchange and their associated clearing entities. These market operators act as self-regulatory bodies, but also as frontline regulators. Any person seeking to trade or clear through their facilities must comply with the policies, rules and procedures

promulgated by each operator (and approved by the SFC). In the case of the SEHK, for instance, these rules govern admissible order types and sizes; trading hours; closing mechanisms; trade reporting; trading misconduct; maximum allowable position and lot sizes; the trading engine; and short selling restrictions, among other topics. Importantly, the SEHK is also the frontline regulator in respect of listing and listing applications.

ENFORCEMENT

Investigatory powers

9 | What powers do national financial services authorities have to examine and investigate compliance? What enforcement powers do they have for compliance breaches? How is compliance examined and enforced in practice?

Both the Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC) have the power to conduct on-site inspections and examinations of the financial services firms they regulate, and to compel the production of certain documents. Both regulators also conduct off-site surveillance – the HKMA of the financial condition of the institutions it authorises, and the SFC of market conditions and trading activity.

In connection with these powers of inspection and surveillance, both regulators are also given the authority to conduct investigations, which can lead to disciplinary, civil or criminal enforcement actions.

Disciplinary powers

10 | What are the powers of national financial services authorities to discipline or punish infractions? Which other bodies are responsible for criminal enforcement relating to compliance violations?

Both the HKMA and the SFC are authorised to take disciplinary or civil enforcement action (subject to the approval of the Department of Justice) in connection with regulatory breaches. A wide range of sanctions is available even in the disciplinary context, including licence revocation or suspension, fines and public reprimands, among others. In many cases, the HKMA and the SFC also require the entities or persons responsible for regulatory violations to strengthen and enhance internal controls and governance. In the civil context, the SFC can also petition the court for winding-up or bankruptcy orders, restoration orders, declarations that securities transactions are void, or for receivership. In addition, the courts and relevant tribunals can require disgorgement, impose financial penalties and enforce activity restrictions and prohibitions on future conduct.

The HKMA and SFC can also seek criminal prosecution in connection with certain regulatory breaches. The SFC can prosecute 'summary offences' on its own, but must refer any indictable offences to the Department of Justice. The HKMA must refer all potential offences to the Department of Justice for prosecution.

The Stock Exchange of Hong Kong (SEHK) also has powers to discipline listed companies and their directors or senior management. In August 2020 the SEHK announced proposals that would increase its disciplinary powers – the first such change to its disciplinary powers since they were first put in place in 1993.

The Memorandum of Understanding entered into between the Independent Commission Against Corruption and the SFC in August 2019 also formalises and enhances collaboration between the two bodies in combating corrupt and illicit activities relating to Hong Kong's securities and futures industry.

Tribunals

11 | What tribunals adjudicate financial services criminal and civil infractions?

Hong Kong has a number of specialised tribunals responsible for the adjudication of disciplinary and civil financial services infractions. In most cases, the regulatory authorities are also able to pursue civil enforcement actions in the Hong Kong courts.

SFC disciplinary decisions, for instance, are subject to appeal to the Securities and Futures Appeals Tribunal, where a full de novo review of the disciplinary proceedings is conducted by a three-member panel consisting of a chairman and two lay members. Final orders entered by the Securities and Futures Appeals Tribunal can be registered in or appealed to the Hong Kong courts.

Similarly, civil breaches of market misconduct provisions are heard by the Market Misconduct Tribunal, a three-member panel (one judge and two lay members) in which the SFC acts as the presenting officer. The Tribunal can issue injunctions, order disgorgement, or impose a prohibition on dealing in securities, taking management roles in listed companies or engaging in future misconduct. Subsequent violations of its orders are punishable by imprisonment and fines.

Otherwise, civil actions are dealt with by the Hong Kong courts.

Penalties

12 | What are typical sanctions imposed against firms and individuals for violations? Are settlements common?

In the disciplinary setting, the most common sanctions are fines (ordinarily three times the profit earned or loss avoided), public reprimands and partial licence suspensions. Penalties can range from incidental amounts to well over US\$50 million, depending on the severity and scope of the relevant violations. Settlement of disciplinary actions is relatively common, but the regulators nearly always require some form of public reprimand.

For civil enforcement actions, the full range of economic and equitable sanctions are available, with disgorgement and prohibitions on future activity (eg, acting as the director of a listed company) being particularly common. Settlements of civil actions are also quite common, although statistics as to the rate of settlement are not publicly available.

COMPLIANCE PROGRAMMES

Programme requirements

13 | What requirements exist concerning the nature and content of compliance and supervisory programmes for each type of regulated entity?

For financial services firms engaged in securities and futures activity, the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct) of the Securities and Futures Commission (SFC) enshrines compliance as one of its nine general principles, and sets out numerous principle-based requirements in respect of internal controls, IT infrastructure and trading systems, the disclosure of firm financials, the handling of client assets, and compliance obligations. Other relevant subsidiary rules and regulations include the Securities and Futures (Accounts and Audit) Rules, the Guidelines on Anti-Money Laundering and Counter-Financing of Terrorism, and the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC.

The HKMA's Supervisory Policy Manual also sets out detailed guidance as to the compliance programmes expected of authorised banking institutions, the principal focus of which is risk management.

The Supervisory Policy Manual also includes a Code of Conduct, which sets out the standards of business conduct and competence expected of authorised institutions and their employees.

Gatekeepers

14 | How important are gatekeepers in the regulatory structure?

Gatekeepers perform crucial functions within Hong Kong financial services firms. For firms engaged in regulated securities and futures activities, the role of gatekeepers is governed by the Securities and Futures Ordinance (Cap. 571) (SFO), its subsidiary rules and regulations, and codes and guidelines issued by the SFC. Under the SFO, firms engaged in regulated securities and futures activities in Hong Kong must have at least one 'responsible officer' for each regulated activity they are licensed to conduct. As recent cases have shown, responsible officers of licensed corporations are expected to actively supervise the functions they oversee and to bear primary responsibility for compliance, including potentially being subject to disciplinary penalties for compliance failures. This expectation is also codified in the Code of Conduct applicable to all licensed entities.

Licensed corporations are also subject to the 'managers-in-charge' regime, which aims to more clearly define who should be regarded as senior management of licensed corporations, and enhance individual accountability. The SFC has identified eight core functions of licensed corporations and requires licensed corporations to designate a manager-in-charge for each. Among the core functions are compliance (including the Chief Compliance Officer/CCO); AML/CFT; finance and accounting; risk management; and operational control and review (including the head of Internal Audit). The managers-in-charge overseeing these gate-keeping functions are subject to SFC's disciplinary powers, even if they are not themselves licensed persons. This means that traditional compliance, back-office and middle-office functions are brought within the scope of the SFC's authority.

These requirements also apply to banking organisations authorised by the HKMA, but registered with the SFC to conduct securities and futures activities. Otherwise, the HKMA takes a more traditional approach to the role of gatekeepers and corporate governance, largely relying on directors and senior officers to manage risk and ensure compliance. The HKMA's Supervisory Policy Manual does, however, set out detailed and extensive guidance as to the role of the internal audit function, including the expectation that authorised institutions will, in most cases, have an audit committee and that the internal audit function will reflect the size, scope and complexity of an authorised institution's business and operations. With respect to risk management and compliance, it is expected that there will be separate, designated risk and compliance officers, with the board of directors principally responsible for ensuring that these functions are adequately resourced.

Directors' duties and liability

15 | What are the duties of directors and senior managers, and what standard of care applies to the boards of directors and senior managers of financial services firms?

Common law directors' duties apply to the boards of directors of financial services firms in Hong Kong. These include the duties to:

- act in good faith for the benefit of the company as a whole;
- exercise power solely for proper purposes;
- exercise independent judgement and refrain from delegation without proper authorisation;
- exercise care, skill and diligence;
- avoid conflicts of interest or abuses of position;
- avoid unauthorised use of firm property or information; and
- maintain proper accounting records.

The statutory standard of care applicable to directors is set out in the Companies Ordinance (Cap. 622). This statute expressly displaces the common law standard of care. In determining whether a director has breached his or her duties, courts in Hong Kong will apply a mixed subjective and objective test, comparing the conduct of the director to that of a 'reasonably diligent person' having the general knowledge, skill and experience reasonably expected of a person in the director's position (the objective component) and the knowledge, skill and experience that the specific director actually possesses (the subjective component).

Generally, directors of financial services firms should also bear in mind the need for management to instil a strong compliance 'tone from the top'. This is especially important in light of heightened regulatory focus on individual and senior management accountability. In May 2017, the SFC published a reminder of steps that directors may take to minimise the risk of corporate misconduct and promote a culture of good corporate governance. These include the following:

- Leading by example, directors are expected to regularly discuss governance-related matters, including by actively consulting senior management regarding observed issues within the firm, and to ensure effective channels for the escalation of concerns and suggestions of improvements.
- In order to promote timely identification of issues, directors should demonstrate genuine interest in the firm's affairs, evidenced by attendance at board meetings and obtaining updates on management accounts and corporate performance.
- In matters where personal conflicts of interest arise, directors should abstain from involvement.
- On a firm-wide level, directors should ensure the implementation of effective internal controls and whistle-blowing procedures. Systems of checks and balances should be in place to prevent policies from being overridden without due cause or accountability.

In July 2019, the SFC issued a reminder to directors and advisers of Hong Kong-listed issuers about their statutory and other legal duties they owe when evaluating or approving the acquisition or disposal of a company or business. The SFC referenced this in a February 2020 regulatory bulletin, highlighting its ongoing concern regarding directors' duties in the context of valuations in corporate transactions. It also gave examples of recurring types of misconduct which they have seen arise in that context, including (1) the lack of independent judgement and accountability, (2) proper investigation and due diligence, and (3) suspicious connected parties (eg, undisclosed relationship or arrangement among purported independent third parties).

16 | When are directors and senior managers typically held individually accountable for the activities of financial services firms?

Directors may be held individually accountable for the activities of financial services firms as a result of regulatory breaches. For instance, the SFO empowers the SFC to seek injunctive relief and other orders on behalf of investors against persons who contravene (or aid, abet, induce, or are involved in the contravention of) any provision of the SFO. The SFO also authorises civil actions against directors who fail to take reasonable measures to establish safeguards against market misconduct. Directors of licensed corporations who are also responsible officers or managers-in-charge are also subject to the SFC's disciplinary powers if found liable for the misconduct of financial services firms.

Recent enforcement cases reflect Hong Kong's regulatory focus on director and senior management accountability for the activities of financial services firms, with the SFC bringing civil proceedings against individual directors for, among other things, failing to act in a company's

best interest in connection with the late disclosure of inside information. These cases serve as reminders of directors' personal accountability to their corporations, and of directors' responsibilities to stay informed and alert to governance or compliance issues within their firms.

Private rights of action

17 | Do private rights of action apply to violations of national financial services authority rules and regulations?

Private rights of actions for regulatory violations are available in only very limited circumstances. Such actions would be relevant for individuals who suffer pecuniary loss as a result of another person committing the market misconduct offences set out in the SFO. These offences include:

- insider dealing;
- false trading;
- price rigging;
- disclosure of information about prohibited transactions;
- disclosure of false or misleading information inducing transactions; and
- stock market manipulation.

They also include the offences of:

- use of fraudulent or deceptive devices in securities, futures contracts or leveraged foreign exchange trading;
- disclosure of false or misleading information inducing transactions in leveraged foreign exchange trading; and
- falsely representing dealings in futures contracts on behalf of others.

Persons found liable in connection with private rights of action brought pursuant to these provisions are required to pay damages if it is 'fair, just and reasonable' in the circumstances. Courts may also impose injunctive relief in addition to or in lieu of orders for damages. Potential defendants under these provisions are not limited to persons directly perpetrating a market misconduct offence. Investors also may seek to recover from persons who knowingly assist or connive with others in the perpetration of market misconduct. Officers of corporations also may be named as defendants if market misconduct was perpetrated by the corporation with the officer's consent or connivance. 'Officers' is widely defined in the SFO: directors, managers or secretaries, or any other person involved in the management of a corporation, are all deemed 'officers of a corporation'.

Standard of care for customers

18 | What is the standard of care that applies to each type of financial services firm and authorised person when dealing with retail customers?

In Hong Kong, the relationship between retail customers and financial institutions is principally a matter of contract, as applied within the context of the common law duties of banks.

In addition, financial services firms licensed or regulated by the SFC must, as a condition of their licences, meet minimum, principles-based regulatory standards governing the treatment of customers which are principally set out in the SFC's Code of Conduct. The Code of Conduct requires licensed entities to act honestly, fairly and diligently, and in the best interests of their clients; to obtain adequate information about the financial situation, investment experience and objectives of clients; to make adequate disclosures of relevant information to clients; and to properly account for and safeguard client assets. The Code of Conduct also elaborates more particularised minimum requirements in respect of, among other things, the content of client agreements and the principles of prompt and best execution.

Banks authorised by the HKMA are expected to comply with the recommended practices prescribed in the Code of Banking Practice, which was promulgated by industry associations, but endorsed by the HKMA. The Code of Banking Practice, although not binding or a condition of authorisation, sets out similar, albeit more particularised expectations for the treatment of banking customers. These are set out by reference to specific banking activities, including account management, card services, payment services, and electronic banking services, among others. These expectations reflect a set of general principles announced in the Code, among which are the equitable and fair treatment of customers, with special attention given to the needs of vulnerable groups.

19 | Does the standard of care differ based on the sophistication of the customer or counterparty?

In respect of securities and futures activity, including when such activity is performed by banks, the standard of care owed to customers varies based on the sophistication of the customer (ie, their net worth and investment experience).

Under the SFO and related guidance promulgated by the SFC, certain customers may be classified as 'professional investors'. In such cases, certain regulatory requirements are relaxed, including those pertaining to obtaining information about a customer's financial condition, experience and objectives; the minimum contents of client agreements; the suitability of investment products; and the type of transaction-related information that must be disclosed to clients.

The HKMA also recognises certain categories of customers (eg, private banking customers) for which suitability and other requirements are reduced. In respect of banking activity, however, the standard of care does not vary based on customer sophistication, aside from the expectation elaborated in the Code of Banking Practice that banks should devote special attention to vulnerable populations (eg, the elderly).

Rule making

20 | How are rules that affect the financial services industry adopted? Is there a consultation process?

With certain exceptions, all subsidiary legislation in Hong Kong ordinarily must go through a process of consultation prior to adoption. This is true for subsidiary legislation adopted by both the SFC and the HKMA (and in some cases, the regulatory bodies are also required to consult with each other). Subsidiary legislation refers to those rules and guidelines promulgated pursuant to express authority in the relevant governing statutes (ie, the SFO and Banking Ordinance).

The consultation process for subsidiary legislation involves the circulation of proposed rules for public consideration, the opportunity for public comment, the circulation of consultation conclusions setting out any public comments received, regulator responses to these comments (as well as any new amendments that substantively differ from the original draft), and publication of the final rules for adoption.

Both the HKMA and SFC also regularly publish circulars and other guidance in which they set out their interpretations of requirements set out in statute or subsidiary legislation. No consultation ordinarily is undertaken in connection with such interpretive guidance as it does not have the force of law.

CROSS-BORDER ISSUES

Cross-border regulation

21 | How do national financial services authorities approach cross-border issues?

Hong Kong largely takes a territorial approach to the regulation of its securities and futures markets. Financial services firms must be licensed by the Securities and Futures Commission (SFC) to conduct regulated securities and futures activities whenever they conduct those activities in Hong Kong, as well as when they actively market to the public in Hong Kong any service that, if performed in Hong Kong, would be a regulated activity. This is true whether the firm is marketing its services from Hong Kong or abroad, including when it does so through a third party (eg, a subsidiary or affiliate). Even when such regulated activity, or the marketing of regulated activity, is conducted in Hong Kong on a temporary or short-term basis only (eg, a one-off meeting with a brokerage client), a temporary licence is required.

Banking organisations authorised in Hong Kong are also subject to regulation in respect of their overseas activity, including the powers of inspection of the Hong Kong Monetary Authority (HKMA). They cannot open overseas branches (or acquire overseas banks) without the approval of the HKMA, and must regularly disclose to the HKMA the assets and liabilities of their overseas entities. The HKMA frequently communicates with overseas counterparts and can disclose information about the operations of institutions authorised in Hong Kong to overseas regulators, as long as there are adequate privacy measures in place. The HKMA also looks to the home regulators of banking organisations incorporated overseas in determining whether to authorise them to conduct banking activity in Hong Kong. Such organisations can only be authorised in Hong Kong if the HKMA is satisfied that they are adequately supervised by their home banking regulator. Without authorisation, overseas banks cannot engage in any banking business, although they can open local representative offices to liaise with local customers.

The SFC and HKMA also both cooperate extensively with international regulators, especially Mainland regulators.

- For example, the SFC and the China Securities Regulatory Commission (CSRC) hold regular meetings to discuss a range of matters concerning cross-boundary enforcement co-operation. In July 2019, the Ministry of Finance of the People's Republic of China (MOF), the CSRC and the SFC entered into a tripartite Memorandum of Understanding (MoU) on access to audit working papers for Hong Kong-listed Mainland companies, thus facilitating the SFC's access to audit working papers when conducting investigations into Mainland-based issuers or listed companies.
- The HKMA has signed MoUs with the China Banking and Insurance Regulatory Commission to enhance the exchange of supervisory information and cooperation, in addition to various other collaborative initiatives with the People's Bank of China, including those relating to mutual bond market access between Hong Kong and Mainland China (Bond Connect).

The SFC has MoUs with Switzerland, the United States, Singapore and Japan to facilitate varying degrees of mutual assistance on a cross-border basis and frequently makes or receives requests for assistance from regulators globally. The HKMA has similar cooperative arrangements with foreign jurisdictions, including with Australia, Canada, the mainland China, France, Germany, India, Japan, the United Kingdom and the United States.

One potential exception to this territorial approach is the catchall fraud provision of the SFO, modelled on Rule 10b-5 in the United States, which the SFC has previously used to target insider dealing in Taiwan

in securities listed on the Taiwan Stock Exchange. Importantly, significant elements of the fraudulent scheme were devised in Hong Kong, but this enforcement action nevertheless shows that the SFC will use its ostensibly territorial jurisdiction to reach conduct that principally occurs offshore, especially where it has effects on Hong Kong's markets and market participants.

Hong Kong also takes a largely territorial approach to banking regulations, although the HKMA frequently communicates with overseas counterparts and can disclose information about the operations of institutions authorised in Hong Kong to overseas regulators, as long as there are adequate privacy measures in place. The HKMA also looks to the home regulators of banking organisations incorporated overseas in determining whether to authorise them to conduct banking activity in Hong Kong. Such organisations can only be authorised in Hong Kong if the HKMA is satisfied that they are adequately supervised by their home banking regulator. Without authorisation, overseas banks cannot engage in any banking business, although they can open local representative offices to liaise with local customers.

International standards

22 | What role does international standard setting play in the rules and standards implemented in your jurisdiction?

Both regulators are active participants in the Financial Stability Board (FSB), an international body that monitors and makes recommendations about the global financial system with a view to reducing vulnerability and safeguarding the smooth functioning of financial markets through enhanced information exchange and cooperation in financial supervision and surveillance. Hong Kong's inclusion in the FSB is a recognition of its status as a systemically important financial centre.

In July 2019, the HKMA implemented the Banking (Exposure Limits) Rules which aim to implement the Basel Committee's large exposures standards (introduced in 2014) and also update other exposure limits to keep pace with market developments and contemporary risk management techniques.

In the anti-money laundering and counter-financing of terrorism (AML/CFT) sector, the SFC and HKMA both work to ensure that the international standards and guidance promulgated by the Financial Action Task Force (FATF) are adequately reflected in Hong Kong's regulatory and compliance framework. In September 2019, FATF announced the results of its recent Mutual Evaluation Report of Hong Kong (FATF Report). The FATF report assessed Hong Kong's AML/CFT regime to be compliant and effective overall (scoring in the top 25 per cent of FATF members globally), and confirmed that Hong Kong has a strong legal foundation and effective system for combating money laundering and terrorist financing.

The FATF Report made a number of recommendations for how Hong Kong could improve its AML/CFT framework. In September 2020, the SFC launched a consultation on proposals to amend its AML/CFT guidelines in line with FATF's recommendations, including proposals to incorporate FATF's recent guidance for adopting a risk-based approach in the securities sector.

UPDATE AND TRENDS

Key developments of the past year

23 | Are there any other current developments or emerging trends that should be noted?

The Securities and Futures Commission (SFC) and the Hong Kong Monetary Authority (HKMA) both continued to focus on emerging technologies in 2020. In particular, the SFC and the HKMA introduced initiatives focusing on cyber resilience and cybersecurity, as evidenced

in the introduction of HKMA's Cybersecurity Fortification Initiative 2.0 (effective from 1 January 2021), as well as additional guidance issued by the SFC in December 2020 on external electronic data storage (eg, cloud storage), a follow-up to its controversial October 2019 guidance setting out updated requirements for storing regulatory records in the cloud.

Another area of regulatory focus in 2020 was on climate risks and sustainability in the financial sector. This is evidenced by various initiatives introduced by the SFC, the HKMA and the Stock Exchange of Hong Kong (SEHK). For example, the SFC and the HKMA established the Green and Sustainable Finance Cross-Agency Steering Group, which aims to coordinate the management of climate and environmental risks to the financial sector. In December 2020, the Steering Group announced the launch of a strategic plan to bolster Hong Kong's position as a leading green and sustainable finance centre, including actions to strengthen climate-related financial risk management and promote the flow of climate-related information to facilitate risk management, capital allocation and investor protection. Also in June 2020, the HKEx announced its plans to launch the HKEx Sustainable and Green Exchange (STAGE), a comprehensive database of sustainable and green investment options that are available on Hong Kong's securities market, with a goal to promote the visibility, transparency and accessibility of sustainable and green finance across asset class and product type.

2020 saw a continued disciplinary focus by Hong Kong financial regulators on ensuring personal accountability of individuals working in the financial services industry. This was demonstrated by the SFC actions against individuals found to have been engaged in market misconduct, including actions to prohibit former responsible officers from re-entering the industry over IPO sponsor failures, theft and AML/CFT-related breaches. The HKMA also took action in this area, concluding a consultation in August 2020 on the implementation of a mandatory reference checking scheme under which recruiting banks would be required to obtain a reference from the prospective employees' current and former employers before a new employment relationship is established. This initiative aims to prevent individuals who were formerly engaged in misconduct (ie, the 'bad apples') from repeating their misconduct at a new financial services employer. Another example of this disciplinary focus is the SEHK's August 2020 announcement of its review of its existing disciplinary regime. The purpose of this proposed update (the first since 1993) is to ensure that there exists a spectrum of graduated sanctions in relation to breaches of the SEHK's Listing Rules. The proposals include introducing director unsuitability statements against individuals, as well as secondary liability for breaches of the Listing Rules in circumstances where the SEHK determines that the individual in question '... has caused by action or omission or knowingly participated in a contravention of the Listing Rules'.

The SFC also continued its recent focus on listed companies over the past year. The regulator reiterated its 'front-loaded' regulatory approach in tackling market and corporate conduct risk, with an emphasis on IPO sponsor work (especially in relation to the due diligence failures arising in the listing application context) and listed companies' transactions (including those conducted to transfer corporate control without disclosing the identities of the incoming controllers, as well as highly dilutive rights issues).

In February 2021, the SFC launched its long-awaited consultation on a proposed code of conduct on book-building and placing activities in equity capital market and debt capital market transactions. The proposed new code seeks to clarify the roles played by intermediaries in equity and debt capital raisings and set out the standards of conduct expected of them in book-building, pricing, allocation and placing activities. The SFC also hopes that its proposals will help tackle issues arising from competitive pressures in the book-building or placing context (eg, conflicts of interest) and align incentives with the responsibilities of intermediaries.

24 What emergency legislation, relief programmes and other initiatives specific to your practice area has your state implemented to address the pandemic? Have any existing government programmes, laws or regulations been amended to address these concerns? What best practices are advisable for clients?

The Securities and Futures Commission (SFC) and the Hong Kong Monetary Authority (HKMA) have both introduced measures aimed at alleviating the impact of the pandemic on regulated institutions, with a focus on ensuring that the financial markets continue to operate in an efficient and orderly manner, assuring investor protection, and preserving market integrity. While the regulatory expectation is that licensed corporations or individuals and other market participants should make all reasonable efforts to maintain 'business as usual' in relation to their regulatory obligations (including regulatory filing, reporting and other deadlines), there has inevitably been greater regulatory flexibility to enable financial institutions to continue to operate amidst the difficulties presented by the global pandemic. Regulated institutions are advised to continuously monitor the impact of the pandemic on its control and compliance risks and to contact the SFC and/or HKMA to the extent that they are facing particular difficulties in complying with the regulatory regime (eg, to check whether extensions and exemptions from strict compliance could be allowed).

The SFC and the HKMA have each published guidance on the various challenges and issues posed by 'the new normal', including working from home arrangements, staff working abroad due to quarantines or airport closures, restrictions on face-to-face interactions, and postal service suspension. Regulated institutions are advised to familiarise themselves with these coronavirus-related circulars and announcements, which can be located in the dedicated sections of the SFC and the HKMA websites.

The following are examples of pandemic-related guidance and measures introduced by the SFC over the course of 2020.

Investor protection

- In light of the impact of the pandemic on market volatility and liquidity, a Circular was issued to licensed and registered persons reminding them of their obligations under the SFC's Code of Conduct in relation to suitability in making a solicitation or recommendation and timely dissemination of information when distributing investment products to clients.
- Reminders to managers, trustees and custodians of SFC-authorized funds of their obligations to properly manage the liquidity of their funds and ensure fair treatment of investors amid the market volatility caused by the pandemic.

Regulatory compliance

- Increased flexibility to assist intermediaries and licensing applicants in fulfilling their obligations in licensing matters, including continuous professional training, notification to the SFC of certain covid-related staffing considerations, work abroad arrangements for staff due to travel restrictions, and overseas licence applications.
- Special guidance on the compliance with the Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules in the context of suspension of Hong Kong and overseas postal services.
- Extended deadlines for intermediaries to implement recently announced SFC regulatory initiatives (eg, use of external electronic data storage; new measures to protect client assets; and data standards for order life cycles).
- Availability to certain groups of extensions to the deadlines applicable to submission of audited accounts and other required documents to the SFC.

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Internal controls

- Guidance to licensed corporations concerning the monitoring and management of cybersecurity risks associated with remote office arrangements; and
- Reminders to intermediaries of the alternative order receiving and recording options to ensure compliance with order recording requirements as set out in the SFC's Code of Conduct.

Listed companies

- Special guidance jointly given by the SFC and the SEHK to listed companies concerning the timely issuance of financial results.

For its part, the HKMA announced the following selected relief measures and guidance in 2020:

- Guidance to authorised institutions encouraging the use of reliable remote/digital customer on-boarding initiatives, and supporting the use of simplified due diligence procedures (which generally require less face-to-face interaction) in cases where the AML/CFT risks are assessed to be low;
- Deferral of the timeline for implementation of Basel III reforms (e.g. revised frameworks on credit risk, operational risk, output floor and leverage ratio; revised market risk framework, and revised credit valuation adjustment framework);
- Lowering of the regulatory reserve requirement on locally incorporated authorised institutions by 50 per cent to provide authorised institutions with a greater lending headroom to support banking customers to cope with the pandemic; and
- Postponement of the 2020 Supervisor-Driven Stress Test to 2021.

In addition to the above-mentioned initiatives, the HKMA also introduced relief measures aimed at individuals and corporations, and encouraged authorised institutions' participation. These measures include (1) the introduction and extension of the Pre-approved Principal Payment Holiday Scheme for Corporate Customers to provide immediate relief to eligible small-to-mid-sized corporates facing financial issues in the wake of the pandemic outbreak, and (2) the launch of the Special 100% Loan Guarantee under the SME Financing Guarantee Scheme intended to ease the cash flow problems faced by enterprises adversely affected by covid-19.

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