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## **HK SFC Enforcement Reporter - Watchlist for 2018**

A discussion on Enforcement Reporter (“Report”) released by the Securities and Futures Commission of Hong Kong (“HK SFC”) in February 2018.

### **Background**

As part of HK SFC’s initiative to enhance the transparency of its work and provide the market with regular updates on enforcement trends and priorities, HK SFC published the Enhancement Reporter on 26 February 2018 setting out HK SFC’s enforcement priorities for year 2018.

Fighting against intermediary misconduct remains one of the top enforcement priorities. While other key tasks include guarding against mis-selling of financial products, battling insider dealing and market manipulation as well as sponsor misconduct.

The article aims to discuss the enforcement priorities put forward by HK SFC in the Enhancement Reporter and to point out areas that financial intermediaries should pay attention to. Financial intermediaries need to pay closer attention to their compliance.

### **Enforcement Priority 1: Fighting Against Intermediary Misconduct**

The report clearly stated that HK SFC will continue to keep close eyes on intermediaries' daily activities with holistic enforcement approach. As a way to strengthen deterrence, HK SFC also indicated in the Report that breaches by the same firm or multiple firms under same corporate group may be dealt with as a whole and HK SFC may seek criminal sanction where appropriate.

Various types of enforcement actions taken by the HK SFC, such as the fining of CLSA Limited, reprimanding of Interactive Brokers Hong Kong Limited, have demonstrated its determination to fight against intermediary fallings that pose systematic risks.

Financial intermediaries should further reinforce their internal risk management procedures and mechanisms and should also provide regular compliance training for internal employees, especially to the Compliance Officers, investment personnel and senior management to reduce the possibility of employees engaging in or participating in any misconducting activities.

## **Enforcement Priority 2: Guarding Against Mis-selling of Financial Products**

A specialist team under the Enforcement division works with other divisions in investigating mis-selling practices. Firms should have in place sufficient controls and training to staff to ensure that all regulated activities are performed in compliance with applicable laws, rules and regulations.

Except for corporate and institutional professional investors who have consented to the exemption of such, licensed persons and corporations should observe the suitability requirements in conducting any marketing activities. As stipulated in the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (“the Code”), the intermediary has a strict responsibility to ensure that the sale or recommendation of any financial product to a client must be reasonably suitable to the client having regard to the client’s financial situation, investment experience and investment objectives. This requirement cannot be waived or derogated by any other agreements signed with the client.

Firms should therefore ensure that licensed persons conducting sales activities should be well aware of the clients’ risk profiles as assessed by risk profiling questionnaire during the account opening stage (or any updated assessments completed thereafter) and should also be reasonably familiar with the Company’s product risk matrix. The salesperson should not recommend any products that exceeds the client’s known risk tolerance levels. Proper product due diligence should also be conducted to avoid risk mismatch.

Furthermore, firms should ensure that all relevant risks of the investment are clearly communicated to the client before signing any agreements. Applicable risk disclosure statements and declarations stipulated in the Code should be printed on all marketing materials to ensure that an informed investment decision may be made.

Proper complaints channels and handling procedures should be established and reviewed by senior management regularly. All complaints should be handled seriously and promptly. The financial intermediary must observe all obligations under the Code in handling clients’ complaints, including advising to the client that he/she has the right to refer the dispute to the Financial Dispute Resolution Centre.

## **Enforcement Priority 3: Battling Insider Dealing and Market Manipulation**

For insider dealing, financial intermediaries which may have access to material non-public price sensitive information should maintain a restricted list, thus prohibiting trading of the relevant stocks or derivatives. Effective mechanisms should be in place pre-trade and post-trade to ensure that the restricted list is observed. Escalation channels should be clearly established for individuals involved in the investment decision making process to disclose and declare any material non-public price sensitive information he/ she has possessed.

For market manipulation, financial intermediaries, especially brokerage firms executing trade orders on clients’ behalf, should have in place robust controls and monitoring programs. Staff should be continuously educated of the common transaction patterns of market manipulation and misconduct, e.g. simultaneous positions selling and buying the same financial instrument may indicate wash trades. Financial intermediaries should provide reporting channels for staff

to report any suspected market misconduct for further handling by the Compliance Officer. The Compliance Officer should detail and record his/her considerations and judgment regardless whether or not the case was eventually reported to the HK SFC or other regulatory bodies. Financial intermediaries are expected to demonstrate robust monitoring mechanisms implemented, through their staff and via the electronic trading system.

## **Enforcement Priority 4: Battling Sponsor Misconduct**

Sponsor misconduct is another key priority that the HK SFC focuses on resolving ongoing sponsor misconduct cases as well as investigating new ones. The HK SFC have investigated 15 sponsor firms, and issued notices of proposed disciplinary actions against eight firms and four sponsor principals. As of February 2018, the HK SFC considered similar disciplinary notices and other enforcement actions against other firms and at least five sponsor principals. The HK SFC's enforcement actions remind sponsors to uphold the highest standards and carry out proper due diligence which is a fundamental safeguard in the listing process. In many of the cases investigated by the HK SFC, sponsors failed to scrutinize and verify key information in a prospectus and examine information with professional skepticism.

The Code has listed out the key compliance requirements for a sponsor. For instance, a sponsor should take reasonable due diligence steps in respect of a listing application; before submitting a listing application a sponsor should complete all reasonable due diligence on a listing applicant except in relation to matters that by their nature can only be dealt with at a later date. A sponsor should also take reasonable steps to ensure that true, accurate and complete disclosure about a listing applicant is made to the public. Proper books and records should be sufficiently maintained to demonstrate its compliance with the Code as well.

Moreover, a sponsor should pay attention to the SFC guideline to sponsors, underwriters and placing agents involved in the listing and placing of GEM stocks issued in January 2017. A sponsor, in its capacity as corporate finance adviser, is required under the Corporate Finance Adviser Code of Conduct ("the CFA Code") to: (a) use all reasonable efforts to ensure that its client understands the relevant regulatory requirements and their implications at all stages of a transaction. Upon becoming aware that its client is not complying with the regulatory requirements, it should advise its client to bring the matter to the attention of the regulators at the earliest opportunity. If this is declined by the client without valid reasons, it should consider the need to cease to act (paragraph 6.3 of the CFA Code); and (b) take all reasonable steps to give its client, in a comprehensive and timely manner, any information required (including advice on the Listing Rules) to enable its client to make a balanced and informed decision (paragraph 6.4 (b) of the CFA Code).

## **Conclusion**

The HK SFC has adopted a new "real time" regulatory approach which enables cross-divisional collaboration to tackle increasingly complex cases and maximise the efficiency of enforcement. The HK SFC emphasizes that corporate fraud is the top enforcement priority to eradicate groups that collude to defraud investors. Companies issuing false or misleading financial statements; initial public offering ("IPO") fraud and related sponsor failures; and failures to manage conflicts of interest by senior management of listed companies are also on the radar of the HK SFC.

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A more holistic enforcement approach which poses systemic risks will be adopted to detect intermediary misconduct. Sponsor misconduct cases are also on the rise that the HK SFC keeps investigating sponsor firms and issued disciplinary notices for the failure to scrutinize and verify key information in a prospectus and examine information with professional skepticism. The HK SFC reminds sponsors to uphold the highest standards and carry out proper due diligence which is a fundamental safeguard in the listing process.

It is foreseen that given the HK SFC's more advanced approach of enforcement, more sophisticated market misconduct will be detected and subject to criminal sanctions. Therefore, licensed corporations are reminded to take note of the suggestions aforementioned to live up to the compliance standard of the HK SFC.

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## **Contact:**

Josephine Chung is Director of CompliancePlus Consulting Limited specializing in compliance matters for hedge fund managers and mutual fund management companies with over 15 years of industry experience. Before joining CompliancePlus Consulting, she was the Head of Legal and Compliance for a major asset management company in Hong Kong.

Josephine can be contacted at +852-3487 6333 (email: [jchung@complianceplus.hk](mailto:jchung@complianceplus.hk))

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