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Hong Kong Licensed Corporations Alert
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The Stock Exchange of Hong Kong Limited Launches Consultation on Hong Kong's Special Purpose Acquisition Companies (SPAC) Regime Proposing a Minimum HK$1 Billion Initial Offering, Voting-related Redemption Restrictions and Specific Role of SPAC Licensed Promoter

On September 17, 2021, The Stock Exchange of Hong Kong Limited (Exchange) published a consultation paper (CP) on Hong Kong's listing regime for special purpose acquisition companies (SPAC). Riding on the success of a "stringent" approach regarding the listing of biotech companies, issuers with WVR structures and secondary "homecomings", the Exchange seeks to set a high entry point for both SPAC listing applicants and business combination (De-SPAC) targets. Key proposals include:

Minimum initial offering size

The CP sets the proposed minimum initial offering size at HK$1 billion. This is slightly higher than the threshold of SG$150 million under the Singapore SPAC regime.

Investor suitability

The CP proposes that the subscription and trading of a SPAC's securities will be restricted to Professional Investors only, with additional approval, monitoring and enforcement measures to ensure compliance with such requirements. A SPAC must distribute each of SPAC shares and SPAC warrants to a minimum of 75 Professional Investors, of which 30 must be Institutional Professional Investors.

SPAC licensed promoters and their obligations

SPAC promoters must meet suitability and eligibility requirements, including the requirement for each SPAC to have at least one SPAC promoter to be a firm that holds: (a) a Type 6 (advising on corporate finance) and/or a Type 9 (asset management) license issued by the Securities and Futures Commission (SFC); and (b) at least 10% of the promoter shares (Licensed Promoter).

Any material change in SPAC promoters would require approval by a special resolution of shareholders (excluding the SPAC promoter and close associates). A redemption right must be made available to shareholders voting against such material change. Licensed Promoters should consider such commitment before agreeing to be appointed.

SPAC promoters collectively cannot have more than (i) 20% shares at the initial offering and (ii) 30% shares at De-SPAC stage, subject to meeting of performance targets by the successor company. There are proposed restrictions which seek to limit dilution of equity holders' interests.

100% of the gross proceeds of a SPAC's initial offering must be held in a ring-fenced trust account located in Hong Kong. Such trust account must be operated by a trustee/custodian whose qualifications and obligations should be consistent with the requirements set out in Chapter 4 of the Code on Unit Trusts and Mutual Funds administered by the SFC.

The majority of directors on the board of a SPAC must be officers (as defined under the Securities and Futures Ordinance) of the SPAC promoters (both licensed and non-licensed) representing the respective SPAC promoters who nominate them.

Special voting-related redemption restrictions

SPACs would be required to provide shareholders with the opportunity to elect to redeem all or part of their shareholdings (at the price at which they were issued in the SPAC's initial offering, plus accrued interest) in the circumstances of a shareholder vote on:

(a) a material change in the SPAC promoter managing a SPAC or the eligibility and/or suitability of a SPAC promoter;

(b) a De-SPAC transaction; and

(c) a proposal to extend the De-SPAC announcement deadline or the De-SPAC transaction deadline.

SPAC shareholders would only be able to redeem SPAC Shares if they vote against one of the above matters.

This is a special feature of Hong Kong's proposed SPAC regime. Implementing this prohibition is expected to help ensure that the shareholder vote on the transaction functions as a meaningful check on the reasonableness of its terms and would help curb abusive practices (such as over-valuation).

Stringent De-SPAC requirements

A successor company will need to meet all new listing requirements (including IPO sponsor engagement to conduct due diligence, minimum market capitalization requirements and financial eligibility tests).

Existing requirements on forward looking statements are proposed to apply to the listing document for a De-SPAC transaction to the same standard as that required for a normal IPO (including the requirement for reports from the reporting accountant and IPO sponsor on such statements).

The CP proposes mandatory outside independent PIPE investment which must: (a) constitute at least 25% of the expected market capitalization of the successor company (or at least 15%, if the successor company's expected market capitalization at listing is over HK$1.5 billion); and (b) result in at least one asset management firm or fund (with assets under management/fund size of at least HK$1 billion) beneficially owning at least 5% of the issued shares of the successor company as at the date of the successor company's listing.

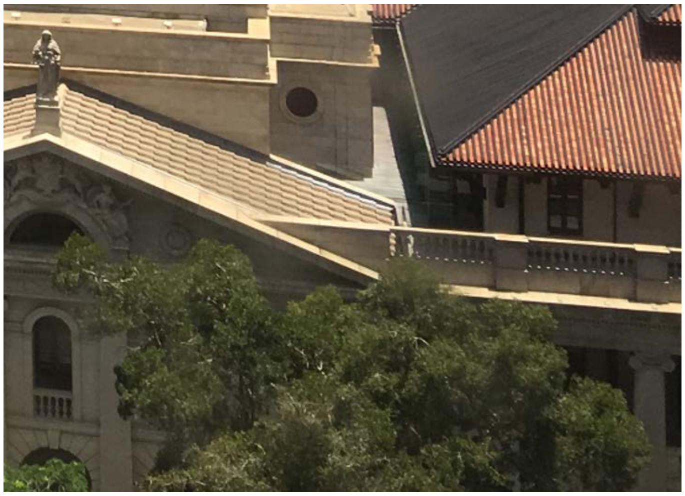
If a SPAC is unable to announce a De-SPAC transaction within 24 months, or complete one within 36 months, the SPAC must liquidate and return 100% of the funds it raised (plus accrued interest) to its shareholders. The Exchange will then de-list the SPAC.

Smaller shareholders' spread requirement

A successor company must ensure an adequate spread of holders of its shares of at least 100 shareholders, rather than the minimum 300 shareholders' requirement normally required for a new listing.

Responses to the CP should be submitted by October 31, 2021.

Source:
https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/September-2021-Special-Purpose-Acquisition-Co/Consultation-Paper/cp202109.pdf?la=en



Updates on Hong Kong Securities and Futures Commission's Anti-money Laundering and Counter-Financing of Terrorism Guidelines

On September 15, 2021, the Securities and Futures Commission of Hong Kong (SFC) issued consultation conclusions (Conclusions) on proposed amendments to, among others, the Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (AML/CFT) (For Licensed Corporations). The consultation was launched on September 18, 2020 and responses were received from industry associations, professional and consultancy firms, brokers and asset management companies.

The amendments aim to align the guidelines with the Financial Action Task Force's (FATF) AML/CFT standards, which include additional guidance to facilitate the implementation of risk-based AML/CFT measures by securities industry participants. Major amendments are listed as follows.

A. Risk Assessment

Licensed corporations (LCs) are required to establish and implement adequate and appropriate AML/CFT policies, procedures and controls (AML/CFT Systems) according to the current AML/CFT Guideline. Such process is known as institutional risk assessment (IRA). The SFC intended to formalize guidance on IRA requirements in its previous circulars with no substantive changes.

The proposed amendments are as follows:

1. Incorporating existing guidance with more elaborative guidance

To identify, assess and understand ML/TF risks, LCs are currently required to perform the following steps when conducting institutional risk assessments:

(a) consider all relevant risk factors before determining the level of overall risk and the appropriate level and type of mitigating measures to be applied;
(b) keep the risk assessment up-to-date;
(c) document the risk assessment;
(d) obtain the approval of senior management of the risk assessment results; and
(e) have appropriate mechanisms to provide the risk assessment information to the SFC.

In order to assist LCs in conducting institutional risk assessments, the revised guideline would provide more elaborative guidance, such as providing:

- the sources of information which LCs should consider, including relevant risk assessments and guidance issued by the FATF, governments and authorities from time to time, such as Hong Kong's ML/TF Risk Assessment Report and any higher risks notified by the SFC;
- examples of how to approach an institutional risk assessment in a manner which is commensurate with the nature, size and complexity of the business of the LC;
- guidance on the range of risk factors such as country risk, customer risk, product/service/transaction risk and delivery/distribution channel risk to be taken into account when conducting institutional risk assessments, together with a non-exhaustive and illustrative list of risk indicators associated with risk factors which may indicate higher or lower ML/TF risks;
- clarity that a periodic review should be conducted at least once every two years or more frequently upon the occurrence of trigger events which materially impact an LC's business and risk exposure. Such two-year review cycle would be the basic requirement. In respect of trigger events, LC should come up with a list of trigger events which may materially affect their specific businesses and ML/TF risk exposures.

Further, when assessing the transparency of beneficial ownership information, an LC should have due regard to the availability of adequate, accurate and timely information about the beneficial ownership of legal persons and legal arrangements that can be obtained or accessed in a timely fashion by competent authorities in the country. LCs are also expected to be able to provide information about their institutional risk assessments to the SFC upon request.

2. Expanding the list of risk indicators for institutional and customer risk assessments

The SFC has included an expanded list of illustrative examples of relevant and useful risk indicators for country risk, customer risk, product/service/transaction risk and delivery/distribution channel risk in the revised guideline.

The non-exhaustive examples are meant to cover only higher or lower risk indicators which are generally applicable. When conducting risk assessments, an LC should holistically take into account all relevant risk factors and their specific circumstances, rather than any single risk factor in isolation.

Particularly, some indicators of higher ML/TF customer risk are set out below:

- the business relationships established in unusual circumstances;
- non-resident customers who have no discernible reasons for opening an account with financial institutions (FIs) in Hong Kong;
- the use of legal persons or arrangements as personal asset-holding vehicles, without any commercial or other valid reasons, irrespective of whether it is a shell vehicle or not;
- customers that have sanction exposure;
- nature, scope and location of business activities generating the funds may be related to high risk activities or jurisdictions posing a higher risk;
- a customer introduced by an overseas financial institution, affiliate or other investor, both of which are based in jurisdictions posing a higher risk; and
- where the origin of wealth (for high risk customers and politically exposed persons (PEPs)) or ownership cannot be easily verified.

Indicators of higher ML/TF product/service/transaction risk include the products or services offered to customers associated with jurisdictions posing a higher risk (e.g. where a customer resides in a jurisdiction posing a higher risk or where the customer's source of funds or source of wealth is mainly derived from jurisdictions posing a higher risk), products or services that may inherently favor anonymity or obscure information about underlying customer transactions, etc.

B. Risk Mitigation

<u>1. Due diligence for cross-border correspondent relationships</u>

Scope of application

The scope of application for the cross-border correspondent relationships provisions covers the securities sector, which aligns with the FATF standards and the requirements in other jurisdictions.

The “cross-border correspondent relationships” are defined as the provision of services for dealing in securities, dealing in futures contracts, or leveraged foreign exchange trading by an FI (hereafter referred to as “correspondent institution”) to another financial institution located in a place outside Hong Kong (hereafter referred to as “respondent institution”). A typical example of a cross-border correspondent relationship is a business relationship established between a securities firm (correspondent institution) executing securities transactions on a stock exchange for an overseas intermediary’s (respondent institution) local customers.

It is however noteworthy than the cross-border correspondent relationships provisions do not apply to a business relationship between a domestic asset management firm (which acts as a delegated asset manager) and an overseas delegating management company as the transactions are initiated by the domestic asset management firm based on a delegated mandate rather than by the customer (i.e. the overseas delegating management company).

Where a delegated asset management relationship is exposed to higher risks (e.g. an overseas delegating management company operates in a high-risk jurisdiction or mentioned in negative news report related to predicate offences for ML/TF or financial crimes), LCs may apply enhanced measures similar to those applicable to a cross-border correspondent relationship as appropriate.

Cross-border correspondent relationships with affiliated companies

LCs may adopt a streamlined approach to applying additional due diligence and other risk mitigating measures for cross-border correspondent relationships with affiliated companies through their group AML/CFT programs.

Under the streamlined approach, an LC could address the risks arising from the lack or incompleteness of information about the underlying customers and transactions of a respondent institution which is an affiliated company by performing a documented assessment approved by a manager in charge (MIC) of AML/CFT, MIC of Compliance or other appropriate senior management personnel, and satisfying itself that, for example:

(a) the group policy which applies to the respondent institution (i.e. the overseas affiliated company) includes: (i) CDD, continuous monitoring of business relationships and record-keeping requirements similar to the requirements imposed under Schedule 2 to the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615 of the laws of Hong Kong) (AMLO); (ii) the AML/CFT responsibilities of the respondent institution within the cross-border correspondent relationship; and (iii) group-wide AML/CFT Systems (including the compliance and audit functions; the provision of customer, account and transaction information to the LC’s group-level compliance, audit or AML/CFT functions and the sharing of such information for the purposes of CDD and ML/TF risk management) which monitor and regularly review the effective implementation of CDD, continuous monitoring of business relationships and record-keeping requirements by the respondent institution as well as support effective group-wide ML/TF risk management;
(b) the group policy is able to adequately mitigate any higher-risk factors including country risk, customer risk, product/service/transaction risk and delivery/distribution channel risk to which the respondent institution is exposed throughout the business relationship; and
(c) the effective implementation of the group policy and group-wide AML/CFT Systems is supervised at the group level by a competent authority.

Principal transactions

The provisions are applicable to transactions effected by the respondent institution on both a principal and agency basis because transactions conducted on a principal basis may expose an LC to similar risks; for example, when the respondent institution performed matched principal trading for its underlying customers but the LC has limited or no information about these underlying customers and transactions. This approach will also reduce the difficulty of ascertaining whether individual transactions are conducted by the respondent institution in matched principal trading.

Additional due diligence and other risk mitigating measures

An FI must carry out CDD measures in relation to a customer including a respondent institution. Although the cross-border correspondent relationships provisions do not require LCs to conduct customer due diligence (CDD) on a respondent institution's underlying customers, FIs, as the correspondent, should still apply the following additional due diligence measures when it establishes a cross-border correspondent relationship to mitigate the associated risks:

(a) collect sufficient information about the respondent institution to understand fully the nature of the respondent institution's business;
(b) determine from publicly available information the reputation and the quality of regulatory supervision of the respondent institution;
(c) assess the AML/CFT controls of the respondent institution and be satisfied that the AML/CFT controls of the respondent institution are adequate and effective;
(d) obtain approval from its senior management; and
(e) understand clearly the respective AML/CFT responsibilities of the FI and the respondent institution within the cross-border correspondent relationship.

If a FI relies on a financial institution within the same group of companies (related FI) to establish a cross-border correspondent relationship, the FI should ensure that its related FI has taken into account its own specific circumstances and business arrangements, and its particular cross-border correspondent relationship with the respondent institution. Nevertheless, an LC relying on a group company to conduct these measures remains responsible for ensuring compliance with the requirements set out in the AML/CFT Guideline.

An FI must also not establish or continue a cross-border correspondent relationship with a shell financial institution, namely, those without a physical presence in a jurisdiction where it is incorporated or licensed and have no management or full-time staff who are appropriately qualified with sufficient AML/CFT knowledge to safeguard against potential ML/TF risks.

FIs should also (a) review the information obtained on a regular basis and/or upon trigger events to ensure that the documents, data and information of the respondent institution obtained are up-to-date and relevant; and (b) monitor transactions of the respondent institution to detect any unexpected or unusual activities, etc.

<u>2. Simplified and enhanced measures under a risk-based approach</u>

To assist LCs in strengthening the risk-based application of CDD and ongoing monitoring measures, the SFC incorporated an expanded list of illustrative examples of possible simplified and enhanced measures.

Some of the additional examples are:

Simplified measures

(a) limiting the type or extent of CDD measures, such as altering the type or range of documents, data or information used for verifying the identity of a customer;

Enhanced measures

(b) evaluating the information provided by the customer with regard to the destination of funds involved in the transaction and the reason for the transaction to better assess ML/TF risks, especially when funds are transferred to jurisdictions posing higher risk;
(c) requiring sale proceeds to be paid to the customer's bank account from which the funds for investment were originally transferred, especially when there is any pattern of frequent changes of bank account details or information; and
(d) in the case where an LC acting as delegated asset manager does not have a business relationship with the overseas delegating management company's customer (i.e. a delegated investment vehicle), and the business relationship with the delegating management company is assessed to present higher ML/TF risks, obtaining additional customer information such as the underlying investor base (e.g. the background and geographical location of the underlying investors of the delegated investment vehicle), the reputation of the overseas delegating management company (e.g. whether it has or had been subject to any targeted sanctions, ML/TF investigations or regulatory actions) and its AML/CFT controls; obtaining senior management approval and understanding respective AML/CFT responsibilities clearly, as appropriate.

<u>3. Red-flag indicators of suspicious transactions and activities</u>

To assist LCs in fulfilling their statutory obligations for suspicious transaction reporting and help them develop and enhance their transaction monitoring systems and controls, the SFC enhanced the list of red-flag indicators for suspicious transactions and activities in the current AML/CFT Guideline.

In particular, while some existing red-flag indicators as removed due to their diminished significance, some new red-flag indicators are incorporated in the revised guideline, such as where a customer has no discernible reason for using the LC's service (e.g. a customer has opened an account for discretionary management services but directs the LC to carry out his own investment decisions).

The revised guideline expanded the 5 groups of red-flag indicators to 6, i.e. customer-related, trading-related, selected indicators of market manipulation and insider dealing, related to deposits of securities, related to settlement and movement of funds and securities and employee-related. Some red-flag indicators are re-categorized or modified to better differentiate the types of transactions or activities to which they relate.

LCs should note that the list of illustrative red-flag indicators of suspicious transactions and activities in the revised guideline is intended solely to provide an aid to LCs, and must not be applied by them as a routine instrument without any analysis or context, and the examples are not intended to be exhaustive.

LCs are reminded that they should not disclose any customer information to other persons, including other customers, when they take follow-up action on red-flag indicators. LCs should also protect data privacy and avoid tipping-off when asking customers for information.

4. Third-party deposits and payments

Apart from incorporating existing guidance provided in previous SFC's circulars regarding the policies, procedures and measures for handling transactions involving third-party deposits and payments, the revised guideline provides facilitative guidance permitting delayed third-party deposit due diligence.

LCs should clearly define in their policies and procedures the identification of those exceptional situations and adopt appropriate risk management policies and procedures concerning the conditions under which such delayed third-party deposit due diligence may be allowed.

The revised guideline sets out the conditions for delayed third-party deposit due diligence including:

(a) any risk of ML/TF arising from the delay in completing the third-party deposit due diligence can be effectively managed;
(b) it is necessary to avoid the interruption of the normal conduct of business with the customer; and
(c) the third-party deposit due diligence is completed as soon as reasonably practicable.

LCs should adopt appropriate risk management policies and procedures, which should include:

(a) establishing a reasonable timeframe for the completion of the third-party deposit due diligence and the follow-up actions if the stipulated timeframe is exceeded (e.g. to suspend or terminate the business relationship);
(b) placing appropriate limits on the number, types or amount of transactions that can be performed by or for the customer;
(c) performing enhanced monitoring of transactions carried out by or for the customer; and
(d) ensuring senior management is periodically informed of all cases involving delays in completing third-party deposit due diligence.

If the third-party deposit due diligence cannot be completed within the reasonable timeframe, LCs should refrain from carrying out further transactions for the customer and assess whether there are grounds for knowledge or suspicion of ML/TF and consider filing a suspicious transaction report to the Joint Financial Intelligence Unit.

C. Others

1. Person purporting to act on behalf of the customer (PPTA)

LCs are required to identify and take reasonable measures to verify the identity of a PPTA, as well as verify that person's authority to act on behalf of the customer. When determining whether a person is a PPTA, LCs should generally have regard to, amongst others, whether a person might be considered as instrumental in carrying out the ML/TF scheme should the account or transaction involved be found to be linked with criminal activity. Those who carry out transactions on behalf of the customer may be considered as PPTAs and any person authorized to act on behalf of a customer to establish a business relationship with an LC should always be considered as a PPTA.

It is provided as a non-exhaustive example in the revised guideline that, where a business relationship with a legal person customer with many PPTAs is assessed to present low ML/TF risks, an LC could verify the identities of the PPTAs with reference to a list of PPTAs whose identities and authority to act have been confirmed by a department or person within that legal person customer which is independent to the persons whose identities are being verified (e.g. compliance, audit or human resources). LCs have the flexibility to implement other streamlined approaches to verify the identity of a PPTA if the business relationship with a customer poses a low ML/TF risk.

In addition to the illustrative examples of PPTA provided, an FAQ will also be issued to provide guidance on whether persons carrying out transactions on behalf of the customer may be considered as PPTAs (e.g. account signatories).

2. Establishing source of funds and source of wealth

Customers who pose higher ML/TF risks (including PEPs) are subject to special requirements or additional measures during the CDD process. This requires LCs to establish the source of funds or source of wealth of the customers, or both in some circumstances.

Source of funds information should not be limited to knowing from where the funds may have been transferred, but should include the underlying activity which generates the funds. This means that even where the funds of a customer are transferred through another financial institution such as a bank, LCs should also understand the activity (e.g. salary income, investment disposal gains) which generated the funds and obtain substantive relevant information to ascertain the nature of the activity by means of which the customer acquired the funds. In this regard, some illustrative and non-exhaustive examples such as salary payments and investment sale proceeds are provided in the revised guideline.

Similarly, when establishing the source of wealth, LCs should gather information to understand how a customer acquired its wealth and gauge the expected size of wealth. Some illustrative and non-exhaustive examples of information and documents which may be used to establish source of wealth, such as evidence of title, copies of trust deeds, audited financial statements, salary details, tax returns and bank statements, are provided in the revised guideline.

Transitional Arrangements

Considering that firms would need time to implement appropriate policies, procedures and controls, the SFC has provided a six-month transition period from the date of gazettal for firms to comply with the new cross-border correspondent relationships requirements. As the other amendments do not require substantial adjustments to firms' existing AML/CFT systems, they will become effective upon gazettal on September 30, 2021.

Conclusion

The revised guidelines provide greater clarity and additional flexibility in meeting the AML/CFT requirements. For example, the SFC has provided a streamlined approach for cross-border correspondent relationships with affiliated companies. Firms may apply additional due diligence and risk mitigating measures by assessing whether the group policy and AML/CFT program which apply to an affiliated company are in line with the FATF standards.

Such amendments to the guideline, together with the updated set of FAQ, are expected to facilitate LCs' understanding of the application of the guidelines, assist LCs in assessing and managing AML/CFT risks more effectively and complying with the regulatory requirements.

Source：
https://apps.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=21PR93
https://apps.sfc.hk/edistributionWeb/api/consultation/conclusion?lang=EN&refNo=20CP4

Management Experience Requirements for Responsible Officers and Related Transferability Issues in the Hong Kong Markets

On June 18, 2021, the Securities and Futures Commission of Hong Kong (SFC) issued consultation conclusions on proposed enhancements to the competency framework for intermediaries and individual practitioners (Conclusions), in which the SFC proposed, among other changes or elaboration on competence requirements, to clarify the management experience requirements for responsible officers (ROs).

Current requirement

The Guidelines on Competence (Guidelines) were issued in March 2003 and have largely remained unchanged since then. Under the Guidelines, all RO applicants are required to accumulate at least two years of management experience prior to submitting their RO application. The Guidelines, however, do not clearly prescribe what kind of management experience would be accepted by the SFC. As a result, some market participants interpret the term to include management experience accumulated in any industry, including those unrelated to regulated activities. The SFC would like to clarify this.

Confining management experience

The SFC proposed to confine management experience to hands-on experience in supervising and managing essential regulated functions or projects in a business setting. This includes the management of staff engaging in relevant regulated functions or projects, such as through managing a team conducting regulated activities or an activity that would have been a regulated activity in the absence of an applicable carve-out. Purely administrative management experience, such as human resources or office administration, would not be counted.

This proposal received general support from the respondents. Individuals who will be approved as an RO for a particular regulated activity are expected to supervise that regulated activity for their principals. They are expected to have knowledge and experience in managing the business in that regulated activity. Experience gained from managing purely administrative functions is not relevant to the proper supervision of regulated activities.

Transferability and other concerns

Some respondents were concerned whether would be a requirement of minimum number of staff managed by an applicant, whether the supervisory experience could be recognized as hands-on experience and whether experience in supervising an investment team not carrying out a regulated function could count as management experience.

SFC clarified that its focus was on the supervision and management of essential regulated functions or projects in a business setting. The number of staff under management, as with other information such as reporting lines and the length of time in management roles, facilitates the SFC's understanding of the applicant's management experience. While the SFC generally expects there to have been at least one professional staff under management, the SFC is of the view that there is no need to prescribe a fixed number for the purpose of the management experience requirement.

Further, a few respondents considered that managerial and supervisory experience is more transferrable across regulated activities and the industry when compared to industry experience, and should be accepted so long as it is relevant to the financial industry. Some were concerned about the complex reporting lines and decision matrices in financial institutions and suggested that the management experience requirement should be satisfied if the applicant's experience is relevant to the financial industry. In this regard, the SFC clarified that management experience acquired in the financial industry would be accepted.

In response to the requests for clarification of the management experience requirement, the SFC set out the following illustrative and non-exhaustive examples of management experience:

- experience as senior management (e.g., Chief Executive, Business Head or Chief Operating Officer) of a licensed corporation, a registered institution or a corporation within the financial industry supervising the performance of regulated activities or financial services;
- experience in supervising an investment team in the performance of an investment function, whether regulated or not; and
- experience acquired from managing another type of regulated activity.

Implementation timeframe

The SFC will proceed with the gazettal of the revised Guidelines on Competence, Guidelines on Continuous Professional Training and Fit and Proper Guidelines which will become effective on January 1, 2022. As the abovementioned guidelines have been substantially revised and amended, the SFC may arrange briefings and publish FAQs with examples where appropriate so that the industry can better understand the implementation of the enhanced competency framework.

Source:
https://apps.sfc.hk/edistributionWeb/api/consultation/conclusion?lang=EN&refNo=20CP8

The Process of Regulation is Subject to Judicial Scrutiny in Open Court - Balancing Interests of Fund Investors and Public Interests in the Case of Christopher James Aarons v. Securities and Futures Commission, SFAT Application No.1 of 2021

On April 13, 2021, the Securities and Futures Appeals Tribunal (Tribunal) handed down its ruling in *James Aarons v. Securities and Futures Commission* (SFAT Application No. 1 of 2021).

<u>Background</u>

The applicant in the case (Applicant) was the chief executive officer of a corporation licensed to conduct regulated activities in the field of asset management (Company) and was responsible for overseeing the investment strategies. The Applicant has been accredited as a licensed representative of the Company in the field of asset management and has been approved to act as a responsible officer.

In 2020, the Securities and Futures Commission (SFC) found that the Applicant appeared to have breached the first and seventh General Principles of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission, concerning the honesty of a licensed or registered person and the compliance with all regulatory requirements. The SFC's provisional findings were based on administrative proceedings in South Korea, in which it was asserted that the Applicant had used "material non-public information" (the equivalent of or similar to the concept of "relevant information" in Hong Kong) to profit from dealing in the shares of a South Korean corporation.

The SFC informed the Applicant that he did not appear to be a fit and proper person to hold the officers of a licensed representative or a responsible officer and later suspended his license to act as a representative and his approval to act as a responsible officer for a period of three years.

<u>Issue of confidentiality of the proceedings</u>

On February 19, 2021, the Applicant filed a notice of application for review with a letter requesting all proceedings before the Tribunal to be held *in camera* (i.e. in private) and the Applicant's name not to be published until the Tribunal otherwise ordered.

The Applicant put forward two arguments: (i) all previous proceedings, including the Korean proceedings, were confidential and the identity of the Applicant was not revealed; and (ii) public hearing prior to determination by the Tribunal was likely to cause irreparable reputational damage to the Applicant various funds managed by him. Innocent investors of the funds may therefore suffer significant loss.

<u>Tribunal's ruling</u>

The Tribunal rejected the arguments of the Applicant on the following grounds.

<u>Confidentiality of previous proceedings</u>

The Tribunal has the power to determine all applications for review as a trial court. Accordingly, the Tribunal pointed out that the fact that the earlier proceedings were conducted as confidential administrative proceedings was of no real relevance in determining how the Tribunal should conduct its own proceedings. Further, it appeared that the Korean proceedings were kept confidential as a matter of course rather than based on some pressing reasons peculiar to the Applicant's matter. The Tribunal found no grounds for holding that, by reason of the confidentiality of the earlier proceedings alone, the protection of confidentiality should continue.

In addition, the Tribunal was aware that if it was to accede to the Applicant's request, there would be a risk not simply of protecting the Applicant but setting a precedent allowing the SFC, by way of a general rule, to be protected from having to divulge what it said in any of its preliminary written exchanges with persons under investigation. This would be against the well-established principle that market regulators have no special privilege and their regulatory actions before the Tribunal and the courts are at all times open to scrutiny by the public at large.

Damage to reputation

In respect of the Applicant's argument on damage to reputation, the Tribunal found that in the common law, unwanted publicity is a normal incidence of litigation. The concerns on damage to reputation were not of sufficient weight to move the principle of open justice.

Risk of financial loss to innocent investors

The Tribunal accepted that highly rated asset managers could be able both to attract investors and lead to their departure in the event of loss of form of any other loss of reputation. If the conduct of asset managers is under review by financial regulators, and there is a danger of their licenses being revoked, it may lead to an influx of redemptions and other risks.

Nonetheless, the Tribunal pointed out that every person in the securities industry who was licensed to hold and invest other peoples' funds stood in the same position of risk. The Applicant was not in a unique position. It is not unusual that a loss of reputation brings consequences to those innocent investors. The Tribunal cannot always provide protection of confidentiality on the sole basis that innocent investors may perhaps stand to be financially prejudiced.

More importantly, as pinpointed by the Tribunal, investors always accept a degree of risk when they invest. If investors wish to follow the banner of one particular asset manager, they must accept the risk.

Importance of open justice

This case demonstrates that the Tribunal places great importance on the transparency of market regulation. The Tribunal regards that a fairly and transparently regulated market, in which the process of regulation is open to scrutiny, will best protect the health of the market and through that the deserved reputation of those licensed to operate within the market. The participants of capital market do not have special privilege against open justice and cannot simply plead confidentiality or potential negative implications to innocent fund investors in opposition to open court proceedings.

Source:
https://www.sfat.gov.hk/files/SFAT%202021-1%20Ruling.pdf

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