Hong Kong and the cauldron of compliance

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It has been quite a time in Hong Kong. And the protests continue. But, is the recent political turmoil a symptom of bringing Hong Kong up to international anti-money laundering (AML) standards?

In our fourth *SEA View* article, Antonia Croke, Byron Phillips, and Nigel Sharman explore the territory's commitment to robust and effective compliance and to combating fast-evolving technologically-advanced threats.

Did outdated AML / counter terrorist financing (CFT) recommendations help stir the pot in Hong Kong?

Under the *"One Country, Two Systems"* framework that came into force after Hong Kong's handover in 1997, the territory was promised civic freedoms and "a high degree of autonomy" for 50 years. The extradition bill, which has fueled the protests in Hong Kong and around the world since March 2019, would, if passed, allow for the extradition of individuals to any jurisdiction in the world with which Hong Kong has no existing formal extradition agreement, including mainland China. It has met widespread opposition, including from Hong Kong's business and legal sectors.

The controversial bill's core supporters tout its potential positive impact on AML and CFT efforts - it has been advocated as a tool to help drive out money laundering and terrorism funding.

During her press conference on 15 June 2019 announcing the suspension of work on the controversial bill, Chief Executive Carrie Lam Cheng Yuet-ngor cited a Financial Action Task Force (FATF) report from 2008. That FATF report described the lack of an extradition deal allowing fugitives to be sent to mainland China, Taiwan, and Macau, as "*the most significant deficit in Hong Kong's extradition arrangements*".

Could that 2008 FATF report have been the kindle for the protests in Hong Kong? Witness the changes since the last FATF mutual evaluation at the end of 2018. Since then, FATF is reported to have changed the language and softened their stance, now describing the situation merely as a "*legal shortcoming*" and no longer a "*matter of priority*".

In a statement summarizing the outcomes of a FATF plenary session held in Orlando, Florida in June 2019, FATF said that Hong Kong had a "*strong legal foundation*" to underpin its AML/ CFT regime, noting that it has "*effective measures to combat terrorist financing and to confiscate the proceeds of crime*" and that the territory actively cooperates with international partners.

The draft report also noted challenges faced by Hong Kong, notably the need to "*...prioritize efforts to prosecute [money laundering] linked to foreign predicates, increase risk understanding and AML/ CFT implementation by smaller institutions, and strengthen supervisory measures for some sectors*." We expect a final report to be published in September.

AML/ CFT efforts are intrinsically linked to the global war on cyberattacks. Cybersecurity risks are obvious - they can expose an organization to government investigations, unwanted media attention, customer demands, litigation and potentially serious reputational damage.

Unfortunately, Hong Kong has become a hotspot for cyber-related fraud - both as a destination of stolen funds and as itself a venue for frauds committed.

It has, of course, also been the venue for one of the world's most wide-scale data breaches (read our analysis here). On 6 June, 2019, Hong Kong's Privacy Commissioner for Personal Data issued an enforcement notice against Cathay Pacific Airways (and its affiliate Hong Kong Dragon Airlines) (together, Cathay Pacific) in respect of a data breach concerning unauthorized access to the personal data of some 9.4 million Cathay Pacific customers.

It is no surprise that the push for a mandatory data breach notification requirement is gathering pace in Hong Kong and Singapore alike.

Good data and bad apples

The need for appropriate supervision in the financial services industry has also been explored in remarks made by Julia Leung, the Deputy Chief Executive Officer of the Securities and Futures Commission (SFC) in the Commission's Compliance Forum 2019 held with the aftermath of the protests still reverberating, on 17 June 2019. Amongst other highlights of the speech:

- The SFC prided itself on its enhanced gatekeeping function involving the use of new licensing forms which became mandatory in April and which were described as a "*kind of software update*". The new forms allow the SFC to collect and analyze the relevant data upfront, making the licensing process more efficient and transparent and helps the SFC get a proper handle on some recurring problems;

- Driving proper behavior. Promoting, encouraging, and enforcing proper conduct among licensed firms and individuals. She referenced the SFC's recent initiative to keep better track of "*rolling bad apples*", in other words, "*people with a record of misconduct which is wiped clean when they change jobs, allowing them to potentially repeat their misbehavior at another firm*".

Also under the spotlight in this regard was the proper conduct of a licensed corporation's (LC) controlling entity, since it had come to their attention that some LCs' related parties may be associated with alleged illegal activities. One example was soliciting mainland China investors to trade on an online platform for foreign exchange margin trading, which unless approved is illegal in mainland China, or being associated with fraudulent London gold activities in Hong Kong. A new circular reminds LCs and their controlling entities to review the legality of the services they provide in Hong Kong and elsewhere, stop illegal activities, and mitigate risks as follows:

- Prudential and conduct regulation. Julia Leung highlighted the need for vigilance in the Commission's prudential and conduct supervision. In off-site monitoring and on-site inspections of LCs, the SFC is closely monitoring credit and market risks, especially those associated with securities margin financing. Selling practices were another key priority, with a recent survey finding that more complex products were being sold with their terms, features and, risks not well understood by retail investors;

- Innovation and technology. A current priority was to facilitate more efficient remote onboarding of clients overseas, using biometrics along with safeguards for mitigating technology risks. Ms Leung also warned of the risks to investors posed by virtual assets. Advanced supervision was assisted by the use of "*new, innovative supervisory technology*", known as Suptech, which the SFC uses in its inspections to identify irregularities, systemic control deficiencies, and significant compliance issues which would otherwise go undetected; and
- Several "thematic reviews" including compliance by internet brokers with 20 baseline cybersecurity requirements which came into effect in July 2018. This includes two-factor authentication for system login, security controls on mobile apps, data privacy, and vendor management.

Blacklists and black arts

Foreign investors might also be forgiven for being unnerved by China's publication in late May 2019 of a so-called 'unreliable entities' list: a list of foreign companies, organizations, and individuals that are said to have damaged Chinese business interests by blocking supplies for non-commercial purposes. There has been speculation the move is in response to the U.S. placing Huawei on a trade blacklist that could prevent U.S. companies from supplying software and electronic components to Huawei.

Beijing will consider four factors in deciding whether to blacklist a foreign entity:

- Whether an entity had cut back or blocked entirely supplies to one or more Chinese firms;
- Whether the act was done for non-commercial purposes;
- Whether the act caused serious damage to Chinese industries; and
- Whether the acts posed a threat or potential threat to China's national security.

China is already investigating FedEx following instances of Huawei packages being diverted or returned to the sender. As the trade war intensifies, there is presently no solution in sight to the ramping up of tariffs and barriers on either side of the Pacific.

Businesses in Hong Kong, Singapore, Kuala Lumpur, their neighboring economies, and investors from across the world will be hoping that some kind of accord is reached quickly in the global trade war to steer them away from what they (for the most part) fear most – uncertainty.

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SEA View

Since April 2019 our monthly periodical has featured investigation, compliance, and regulatory developments in Southeast Asia (SEA). For a 12-month period, one monthly article will showcase our insights on particular developments in the region, liaising with our extensive global network. We draw on the firm's market-leading practices, including our assembled Global Regulatory team, to lead clients' businesses through challenges encountered in and out of SEA. *SEA View* is horizon spotting in practice. This month's analysis explores the compliance landscape in Hong Kong, testing the conditions that have contributed to the on-going protests. Having showcased our know-how on navigating sanctions for financial institutions and the key regulatory developments for the mining industry in Australia and the region in previous editions, next month we will have an update from Vietnam.