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Hong Kong SFC Places Key Reforms to SFO Enforcement Provisions on Hold Following Industry Feedback

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On August 8, 2023, Hong Kong's Securities and Futures Commission ("**SFC**") published its consultation conclusions on proposed amendments to enforcement-related provisions of the Securities and Futures Ordinance ("**SFO**") (the "**Consultation Conclusions**").[1] We previously covered the SFC's consultation paper regarding the same ("**Consultation Paper**") in a client alert.[2]

By way of refresher, the SFC had previously proposed in its Consultation Paper to make three key significant reforms to the SFO: (i) to amend the scope of section 213 to allow it to seek orders under this provision where the SFC has exercised its disciplinary powers under sections 194(1), 194(2), 196(1) or 196(2) against a regulated person, including an order that would allow the Court of First Instance (**"CFI**") to restore parties to any transaction to the pre-transaction position; (ii) to amend section 103(3)(k) to focus on the point in time when the advertising materials are issued; and (iii) to extend the scope of the insider dealing provisions in Hong Kong to address insider dealing in Hong Kong with regard to overseas-listed securities or their derivatives, and to address conduct outside of Hong Kong in respect of Hong Kong listed securities or their derivatives.

In light of significant concerns raised by the industry, the SFC has eventually decided to only proceed at this stage with the amendments to the insider dealing provisions. However, the SFC has stressed that it remains committed to investor protection despite deciding not to proceed with the other amendments at this stage, as discussed further below. In this client alert, we provide some colour to the SFC's responses and policy rationale under the Consultation Conclusions.

I. Expansion of section 213 of the SFO

The SFC had proposed to:

- introduce an additional ground in section 213(1) which would allow the SFC to apply for orders under section 213 where it has exercised any of its powers under sections 194(1), 194(2), 196(1) or 196(2) of the SFO against a regulated person (i.e. wherever it finds that a regulated person has engaged in misconduct or is no longer fit and proper);
- introduce an additional order in section 213(2) that would allow an order to be made by the CFI to restore the parties to any transaction to the position in which they were before the transaction was entered into, where the SFC has exercised any of its powers under sections 194 or 196 in respect of the regulated person; and
- enable the CFI to make an order under section 213(8) against a regulated person to pay damages where the SFC has exercised any of its disciplinary powers against a regulated person (collectively, the "**Section 213 Amendments**").

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The concerns raised by respondents in relation to the Section 213 Amendments can be grouped into five key themes, as summarised below alongside the SFC's responses to each of these concerns:

Concerns raised by respondents	The SFC's responses
Legal and jurisprudence concerns A number of respondents questioned whether it would be appropriate from a jurisprudential perspective to allow the SFC to seek court orders for a breach of codes and guidelines (e.g. the SFC's Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("**Code of Conduct**")) which do not themselves have the force of law and are not subject to the same scrutiny and oversight in their formulation. Respondents also considered this to be a concern given that the SFC's codes and guidelines are broad and principles based and as such the Section 213 Amendments could create significant legal and regulatory uncertainty to intermediaries. Respondents also noted that the proposed amendments were likely contrary to section 399(6) of the SFO, which provides that any failure to comply with the provisions of codes and guidelines does not give rise to a right of action.	The SFC did not agree that allowing legal consequences to stem from a breach of the SFC's codes and guidelines would fundamentally alter the status of these codes and guidelines. The SFC pointed out that the current law already allows the SFC to seek section 213 orders for breaches of licensing conditions, which also do not have the force of law. The SFC further stated that the legislative intent of section 213 has always been "to allow the court to exercise its discretion and order relief as it considers necessary to protect investors adversely affected by others' misconduct (in a general sense of the word), whether in the form of a breach of a statutory provision or a condition of a licence." Further, while reiterating that it did not consider these amendments would have changed the legal status of codes and guidelines, the SFC acknowledged that it would have needed to amend section 399(6) to align the two provisions if it had proceeded with these changes to section 213 in order to avoid inconsistencies.
Implementation difficulties Some respondents pointed to a risk of parallel proceedings and conflicting outcomes, namely, where an appeal to disciplinary proceedings to the Securities and Futures Appeals Tribunal ("**SFAT**") and the Court of Appeal could lead to a different outcome from the CFI's decision in relation to section 213 proceedings.	The SFC acknowledged that the Section 213 Amendments would have created a new link between the disciplinary regime and section 213 where currently none exists. While noting that it was aware of the possibility of parallel proceedings prior to the release of the Consultation Paper, the SFC noted that this issue could be "administratively mitigated" by the SFC not commencing section 213 proceedings until the appeal process in relation to disciplinary proceedings had been exhausted.
Fairness and proportionality concerns Some respondents raised concerns that the Section 213 Amendments would result in all forms of disciplinary action potentially triggering an action under section 213, including where the misconduct in question was minor. Other respondents noted that intermediaries could face both disciplinary sanctions and section 213 orders (including significant monetary penalties) stemming from the same misconduct, which they considered could lead to an unduly harsh burden on intermediaries. Other respondents pointed out that the Section 213 Amendments could lead to a potential extension of the limitation period. At present, the statutory limitation period starts from the date of the loss or the date of the breach. Under the SFC's proposal, the SFC's power to apply for section 213 orders would be triggered after a disciplinary action is made. Effectively, this could mean that the statutory limitation period commences from the date of the disciplinary action as opposed to the date of the loss or breach. This extension could significantly increase the potential liability of intermediaries.	The SFC acknowledged the industry's concerns regarding the impact of the Section 213 Amendments, and indicated that it would consider these concerns in further detail. In particular, the SFC noted that while it was not its intention to extend the statutory limitation period, that would have been the "natural result" of the proposed amendments in their initial form. They noted that while the industry may perceive section 213 compensation orders as "punitive in nature" due to their size, the fundamental nature of these orders is to restore aggrieved investors to the position that would have been in had the intermediary's misconduct not taken place. This is distinct from the purpose of regulatory fines which are to deter future non-compliance.
Concerns regarding Hong Kong's competitiveness and status as an international financial centre	The SFC strongly rejected these concerns. Instead, the SFC emphasised that:

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Many respondents raised concerns regarding the Section 213 Amendments' impact on Hong Kong's competitiveness and status as an international financial centre. In particular, respondents argued that the lack of predictability about the total financial impact of SFC enforcement actions, coupled with the combined financial burden of compensation orders under section 213 and disciplinary sanctions, could dissuade companies from participating in high risk regulated activities (e.g. sponsoring of IPOs), or even drive businesses away from Hong Kong.	• it considered an effective regulatory regime should aim to strike a balance between "providing a proportionate degree of protection for investors and enabling the industry to conduct business in an environment which is not hampered by unnecessary regulatory barriers to innovation and competition"; and • higher regulatory standards and active enforcement of such standards would in fact strengthen investor confidence in the market, thereby making Hong Kong an attractive and competitive market for international investors.
<u>Concerns regarding adequacy of current investor compensation regime</u> Several respondents stated that the current laws already provide adequate legal protection and safeguards for investors, and questioned whether there was a need for the Section 213 Amendments. These respondents pointed to existing frameworks under consumer protection laws, the option of civil litigation, the Financial Dispute Resolution Scheme, as well as intermediaries' own complaint handling procedures.	The SFC strongly rejected these concerns, and expressly stated that it did not consider that the current regime ensured investors (especially retail investors) were appropriately compensated when they suffer loss as a result of intermediaries' misconduct. The SFC noted that this was due to the limited resources often available to retail investors to pursue civil actions and the lack of a class action mechanism in Hong Kong. Given these factors, the SFC stated that it considered it to be appropriate for the SFC to obtain compensation on behalf of investors.

While ultimately stating that it would place the Section 213 Amendments "on hold" for the time being, the SFC was at pains to emphasise that it considers its inability to require intermediaries to compensate aggrieved clients or investors for losses as a result of breach of SFC codes or guidelines to be a "clear regulatory gap" which these amendments were intended to fix. However, the SFC has acknowledged that respondents raised a number of complex concerns which warrant further study, and noted that it may need to consider a broader range of options for remedying this gap, including strengthening the existing disciplinary regime.

Given this, we consider the key takeaway from the Consultation Conclusions in relation to the Section 213 Amendments to be that the SFC remains determined to protect investors by improving their ability to receive fair compensation in intermediary misconduct cases. As such, we expect to see future proposals from the SFC in this space in the short to medium term which will be intended to either overcome or avoid the concerns raised by the industry in relation to the Section 213 Amendments.

II. Amendments to exemptions in section 103 of the SFO

The second change proposed by the SFC was to amend section 103(3) of the SFO. Section 103(1) makes it a criminal offence to issue or be in possession for the purposes of issue of an advertisement, invitation or document which, to the person's knowledge, contains an invitation to the public to enter into an agreement to deal in securities or any other structured products, to enter into regulated investment agreements, or to participate in a collective investment scheme, unless authorized by the SFC to do so. Section 103(3) further contains a list of exemptions to the marketing restrictions under section 103, including section 103(3)(k), which provides an exemption from the authorization requirement for advertisements of offers of investments that are disposed of, or intended to be disposed of, only to professional investors (the "**PI Exemption**").

In the Consultation Paper, the SFC proposed the amendment of section 103(3)(k) (and consequential amendments to section 103(3)(j)) to focus on the point in time when the advertising materials are issued, by exempting from the authorisation requirement those advertisements which are issued only to PIs (the "**Section 103 Amendments**").

The respondents' comments centred on the necessity of the Section 103 Amendments and the operational difficulties and impact on business development and marketing

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processes. In light of the feedback received, the SFC has decided *not* to proceed with the Section 103 Amendments, as summarized below:

Concerns raised by respondents	The SFC's responses
Necessity of the Section 103 Amendments Many respondents questioned whether the amendments are necessary on the basis that they viewed there to be no material risk to retail investors from merely being exposed to unauthorised advertisements of investment products given that these investors are not allowed to invest in these products. Respondents raising these concerns emphasised that the existing framework, current suitability requirements,[3] risk disclosures and know-your-client ("**KYC**") procedures already provide sufficient safeguards to investors. As such, respondents argued that the SFC has not identified a specific harm posed to investors by general distribution of advertisements concerning investment products. Operational difficulties and impact on business Many respondents also argued that the Section 103 Amendments are detached from commercial realities, and would have unnecessarily disrupted common marketing activities. These respondents pointed out that PIs are usually reluctant to provide KYC information upfront at the preliminary marketing stage. By limiting marketing efforts to PIs who have already been identified through intermediaries' KYC procedures, the Section 103 Amendments would significantly reduce intermediaries' ability to market to prospective investors. Furthermore, the Section 103 Amendments would also disproportionately restrict online marketing efforts, which could jeopardise Hong Kong's competitiveness and status. For example, many intermediaries currently make marketing materials freely available on their website to users, or allow only self-certification of PI status to access certain marketing materials. If the Section 103 Amendments were made, many forms of online marketing would likely be in contravention.	The SFC reasoned that the original legislative intent of section 103 of the SFO is to protect investors at the point when marketing materials are issued. The proposed amendments to section 103(3)(k) aim to reflect this original legislative intent. The SFC noted that it was also motivated by multiple instances of intermediaries selling products intended for PI to retail investors (e.g. Chapter 37 bonds) in breach of suitability requirements.[4] That being said, it acknowledged that the upside of investor protection must be balanced against the practical impact any such amendments have on existing marketing processes. In particular, it acknowledged two practical difficulties (see table at left) highlighted by respondents in relation to i) PIs' reluctance to provide detailed KYC information in the pre-marketing stage and ii) impact on online distribution of investment products.

The SFC's decision not to pursue the Section 103 Amendments should not be seen as an abandonment of the issue, as the SFC emphasised that it would monitor the need for amendments in this area in the longer term and would consult again if necessary. However, it also noted that it would take a strong view against anyone misusing the PI Exemption to attempt to sell unsuitable products to retail investors. Instead, the SFC stated in the Consultation Conclusions that any person seeking to rely on section 103(3)(k) must be able to demonstrate a clear intention to dispose of investment products only to PIs, and that in order to do so, it should be "*plainly apparent*" from the face of the advertisement that the underlying investment product is intended only for disposal to professional investors.

Importantly, the SFC noted that it considers the "*clear display of an appropriate message or warning on all advertising materials would go a long way*" in helping an issuer in establishing this intention, and that intermediaries should consider how best to present this message or warning and put in place appropriate safeguards. Notably, it has indicated that it is considering providing further guidance to the market on this point.

III. Amendment to territorial scope of insider dealing provisions

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The final change proposed by the SFC concerns the civil and criminal regimes under sections 270 and 291 of the SFO in respect of insider dealing. The SFC's proposed amendments will extend the scope of the insider dealing provisions in Hong Kong to address insider dealing in Hong Kong with regard to overseas-listed securities or their derivatives, and to address conduct outside of Hong Kong in respect of Hong Kong listed securities or their derivatives (the "**Insider Dealing Amendments**").

Most respondents supported the Insider Dealing Amendments on the basis that it would strengthen investor protection, protect the integrity and reputation of Hong Kong's markets, and align the SFC's insider dealing regime with other major common law jurisdictions. In light of this support, the SFC *will* proceed with the Insider Dealing Amendments.

During the consultation, several respondents requested clarifications on the scope and application of the Insider Dealing Amendments. These requests and the SFC's corresponding responses are summarized as follows:

Clarifications requested by respondents	The SFC's responses
Whether insider dealing would be determined by reference to Hong Kong or the laws of the overseas jurisdiction when assessing insider dealing of overseas-listed securities or their derivatives	The SFC stated that the amended insider dealing provisions will stipulate that the misconduct would also need to be unlawful in the relevant overseas jurisdiction. However, the SFC will not prescribe a list of selected overseas markets to which the amended insider dealing provisions will apply, as this would counterintuitively narrow the scope of enforcement against cross-border insider dealing.
Whether the Insider Dealing Amendments would apply to over-the-counter ("**OTC**") transactions in overseas-listed securities	The SFC clarified that the Insider Dealing Amendments change the territorial scope, and not the applicability, of the insider dealing regime. This means that once the Insider Dealing Amendments are enacted, the insider dealing regime would apply to OTC transactions in overseas-listed securities, just as how existing insider dealing laws apply to OTC transactions in Hong Kong-listed debt securities.
Whether the SFC will provide a transition period to enable firms to update their internal compliance policies and manuals to reflect the Insider Dealing Amendments	The SFC will *not* be introducing any transitional period. From the SFC's standpoint, firms will have sufficient time to update their internal procedures and manuals once the legislative amendments are published.
Whether a regulated person is required to report breaches with respect to overseas-listed securities and how such reports should be made, especially considering data transfer restrictions in different jurisdictions	The SFC clarified that reporting obligations set out under the Code of Conduct would apply to breaches of the Insider Dealing Amendments, once enacted.[5]

The SFC's responses make clear that its intention is to expand its ability to take action in relation to cross-border insider dealing to better protect the reputation of Hong Kong's markets. In explaining its decision to proceed with these amendments, the SFC noted that while it is open to it to deal with cross-border insider dealing by providing intelligence to securities regulators in other jurisdictions under existing cross-border regulatory cooperation arrangements, this is not always the most effective means to tackle cross-border insider dealing.

IV. Next steps

The SFC indicated that it will now proceed with introducing the Insider Dealing Amendments, although it has not specified a timeframe for introducing the draft text of the amendments to the Legislative Council. It has indicated that the industry will have the opportunity to review the draft text of these amendments in the course of the legislative process.

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We recommend that intermediaries continue to monitor this issue to ensure that they update their internal policies and procedures in relation to insider dealing in a timely fashion once the timeline for the enactment of the Insider Dealing Amendments becomes clearer.

We suggest that intermediaries also review their use of disclaimers in advertisements reliant on the PI Exemption to ensure that they are in line with the SFC's guidance in the Consultation Conclusions. We recommend intermediaries also continue to monitor for any further guidance from the SFC with respect to best practices when relying on the PI Exemption.

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[1] "*Consultation Conclusions on Proposed Amendments to Enforcement-related Provisions of the Securities and Futures Ordinance*" (August 8, 2023), published by the SFC, available at: https://apps.sfc.hk/edistributionWeb/api/consultation/conclusion?lang=EN&refNo=21CP3.

[2] "*Hong Kong SFC Consults on Significant Reforms to the SFO Enforcement Provisions*" (June 14, 2022), published by Gibson, Dunn & Crutcher, available at: https://www.gibsondunn.com/hong-kong-sfc-consults-on-significant-reforms-to-the-sfo-enforcement-provisions/.

[3] See "*Frequently Asked Questions on Compliance with Suitability Obligations by Licensed or Registered Persons*" (last updated on December 23, 2020), published by the SFC, available at: https://www.sfc.hk/en/faqs/intermediaries/supervision/Compliance-with-Suitability-Obligations/Compliance-with-Suitability-Obligations#759450F3651D4BBF8AAA2F39C9F2BE88.

[4] The SFC has previously clarified that bonds offered for subscription and listed under Chapter 37 of the Main Board Listing Rules ("**Chapter 37 Bonds**") are unsuitable for sale to retail investors, and warned intermediaries against this practice. See "*Circular to Licensed Corporations distribution of bonds listed under Chapter 37 of the Main Board Listing Rules and local unlisted private placement bonds*" (March 31, 2016), published by the SFC, available at: https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/suitability/doc?refNo=16EC18.

[5] Under the Code of Conduct, a licensed or registered person should report to the SFC immediately upon (among other things) "any material breach, infringement of or non-compliance with any law, rules, regulations, and codes administered or issued by the [SFC], the rules of any exchange or clearing house of which it is a member or participant, and the requirements of any regulatory authority which apply to the licensed or registered person". See paragraph 12.5 of the "*Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission*" ("**Code of Conduct**") (March 2023 edition), published by the SFC, available at: https://www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/codes/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission/Code_of_conduct-Mar-2023_Eng.pdf?rev=7b4576843262491cb40638b09441d89b.

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Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. If you wish to discuss any of the matters set out above, please contact any member of Gibson Dunn's Global Financial Regulatory team, including the following in Hong Kong:

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