Debevoise Insight: Round-up of Recent Anti-Money Laundering Developments in Hong Kong

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Introduction

In this Insight, we review recent anti-money laundering and counter financing of terrorism ("AML/CTF") developments in Hong Kong, which demonstrate that this issue remains at the forefront of the regulators' list of priorities. In summary:

- As readers will be aware, the Hong Kong Securities & Futures Commission (the "SFC") has for many years adopted a zero tolerance approach to AML controls failures, in order to maintain Hong Kong's status as a leading international financial centre. According to the statistics in its Q4 2019 quarterly report (published on 21 February 2020), non-compliance with AML guidelines continued to be one of the most frequent breaches during the SFC's on-site inspections. We look at the lessons learnt from three recent enforcement actions.

- We also consider the recent thematic review of remote customer on-boarding initiatives by the Hong Kong Monetary Authority (the "HKMA"). The HKMA observed that firms should ensure that such technology meets AML requirements on an ongoing basis. Given the continued focus on enforcement of AML controls failures, firms need to remain vigilant to the challenges created by such technology.

- These regulatory developments also coincide with a recent decision by the Hong Kong Court of Final Appeal (the "CFA") that confirmed that the mental element of the statutory offence of dealing with the proceeds of crime is an objective test, whereby a defendant must show that his belief that the relevant proceeds were legitimate was reasonably held.

These developments serve as a timely reminder to financial services firms and other businesses that deal with large financial transactions to ensure that adequate AML controls and record-keeping policies are in place. In this context, financial services firms can expect little sympathy from the regulators for any failure to comply with the relevant AML rules and regulations as a result of the logistical and practical difficulties caused by the ongoing COVID pandemic; and so particular vigilance is required even in these challenging times.

Debevoise & Plimpton has significant experience advising on matters concerning domestic and cross-border AML issues. Please contact the team if you wish to discuss any of the issues discussed in this update.

SFC Enforcement: "*AML/CFT Failures Will Not Be Tolerated*"

Financial services firms under the supervision of the SFC are required to take all reasonable measures to ensure that proper safeguards exist to mitigate the risks of money laundering and to prevent contravention of the customer due diligence and record-keeping requirements under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (the "AMLO").

According to its Q4 2019 quarterly report, the SFC found 277 instances of non-compliance with anti-money laundering guidelines during on-site inspections in the period between April and December 2019. There has been a notable surge of 137 instances compared to the same period in 2018. Further, in 2020, the SFC has publicly reprimanded and fined two securities firms for breaches of the AMLO and the SFC's Guideline on Anti-Money Laundering and Counter-Terrorist Financing (April 2015) (the "AML Guideline").

BMI Securities Limited ("BMI")

According to the SFC's findings, certain of BMI's clients subscribed to a placement of shares in two listed companies in 2016 and subsequently transferred those shares to third parties using bought and sold notes in off-exchange transactions. These transactions ranged from HK$4,462,500 to HK$855,869,760. According to the SFC's findings, the transactions were suspicious because:

- The customer did not conduct any on-exchange transactions through his BMI account. It appears that the customer had opened the account to conduct two transactions only.

- The use of bought and sold notes suggested that the transactions were pre-arranged off-exchange trading that were out of the ordinary range of services normally requested.

- The relationships between the customers and the third party and the reasons for using bought and sold notes to conduct the two transactions were unknown.

According to the SFC, these suspicious circumstances should have raised red flags and the SFC found that BMI:

- failed to conduct appropriate customer due diligence to understand the background and source of wealth and funds;

- did not carry out further customer due diligence procedures to review the clients' information, and ensure that the AML/CFT risks involved were fully understood and the clients' data and information remained up-to-date and relevant; and

- did not make any enquiries to examine the background and purpose of the relevant transactions or take any steps to ascertain the relationships.

The SFC concluded that BMI's AML systems were deficient and that these failures were attributable to the Money Laundering Reporting Officer (the "MLRO")'s failure to discharge her duties as a responsible officer.

The SFC reprimanded and fined BMI HK$3.7 million in February 2020, noting that the sanction was intended to act as "*a clear and deterrent message […] to the market that AML/CFT failures will not be tolerated*". The MLRO's license was also suspended for five months.

Southwest Securities (HK) Brokerage Limited ("SSBL")

In May 2020, the SFC reprimanded and fined SSBL HK$5 million for failures in complying with AML requirements in 2016. In particular, SSBL did not have adequate and effective systems and procedures in place to review the source of funds deposited into the accounts maintained by SSBL with other banks that were set up for SSBL's clients to deposit money into their securities account with SSBL.

According to the SFC's findings, 89% of the third-party deposits into the sub-accounts in 2016 were not identified due to a lack of systems and procedures to review the source of funds. In certain cases where third-party deposits were identified by SSBL, the clients' relationship with the third-party depositors (e.g., "*friend*") and the reasons for these deposits (e.g., "*busy at work*") provided by the clients failed to explain the rationale for the transfers satisfactorily. However, SSBL did not critically evaluate these deposits and document the enquiries, or the reasons for approving the deposits.

In addition, SSBL did not have systems and controls to generate exception reports to identify suspicious transactions. SSBL filed only one suspicious activity report to the Joint Financial Intelligence Unit (the "JFIU") in 2016. Upon review of all client deposits and trading activities for 2016 as requested by the SFC, SSBL submitted 31 additional reports, indicating failures to identify and report suspicious transactions in a timely manner.

The SFC concluded that "*having considered all relevant circumstances, the SFC is of the opinion that SSBL is guilty of misconduct and its fitness and properness to carry on regulated activities have been called into question*". Consequently, SSBL was reprimanded and fined HK$5 million.

Guotai Junan Securities (Hong Kong) Limited ("Guotai")

On 22 June 2020, the SFC reprimanded and fined Guotai HK$25.2 million for multiple internal control failures attributing to an array of regulatory breaches. These breaches included non-compliance with AML requirements to implement proper safeguards in relation to third-party fund transfers between 2014 and 2016 and a failure to conduct proper enquiries and sufficient scrutiny on third-party deposits used for share subscriptions. The SFC also found that Guotai had failed to implement effective controls to detect wash trades and report to the SFC of any material errors or defects in a timely manner.

During the relevant periods, Guotai processed a total of 20,990 third-party fund transfers. According to the SFC, more than half of these transfers were frequent transfers with third parties who were either unrelated to the client or whose relationship with the client was unverified or difficult to verify (e.g., "*friends*"). The SFC also found that in 537 cases, the identity of the third-party depositor was missing and could not be identified. Further, despite requiring clients to provide reasons for any third-party transfers, the reasons and/or relationships provided often did not properly explain the purpose of the transfer or the use of a securities account for the transfer (e.g., "*incoming and outgoing*"). In the SFC's sampling checks, it was also discovered that certain activities in client accounts were inconsistent with the clients' profiles and the

initial deposits to some client accounts were made by third parties with unclear source of funding.

According to the SFC, whilst Guotai acted as a placing agent for the global offering of a listed company's shares in Hong Kong between December 2015 and January 2016, it failed to take reasonable steps to verify the ultimate beneficiaries and source of funds of five clients subscribing those shares. Despite the funds that were used to subscribe the shares (HK$28.8 million worth) originating from the same third party, Guotai failed to make any appropriate enquiries to verify the identity of the 5 clients and the source of funding. Due to its failure to identify and act on these red flags, it was later discovered that 3 of the 5 clients were Guotai employees. As a result, the allotment of more than 10% of the listed shares to these 3 clients breached the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited.

The SFC found that Guotai had failed to implement adequate procedures for employees including its MLRO to actively identify suspicious transactions, did not provide sufficient guidance and training to its employees in relation to verifying third-party fund transfers, and failed to ensure effective monitoring of client activities by its Operations and Compliance teams. Mr. Thomas Atkinson of the SFC observed that Guotai's "*serious systemic deficiencies and failures across its internal controls should serve as a stark reminder to licensed corporations the importance of having adequate and effective safeguards in place to mitigate the real risk of becoming a conduit to facilitate illicit activities, such as money laundering, when exposed to potentially suspicious transactions.*"

The HKMA's Thematic Review of Remote Customer On-boarding Initiatives

On 3 June 2020, the HKMA published its thematic review of remote customer on-boarding initiatives, in which it made the following key observations:

- whilst the HKMA welcomes technological innovation, Authorised Institutions ("AIs") must adequately assess AML/CFT risks associated with a remote on boarding initiative prior to its launch;

- AIs should apply a risk based approach in the design and implementation of AML/CFT control measures for remote on-boarding initiatives; AIs should monitor and manage the ability of the technology adopted to meet AML/CFT requirements on an ongoing basis; and

- ongoing monitoring should take into account vulnerabilities associated with the product and delivery channel.

It is apparent from these observations that, whilst the HKMA recognises the heightened challenges arising from social distancing and remote on-boarding, there is no relaxation in the HKMA's expectations that AIs comply with the AML rules and ensure that any technological initiatives meet those requirements.

The Court of Final Appeal Reformulates the Test for Determining If a Person Has "Reasonable Grounds to Believe" Property Represents the Proceeds of Crime

The Organized and Serious Crimes Ordinance (Cap. 455) (the "OSCO") is Hong Kong's flagship legislation for dealing with organised crime, the proceeds of crime and the confiscation of proceeds of crime.

Under section 25 of OSCO, a "*person commits an offence if, knowing or having reasonable grounds to believe that any property in whole or in part directly or indirectly represents any person's proceeds of an indictable offence, he deals with that property*". Since its enactment, the meaning and scope of this provision has been the subject of extensive judicial and academic debate.

In *HKSAR v. Harjani Haresh Murlidhar* [Dec 2019] HKCFA 47, the CFA clarified and reformulated the test for determining if a person has "*reasonable grounds to believe*" the relevant property represents proceeds of an indicatable offence.

Background

The case related to a fraud arising from email hacking and can be summarized as follows:

- A contract was made by exchange of emails for the sale by Dohigh Trading Limited ("Dohigh") to Dragon Asia Fertilizer Limited ("Dragon Asia") of a shipment of fertilizer to be shipped from a Chinese port to Bangladesh for US$10,788,000. Dragon Asia was required to make a down payment of 5% of the sum.

- Those emails were hacked and modified so as to deceive Dragon Asia into paying the required deposit into a bank account of Sino Investment and Trading Limited ("SIAT") and into nominating SIAT as the beneficiary of the letter of credit.

- Accordingly, on 9 July 2014, the sum of US$539,375 was diverted and paid into the Hong Kong bank account of SIAT instead of to Dohigh.

- SIAT was a Hong Kong company owned by the defendant/appellant and another individual. The appellant made a number of withdrawals from SIAT's bank account with an aggregate value of US$539,375.

The fraud came to light in July 2014 when Dohigh informed Dragon Asia that it had not been paid and Dragon Asia revoked the letter of credit. The defendant was arrested on 21 July 2014 and charged with conspiracy to deal with the US$539,375 knowing or having reasonable grounds to believe that it represented the proceeds of an indictable offence, contrary to sections 25(1) and (3) of the OSCO and sections 159A and 159C of the Crimes Ordinance.

At trial, the defendant admitted that Dragon Asia had been deceived by fraudsters and that the deposits and withdrawals had occurred. The defendant's case was that he was a legitimate businessman and that he believed that one of the fraudsters was a bona fide agent acting on behalf of the principals in the fertilizer deal with the funds in question deriving from a genuine commercial transaction.

The defendant claimed that he was asked to execute the letter of credit and to receive the deposit and the letter of credit proceeds in the SIAT account as an account that had been designated by Dragon Asia, the letter of credit's applicant. The reward for so doing and for providing inspection services at shipment would be 15% of the contract price. The defendant claimed that he was deceived into unwittingly receiving the proceeds of that fraud.

The CFA Reformulates the Test for Determining If a Person Has "*Reasonable Grounds to Believe*"

In upholding the first instance decision to convict the defendant, the CFA reformulated the test as follows:

- What facts or circumstances, including those personal to the defendant, were known to the defendant that may have affected his belief as to whether the property was the proceeds of crime ("tainted")?

- Would any reasonable person who shared the defendant's knowledge be bound to believe that the property was tainted?

- If the answer to question (ii) is "yes", the defendant is guilty. If it is "no", the defendant is not guilty.

Although neatly expressed as an objective test, i.e., "*would any reasonable person believe the property was tainted?*", the test is nuanced in that, in its application, the court must give due consideration to the evidence given by the defendant as to what he believed and why. The court has to consider two interrelated questions: (i) is the defendant telling the truth when he says that he did not believe that the property was tainted and (ii) could a reasonable person in the position of the defendant have failed to believe that the property was tainted?

Implications of the Case

According to the decision, a person is liable to be convicted despite a genuinely held belief that the relevant proceeds are legitimate if that belief is judged to be unreasonable by objective standards.

The case has implications for persons or businesses that routinely deal with large financial transactions and which are exposed to the risk of dealing with the proceeds of crime. Anyone caught up in dealing with the proceeds of crime will need to evidence that his belief that the transactions were legitimate was reasonable. The best way to achieve this is to ensure that proper enquiries are made and, crucially, that written records of such due diligence are retained. This requires both a proactive approach to making proper enquiries, as well as ensuring that record-keeping systems are adequate.

To ensure that this is consistently achieved, businesses must have adequate AML policies and procedures in place. Such policies and procedures should cover the following:

- policies should be specific to business areas and kept up to date with new regulations and guidelines issued by local and international enforcement agencies;
- employees involved in handling financial transactions should be given regular training and there should be clear guidance on when issues should be escalated;
- a designated MLRO should be appointed and his or her role should be explained to employees. There must be clear and accessible reporting systems; and
- systematic document retention policies should be implemented.

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Please do not hesitate to contact us with any questions.

HONG KONG


Mark Johnson
mdjohnson@debevoise.com


Gareth Hughes
ghughes@debevoise.com


Elly Tso
etso@debevoise.com


Ralph Sellar
rsellar@debevoise.com


Tiffany Chan
tchan@debevoise.com