For discussion
on 3 January 2017

Legislative Council Panel on Financial Affairs

Enhancing Hong Kong's Regulatory Regime for Combating Money Laundering and Terrorist Financing

PURPOSE

This paper briefs Members on the Administration's plan to conduct consultations on proposals to enhance the regulatory regime for combating money laundering and terrorist financing in fulfilment of Hong Kong's obligations under the Financial Action Task Force ("FATF"), thereby safeguarding the integrity of our business environment and reputation as an international financial centre.

BACKGROUND

2. The FATF is an inter-governmental body established in 1989 that sets international standards on combating money laundering and terrorist financing. Over the years, the FATF has developed an elaborate set of 40 recommendations, based on which the international community has been strengthening regulation to combat money laundering and terrorist financing. Meanwhile, member jurisdictions take turns to evaluate the domestic anti-money laundering and counter-financing of terrorism ("AML/CFT") regime of each other, and assess the extent to which it is in observance of the relevant FATF recommendations both in terms of technical compliance and effectiveness of implementation.

3. Hong Kong has been a member of the FATF since 1991. We are scheduled to undergo a mutual evaluation in 2018/19. To prepare for the exercise, we have conducted a gap analysis which suggests the following deficiencies in our AML/CFT regime vis-à-vis the FATF recommendations –

(a) absence of statutory customer due diligence ("CDD") and record-keeping requirements for designated non-financial businesses and professions ("DNFBPs"); and

(b) absence of statutory requirements for companies and trustees to keep beneficial ownership information of legal entities and arrangements.

4. Given the openness of our economy, we expect keen interest and heightened scrutiny from other FATF members in the upcoming mutual evaluation. If no remedial actions are taken to address the above deficiencies in the run-up to 2018, it is almost certain that Hong Kong will receive adverse ratings in the exercise. Hong Kong will be put to an "enhanced follow-up" process whereby our perceived failings in relevant areas will be subject to frequent reporting and close scrutiny of member jurisdictions during annual plenary meetings. More importantly, this will jeopardize our reputation as an international financial centre, as well as a safe and clean city for doing business. We need to take our international obligations to combat money laundering and terrorist financing seriously.

5. Although we have a generally robust, mature and effective AML/CFT framework developed over the years, the international standards have evolved quickly in light of the changing financial market and security landscapes. While it is not possible to aim for perfection and close all the gaps in technical compliance and implementation by 2018, we recommend targeting the deficiencies identified in paragraph 3 above, and take forward the following legislative proposals to address the gaps –

(a) The Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (Cap. 615) ("AMLO") be amended to –

(i) prescribe statutory CDD and record-keeping requirements applicable to solicitors, accountants, real estate agents, and trust or company service providers ("TCSPs") when these professionals engage in specified transactions; and

(ii) introduce a licensing regime for TCSPs, whereby they will be required to apply for a licence from the Registrar of Companies and satisfy a "fit-and-proper" test before they can provide trust or company services as a business for the public; and

(b) The Companies Ordinance (Cap. 622) ("CO") be amended to require companies incorporated in Hong Kong to –

(i) take reasonable steps to ascertain the individuals who (and legal entities which) have significant control over a company, give notice to them, and obtain accurate and up-to-date information about their identities; and

(ii) maintain a register of people with significant control over the company, containing required particulars of their identities, for inspection upon request.

LEGISLATIVE PROPOSALS

(A) Anti-Money Laundering Regulation for Designated Non-financial Businesses and Professions

FATF Requirements

6. CDD and record-keeping requirements are the main strands of an effective AML/CFT regulatory regime to deter and disrupt money laundering activities and ensure the integrity of our financial systems. The FATF recommends that financial institutions should implement CDD measures to identify and verify customers, and maintain records on customer identification and transactions for at least five years. Meanwhile, CDD and record-keeping requirements should be codified into the statute.

7. Financial institutions apart, the FATF considers that DNFBPs which engage in specified transactions[1] should also be subject to similar statutory CDD and record-keeping requirements. In the FATF parlance, DNFBPs cover casinos, dealers in precious metals and stones, real estate agents, lawyers, notaries, accountants, and trust or company service providers (TCSPs).[2]

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[1] Specified transactions include real estate transactions; management of client money, securities or other assets; management of bank, savings or securities accounts; company formation and management; and buying and selling of business entities.

[2] As there are no casinos in Hong Kong, the relevant FATF recommendations are only applicable to the other five sectors in the Hong Kong context. Since barristers and notaries in Hong Kong do not engage in transactions as specified by the FATF, they are also not relevant in our context. As regards dealers in precious metals and stones, they are covered under the FATF recommendation of DNFBPs because they are involved in cash-based transactions that may be used by criminals to hide proceeds in valuable commodities such as gold, jewellery or diamonds. We understand from the trade, however, that cash transactions are no longer common as in the old days. According to the Hong Kong Police Force, no dealer has been found linked to or convicted for money laundering offences over the past five years. Its assessment is that the sector does not pose insurmountable risks in the overall AML/CFT institutional framework in Hong Kong requiring immediate mitigation. This notwithstanding, the Government has been stepping up education in this sector to raise the AML awareness through capacity-building seminars and the issuance of guidelines. While it takes time to prepare the sector for undertaking statutory AML responsibilities (given the absence of a sector-specific authority), we suggest covering those DNFBP sectors that are more ready in the current legislative exercise. This will be a more proportionate and pragmatic response in light of the risk-based approach advocated by the FATF. We will keep in view international development and review the need to subject these dealers to regulation under the AMLO in future.

8. The FATF also requires that competent authorities or self-regulatory bodies with adequate powers be designated to monitor and ensure compliance of the relevant DNFBP sectors with AML/CFT requirements, and to apply a range of proportionate and dissuasive sanctions (whether criminal, civil or administrative) to deal with non-compliance.

Hong Kong's Present Regime

9. In Hong Kong, we enacted the AMLO in April 2012 to implement the relevant FATF recommendations in respect of financial institutions.[3] A regulatory gap remains in respect of DNFBPs. Having regard to the FATF's defined scope of DNFBP coverage and the nature of business engaged by the corresponding professions in Hong Kong, we intend to extend the AMLO[4] to cover solicitors, accountants, real estate agents and TCSPs.

Solicitors, Accountants and Estate Agents

10. For solicitors, accountants and real estate agents, they are currently subject to professional self-regulation by the respective regulatory bodies, which have promulgated guidelines on CDD and record-keeping procedures for voluntary or mandatory subscription by members. The Law Society of Hong Kong, the Hong Kong Institute of Certified Public Accountants ("HKICPA") and the Estate Agents Authority ("EAA") enjoy broadly similar powers under their respective Ordinances to deal with professional misconduct of registered professionals.

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3 The AMLO, which was passed by the Legislative Council in June 2011 to enhance the AML regulation for the financial sector, came into effect on 1 April 2012. Under the AMLO, specified financial institutions, including banks, securities firms, insurance companies and intermediaries, and remittance agents and money changers have a statutory obligation to conduct CDD on their customers and keep the relevant records for a specified period. Non-compliance may render them liable to supervisory and criminal sanctions.

4 Schedule 2 to the AMLO prescribes the circumstances under which the CDD measures must be carried out, the required steps to complete the due diligence (including verifying a customer's identity, identifying beneficial owners in relation to the customer, monitoring business relationship continuously, enquiring into the source of funds of high-risk customers such as politically exposed persons, etc.), the procedures required to permit reliance on qualified third parties in performing the due diligence, as well as the duty of keeping relevant transaction records for a period of six years. The Schedule provides a ready basis for extending CDD requirements to cover DNFBPs in the current proposal.

11. To minimise the compliance burden on these sectors, we intend to leverage on the existing regulatory regimes applicable to the three sectors under the Legal Practitioners Ordinance (Cap. 159), the Professional Accountants Ordinance (Cap. 50) and the Estate Agents Ordinance (Cap. 511) respectively to enforce the statutory CDD and record-keeping requirements. The Law Society, the HKICPA and the EAA will be entrusted to assume statutory oversight for monitoring and ensuring compliance of their respective professions with the AMLO requirements. Non-compliance with the requirements will be handled in accordance with the prevailing investigation, disciplinary and appeal mechanisms under the three Ordinances governing professional misconduct.

12. The Legal Practitioners Ordinance, the Professional Accountants Ordinance and the Estate Agents Ordinance have already stipulated a set of appropriate disciplinary and sanction measures ranging from reprimands, orders for remedial actions, to civil fine, and suspension from practice or revocation of licence (as the case may be). This should arguably provide sufficient deterrent effect in terms of the proportionality and dissuasiveness of relevant sanctions applying to the three sectors. We do not intend to propose further criminal sanctions on non-compliances, having regard to the inherent risks concerning these DNFBP sectors vis-à-vis financial institutions.[5]

Trust or Company Service Providers

13. At present, there is no regulatory body with statutory power to manage AML compliance of firms or corporates providing trust or company formation services in Hong Kong. We propose introducing a licensing regime to enforce the codified CDD and record-keeping requirements applicable to TCSPs.

14. TCSPs will be required to apply for a licence from the Registrar of Companies before they can provide trust or company service as a business for the public. It will be a criminal offence to operate a TCSP business without a licence. The licensing requirements, mainly involving a "fit-and-proper" test for applicants, will be modelled on a

[5] The maximum criminal sanctions for a contravention by a financial institution and its employees of the Schedule 2 requirements are a fine of $1 million and imprisonment of seven years under the AMLO. Alternative to the criminal route, the AMLO empowers relevant authorities to take a range of disciplinary actions, including public reprimand, remedial orders, a civil penalty not exceeding $10 million or three times the amount of profit gained or costs avoided as a result of the contravention (whichever is higher).

similar regime for money service operators [6] under the AMLO. Exemption from the new licensing requirements may be given to financial institutions, qualified accountants and solicitors to avoid regulatory overlap.

15. On enforcement, the Registrar of Companies will be empowered to investigate any non-compliance in relation to registered TCSPs and impose disciplinary sanction on them (including public reprimand, remedial order, a pecuniary fine not exceeding $500,000, and suspension or revocation of the licence), in line with the maximum level of civil sanction for solicitors and accountants. Appeals can be made to a review tribunal against future decisions made by the Registrar in implementing the licensing and disciplinary regime.

16. Similar to the consideration explained in paragraph 12 above, we also do not plan to introduce criminal offences for any non-compliance by a TCSP with a statutory CDD and record-keeping provision, having regard to the risk of this sector and the need to maintain some degree of consistency among the DNFBP sectors.

(B) Enhancing Transparency of Beneficial Ownership of Hong Kong Companies

FATF Requirements

17. Despite the essential and legitimate roles companies play in conducting businesses under the global economy, there are increasing international concerns over the misuse of companies, particularly those under complex ownership and control structures, as a way to disguise and hide crime proceeds, facilitate money laundering, or serve illicit purposes such as tax evasion, corruption or terrorist financing. Often the ultimate ownership of such companies is obscured so that those with criminal motives can distance themselves from the assets they really control. This is posing significant challenges to law enforcement agencies when investigating the identity of known or suspected criminals who conceal the true purpose of an account or property, or the source or use of certain funds held through companies or layers of companies in a complicated structure across different locations/jurisdictions.

[6] The regime is operated by the Customs and Excise Department ("C&ED"). In determining whether a person is a fit and proper person, C&ED shall consider, among other things, whether the person has been convicted of an offence in Hong Kong or persistently failed to comply with any requirement imposed under the AMLO or other relevant legislation.

18. The FATF requires member jurisdictions to take measures to prevent the misuse of legal persons for money laundering and terrorist financing, by ensuring that adequate and accurate information on the beneficial owners and control of legal persons can be obtained or accessed in a timely fashion by competent authorities including law enforcement agencies. The FATF defines a beneficial owner as the natural person who ultimately has a controlling ownership interest in a company, or is exercising control of the company through other means.

Hong Kong's Present Regime

19. At present, the CO requires a company incorporated in Hong Kong to disclose information on its members (including the shares held by each member and the paid-up capital), directors and company secretaries, by keeping the information in the relevant registers kept by the company at its registered office (or a prescribed place), and filing the information with the Companies Registry (CR) via an annual return or, where applicable, returns on change of particulars, for public inspection. The current law focuses on the disclosure of the legal ownership, and it does not require a company to ascertain, keep or file information about its ultimate beneficial owner (i.e. the natural person who ultimately owns or controls the company after lifting the veil of corporate layers), except in the case of a listed corporation which is required under the Securities and Futures Ordinance (Cap. 571) ("SFO") to keep a register of those individuals or entities owning 5% or more interests in any class of voting shares (including any beneficial owner of such interests).[7]

20. Separately, the AMLO currently requires a financial institution to take reasonable measures, as part of the CDD process, to verify the identity of the ultimate beneficial owner in relation to a customer,

[7] Generally, under the SFO, a person comes under a duty of disclosure when (i) the person acquires 5% or more interests in any voting shares in a listed corporation; (ii) there are any changes in the percentage level or nature of the interests in such shares; or (iii) the person ceases to have 5% or more interests in such shares. The person shall give notification to the listed corporation concerned and to The Stock Exchange of Hong Kong of the interests which the person has, or ceases to have, in voting shares in the listed corporation. A beneficial owner of a listed corporation who comes under a duty of disclosure, as summarised above, must give a notification under the SFO. Every listed corporation shall keep a register of interests in shares and short positions under section 336(1) of the SFO. Whenever a listed corporation receives information from a person given in performance of a duty imposed on the person by any relevant provision (including the notification mentioned above), the listed corporation is under a duty to record it in the register. The register shall, for the purposes of enabling members of the public to ascertain the identity and the particulars of persons who are the true owners of voting shares in the listed corporation, be made available for inspection. Any member of the corporation or any other person may require a copy of any such register on payment of a fee.

including measures to enable the financial institution to understand the ownership and control structure of a corporate customer. However, this information gathered is not normally accessible to by law enforcement agencies, unless when a court order is obtained to mandate a specific financial institution to produce the relevant records. This is often time-consuming, and can only be accomplished when an investigator knows the financial institution with which a suspicious company has established business relationship, thus the present regime is not very effective in disrupting illicit financial flows.

Salient Features of the Proposal

21. In the light of the FATF recommendation to enhance transparency of corporate beneficial ownership, we propose to amend the CO requiring companies incorporated in Hong Kong to obtain and hold up-to-date beneficial ownership information for inspection upon request. The requirement will apply to all companies incorporated under the CO in Hong Kong, including companies limited by shares, companies limited by guarantee, and unlimited companies, which currently amount to some 1.3 million.[8]

22. Listed companies will be exempted from the proposed requirements as the SFO has a more stringent regime requiring every listed corporation to keep a register of interests in shares. This aside, we do not intend to exempt any other particular class of companies, unless it transpires that any such companies are bound by disclosure and transparency rules (in Hong Kong or elsewhere) broadly similar to the ones being proposed in relation to beneficial ownership.

23. For the purpose of keeping accurate and timely beneficial ownership information, a company will have to maintain a register of people with significant control ("PSC") over the company. The PSC register will need to contain information on registrable individuals, namely any individual (i.e. a natural person) who ultimately has a controlling ownership interest (e.g. holding more than 25% of the voting rights or shareholding) in a company, or is exercising control of the company through other means (e.g. holding the right to appoint or

[8] As at the end of October 2016, there are 1 332 452 companies incorporated in Hong Kong, comprising 663 public companies (including 212 listed companies), 1 318 744 private companies limited by shares, 13 033 companies limited by guarantee, and 12 unlimited companies. It is estimated that around 80% of newly incorporated companies in Hong Kong have single shareholding structures.

remove a majority of directors).[9]

24. We believe that a beneficial owner may hold an interest in a company indirectly through successive layers of companies in a chain of ownership. To facilitate identification of the holding structure in such cases, we propose that a company should also be required to identify and register a relevant legal entity with significant control over the company. A legal entity – whether or not it is formed or incorporated in Hong Kong – is registrable only if it meets the specified conditions pertaining to controlling ownership interest, and if it is a legal entity immediately above the company in the company's ownership chain.

25. To ensure the availability and accuracy of beneficial ownership information which may not be readily available or apparent, we propose requiring a company to take reasonable steps[10] to identify and ascertain its registrable individual or registrable legal entities by giving notice to the latter. A notice addressee who is believed to be a registrable individual or a registrable legal entity will also be required to comply with a notice to ascertain and confirm the relevant required particulars[11] or relevant changes served by the company. The required particulars of

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[9] Under the current proposal, a registrable individual, or a beneficial owner, in relation to a company is an individual who meets one or more of the following specified conditions –
(a) directly or indirectly holding more than 25% of the shares;
(b) directly or indirectly holding more than 25% of the voting rights;
(c) directly or indirectly holding the right to appoint or remove a majority of directors;
(d) otherwise having the right to exercise, or actually exercising, significant influence or control; or
(e) having the right to exercise, or actually exercising, significant influence or control over the activities of a trust or a firm that is not a legal person, but whose trustees or members satisfy any of the first four conditions (in their capacity as such) in relation to the company, or would do so if they were individuals.

[10] "Taking reasonable steps" includes reviewing the company's register of members, articles of association, statement of capital, relevant covenants or agreements, and serving a notice to any person or any legal entity (i) who or which knows or may have reasonable cause to know the identity of a person or legal entity with significant control over the company; and (ii) whom or which the company knows or has reasonable cause to believe to be registrable

[11] When a company has identified a registrable individual or a registrable legal entity, the company should obtain and ascertain the accuracy of the following required particulars in relation to the individual and the legal entity for entry into its PSC register –
(a) the name of the registrable individual or registrable legal entity;
(b) the number of the identity card, or the number and issuing country of any passport, of the registrable individual;
(c) the legal form of the registrable legal entity (including the law by which it is governed) and the company registration number or the equivalent in its place of incorporation or formation;
(d) the correspondence address (excluding post office box number) of the registrable individual, and the address of the registered or principal office of the registrable legal entity;
(e) the date when the person became a registrable individual, and the date when the legal entity became a registrable legal entity; and
(f) the nature of the control of the registrable individual or of the registrable legal entity over the company in accordance with the specified conditions.

a registrable individual should not be entered into the PSC register unless supplied or confirmed by the registrable individual.

26. A company will be required to keep a PSC register of registrable individuals and registrable legal entities (or declare that such do not exist for the company) at its registered office or a prescribed place in Hong Kong. The PSC register should be made available for inspection upon request. The company will have to nominate an authorised person for cooperation with law enforcement agencies should the need arise.

27. Non-compliance with the requirement of keeping a PSC register will be a criminal offence, attracting a fine for a company and its responsible person(s) at a level comparable to that currently applicable to failure to keep registers of members, directors and company secretaries under the CO. The maximum penalty for such non-compliance is a fine at level 4 (i.e. $25,000) and a further daily fine of $700. We propose applying a similar penalty (i.e. maximum of $25,000) for persons or legal entities that fail to comply with the notice requirements.

28. If any person knowingly or recklessly makes, in a PSC register or in a document replying to a company's notice, a statement which is misleading, false or deceptive in any material particular, we propose that the person will commit an offence equivalent to that under an existing provision of the CO on false statements and will be liable on conviction on indictment to a fine of $300,000 and to imprisonment for two years; or on summary conviction to a fine at level 6 (i.e. maximum of $100,000) and to imprisonment for six months.

29. We note from overseas regimes (e.g. the UK and Switzerland) that they provide companies with the power to issue restriction notices to a registrable individual or a registrable legal entity that fails to comply with the notice requirements, which will restrict some of their rights such as voting rights, right to receive dividends, etc. While this may be regarded as a disproportionately serious measure to persons owning companies in Hong Kong, it can help strengthen enforcement in respect of registrable individuals or relevant registrable legal entities that fail to comply with the proposed requirements. We have an open mind on this and will invite public views on whether or not companies should be so empowered.

PUBLIC CONSULTATION

30. The proposals are pertinent to our fulfilment of the relevant FATF obligations and will reduce the risks of money laundering and terrorist financing in the relevant DNFBP sectors and the wider corporate world. This will help safeguard the integrity of our financial markets and business environment, and add to our credibility as a transparent, trusted and competitive place to invest and do business.

31. We plan to launch two consultation exercises in January 2017 on the above two proposals. We will consult the affected sectors on the proposal to subject DNFBPs to statutory CDD and record-keeping requirements under the AMLO. We will also consult the wider public on the proposal to enhance transparency of corporate beneficial ownership. The consultation will last for two months.

32. Depending on the outcome of the consultation exercises, we will fine-tune the legislative proposals and seek to introduce the relevant amendment bills into the Legislative Council by July 2017.

ADVICE SOUGHT

33. Members are invited to note and give views on the above proposals.

Financial Services and the Treasury Bureau
December 2016