LAW AND PRACTICE IN THE GREATER BAY AREA IV

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INTRODUCTION

MASTERY OF THE LAW FROM ASIA FOR THE WORLD

In March 2022, King & Wood Mallesons (KWM) celebrated its 10th anniversary as an international law firm. A decade ago, King & Wood, a top Chinese law firm, and Mallesons Stephen Jaques, a long-established Australian law firm, combined to create a new global law firm, King & Wood Mallesons. This has changed the landscape of the international legal market. Over the past decade, we have become a leader in Asia by virtue of our innovative and enterprising spirit, unique global platform and diversified perspectives. Currently, we have over 3,000 lawyers across 30 offices in China, Japan, Singapore, Australia, Europe, the United States and the Middle East.

KWM International Center was established in the Guangdong-Hong Kong-Macao Greater Bay Area (GBA) in April 2018. The International Center has more than 140 partners and 600 professionals in Shenzhen, Hong Kong, Guangzhou, Haikou, Sanya and Hengqin offices. It provides core legal services on "going global", fintech, cross-border M&A, capital markets, private equity/ venture capital, general corporate practice, IP protection, cross-border dispute resolution, asset management, customs and foreign exchange. KWM International Center not only has localized comprehensive service capacity in three jurisdictions of GBA, but also has comprehensive and one-stop international legal service capacity in GBA, relying on its global network, personnel transfer between offices and cross-border talent training plan.

KWM International Center was established to echo the development of the GBA. The *Outline Development Plan for the Guangdong-Hong Kong-Macao Greater Bay Area* specifies that by 2022, "the framework for an international first-class bay area and world-class city cluster should essentially be formed." In 2021, the GBA had a population of more than 80 million, a GDP of about RMB 12.6 trillion (about USD 1.89 trillion), and 25 enterprises ranking among the world's top 500. In terms of "infrastructure connection", Huangpu Bridge, Nansha bridge, Guangzhou-Hong Kong High-speed Railway, Humen Bridge and Hong Kong Zhuhai Macao Bridge have been erected one after another, and the Shenzhen-Zhongshan Bridge and Lion Ocean Bridge are also under construction. In addition, the railway operating mileage in GBA has reached nearly 2500 kilometers, and the "GBA on the track" is accelerating its formation; in terms of "soft connectivity", Guangdong Province has continued to promote the construction of the "Bay Area connectivity" platform. The rules and mechanisms of Guangdong, Hong Kong and Macao have been deepened. The business environment has been continuously optimized. The interconnection of financial markets has been promoted in an orderly manner. The scope of professional qualification recognition and standard convergence has been continuously expanded. The interconnection makes the flow of funds and personnel between cities in the bay area more convenient and economic activities more active.

According to relevant reports, in more than two months since the implementation of the pilot business of "Cross-boundary Wealth Management Connect", more than 20,000 residents in the GBA have participated in the scheme, transferring RMB 486 million in 5,855 deals. This shows a balanced two-way flow of funds and active transactions. In the eight months after the release of the *General Plan for Building a Guangdong-Macao In-Depth Cooperation Zone in Hengqin*, the Macao single-license vehicles entering and exiting the Cooperation Zone stand at 500,000, and the daily average trips by Macao residents between Hengqin and Macao via Hengqin port reach more than 7,000.

KWM is committed to identifying and unlocking opportunities for clients. We assist our clients to expand domestically and beyond. As the fourth issue of the GBA Series, the *Law and Practice in the Greater Bay Area IV* consists of Financial Markets, Private Equity, Dispute Resolution, Corporate Compliance and Investment. Lawyers from KWM International Center and other offices shared their analysis and research on the latest policies, regulations and market practices in this publication. We hope that this publication can help clients more deeply understand the policies and regulations of GBA, gain a thorough comprehension of the market dynamics of GBA, and more accurately grasp its business opportunities and development chances.

WANG LIXIN

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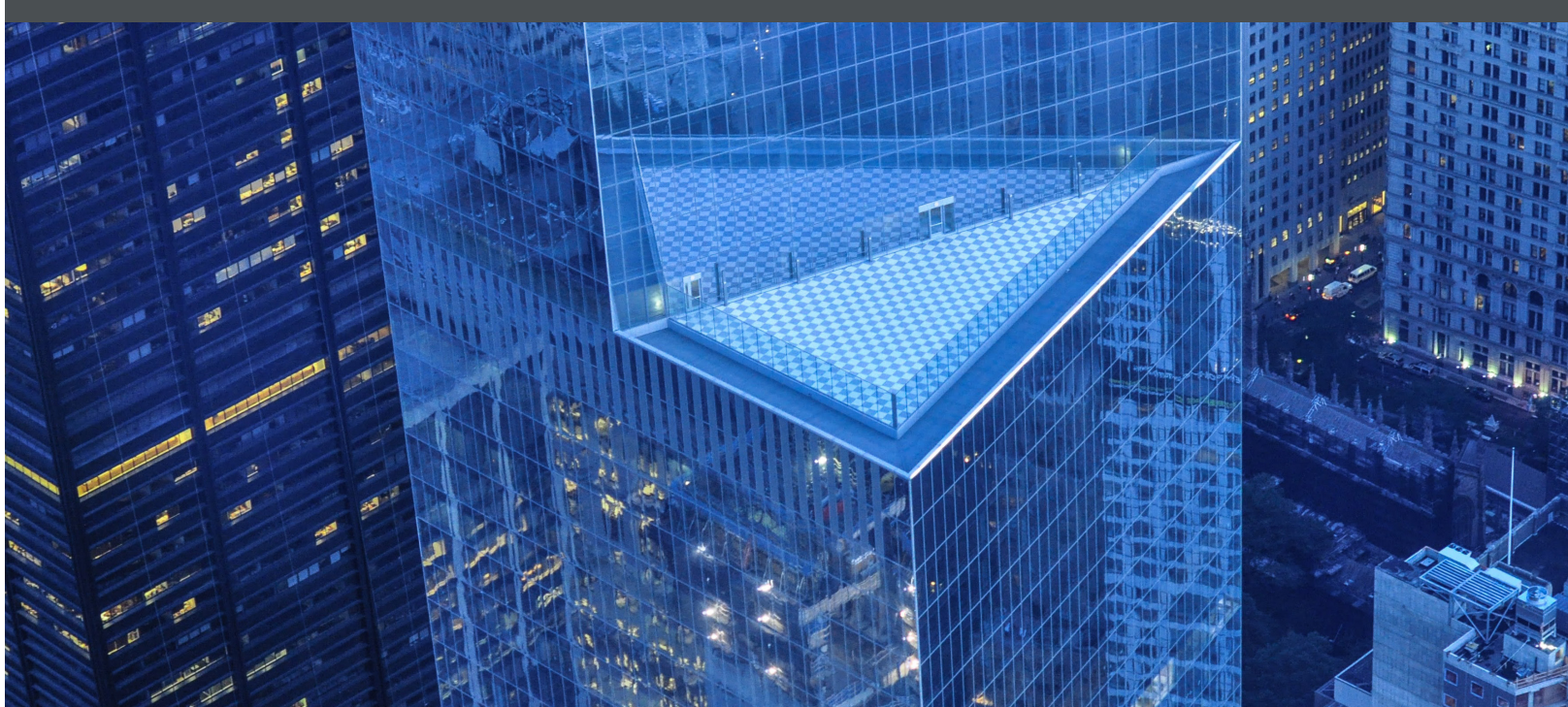
FINANCIAL MARKETS



RISE OF THE HONG KONG ILS MARKET – INSURANCE AUTHORITY PUBLISHES *GUIDELINES ON APPLICATION FOR AUTHORISATION TO CARRY ON SPECIAL PURPOSE BUSINESS*

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The "*Guidelines on Application for Authorisation to Carry on Special Purpose Business*" (GL-33)[1] recently published by the Hong Kong Insurance Authority (IA) signals another milestone in the rollout of insurance-linked securities (ILS) regime in Hong Kong. GL-33 took effect on 30 June 2021.

To encourage firms to apply for authorisation as a special purpose insurer (SPI) to carry on special purpose business (SPB) in or from Hong Kong, the IA has also announced details[2] of the two-year Pilot Insurance-linked Securities Grant Scheme (Grant Scheme) to promote the introduction of ILS to strengthen Hong Kong's status as a risk management centre.

This article outlines the key requirements for an SPI applicant as set out in GL-33 and the steps that firms should be taking in order to apply for authorisation as an SPI, and the details of the Grant Scheme.

I. Overview of GL-33

Subsequent to the gazettal of the Insurance (Amendment) Ordinance 2020 and the Insurance (Special Purpose Business) Rules (Cap. 41P of the Laws of Hong Kong) (SPB Rules), the regulatory framework and regime for SPIs came into effect on 29 March 2021. GL-33 provides further guidelines on the application requirements for an SPI to issue ILS in and from Hong Kong.

For an overview of the Hong Kong ILS regime, please refer to our previous client alerts: Fostering growth as reinsurance and

[1] https://www.ia.org.hk/en/legislative_framework/files/GL33EN.pdf

[2] Insurance Authority's press release dated 3 May 2021, available at: https://www.ia.org.hk/en/infocenter/press_releases/20210503_1.html

risk management centres in the GBA – Hong Kong sets to introduce insurance linked securities legislation[3] and Greater Bay Area Series – Developments for Hong Kong insurance linked securities[4].

II. Requirements for authorisation of an SPI

Under section 6(1) of the Insurance Ordinance (Cap. 41 of the Laws of Hong Kong) (Insurance Ordinance), no person shall carry on any class of insurance business in or from Hong Kong except a company authorised under section 8 or 8A of the Insurance Ordinance to carry on that class of insurance business, Lloyd's or an association of underwriters approved by the IA. Any company which intends to carry on SPB in or from Hong Kong must apply to the IA under section 8A of the Insurance Ordinance.

An SPI applicant is expected to fulfill the following requirements:

Requirements	Details
Appointment of administrator(s) and directors	The SPI applicant must have at least one individual administrator and two directors, one of whom must be a resident in Hong Kong. The appointment of each of these key operators must be approved by the IA. The IA must be satisfied that the administrator(s) and directors of the SPI applicant are **fit and proper** persons to hold such positions in the applicant before it may grant authorisation. In considering whether a person is fit and proper for the position, the IA will take into account all relevant factors as set out in section 14A of the Insurance Ordinance and the Guideline on "Fit and Proper" Criteria[5], including **qualifications, experience, ability to act competently, honestly and fairly, reliability and integrity, as well as financial status**.
Financial and solvency requirements	The SPI must be **fully funded**, meaning that its full liabilities must be **fully backed by assets** including funds raised through debt or other financing arrangements. To further illustrate, the IA notes that the reinsurance contract entered into between the SPI and the cedant will be considered fully funded if the value of the assets held under the terms of the reinsurance contract by, or on behalf of, the SPI for the benefit of the cedant is not less than the amount of the SPI's liabilities (whether actual or potential) under the reinsurance contract at any time and under all reasonably foreseeable circumstances, taking into account (i) the obligations of the SPI to the cedant under the reinsurance contract; and (ii) the expenses the SPI expects to incur.

[3] https://www.kwm.com/en/hk/knowledge/insights/hk-sets-to-introduce-insurance-linked-securities-legislation-20190402

[4] https://www.kwm.com/en/hk/knowledge/insights/gba-insurance-linked-securities-20200727

[5] Available at: https://www.ia.org.hk/en/legislative_framework/files/GL4.pdf

Requirements	Details
Bankruptcy remoteness and limited recourse	Each reinsurance agreement between the SPI and its cedant(s) must include a clear and unequivocal **limited recourse clause** which ensures that the maximum amount recoverable from the SPI under the reinsurance contract is limited to the lower of: (i) aggregate limit under the reinsurance contract; or (ii) available assets held under the terms of the reinsurance contract by, or on behalf of, the SPI for the benefit of the cedant(s). An SPI must also be "**bankruptcy remote**". That is: • the SPI must not be a company within the same group of companies to which the cedant belongs; and • the ILS investors must have no recourse to the assets of the cedant, in the event the SPI defaults on its payment obligations under the ILS it has issued. An SPI applicant must obtain a written legal opinion to confirm its bankruptcy remoteness for submission to the IA, as a supporting document for the IA's approval.
Selling restrictions	Under the SPB Rules, ILS issued by an SPI can only be offered, sold to and purchased by "eligible ILS investor". The IA requires undertakings to be made by the SPI applicant and the arranger/placement agent of the ILS that the selling restrictions will be strictly adhered to.
Auditor appointment	The SPI applicant is required to appoint an auditor **within one month** from the date on which the SPI commences its SPB, and notify the IA accordingly.

III. Restrictions on the sales of ILS

The IA puts emphasis on compliance with Rule 3(1) of the SPB Rules, which limits the scope of persons to whom ILS may be offered or sold. In particular, the SPB Rules imposes a minimum investment size of US$250,000 (or its equivalent in other currency) for each ILS transaction, and an SPI and ILS investor (in the event of a secondary transaction) must not sell or offer to sell any ILS to another person who is not an "eligible ILS investor" as defined under the SPB Rules.

The SPI and any intermediary involved in an ILS transaction must also observe the sales restrictions in the SPB Rules as well as guidelines, codes, circulars, and other requirements issued by the IA and other regulatory authorities from time to time.

IV. Corporate governance and risk management

The IA emphasises that an SPI is required to have sound and effective corporate governance and risk management frameworks in place that are proportionate to its risk profile. The frameworks should facilitate effective and efficient operations and address the organisational structure of the SPI, including segregation of duties and management of conflicts of interest.

V. Reporting, record-keeping and filing requirements

GL-33 also provides that the SPI is required to keep and maintain proper accounting and other records at any of its offices in Hong Kong, or offices of its accountant in Hong Kong, as long as it is authorised as an SPI.

The SPI will generally be subject to more simplified reporting requirements, and will be required to submit a director's report, balance sheet, revenue account and profit and loss account to the IA.

VI. Disclosure requirement

GL-33 imposes certain mandatory disclosure requirements in the offering and contractual documentation, including:

- a statement that the SPI is "bankruptcy remote";
- the rights of the ILS investors under the ILS notes are fully subordinated to the claims of policy holders (i.e. the cedant(s)) under the SPI's reinsurance contract;
- the investment guidelines governing the composition of the SPI's assets, including the types, issuers, and target credit ratings of the investments;
- if the SPI will be reused for subsequent issuance of ILS, the allocation of assets to different contracts and the aggregated limit of each contract in order to demonstrate that the SPI will meet the fully-funded requirement at all times; and
- an SPI and ILS investor (in the event of a secondary transaction) must not sell or offer to sell any ILS below the monetary threshold as set out in SPB Rules.

VII. SPI application pack

An SPI applicant is required to complete and submit an SPI application form (which can be obtained directly from the IA) together with supplementary information and documents for the IA's evaluation, including:

- **IA's specified forms**——Particulars of the applicant and its service providers, including the proposed administrator(s) and the director(s) of the SPI;
- **Undertakings**——Written and binding undertakings to be provided by the SPI and/or written representation from the placement agent(s)/arranger(s) of the proposed ILS transaction in respect of compliance with the selling restrictions under the SPB Rules;
- **Details of the SPI applicant and cedant(s)**——Investment strategies and types of potential investments by the SPI, financial projections of the SPI and copies of the financial statements of the cedant(s);
- **Details of the ILS transaction**——Types of perils to be covered and respective triggering events and draft term sheet and draft offering document(s) for the ILS;
- **Draft contractual documentation**——indenture, reinsurance contract to be entered into by the SPI and cedant(s) and such other contractual documentation relevant to the ILS transaction; and
- a detailed written explanation of how the SPI will satisfy the "fully-funded" requirement under the Insurance Ordinance.

In the event the SPI will be "recycled" for issuing multiple ILS, the SPI applicant should also disclose such intention to the IA in its SPI application. Any subsequent issuance of ILS using the same SPI would require the IA's no objection.

VIII. ILS Grant Scheme

With reference to the IA's press release dated 3 May 2021, authorised SPIs may qualify for the reimbursement of eligible expenses attributable to issuing an ILS bond in Hong Kong if:

- at least 20% of the upfront issuance costs of the ILS are attributable to the revenue of Hong Kong-based service providers; and
- the ILS issuance takes place in Hong Kong, with an issuance size of at least HK$250 million (or the equivalent in foreign currency).

Priority of the Grant Scheme will be given to initial issuers and sponsors, and issuances lodged with and cleared by the Central Moneymarkets Unit operated by the Hong Kong Monetary Authority, where feasible.

The sum of grant for each issuance is:

- **for ILS with a maturity of three or more years**——the lesser of:
  - HK$12 million; or
  - 100% of total upfront costs incurred; or
- **for ILS with maturity of one year to less than three years**——the lesser of:
  - HK$6 million; or
  - 50% of total upfront costs incurred.

IX. Conclusion

By introducing the ILS regime, Hong Kong seeks to further sharpen its competitive edge in asset and wealth management as a regional centre for ILS issuances. Prospective SPI applicants should consult the IA on its proposal before lodging a formal application.

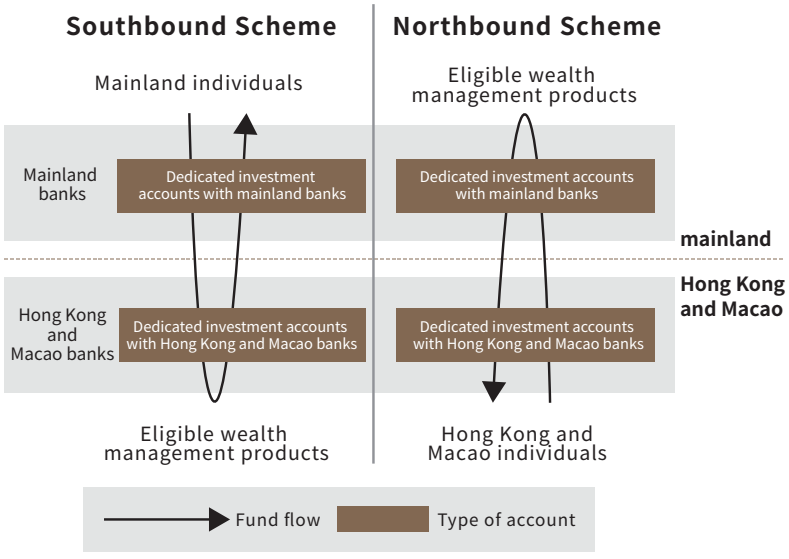
We observe that a number of interested market players have been engaging in soft consultations for SPI applications with the IA in advance of the publication of the GL-33. A dedicated team at King & Wood Mallesons across our network has been working on insurance, regulatory, licensing and taxation advice to support the upcoming ILS regime in Hong Kong. We look forward to working with our clients on this latest regulatory initiative for Hong Kong. Please speak to us if you have any questions.

CROSS-BOUNDARY WEALTH MANAGEMENT CONNECT PILOT SCHEME

Minny Siu, Yu Leimin, David Mu, Wang Rong

The Cross-boundary Wealth Management Connect (Cross-boundary WMC) is a scheme allowing eligible Chinese mainland, Hong Kong and Macao residents in the Guangdong-Hong Kong-Macao Greater Bay Area (GBA) to invest in wealth management products distributed by banks in the GBA. The Cross-boundary WMC consists of the Southbound Scheme and the Northbound Scheme. The Southbound Scheme refers to the purchase of qualified investment products sold by banks in Hong Kong and Macao by residents in the mainland GBA cities (mainland residents) through opening dedicated investment accounts with banks in Hong Kong and Macao. The Northbound Scheme means that eligible residents in Hong Kong and Macao (Hong Kong and Macao Residents) purchase qualified financial products sold by mainland banks by opening dedicated investment accounts with mainland banks in the GBA (mainland banks).

Diagram 1: Major business models of Cross-boundary WMC



On 5 February 2021, the People's Bank of China (PBOC) announced that the financial regulatory institutions of the Chinese mainland, Hong Kong Special Administrative Region of China (Hong Kong), and Macao Special Administrative Region of China (Macao) formally signed the

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Memorandum of Understanding on the Launch of the Cross-boundary Wealth Management Connect Pilot Scheme in the Guangdong-Hong Kong-Macao Greater Bay Area (MoU). The main contents of the MoU are basically consistent with those of the *Joint Announcement on the Launch of the Cross-boundary Wealth Management Connect Pilot Scheme* in the Guangdong-Hong Kong-Macao Greater Bay Area issued in June 2020. However, the MoU additionally provides that funds and wealth management products under the Cross-boundary WMC shall not be pledged or guaranteed, further highlighting the regulatory principle of "special funds for special purposes and closed-loop management".

As an innovative initiative to facilitate cross-border investment by individual residents in the GBA, the Cross-boundary WMC requires supporting policies. Current concerns in the industry focus on the opening of dedicated investment accounts, cross-boundary marketing and electronic authentication. This article will discuss the business challenges and policy expectations from these three perspectives.

I. Opening of dedicated investment account

The opening of a dedicated investment account is a prerequisite for the subsequent remittance and transfer of funds in the investment. As such, opening a bank account under the Southbound Scheme and Northbound Scheme is the first problem to be addressed, especially when the flow of people is still affected by the pandemic.

(I) Opening dedicated investment account with Hong Kong and Macao banks under Southbound Scheme

1. Account opening

Currently, the regulations on foreign exchange control do not specify the opening of overseas accounts by mainland residents, but the overseas capital project investment by mainland residents is under strict control. In practice, there are two main ways for mainland residents to open accounts with Hong Kong and Macao banks:

(1) Pursuant to the relevant foreign exchange control regulations, a mainland bank may provide attestation services to open Hong Kong or Macao bank accounts for mainland residents on behalf of its overseas branch; where a mainland bank provides attestation services to open accounts for mainland residents on behalf of an overseas bank, it shall obtain the consent of the banking and insurance regulatory authorities in advance. This way applies mainly to groups such as international students who have reasonable needs for an overseas account and foreign exchange. The relevant mainland residents are required to have obtained a long-term visa valid for more than three months. In this way, mainland residents may open Hong Kong or Macao bank accounts by using the attestation services provided by a mainland bank without going to Hong Kong or Macao.

(2) Mainland residents go to Hong Kong or Macao in person to open accounts offline at Hong Kong or Macao bank outlets.

It is not yet clear how a Hong Kong or Macao dedicated investment account will be easily opened by mainland residents under the Southbound Scheme. As the Cross-boundary WMC emphasizes the principles of "account bundling" and "closed-loop operation", it is reported that a Hong Kong or Macao bank can only select one mainland cooperative bank to carry out the Cross-boundary WMC business. Furthermore, Hong Kong or Macao bank accounts opened by mainland residents prior to their participation in the Cross-boundary WMC business are not allowed to be used as dedicated investment accounts, and a new dedicated investment account shall be opened with a Hong Kong or Macao bank. The opening bank for "one-to-one bundling" of mainland bank accounts may provide mainland residents with the attestation services for the opening of a dedicated investment account with a Hong Kong bank, but only to the exent of accepting materials and assisting Hong Kong banks in the preliminary examination. After passing the preliminary examination, the mainland residents still need to go to Hong Kong for the final opening of the account,

so as to form "one-to-one bundling" and "closed-loop relationship" between the mainland bank account and Hong Kong dedicated investment account.

Amid the COVID-19 pandemic, it is difficult to apply the existing Hong Kong and Macao bank account opening methods. While ensuring safety and controllability, opening bank accounts online may be a solution under the Southbound Scheme. It is worth noting that in recent years, Hong Kong has approved eight virtual banks, allowing Hong Kong residents to open bank accounts remotely. Under the Southbound Scheme, it remains to be seen whether traditional banks in Hong Kong and Macao involved in the Cross-boundary WMC will take advantage of virtual banks to allow account opening online.

2. Identity verification

The MoU stipulates that mainland banks and Hong Kong and Macao banks are required to perform anti-money laundering obligations in the course of establishing business relationships with their customers, of which verification of customer identity is an important part. Currently, mainland banks, when opening bank accounts for mainland residents, are required to conduct online verification through the National Citizen Identity Information Center (NCIIC) established and operated by the Ministry of Public Security, in addition to verifying the account opening materials and information. However, under the Southbound Scheme:

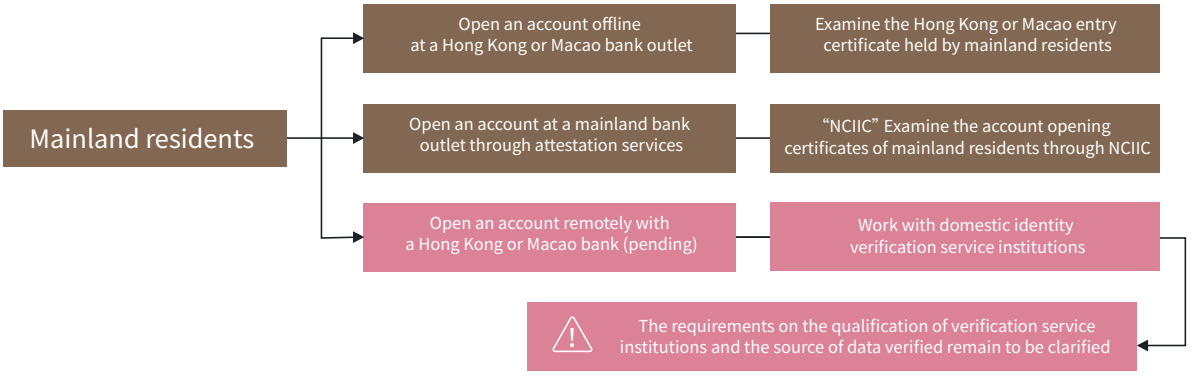
(1) If a mainland resident opens an account directly at a Hong Kong or Macao bank outlet, the bank may examine the Hong Kong or Macao entry certificate held by the resident;

(2) If a mainland resident uses the attestation services provided by a mainland bank, the mainland account opening attestation bank shall conduct online verification of the account opening certificates of the resident;

(3) If Hong Kong or Macao banks are allowed to provide cross-border online account opening services in the future (as envisaged in Section 1.1 above), it may be difficult for them to verify the identity of mainland residents directly because they are not yet qualified to access NCIIC for online verification.

We often receive business proposals from Hong Kong or Macao banks, indicating that they intend to engage domestic identity verification service institutions to verify some account opening information. However, due to the lack of uniform provisions on the qualification of verification service institutions and the source of data verified in mainland laws and regulations, we often remind such banks of the compliance risks and the uncertainty of regulatory recognition in such business plans.

Diagram 2: Review and verification methods under the Southbound Scheme



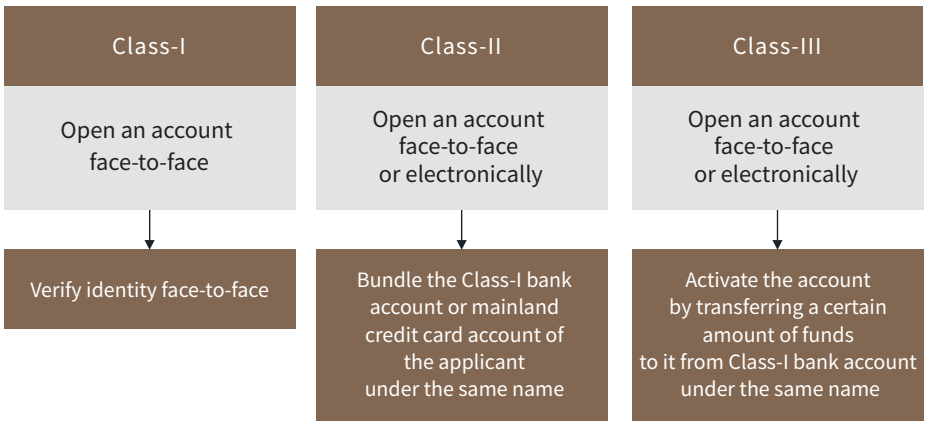
(II) Opening a mainland bank account under Northbound Scheme

1. Account opening

Similarly, it is also reported that the mainland RMB accounts opened by Hong Kong and Macao residents prior to their participation in the Cross-boundary WMC shall not be used for the business, and a new mainland dedicated investment account shall be opened separately.

Pursuant to the PBOC's requirements on classified management of individual accounts, bank settlement accounts for individuals are divided into Class-I, Class-II and Class-III. Currently, Class-I bank accounts can only be opened via face-to-face identity verification by bank personnel[1], while Class-II and Class-III bank accounts can be opened electronically[2].

Diagram 3: Ways of opening bank settlement accounts for individuals in the mainland



It is reported that the mainland dedicated investment account under the Northbound Scheme must be a Class-I bank account. If it is true, Hong Kong and Macao Residents will need to go to a mainland bank in the GBA to open such an account. This may limit the scale or convenience of the Northbound Scheme, particularly posing challenges when the pandemic is still raging. Furthermore, the MoU reiterates the regulatory principles of "special funds for special purposes, use of cross-border RMB, closed-loop management and quota management", and additionally imposes the regulatory requirement that funds and wealth management products under the Cross-boundary WMC shall not be pledged, or guaranteed, thus minimizing the payment and settlement function of the dedicated investment account. Therefore, whether the requirement for opening Class-I bank account can be relaxed to allow the remote opening of a mainland investment account is the key to the successful launch of the Northbound Scheme.

[1] In addition to opening accounts at the counter of bank outlets (i.e., face-to-face account opening), account holders may also open accounts via self-service machines. Although customers are not required to go to the counter to open accounts at self-service machines, such machines are generally placed at the business outlets of mainland banks and their use is guided by the bank staff. Therefore, there is no substantive difference between opening accounts via the counter and via self-service machines.

[2] When opening a Class-II bank account, the identity verification shall be conducted by bundling the Class-I bank account or mainland credit card account of the applicant under the same name for verification of identity.

2. Account restrictions

Another solution is to expand and upgrade the Class-II bank account to make it compatible with the investment account under the Northbound Scheme[3].

From the perspective of account opening, there is no obstacle to the remote opening of Class-II bank accounts (non-counter account opening). In 2019, the Guangzhou Branch of the PBOC applied the "regulatory sandbox" concept and organized the Bank of China and the Industrial and Commercial Bank of China to launch the pilot program of opening Class-II and Class-III bank settlement accounts for individuals through attestation services by Hong Kong or Macao banks. In May 2020, four authorities including the PBOC issued the *Opinions on Providing Financial Support for the Development of the Guangdong-Hong Kong-Macao Greater Bay Area*, which for the first time specifies the "launching of the pilot program of opening Class-II and Class-III bank settlement accounts for Hong Kong and Macao residents through attestation services". Hong Kong and Macao residents who do not hold a Class-I mainland bank account under the same name may go to an outlet of a Hong Kong or Macao bank to complete verification of identity and their willingness in order to open an account through attestation services. This shows the possibility of remote opening of Class-II and Class-III bank accounts under the Northbound Scheme.

From the functional perspective, pursuant to the PBOC's relevant provisions on account management, there is no amount limit for purchasing wealth management products with Class-II bank accounts, but there is a daily cumulative limit of RMB 10,000 and an annual cumulative limit of RMB 200,000 for fund transfers between Class-II bank accounts and unbundled accounts (the transfer-in and transfer-out limits shall be calculated cumulatively respectively).

Mainland bank accounts under the Northbound Scheme are, in fact, "dedicated investment accounts" featuring "closed-loop funds flow", rather than "bank settlement accounts". From the perspective of operability, if Class-II bank accounts are permitted to be used as investment accounts under the Northbound Scheme, Hong Kong and Macao bank accounts may be considered as "bundled accounts" to verify customers'identity and willingness to open accounts. Meanwhile, restrictions need to be imposed on the amount, transfer and withdrawal of funds and other functions of Class-II bank accounts used by Hong Kong and Macao residents under the Northbound Scheme. However, there are no specific regulatory rules on this issue.

II. Southbound Scheme business and cross-border marketing

Although the "Hong Kong Stock Connect", QDII and other Southbound products are also targeted at offshore financial products, it is mainland financial institutions that provide account and product management services to mainland residents, which is significantly different from Cross-boundary WMC, where banks in Hong Kong or Macao provide account and product management services directly to mainland residents. Given the management principles of Cross-boundary WMC business, such as "closed-loop funding" and "account bundling", and especially in light of reports that "banks in Hong Kong or Macao can only cooperate with one cooperating bank in the mainland", the future Southbound Scheme business needs to rely on cooperation with cooperating banks in the mainland. As the Southbound Connect business is targeted at individual residents of the mainland, it is recommended to pay special attention to the regulatory trends of mainland regulators on the following two dimensions of cross-border marketing.

(I) Hong Kong and Macao banks facing mainland residents: "cross-boundary payment" or "offshore consumption"

When China joined the WTO, it did not make any commitments to opening up the market for banking financial services through "cross-boundary payment". Therefore, mainland regulatory authorities have always been cautious and conservative towards the unauthorized marketing and promotion of offshore financial products or services by offshore

[3] Currently, Class-III bank account opened by mainland banks only cover consumption and payment services with limited amount. Therefore, mainland bank account under Northbound Scheme shall be Class-I or Class-II bank account.

financial institutions in the mainland. On the other hand, it has committed to opening up the market for "offshore consumption", imposing no restrictions on all other services except for advertising and insurance brokerage, for which there are restrictions or no commitments.

With the development of network technology, Hong Kong and Macao banks can provide their services or products to users all over the world through Internet platforms, which further blurs the distinction between "cross-boundary delivery" and "offshore consumption". In some international multilateral rule negotiations in recent years, some countries or regions advocate distinguishing between "cross-boundary delivery" and "offshore consumption" based on whether the offshore service providers "solicit" or "carry out" cross-boundary business. That is to say, if a consumer voluntarily accesses the website of an offshore institution and receives the cross-boundary financial services provided by the institution, and the offshore institution does not solicit or carry out business in the country or region where the consumer is located, the situation shall be deemed as the consumer's "offshore consumption" rather than "cross-boundary delivery of financial services"[4]. Therefore, the financial regulatory authorities in some countries and regions determine the compliance of cross-boundary business based on whether the offshore service provider "actively" carries out financial activities (including marketing). For example, in accordance with relevant securities and futures regulations in Hong Kong, any person who actively promotes any regulated activity to the Hong Kong public in or from outside Hong Kong will be subject to the Hong Kong financial regulatory framework. However, if the Hong Kong public actively seeks or invites such services, such activities shall be deemed as "Reverse Solicitation", which shall not constitute activities subject to Hong Kong regulation[5].

Currently, the mainland's foreign commitments on cross-boundary financial services are still subject to its commitments under the WTO General Agreement on Trade in Services, and "Reverse Solicitation" is not used as a strict distinguishing standard. However, in practice, "Reverse Solicitation" is often used as a risk mitigation measure and defense for "conducting financial business without a license in the mainland"[6]. The MoU specifies the "investor protection" and "regulatory liaison and negotiation mechanism", and introduces certain regulatory requirements, such as "account bundling, special funds for special purposes, and prohibition of mortgage or pledge", which put the Cross-boundary WMC under the regulation the mainland and Hong Kong and Macao, substantially reducing regulatory conflicts and regulatory blind spots caused by "cross-boundary delivery".

(II) Cooperation between Hong Kong/Macao banks and mainland banks: How to determine the place of purchase and sale of wealth management products

Given the unique nature of Cross-boundary WMC, it is inevitable that mainland banks cooperating with Hong Kong or Macao banks will be exposed to the marketing and promotion relating to "Hong Kong/Macao bank accounts" and "eligible wealth management products of Hong Kong/Macao banks" while carrying out the Southbound Scheme. However, the relevant provisions of the MoU are not clear on such matters.

(1) Article 21 of Part 5 of the MoU provides that "The Parties agree to … based on the principle of 'regulation by the jurisdiction where the business is conducted'. Complaints arising from the process of cross-boundary remittance and purchase and sale of wealth management products under the Scheme shall be handled by the relevant financial regulators in accordance with laws and regulations of where the banks conduct the relevant business." In addition, Article 9 of Part 2 of the MoU provides that the HKMA and AMCM agree to provide guidance to Hong Kong and Macao banks respectively to comply with obligations relating to, among other things, anti-money laundering and counter-financing of terrorism when launching the Southbound Scheme. Pursuant to the foregoing provisions, the attestation agency and fund remittance and transfer services provided by mainland banks under the Southbound Scheme shall comply with the

[4] Sun Tianqi: Opening-up and Regulation of "Cross-boundary Delivery" Financial Services in the Context of Fintech, https://mp.weixin.qq.com/s/Z-LTI7XsjsKe33kB1474IQ

[5] www.sfc.hk/web/TC/faqs/intemediaries/licensing/active-marketing-under-section-115-of-the-sfo.html#1

[6] With the implementation of the *Regulations on the Prevention and Punishment against Illegal Fund-raising* on 1 May 2021 and the abolishment of the *Measures for the Clampdown of Illegal Financial Institutions and Illegal Financial Business Activities* on the same day, the compliance risk of "conducting financial business without a license in the mainland" may need to be re-assessed.

financial regulatory rules in the mainland, and anti-money laundering and transactions shall comply with the financial regulatory rules in Hong Kong and Macao. However, it is still difficult to determine whether the place of purchase and sale of wealth management products under the Southbound Scheme is in Hong Kong, Macao or the mainland. Therefore, it is necessary to be clear on the relevant regulatory authorities and applicable laws for the sale and marketing of wealth management products under Southbound Scheme in the future.

(2) The MoU does not set forth provisions on the cross-boundary marketing of wealth management products. If mainland banks under the Southbound Scheme only provide witness agency and fund remittance and transfer services, and Hong Kong/Macao banks provide investor qualification review and sales services, it is uncertain whether the cooperating mainland banks can assist the Hong Kong/Macao banks in carrying out marketing activities for eligible wealth management products in the mainland.

(3) Considering the features of Internet-based global information services, further regulatory clarification will be needed to determine whether the Hong Kong/Macao banks, when "soliciting" mainland residents and promoting their "dedicated investment accounts" or "eligible wealth management products" through APPs, special websites established within the mainland or WeChat official accounts under the Southbound Scheme, should comply with the Reverse Solicitation provisions in the financial regulatory area in Hong Kong, and whether such action violates the financial regulations of mainland and constitutes the provision of financial services by means of "cross-boundary delivery".

We understand that in the Southbound Scheme busines, Hong Kong/Macao banks should adhere to the principle of providing services in Hong Kong and Macao (i.e. "offshore consumption"), and use Reverse Solicitation as a way to mitigate risks. The cooperating mainland bank should limit their marketing collaboration to the general introduction of Cross-boundary WMC or agency witness account opening services, and refrain from promoting, interpreting, assessing the appropriateness and explaining risks of eligible wealth management products in Hong Kong or Macao or engaging in other marketing and sales activities that should be provided by Hong Kong and Macao banks.

III. Mutual recognition of electronic signatures

In the Southbound Scheme business, Hong Kong and Macao banks directly provide investment account and product management services, and therefore need to directly enter into account service and product sales contracts with mainland residents, which is different from the existing southbound products such as Hong Kong Stock Connect and QDII. Currently, the mainland only has financial regulations on the attestation of the opening of accounts by mainland banks, but not on the signing of witnessing contracts. If Hong Kong/Macao banks enter into contracts with mainland residents online in a "non-face-to-face" manner, the issue of mutual recognition of electronic signatures among the mainland, Hong Kong and Macao should be taken into consideration.

In accordance with the market practice and Article 16 of the *Electronic Signature Law of the PRC*, the certification of a reliable electronic signature requires the certification service offered by a lawful third-party electronic certification service provider. However, Article 42 of the *Administrative Measures on Electronic Certification Services* stipulates that the Ministry of Industry and Information Technology (MIIT) shall verify the electronic signature certificates issued overseas by foreign electronic certification service institutions in accordance with relevant agreements or the principle of reciprocity. Therefore, the certificates issued by the electronic signature certification institutions in Hong Kong and Macao are not guaranteed to be binding in the mainland.

Since 2008, under the framework of CEPA, the MIIT has promoted Guangdong Province to set up pilot working groups for the mutual recognition of electronic signatures between Guangdong and Hong Kong and between Guangdong and Macao, signed opinions on the mutual recognition framework, and issued administrative measures for the

mutual recognition and certificate strategies. On 24 October 2016, the Hong Kong Securities and Futures Commission issued the *Advisory Circular to Intermediaries – Client Identity Verification in Account Opening Process*, which allows Hong Kong brokers to verify client identity and sign contracts by using electronic signatures recognized by mainland regulators when opening accounts online. The above has provided the institutional basis and reference cases for Guangdong, Hong Kong and Macao to conduct online Cross-boundary WMC business with electronic signatures.

IV. Conclusion and prospect

At present, the business processes and detailed rules of the Cross-boundary WMC are still to be formulated. The signing of the MoU indicates that the implementation of Cross-boundary WMC has been further promoted. The above-mentioned account opening, cross-boundary marketing and mutual recognition of electronic signatures are the key business processes of the Cross-boundary WMC, which still require further policy guidance or clarification from regulatory authorities. We will pay close attention to these issues.

SOUTHBOUND BOND CONNECT – OFFSHORE BOND INVESTMENTS BY MAINLAND INVESTORS

Minny Siu, Molly Su, Richard Mazzochi, Hao Zhou, Michael Lu, Song Yue

I. Debut launch of Southbound Bond Connect on 24 September 2021

Bond Connect is a mutual market access scheme launched in 2017 that facilitates cross-border bond trading and settlement. Northbound Bond Connect[1] commenced trading in July 2017 and allowed Hong Kong SAR and other offshore investors to access China's Interbank Bond Market of China (CIBM).

Southbound Bond Connect is the "southbound" version of Northbound Bond Connect. Please refer to our previous client alert[2] for further information on the Northbound Bond Connect scheme.

Southbound Bond Connect is the "southbound" mirror image of the Northbound scheme and allows eligible Chinese mainland institutional investors (Chinese mainland Investors) to access the offshore bond market in Hong Kong SAR. Southbound Bond Connect is operated and supported through cooperation between the relevant bond trading, custody and settlement infrastructure institutions (Financial Infrastructure Services Institutions) in Hong Kong SAR and Chinese mainland. The People's Bank of China (PBOC) and Hong Kong Monetary Authority (HKMA) approved the collaboration of the Financial Infrastructure Services Institutions on 15 September 2021 for the purposes of establishing Southbound Bond Connect.

According to data from the HKMA and the PBOC, the first batch of trading under Southbound Bond Connect on 24 September 2021 recorded more than 150 transactions in bonds commonly traded on the Hong Kong SAR market with participation from over 40 Chinese mainland Investors and 11 Offshore Market Makers.[3]

According to the Joint Announcement, Southbound Bond Connect supports the continued development of Hong Kong SAR and enhances cooperation between Chinese mainland and Hong Kong SAR, and is "*conducive to the diversification of investment channels for mainland institutional investors, to the steady and progressive two-way opening up*

[1] According to the HKMA's data, Northbound Bond Connect has attracted over 2,400 global institutional investors and has facilitated Chinese sovereign bonds to be included into various major global bond indices such as Bloomberg-Barclays Global Aggregate Index and J.P. Morgan Government Bond Index – Emerging Markets. In 2020, the scheme recorded an average daily turnover of nearly RMB20 billion, accounting for 52% of foreign investors' total turnover in the CIBM.

[2] https://www.kwm.com/en/hk/knowledge/insights/the-first-northbound-trade-under-bond-connect-launches-today-20170703

[3] http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/4348768/index.html and https://www.hkma.gov.hk/eng/news-and-media/press-releases/2021/09/20210924-5/

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of the mainland financial markets, to the enhancement of Hong Kong's competitive advantages and consolidation of Hong Kong's status as an international financial centre, and to the upholding of long-term prosperity and stability of Hong Kong".

In this article, references to the term "**onshore**" refers to Chinese mainland, and "**offshore**" refers to jurisdictions outside Chinese mainland (such as Hong Kong SAR).

II. Key features of Southbound Bond Connect

(I) Infrastructure of Southbound Bond Connect – key participants

The key Financial Infrastructure Services Institutions and their respective roles under Southbound Bond Connect are summarised in this table:

Participant	Role
PRC Financial Infrastructure Services Institutions	
China Foreign Exchange Trade System (CFETS) – the PBOC approved trading system for bonds traded on the CIBM	Provide market participants with bond trading related services including providing Offshore Trading Platforms (as defined below) with information relating to the relevant bonds, facilitating with requests for quotations and providing information on completed transactions[4]
China Central Depository & Clearing Co., Ltd. (CCDC) – one of the designated central securities depositories of the CIBM	Through collaboration with the CMU (as defined below), open nominee accounts for Chinese mainland Investors
Interbank Market Clearing House Co., Ltd. (SHCH) – one of the designated central securities depositories of the CIBM	Through collaboration with the CMU (as defined below), open nominee accounts for Chinese mainland Investors
Onshore custody and settlement banks	Through connection with CMU (as defined below) and/or Hong Kong SAR custodian banks, provide bond custody and settlement services to Chinese mainland Investors
Cross-Border Interbank Payment System (CIPS)	Offer clearing and settlement services for cross-border RMB payments and trade
Hong Kong SAR of the PRC Financial Infrastructure Services Institutions	
Hong Kong Exchanges and Clearing Co., Ltd. (HKEX) – part operator of Bond Connect Company Limited (BCCL) and owner of The Stock Exchange of Hong Kong (SEHK)	BCCL is a joint venture established by CFETS and the HKEX to support Bond Connect trading services. Most bonds available to investors in Hong Kong SAR are not listed or traded[5] on the SEHK.
Central Moneymarkets Unit (CMU) – the debt securities clearing and settlement system in Hong Kong SAR owned and operated by the HKMA	Provide clearing, settlement and custodian services for debt securities issued by both public and private sector entities in Hong Kong SAR
Hong Kong custodian banks	Chinese mainland Investors that choose to hold bonds with an onshore custody and settlement bank can do so through a settlement link between such onshore custody and settlement bank and CMU or a Hong Kong custodian bank (although the implementation details of this settlement link are pending clarification)

[4] The SFC approved CFETS to provide automated trading services for the purposes of facilitating the conduct of trading under Bond Connect in September 2021.

[5] Listing of bonds on the SEHK mainly provides a listing status to meet the investment mandates for certain types of investors such as mutual funds and unit trusts, but typically, those bonds listed on the SEHK are not traded on the SEHK.

(II) Eligible Chinese mainland Investors

The following Chinese mainland Investors are now permitted to trade under Southbound Bond Connect:

1. the 41 banking financial institutions (excluding non-bank financial institutions and rural financial institutions[6]) that are designated by the PBOC as Tier 1 dealers for open market business in 2020 – a complete list of such dealers (including the excluded non-bank financial institutions and rural financial institutions) as listed in **Appendix A** of this article; and
2. Qualified Domestic Institutional Investors (QDIIs) and Renminbi Qualified Domestic Institutional Investors (RQDIIs and together with QDIIs, (R)QDIIs) (although their investments do not count towards the quota usage, as set out below).

We understand that unincorporated investment vehicles launched in Chinese mainland are permitted to invest through Southbound Bond Connect (although the specific product types that can be accessed through Southbound Bond Connect remain to be clarified).

Registration requirements: Chinese mainland Investors are required to submit certain information to CFETS before commencing its Southbound Bond Connect business and comply with other procedural requirements stipulated by the relevant regulators.

(III) Eligible market makers (trade counterparty)

An eligible Chinese mainland Investor can only trade under Southbound Bond Connect with a financial institution in Hong Kong SAR that is a designated market maker for Southbound Bond Connect by the HKMA (Offshore Market Makers). There are currently 13 approved Offshore Market Makers (as listed in **Appendix B** of this article).[7]

Selection criteria: The Offshore Market Makers were selected pursuant to the HKMA's internal evaluation process based on several criteria "including certain basic conditions such as licenses for carrying on relevant activities, adequate internal control systems, and regulatory compliance; and other factors including the financial institutions' activities in the Hong Kong bond market, their business presence in Hong Kong, counterparty network with mainland financial institutions".[8]

Registration requirements: Offshore Market Makers must submit

[6] "Rural financial institutions" primarily comprise of rural commercial banks in Chinese mainland.

[7] Please refer to https://www.hkma.gov.hk/eng/news-and-media/press-releases/2021/09/20210917-6/

[8] https://www.hkma.gov.hk/eng/news-and-media/press-releases/2021/09/20210917-6/

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certain information to CFETS prior to commencing any Southbound Bond Connect trades and must comply with other procedural requirements stipulated by the relevant regulators.

(IV) Eligible bond products

Eligible Chinese mainland Investors may access **all bonds that are (i) issued offshore and (ii) traded in the Hong Kong SAR market with liquidity** under Southbound Bond Connect. It remains to be seen whether the regulators will stipulate further eligibility requirements to narrow the eligible bond product scope, for example, by qualifying what constitutes "with liquidity", and stipulating the required product features of the bonds.

We understand CFETS intends to publish a list of the eligible bonds for trading on its platform. This list will be updated from time to time in response to market conditions and investor needs.

(V) Annual and daily quota

The cross-border capital net outflow for Southbound Bond Connect is subject to an annual quota limit, as well as a daily quota limit.

Annual total quota	RMB500 billion
Daily quota	RMB20 billion

Investments made by (R)QDIIs under Southbound Bond Connect will not be included in calculating quota usage of Southbound Bond Connect.

CFETS will monitor the quota usage on a real-time basis. Once exceeded, CFETS will not accept further buy orders under Southbound Bond Connect.

(VI) Settlement cycle

Southbound Bond Connect trades adopt the trading days and trading hours of the CIBM (i.e., Beijing time 9.00am – 12.00pm and 1.30pm – 8.00pm on a trading day). The SHCH provides gross settlement services and supports Southbound Bond Connect transactions with a settlement cycle of T+1 to T+3.

A transaction executed under Southbound Bond Connect must be settled only on a day which is a working day on both the CIBM and the Hong Kong SAR bond market.

(VII) Foreign exchange conversion and cross-border funds under Southbound Bond Connect

The quoting, transaction and settlement currency of trades conducted under Southbound Bond Connect are governed by the terms of the underlying bond.

A Chinese mainland Investor intending to trade in foreign currency denominated bonds under Southbound Bond Connect may exchange its RMB for the relevant foreign currency in China's interbank foreign exchange market and hedge its foreign currency risks through foreign exchange derivatives.

Capital flow under Southbound Bond Connect will be kept in a close-loop – that is, any sales proceeds derived by a Chinese Mainland Investor must be remitted back to Chinese mainland and exchanged back into RMB.

III. Trading link

(I) General trading flow – RFQ

Trades under Southbound Bond Connect are conducted by way of the placement of a Request-for-Quote (RFQ) by a Chinese mainland Investor with an Offshore Market Maker. The key steps involved in a trade execution are:

Step 1	**A Chinese mainland Investor** sends a RFQ through CFETS to the Offshore Market Maker(s). The RFQ: • may be sent to one or more Offshore Market Makers; • should stipulate the trading parameters such as direction (bid or offer), bond code, total face value, settlement date, etc.; • may include a validity period, upon the expiry of which the RFQ automatically lapses; and • should follow the minimum nominal amount and tick size of the underlying bond.
Step 2	**An Offshore Market Maker** responds to the RFQs through CFETS or Offshore Trading Platforms. The response: • should quote a price and include the trading parameters such as the amount of tradable bonds, net price and yield at maturity; and • may be subject to a validity period, upon the expiry of which the quote automatically lapses if it is not accepted. • The Offshore Market Maker may choose not to respond to an RFQ.
Step 3	**The Chinese mainland Investor** decides whether to accept any given quote.

(II) Types of trading links

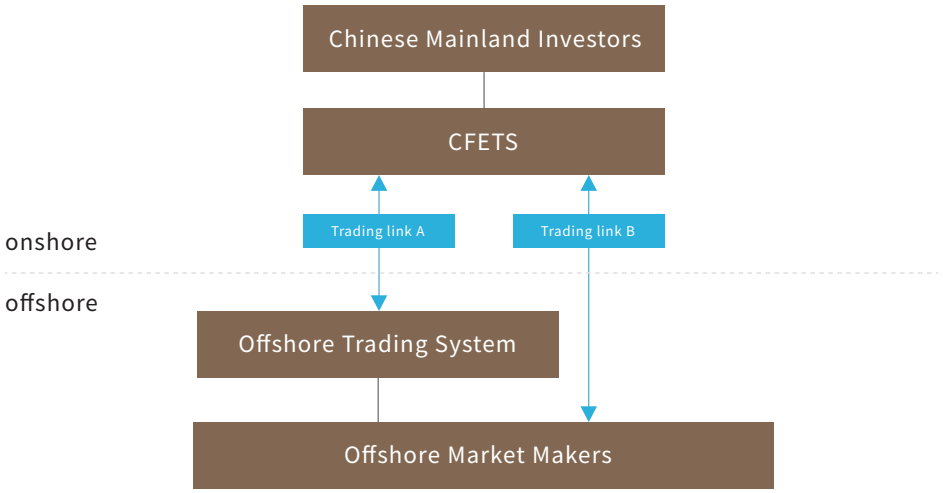
Unlike Northbound Bond Connect, Offshore Market Makers are offered two types of trading links for connection to CFETS'trading platform:

1. **Trading Link A** (described further below) - the trading link is between CFETS'trading platform and the designated Offshore Trading Platform (such that the Offshore Market Makers may simply connect their systems with the Offshore Trading Platform); and

2. **Trading Link B** (described further below) - the trading link is between CFETS'trading platform and the Offshore Market Makers (i.e., no Offshore Trading Platform is involved).

Both variations adopt (broadly speaking) the RFQ trading flow described above.

The trading links are illustrated in this diagram:



(III) Trading Link A – Trading link between CFETS'trading platform and Offshore Trading Platforms

This model allows Offshore Market Makers to conduct the RFQ process on an Offshore Trading Platform, which allows market makers to avoid the need to connect to CFETS, thereby reducing their pre-trade system connection costs and administrative burden.

Under this model, a trade completes when:

- the Chinese mainland Investor accepts a quote provided by an Offshore Market Maker in response to the investor's RFQ; or
- if the Offshore Trading Platform offers a "last look" function and the function is adopted by an Offshore Market Maker, (i) a quote is accepted by a Chinese mainland Investor and (ii) the acceptance by the investor is confirmed by the relevant Offshore Market Maker.

(IV) Trading Link B – Direct trading link between CFETS'trading platform and Offshore Market Makers

Under this model, Offshore Market Makers are linked to, and trade directly on, the CFETS platform. A trade completes when the Chinese mainland Investor accepts a quote provided by an Offshore Market Maker in response to the investor's RFQ.

(V) (R)QDII

(R)QDIIs trading through Southbound Bond Connect may also use trading routes permitted for their offshore bond trading.

IV. Settlement and custody link

(I) Nominee holding structure

Again, similar to Northbound Bond Connect, bonds traded under Southbound Bond Connect are held and settled under the nominee holding structure. However, under Southbound Bond Connect, Chinese mainland Investors may choose to hold their Southbound Bond Connect bonds through:

1. onshore bond registration and settlement institutions recognised by the PBOC (i.e., CCDC/SHCH) (Onshore CSD Settlement Route) – trades under this route are settled via a settlement link between the bond registration and settlement institutions recognised by the PBOC (i.e., CCDC and SHCH) in Chinese mainland and CMU; or

2. an onshore custody and settlement bank[9] (Onshore Settlement Bank Route) – pending detailed rules on the settlement structure for this route, trades under this route are settled via a settlement link between the onshore custody and settlement bank and CMU or Hong Kong SAR custodian banks.

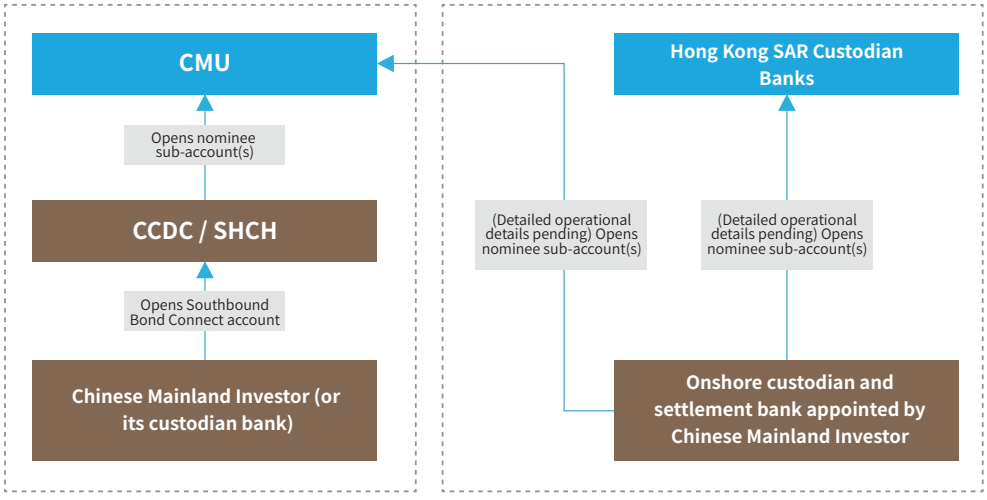
Although the rules and regulations have not provided extensive details for the Onshore Settlement Bank Route, the key differences between these routes are as follows:

	Onshore CSD Settlement Route	Onshore Settlement Bank Route
Account opening	Chinese mainland Investor or its custodian bank opens a "Southbound Bond Connect" account with CCDC or SHCH to record its bond holdings at CCDC or SHCH (as applicable). CCDC/SHCH opens segregated nominee sub-account(s) with CMU to record its bond holdings on behalf of Chinese mainland Investors (at individual investor level). The bond holdings recorded in the Southbound Bond Connect account opened at CCDC/SHCH should match the holding as recorded in each nominee holder account opened by CMU for CCDC/SHCH.	The operational details for this route have yet to be clarified. Pursuant to the PBOC Notice, where a Chinese Mainland Investor opts for this route, the Onshore Settlement Banks should establish a settlement link with CMU or Hong Kong SAR custodian banks in order to provide Chinese mainland Investors with services such as bond custody and settlement but no further details are provided. We believe this route is intended to allow Chinese mainland Investors to directly invest in bonds denominated in non-Renminbi currencies after purchasing foreign exchange in Chinese mainland. We anticipate that the settlement mechanism under this route will be similar to the settlement mechanism for bonds traded via the CIBM direct access regime.[10]
Fund settlement	Settled via CIPS	Pending clarification.

[9] The onshore custody and settlement banks currently recognised by the PBOC are Industrial and Commercial Bank of China, Bank of China and China CITIC Bank.

[10] That is, investors will need to entrust a bond settlement agent onshore to engage in trading and settlement for them.

This diagram illustrates the Onshore CSD Settlement Route and Onshore Settlement Bank Route:



(II) Bondholders'rights

Only SHCH has published guidelines on Southbound Bond Connect as of the date of this article. According to the SHCH's rules, Chinese mainland Investors are entitled to rights and interests in the bonds in accordance with the law. SHCH must act in accordance with the investors'instructions.

(III) Settlement on delivery versus payment (DVP) basis

Under Southbound Bond Connect, transactions are settled on a DVP basis. Taking SHCH as an example, it provides gross settlement services and supports transactions under Southbound Bond Connect with a settlement cycle of T+1 to T+3.

This table summarises the operation of settlement through SHCH on a DVP basis:

Timeframe		Operation flow
CIBM trading day immediately preceding settlement date	before 3.30pm	Chinese mainland Investors confirm settlement instructions through SHCH.
	During the day	SHCH submits settlement instructions to CMU following CMU's requirements.

Timeframe		Operation flow
Settlement date	8.30am	After confirming that the seller has sufficient bonds for settlement, CMU locks up the relevant bond position in the seller's account and sends a CIPS135 message to CIPS. CIPS forwards the CIPS135 message to the buying and selling CIPS participant.
	3.30pm	Chinese mainland Investor or its entrusted CIPS participant sends a CIPS136 message to CIPS notifying CIPS of the investor' s consent on the transfer of funds. CIPS transfers the funds pursuant to the CIPS136 message and sends a CIPS601 message to update CMU on the status of the transfer, based on which CMU completes the distribution of bond. If the seller has insufficient holding positions in its account, or if the buyer has not transferred the funds required, SHCH will submit a cancellation request to the CMU to terminate settlement for that transaction.
	before 5.30pm	When a DVP settlement is completed by CMU, SHCH will generate individual internal settlement instructions to credit or debit the balance of the respective Southbound Bond Connect accounts.
	after 5.30pm	Chinese mainland Investors may enquire settlement results through the SHCH's system.

V. Key legal and regulatory issues

(I) Applicable laws and regulations

Southbound Bond Connect is subject to the laws and regulations in Hong Kong SAR and Chinese mainland. The settlement of a transaction under Southbound Bond Connect must comply with the regulatory requirements and business rules of the jurisdiction in which the settlement takes place.

All Chinese mainland Investors participating in Southbound Bond Connect are subject to the following rules and regulatory bodies:

Investment activities	Rules and regulations of the PBOC and CFETS (for example, Chinese mainland Investors must use any Southbound Bond Connect market data obtained via CFETS'trading platform for trading purposes only and are strictly prohibited from downloading, recording or providing such data or using such market data for index compilation or provision of derivatives without authorisation) Applicable trading rules of the interbank market
Fund remittance and cross-border payment activities	Supervision by the PBOC and the State Administration of Foreign Exchange
Custody and settlement of bonds	Comply with the relevant rules of the CCDC, SHCH and CMU
Legal relationship with bond issuer	Determined in accordance with the legal documentation underlying the bond issuance

(II) Contravention of the applicable laws and regulations

Where CFETS has reasonable grounds to believe that any Southbound Bond Connect participant has violated the relevant laws and regulations or otherwise engaged in activity which affects the operations of Southbound Bond Connect in a material adverse way, it may suspend the participant's use of the system and report the same to the PBOC.[11]

(III) Tax

The SHCH Guide clarifies that the Chinese mainland Investor bears all (onshore and offshore) tax labilities arising from its Southbound Bond Connect investments.

VI. Benefits of Southbound Bond Connect compared with (R)QDII

(I) Flexibility of asset allocation

Prior to the launch of Southbound Bond Connect, the (R)QDII regime was the main channel through which Chinese mainland Investors invested in the offshore bond market. However, as a general rule under the (R)QDII regime, any instruments in the form of securities (including bonds) issued by an offshore entity and sold to a (R)QDII counterparty cannot be distributed to PRC investors directly or on-sold by a (R)QDII counterparty. Rather, the products must be repackaged or "wrapped" by the (R)QDII counterparty as its own product and then sold to PRC investors. (R)QDIIs did not have the flexibility to adjust their positions and allocate their assets according to market conditions.

Under Southbound Bond Connect, a Chinese mainland Investor may trade any eligible bond via the trading link with Offshore Market Makers directly, greatly enhancing the flexibility for asset allocation.

(II) Focus on bonds products with larger quota

Apart from bonds, the range of (R)QDII products also includes stocks, structured products, financial derivatives and funds. As the quota for (R)QDII is relatively scarce, a large proportion of the (R)QDII quota is allocated to investment in other offshore asset classes, thereby restricting the quota for bond investment.

[11] CFETS Trading Rules

The annual quota limit and daily quota limit for Southbound Bond Connect are higher than the quotas for the Shanghai-Hong Kong Stock Connect when it launched (the aggregate quota limit for the Shanghai-Hong Kong Stock Connect was RMB250 billion and the daily quota was RMB10.5 billion in 2014). At present, there is no aggregate quota for the Shanghai-Hong Kong Stock Connect or Shenzhen-Hong Kong Stock Connect, and the southbound daily quota for each of the Stock Connect schemes is RMB42 billion.

(III) Potential range of bond varieties

Different types of (R)QDIIs are subject to different restrictions on their scope of bond investment. For instance, bank (R)QDIIs are subject to certain requirements on bond rating (i.e., BBB above) and on the issuing entity. Under Southbound Bond Connect, however, there is currently no specific requirement on the rating of the target bonds nor the issuing entity. Therefore, Southbound Bond Connect may provide Chinese mainland Investors with a broader range of offshore bond investments.

VII. Comparison table of Northbound and Southbound Bond Connect

	Northbound Bond Connect	Southbound Bond Connect
Eligible investors	Offshore institutional investors	Chinese mainland institutional investor
Account opening	Offshore account opening with CMU	Onshore account opening with CCDC or SHCH
Eligible product scope	All cash bonds in CIBM	All bonds issued offshore and traded with liquidity in Hong Kong SAR (subject to any further rules or guidelines published by the regulators to further refine the scope)
Trading platform	All trades are executed on the CFETS RMB Trading System, which is accessible by offshore investors through Offshore Trading Platforms	Pending further clarification, all trades are executed on CFETS'electronic trading platform
Trading mechanism	RFQ	RFQs (with minor variations)
Investment quota	None	Subject to daily and aggregate quotas
Hedging instruments	Offshore investors may hedge foreign exchange exposure with foreign exchange settlement banks	Chinese mainland Investors may hedge their foreign currency risks through foreign exchange derivatives in China's interbank foreign exchange market

	Northbound Bond Connect	Southbound Bond Connect
Settlement structure	Adopts multi-tier custody structure - CMU acts as the single nominee of all offshore investors and holds one omnibus bond account with CCDC and SHCH. Offshore investors can open subaccounts with the CMU through a Hong Kong SAR custodian that holds CMU membership, or through their global custodian, who then appoints a Hong Kong SAR custodian for subaccounts handling. Cross-border cash settlement is completed through CIPS.	Chinese mainland Investors may hold and settle their Southbound Bond Connect trades through the Onshore CSD Settlement Route (using the settlement link between CMU and CCDC/SHCH) or Onshore Settlement Bank Route (the settlement structure under this route awaits further clarification but we expect it to be similar to the structure under the CIBM direct access regime). Southbound trading under the Onshore CSD Settlement Route is settled through CIPS.

VIII. Conclusion

Certain aspects of Southbound Bond Connect, such as the initial range of eligible bonds and the detailed trading, custody and settlement rules, await further clarification. In particular, we understand that the CCDC has yet to publish its implementation rules for Southbound Bond Connect. We will continue to work closely with the regulatory authorities and the relevant Financial Infrastructure Services Institutions and keep an eye on any regulatory updates. We expect to see further developments and innovations in Chinese mainland-Hong Kong SAR southbound investment brought about by Southbound Bond Connect.[12]

[12] List of Bond Connect dealers (including the excluded non-bank financial institutions and rural financial institutions), see https://www.kwm.com/content/dam/kwm/media/library/Files/PDF/2021/09/southbound-appendix-a.pdf; List of Offshore Market Makers (in alphabetical order), see https://www.kwm.com/content/dam/kwm/media/library/Files/PDF/2021/09/southbound-appendix-b.pdf.

HOW CAN LISTED COMPANIES IN HONG KONG ENGAGE IN THE VIRTUAL ASSET SECTOR? KEY THINGS TO KNOW

John Baptist Chan, Urszula McCormack, Carlton Ng

The recent wave of virtual asset sector institutionalisation has seen a special class of regulation become especially relevant – stock exchange listing rules. Many listed companies are interested in gaining exposure to virtual assets through directly holding virtual assets or through blockchain sector investments.

What are the rules governing listed companies in Hong Kong (HK Listed Companies) when making investments into virtual assets or venturing into virtual asset-related business activities? Further, what are the listing requirements for new listing applicants whose principal line of business involves virtual assets?

In this alert, we will examine some of the key things to know about Hong Kong's requirements for HK Listed Companies and potential listing applicants, focusing on the following key areas:

- Is the activity within the "ordinary and usual course of business"?
- Disclosure rules;
- Investment policies and governance;
- HK IPO (new listings).

I. Is the activity within the HK Listed Company's existing "ordinary and usual course of business"?

The key regulatory framework relevant to the activities of listed companies is set out in the rules and guidance of the Stock Exchange of Hong Kong Limited (HKEx). Overall, HK Listed Companies have a strong degree of latitude in relation to their investment and business activities in the "ordinary and usual course of business", subject to applicable disclosure rules (see section 2 of this article), governance standards (see section 3 of this article) and the general compliance with the requirements of the HKEx and the laws of the Hong Kong SAR (Hong Kong).

The concept of the "ordinary and usual course of business" is especially relevant because any transactions of HK Listed Companies outside such ambit will need to comply with the requirements under Chapter

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14 (Notifiable Transactions) of the Rules Governing the Listing of Securities on HKEx (Listing Rules). For more details, please refer to section 2 of this article.

Proprietary securities and/or investment activities (Proprietary Trading and Investment) conducted by HK Listed Companies will normally **not** be regarded as business carried out in the ordinary and usual course of business *unless* they are carried out by a banking company, an insurance company or a securities house that is mainly engaged in regulated activities. Of course, it is not uncommon for HK Listed Companies to make Proprietary Trading and Investment outside their ordinary and usual course of business, but they must comply with the Listing Rules.

(I) Are there any special rules for Proprietary Trading and Investment in virtual assets?

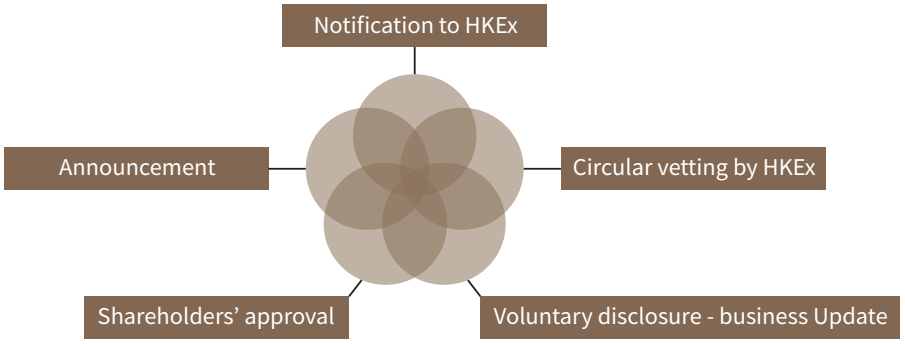
Not at this time. Proprietary Trading and Investment in virtual assets does not carry any special requirements under the Listing Rules. This means that there is a strong degree of latitude for compliance with the Listing Rules, although a degree of market practice is emerging and HK Listed Companies should consider what unique considerations apply (see more on this below).

Examples of virtual asset sector engagement by HK Listed Companies

- **From app operation to blockchain**: A HK Listed Company which operated online advertising and premium subscription services and in-app purchase business, announced that its board had purchased virtual assets with an aggregate consideration at the time of around US$40million, comprising Ether and Bitcoin. The same company later made another public announcement pursuant to Chapter 14 of the Listing Rules regarding its further acquisitions of virtual assets with an aggregate consideration of approximately US$90 million, which triggered the Listing Rules disclosure requirement (see section 2).
- **Building a new virtual asset business segment**: A HK Listed Company which operated a traditional advertising and business park area management business expanded its group activities to include blockchain sector businesses containing a Hong Kong-regulated exchange, custody services and software-as-a-service solutions. A joint venture involving the group and the venture arm of a leading bank was also recently announced with the aim of establishing a virtual asset platform for institutional and corporate clients in the United Kingdom and Europe.
- **Managing funds to investing in virtual assets:** A HK Listed Company which sells power-related and electrical/electronic products and provides technology solution services announced that it had launched four virtual asset-related funds, after obtaining its virtual asset manager licences from the Securities and Futures Commission of Hong Kong (the "**SFC**"). The virtual asset-related funds included two virtual asset tracker funds and a multi-strategy virtual asset fund, all of which were solely invested in virtual assets.

II. Disclosure requirements under the Listing Rules framework

Pursuant to Chapter 14 of the Listing Rules, HK Listed Companies may be required to satisfy the following key requirements, depending on the size, nature and counterparties involved in the transaction.



Under Chapter 14 of the Listing Rules, "transaction" includes, *inter alia*, the acquisition or disposal of assets; the definition of "assets" encapsulate both tangible and intangible assets and include businesses, companies and securities, whether listed or not (unless otherwise stated in the Listing Rules). Thus, by definition, as virtual assets would be considered intangible assets, their acquisition or disposal would be a transaction that would fall into the ambit of Chapter 14 of the Listing Rules.

As noted above, the specific rules that apply will depend on whether certain thresholds are met. For example, as disclosed in the announcement of one HK Listed Company, the aggregate consideration of both its acquisitions of virtual assets reached the threshold of an announcement, but did not reach the threshold of the shareholder approval requirement, therefore, no shareholders'approval was needed, nor was there a requirement to have the circular vetted by HKEx.

(I) Are virtual assets unique from a HKEx standpoint?

Given the relatively short history of investment in virtual assets, HKEx has yet to publish any specific guidelines or impose additional disclosure requirements for HK Listed Companies on this area. As at the date of this article, no HK Listed Company has reached the shareholders'approval threshold to issue circular which required to obtain clearance from the vetting team of the HKEx prior issuance. Therefore, it is still uncertain on the regulator's vetting attitude towards investment in virtual assets.

That said, virtual assets do carry a unique set of opportunities and risks, emphasizing the need for robust disclosure to the retail market. By way of example, the virtual asset sector experiences periodic volatility, and two key outcomes can emerge:

1. **Direct exposure** – If the HK Listed Company directly holds virtual assets, and the market value of those virtual assets drops significantly, the HK Listed Company could be undermined financially. The size of the investment, as well as the accounting treatment evaluating such loss, will be relevant to evaluate the risk exposure to shareholders.

2. **Indirect exposure** – If the HK Listed Company makes an investment into a company that has material virtual asset exposure and the market drops significantly and the investee company is forced to liquidate at a net loss, HK Listed Company shareholders would also be exposed to loss indirectly.

Arguably, the virtual asset sector is not wholly unique and the same principles apply to other types of investments – for example, even traditional sector stocks can be volatile and regular "bricks and mortar" businesses can fail through exposure to volatile *tangible* commodities. However, just as those risks must be assessed and properly disclosed, it is important to take into account that smart contract and distributed ledger technologies are still relatively new in the virtual asset sector and that many virtual assets and blockchain protocols are still in an experimental phase. On top of this, governance and regulatory frameworks are also in a phase of rapid development globally.

What this means for HK Listed Companies is that due diligence and expert support are essential to be able to make the right choices in any Proprietary Trading and Investment – including decisions on selecting virtual assets, acquisition, trading and liquidation strategies, custodial arrangements and third party trading venues. In addition, retail (and other) investors are likely to rely on HK Listed Companies for information about virtual assets and on the quality of HK Listed Companies'diligence. This heightens the risk of disputes for HK Listed Companies that do not adopt a prudent approach.

If virtual assets become a more common target of Proprietary Trading and Investment among HK Listed Companies, it would be especially useful for retail investors if HKEx issues additional guidance to standardise the approach to disclosure and scrutiny of these assets akin to the approach on ESG (see our Legal Guide to ESG[1] and April 2021 alert[2]

[1] https://www.kwm.com/en/hk/knowledge/downloads/2019/a-legal-guide-to-esg-and-creating-sustainable-financial-products-0522

[2] https://kwm.com/en/hk/knowledge/downloads/esg-and-sustainable-investment-in-hong-kong-20210412

on these issues). The SFC has also made significant strides in setting standards for its regulated entities, and more achievements will be released in succession.[3] Further afield, the Australian Securities and Investment Commission is also consulting on listed products that have virtual asset underlying.[4]

III. Investment policies and governance

Apart from complying with the disclosure requirements mentioned above, the directors of HK Listed Companies are required to fulfil their fiduciary duties and the duty of skill, care and diligence to a standard at least commensurate with the standard established by the laws of Hong Kong, which includes acting within the ambit and scope of the authorities granted to them pursuant to the HK Listed Companies' articles of associations.

Technically speaking, it is subject to interpretation whether a director is allowed to make investments in certain areas when no restrictions are imposed or specified in the articles of associations or terms of references for subordinate board committees (Constitutional Rules). Nevertheless, in order to enhance the standard of corporate governance, amending and explicitly stipulating the directors' authority in the Constitutional Rules to invest in virtual assets may be a more viable step to justify the board's decision to make such Proprietary Trading and Investment in the future, and may enable investment strategies for the Proprietary Trading and Investment to be seamlessly implemented.

For instance, one HK Listed Company approved and adopted a virtual asset investment plan for making acquisitions of virtual assets by cash reserves other than proceeds from its initial public offering.

From a corporate governance perspective, having considered the unique characteristics virtual assets marked with a relatively short trading history, HK Listed Companies may consider explicitly endorsing and approving any Proprietary Trading and Investment in virtual assets in their amended Constitutional Rules, which in turn would have to be considered by the shareholders and approved to grant explicit authority to the directors to make such investments. As foreshadowed in section 2, we would strongly recommend proper due diligence and expert involvement in defining the approach, as well as creating appropriate policies and procedures governing which assets are invested and how.

A similar approach could be taken for other blockchain sector investments and business expansions.

IV. New listings

HKEx adopts a disclosure-based approach and looks at a basket of requirements embedded in the Listing Rules when deciding whether to approve the listings of new applicants. HKEx also retains an absolute discretion in its decision[5] despite all such requirements having been met. Apart from the general listing requirements which all new listing applicants would need to meet, *inter alia*, financial requirements, suitability requirements and management and ownership continuity requirements, there are also other requirements which warrant new issuers' attention prior to the preparation of their IPO applications on the HKEx.

(I) Special HKEx guidance for internet-based business models

In July 2018, HKEx published a guidance letter to provide guidance on HKEX's approach to new listing applicants in the internet-based business models to facilitate their listing within the existing regulatory framework[6]. The special requirements for internet-based new listing applicants are summarised below. In particular, HKEx has highlighted how the lack of an established regulatory environment is an important element that would warrant higher level of disclosure. If the laws and regulators applicable to the new listing applicants are still developing and are not expected

[3] https://www.kwm.com/en/hk/knowledge/downloads/hong-kongs-proposed-pathway-to-fully-licensing-virtual-asset-exchanges-20201125

[4] https://www.kwm.com/en/au/knowledge/insights/asic-calls-for-submissions-on-treatment-of-crypto-assets-20210705

[5] Listing Rule 8.01

[6] Guidance Letter 97-18

to be promulgated in the near future – HKEx would expect such applicants to ensure that the disclosure of associated risks in the prospectus is sufficient. However, if it is clear in the circumstances of the case that draft regulations affecting the new listing applicant's business will be promulgated in the near future, HKEx will impose additional requirements and expect the new listing applicant to demonstrate, with the support of a local legal opinion, that it is able to comply with the requirements of the draft regulations in the event such are actually promulgated.

(II) What does this mean for virtual assets?

The HKEx guidance letter noted above is not specifically targeted at blockchain or virtual assets, but it does signal a regulatory attitude and expectations that are relevant to them. In particular, virtual asset regulations are rapidly unfolding in Hong Kong (with both strong SFC guidance and Hong Kong government proposals for a new regime underway), as well as in other major markets. An applicant (as well as established HK Listed Company) will therefore be expected to:

- understand the regulatory environment for their business and their investments – not just generically, but with specific reference to its specific objectives, strategies and activities; and
- consider the viability and sustainability of its business model. This may be especially relevant, for example, to applicants that are focused on a particular type of technology (say, virtual asset mining equipment) if market trends and technological advancements suggest that this will be obsolete because of competitor technologies or because the sector is moving in a different direction (say, proof of stake blockchain protocols that require a different approach).

To sum up

Virtual assets and related companies are likely to be a continuing trend, particularly as institutional-grade platforms and new regulatory frameworks support greater confidence to the market. Despite the lack of specific regulations for HK Listed Companies to engage in the sector, there are multiple existing principles that support Proprietary Trading and Investment and new listings related to the sector. Ultimately, due diligence, disclosure and governance are the key pillars for complying with HKEx expectations and avoiding unintended downside risk to shareholders.

The evolving regulatory environment in Hong Kong and other jurisdictions, coupled with the growth and maturing of blockchain infrastructure, is likely to have an especially large role to play in how HKEx, HK Listed Companies and investors assess the relative risks and opportunities.

FIRST PRC-LISTED SECURITIES FIRM TO CONDUCT A+H SHARES RIGHTS ISSUE

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In 2020, China Merchants Securities Co., Ltd. (China Merchants Securities) completed its HK$16.35 billion A+H Shares Rights Issue (China Merchants Securities Rights Issue), one of the largest A+H Shares Rights Issue since 2014 in terms of funds raised. This is also the first PRC-listed securities firm to conduct A+H Shares Rights Issue, the first transaction of its type in the market.

This article draws on the experience of our Hong Kong and Guangzhou team to share key highlights from advising China Merchants Securities on this first to market transaction.

I. Complex structure involving repurchase of A Shares subsequently used for ESOP

China Merchants Securities is a full-service securities firm in the PRC and a member of China Merchants Group. It is a state-controlled listed securities joint stock company incorporated in the PRC with limited liability, the A Shares and H Shares of which are listed on the Shanghai Stock Exchange (stock code: 600999) and on the Main Board of the Hong Kong Stock Exchange (stock code: 6099), respectively.

In March 2019, China Merchants Securities announced its plan for the repurchase of its A Shares (A Share Repurchase) to set up an Employee Stock Ownership Scheme (ESOP) and the China Merchants Securities Rights Issue (collectively the Transaction). Prior to the implementation of the China Merchants Securities Rights Issue, China Merchants Securities conducted the A Share Repurchase from 8 November 2019 to 19 December 2019.

China Merchants Securities is the first securities firm which successfully conducted repurchase of shares for the purpose of setting up an ESOP since the China Securities Regulatory Commission, the Ministry of Finance, and the State-owned

Assets Supervision and Administration Commission recently jointly issued the "*Opinions on Supporting Listed Companies to Repurchase Shares*" in 2018.

The A Shares were repurchased by China Merchants Securities using its own funds through the centralised bidding. The A Shares repurchased under the A Share Repurchase was then used for an ESOP which was adopted in January 2020.

The ESOP was formulated in accordance with the Company Law of the PRC, the Securities Law of the PRC, the *Guiding Opinions on the Pilot Implementation of Employee Stock Ownership Scheme by Listed Companies*, the *Opinions on Supporting the Repurchase of Shares by Listed Companies*, the *Notice on Issuing the Guidelines of Shanghai Stock Exchange for Information Disclosure for Employee Stock Ownership Plans of Listed Companies*, the *Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited*, and other applicable laws and regulations and normative documents as well as the relevant provisions of the Articles of Association.

The KWM team liaised with multiple relevant authorities to obtain all relevant approvals, and ensure all above relevant rules and regulations are complied with.

II. A Share Rights Issue and H Share Rights Issue

After the completion of the A Share Repurchase and the setting up of the ESOP, China Merchants Securities conducted a simultaneous A Share Rights Issue and H Share Rights Issue. The A Share Rights Issue and H Share Rights Issue were inter-conditional.

The China Merchants Securities Rights Issue was conducted to raise funds to strengthen the capital base of China Merchants Securities and for its continuing development and business growth.

III. Public float and Takeovers Code implications

At the outset, given the plan of the Transaction was announced in March 2019 where the details of the Transaction were subject to changes, there may be circumstances where shareholdings of the existing shareholders of China Merchants Securities may increase, which may in turn affect the public float of China Merchants Securities.

Further, given that (i) the A Share Rights Issue proceeded on a best effort basis and the H Share Rights Issue was fully underwritten; and (ii) China Merchants Securities' controlling shareholders and its parties acting in concert have undertaken to subscribe for Rights Shares to be issued by China Merchants Securities, the shareholding percentage of the controlling shareholders of China Merchants Securities may in certain

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circumstances increase by more than 2%. As a result, a mandatory offer may be triggered under the Takeovers Code. As the A Share Repurchase may constitute disqualifying transactions under the Takeovers Code, the timetable and offering structure have been tailormade to tackle the issue.

IV. Pioneers for Chinese mainland-Hong Kong SAR Southbound Trading arrangement

China Merchants Securities is one of the pioneers listed issuers with Chinese mainland-Hong Kong Southbound Trading arrangement. Mainland Southbound Trading Investors of China Merchants Securities could also participate in the H Share Rights Issue through ChinaClear.

ChinaClear provided nominee services for mainland Southbound Trading Investors to (i) sell (in full or in part) their Nil-paid H Rights on the Hong Kong Stock Exchange under the Shanghai-Hong Kong Stock Connect and the Shenzhen-Hong Kong Stock Connect; and/or (ii) subscribe (in full or in part) for their pro-rata entitlement in respect of Shares held on the H Share Record Date at the Subscription Price under the H Share Rights Issue in accordance with the relevant laws and regulations.

It should be noted that ChinaClear does not support applications by such mainland Southbound Trading Investors for excess H Rights Shares under the Rights Issue through Shanghai- Hong Kong Stock Connect or Shenzhen-Hong Kong Stock Connect.

Mainland Southbound Trading Investors (or the relevant ChinaClear participants as the case maybe) whose stock accounts in the ChinaClear are credited with nil-paid H Rights Shares can only sell those nil-paid Rights Shares on the Hong Kong Stock Exchange via ChinaClear under Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect and can neither purchase any Nil-paid H Rights nor transfer such Nil-paid H Rights to other Mainland Southbound Trading Investors.

V. Overseas investors in over 20 jurisdictions

With overseas investors in over 20 jurisdictions, China Merchant Securities was required to make enquiries regarding the legal restrictions under the laws of all these relevant jurisdictions and the requirements of the relevant regulatory body or stock exchange as to feasibility of extending the H Share Rights Issue to these overseas shareholders. China Merchant Securities could only exclude such overseas shareholders on the basis that, having made such enquiry, it would be necessary or expedient to do so.

In this regard, the firm assisted China Merchant Securities in obtaining legal advice from over 20 jurisdictions, including but not limited to Australia, Bermuda, British Virgin Islands, Canada, Germany, Japan, Liechtenstein, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Portugal, the PRC, Singapore, South Africa, South Korea, Switzerland, the United Kingdom and the United States.

Conclusion

The China Merchants Securities A+H Share Rights Issue marks the first PRC-listed securities firm to conduct A+H Share Rights Issue.

Members of our Hong Kong and Guangzhou offices, worked seamlessly to offer one-stop-shop support and knowledge in respect of the PRC and the US laws and our Perth office, London office, Frankfurt office, Tokyo office and Beijing office provided support on the overseas legal opinion on the legal restriction of conducting H Share Rights Issue across these overseas jurisdictions, including Australia, England, Germany, Japan, the PRC and the United States.

OPEN BANKING MOVES FORWARD IN HONG KONG - IMPLEMENTATION OF PHASE III AND IV OF THE OPEN API FRAMEWORK

Richard Mazzochi, Peter Bullock, Urszula McCormack, Alison Leung, Nikita Ajwani

The Open Application Programming Interface (Open API) Framework for the Banking Sector is one of the seven Smart Banking initiatives announced by the Hong Kong Monetary Authority (HKMA) in September 2017. Following an industry consultation on a draft Open API Framework with participants from banks, industry associations and other stakeholders, the HKMA published the final Open API Framework in July 2018.

In this alert, we provide an update on:

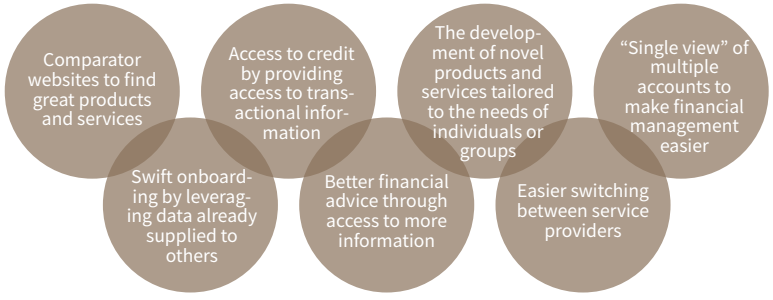
- why Open APIs are relevant and the role they can play;
- Hong Kong's framework and key developments;
- our recommendations for the critical upcoming phases; and
- a snapshot of other market developments.

I. A short primer

In short, APIs are "pipes" that enable the exchange of information and various functions to occur between different computer systems. This can already be done at multiple levels, for multiple purposes and between parties on a privately agreed basis. However, "Open APIs" broadly refer to enabling third party access to certain computer systems and information in an open, documented manner with the imprimatur or encouragement of a regulator.

In the context of the banking industry, this often relates to accessing valuable product, service, personal or transactional information to facilitate collaboration, competition and other consumer interests through data portability.

By way of example, APIs can facilitate:



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APIs also have a role to play in rapidly emerging areas of finance, such as the issuance and redemption of stablecoins.

Hong Kong's development of an Open API Framework

In Hong Kong, an industry-wide Open API Framework seeks to enable collaboration between banks and third-party service providers (TSPs) in developing innovative and integrated banking services that can improve customer experience, thereby maintaining the competitiveness and relevance of the Hong Kong banking sector. The HKMA has adopted a risk-based principle and a four-phased progressive implementation approach.

The four phases are summarised as below.

Phase	Open API functions	Examples / description
I	**Product information**	Deposit rates, credit card offerings, service charges and other public information
II	**Customer acquisition**	New applications for credit cards, loans and other products
III	**Account information**	Account balance, credit card outstanding balance, transaction records, credit limit change and others
IV	**Transactions**	Payment and transfers *This phase will cover the Faster Payment System (FPS) App-to-app payments.*

- **Phases I and II** were launched in January and October 2019 respectively.
- **Phases III and IV** – the HKMA announced that these phases will be implemented progressively **from December 2021**, and there have been ongoing consultations and discussions with stakeholders and market players on implementation details.

Two sets of guidance documents regarding Phases III and IV are expected to be published **by the end of 2021**:

1. a set of standards covering key areas including customer experience and authentication, technical and data standards, information security, and operation standards (Standards); and
2. the Common Baseline[1] developed by the Hong Kong Association of Banks (HKAB), which currently covers only Phase II, will be refined to include the scope of Open API Phases III and IV implementation.

This is an opportune time for banks and TSPs to refresh and evaluate any plans for development. This article provides an overview on the status of, and summarises the implementation plan for, Phases III and IV.

II. Where is Hong Kong at right now?

The HKMA commissioned an external consultant to analyse and prepare a study report regarding the implementation of the Open API Framework, titled "the Next Phase of the Banking Open API Journey"[2] ("Study Report"). Key findings are below.

[1] https://www.hkab.org.hk/DisplayArticleAction.do?sid=5&ss=22

[2] https://www.hkma.gov.hk/media/eng/doc/key-functions/ifc/fintech/The_Next_Phase_of_the_Banking_Open_API_Journey.pdf

(I) Adoption status – Phases I and II

There has been a high adoption rate of Phase I and II, with more than 20 participating banks[3] having launched over 800 Open APIs covering a wide range of banking products and services as of May 2021. The most adopted categories of Phase I and II retail banking use cases include:

Product and service information enquiries from third-party websites	Real-time product and service comparisons	Streamlining of product and service subscriptions
eg. enquiries about branch locations, mortgage rates or foreign exchange rates	eg. comparisons of time deposit interest rates, foreign exchange rates or travel insurance products	eg. applications for mortgages, credit cards or loans

(II) Adoption status – Phase III and IV

A number of banks proactively advanced banking Open API prior to the announcement of the implementation timeline for Phases III and IV. The most popular Phase III and IV retail use cases launched by these banks include:

Account information aggregation services	Transaction initiation services
eg. consolidation of data from different bank accounts to enable a one-stop view for better financial management	eg. pay-with-points or loyalty points redemption on merchant sites

III. Phases III and IV implementation

Based on the recommendations in the Study Report, the HKMA has decided to adopt a progressive approach in implementing Phase III and IV API functions. The aim is to lower the overall implementation costs and risks and at the same time incrementally increase customers'confidence.

The initial batch of Phases III and IV Open API functions include:

1. **deposit account information**, which covers read-only access to selected deposit account information, including account availability, account status, account balance and transaction details for retail and corporate customers; and
2. **online merchant payments**, which cover Faster Payment System (FPS) app-to-app payments.

The target go-live dates for Phases III and IV implementation of each of the 28 participating banks are available on the HKMA website[4].

By the end of 2021, the Standards and the Common Baseline are expected to be published to promote the secure and efficient implementation of Phases III and IV.

[3] The list of participating banks (and other information on the Open APIs) can be found in the Data Studio of the Hong Kong Science and Technology Parks.

[4] https://www.hkma.gov.hk/eng/key-functions/international-financial-centre/fintech/open-application-programming-interface-api-for-the-banking-sector/target-dates/

IV. Recommendations and practical considerations in implementing Phases III and IV

(I) Closely monitor the development of the Standards and the Common Baseline

Importantly, banks and TSPs should closely monitor the development of the Standards and the Common Baseline which will provide detailed guidance on the Phases III and IV implementation.

1. Standards

TSPs should continuously comply with the Standards to ensure the security of customer data, fast rollout of new products and services and low implementation costs.

The HKMA will facilitate the HKAB to develop the Standards to address the issues of high implementation costs due to the varying technical standards across banks.

2. Common Baseline

It is expected that the Common Baseline may refine certain key areas to cover Phases III and IV having regard to common international practices, so that TSPs are subject to enhanced obligations, including:

Key areas	Examples
Data protection	To demonstrate that they have in place consent management capabilities (eg. to obtain consent, and to comply with a customer's withdrawal of consent) so as to protect customers against the sharing of data without their explicit consent when using banking Open API services. To have in place appropriate authentication methods to protect the customers' identity against unauthorised access.
Customer care and business practices	Common Baseline can provide further worked examples or principles relating to complaint management mechanisms (eg. the accessibility of TSPs'complaint handling procedures to customers) to specify the requirements or expectations of the banking sector.
Technology risk management and cybersecurity	To ensure their policies and procedures adhere to the security measures set out in the Standards. To adopt adequate security controls or measures to protect sensitive customer data.
TSP governance and general risk management policies and procedures	To have in place specific policies and procedures relevant to the risks associated with their business having regard to international best practices (eg. a risk management plan to mitigate money laundering risks or fraudulent activities in providing banking Open API transaction services).

(II) Other recommended practices

In addition, banks and TSPs should also consider the following recommended practices before implementing Phases III and IV:

1. Adopting risk management strategies

This should involve regular review of risk management frameworks to ensure risks associated with cybersecurity, system resilience, data privacy, liability, and fraud and money laundering are addressed, and constant monitoring of those risks using these frameworks.

2. Introducing appropriate protection mechanisms

This should involve mitigation of risks, and adoption of protection measures to address key areas of data protection and retention, customer consent, disclosure and transparency, liability, complaint handling, etc.

3. Designing compelling propositions for customers

This should involve designing customer-centric propositions, with the aim to foster trust towards TSPs, educate customers, satisfy market needs and drive adoption of banking Open APIs.

4. Understanding the range of bank capabilities required

This should involve adopting a federated operating model, with a robust core system and technical enablers (eg. API portals), to ensure secure and efficient implementation of Phases III and IV.

5. Understanding the range of TSP capabilities required

TSPs should have a well-defined operating model, strong data management, and information security capabilities that commensurate their business.

6. Selecting one or more appropriate business / finance models

Banks and TSPs should develop a suitable monetisation strategy with a range of direct and indirect monetisation models which can be adopted according to the use cases they choose to implement.

7. Monitoring the ecosystem

To ensure reliability of banking Open APIs, banks and TSPs should have in place appropriate monitoring mechanisms for fraud monitoring, API availability and performance monitoring.

V. What is happening in other jurisdictions?

(I) Value propositions offered and a comparison with the UK

In Hong Kong, there are 33 TSPs as of the date of this alert.[5] These TSPs consist of mortgage and real state agencies, stored value facilities issuers, travel agencies and a number of retail stores which provide customer loyalty programmes or rewards programmes (including convenience stores, supermarkets and cinemas).

In comparison, the vibrant Open API ecosystem in the UK may give you an insight into the possible future for Hong Kong.

In the UK, there were more than 300 third party providers and 8 million API calls per month in Q2 2021.[6] These third party providers consist of a wide range of companies, and more than 230 of these third party providers are regulated in or outside the UK.[7] Key value propositions offered by third party providers include (for individuals) personal finance

[5] See the list of participating TSPs in the Data Studio.

[6] See https://www.openbanking.org.uk/fintechs/

[7] See https://www.openbanking.org.uk/regulated-providers/?query=directories&filter-search=&filter-provider-type=third-party-providers&filter-sort=0.

tools, bank account aggregators, product comparison, credit file enhancements, micro-savings, financial safeguarding, etc; and (for small medium size enterprises) financial management, eCommerce payments, accountancy and tax, cash flow management, loans and alternative lending, identity verification, debt management, etc.[8]

We summarised a number of other key aspects of the UK framework in our June 2019 alert[9].

(II) Australia is also a few steps ahead

In Australia, the Competition and Consumer (Consumer Data Right) Rules (Consumer Rights Rules) were recently amended to provide greater control and choice to consumers in sharing their data, promote innovation, and provide businesses with new opportunities to participate in the Consumer Rights Rules regime.

To learn more about the approach and consumer protection measures adopted by Australia when implementing open banking, please refer to the following alerts: *A more accessible Consumer Data Right*[10]*, Future Directions for Consumer Data Right Report Released*[11]*, Building on the Consumer Data Right to grow Australia's digital economy*[12]

(III) Other key markets

Hong Kong SAR of the PRC, the UK and Australia are not alone, with Open API ecosystems developing in jurisdictions such as Canada, Mexico, Brazil and the United States.

The sharing of data is also an implicit part of cross-border and cross-boundary initiatives such as Wealth Management Connect, albeit through different channels. Importantly, such data transfers need to sensibly navigate data transfer restrictions, whilst complying with regulatory requirements – this can pose an especially critical challenge to navigate through strong data mapping.

[8] See page 21 of the annual report of OBIE.

[9] https://www.kwm.com/en/au/knowledge/insights/open-banking-convergence-new-offshore-frameworks-reveal-shared-thinking-on-data-sharing-20190626

[10] https://www.kwm.com/en/au/knowledge/insights/a-more-accessible-consumer-data-right-20211019

[11] https://www.kwm.com/en/au/knowledge/insights/future-directions-for-consumer-data-right-report-released-20210112

[12] https://www.kwm.com/en/au/knowledge/insights/building-on-the-consumer-data-right-to-grow-australias-digital-economy-20200309

SECURITY OF PAYMENT IN HONG KONG: CHANGES COMMENCE FROM DECEMBER 2021

Donovan Ferguson, Lucinda McPhee, Christopher Seaman, Dong Long

I. Introduction

Security of Payment (SOP) regimes have been enacted via legislation in numerous jurisdictions around the world, as a means of ensuring that construction industry participants working in those jurisdictions are paid on time, and in accordance with their contractual rights. SOP legislation is recognised as being a relatively effective way of ensuring that contractors and sub-contractors can maintain healthy cash flow.

The Hong Kong construction industry has been considering implementing SOP legislation for over 10 years now. Recently the Hong Kong government took its biggest step yet by releasing Technical Circular (Works) No.6/2021[1] (Circular) that has the effect of introducing mandatory SOP provisions into Public Works Contracts. Whilst we still do not have an indication of when the long-anticipated SOP legislation might be enacted, the introduction of these provisions is intended to be a *trial run* before the government enacts that legislation.

Depending on the type of Public Works Contract, these changes come into effect for contracts for which the tender invitations are issued after **31 December 2021** or **1 April 2022**.

II. The key changes

(I) SOP Framework

While the specifics of the SOP legislation that the government intends to enact are still being finalised, the Circular relevantly includes, in Annexure A, a "Security of Payment Framework" ("SOP Framework") that gives a good overview of the key mechanisms that are intended to be implemented in the SOP legislation, when it is enacted.

The four mandatory requirements of the SOP Framework, that parties **will not** be able to contract out of when the SOP legislation is implemented, are:

1. **Due dates:** a Respondent will have 30 days following receipt of a Payment Claim to serve a Payment Response, and 60 days to pay the admitted amount.

[1] https://www.devb.gov.hk/filemanager/technicalcirculars/en/upload/386/1/C-2021-06-01.pdf

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2. **Conditional payment provisions**, or "pay-when-paid" clauses will be rendered unenforceable.

3. **Referral to adjudication:** a Claimant may refer a dispute about payment to adjudication, and the Adjudicator must determine the dispute (and the amount payable to the Claimant) within 55 days of being appointed.

4. **Suspension / go-slow rights:**, a Claimant that has not been paid an amount which the Respondent admits is due, or an amount the Adjudicator has decided is owing, may suspend work or reduce its rate of progress.

(II) ACC and SCC provisions to be incorporated

The Circular also includes, in Annexures B to H, Additional Conditions of Contract (ACC) and Special Conditions of Contract (SCC) that are intended to implement "*the spirit of the SOP legislation*" (in line with the SOP Framework).

These ACC and SCC will be incorporated into contracts and sub-contracts for Public Works projects tendered from 31 December 2021, onwards.

The most significant ACC and SCC provisions can be found in Annex B and Annex C of the Circular.

III. Features of the adjudication process

The most significant features of the adjudication process that are foreshadowed in the SOP Framework and incorporated in the key ACC and SCC provisions are set out below.

(I) The reference date and the Payment Claim

A reference date is the date from which a Claimant is entitled to make a Payment Claim to commence the adjudication process. A Claimant will be entitled to submit a single Payment Claim for each reference date, which will generally arise at the end of the month, or at the end of a milestone period. There are strict rules that apply to the Payment Claim; it must:

1. be in writing;

2. identify the construction work or related goods and services to which the payment claim relates;

3. state the amount of the progress payment which is claimed to be payable; and

4. not include any amount that is the subject of an ongoing adjudication.

Interestingly, there is no requirement for a Payment Claim to be specifically endorsed as such for the purpose of the SOP regime: a requirement in many other jurisdictions. This is important. It means that those receiving documents that could qualify as Payment Claims, at all tiers, should treat each claim for payment as possibly engaging the SOP regime, and act on it accordingly.

Relevantly, Payment Claims under the SOP regime can include contractual claims for payment for extensions of time. The Circular addresses this issue in some detail.

(II) The payment response

After receiving a Payment Claim, the Respondent has 30 days (or an earlier agreed timeframe) to serve a "Payment Response". Again, there are strict formal requirements which must be followed, and the Payment Response must:

1. be in writing and identify the Payment Claim;

2. state the amount accepted as due and the basis for the calculation;

3. state the amount disputed as due, the grounds for the dispute and the basis for the calculation;

4. state the amount, the grounds for and the basis of the calculation of any amount to be set off or withheld; and

5. state the net amount to be paid and the calculation of the amount.

It is critical that the Respondent submits the Payment Response and provides any reasons for non-payment at this stage. This is because a Respondent cannot raise any set-off claim later in the adjudication proceedings if it has not submitted a Payment Response.

(III) The payment dispute

A central feature of the SOP Framework is the concept of the "Payment Dispute"; the right to refer a dispute to adjudication hinges upon the existence of a Payment

Dispute. A Payment Dispute will generally arise when:

1. a Payment Claim is disputed (in whole or in part) through a Payment Response;
2. the Respondent has admitted the amount claimed is due, but has failed to make payment; or
3. the Respondent has failed to serve a Payment Response by the due date (30 days, unless an earlier date is agreed).

Although this sounds straightforward, the position is complicated in that a Payment Dispute will not arise in relation to that Payment Claim until the "**claim handling procedure**" under the contract has been complied with. Broadly speaking, this means that the contractual process for assessing claims must be completed before any further steps can be taken. Ambiguities about whether and when the claim handling procedure has been complied with could present an obstacle for parties wanting to move forward with the adjudication process. This is an unusual feature of the SOP Framework and one we expect to be carefully considered as part of drafting of contracts and sub-contracts.

(IV) Referral to adjudication and the adjudication submission

The next step in the adjudication process involves the disgruntled Claimant referring the Payment Dispute to adjudication. To do so, a Claimant must serve a "notice of adjudication" on the Respondent and the adjudicator nominating body within 28 days of when the Payment Dispute arose.

An Adjudicator will then be appointed within 5 working days. Once an Adjudicator is appointed, the Claimant will have only 1 business day to serve an "Adjudication Submission". This is, in essence, the Claimant's case, and needs to include the submissions and arguments relied upon as well as any supporting documents and evidence. **This is an incredibly tight time frame,** given we expect a contested Adjudication Submission in relation to a complex construction project to include legal submissions, witness evidence and possibly expert evidence.

(V) The adjudication response

After it has received an Adjudication Submission, the Respondent has 20 working days to serve its "Adjudication Response". In a similar way to the Adjudication Submission, the Adjudication Response must include the submissions and arguments relied upon as well as any supporting documents and evidence. This is another incredibly tight frame and it will be fundamental to deploy the necessary resources quickly and to the right areas to maximise the use of time. Any delay here will be costly.

(VI) The adjudicator's powers and the adjudication process

The SOP Framework and the key ACC and SCC provisions set out the rules for how the adjudication is to be conducted, and what powers the Adjudicator will have in deciding how much is payable to the Claimant. The Adjudicator will not be bound by the same rules of evidence as would apply to court proceedings; they will have broad powers including the ability to call a conference and question any of the parties.

Our experience in other jurisdictions is that the adjudication process is often carried out "on the papers". This means that there will be no hearing and the adjudicator will decide the issue on written submissions only. However, it remains to be seen whether the practice of conferences will be adopted in Hong Kong.

(VII) What about costs?

With respect to costs, unlike court or arbitration proceedings, it is **not** possible to recover legal costs of the adjudication. This means each party is responsible for its own costs. The Adjudicator will charge a fee and can determine to apportion those costs in a manner which he/she sees fit.

(VIII) The Adjudication Decision

The Adjudicator has 55 working days to deliver an Adjudication Decision to the parties, which must determine:

1. the amount to be paid to the Claimant;
2. the due date for payment; and
3. the proportion of Adjudicator's fees payable by each party.

(XI) What happens if a party is unhappy with the Adjudication Decision?

It is almost inevitable that from time to time, an unhappy party will want to challenge an Adjudication Decision.

Because the SOP Framework that is incorporated in the key ACC and SCC provisions is a creature of contract, and not statute, parties will not be entitled to apply to the Court to overturn or enforce Adjudication Decisions (as they are in other jurisdictions where SOP legislation has been enacted).

Under the ACC and SCC provisions, an Adjudication Decision will be final and binding, on an interim basis, until the Payment Dispute is resolved in writing between the parties, or the Payment Dispute is decided by the dispute resolution mechanism set out in the main contracts/sub-contracts. Parties trying to enforce an Adjudication Decision are limited to making claims for direct payment or exercising their rights to suspend work.

Although the Circular does anticipate that the SOP legislation will allow the Claimant or Respondent to apply to the Court to set aside the Adjudication Decision within 14 days of delivery of the Decision, no guidance has been released so far as to what grounds either party would have to mount such a challenge.

IV. Procedural requirements

The SOP Framework that is incorporated in the key ACC and SCC provisions also introduces several procedural/ administrative requirements that contractors and sub-contractors will need to be aware of.

(I) Mandatory sub-contract conditions

The main contractor will be required to ensure that the mandatory SOP provisions in Annex D of the Circular are contained in relevant sub-contracts and must also take all reasonable steps to ensure that sub-contracts at lower tiers (i.e. sub-sub-contracts) contain the necessary provisions. Sub-contractors have similar back-to-back obligations.

(II) Additional reporting requirements

The main contractor is required to submit copies of its construction sub-contracts to the Employer's Representative. It is envisaged that a technical audit could be carried out by the responsible Works Department for the purpose of ensuring all contract documents comply with the SOP regime.

Throughout the course of a project, the main contractor will also be required to report on a monthly basis to the Employer's Representative as to whether any notices of adjudication have been served, and the status of payment or settlement of any adjudicated amounts.

(III) Directing payments from the employer

Where a party at any of the contracting tiers is successful in obtaining an adjudication decision from its counter-party, and the whole or part of the adjudicated amount is not paid, the aggrieved party can request for the Employer to make direct payment of the outstanding amount. There is also a right to direct payment from the Employer where a subcontractor at any higher tier to the Claimant has an insolvency event occur to it. Where the necessary conditions for payment have been met, the Employer will make payment to the lower-tier sub-contractor and charge that amount to the contractor.

(IV) Requirement to display site notices

To ensure transparency and accountability at all contracting levels (and to allow lower-tier sub-contractors to properly engage in the process of directing payments from the Employer), a Contractor will be required to display a Site Notice in an approved form (found in Annex H of the Circular) that contains information including the contact details of the Employer and the Main Contractor.

V. What can you do to prepare for these changes?

The mandatory contractual provisions will require careful consideration by contractors, of all tiers, working on Public Works projects that are tendered after December 2021. It will be important to ensure that sub-contracts are compliant and that contract administrators are prepared to handle adjudication claims, and comply with various notice requirements. It is also crucial that parties are aware of their rights to suspend works and make and defend claims for direct payment.

WEALTH MANAGEMENT CONNECT LAUNCH IN OCTOBER 2021

Richard Mazzochi, Minny Siu, Yu Leimin, Mu Mu (David) , Agnes Chan

I. Background

After almost two years of market expectation, we welcome the release by the Hong Kong Monetary Authority (HKMA) of the final version of the "Implementation Arrangements for the Cross-boundary Wealth Management Connect Pilot Scheme in the Guangdong-Hong Kong-Macao Greater Bay Area" ("Hong Kong Implementation Rules")[1] on 10 September 2021.

On the same day, the Guangzhou Branch of the People's Bank of China (PBOC), Shenzhen Central Sub-branch of PBOC, Guangdong Supervision Bureau of China Banking and Insurance Regulatory Commission (CBIRC), Shenzhen Supervision Bureau of CBIRC, Guangdong Supervision Bureau of China Securities Regulatory Commission (CSRC) and Shenzhen Supervision Bureau of CSRC issued the final version of the "Implementation Arrangements for the Cross-boundary Wealth Management Connect Pilot Scheme in the Guangdong-Hong Kong-Macao Greater Bay Area" ("mainland Implementation Rules")[2].

The Hong Kong and mainland Implementation Rules are substantially based on the earlier consultation drafts published in May 2021 with only slight adjustments[3].

The Cross-boundary Wealth Management Connect (Wealth Management Connect) will soon operate across the GBA, with launch by the first batch of participating banks being initiated in October 2021.

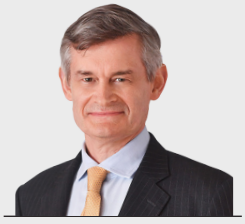
According to the Hong Kong Implementation Rules, eligible banks in Hong Kong which intend to embark on the Wealth Management Connect business must submit a self-assessment to the HKMA at least one month prior to the launch[4]. Hong Kong banks may only commence that business

[1] Available at https://www.hkma.gov.hk/eng/regulatory-resources/regulatory-guides/circulars/.

[2] Available at http://guangzhou.pbc.gov.cn/guangzhou/129142/129156/129119/4337736/index.html/.

[3] The consultation draft of the mainland Implementation Rules "Implementation Arrangements for the Cross-boundary Wealth Management Connect Pilot Scheme in the Guangdong-Hong Kong-Macao Greater Bay Area (《关于＜粤港澳大湾区"跨境理财通"业务试点实施细则＞公开征求意见的通知》)" (dated 6 May 2021) is available at http://guangzhou.pbc.gov.cn/guangzhou/129142/129156/3833128/4243943/index.html (Chinese only).

[4] Under the Hong Kong Implementation Rules, registered institutions registered under the Securities and Futures Ordinance (Cap. 571, The Laws of Hong Kong) ("**SFO**") for carrying on Type 1 regulated activity (dealing in securities), and engaging in retail banking or private banking business are eligible banks in Hong Kong.



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upon receiving "no objection" notification from the HKMA.

The mainland Implementation Rules took effect after 10 October 2021. Eligible mainland banks must complete their system assessment and filing under the supervision and guidance of the mainland regulatory authorities before launching.

This article summaries the important information about the Wealth Management Connect.

II. Wealth Management Connect – Southbound and Northbound

As mentioned in our article entitled "Greater Bay Area Series – Framework for the Wealth Management Connect announced" (July 2020)[5], the Wealth Management Connect refers to an arrangement under which individual residents in the Guangdong-Hong Kong-Macao Greater Bay Area (**GBA**)[6] carry out cross-boundary investment in wealth management products distributed by banks in the GBA.

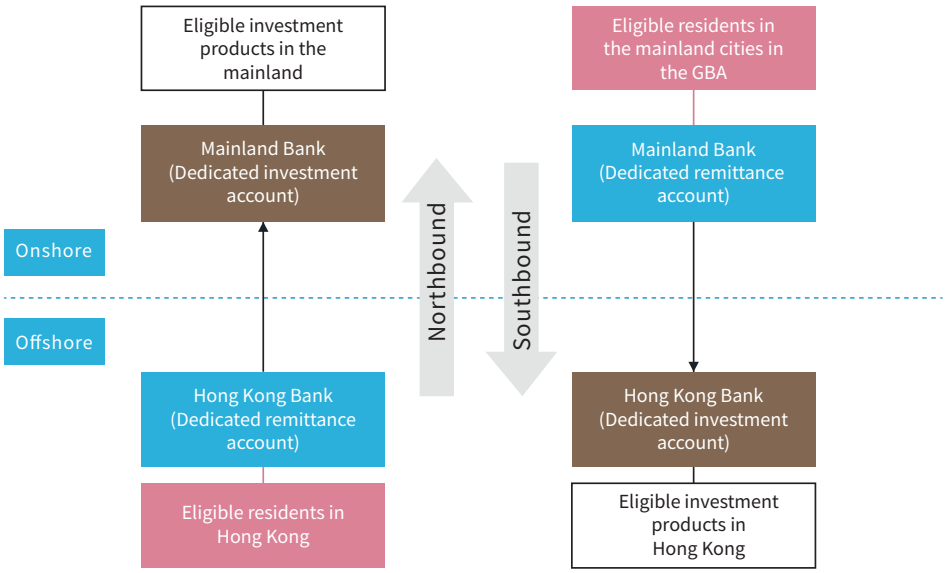
The Wealth Management Connect between Hong Kong and mainland consists of the Southbound Scheme and the Northbound Scheme:

- under the Southbound Scheme, eligible residents in the mainland cities in the GBA invest in wealth management products distributed by banks in Hong Kong (**Hong Kong Banks**) via designated channels.
- under the Northbound Scheme, eligible residents in Hong Kong invest in wealth management products distributed by banks in the mainland cities in the GBA (**Mainland Banks**) via designated channels.

The diagram below illustrates investment flows of the Southbound Scheme and the Northbound Scheme:

[5] Available at https://www.kwm.com/en/hk/knowledge/insights/gba-series-wealth-management-connect-20200706.

[6] The Guangdong-Hong Kong-Macao Greater Bay Area ("GBA") comprises the two Special Administrative Regions of Hong Kong and Macao, and the nine municipalities of Guangzhou, Shenzhen, Zhuhai, Foshan, Huizhou, Dongguan, Zhongshan, Jiangmen and Zhaoqing in Guangdong Province. This may be subject to change from time to time.



III. Key features

Key features of the Wealth Management Connect are highlighted below:

(I) Scope of eligible investors – residents in the GBA

Eligible individuals in the mainland cities of the GBA and Hong Kong can personally (but not in joint names) make cross-boundary investments through the Wealth Management Connect.

1. The Southbound Scheme

According to the mainland Implementation Rules, eligible mainland investors must meet the following requirements:

1) having full capacity for civil conduct;

2) having household registration in any of the 9 mainland cities in the GBA or having paid social security or personal income tax in any of the 9 mainland cities in the GBA continuously for at least 5 years;

3) having more than 2 years of investment experience and an end-of-month balance of household financial net asset which is not less than Renminbi 1 million in the last 3 months, or having an end-of-month balance of household financial asset which is not less than Renminbi 2 million in the last three months; and

4) using their own funds to purchase investment products.

2. The Northbound Scheme

All Hong Kong residents (including permanent and non-permanent residents) who hold a Hong Kong identity card and who are assessed by a Hong Kong Bank as not being a vulnerable customer are eligible to participate in the Northbound Scheme.

3. Vulnerable customers

The Hong Kong Implementation Rules specify that Hong Kong Banks should conduct an assessment according to the

relevant guidelines issued by the HKMA to ensure each investor is not a vulnerable customer before providing Wealth Management Connect services to the investor[7]. This applies to both the Southbound and the Northbound Schemes. If, however, an existing customer becomes a vulnerable customer due to a change in personal circumstances, the Hong Kong Bank can continue to provide the Wealth Management Connect Service by implementing certain enhanced protection measures.

(II) Eligible investment products – simple and "low" to "medium" risk products

1. Southbound Scheme

According to the Hong Kong Implementation Rules, eligible wealth management products under the Southbound Scheme (i.e. Hong Kong wealth management products available for residents in the mainland cities in the GBA to invest) include:

1) investment products (excluding products listed and traded on the Hong Kong Exchanges and Clearing Limited)

The following products, which are assessed as "low" risk to "medium" risk and "non-complex" by Hong Kong Banks distributing such products:

a) funds domiciled in Hong Kong and authorised by the Securities and Futures Commission (SFC); and

b) bonds; and

2) deposits[8] – Renminbi, Hong Kong currency and foreign currency deposits[9]

The first category (i.e. Hong-Kong-domiciled funds authorised by the SFC) presents significant business opportunities for Hong Kong based fund managers as it may lead to an expansion in the retail client base - there being over 70 million people in the GBA[10]. There is room for structuring a Hong Kong-domiciled fund to contemplate different underlying investments or asset classes, provided that the fund is assessed to have a "low" to "medium" risk rating.

Certificate of Deposits (CD) may potentially qualify as an eligible investment product if the CD is assessed as "low" risk to "medium" risk and "non-complex" and is not a structured deposit.

If a wealth management product is denominated in a currency other than Renminbi, the investor must convert Renminbi into the relevant foreign currency in Hong Kong and will be exposed to currency exchange risk. According to the mainland Implementation Rules, all cross-boundary remittances of the Wealth Management Connect must be conducted in Renminbi only and any FX/CNY currency conversion must take place in Hong Kong. It is therefore crucial to remind mainland investors of the currency exchange risk associated with their investments under the Southbound Scheme.

2. Northbound Scheme

Under the Northbound Scheme, onshore mainland wealth management investment products available for Hong Kong

[7] For more details, please refer to section (A)(III.2) of Annex 1 to the circular issued by the HKMA on 25 September 2019 entitled "Investor Protection Measures in respect of Investment, Insurance and Mandatory Provident Fund Products", available at: https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2019/20190925e2.pdf.

[8] Please refer to the definition of "deposits" in the Banking Ordinance (Cap. 155, The Laws of Hong Kong) (BO). For the purpose of the Hong Kong Implementation Rules, deposits are regarded as wealth management products. For the avoidance of doubt, "deposits" as referred does not include structured deposits.

[9] In its "Frequently Asked Questions on the Cross-boundary Wealth Management Connect in the Guangdong-Hong Kong-Macao Greater Bay Area" (dated 10 September 2021) ("FAQs"), the HKMA recommended that besides Renminbi and Hong Kong currency, eligible deposits offered by Hong Kong Banks be denominated in one of the following currencies: Australian dollar, Canadian dollar, Euro, Japanese Yen, New Zealand dollar, Singapore dollar, Swiss Franc, UK Pound Sterling and US dollar. The FAQs are available at https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2021/20210910e1a3.pdf.

[10] With a population of over 70 million, the GBA has a combined GDP of US$1.6 trillion, greater than some of the G20 economies; and its per-capita GDP of US$23,000 is comparable to some middle-income countries. For more details, please refer to the HKMA's inSight "Wealth Management Connect Scheme in the Greater Bay Area" (dated 10 September 2021), available at https://www.hkma.gov.hk/eng/news-and-media/insight/2020/06/20200629/.

residents to invest include:

a) publicly offered fixed income and equities wealth management products (except cash management financial products) issued by Chinese mainland wealth management companies (including wealth management subsidiaries of PRC banks, and Sino-foreign wealth management joint venture companies), which are assessed by the issuers and mainland banks to be of "level 1" to "level 3" risk ratings[11]; and

b) publicly offered securities investment funds assessed by mainland public fund managers and the mainland Banks with a risk rating of "R1" to "R3".

(III) Account opening via attestation permitted under the Southbound Scheme

Under both the Southbound and Northbound Schemes, investors must designate a local account as the dedicated remittance account. After a local bank has reviewed the requisite application documents, investors may open a dedicated investment account with a designated bank in the other jurisdiction.

In respect of the Southbound Scheme, regardless of whether an eligible mainland investor already has existing accounts with a Hong Kong Bank, the investor must open a separate investment account with a Hong Kong Bank as the dedicated investment account for the Wealth Management Connect service. The rules permit mainland investors to open bank accounts with Hong Kong Banks remotely by attestation without any visa requirements. We believe this will greatly reduce the difficulty for mainland investors to open accounts and increase their willingness to participate in the Southbound Scheme, especially in the current epidemic situation.

As regards the Northbound Scheme, a Hong Kong investor may open a new account following the prevailing rules and regulations or designate an existing account as the investment account. The HKMA is also exploring with mainland regulatory authorities on establishing arrangements for account opening by attestation under the Northbound Scheme[12].

(IV) Account pairing and closed-loop mechanism

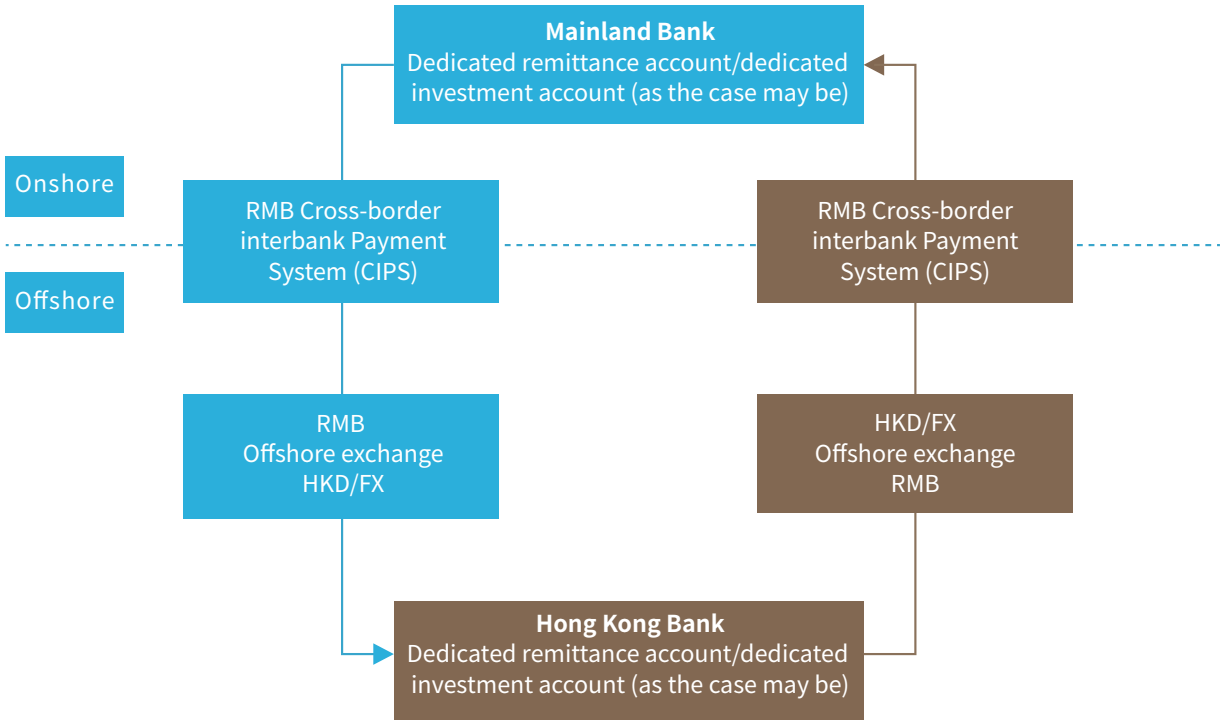
Like other cross-border connect schemes, one of the key issues under the Wealth Management Connect is the restriction under the foreign exchange control policies in Chinese mainland. The account pairing and closed-loop cross-boundary fund flow requirements are the key starting points in ensuring such policies are complied with.

Under both the Southbound and Northbound Schemes, each investor must pair the investor's dedicated investment account with the investor's dedicated remittance account. The cross-boundary flow of funds between Chinese mainland and Hong Kong will be implemented through the link between the accounts, the closed-loop flow of funds and subject to quota restrictions.

The following diagram shows the closed-loop mechanism of cross-boundary funds flow through the Cross-border Interbank Payment System (CIPS).

[11] Wealth management products offered in the mainland are generally categorised into risk levels ranging from level 1 (lowest risk) to level 5 (highest risk).

[12] HKMA, inSight "Cross-boundary Wealth Management Connect in the Guangdong-Hong Kong-Macao Greater Bay Area" (dated 10 September 2021), available at https://www.hkma.gov.hk/eng/news-and-media/insight/2021/09/20210910/.



The key features of remittances are summarised as follows:

1. an investor may effect cross-boundary remittance of funds only if:

    1) the remittance is effected between the dedicated investment account and the dedicated remittance account of the investor;

    2) the remittance is in Renminbi only; and

    3) the remittance complies with the aggregate and individual investor quotas prescribed by the regulators from time to time;

2. funds deposited in the dedicated investment account can only be used to purchase eligible investment products. If the wealth management product is denominated in Hong Kong currency or other foreign currencies, Renminbi will be converted into an appropriate currency in Hong Kong;

3. investors cannot withdraw money from the dedicated investment account; and

4. realised investment proceeds will be converted into Renminbi and remitted through the CIPS for cross-boundary remittance.

(V) Quota restriction

The cross-boundary fund flows under the Wealth Management Connect are subject to aggregate and individual investor quotas, calculated on a net basis. The current aggregate quota is set at Renminbi 150 billion yuan for each of the Southbound Scheme and Northbound Scheme and the individual investor quota is set at Renminbi 1 million yuan:

	Southbound Scheme	Northbound Scheme
Usage of aggregate investor quota	Cumulative remittances from the mainland to Hong Kong and Macao under the Southbound Scheme - Cumulative remittances from Hong Kong and Macao back to the mainland under the Southbound Scheme	Cumulative remittances from Hong Kong and Macao to the mainland under the Northbound Scheme - Cumulative remittances from the mainland back to Hong Kong and Macao under the Northbound Scheme
Usage of individual investor quota	Cumulative remittances from the mainland to Hong Kong and Macao under the Southbound Scheme - Cumulative remittances from Hong Kong and Macao back to the mainland under the Southbound Scheme	Cumulative remittances to the mainland under the Northbound Scheme - Cumulative remittances from the mainland under the Northbound Scheme

IV. Other issues

(I) Cross border marketing issues

As an innovative mechanism to facilitate cross-border investments, Wealth Management Connect will inevitably require onshore and offshore partner banks to cooperate in providing, and supporting the on-going offering of financial services to customers in the GBA.

Under the Southbound Scheme, the restrictions on cross-border marketing activities in the mainland almost reflect the current cross-border marketing principles applicable to banks in Hong Kong, and primarily adopts an "execution only" model on cross-border sales and marketing arrangements.

Similarly, under the Northbound Scheme, mainland Banks are not allowed to travel to Hong Kong or Macao to carry out actual sales activities. In addition, the mainland Implementation Rules also prohibit mainland banks from actively inviting or soliciting customers, or providing investment advice across borders.

Cross-border sales and marketing activities continue to be subject to strict regulatory controls. Regulators must strike a balance between protecting investors' interests and fostering economic development. Financial institutions must ensure that all employees engaged in the Wealth Management Connect service clearly identify the regulatory boundaries of any marketing activity.

(II) Cooperation between Hong Kong banks and mainland banks

Banks across the GBA which intend to form a partnership should formulate a clear division of responsibilities in respect of the following issues:

1. the operational arrangement in respect of account pairing;
2. measures to ensure closed-loop fund remittance and quota monitoring;
3. restrictions on the use of accounts;

4. how to fulfill the anti-money laundering, anti-terrorism financing and anti-tax evasion obligations;

5. personal data compliance obligations; and

6. internal control on cross-border marketing activities.

In an earlier consultation draft of the Hong Kong Implementation Rules, a Hong Kong Bank could only partner with one mainland bank under each of the Southbound Scheme and the Northbound Scheme. The exclusive partnering requirement prompted onshore and offshore banks to liaise and enter into intra-group cooperation agreements with their affiliated institutions established in the jurisdiction of the other side.

After extensive market consultation and a policy to drive the level-playing field for banks across the mainland, Hong Kong and Macao, the final version of the Hong Kong Implementation Rules and mainland Implementation Rules no longer includes the exclusive partnering requirement. All Hong Kong Banks are now permitted to form partnerships with more than one mainland bank. This is well received by the market. In assessing any partnering with banks that aren't affiliates, the partnering banks will need to assess and negotiate the cooperation agreement carefully. Banks must pay close attention to an array of commercial terms, the governing law clauses and cross-border dispute resolution clauses.

V. Conclusion

Wealth Management Connect is the first mutual market access mechanism for individual investors in the GBA. It is conducive to the facilitation of cross-boundary investment by individual residents in the GBA, and is a crucial project and milestone in the financial development of the GBA. It will "further consolidate Hong Kong's role as an international financial centre and the world's offshore Renminbi business hub". Edmond Lau, the Deputy Chief Executive of the HKMA, pointed out that[13]:

"[the] Cross-boundary WMC can provide investors with a greater variety of wealth management products, further facilitate cross-boundary investment and create new opportunities for the financial industry in Hong Kong."

[13] HKMA, inSight "Cross-boundary Wealth Management Connect in the Guangdong-Hong Kong-Macao Greater Bay Area" (dated 10 September 2021), available at https://www.hkma.gov.hk/eng/news-and-media/insight/2021/09/20210910/.

PRIVATE EQUITY

SFC GUIDANCE ON ENHANCED DISCLOSURES FOR ESG FUNDS

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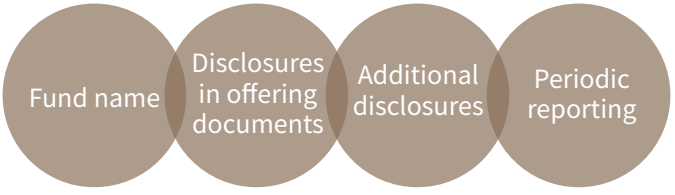
The Securities and Futures Commission (SFC) has recently issued a circular[1] to provide guidance on its expectations on enhanced disclosure for environmental, social and governance (ESG) funds. The new guidance covers the following:



This alert sets out and summarises the new guidance, which supersedes a 2019 SFC circular on the same topic (2019 Circular).[2]

I. Why has the circular been issued?

The number of ESG linked funds offered to the public in Hong Kong has more than doubled since 2019. The SFC's focus on ESG has featured as a prominent agenda item in all major speeches given by Ashley Alder in recent months, placing emphasis on establishing harmonised disclosure standards and the avoidance of "greenwashing" (the practice of exaggerating the green credentials of a fund).

"Making sustainability-related disclosures more transparent, comparable and consistent will help investors identify suitable ESG funds and reduce opportunities for greenwashing," Ashley Alder, the SFC's Chief Executive Officer.[3]

[1] https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/products/product-authorization/doc?refNo=21EC27

[2] Available here: https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=19EC18

[3] https://apps.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=21PR67

II. Which funds must comply with the requirements under the circular?

The circular was issued to SFC-authorised funds which incorporate ESG factors as a key investment focus (ESG Funds). The SFC maintains a list of such funds[4] compiled based on confirmations and representations provided by the respective fund managers. There are currently around 60 funds on the list. The circular took effect on 1 January 2022.

III. What are the naming requirements?

The product name must not be misleading. Reference to ESG or similar in the name or marketing materials must accurately reflect the ESG features of the fund without exaggeration.

IV. What are the requirements for offering documents?

Fund offering document must provide information necessary for investors to be able to make an informed judgement of the investment. The new guidance sets out what this means for ESG Funds, as described below.

Disclosure	Requirement
ESG focus	• A description of the ESG focus through a clear description of the aim and a list of ESG criteria (eg filters, third party ratings) used to measure the attainment of the ESG focus. For example, the BlackRock Global Funds "Nutrition Fund" (ARQ483) offering document listed on the SFC webpage, includes the following statement: *"The three major sustainable nutrition trends in focus are: the promotion of healthy and sustainable eating choices, delivering efficiencies across global food supply chains, and enabling less resource intensive farming."*
	Specific to funds claiming to be climate focused (Climate Funds): • SFC examples of acceptable focus areas are: primarily investing in companies which contribute to climate change mitigation or adoption, seeking a lower carbon footprint as compared to a reference benchmark, contributing to reduction of greenhouse gas emission, achieving positive impact to mitigate or adapt to climate change, and facilitating transition to a low carbon economy. • SFC examples of climate related indicators are: carbon footprint, weighted average carbon intensity, greenhouse gas emission, revenue or profit generated from or capital or operating expenditure commitment in activities that favourably contribute to climate change mitigation or adaption.

[4] Available here: https://www.sfc.hk/en/Regulatory-functions/Products/List-of-green-and-ESG-fund

Disclosure	Requirement
ESG investment strategy	• A description of the investment strategy adopted by the ESG fund, the binding elements and significance of that strategy in the investment process, and how the strategy is implemented in the investment process on a continuous basis. • A summary of the process of consideration of ESG criteria which may include methodologies in measuring ESG criteria and sequencing those criteria in order of importance. • A description of whether an exclusion policy is adopted and the types of exclusion. For example, the HSBC Global Investment Funds "Global Equity Climate Change" (AQC936) offering document includes the following: *"ESG and Lower Carbon Criteria, which together with fundamental qualitative company analysis, are used to determine the sub-fund's investible universe, may include, but are not limited to:* - *excluding issuers involved in low ESG rated sectors such as, but not limited to, weapons and tobacco.* - *excluding issuers who derive more than 10% of revenue from thermal coal activities.* - *excluding issuers considered to be breaching the United Nations Global Compact Principles."* [5]
Asset allocation	• The expected or minimum proportion of securities that are commensurate with the fund's ESG focus.
Reference benchmark	• Where a fund is tracking an ESG benchmark (eg an index fund) for the purpose of attaining the ESG focus, details of the benchmark and an explanation of how the designated reference benchmark is relevant to the fund. Specific to Climate Funds, the disclosure should include an explanation of how any climate benchmark is continuously aligned with or relates to the funds climate-related focus and why and how the designated index differs from a broad market index, where appropriate.
Additional information	• An indication of where investors can find additional information about the ESG Fund.
Risks	• A description of the risks or limitations associated with the ESG focus must be disclosed. For example, the BNP Paribas Funds "BNP Paribas Funds Energy Transition" (BAC421) offering document includes the following: *"The lack of common or harmonized definitions and labels integrating ESG and sustainability criteria at EU level may result in different approaches by managers when setting ESG objectives. This also means that it may be difficult to compare strategies integrating ESG and sustainability criteria to the extent that the selection and weightings applied to select investments may be based on metrics that may share the same name but have different underlying meanings."*

[5] Available here: file:///C:/Users/letear/Downloads/AAU032_HSBC+Global+Investment+Funds_Prospectus_Eng_202106.PDF

V. What are the requirements for disclosing additional information?

An ESG Fund should disclose on the fund manager's website or "by other means":

- how the ESG focus and performance is measured and monitored throughout the lifecycle of the ESG fund;
- ESG due diligence procedures in respect of the fund's underlying assets;
- the engagement approach, including proxy voting; and
- the ESG data sources and processing or relevant assumptions where data is not available.

Specific to Climate Funds, the methodologies for measuring climate indicators should include the metrics used and their calculation basis or formulas, the relevant data sources, any assumptions or estimations made and their limitations.

VI. What are the periodic assessment and ongoing monitoring requirements?

An ESG Fund should conduct a periodic assessment, at least annually, to assess how the fund has attained its ESG focus. The below should then be disclosed, for example through annual reports.

Disclosure	Requirement
ESG focus	How the ESG focus has been attained including: • the actual proportion of underlying investments commensurate with the fund's ESG focus; • the actual proportion of the investment universe that was eliminated or selected as a result of the fund's ESG-related screening; • a comparison of the performance of the fund's ESG factors against the designated reference benchmark (if any); • actions taken in attaining the fund's ESG focus. For example, shareholder engagement activities or proxy voting records of the ESG Fund with respect to its investee companies; and • a catch all - any other information, considered necessary by the fund manager.
	A Climate Fund could demonstrate the attainment of its climate-related focus by comparing the funds climate indicator(s) against those of the previous assessment period or the reference benchmark or the investment universe.
Basis of assessment	A description of how the ESG focus attainment has been assessed, including any estimations or limitations.
Comparison information	A comparison to the previous assessment period (where applicable).

Fund managers must regularly monitor and evaluate underlying investments to ensure the ESG focus continues to be met. If ESG is no longer the focus of a fund, investors and the SFC must be informed as soon as reasonably practicable. Such a fund may be removed from the SFC list as appropriate. This may lead to regulatory action by the SFC for any compliance failings including failure to meet the stated investment objective or strategy in the offering documents.

VII. What is the impact on UCITS funds?

The SFC has considered the European regulations on sustainability-related disclosures (SFDR) and states that UCITS funds will be ESG Funds if they incorporate ESG factors as their key investment focus and reflect that focus in their investment objective or strategy. UCITS ESG Funds which meet the disclosure and reporting requirements for Article 8 or Article 9 funds under the SFDR will be deemed to have generally complied in substance with the SFC's disclosure requirements.

VIII. Next steps

Fund managers should:

- establish an ESG governance structure;
- review existing ESG policies or if none, adopt a clear ESG policy;
- review existing disclosures for any ESG Funds;
- ensure staff and management understand ESG commitments and risks;
- provide ESG training to relevant staff.

Reach out to us for assistance with ESG compliance, applications to the SFC or, if there are concerns regarding compliance to date, SFC engagement and regulatory enforcement action. We offer full life-cycle regulatory assistance in relation to all aspects of ESG finance.[6]

[6] All quotes from offering documents in this alert are snippets only and do not constitute full statements or disclosures from the fund documents and are not to be taken as any form of endorsement by King & Wood Mallesons.

DISPUTE RESOLUTION

PILOT MECHANISM IN CROSS-BORDER INSOLVENCY

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Introduction

On 14 May 2021, representatives of the government of the Hong Kong Special Administrative Region (HKSAR) and the Supreme People's Court (SPC) in the Chinese mainland (mainland) signed the Record of Meeting[1] on Mutual Recognition of and Assistance to Bankruptcy (Insolvency) Proceedings between the Courts of the mainland and of the HKSAR (Record of Meeting). It sets out the long-awaited pilot mechanism for relevant courts in the two jurisdictions to mutually recognise certain types of bankruptcy proceedings and provide assistance to liquidators appointed in the other jurisdiction (Pilot Mechanism). This development takes place after the Hong Kong courts issued a series of ground-breaking judgments in 2020[2] which recognised and assisted mainland liquidators, and will be welcomed by insolvency practitioners across both jurisdictions.

The detailed arrangements for the mainland courts' implementation of the Pilot Mechanism is outlined in a separate Opinion[3] (SPC Opinion). Similarly, the procedural requirements for mainland bankruptcy administrators'applications at the High Court of HKSAR is also provided in a separate Practical Guide[4] (Practical Guide).

This Pilot Mechanism is only implemented with a limited scope at this stage. Three designated mainland courts in the relevant municipalities - Shanghai, Xiamen and Shenzhen will participate as "pilot courts" to implement this mechanism, and the SPC has prescribed multiple criteria which may trigger refusal by the designated mainland courts to recognise and assist the Hong Kong insolvency proceedings.

In this alert, we provide an overview of the Pilot Mechanism

[1] https://www.doj.gov.hk/tc/mainland_and_macao/pdf/RRECCJ_RoM_tc.pdf

[2] See *Re CEFC Shanghai International Group Limited* [2020] HKCFI 167; *Re Shenzhen Everich Supply Chain Co., Ltd* [2020] HKCFI 965, https://legalref.judiciary.hk/lrs/common/search/search_result_detail_frame.jsp?DIS=128463&QS=%24%28Re%7CShenzhen%7CEverich%7CSupply%7CChain%7CCo%7CLtd%7C%5B2020%5D%7CHKCFI%7C965%29&TP=JU; Re Ando Credit Limited [2020] HKCFI 2775.

[3] https://www.doj.gov.hk/en/mainland_and_macao/pdf/RRECCJ_opinion_en_tc.pdf

[4] https://www.doj.gov.hk/en/mainland_and_macao/pdf/RRECCJ_practical_guide_en.pdf

by summarising its salient features, and identify the restrictions of the regime and their implications for insolvency practitioners in both jurisdictions.

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I. Salient features of the mainland arrangements in the Pilot Mechanism

Under the Pilot Mechanism, a mainland administrator may apply to the High Court of the HKSAR for recognition of bankruptcy liquidation, reorganisation and compromise proceedings under the *Enterprise Bankruptcy Law of the People's Republic of China* (mainland Insolvency Proceedings). The procedural requirements which the mainland administrator will need to comply with are set out in the Practical Guide. The Hong Kong court will grant a recognition order in the form set out in the Practical Guide, which will include a series of powers the mainland administrator may exercise in the HKSAR.

As to the arrangements in respect of the mainland courts pursuant to the Pilot Mechanism, we summarise its salient features below:

(I) Scope of application of the Pilot Mechanism

Hong Kong liquidators must satisfy the following criteria before they can successfully apply for recognition and assistance from mainland courts under the Pilot Mechanism:

1. **The "centre of main interest" of the debtor company must be HKSAR (Provision 4 of the SPC Opinion)**. Generally, if the place of incorporation of the debtor company is HKSAR, this criteria would be satisfied. However, the mainland court will also consider the debtor company's place of principal office, the principal place of business, the place of principal assets etc.

2. **The debtor company must have principal assets or a place of business / representative office in Shanghai, Xiamen or Shenzhen (collectively referred to as the "Pilot Areas") (Provisions 1 and 5 of the SPC Opinion)**. As only the mainland courts in the Pilot Areas received designation from the SPC to participate in the Pilot Mechanism, accordingly, the debtor company must either have substantial assets or a business presence in such Pilot Areas.

3. **The relevant insolvency proceeding in Hong Kong must be one of the following: compulsory winding up, creditors'voluntary winding up or restructuring proceeding initiated by a liquidator or provisional liquidator and approved by the High Court of the HKSAR (Provision 2 of the SPC Opinion).**

4. **None of the circumstances where the mainland courts will refuse to grant recognition or assistance pursuant to Provision 18 of the SPC Opinion exists.** Such circumstances include: where the centre

of main interests of the debtor is not situated Hong Kong or it has been situated in the Hong Kong for less than six months continuously, where Article 2 of the *Enterprise Bankruptcy Law of the People's Republic of China* is not satisfied, where the mainland creditors are unfairly treated or where there is fraud.

(II) Effect of mainland court's recognition of the Hong Kong insolvency proceedings

Recognition by the relevant mainland Court on Hong Kong insolvency proceedings has the following effect:

1. The debtor company's payment made to individual creditors shall be invalid (Provision 11 of the SPC Opinion).
2. Any ongoing civil action or arbitration involving the debtor company shall be suspended until the Hong Kong liquidator takes over the debtor company's property (Provision 12 of the SPC Opinion).
3. The measures for preserving the property of the debtor company shall be lifted and the procedure for execution shall be suspended (Provision 13 of the SPC Opinion).
4. The Hong Kong liquidator may exercise a range of power in Chinese mainland, including investigation into the debtor company's financial position, carrying out the internal management of the debtor company, dealing with the debtor company' s property, commencing legal proceedings on behalf of the debtor company, etc (Provision 14 of the SPC Opinion).
5. In exercising their powers following recognition by the mainland courts, the Hong Kong liquidators may need to familiarise themselves with the relevant law in order to comply with some of the provisions in the SPC Opinion. For example, according to Provision 20 of the SPC Opinion, even if the Hong Kong insolvency proceeding in question is duly recognised in the relevant mainland court, the property of the debtor company in mainland must still first satisfy preferential claims under the law of the mainland, before the remaining property could be distributed in accordance with the Hong Kong proceedings.

II. Limitations of the Pilot Mechanism and potential difficulties facing Hong Kong liquidators

Despite the fact that the Pilot Mechanism is much welcomed as a first step to streamline cross-border insolvency procedure as between Hong Kong and mainland, there remain obvious limitations in its implementation:

Firstly, only mainland courts in the three Pilot Areas will participate in the Pilot Mechanism. Therefore, where the debtor company in question has assets in mainland cities or regions other than the three Pilot Areas, difficulties remain for the Hong Kong liquidator to apply for recognition and assistance.

Secondly, separate approval is required for the Hong Kong liquidator to perform certain duties, e.g. transfer of property out of the mainland and creation of security on the property (see Provision 14 of the SPC Opinion). Due to this requirement, the Hong Kong liquidator may incur delay and extra costs as well as potential difficulties in their dealing with the debtor company's assets in mainland.

Thirdly, Provision 15 of the SPC Opinion allows for the designation of a mainland administrator by the mainland court upon application by ***either*** a Hong Kong administrator ***or*** a creditor after the Hong Kong Insolvency Proceedings is recognised in the mainland. However, the SPC Opinion does not specify whether and in what circumstances the mainland court would grant a creditor's application where a Hong Kong administrator is already appointed. Assuming a creditor is allowed to make such an application under this provision despite a Hong Kong administrator being already appointed, a potential conflict may arise between the Hong Kong administrator and the mainland administrator appointed by the creditor. Provision 15 does not provide any clear guidance on how to address any potential conflict between administrators of the two jurisdictions. It remains to be seen as to how the mainland court would respond to a creditor's application and whether the risk envisioned would materialise.

Conclusion

Following the launch of the Pilot Mechanism, Hong Kong has become the first jurisdiction to have an established mechanism of mutual recognition and assistance in insolvency proceedings with the mainland. As a result, insolvency practitioners in Hong Kong and mainland alike are now better equipped to carry out asset-recovery activities on companies with cross-border features.[5] With this crucial first step of the Pilot Mechanism in place, we look forward to further expansion of the Pilot Mechanism to more mainland regions and increasing co-operation between the two jurisdictions.

[5] As at January 2022, the appointment of a liquidator for Samson Paper Holdings Limited by a Hong Kong court has been successfully recognised by a mainland court. See *re Samson Paper Holdings Limited* [2021] HKCFI 2151; [2021] HKCLC 1053, and *Re Samson Paper Holdings Limited* (2021) Yue 03 Ren Gang Po No. 1 (15 December 2021).

THE FIRST APPEAL CASE FROM THE COMPETITION TRIBUNAL

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On 18 June 2021, the Honourable Mr Justice Lam VP handed down the reasons for judgment for *Competition Commission v W Hing Construction Company & Others* [2021] HKCA 877[1]. This article discusses the Competition Commission's first ever appeal case heard in the Hong Kong Court of Appeal (Court). This appeal was initiated by the two individual partners (Appellants) named in the title of the proceedings as the partners of the firm Tai Dou Building Contractor (Tai Dou) against the Hong Kong Competition Tribunal (Tribunal)'s judgment made on 17 May 2019[2]. The Appellants, in their capacity as partners of Tai Dou, were found by the Tribunal to have contravened the First Conduct Rule[3] in their market sharing and price fixing arrangements while providing decoration services to tenants at a public housing estate. In gist, the Court considered issues on the nature on the contravention of the First Conduct Rule, the standard of proof and the identity of the 4th Respondent (R4).

I. Nature of contravention of the First Conduct Rule

The Appellants contended that the proceedings were criminal in nature hence *mens rea* of each of the respective Appellants were required in order to prove contravention of the First Conduct Rule. In other words, individual partners should be treated as separate entities from the partnership in the criminal context.

This contention was rejected by the Court. Although allegations of contravention are to be classified as criminal charges for the purpose of Article 11 of the Hong Kong Bill of Rights, it does not follow that the contravention of the First Conduct Rule is to be regarded as a criminal offence incorporating the requirement of *mens rea*. It was held that whether the current proceedings are to be characterised as criminal in nature is wholly a question of statutory construction. Hence, the safeguards under Article

[1] King & Wood Mallesons acted for the Competition Commission.

[2] [2019] HKCT 3

[3] The First Conduct Rule prohibits "agreements and concerted practices having the object or effect of preventing, restricting or harming competition" as laid out in the Competition Ordinance (Cap. 619) (**Ordinance**).

11 (which guarantee the procedural fairness of a trial on a criminal charge by way of human rights protection) is a separate question from determining if the Ordinance has created the contravention of the First Conduct Rule to be a criminal offence. The requirement of *mens rea* is not one of the safeguards prescribed by Article 11 and the First Conduct Rule contravention did not fall into the ambit of criminal offences specified in the Ordinance (sections 52 to 55 and sections 172 to 175).

Further, section 171(1) of the Ordinance stipulates that proceedings for criminal offences may not be brought in the Tribunal. Since proceedings for the contravention of the First Conduct Rule and the corresponding enforcement actions are brought in the Tribunal through civil proceedings, the Court concluded the offence in question cannot be regarded as criminal in nature. Considering the construction of the Ordinance as a whole, there is no basis for the counsel of the Appellants to import the requirement to prove *mens rea* on the part of the individual partners for purposes of the current proceedings.

The Court therefore rejected the Appellants'submission regarding Mr Cheung and Mr Wong's apparent lack of *mens rea* on the fundamental ground that contravening the First Conduct Rule does not bring about criminal proceedings.

II. Standard of proof

G Lam J had decided at first instance[4] that because allegations of contravention of the First Conduct Rule is classified as a criminal charge pursuant to Article 11 of the Hong Kong Bill of Rights, the standard of proof required to establish liability should be the higher standard of beyond reasonable doubt. In the appeal, the Commission asked the Court to lower the standard of proof to the civil standard of balance of probabilities with cogent evidence being required commensurably with the seriousness of the allegations.

While the Court did recognise the Commission's concerns with regard to the real possibility of frustrating effective enforcement of competition law with the heightened criminal standard of proof, the Court declined to make a decision because R4 had already been found to be liable beyond reasonable doubt[5]. The Court took the view that it would be better if the Tribunal could test this issue in a future case where the application of the standard of proof on specific facts and evidence would have a real (instead of conceptual) impact.

III. Identity of R4

The Appellants also contended that the two of them (i.e. Mr Cheung and Mr Wong), being the only two partners of Tai Dou named in the Originating Notice of Application dated 14 August 2017[6], should not have been so named and that they should not be held liable in light of the absence of any personal involvement by them in the acts constituting the breach of the First Conduct Rule.

The Court rejected the Appellants'contention on the basis that it was clear the enforcement proceedings were brought against Tai Dou the firm and not the two individuals Mr Cheung and Mr Wong. Since Tai Dou was appointed by the Housing Authority for the decorative works[7], the Appellants' liability arose from their capacity as partners of Tai Dou[8].

IV. Conclusion

It is important that the Court confirmed that contravention of the First Conduct Rule is not a criminal offence and enforcement proceedings in the Competition Tribunal are not criminal proceedings. While the Court declined to decide on the issue of standard of proof, this would no doubt be challenged in a future case. This is an issue of great public importance to the development of competition law in Hong Kong, and we look forward to any future decision on this issue.[9]

[4] *Competition Commission v Nutanix Hong Kong Limited* [2019] HKCT 2 (**Nutanix**) paragraph 553; *Competition Commission v W Hing Construction Company & Others* [2019] HKCT 3 paragraphs 38 and 39.

[5] According to paragraph 75 of the appeal judgment, the Tribunal' s judgment adopted the ruling in *Nutanix* where the standard of proof is proof beyond reasonable doubt.

[6] R4 was named as "Cheung Yiu Fai Danny and Wong Tung Hoi (in partnership trading as [Tai Dou]" in the title of the proceedings.

[7] For example, at paragraphs 22 to 24 of the Originating Notice of Application, it was pleaded the Respondents (including R4) were the Appointed Contractors appointed by the Housing Authority and each of them had received letter from it and executed a Licence. Tai Dou was the appointed contractor, not the Appellants. Paragraph 33(1) referred to the allocation of floors to Tai Dou, not to the Appellants.

[8] This was consistent with section 11 of the Partnership Ordinance (Cap. 38) where every partner in a firm is jointly liable with the other partners for all debts and obligations of the firm incurred while he is a partner.

[9] King & Wood Mallesons acted for the Competition Commission in CACV 257 of 2019.

HONG KONG COMPANIES' COURT FOR THE FIRST TIME REFUSED TO GRANT ASSISTANCE TO SOFT-TOUCH PROVISIONAL LIQUIDATORS

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The recent case of *Re China Bozza Development Holdings Ltd* [2021] HKLRD 977 demonstrated the attitude and increased scrutiny of the Hong Kong Companies'Court towards offshore soft-touch provisional liquidation.

The leading authority on the meaning of soft-touch is the British Virgin Islands case of *Re Constellation Overseas Ltd* BVIHC (Com) 2018/0206, 0207, 0208, 0210 and 0212. (§ 3) :

"The essence of a 'soft-touch' provisional liquidation is that a company remains under the day to day control of the directors but is protected against actions by individual creditors. The purpose is to give the group the opportunity to restructure its debts, or otherwise achieve a better outcome for creditors than would be achieved by liquidation."

I. Re China Bozza Development Holdings Ltd

China Bozza Development Holdings Ltd (China Bozza) was incorporated in Cayman Islands and listed on the Hong Kong Stock Exchange. A petition was first presented in Hong Kong Court for the winding up of China Bozza on the ground of insolvency.

Within a span of few months, a director of China Bozza presented a petition in Cayman Islands for the winding up of China Bozza, and subsequently, applied for the appointment of soft-touch provisional liquidators in Cayman Islands to facilitate a restructuring of the debts of China Bozza.

The Cayman Court approved the application and appointed joint provisional liquidators over China Bozza. Thereafter, the soft-touch provisional liquidators of China Bozza applied to the Hong Kong Court for recognition of and assistance to the insolvency proceedings in Hong Kong.

The Court granted an order for recognition of the insolvency proceedings in Cayman Islands, but refused to grant an order for assistance to the provisional liquidators at this stage. In his Decision, Harris J expressed his concerns over the increasing use of the commonly called "Z-Obee" technique in debt restructuring. Particularly, his Lordship was concerned that the Z-Obee technique is being abused to obtain a *de facto* moratorium of enforcement action by creditors in Hong Kong.

II. What is the Z-Obee technique?

This technique is named after the case of *Re Z-Obee Ltd* [2018] 1 HKLRD 165. It was developed as a result of the Court's clarification that section 193 of the Companies (Winding Up and Miscellaneous Provisions) Ordinance does not allow provisional liquidators to be appointed **solely** for the purpose of corporate restructuring or rescue.

To get around this statutory limitation, a foreign company faced with a winding-up petition in Hong Kong may procure the appointment of soft-touch provisional liquidators in its place of incorporation in order to facilitate restructuring of the company. Upon their appointment, the soft-touch provisional liquidators would then petition the Hong Kong Court to recognise their appointment and to provide assistance to the soft-touch provisional liquidators pursuant to the terms of a letter of request issued by a court of its place of incorporation.

Harris J emphasized that the interests of creditors should take precedence over the proprietary interests of the shareholders once it appears likely that the company is insolvent. Various other authorities include *dicta* to the effect that once a company becomes insolvent, the directors' fiduciary duties are owed to the general body of creditors, instead of the shareholders. As such, creditors are expected to have a central role in the development of any plan to restructure a company's debts in the circumstances. His Lordship was wary about giving blessing to soft-touch provisional liquidations when creditors'interests may be unheard due to their non-involvement in the restructuring process.

In the case of China Bozza, the circumstances leading to the present application set alarm bells ringing:

1. China Bozza did not have any restructuring plan at the time of the application. Rather, it was seeking to appoint soft-touch provisional liquidators, who would then make efforts to formulate such a plan;

2. the Hong Kong Court was told nothing about the business of China Bozza, such as how it became profitable, why any investor might be interested in injecting funds into China Bozza, or how the Board thought the business of China Bozza might be rehabilitated;

3. the Board did not seek legal or other professional advice on the consequences and implications of the dire financial position of China Bozza, the statutory demand nor of the petition issued against it; and

4. China Bozza did not have any banking debts in Hong Kong. The creditors were members of the public who had little understanding of their rights or the methods available for securing maximum return on the loans that they had made.

Harris J came to a view that no consideration appeared to have been given by China Bozza or its advisers as to whether or not it might be in the interests of its creditors for China Bozza to be wound up. Whilst he recognised that a liquidator, including a provisional liquidator, appointed by the courts of the place of incorporation of a company ought to be recognised as a matter of private international law, Harris J refused to grant an order providing assistance to the provisional liquidators at this stage due to concerns about the way China Bozza approached the case.

III. Insights

While certainly *Re China Bozza* is not a blanket denial to soft-touch provisional liquidations, it clearly shows the Companies Court's desire to scrutinise deployment of the Z-Obee technique in the future. This comes as no surprise as we continue to see an upward surge of companies relying on offshore soft-touch provisional liquidation as a means to obtain a *de facto* moratorium of enforcement action by creditors in Hong Kong.

The Companies Court made it clear that the grant of recognition of foreign insolvency proceedings does not automatically entail adjournment of any winding up petition presented in Hong Kong. The Hong Kong court will only adjourn the petition upon satisfactory evidence that the prospect of a successful restructuring during the adjournment is justifiably strong.

In view of the various comments made by Harris J regarding soft-touch provisional liquidations, any company wishing to deploy the Z-Obee technique should be prepared to address the Hong Kong court on the following issues:

1. details of the restructuring plan that the company wishes to implement out of provisional liquidation;
2. whether creditors' input has been sought in the process of formulation of the restructuring plan;
3. details of the business of the company;
4. the reasons for the Board to have taken a view that the business of the company might be rehabilitated through the restructuring plan;
5. details of legal and other professional advice on the company's financial position and restructuring plan.

In addition, for companies which are likely insolvent, their directors must be advised that their fiduciary duties are owed to the general body of creditors rather than the shareholders.

CORPORATE COMPLIANCE

INTERPRETATION OF THE DATA REGULATIONS OF THE SHENZHEN SPECIAL ECONOMIC ZONE (I) — PERSONAL DATA PROTECTION

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Introduction

This article will examine the compliance requirements of enterprises and the corresponding liability for non-compliance under the *Data Regulations of the Shenzhen Special Economic Zone* (the Regulations) from the perspective of personal data protection, in order to help enterprises get well prepared.

The Regulations officially came into force as of 1 January 2022. As the first comprehensive local data legislation, the Regulations consist of 100 articles in seven chapters, covering the protection of personal data, the sharing, disclosure and utilization of public data, the cultivation and protection of the data element market, data security and supervision, legal liabilities, etc. The Regulations not only provide more detailed provisions supplementary to the existing Civil Code, the *Cybersecurity Law* (CSL), the *Data Security Law* (DSL), the *Personal Information Protection Law* (PIPL) and other higher-level laws, but also make breakthroughs and pilot tests in the fields where there are still legislative gaps, such as data rights and interests, data transactions, and the development of the data element market system. First, the Regulations confirm, for the first time, data rights and interests at the legislative level, specifying that natural persons have personality rights and interests in personal data, and natural persons, legal persons and unincorporated associations have property rights and interests in data products and services generated from their lawful data processing. Second, under the background of recognizing the rights and interests of data property and the promotion of the establishment of the data element market by the state, the Regulations made the first exploration on the data transaction system, specifying that data products and services formed through lawful processing may be traded in accordance with the law, so as to better realize the value of data elements. Third, given the current difficulties in safeguarding rights in the

data field, the Regulations for the first time propose a public interest litigation system in the field in the form of local legislation.

I. Definitions

(I) Personal data

Item (2) of Article 2 of the Regulations is pioneering in using the concept of "personal data", i.e. "data containing information that can identify specific natural persons, excluding anonymized data", instead of the term Personal Information ("PI") previously used in the Civil Code, the CSL, the DSL and the PIPL. It is worth noting that the concept of "personal data" is consistent with the expression of "personal data" in the General Data Protection Regulation ("GDPR").

(II) Data processing

In accordance with Item (6) of Article 2 of the Regulations, data processing refers to "activities such as the collection, storage, use, processing, transfer, provision and disclosure of data", which is generally consistent with the definition of PI processing in the PIPL.

II. Compliance obligations of enterprises in processing personal data

Chapter II of the Regulations puts forward the following basic principles and requirements for enterprises to collect, store, use, process, transfer, provide and disclose personal data:

(I) Basic principles for processing personal data

Since the Civil Code and the PIPL came into effect, legality, legitimacy, and necessity have become the three basic principles for processing PI. Article 10 of the Regulations further clarifies and expands the three principles for personal data processing:

- Personal data processing is for a definite and reasonable purpose and in a lawful and legitimate manner;
- Subject to the minimum scope necessary to achieve the processing purpose and in a manner with the least impact on the rights and interests of individuals, and refraining from processing personal data irrelevant to the processing purpose ("Minimum Necessity");
- Informing individuals of the category, scope, purpose and method of personal data processing and obtaining their consent in accordance with the law;
- Ensuring the accuracy and necessary completeness of personal data, and avoiding damage to the parties concerned due to inaccuracy and incompleteness of personal data; and
- Ensuring personal data security, and preventing personal data against breach, destruction, loss, tampering and illegal use.

Article 11 of the Regulations further clarifies the specific connotation of the above-mentioned "Minimum Necessity", and enumerates five circumstances of "the minimum scope necessary to achieve the processing purpose and in a manner with the least impact on the rights and interests of individuals", providing relatively clear guidance for enterprises'personal data processing activities:

- The category and scope of personal data to be processed shall be directly related to the processing purpose, which cannot be achieved without processing of such personal data;

- The quantity of personal data to be processed shall be the minimum necessary to achieve the processing purpose;
- The frequency of automatic processing of personal data shall be the minimum necessary for the processing purpose;
- The storage period shall be the minimum time required for the processing purpose; if the storage period is exceeded, personal data shall be deleted or anonymized, unless otherwise stipulated by laws and regulations or consented by natural persons;
- An access control strategy with minimum authorization shall be established so that personnel authorized to access personal data can only access the minimum personal data required for the fulfillment of their duties and have the minimum authority to process data required for the fulfillment of their duties.

(II) Specific obligations of enterprises in processing personal data

Based on the aforementioned basic principles for personal data processing, Chapter II of the Regulations sets forth the following specific obligations for enterprises engaged in personal data processing activities:

1. **Obligations of not refusing to provide core functions and services:** data processors shall not refuse to provide the relevant core functions and services to a natural person for the reason that he/she does not agree to process his/her personal data (Article 12).

2. **Obligations of express notification:**

    1) Prior to the processing of personal data, a natural person shall be informed of the following matters completely, truthfully and accurately in an easy-to-understand, specific and accessible manner: name and contact information of the data processor; category and scope of personal data to be processed; purpose and method of personal data processing; storage period of personal data; potential security risks of processing personal data and security protection measures taken for their personal data; relevant rights to which the natural person is entitled in accordance with the law and the method to exercise such rights; and other matters that shall be informed in accordance with laws and regulations (Article 14 Paragraph 1).

    2) Where sensitive personal data[1] is processed, the necessity of processing such data and the possible impact on natural persons shall be indicated by more prominent identification or highlights in accordance with the aforesaid provisions (Article 14 Paragraph 2).

    3) Where a data processor makes user profiling[2] of a natural person to improve the quality of its products or services, it shall indicate to the natural person the specific purposes and main rules for the user profiling. A natural person may refuse the user profiling made by a data processor in accordance with the preceding provisions or the recommendation of personalized products or services based on the user profiling, and the data processor shall provide the natural person with effective means for refusal in an easily accessible manner (Article 29).

3. **Obligations to obtain consent and exceptions:**

    1) Data processors shall, prior to processing personal data, obtain the consent of natural persons and process personal data within the scope of the consent, unless otherwise provided for by laws, administrative regulations and the Regulations. In case of any change to the aforesaid matters for which the consent shall be

[1] Article 2 (3) of the Regulations: Sensitive personal data refers to the personal data that, if divulged, illegally provided or misused, may lead to discrimination against natural persons or serious harm to their personal or property safety. The specific scope of such data shall be determined in accordance with laws and administrative regulations.

[2] Article 2 (8) of the Regulations: User profiling refers to the activities of automatic processing of personal data for the purpose of assessing certain conditions of a natural person, including automatic processing conducted for the purpose of assessing a natural person's work performance, economic conditions, health conditions, personal preference, interest, reliability, behavior pattern, locations and whereabouts of a natural person.

obtained, a separate consent shall be obtained (Article 16).

2) Where sensitive personal data is processed, the express consent of the natural person concerned shall be obtained in advance (Article 18).

3) Where biometric data[3] is processed, an alternative plan for processing other non-biometric data shall be provided with the express consent of the natural person concerned (Article 19).

4) Where the personal data of an adult without or with limited capacity for civil conduct is processed, the express consent of the adult's guardian shall be obtained prior to such processing (Article 20 Paragraph 2).

5) Exceptions to obtaining consent, i.e., the processing of personal data under any of the following circumstances may be made without obtaining the consent of the natural person prior to the processing: (1) Processing of the personal data made public by a natural person himself/herself or other personal data that has been legally made public, and in line with the purpose when such personal data is made public; (2) Processing is necessary for the conclusion or performance of a contract to which the natural person is a party; (3) Processing is necessary for the data processor to process the personal data of its employees within a reasonable scope due to the need for human resource management and protection of trade secrets; (4) Processing is necessary for public administration and service agencies to perform public administration duties or provide public services in accordance with the law; (5) Processing is necessary for news reporting by news agencies in accordance with the law; or (6) Other circumstances prescribed by laws and administrative regulations (Article 21).

4. **Provide channels for withdrawing consent:** when processing personal data, channels for natural persons to withdraw their consent shall be provided in an easily accessible way, and it is not allowed to impose unreasonable restrictions or conditions on natural persons to withdraw consent through service agreements or technologies (Article 23).

5. **Special requirements for processing minors'personal data:**

   1) The processing of the personal data of minors under the age of 14 shall be carried out in accordance with the relevant provisions on the processing of sensitive personal data, and the express consent of their guardians shall be obtained prior to such processing (Article 20 Paragraph 1).

   2) Data processors shall not recommend personalized products or services to minors under the age of 14 based on user profiling, except in order to protect their legitimate rights and interests and with the express consent of their guardians (Article 30).

6. **Obligations of timely deletion:** data processors shall timely delete the personal data under any of the following circumstances: the storage period specified by laws and regulations or agreed upon expires; the purpose of processing personal data has been achieved or the processing of personal data is no longer necessary for the processing purpose; a natural person withdraws the consent and requests deletion of the personal data; data processors process data in violation of laws and regulations or the agreement between the parties, and a natural person requests deletion of the personal data; or other circumstances stipulated by laws and regulations.

7. **Obligations of de-identification and anonymization:** where a data processor provides others with the personal data it processes, it shall de-identify such personal data so as to make it impossible for the provided personal data to identify a specific natural person without reference to other data. Where anonymization is required by laws and regulations or by the agreement between a natural person and a data processor, the data processor shall anonymize the data so required or agreed (Article 26).

[3] Article 2(4) of the Regulations: Biometric data refers to the personal data obtained by processing the physical, physiological, behavioral and other biometric features of a natural person that can be used to uniquely identify the natural person, including the gene, fingerprint, voiceprint, palm-print, auricle, iris, and facial recognition features of the natural person.

8. **Obligations of establishing a complaint and reporting mechanism:** a data processor shall establish a mechanism for natural persons to exercise the relevant rights and to make complaints and report, and provide effective channels in an easily accessible manner (Article 31).

III. Legal liabilities for breach of compliance obligations in processing personal data

Article 92 of the Regulations provides that any person who processes personal data in violation of the Regulations shall be punished in accordance with the relevant laws and regulations on PI protection.

In accordance with the current *Law on the Protection of Consumer Rights and Interests*, the CSL and the PIPL, enterprises processing personal data in violation of regulations may incur the following legal liabilities:

(I) Civil liabilities

1. Article 69 of the PIPL: Where PI processing infringes upon personal rights and interests and causes damage, the PI processor shall be liable for damages and other tort liabilities **if it cannot prove that it is not at fault**. The liability for damages shall be determined based on the losses suffered by the individual or the benefits thus obtained by the PI processor; where it is difficult to determine such losses or benefits, the damages shall be determined based on the actual circumstances.

2. Article 50 of the *Law on the Protection of Consumer Rights and Interests*: Business operators who infringe upon consumers' personal dignity, personal freedom or the right to PI protected by the law shall cease the infringement, restore consumers' reputation, eliminate adverse effects, make apologies, and compensate the consumers for losses.

(II) Administrative penalties

Violations	Basic penalties	Penalties for serious violations	Others	Legal basis
Processing PI in violation of regulations, or failing to take necessary security protection measures in accordance with the provisions when processing PI	• Order rectification, give a warning, confiscate illegal gains, and order the application that illegally processes PI to suspend or terminate the provision of services; where the violators refuse to make rectifications, a fine of up to RMB 1 million will be additionally imposed • Impose a fine between RMB 10,000 and RMB 100,000 on the person directly in charge and other persons directly liable	• Order rectification, confiscate illegal gains, and impose an additional fine of less than RMB 50 million or less than 5% of the previous year's turnover, and order suspension of the relevant business or cessation of business operations for rectification, and notify the relevant competent department to revoke the relevant business permit or business license • Impose a fine between RMB 100,000 and RMB 1 million on the person directly in charge and other directly liable persons, and prohibit them from acting as directors, supervisors, senior officers or PI protection officers	Record in the credit files and make public	Articles 66 and 67 of the PIPL

Violations	Basic penalties	Penalties for serious violations	Others	Legal basis
Infringe upon the right to PI protected by the law	• Where the punitive authorities and punitive modes are provided by other laws and regulations, the provisions of these laws or regulations shall apply • In absence of such provisions in the laws or regulations, violators shall be ordered to make rectifications, and may, in light of the circumstances, be punished exclusively or concurrently with warning, confiscation of illegal gains, or imposition of a fine of more than one time but less than ten times the value of the illegal gains; in case of no illegal gains, the violators shall be subject to a fine of up to RMB 500,000	Order suspension of business for rectification and revocation of business licenses	Record in the credit files and make public	Article 56 of the *Law on the Protection of Consumer Rights and Interests*

Violations	Basic penalties	Penalties for serious violations	Others	Legal basis
Where network products and services have the function of collecting users' information, the providers fail to expressly indicate the same to users and obtain their consent; where users'PI is involved, the providers fail to comply with the CSL and the relevant laws and administrative regulations on PI protection Network operators' collection and use of PI fail to follow the principles of lawfulness, legitimacy and necessity, disclose the rules of collection and use, expressly state the purpose, method and scope of such collection and use, and obtain the consent of individuals whose information is to be collected. Collect PI that is not related to the services provided, collect and use PI in violation of laws, administrative regulations, or the agreement between the parties, and fail to process the stored PI in accordance with laws and administrative regulations and the agreement with the user.	• Order rectification, and may, in light of the circumstances, punish exclusively or concurrently with warning, confiscation of illegal gains, or imposition of a fine of more than one time but less than ten times the value of the illegal gains; in case of no illegal gains, the violators shall be subject to a fine of up to RMB 1 million • Impose a fine between RMB 10,000 and RMB 100,000 on the person directly in charge and other persons directly liable	Order suspension of the relevant business or cessation of business operations for rectification, shut down of website, and revocation of licenses for the related services or business license	/	Article 64 of the CSL

Violations	Basic penalties	Penalties for serious violations	Others	Legal basis
Network operators divulge, tamper or damage the PI they have collected, and provide such PI to others without the consent of the individuals whose PI (except for the information that has been processed so as not to identify a particular individual and that cannot be recovered) is collected. Fail to take technical measures and other necessary measures to ensure the security of the PI collected. Fail to take immediate remedial measures and promptly notify the user and the relevant competent authorities in accordance with the regulations in the event of any actual or potential breach, destruction or loss of PI.	• Order rectification, and may, in light of the circumstances, punish exclusively or concurrently with warning, confiscation of illegal gains, or imposition of a fine of more than one time but less than ten times the value of the illegal gains; in case of no illegal gains, the violators shall be subject to a fine of up to RMB 1 million • Impose a fine between RMB 10,000 and RMB 100,000 on the person directly in charge and other persons directly liable	Order suspension of the relevant business or cessation of business operations for rectification, shut down of website, and revocation of licenses for the related services or business license	/	Article 64 of the CSL
Network operators fail to take measures to delete or correct PI as required by PI subjects.				
Steal or otherwise illegally obtain PI, or illegally sell or provide PI to others.	Where the violation does not constitute a crime, the public security authority shall confiscate the illegal gains and impose a fine of more than one time but less than ten times the illegal gains; in case of no illegal gains, a fine of up to RMB 1 million shall be imposed			

(III) Penalties for administration of public security

According to Article 71 of the PIPL, those who process PI in violation of regulations, which constitutes a breach of public security administration, shall be subject to the penalties for administration of public security in accordance with the law.

The current *Law on Penalties for Administration of Public Security* does not provide a specific basis for penalties with respect to violations of personal data protection obligations. Based on our investigation on typical penalties involving PI in the past three years (see the table below), we found that in practice, the competent authorities have mainly imposed penalties for invasion of privacy and suspected crimes of infringement of citizens' PI, based on Article 42 of the Law: "A person who commits one of the following acts shall be detained for not more than five days or be fined not more than RMB 500; and if the circumstances are relatively serious, he/she shall be detained for not less than 5 days but not more than 10 days and may, in addition, be fined not more than RMB 500: ...(6) peeping, secretly taking photos, eavesdropping, or spreading the privacy of another person."

(IV) Criminal liability

Notice of penalty decisions	Cause of penalty	Penalty
Qi Gong (Xing) Jue Zi [2021] No. 0232	Between November 2020 and April 2021, the offender, surnamed Yu, who worked at XXX Mobile Phone City, Baishui Town, Qiyang County, took advantage of his/her work to register an account with a customer's mobile phone number and PI, and then provided the account number and verification code to others for profits. During this period, Yu illegally obtained, sold or provided to others about 350 pieces of PI, making a profit of about RMB 3,600.	A fine of RMB 500
Qing Gong (Chang) Xing Fa Jue Zi [2020] No. 0980	The offender, surnamed Zhang, forwarded the investigation report information of the victim, surnamed Luan, to a 14-person WeChat group, resulting in the breach of Luan's PI.	Administrative detention for 7 days
Hang Jiang Gong (Kai) Xing Fa Jue Zi [2021] No. 01843	At about 23:31 on 4 May 2021, the offender, surnamed Sun, an auxiliary police officer of the Public Security Brigade of Jianggan District Branch of Hangzhou Public Security Bureau, accepted a private request from a person, surnamed Lei, to use the digital certificate of the civilian police to illegally inquire about the PI of others in the Intelligence and Research Center of the Public Security Brigade, and sent the results of the inquiry to Lei, resulting in the leakage of others'privacy.	Administrative detention for 3 days
Tai Gong (Huang) (Cheng Dong) Xing Fa Jue Zi [2020] No. 00261	On the afternoon of 17 February 2020, the offender, surnamed Wang, received a document entitled "(Verification Notice No. 64 Annex 1) 2.15 Fish Buyer List" via WeChat at his home in Room 101, Unit 2, Building 4, Lane 63, Fangshan Road, Dongcheng Street, Huangyan District, and later forwarded the same to a 3-person WeChat group, resulting in the breach of PI of the citizens on the list.	Administrative detention for 7 days

Notice of penalty decisions	Cause of penalty	Penalty
Hang Gong Jiao Zhi (Xing) Xing Fa Jue Zi [2019] No. 00001	At about 15:00 on 27 April 2018, the offender, surnamed Huang, at the request of a person, surnamed He, contacted another person surnamed Yu who was asked to inquire about citizens' PI through the public security network computer at the Canal Water Police Station without permission, and photograph and send the obtained PI to Huang via WeChat. Huang then sent the illegally obtained PI to He Yi via WeChat, who later sent the same to another person, surnamed Chen in the same way. Huang made a profit of RMB 1,000, of which RMB 600 was paid to Yu, and RMB 200 to He. Huang's act constituted the illegal act of spreading others'privacy.	Administrative detention for 7 days and recovery of the illegal gains of RMB 200
Xi Gong (Zhen) Xing Fa Jue Zi [2020] No. 0080	At about 18:00 on 22 February 2020, the offender surnamed Geng forwarded the PI of others from the WeChat group of xxxx community.	A fine of RMB 500
Qian Gong (Cheng) Xing Fa Jue Zi [2020] No. 0655	In early January 2020, the offender surnamed Ji posted a message containing the mobile phone number (xxxxxxx) of the victim, surnamed He, on WeChat Moments, bringing lots of harassment to He due to the breach of He's PI.	Administrative detention for 8 days and a fine of RMB 400
Zhu Gong (Gong) Xing Fa Jue Zi [2020] No. 01810	At around 8:45 am on 3 April 2020, the offender surnamed Weng saw some PI about the victim surnamed Yu from a WeChat group, which included age, gender, marital status, occupation, hospital admission time, and travel track. Weng, knowing that such information was personal privacy, forwarded the above information to an 11-person WeChat group without the consent of Yu, which had infringed on Yu's personal privacy.	Administrative detention for 3 days
Ci Gong (Xiao) Xing Fa Jue Zi [2020] No. 02727	Since February 2018, the suspect surnamed Dang repeatedly inquired about others' information from a party through WeChat and other channels, and then sold to other parties such PI as hotel check-in records, personnel information, and property information to make profits. Eight acts of illegally obtaining information by Dang were verified to be true. Dang received a total amount of RMB 4735.76, of which the amount that could be determined to be from illegal sales of citizens'PI was only RMB 1,100, less than RMB 5,000, the threshold for criminal prosecution standard. According to Article 5 of the *Interpretations of the Supreme People's Court and the Supreme People's Procuratorate on Several Issues Concerning the Application of Law in the Handling of Criminal Cases of Infringement of Citizens'Personal Information* (the "Interpretations"), where the illegal gain is less than RMB 5,000, it does not constitute the crime of infringement of citizens' PI if there are no other serious acts. Although Dang's act did not constitute such crime, it still constituted a public security violation as Dang's act of spreading others'privacy on the Internet was serious.	Administrative detention for 10 days
Sui Gong Yun Xing Fa Jue [2018] No. 16278	Crime of infringement of citizens' PI	Administrative detention for 10 days and a fine of RMB 500

Processing personal data in violation of regulations may, if the circumstances are serious, be suspected of the crime of infringement of citizens'PI as stipulated in Article 253(a) of the *Criminal Law*, i.e. whoever, in violation of the relevant provisions of the State, sells or provides citizens' PI to others (including stealing or otherwise illegally obtaining citizens'PI) shall, **if the circumstances are serious**, be sentenced to fixed-term imprisonment of not more than three years or subject to criminal detention and be concurrently or separately fined; **if the circumstances are particularly serious**, the person shall be sentenced to fixed-term imprisonment of not less than three years but not more than seven years and be concurrently fined. Whoever, in violation of the relevant provisions of the State, sells or provides to others the citizens' PI obtained during the course of performing duties or providing services shall be given a heavier penalty in accordance with the preceding paragraph.

Where an organization commits the crime of infringement of citizens' PI, a fine shall be imposed on the organization, and the persons directly in charge of the organization and other persons directly liable shall be punished in accordance with the respective provisions of the preceding paragraphs.

According to Article 253(a) of the *Criminal Law*, "serious circumstance" is an important element for establishing the crime of the infringement of PI, while "particularly serious circumstance" is a factor for determining whether a heavier penalty will be imposed.

According to Article 5 of the Interpretations, "serious circumstances" specified in the crime of infringement of citizens'PI include the following: (1) Selling or providing information about one's whereabouts which is used by others to commit a crime; (2) Selling or providing citizens' PI to another person when the seller or provider knows or should know that such person will use such information to commit a crime; (3) Illegally acquiring, selling or providing more than 50 pieces of information about whereabouts, communication contents, credit and property; (4) Illegally acquiring, selling or providing more than 500 pieces of PI of citizens, such as accommodation information, communication records, health and physiological information, transaction information and other PI that may affect personal or property safety; (5) Illegally acquiring, selling or providing more than 5,000 pieces of PI of citizens other than those specified in subparagraphs (3) and (4); (6) The quantity does not reach the standards specified in subparagraphs (3) to (5), but the total quantity reaches the relevant standards according to the corresponding proportion; (7) The illegal gain is more than RMB 5,000; (8) Selling or providing to others citizens' PI obtained in the course of performing duties or providing services, the quantity or amount of which reaches more than half of the standards stipulated in subparagraphs (3) to (7); (9) Illegally acquiring, selling or providing citizens' PI again despite the history of having received criminal penalty for infringement of citizens' PI or having received administrative penalty within two years; and (10) other serious circumstances.

The "particularly serious circumstances" stipulated in Article 253(a) include the following: (1) Causing serious consequences such as death, serious injury, mental disorder or kidnapping of the victim; (2) Causing significant economic loss or adverse social impact; (3) The quantity or amount reaches more than ten times the standard stipulated in the preceding subparagraphs (3) to (8); and (4) other particularly serious circumstances.

(V) Public interest litigation

Article 58 of the current *Civil Procedure Law* provides the basic legal basis for the public interest litigation system in China, which provides that "Legally designated institutions and relevant organizations may initiate proceedings at the people's court against acts jeopardizing public interest such as causing pollution to the environment or damaging the legitimate rights or interests of consumers at large. In the event that a people's procuratorate finds any act that does harm to the protection of the ecological environment and resources, any practice in the food and drug safety field that infringes upon the legitimate rights and interests of consumers, or any other behavior that damages the social benefits of the masses, while performing its duties and functions, it may file an action to the people's court, provided that there is no such organ or institution specified in the preceding paragraph or the organ or institution

specified in the preceding paragraph decides not to bring a lawsuit. Where the organ or institution specified in the preceding paragraph files a lawsuit, the people's procuratorate may give endorsement to such lawsuit." The *Law on the Protection of Consumer Rights* and Interests, the *Law on Environmental Protection*, the *Law on the Protection of Minors*, the *Law on Production Safety* and other substantive laws all have provisions for public interest litigation.

In the field of PI and data, due to the high secrecy of data infringement in practice, it is often difficult for the infringed party, even if it is aware of the infringement, to defend its rights due to the difficulty in obtaining evidence, as well as time or economic cost. In order to alleviate such situation, Article 70 of the PIPL provides a legal basis for the public interest litigation system in the field of PI: "Where a personal information processor processes personal information in violation of this Law, which infringes upon the rights and interests of a large number of individuals, the people's procuratorate, the consumer organizations designated by the law and organizations determined by the national cyberspace administration may file a lawsuit with the people's court in accordance with the law."

The Regulations, however, establish for the first time a public interest litigation system in the field of data from the perspective of local legislation. Article 98 of the Regulations provides that: "Where the processing of data in violation of the Regulations results in damage to national or public interests, the organizations specified by laws and regulations may institute civil public interest litigations in accordance with the law. Where such organizations institute civil public interest litigations, the people's procuratorate may support such litigations if it deems necessary; where such organizations do not institute the litigations, the people's procuratorate may do so in accordance with the law. Where the people's procuratorate found that any department responsible for data supervision and administration illegally exercises its functions and powers or fails to perform its duties, which results in damage to national or public interests, the people's procuratorate shall make a procuratorial proposal to the relevant administrative organ. If the administrative organ fails to perform its duties in accordance with the law, the people's procuratorate may institute an administrative public interest litigation in accordance with the law."

IV. Compliance takeaways

Based on the above review of the obligations and liabilities for the personal data processing, we put forward the following advice for enterprises on how to process personal data in a legal and compliant manner:

(I) Identifying and updating applicable compliance obligations

Currently, China's legislation and practice in personal data protection are still in the primary stage, and the top-level legal framework is still underway. The relevant departments and localities have formulated rules, regulations, standards, policies and guiding documents applicable to specific fields, industries and regions according to their actual needs. Therefore, enterprises should first identify their compliance obligations in order to process personal data in a legal and compliant manner. Given the rapid development in the legislation and related policies in the data sector, and considering the applicable legislative documents and relevant policies are constantly updated, enterprises'compliance obligations are also adjusted accordingly. As such, enterprises must regularly update their identified obligations and risks.

(II) Developing and improving internal regulations relating to the personal data processing

After identifying the applicable compliance obligations, enterprises should, based on their actual situation and in combination with the requirements of relevant laws and regulations, formulate and improve their internal management systems, operating procedures and format texts related to the personal data processing in accordance with the relevant laws and regulations so as to regulate the behaviour of employees in processing personal data. Enterprises should perform compliance obligations throughout their daily production and operation activities.

(III) Keeping records relating to personal data processing

With regard to the possible civil liability arising from the personal data processing, Article 69 of the PIPL provides the principle of "presumption of fault" for PI processors. The principle specifies that if an enterprise cannot prove that it is not at fault for the infringement of the rights and interests of PI subjects in data processing, it shall be liable for damages and other tort liabilities. In order to avoid the tort liabilities in future disputes, enterprises should keep records relating to personal data processing, so that in case of disputes, they can prove that they have processed personal data in a legal and compliant manner.

INTERPRETATION OF THE DATA REGULATIONS OF THE SHENZHEN SPECIAL ECONOMIC ZONE (II) - DATA SECURITY COMPLIANCE

Liu Ting, Hu Bingxin

Introduction

This article will examine the compliance requirements of enterprises and the corresponding liability for non-compliance under the *Data Regulations of the Shenzhen Special Economic Zone* (the Regulations) from the perspective of data security, in order to help enterprises get well prepared.

I. Definitions

(I) Data

"Data" refers to "any information recorded by electronic or other means" according to Article 2 (1) of the Regulations. This definition directly adopts the definition of "data" in the Data Security Law (the DSL).

(II) Data processing

Data processing refers to "the collection, storage, use, processing, transfer, provision, disclosure and other activities in respect of data" according to Article 2 (6) of the Regulations. Article 2 of the DSL stipulates that the DSL applies to data processing activities and the security regulation of such activities within the territory of the People's Republic of China (the PRC). Therefore, enterprises should first apply the relevant provisions of DSL when conducting data processing activities.

(III) Data security

"Data security" means the "adoption of measures necessary to ensure that the data is in a state of effective protection and legal utilization, and to possess the capability to guarantee the continuous security of data", according to Article 3 of the DSL.

II. Data security protection obligations

Data processing activities by an enterprise as a data processor such as collection, storage, use, processing, transfer, provision, disclosure and other processing activities are directly regulated by the DSL. Chapter 5 of the Regulations, on the basis of Chapter IV "data security protection obligations" of the DSL, further sets forth more specific data security protection obligations from the following two aspects:

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(I) Clarifying a data processor's data security management responsibilities. The data processor is required to comply with the security management obligations during data collection, processing, storage, sharing, disclosure, destruction, sub-processing and cross-border transfer, among others, and to properly monitor, give early warnings, and respond to data security incidents:

No.	Specific compliance obligations under the Regulations	Corresponding provisions of the DSL
1	The data processor shall record its whole data processing procedure and ensure that the source of data is lawful and the whole processing procedure is clear and traceable (Article 75).	Whoever carries out data processing activities shall, in accordance with the laws and regulations, establish and improve the whole-process data security management system, organize and carry out data security education and training, and take appropriate technical and other necessary measures to ensure data security. When information networks such as the internet are used to carry out data processing activities, the above obligations of data security protection shall be performed on the basis of the multi-level protection scheme for cybersecurity[1] (Article 27 Paragraph 1).
2	The data processor shall, in accordance with the laws and regulations and national standards, de-identify or anonymize the personal data collected, and store such data separately from the data that may be used to re-identify a specific natural person (Article 76 Paragraph 1).	
3	The data processor shall manage data storage by domain and by classification, and select the storage carriers whose security performance and protection level match the security level (Article 77).	
4	The data processor shall carry out technical security protection for the data processing, and establish a disaster recovery and backup system for important systems and core data (Article 78).	
5	Where the data processor shares and discloses data, the processor shall establish a security management system for data sharing and disclosure, and establish and improve a security management mechanism for external data interface (Article 79).	
6	The data processor shall establish a data destruction procedure to effectively destroy the data that needs to be destroyed. Where a data processor is terminated or dissolved without a data recipient, the processor shall effectively destroy the data under its control in a timely manner, unless otherwise provided by laws and regulations (Article 80).	
7	Where a data processor engages another party to process data, the processor shall enter into a data security protection contract with that party, specifying the security protection responsibilities of the parties. After completing the sub-processing, the engaged party shall, in a timely and effective manner, destroy the data it may have stored, unless otherwise provided by laws and regulations or agreed by the parties (Article 81).	

[1] Article 21 of the CSL: The state implements the multi-level protection scheme for cybersecurity, under which network operators are required to fulfill the following security protection obligations to protect the network from interference, damage or unauthorized access and prevent the network data from divulgence, theft or tampering: (1) developing internal security management systems and operating procedures, determining the person in charge of cybersecurity, and enforcing the responsibilities for cybersecurity; (2) taking technical measures to prevent computer virus, network attacks, network intrusions and other activities that may endanger cybersecurity; (3) taking technical measures to monitor and record network operation and cybersecurity incidents, and maintaining the relevant network logs for no less than six months as required; (4) taking such measures as data classification, and backup and encryption of important data; and (5) performing other obligations provided for in relevant laws and administrative regulations.

No.	Specific compliance obligations under the Regulations	Corresponding provisions of the DSL
8	Where a data processor provides an overseas party with personal data or important data specified by the state, the processor shall, in accordance with the relevant provisions, apply for security assessment of cross-border data transfer to go through the State security review (Article 82).	The provisions of the PRC Cybersecurity Law (the CSL)[2] shall apply to the security management for the cross-border transfer of important data collected or generated by critical information infrastructure operators during their operations within the territory of the PRC; and the security management measures for cross-border transfer of important data collected or generated by other data processors during their operations within the territory of the PRC shall be formulated by the national cyberspace administration in conjunction with relevant authorities under the State Council (Article 31).
9	The data processor shall implement measures commensurate with the data security protection level to monitor and give early warnings about abnormalities such as data leakage, damage, loss and tampering. Upon detecting any actual or possible data security incident such as data leakage, damage, loss and tampering, the data processor shall immediately take remedial and preventive measures (Article 83).	Whoever carries out data processing activities shall strengthen risk monitoring and take immediate remedial measures upon discovery of any data security defect, vulnerabilities or other risks; and take immediate response measures upon occurrence of a data security incident, notify users in a timely manner in accordance with the relevant provisions and report to the relevant competent authority (Article 29).
10	The data processor shall establish a data security emergency response mechanism and develop a data security emergency plan which shall classify data security incidents according to factors such as the degree of damage and scope of impact, and stipulate corresponding emergency response measures (Article 85).	
11	In case of any data security incident such as data leakage, damage, loss and tampering, the data processor shall immediately activate the emergency plan, take corresponding emergency response measures, inform relevant right holders in a timely manner, and report to the municipal cyberspace and public security authorities and the relevant competent authority of the industry in accordance with relevant provisions (Article 86).	

[2] Article 37 of the CSL: Personal information and important data collected or generated by critical information infrastructure operators during their operations within the territory of the PRC shall be stored within the PRC. If it is necessary to provide such personal information or important data to overseas recipients due to business needs, a security assessment shall be conducted in accordance with the measures formulated by the national cyberspace administration in conjunction with relevant authorities under the State Council; where laws and administrative regulations provide otherwise, such provisions shall prevail.

(II) Enhancing the protection and security management responsibilities for sensitive personal data and important data:

No.	Specific compliance obligations under the Regulations	Corresponding provisions of the DSL
1	Whoever processes sensitive personal data or important data specified by the state shall, in accordance with the relevant provisions, set up a data security management body, identify a person responsible for data security management, and implement special technical protection (Article 73).	An important data processor shall identify the person and management body in charge of data security to enforce the responsibilities for data security and protection. (Article 27 Paragraph 2).
2	The data processor shall develop and implement de-identification, anonymization or other security measures for sensitive personal data and important data specified by the state (Article 76 Paragraph 2).	/
3	The data processor shall also take encrypted storage, authorized access or other stricter security protection measures for sensitive personal data and important data specified by the state (Article 77).	/
4	Whoever processes sensitive personal data or important data specified by the state shall, in accordance with the relevant provisions, conduct regular risk assessments and submit risk assessment reports to the relevant competent authority (Article 84).	An important data processor shall, in accordance with the relevant provisions, conduct regular risk assessments of its data processing activities and submit risk assessment reports to the relevant competent authority. The risk assessment report shall contain the categories and amount of important data processed, the information on the data processing activities carried out, the data security risks faced and its countermeasures (Article 30).

III. Legal liability for breach of data security protection compliance obligations

In view that the provisions of the Regulations on data security are mainly the refinement of the relevant provisions of the DSL, the Regulations do not set up additional legal liabilities in addition to the provisions of the upper-level law. Article 96 of the Regulations provides: "Where, in violation of the Regulations, a data processor fails to perform data security protection responsibilities, the processor shall be punished in accordance with the relevant data security laws and regulations." The key existing data security laws and regulations include the DSL and the CSL.

Under the framework of the DSL and the CSL, a breach of obligations related to data security protection may result in the following liability:

(I) Civil liability

Whoever violates the DSL and causes damage to others shall bear civil liability in accordance with the law (Article 52 Paragraph 1, the DSL).

(II) Administrative penalties

Violations	Penalties	Heavier penalties	Legal basis
• The data processor fails to establish a sound data security management system, to conduct security education and training, to take corresponding technical and other necessary measures to ensure data security, or to identify the person and management body in charge for important data; • In processing data, the data processor fails to strengthen risk monitoring as required; to take remedial measures immediately upon discovery of any data security defect, vulnerabilities or other risks; or to take immediate response measure upon occurrence of a data security incident, notify users in a timely manner in accordance with the relevant provisions or report to the relevant competent authority; • The important data processor fails to, in accordance with the relevant provisions, conduct regular risk assessments of its data processing activities and submit risk assessment reports to the relevant competent authority.	• Order rectification, give a warning, and may concurrently impose a fine between RMB 50,000 and RMB 500,000; • May impose a fine between RMB 10,000 and RMB 100,000 on directly responsible persons in charge and other directly liable persons.	• Impose a fine between RMB 500,000 and RMB 2,000,000 if the data processor refuses to make rectifications or causes serious consequences such as massive data leakage; • May also order suspension of related business activities, cessation of business for rectification, revocation of related business permit or business license; • Impose a fine between RMB 50,000 and RMB 200,000 on directly responsible persons in charge and other directly liable persons.	Article 45 Paragraph 1, the DSL
Violating the national core data management system, thus endangering the national sovereignty, security and development interests	• The relevant competent authority shall impose a fine between 2,000,000 and RMB 10,000,000; • As applicable, also order suspension of related business activities, cessation of business for rectification, revocation of related business permit or business license.		Article 45 Paragraph 2, the DSL

Violations	Penalties	Heavier penalties	Legal basis
Providing important data to an overseas party in violation of the relevant provisions on security management of cross-border transfer of such data	• Order rectification, give a warning, and may concurrently impose a fine between RMB 100,000 and RMB 1,000,000; • May impose a fine between RMB 10,000 and RMB 100,000 on directly responsible persons in charge and other directly liable persons.	• Impose a fine between RMB 1,000,000 and RMB 10,000,000 if the circumstances are serious; • May also order suspension of related business activities, cessation of business for rectification, revocation of related business permit or business license; • Impose a fine between RMB 100,000 and RMB 1,000,000 on directly responsible persons in charge and other directly liable persons.	Article 46, the DSL
The critical information infrastructure operator fails to, as required, store within the PRC personal information and important data collected or generated during its operations within the territory of the PRC; or fails to conduct any security assessment in accordance with the relevant national provisions, stores network data outside the PRC or provide network data to an overseas party	• Order rectification, give a warning, confiscate illegal gains, and impose a fine between RMB 50,000 and RMB 500,000; • May also order suspension of related business activities, cessation of business for rectification, shutdown of website, revocation of related business permit or business license; • Impose a fine between RMB 10,000 and RMB 100,000 on directly responsible persons in charge and other directly liable persons.		Article 66, the CSL

(III) Penalties for administration of public security

Article 52 Paragraph 2 of the DSL stipulates that those who violate the provisions of the data security law and constitute violations of public security management shall be given public security management punishment according to law. The current *Law on Penalties for Administration of Public Security* (the PAPS Law) does not provide any specific basis for penalties for breach of data security protection obligations and the DSL has not yet come into effect. In practice, therefore, there are few cases involving penalties for breach of data security protection obligations. According to the relevant CSL enforcement practice, however, it is foreseeable that a data processor who breaches its data security protection obligations may be subject to penalty for administration of public security based on the alleged intrusion or destruction of computer information systems specified in Article 29 of the PAPS Law. Take for example the Administrative Penalty Decision [2018] No. 70006 issued by Zhaoshang Police Station of Nanshan Branch of Shenzhen Public Security Bureau. In the Decision, Shenzhen Public Security Bureau found that the violator's failure to take technical measures for international networking security protection constituted the violation specified in

Article 29 (4) of the PAPS Law, i.e. "intentional production or dissemination of computer viruses or other destructive programs which affects the normal operation of computer information systems". Pursuant to Articles 21 and 24 of the CSL and Article 12 of the *Administrative Measures for the Protection of International Networking Security of Computer Information Networks*, Shenzhen Public Security Bureau decided to give a warning and order rectification.

(IV) Criminal liability

According to Article 45 Paragraph 2 of the DSL, those who violate the national core data management system and endanger national sovereignty, security and development interests and constitute a crime shall be held criminally liable in accordance with the law. According to the relevant provisions of the PRC Criminal Law, the abovementioned violations of data protection obligations may involve the following criminal liabilities:

1) Article 111, the PRC Criminal Law [Crimes of Stealing, Spying, Buying or Unlawfully Supplying State Secrets or Intelligence for Parties Outside the Territory of China] Whoever steals, spies into, buys or unlawfully supplies State secrets or intelligence for an organ, organization or individual outside the territory of China shall be sentenced to fixed-term imprisonment of not less than five years but not more than 10 years; if the circumstances are especially serious, he shall be sentenced to fixed-term imprisonment of not less than 10 years or life imprisonment; if the circumstances are minor, he shall be sentenced to fixed-term imprisonment of not more than five years, criminal detention, public surveillance or deprivation of political rights.

   It should be noted that once any person is found to have stolen, spied, bought, or unlawfully provided State secrets or intelligence for an organ, organization, or individual outside the country as prescribed by the above provision, the offence is completed.

2) Article 286 (A), the PRC Criminal Law [Crime of Refusal to Perform the Information Network Security Management Obligation] Network service providers who fail to perform their information network security management obligation provided by laws and administrative regulations, and refuse to make corrections after being ordered by the regulatory authority to take corrective measures shall be sentenced to fixed-term imprisonment of not more than three years, criminal detention or public surveillance in addition to a fine or be sentenced to a fine only under any of the following circumstances: (1) causing the massive dissemination of a large amount of illegal information; (2) causing the leakage of users' information, with serious consequences; (3) causing the loss of criminal case evidence, with serious circumstances; and (4) any other serious circumstance. Where an entity commits the crime as provided for in the preceding paragraph, a fine shall be imposed on it, and its directly responsible person in charge and other directly liable persons shall be punished in accordance with the provisions of the preceding paragraph.

   On 25 October 2019, the Supreme People's Court and the Supreme People's Procuratorate jointly released the *Interpretations on Several Issues Concerning the Application of Law in Handling Criminal Cases Involving Crimes of Illegally Using an Information Network or Facilitating Criminal Activities in Relation to Information Network*, further defining the standards for the crime of refusal to perform the information network security management obligation:

   a) Circumstances that "cause the massive dissemination of a large amount of illegal information" include:: (1) causing the dissemination of more than 200 illegal video files; (2) causing the spread of not less than 2,000 pieces of illegal information other than illegal video files; (3) causing the dissemination of illegal information, although the quantity does not meet the standards specified in Item 1 and Item 2, but the total amount after conversion meets the relevant quantity standards according to the corresponding proportion ; (4) causing the spread of illegal information to not less than 2,000 user accounts; (5) causing the spread of illegal information by taking advantage of communication groups with not less than 3,000 accumulative member accounts or Social Networking Services (SNS) with not less than 30,000 accumulative followers; (6)

causing not less than 50,000 clicks on illegal information; or (7) other circumstances causing the spread of a large amount of illegal information.

b) Circumstances that "cause the leakage of users'information, with serious consequences" include: (1) causing the disclosure of not less than 500 pieces of track information, communication content, credit information, and property information; (2) causing the disclosure of not less than 5,000 pieces of accommodation information, communication records, health and physiological information, transaction information and other user information that may affect personal or property safety; (3) causing the disclosure of not less than 50,000 pieces of user information other than the information set forth in Subparagraphs 1 and 2; (4) causing the disclosure of user information the quantity of which does not meet the standards set forth in Subparagraphs 1, 2 and 3 but meets the relevant quantity standards after conversion at the corresponding proportion in aggregate; (5) causing deaths, serious injuries, mental disorders or kidnapping of others, or other serious consequences; (6) causing material economic losses; (7) seriously disturbing the social order; or (8) causing other serious consequences.

c) Circumstances that "cause the loss of criminal case evidence, with serious circumstances" include: (1) causing loss of evidence of cases involving crimes of endangering State security, crimes of terrorism, crimes committed by mafia-like gangs, and crimes of embezzlement or bribery; (2) causing loss of evidence of cases in which the criminal suspect may be sentenced to fixed-term imprisonment of five years or a severer punishment; (3) causing loss of evidence of criminal cases for multiple times; (4) causing serious impact on criminal proceedings; or (5) other serious circumstances.

d) Circumstances that "cause any other serious circumstance" include: (1) failing to retain a vast majority of user logs or perform the obligation of identifying the authentic identity information; (2) refusing to take corrective actions after being ordered to do so for multiple times within two years; (3) causing information network services to be mainly used for illegal criminal activities; (4) causing information network services and network facilities to be used for implementing cyberattacks, thus seriously affecting the production or life; (5) causing information network services to be used for committing crimes of endangering State security, crimes of terrorism, crimes committed by mafia-like gangs, crimes of embezzlement or bribery or other major crimes; (6) causing damage to the information networks, providing public services, of State organs or in communication, energy, transportation, water conservancy, finance, education, medical care, and other fields, thus seriously affecting the production or life; or (7) other circumstances seriously violating the information network security management obligation.

3) Article 398, the PRC Criminal Law [Crime of Intentionally Divulging State Secrets, Crime of Negligently Divulging State Secrets] Any functionary of a state organ who, in violation of the Law on Guarding State Secrets, intentionally or negligently divulges State secrets, shall be sentenced to fixed-term imprisonment of not more than three years or criminal detention if the circumstances are serious; he shall be sentenced to fixed-term imprisonment of not less than three years but not more than seven years if the circumstances are especially serious. Any person who is not a functionary of a state organ commits the crime mentioned in the preceding paragraph shall, in the light of the circumstances, be punished in accordance with the preceding paragraph.

As to the determination of "serious" and "especially serious" circumstances, the *Provisions of the Supreme People's Procuratorate on the Criteria for Filing Cases of Malfeasance and Infringement Crimes* clarifies the criteria for filing cases of crimes of intentionally and negligently divulging State secrets. All other state-level interpretations or clarifications are silent on the determination.

a) For the crime of intentionally divulging State secrets, a case shall be filed for investigation and prosecution

under any of the following circumstances: (1) divulging at least one State secret at the top-secret level; (2) divulging at least two State secrets at the secret level; (3) divulging at least three State secrets at the confidential level; (4) divulging State secrets to non-overseas organs, organizations or individuals, which has caused or may cause serious consequences such as jeopardizing social stability, economic development or national defense security; (5) spreading or disseminating State secrets orally, in writing or via the internet; (6) using powers to instigate or force others to divulge State secrets in violation of the Law on Guarding State Secrets; (7) divulging State secrets for personal gains; or (8) any other serious circumstance.

b) For the crime of negligently divulging State secrets, a case shall be filed for investigation and prosecution under any of the following circumstances: (1) divulging at least one State secret at the top-secret level; (2) divulging at least three State secrets at the secret level; (3) divulging at least four State secrets at the confidential level; (4) divulging State secrets by connecting computers or computer information systems containing State secrets to the internet in violation of the confidentiality rules; (5) after divulging State secrets or losing the carriers of State secrets, failing to report it, truthfully provide the relevant information or take remedial measures; or (6) any other serious circumstance.

(V) Other consequences

Where, in performing its duty to supervise data security, a relevant competent authority discovers that any data processing activities present a relatively large security risk, it may interview the relevant organization and individuals in accordance with the prescribed authority and procedures, and require the organization and individuals to take measures to address issues and eliminate potential risks. (Article 44, the DSL)

(VI) Public interest litigation

Article 58 of the current *Civil Procedure Law* provides the basic legal basis for the public interest litigation system in China, which provides that "Legally designated organs and relevant organizations may file an action with the people's court against acts jeopardizing public interest such as causing pollution to the environment or damaging the legitimate rights or interests of consumers at large. In the event that a people's procuratorate finds any act that does harm to the protection of the ecological environment and resources, any practice in the food and drug safety field that infringes upon the legitimate rights and interests of consumers, or any other behavior that damages the social benefits of the masses, while performing its duties and functions, it may file an action with the people's court, provided that there is no such organ or organization specified in the preceding paragraph or the organ or organization specified in the preceding paragraph decides not to bring a lawsuit. Where the organ or organization specified in the preceding paragraph files an action, the people's procuratorate may give endorsement to such action." The *Law on the Protection of Consumer Rights and Interests*, the *Law on Environmental Protection*, the *Law on the Protection of Minors*, the *Law on Production Safety* and other substantive laws all have provisions for public interest litigation.

In the field of personal information and data, due to the high secrecy of data infringement in practice, even if it is detected by the infringed party, it is often difficult to defend the rights due to the difficulty in obtaining evidence, as well as time or economic cost. In order to alleviate the current difficult situation of data rights protection, Article 70 of the PIPL provides a legal basis for the public interest litigation system in the field of personal information: "Where a personal information processor processes personal information in violation of this Law, which infringes upon the rights and interests of a large number of individuals, the people's procuratorate, the consumer organizations designated by the law and organizations determined by the national cyberspace administration may file a lawsuit with the people's court in accordance with the law."

The Regulations, however, establish for the first time a public interest litigation system in the field of data rather than personal information from the level of local legislation. Article 98 of the Regulations provides: "Where the processing

of data in violation of the Regulations results in damage to national or public interests, the organizations specified by laws and regulations may institute civil public interest litigations in accordance with the law. Where such organizations institute civil public interest litigations, the people's procuratorate may support such litigations if it deems necessary; where such organizations do not institute the litigations, the people's procuratorate may do so in accordance with the law. Where the people's procuratorate finds that any department responsible for data supervision and administration illegally exercises its functions and powers or fails to perform its duties, which results in damage to national or public interests, the people's procuratorate shall make a procuratorial proposal to the relevant administrative organ. If the administrative organ fails to perform its duties in accordance with the law, the people's procuratorate may institute an administrative public interest litigation in accordance with the law."

IV. Compliance takeaways

Based on the above analysis of data security protection obligations and responsibilities for violations, we put forward the following recommendations for enterprises on how to process data in a legal and compliant manner:

(I) Closely following up with the introduction of key data catalogues and relevant requirements, focusing on identifying important data

The protection of important data is a major security supervision obligation under the framework of the DSL. It rests with various regions and departments to determine which data is important by introducing the relevant catalogs and interpretations. The competent authorities of various industries will determine and explain the definition and scope of important data in their industries in light of the latest developments and introduce or improve relevant rules. Therefore, enterprises are advised to pay close attention to the catalogs of important data formulated by the state, region, competent authority and industry. They should establish or refine their internal data protection catalogs and systems accordingly, so as to satisfy the requirements for classified and graded data protection and supervision of important data and get prepared in advance.

For risk assessment and management of cross-border transfer of important data, enterprises may consult with a legal counsel or other third-party institutions in preparing relevant reports to better meet regulatory requirements and carry out relevant business in compliance with laws and regulations.

(II) Setting up a comprehensive internal data security management framework and system for regular and whole-process performance of data security protection obligations

For many enterprises, their daily operations involve a large number of data collection and processing activities. A data security management framework and system that runs through the whole life cycle of data is undoubtedly a cost-effective and highly efficient way to fulfill the regular and whole-process data protection obligations of enterprises as data processors. Enterprises should enhance compliance awareness in data protection. Based on their own business scenarios, enterprises need to establish their own whole-process data management framework and system and formulate corresponding rules, processes and operating guidelines for data collection, storage, use, processing, transfer, sharing and disclosure.

INTERPRETATION OF THE DATA REGULATIONS OF THE SHENZHEN SPECIAL ECONOMIC ZONE (III) - DATA RIGHTS AND INTERESTS AND DATA TRANSACTIONS

Liu Ting, Hu Bingxin

Introduction

This article will examine the compliance requirements of enterprises and the corresponding liability for non-compliance under the *Data Regulations of the Shenzhen Special Economic Zone* (the Regulations) from the perspective of data rights and interests and data transactions, in order to help enterprises get well prepared and better participate in data transactions.

I. Data rights and interests and data transactions

The protection of data rights and the data transaction system are one of the highlights and breakthroughs of the Regulations, which are the first local legislation that provides for the protection of data rights and interests and attempt to establish a data transaction management system. Previously, there was no legislative provision on the definition and entitlement to data rights and interests, as well as how to realize and regulate data transactions. Article 127 of the PRC Civil Code provides: "where the law has provisions on the protection of data and network virtual property, the provisions shall be followed". This provision offers a window for the protection of data rights and interests. Article 19 of the PRC Data Security Law proposes for the first time that "the State establishes and improves a data transaction management system, regulate data transaction practices and foster a data transaction market", indicating support for legitimate data transactions.

On 24 January 2022, the National Development and Reform Commission and the Ministry of Commerce jointly issued the *Opinions on Several Special Measures to Relax Market Access for Shenzhen to Build a Pilot Demonstration Zone for Socialism with Chinese Characteristics* (Fa Gai Ti Gai [2022] No. 135), which stresses the following: "Relaxing market access in related fields such as data element transactions and cross-border data business. On the premise of strict quality control and a feasible business model, we should prudently study the establishment of a data element

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trading place, accelerate the gathering and circulation of data elements in the GBA, and encourage Shenzhen, under the framework of national laws and regulations, to carry out local policy research and exploration and establish basic systems and technical standards for data resource property rights, trading and circulation, cross-border transfer, information rights and interests, and data security protection." The all-round development of data element market and data industry in Shenzhen has been guaranteed by the national policy.

Article 3 of the Regulations clearly and comprehensively stipulates the personality rights and interests of personal data subjects, such as the right to know, the right to supplement and rectification, the right to erasure, and the right to access and copy. Articles 4, 58 and 67 of the Regulations specify the property rights and interests in data products and services, and explicitly provide that data products and services formed from the lawful processing may be transacted in accordance with the law.

- Article 4: Natural persons, legal persons and unincorporated organizations are entitled to the property rights and interests stipulated by laws, administrative regulations and the Regulations in relation to data products and services formed from lawful processing of data; provided, however, that such entitlement shall not endanger national security or public interests or damage the legitimate rights or interests of others.
- Article 58: Market players may, in accordance with the law, independently use, obtain profits from, and dispose of data products and services formed from lawful processing of data.
- Article 67: Data products and services formed from the lawful processing of data by market players may be transacted in accordance with the law.

The above provisions mean that enterprises have the property rights and interests specified in the Regulations in respect of their data products and services that meet the principles and requirements of personal data processing and are formed from lawful processing. Thus, they have the right to participate in data trading activities.

II. Data transaction rules and related compliance obligations

The state is promoting the establishment of data element market. In this context, market players may trade through a data transaction platform or with each other on their own in accordance with the law. Shenzhen is also promoting the establishment of the data exchange. Enterprises should observe the following rules and obligations in the course of data transaction, and in the use and disposal of their products and services formed from lawful processing of data:

1. **Implementing the primary data management responsibilities:** Market players carrying out data processing activities shall implement the primary data management responsibilities, establish and improve an organizational structure, management system and self-evaluation mechanism for data governance, implement classified and graded data protection and management, strengthen data quality management, and ensure the veracity, accuracy, integrity and timeliness of data (Article 57).
2. **Disclosing or providing personal data to third parties for use in compliance with the applicable regulations and agreements:** When disclosing or providing personal data to third parties for use, market players shall comply with the relevant provisions of Chapter 2 of the Regulations; when disclosing, having sub-processed, providing personal data to specific third parties for use, market players shall enter into the relevant agreements (Article 59).
3. **Complying with the personal data laws and regulations and relevant agreements:** Use, transfer or sub-processing of data products and services of other market entities shall comply with Chapter 2 of the Regulations and the relevant agreements if personal data is involved (Article 60).
4. **No prohibitions on transaction:** Data products and services formed from the lawful processing of data by market

entities may be transacted in accordance with the law, except: (i) where the data products and services transacted contain personal data that are not authorized in accordance with the law; (ii) where the data products and services transacted contain public data that has not been lawfully made available; or (iii) where otherwise prohibited by laws and regulations (Article 67).

5. **Performing the obligation of fair competition:**

   a) Market players shall observe the principle of fair competition, and shall not commit the following acts infringing upon the legitimate rights and interests of other market players: (i) obtaining data from other market players by illegal means; (ii) providing alternative products or services by making use of illegally collected data of other market players; or (iii) other acts prohibited by laws and regulations (Article 68).

   b) Market players shall not make use of data analysis to give discriminatory treatment to trading counterparties with the same trading conditions (i.e. the so called "big data-enabled price discrimination against existing customers"), except under any of the following circumstances: (i) implementing different trading conditions in accordance with the actual needs of trading counterparties and in line with proper trading practices and industry customs; (ii) carrying out preferential activities within a reasonable period of time for new users; (iii) implementing random trading on the basis of fair, reasonable and non-discriminatory rules; and (iv) other circumstances prescribed by laws and regulations (Article 69).

   c) Market players shall not exclude or restrict competition by entering into monopoly agreements, abusing their dominant position in the data element market, illegally implementing concentration of undertakings or otherwise (Article 70).

III. Legal liability for violations in data transactions and data element market activities

(I) Administrative penalties

In accordance with Articles 94 and 95 of the Regulations, enterprises violating the rules of data transactions and using their products and services formed from lawful processing of data for unfair competition will mainly be subject to administrative penalties. On 5 January 2022, the Shenzhen Administration for Market Regulation issued the *Implementing Standards on the Discretion Regarding Administrative Penalties under the Data Regulations of the Shenzhen Special Economic Zone*, further clarifying the implementing standards and corresponding circumstances for the penalty provisions stipulated in the Regulations.

Penalties and circumstances for the violations mentioned in the above paragraph are as follows:

Penalty provision	Illegal activities	Relevant circumstances	Penalties
Article 94, the Regulations	• Transacted data products and services contain personal data for which authorization has not been obtained in accordance with the law; • Transacted data products and services contain public data that has not been lawfully made available; or • Data transactions are otherwise prohibited by laws and regulations.	• Having been subject to administrative penalty for two or more times for violations of the same kind; • Obstructing law enforcement officers from performing their duties according to law by means of violence or threat; • Refusing or evading supervision or inspection, or forging, destroying or concealing relevant evidence materials; or • Refusing to take corrective, emergency or other measures, resulting in the increased consequences.	Order rectification, confiscate illegal gains, and impose a fine of RMB 200,000 if the transaction amount is less than RMB 10,000 or a fine of RMB 1,000,000 if the transaction amount is RMB 10,000 or more.
		• Having been subject to administrative penalty for one time for violations of the same kind; • Obstructing or interfering with law enforcement by means of other than violence; or • Submitting false materials in the course of investigation.	Order rectification, confiscate illegal gains, and impose a fine of RMB 100,000 if the transaction amount is less than RMB 10,000 or a fine of RMB 500,000 if the transaction amount is RMB 10,000 or more.
		• Violating regulations for the first time, with minor harmful consequences; • Cooperating with law enforcement officers in investigating and punishing the violations; • Actively eliminating or mitigating the harmful consequences of the violations; or • Cooperating in the investigation of the case.	Order rectification, confiscate illegal gains, and impose a fine of RMB 50,000 if the transaction amount is less than RMB 10,000 or a fine of RMB 200,000 if the transaction amount is RMB 10,000 or more.

Penalty provision	Illegal activities	Relevant circumstances	Penalties
Article 95, the Regulations	• Violating the principle of fair competition and infringing upon the legitimate rights and interests of other market players; or • Making use of data analysis to give discriminatory treatment to transaction counterparties with the same transaction conditions.	• Having been subject to administrative penalty for two or more times for violations of the same kind; • Obstructing law enforcement officers from performing their duties according to law by means of violence or threat; • Refusing or evading supervision or inspection, or forging, destroying or concealing relevant evidence materials; or • Causing serious social impact and consequences.	A fine of RMB 500,000 shall be imposed; if the circumstances are serious, a fine of 5% of the turnover of the previous year, but not more than RMB 50 million at the maximum shall be imposed.
		• Having been subject to administrative penalty for one time for violations of the same kind; • Obstructing or interfering with law enforcement by means of other than violence; or • Submitting false materials in the course of investigation.	A fine of RMB 250,000 shall be imposed; if the circumstances are serious, a fine of 3% of the turnover of the previous year, but not more than RMB 30 million at the maximum shall be imposed.
		• Violating regulations for the first time, with minor harmful consequences; • Cooperating with law enforcement officers in investigating and punishing the violations; • Actively eliminating or mitigating the harmful consequences of the violations; or • Cooperating in the investigation of the case.	A fine of RMB 50,000 shall be imposed; if the circumstances are serious, a fine of 1% of the turnover of the previous year, but not more than RMB 10 million at the maximum shall be imposed.
	Violating Article 70 of the Regulations by conducting unfair competition or monopoly.	Impose penalty in accordance with the relevant laws and regulations on anti-unfair competition or anti-monopoly.	

(II) Civil liability

With the rapid development of industry and technology, market players gradually realize the economic value of the data they collect and control. Data rights and interests, like intellectual property and other property rights and interests, should be recognized and protected by law. Before the legislation is clear on data rights, disputes related to data rights and interests had been arising. Previously, since the legislation did not explicitly empower data rights and interests, nor did it define the boundaries for the acts of infringing the data rights and interests, the parties involved in the data rights and interests disputes used to resort to the Anti-Unfair Competition Law, claiming that their legitimate rights and interests were damaged by unfair competition. The Regulations clearly empower the property rights and interests of data products and services from the local legislative level for the first time. Thus, the parties to disputes over data rights and interests are provided with a strong theoretical basis to claim that their legitimate rights and interests are damaged by unfair competition.

Data is an important resource for which market players are competing fiercely. In the business activities of an enterprise, infringement of the data rights and interests of other right holders may constitute unfair competition and render the enterprise subject to civil liability. Take for example an unfair competition dispute between a computer company and a network technology company[1]. The plaintiffs claimed that the defendants monitored, captured and stored on its own server the account information, friendship chain information and user operation information of the plaintiffs'software users, thus seizing the plaintiffs'data resources and infringing upon the plaintiffs'legitimate rights and interests in its data. The defendants argued as below: the rights and interests in the social data on the software users and their friends should belong to the users; the plaintiffs did not enjoy any data rights or interests; users had the right to carry personal data, and their choice of backup and storage of the personal data is unrelated to the original data controller. The court of first instance held that the plaintiffs had legitimate rights and interests in the data resources of its products. By signing the Service Agreement, the Privacy Policy and other agreements with the user, the plaintiffs had obtained the consent of the user for the collection and control of user data. The plaintiffs did not illegally collect or control any data or use any data in other platforms. The plaintiffs'product data resources were formed from lawful operations with a large investment in human and material resources. The data resources can bring commercial benefits and competitive advantages to the plaintiffs. The plaintiffs should enjoy the competitive rights and interests in its product data resources. Without authorization, the defendants collected the plaintiffs'user data through the allegedly infringing plug-in software, and stored the data in the server under his control. Their unauthorized collection and storage constituted unfair competition because they not only endangered the security of the plaintiffs'user data, but also substantially harmed the plaintiffs'competitive rights and interests based on the data resources as a whole. The court of first instance ruled that the defendants should cease the unfair competition and compensate the plaintiffs for economic losses and reasonable expenses totaling RMB 2.6 million. The defendants subsequently filed an appeal but withdrew it during the second instance.

(III) Criminal liability

If an enterprise uses improper means (such as illegally use of crawler technology) in competing for data resources, which endangers the security of information systems, in addition to the aforementioned civil liability, the enterprise may be criminally suspected of, and bear criminal liability for, illegally obtaining computer information system data if the circumstances are serious.

Article 285 of the Criminal Law describes the abovementioned crime as below: "whoever, in violation of state regulations, invades a computer information system other than those in the fields of state affairs, national defense construction or sophisticated science and technology or uses other technical means to obtains data stored, processed or transmitted in the said computer information system, and the circumstances are serious". According to the

[1](2019) Zhe 8601 Min Chu No. 1987.

Interpretations of the Supreme People's Court and the Supreme People's Procuratorate on the Issues Concerning the Application of Laws in Handling Criminal Cases of Harming Computer Information System Security, procedures or instruments used for "intrusion" are described as "having functions that can avoid or break through the security protection measures of computer information systems to obtain computer information system data without authorization or beyond authorization".

Take for example a network technology company's criminally illegal acquisition of computer information system data[2]. The accused company had been using web crawler technology to crawl the property data of a website operated by a company in Beijing since 2018. After the aggrieved website operator took anti-crawling measures, the accused company cracked the anti-crawling measures by cracking verification codes, bypassing challenge logins and other means, and continued to illegally obtain the property data of the website between October 2019 and July 2020. The accused company also used such data in an application developed by itself, and charged its users membership fees to make profits. The court of first instance held that the accused company obtained the computer information system data of the website operator in violation of the national regulations. As the circumstances were particularly serious, the accused company should be punished in accordance with the law. The court convicted the accused company and its relevant responsible persons, and sentenced the company to a fine of RMB 200,000, and its three relevant individuals to imprisonment of 8-18 months and a fine of RMB 10,000-20,000.

IV. Compliance takeaways

(I) Ensuring the compliance of data sources

Processing data in compliance with the applicable regulations and agreements is the fundamental requirement for carrying out data transactions and participating in data element market activities in accordance with the Regulations. The compliance of data sources is fundamental for enterprises to claim their data assets and their property rights and interests in data. Enterprises may refer to the previous articles in this series for the compliance requirements relating to personal data processing and data security protection to identify their obligations and ensure data compliance.

(II) Developing appropriate competition strategies to compete in the data element market

The state encourages the use of data assets to participate in market transactions and competition. An enterprise should standardize corresponding market competition strategies for its core data products in light of its business characteristics. The enterprise should avoid unfair competition, violation of the principle of fair trade or other illegal means to disrupt the market competition order or infringe on the legitimate rights and interests of other market players.

(III) Establishing a mechanism for protecting data rights and interests

At the legislative level, China is promoting the establishment of a data property right system, clarifying relevant rules on data ownership and data infringement to protect data rights and interests. While ensuring their own data security and compliance, enterprises should actively protect their legitimate rights and interests in data resources. For example, they should timely identify the improper use of their data resources by other players in the market and hold the infringing parties civilly liable in accordance with the Unfair Competition Law. By doing so, they can better maintain and develop the commercial value of data resources and enhance their core market competitiveness.

[2](2020) Jing 0105 Xing Chu No. 2594.

INVESTMENT FRONTIER

INTERPRETATION OF KEY POINTS OF THE GENERAL PLAN FOR THE CONSTRUCTION OF THE GUANGDONG-MACAO IN-DEPTH COOPERATION ZONE IN HENGQIN

Liu Xinyu, Hana Ke, Zhang Bo, Lu Tingting, Rong Bingyu

On 5 September 2021, in order to fully implement the important instructions and guidelines of General Secretary Xi Jinping on the cooperation between Guangdong and Macao in the development of Hengqin and support the development of the Guangdong-Macao In-depth Cooperation Zone in Hengqin (the Cooperation Zone), the Central Committee of the Communist Party of China and the State Council issued the *General Plan for the Construction of the Guangdong-Macao In-depth Cooperation Zone in Hengqin* (the General Plan), which has attracted widespread attention of the society. The issuance of the General Plan indicates the Central Government's decision to strongly support the cooperation between Guangdong and Macao and to inject new impetus into Macao's long-term development, another great practice under the system of "One country, Two systems", which has important historical and practical significance. In this article, we will sort out the development policies of Hengqin, compare the policies of the Cooperation Zone with those of the Hainan Free Trade Port, and analyse the features of the General Plan on this basis, suggesting that enterprises should pay attention to the relevant legal risks while grasping opportunities.

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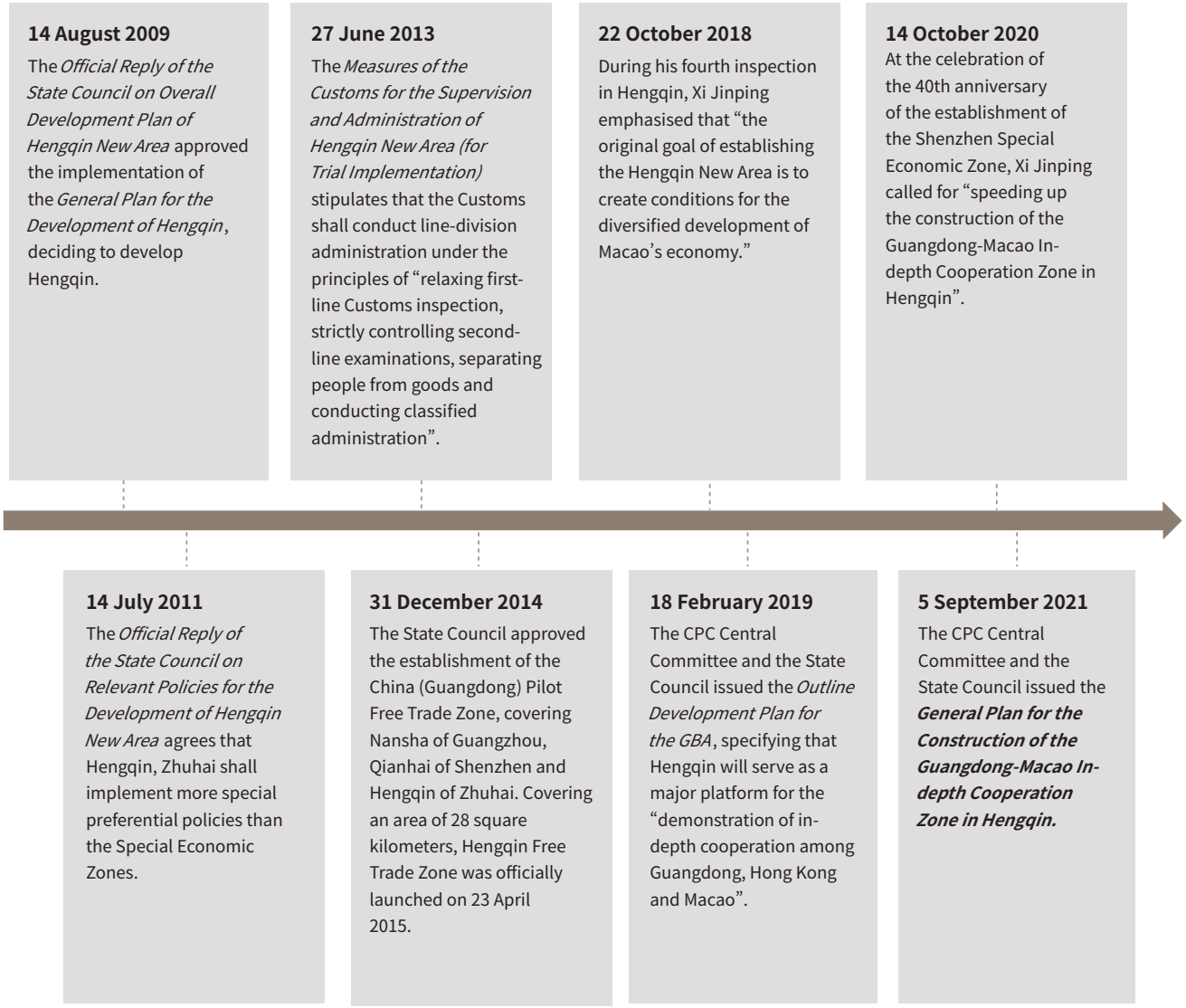
I. Background and significance

Hengqin is located in the south of Zhuhai City, linking to Macao by a bridge over the Pearl River. It has innate advantages in facilitating cooperation between Guangdong and Macao. Therefore, as early as August 2009, the State Council approved the overall development plan of Hengqin, planning to gradually develop Hengqin into a demonstration zone for the new model of cooperation among Guangdong, Hong Kong and Macao under "One country, Two systems", a pioneer zone for deepening reform and opening-up and technological innovation, and a new platform for promoting industrial upgrading in the west bank of the Pearl River Estuary. The *Official Reply of the State Council on Relevant Policies for the Development of Hengqin New Area* issued in 2011 further specifies that Hengqin will implement more special preferential policies than the Special Economic Zones. In recent years, with the gradual implementation of the overall development plan of Hengqin and the overall promotion of the construction of the Greater Bay Area (GBA),

Hengqin has made remarkable achievements in economic and social development, deepened institutional innovation, and constantly improved the level of opening up.

Picture 1: Legislation and development of Hengqin



On 22 October 2018, during his fourth inspection in Hengqin, Xi Jinping emphasised that "the original goal of establishing the Hengqin New Area is to create conditions for the diversified development of Macao's economy." On 14 October 2020, at the celebration of the 40th anniversary of the establishment of Shenzhen Special Economic Zone, Xi Jinping called for "speeding up the construction of Guangdong-Macao In-depth Cooperation Zone in Hengqin". On 5 September 2021, the CPC Central Committee and the State Council issued the General Plan, clarifying the strategic positioning of the Cooperation Zone, and setting "three-step" development goals for 2024, 2029 and 2035. The construction of the Cooperation Zone is an important initiative for the in-depth implementation of the *Outline Development Plan for the GBA*, a major deployment to enrich the practice of "One country, Two systems", and an important driving force for the long-term development of Macao.

II. Comparison between the Cooperation Zone and the Hainan Free Trade Port

The construction of the Cooperation Zone and the Hainan Free Trade Port has been the focus of public attention in recent years. In this article, we will briefly compare the similarities and differences between the Cooperation Zone and the Hainan Free Trade Port in terms of geographical characteristics, strategic advantages and preferential policies, so as to reflect the characteristics and advantages of the Cooperation Zone.

1. Geographical characteristics

Picture 2: Location of Hengqin[1]

Only 187 meters away from Macao on the east side, Hengqin is the only free trade zone directly connected to Hong Kong and Macao by the land transportation system. Its unique location gives it advantages in promoting in-depth cooperation among Guangdong, Hong Kong and Macao. The implementation scope of the Cooperation Zone is the Customs supervision area between the "first line" and the "second line" of Hengqin Island, with a total area of approximately 106 square kilometers. Specifically, the first line refers to Hengqin and the Macao Special Administrative Region (SAR) and the second line refers to the line between Hengqin and other Customs territories of the People's Republic of China (the mainland). The Cooperation Zone is subject to zoning and classified policy management based on the actual situation. The Hengqin Campus of the University of Macau and the Macao jurisdiction of Hengqin Port are subject to the administration of the Macao SAR government authorised by the Standing Committee of the National People's Congress, and are subject to relevant systems and regulations of Macao, which are separated from other areas by physical fences; the region subject to joint consultation, construction, management and sharing between Guangdong and Macao implements special policies for eligible market players by adopting electronic fence regulation and catalogue lists.

[1] Picture credit: *Southern Metropolitan Daily*.

The implementation scope of the Hainan Free Trade Port covers the entire Hainan Island, which is separated from the Leizhou Peninsula by the Qiongzhou Strait. This has created the offshore advantage of being relatively independent, which is conducive to the establishment of a free trade system with closed Customs operations throughout the island. The Hainan Free Trade Port implements special tax policies and regulatory measures by taking what lies between the Port and other countries and regions outside the Customs territory of the PRC as the first line, and that between the Port and other areas within the Customs territory of the PRC as the second line.

2. Strategic positioning

The distinctive geographical characteristics of the Cooperation Zone and the Hainan Free Trade Port lead to their different strategic positioning. The General Plan specifies the strategic positioning of the Cooperation Zone, including the following four points: a new platform for promoting the moderate and diversified economic development of Macao; a new space facilitating Macao residents' living and employment; a new demonstration model for the practice of "One Country, Two Systems"; and a new highland for promoting the development of the GBA. The strategic positioning of the Hainan Free Trade Port in *the General Plan for the Construction of the Hainan Free Trade Port* is to build a pilot area for comprehensive deepening reform and opening up, a national-level pilot zone for eco-civilisation, an international tourism and consumption center and a service-zone providing services for national major strategic projects.

We can see that the strategic positioning of the Cooperation Zone highlights its significance for the diversified economic development of Macao and the construction of the GBA, committed to becoming a new demonstration of the practice of "One Country, Two Systems"; while the strategic positioning of the Hainan Free Trade Port emphasises its strategic significance for deepening reform, promoting a high level of openness and serving major national strategies, to become an important gateway to the outside world.

3. Preferential policies

Both the Cooperation Zone and the Hainan Free Trade Port have proposed preferential policies in such aspects as entry and exit of goods and personnel, taxation system, market access, financial management, introduction of talents, and safe and orderly flow of data. The specific policy comparison is shown in the following table:

(The following is only a basic list according to the overall arrangements of the Central Government; the specific measures taken by the Cooperation Zone and the Hainan Free Trade Port to implement the central arrangements are not compared.)

	Cooperation Zone	Hainan Free Trade Port[2]
Entry and exit of goods	Relaxing "first line" Customs inspection and strictly controlling "second line" examinations.	
	Goods that are manufactured by enterprises in the Cooperation Zone and do not contain imported materials and parts, or goods that contain imported materials and parts and whose added value reaches or exceeds 30% after processing in the Cooperation Zone shall be exempted from import duties when entering the mainland through the "second line". The relevant goods entering the Cooperation Zone from the mainland through the "second line" shall be deemed as exports to which VAT and consumption tax refund shall be implemented in accordance with the prevailing tax policies. Efforts should also be made to study and adjust the scope of goods subject to the tax refund policy and implement negative list management.	Goods that are manufactured by the encouraged industrial enterprises and do not contain imported materials and parts or goods that contain imported materials and parts and whose added value exceeds more than 30% (including) after processing in the Hainan Free Trade Port shall be exempted from import duties when entering the mainland through the "second line", and shall be levied the import VAT and consumption tax in accordance with the regulations. Goods entering the Hainan Free Trade Port from the mainland shall be managed in accordance with circulation provisions, and VAT and consumption tax that have been collected shall be refunded in accordance with the relevant regulations of the State Council.
Entry and exit of people	At the "first line", it is imperative to actively promote the Customs clearance mode of cooperative inspection and one-off release. At the "second line", no restriction is set on the entry and exit of people. (Focusing on the entry and exit of people between the Cooperation Zone and Macao)	Access facilitation should be provided to high-level talents of foreign nationalities in terms of investment and start-ups, lecturing and exchanging activities, and business and trade. A visa-free access policy applicable to a broader range should be phased in and the visa-free duration of stay should be gradually extended.
Taxation system	Efforts should be made to reduce the corporate income tax rate to 15% for the qualified industries and enterprises in the Cooperation Zone. The income derived by the enterprises in the tourism industry, modern service industry and high-tech industry established in the Cooperation Zone from new overseas direct investment shall be exempted from corporate income tax. For the domestic and foreign high-end talents and urgently-needed talents working in the Cooperation Zone, their individual income tax exceeding 15% of the taxable income shall be exempted.	Enterprises registered in the Hainan Free Trade Port and engaged in substantive business activities (except those in the industries on the negative list) are entitled to a reduced corporate income tax rate of 15%. Enterprises in the tourism, modern service and high-tech industries established in the Hainan Free Trade Port are entitled to corporate tax exemption for income from new overseas direct investment before 2025. High-end talents and highly-demanded talents employed in the Hainan Free Trade Port are entitled to the personal income tax rate of 15%.

[2] The comparison in this section is mainly based on the *Overall Plan for the Construction of the Hainan Free Trade Port.* With the gradual advancement of the construction of the Hainan Free Trade Port, a series of policies and measures on this basis were subsequently introduced. However, due to the limitation of space, the subsequent policies and measures are not specifically introduced and analysed here.

	Cooperation Zone	Hainan Free Trade Port
Market access	Implementing the system of market access upon commitment.	
	Efforts should be made to relax restrictions in respect of qualification requirements, shareholding proportion and industry access for various types of investors carrying out investment and trade in the Cooperation Zone. Formulating special measures for relaxing market access in the Cooperation Zone.	Implementing the management system of pre-access national treatment plus the negative list for foreign investment, and substantially reducing the prohibiting and restrictive provisions.
Financial management	Changing from pre-examination to post-examination in authenticity review by banks. Simplifying management in accordance with the model of pre-access national treatment plus a negative list. Making the registration and exchange process in the exchange link more convenient. Exploring new forms of cross-border investment management that meet market needs. Exploring the establishment of a new foreign debt management system.	
	Promoting the financial market in the Cooperation Zone to take the lead to be opened to a high degree.	Providing basic conditions for realizing the free and convenient cross-border capital flow between the Hainan Free Trade Port and foreign countries.
Safe and orderly flow of data	Carrying out the pilot cross-border data transfer security management. Achieving the cross-border interconnectivity of scientific research data.	Further opening up the data field and innovating the design of security systems to realise sufficient data aggregation and foster the development of a digital economy.
Favorable policies for talents	For the domestic and foreign high-end talents and urgently-needed talents working in the Cooperation Zone, the part of individual income tax burden exceeding 15% shall be exempted. As for the Macao residents working in the Cooperation Zone, the portion of their individual income tax burden exceeding that in Macao shall be exempted.	More open talent policies and stay and residence policies for high-end talents should be enacted to foster talent clusters. For high-end talents and urgently-needed talents employed in the Hainan Free Trade Port, the part of individual income tax burden exceeding 15% shall be exempted. Access facilitation should be provided to high-level talents of foreign nationalities.

	Cooperation Zone	Hainan Free Trade Port
Encouraged industries	• Scientific and technological R&D and high-end manufacturing; • Macao brand industries such as traditional Chinese medicine; • Cultural, tourism, exhibition, commerce and trade; and • Modern finance.	• Tourism; • Modern service; and • High-tech industries.
Others	**Making the living and employment of Macao residents convenient:** • Attracting Macao residents to work and start their own businesses; • Strengthening the cooperation with Macao on livelihood; and • Promoting infrastructure interconnection. **Improving the new system featuring joint consultation, construction, management and sharing between Guangdong and Macao:** • Guangdong and Macao will jointly set up a Management Committee of the Cooperation Zone; • The Management Committee of the Cooperation Zone shall set up an executive committee; • The Cooperation Zone will be under the administration of Guangdong Province; • Establishing a benefit-sharing mechanism for the Cooperation Zone; and • Establishing a normal evaluation mechanism.	**Free and convenient transportation:** • Building the home port of "Yangpu Port of China"; • Supporting ship registration at the Hainan Free Trade Port; • Advancing the joint boarding inspection of ships. Formulating more efficient, convenient and superior flag-country special supervision policies. **Social governance:** • Deepening the reform of government institutions; • Promoting the transformation of government functions; • Creating a social governance pattern of joint construction, joint governance and sharing; and • Innovating the ecological civilisation system and mechanism. **Rule of law:** Efforts should be made to establish a free trade port law system with the *Hainan Free Trade Port Law* as the basis and local regulations and commercial disputes resolution mechanisms as important components so as to create a world-class free trade port legal environment.

The above table shows that although there are similarities between the preferential policies of the Cooperation Zone and the Hainan Free Trade Port in terms of trade facilitation, investment facilitation and taxation system, there are still some differences in the types of industries to be developed and other facilitation measures based on their different geographical locations and strategic positioning. The preferential policies of the Cooperation Zone are more focused on promoting Macao's economic development, the cooperation among Guangdong, Hong Kong and Macao and high-level opening up.

III. Interpretation of highlights of the policies of the Cooperation Zone

1. The new system featuring joint consultation, construction, management and sharing between Guangdong and Macao

The Cooperation Zone innovates the management system. Based on the actual situation of the whole island of Hengqin, the Cooperation Zone will be subject to zoning and classified policy management, including the region subject to the administration of the Macao SAR government and the region subject to joint consultation, construction, management and sharing between Guangdong and Macao. The General Plan requires that, under the leadership of the Leading Group for the Construction of the GBA, Guangdong and Macao will jointly set up a Management Committee of the Cooperation Zone, which will make decisions on the major plans, policies, projects and important appointments and dismissals of personnel within their limits of authority. The Management Committee of the Cooperation Zone shall adopt a dual-director system under which the Governor of Guangdong Province and Macao SAR Chief Executive shall jointly assume the posts. The Macao SAR shall appoint an executive vice-chairman and the other vice-chairmen shall be determined by Guangdong and Macao through consultation. The Management Committee of the Cooperation Zone shall set up an executive committee to carry out the functions of international promotion, investment promotion, industry induction, land development, project construction and livelihood management. The Cooperation Zone shall be upgraded to be under the administration of Guangdong Province, and the representative offices of the Guangdong Provincial Committee and the Provincial Government shall be set up.

2. Relaxing "first-line" Customs inspection and strictly controlling "second line" examinations of goods

In June 2013, the General Administration of Customs promulgated the *Measures of the PRC Customs for the Supervision and Administration of Hengqin New Area (for Trial Implementation)*, which stipulates that the ports between Hengqin and Macao shall be subject to the "first-line" administration, and the channels between Hengqin and other areas within the Customs territory of the PRC shall be subject to the "second-line" administration. The Customs shall conduct line-division administration under the principles of "relaxing first–line Customs inspection, strictly controlling second–line examinations, separating people from goods and conducting classified administration". The General Plan basically maintains this principle. The Customs implement filing administration on goods entering and exiting Hengqin via the "first line". Goods entering the mainland via the "second line" from the Cooperation Zone shall be subject to administration as imported goods, and goods entering the Cooperation Zone from the mainland through the "second line" shall be deemed as exports.

In particular, the General Plan specifies that "Goods that are manufactured by enterprises in the Cooperation Zone and do not contain imported materials and parts, or goods that contain imported materials and parts and whose added value reaches or exceeds 30% after processing in the Cooperation Zone shall be exempted from import duties when entering the mainland through the 'second line' ". However, in accordance with the *Measures of the PRC Customs for the Supervision and Administration of Hengqin New Area (for Trial Implementation)*, for the bonded goods produced, processed and sold to other areas by enterprises established in Hengqin, the Customs shall levy import VAT and consumption taxes in compliance with regulations according to the actual inspection declaration status of the goods. The General Plan provides tax incentives for goods processed in the Cooperation Zone with added value, promoting trade development and benefiting the development of the real economy in the Cooperation Zone.

3. Implementing the policy for highly convenient entry and exit of personnel

The General Plan stipulates that, at the "first line", it is imperative to actively promote the Customs clearance mode of cooperative inspection and one-off release, strictly carry out health quarantine and exit and entry border inspection and implement regulations on inbound and outbound luggage in accordance with the law. At the "second line", no restriction is set on the entry and exit of people, and appropriate tax policies shall be formulated for the articles that enter the mainland in the Cooperation Zone through the "second line" and such articles shall be regulated as required. In addition, the General Plan specifically proposes to accelerate the construction of a special passageway between the Hengqin Campus of the University of Macau and Hengqin Port, so as to facilitate the access of the teachers and students of the University of Macau to the Cooperation Zone. It can be predicted that these measures will greatly activate the exchange of all kinds of talents, and thus inject vitality into the talent construction and economic development of the Cooperation Zone.

4. Taxation policies

In terms of corporate income tax, the Cooperation Zone includes all the industries conducive to the moderate and diversified economic development of Macao in the policy scope, and impose enterprise income tax at a reduced rate of 15% on qualified industries and enterprises in the Cooperation Zone. For the qualified capital expenditure of an enterprise, a one-off pre-tax deduction or accelerated depreciation and amortisation is permitted to be made in the expenditure during the current period. The income derived from the new overseas direct investment of the tourism, modern service and high-tech industries established in the Cooperation Zone shall be exempted from corporate income tax.

In terms of individual income tax, the domestic and foreign high-end talents and urgently-needed talents working in the Cooperation Zone shall be subject to list administration, and the part of their individual income tax burden exceeding 15% shall be exempted. As for the Macao residents working in the Cooperation Zone, their individual income tax burden exceeding that in Macao shall be exempted.

The above-mentioned income tax incentives and exemptions fully reflect the positioning of the Cooperation Zone to "promote the moderate and diversified economic development of Macao", "facilitate the living and employment of Macao residents" and "promote the construction of the GBA", which will be conducive to attracting high-end talents and laying a solid foundation for the development of high-end industries.

5. Foreign exchange

The General Plan first puts forward the requirement of innovating cross-border financial management, exploring free inflow and outflow of cross-border capital and promoting the convertibility of capital items in the Cooperation Zone. In addition, the General Plan specifies the measures to implement innovative cross-border financial management, mainly including: (1) for improving banks' financial services, the General Plan requires that banks should change from pre-examination to post-examination in authenticity review, echoing the change in recent years of banks'authenticity review to weaken specific documentary review requirements and shift to post-examination with the core of the three principles of business development; (2) for cross-border direct investment, the General Plan specifies that it is imperative to simplify management in accordance with the mode of pre-establishment national treatment plus a negative list, and making the registration and exchange process in the exchange link more convenient, which reflects the "free inward and outward remittance of RMB or foreign exchange" mentioned in the *Foreign Investment Law*; (3) for cross-border financing, the General Plan proposes to explore the establishment of a new foreign debt management system and enhance the facilitation level of foreign debt funds exchange, which will help market players in the Cooperation Zone to make full use of the "two markets and two kinds of resources" in the international and domestic markets; and (4) for cross-border securities investment and financing, the General Plan proposes to focus on serving the investment and financing needs of the real economy, provide active support in aspects such as overseas listing and

bond issuance, and simplify exchange management, so as to conform to the trend of foreign exchange management reform to serve the real economy.

6. Market access

The General Plan requires that the Cooperation Zone shall implement the market access commitment and manage market access through relaxing requirements and special measures, and emphasises interim and ex-post regulation. Under the premise of "under strict control", for the fields subject to mandatory standards, it is required to cancel the licensing and approval formalities in principle, and establish a sound filing system. Efforts should be made to constantly relax restrictions in respect of qualification requirements, shareholding proportion and industry access for various types of investors carrying out investment and trade in the Cooperation Zone. Moreover, special measures for relaxing market access in the cooperation zone were formulated and promulgated. Efforts should also be made to strengthen interim and ex-post regulation and establish regulatory standards and norms aligned with Macao and international practices.

7. Encouraged industries

The General Plan supports the development of four types of industries in the Cooperation Zone, i.e. scientific and technological R&D and high-end manufacturing, Macao brand industries such as traditional Chinese medicine, culture, tourism, exhibition, commerce and trade, and modern finance. The above industries are provided with preferential policies on corporate income tax and related talent policies.

In the development of scientific and technological R&D and high-end manufacturing industries, the General Plan proposes to vigorously develop integrated circuits, electronic components, new materials, new energy, big data, artificial intelligence (AI), Internet of Things and biomedicine industries. Efforts should be made to speed up the construction of a microelectronics industry chain for characteristic chip design, testing and detection. Moreover, it is important to build an artificial intelligence collaborative innovation ecology and build the application demonstration projects of Internet Protocol version 6 (IPv6), the application demonstration projects of the fifth generation of mobile communication (5G) and the next-generation Internet industry clusters.

In the development of modern financial industries, the General Plan proposes to give full play to the role of Macao as a window to Portuguese-speaking countries and support the building of a financial service platform for China and Portuguese-speaking countries in the Cooperation Zone, which will promote exchanges between China and Portugal, Brazil and other Portuguese-speaking countries, and help the construction of the "Belt and Road Initiative".

8. Safeguard measures

In addition to providing convenience, the General Plan also specifies safeguard measures in terms of Party leadership, rule of law construction, empowerment and risk management mechanisms. Specifically, under the premise of abiding by the Constitution and the *Basic Law of the Macao Special Administrative Region*, it is imperative to gradually build an institutional system in which civil and commercial rules converge with Macao and integrate with international practices. It is necessary to study and formulate the regulations for the Cooperation Zone to provide institutional guarantees for the long-term development of the Cooperation Zone. Zhuhai should be allowed to make flexible provisions on laws, administrative regulations and local regulations as authorised, based on the reform, innovation and practice needs in the Cooperation Zone. It is also required to increase power delegation based on the rule of law. The Cooperation Zone shall be supported in deepening reform and expanding opening-up in key fields such as economic management, business environment and market regulation in the form of list application and authorisation. If the relevant policies and measures of reform and opening-up involve the adjustment of the existing laws, the parties concerned shall submit relevant proposals to the National People's Congress or its Standing Committee according to legal procedures, and implement them upon authorisation or decision; if the relevant existing administrative

regulations involve the adjustment of any existing administrative regulation, the parties concerned shall submit the same to the State Council for authorisation or decision according to legal procedures, and implement them upon approval. These policies further enrich the theoretical practice and give full play to the advantages of "One Country, Two Systems".

IV. Analysis on key compliance matters for conducting business in the Cooperation Zone

As mentioned above, the General Plan further deepens the cooperation among, and the opening up of, Guangdong, Hong Kong and Macao, and sets out clear and specific preferential policies. Driven by the preferential policies and the open market with in-depth cooperation, many domestic and foreign enterprises are expected to do business in the Cooperation Zone. As stated in Article 28 of the General Plan, however, "We should pay more attention to the security as we further open up; we should prepare for worst-case scenarios, enhance awareness of risk prevention, and promptly study and deal with various risks in the process of reform and opening up of the Cooperation Zone". In the coming text, we will, based on the latest policies of the Cooperation Zone, discuss the key compliance matters that may have a greater impact on enterprises, with a focus on cross-border trade. Relevant enterprises are expected to pay special attention to them.

1. The basic compliance in the relaxation of "first-line" Customs inspection

(1) Paying close attention to the list of non-duty free (bonded) goods and making accurate declarations and classifications

According to Article 15 of the General Plan, in respect of relaxing "first line" Customs inspection, the goods (except those passing through the Cooperation Zone) flowing between the Cooperation Zone and Macao through the "first-line" will continue to be subject to the filing administration, and the declaration procedures and elements shall be further simplified. Enterprises should study the list of non-duty free (bonded) goods under national laws and administrative regulations, and make appropriate adjustments. Before making declarations for entering the Cooperation Zone, enterprises should confirm the classification of goods, especially if the classification may be ambiguous. Enterprises should distinguish whether certain goods should be classified in the list or not.

Goods that are not included in the list may enter and exit the "first line" free of duty and, if included in the list, may still be subject to declaration, duty payment or other formalities as required. If an enterprise is suspected of making a false declaration by declaring goods included in the list as goods out of the list, the enterprise may bear the corresponding liability for violating the regulations and be subject to administrative penalties. If the declaration is made on purpose, the enterprise may be suspected of smuggling and bear the corresponding criminal liability. Enterprises need to be reminded that, based on the *Measures for Credit Management of Enterprises Registered and Filed with the Customs* and its supporting regulations[3], enterprises being found guilty of smuggling or being subject to heavy administrative penalties for non-compliance may be downgraded as dishonest enterprises, which will result in a significant increase in Customs clearance costs. Therefore, enterprises need to pay great attention to this issue. We suggest that enterprises, when unable to accurately determine the classification of goods entering via the "first line", apply to the Customs for advance ruling for classification and make declarations according to the results of the ruling, so as to avoid relevant legal risks.

(2) No import of solid wastes prohibited from import

In recent years, China has continuously tightened its policies on the import of solid wastes, which has been clarified through the relevant legislation. On 1 September 2020, the new *Law on the Prevention and Control of Environmental Pollution Caused by Solid Waste* officially came into force. Article 23 of the Law stipulates that solid wastes from

[3] Article 22 of the *Measures for Credit Management of Enterprises Registered and Filed with the Customs.*

abroad are prohibited from being dumped, piled up or disposed of in the territory of the PRC. In January 2021, the *Announcement on Matters Relating to the Comprehensive Ban on the Import of Solid Wastes* (Announcement [2020] No. 53 of the Ministry of Ecology and Environment, the Ministry of Commerce, the National Development and Reform Commission and the General Administration of Customs) came into force, stipulating that it is prohibited to import solid wastes in any form, and overseas solid wastes are prohibited from being dumped, piled up or disposed of in the territory of the PRC, and the previously issued catalogue of solid wastes management was abolished.

Therefore, we suggest that enterprises should be fully aware of the properties of the goods to be imported when they enter the Cooperation Zone through the "first line", in order to avoid the relevant risks. Especially in the current new situation, the following two points deserve special attention: (1) the import volume of solid wastes is often enourmous. An enterprise may be deemed as a violator of regulations if it has no subjective intention of smuggling, or being suspected of smuggling wastes if it has such intention. In either case, however, the enterprise shall at least be unable to apply the administrative measures for advanced certification enterprises, and may even be directly downgraded to a dishonest enterprise and, on this basis, be included in the list of seriously dishonest entities[4], which will have a great impact on the normal operation of the enterprise; and (2) Even just from the penalty amount for the violation without considering the degradation and dishonesty issues, in accordance with Paragraph 1 of Article 115 of the new *Law on the Prevention and Control of Environmental Pollution Caused by Solid Waste*, if an entity, in violation of this Law, imports solid waste from abroad into the PRC, it shall be ordered by the Customs to ship back the solid wastes, and pay a fine of not less than RMB 500,000 but not more than RMB 5 million. This penalty amount is five times the previous amount of RMB 100,000 to RMB 1 million, and the relevant risks and burdens of the enterprise will increase dramatically.

2. Compliance risks under the strict control of "second line" examinations

(1) Paying attention to the value-added proportion of processing

According to Article 15 of the General Plan, the duty-free (bonded) goods that enter the mainland from the Cooperation Zone through the "second line" shall go through the Customs formalities in accordance with the relevant provisions on imported goods and be subject to tariffs and import-related taxes. Goods that are manufactured by enterprises in the Cooperation Zone and do not contain imported materials and parts, or goods that contain imported materials and parts and whose added value reaches or exceeds 30% after processing in the Cooperation Zone shall be exempted from import duties when entering the mainland through the "second line". Particular attention should be paid to the latter part of this provision, i.e. enterprises should have a clear picture of whether the added value of the goods reaches or exceeds 30% and have sufficient evidence to support this. If enterprises have met relevant standards, they will be exempted from import duties and save costs. However, enterprises may risk being imposed administrative penalties or committing smuggling offences if they make inaccurate declarations against the relevant standard, or make wrong declarations for the purpose of tax evasion.

For example, if the imported goods declared by an enterprise do not comply with the relevant provisions on the value-added proportion of processing in the Cooperation Zone, which leads to the tax evasion of the enterprise, the Customs will, in accordance with Article 5 and Article 15(4) of the *Implementing Regulations of the Customs on Administrative Penalties* (the Regulations)[5], impose a fine of not less than 30% of, but not more than 2 times the unpaid tax and order the enterprise to make up the tax. However, if an enterprise is found to have the subjective intention of evading tax at the time of declaration, it shall be held liable in accordance with the provisions on "smuggling act" or "smuggling crime" respectively, depending on whether the evaded tax payable reaches the threshold of RMB 200,000 for the crime of smuggling common goods and articles by an entity.

[4] Article 23 of the *Measures for Credit Management of Enterprises Registered and Filed with the Customs.*

[5] Article 5 of the Regulations (issued on 19 September 2004 and came into force on 1 November of the same year) provides that "where an administrative penalty such as warning or fine is imposed in accordance with the Regulations, without the confiscation of imported or exported goods, articles or transportation vehicles, the relevant party shall not be exempted from the obligation to pay taxes, submit import and export permits and go through relevant Customs formalities."

Article 15 (4) provides that "if the collection of national taxes is affected, a fine of not less than 30% of, but not more than 2 times the unpaid tax shall be imposed."

For smuggling acts that do not reach the threshold, the Customs will usually, in accordance with Article 9(3) of the Regulations[6], impose an administrative penalty of confiscating the smuggled goods and illegal gains, and also a fine of up to three times the amount of the evaded tax payable. Where an entity committing the crime of smuggling common goods, the Customs Anti-Smuggling Department will, after completing the relevant work at the investigation stage, refer the case to the procuratorial authorities for examination and prosecution, and a people's court will, in accordance with Article 153 of the *Criminal Law* and the relevant provisions of the *Interpretations of the Supreme People's Court and the Supreme People's Procuratorate on Several Issues Concerning the Application of Law in Handling Criminal Cases of Smuggling* (the Interpretations), impose a fine on the entity and hold the person directly in charge and other directly responsible persons criminally liable[7]. In addition, the entity may be downgraded to a dishonest enterprise, which will seriously affect the operation or even the survival of the enterprise.

(2) The issue of "carrying goods by passengers" cannot be ignored

According to Article 16 of the General Plan, at the "second line", no restriction is set on the entry and exit of people, and appropriate tax policies shall be formulated for the articles that enter the mainland in the Cooperation Zone through the "second line" and such articles shall be regulated as required. Please be noted that the provisions here only impose no restrictions on the entry and exit of people, while the "goods, articles and means of transport" are still subject to regulation[8]. In other words, the articles carried by people will still be subject to regulation according to specific policies.

According to the relevant laws and regulations, the Customs has a certain limit on the luggage that passengers can bring in and out of the territory, and these articles must be for personal use or used as gifts to friends and relatives, and cannot be used for secondary sales, nor should they be used as tools and parts for enterprise production. The act of "carrying goods by passengers" obviously does not meet the regulatory requirements of Customs. Once the Customs ascertain that there is subjective intention in the act, with a large amount of tax evaded, or the related goods or articles belong to the prohibited or restricted categories, it may lead to the corresponding risk of smuggling crimes. Therefore, we would like to remind all enterprises and their employees to pay close attention to the subsequent policies of the Cooperation Zone, and at the same time, to fully understand the regulatory requirements of Customs, so as to avoid greater legal risks.

3. Risks associated with export controls and sanctions

According to Article 6 of the General Plan, the Cooperation Zone will vigorously develop the industries of integrated circuits, electronic components, new materials, new energy, big data, AI, Internet of Things and biomedicines. These industries are also the focus of export controls and economic sanctions of some countries such as the United States. For example, from the perspective of export controls, many Chinese integrated circuit enterprises have been included in the Entitiy List subject to export controls by the United States. When exporting the related US semiconductor items to enterprises on the Entitiy List, the exporting enterprises need to apply to the US Department of Commerce for export licenses in advance. In addition, some chips and modules of semiconductor enterprises in Asia, Europe and other regions may also involve US technologies or materials. Therefore, the products of such regions are also subject to the relevant US export controls to a certain extent if they were sold to enterprises on the Entitiy List. Enterprises shall pay

[6] Article 9(3) of the Regulations provides that "where anyone evades taxes payable but does not evade the administration of permit and smuggles goods or articles that shall pay taxes according to law, the goods or articles smuggled and the illegal gains shall be confiscated, and a fine of not more than 3 times the evaded taxes payable may also be imposed."

[7] Article 24 of the Interpretations provides that "where an entity commits the crime of smuggling common goods or articles and the evaded tax payable is not less than RMB 200,000 but not more than RMB 1 million, the entity shall be fined, and the persons directly in charge and other directly responsible persons for the offence shall be sentenced to a fixed-term imprisonment of not more than three years or subject to criminal detention in accordance with Paragraph 2 of Article 153 of the *Criminal Law*; where the evaded tax payable is not less than RMB 1 million but not more than RMB 5 million, the circumstance shall be deemed to be 'serious'; where the evaded tax payable is not less than RMB 5 million, the circumstance shall be deemed to be 'particularly serious'."

[8] Article 2 of the Customs Law provides that "the Customs of the People's Republic of China is the State organ for the supervision and management of entry and exit. The Customs shall, in accordance with this Law and other relevant laws and administrative regulations, supervise means of transport, goods, articles of luggage, postal articles and other articles entering and leaving the territory, collect Customs duties and other taxes and fees, investigate and suppress smuggling, and compile Customs statistics and conduct other Customs operations."

attention to these aspects. For the relevant enterprises carrying out the business in the above areas in the Cooperation Zone, we recommend them to have a comprehensive understanding of their own supply chain and upstream and downstream transaction parties, prudently assess the legal risks associated with export controls and sanctions, and establish the relevant compliance system and emergency response mechanism as soon as possible, getting prepared for unexpected blows.

4. Compliance risks in the financial sector

According to Article 28 of the General Plan, the Cooperation Zone shall establish a sound risk management mechanism and promptly study and deal with various risks in the reform and opening up of the Cooperation Zone. The General Plan proposes to build a financial "firewall" by establishing a financial monitoring system for anti-money laundering, anti-terrorist financing and anti-tax evasion.

With the continuous deepening of innovation and opening up in the financial field, the regulatory practice is bound to gradually align with international standards. The review and monitoring of anti-money laundering, anti-terrorist financing and anti-tax evasion should be further strengthened. This also requires enterprises to pay attention to compliance risks in the financial sector, and manage the risks timely and properly. They should develop an awareness of compliance risks, improve their compliance risk management structure, and build internal control and risk management systems and processes for anti-money laundering and anti-terrorist financing in accordance with relevant regulations in order to conduct relevant business in a more compliant manner. Additionally, the relevant enterprises should also actively address the relevant risks, regularly check their financial compliance risks based on internal control and risk management systems and processes, and promptly screen their businesses for compliance risks. They should also review the flow of funds and analyse the reasons for the inflow or outflow of funds to prevent the risk of abnormal cross-border fund flows.

Conclusion

Following the plan for the development of the Hainan Free Trade Port, the introduction of the General Plan undoubtedly points out the direction for the future economic development of the Cooperation Zone, not only conducive to promoting the development of Macao, but also a new attempt of "One Country, Two Systems". This new system featuring joint consultation, construction, management and sharing is not only applicable at home, but also expected to be used for reference in future international exchanges. Supporting regulations are expected to be released following the introduction of the General Plan. We will continue to pay attention to the related developments and provide professional interpretations to help enterprises grasp the opportunities of the times and ride the waves.

KWM INTERNATIONAL CENTER

In response to the national GBA development strategy, KWM established the KWM International Center in the GBA on 28 April 2018 to better serve the clients and continuously promote its international development strategy. Backed by KWM Shenzhen, Hong Kong, Guangzhou, Haikou, Sanya and Zhuhai offices, KWM International Center will closely follow the market demand in the GBA, connect and release the KWM global network resources and focus on the business areas with strong market demand including the "Belt and Road"/"Going Global", high-end financial services, private equity/venture capital, capital market, unicorn, intellectual property protection, and cross-border dispute resolution.

KWM Hong Kong office currently has nearly 240 lawyers and other legal professionals. Many partners and lawyers are licensed to practice law in multiple jurisdictions and well versed in crossborder transactions. In addition to provision of services under the laws of Hong Kong SAR, Australia, the UK, the US and other jurisdictions, KWM Hong Kong team deeply understands the needs of Chinese enterprises in respect of culture and operation/management and is able to leverage the extensive international experience to provide all-round services in all aspects of banking and financing, corporate, private equity, M&A and commercial affairs, competition, trade and regulation, international fund, securities and capital market, dispute resolution and litigation/arbitration, construction disputes, projects, energy and resources, real estate, etc.

KWM has two offices in South China –Shenzhen office and Guangzhou office. The Shenzhen office was established in 1998 and has over 200 lawyers and other legal professionals; the Guangzhou office was founded in 2002 and gathers more than 160 lawyers and other legal professionals. These two offices provide a full range of legal services covering foreign investment, overseas investment, M&A and restructuring, banking and project financing, listing, wealth management and trust, international and domestic dispute resolution, bankruptcy & liquidation, IP and regulatory compliance, etc., and have received recognition from the market and the industry for their high quality and professional legal services. KWM Shenzhen and Guangzhou offices KWM International Center have advised on numerous representative and high-profile projects and cases in the GBA area and across China, and are committed to providing onestop and comprehensive legal services for clients during the implementation of the GBA Outline Plan.

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KWM Institute is a non-profit research organization co-sponsored and –founded by KWM and KWM Pro Bono Foundation. Since its establishment, KWM Institute is committed to building a new type of think tank with Chinese characteristics and international influence. Over the recent 25 years, KWM has accumulated extensive practical experience and professional insights in the course of providing services for the national economic and legal development. With such experience and insights, KWM Institute analyzes and studies the major issues that businesses may come across in implementing their “going global” strategy, so as to provide constructive and pragmatic policy recommendations and advice.

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