

Asterisk 2018

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Anti-money Laundering and Cryptocurrencies

Paul Dorrans

Kane Mak

Introduction

- Cryptocurrencies: definitions
- The regulatory and enforcement landscape
- Key risk for 2018

“An executive of UK-registered cryptocurrency exchange kidnapped in Ukraine...has been released after paying a ransom of more than \$1m Bitcoins...”

Financial Times, 30 December 2017

Have you bought or used Bitcoin or other cryptocurrencies?

- A. Yes.
- B. No.
- C. No, but I wish I had.

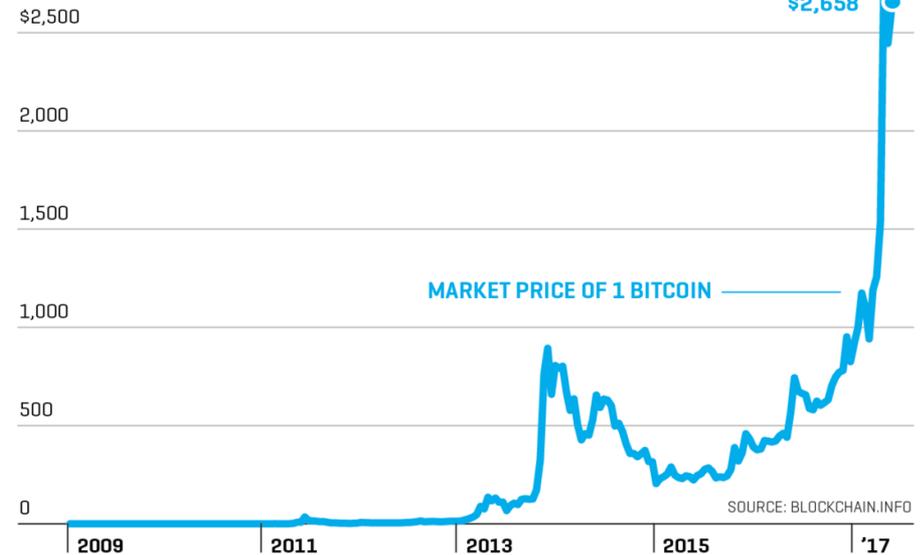


Source: <https://www.businesslive.co.za/bd/companies/financial-services/2018-01-15-how-bitcoin-cash-may-spell-end-of-bitcoin//>

Cryptocurrencies?

- Cryptocurrencies are more than Bitcoin, but what exactly are they?
- Market volatility?
- Decentralized and untraceable? Is that a good thing?
- Vested interests at play?
- Regulating ICO's and cryptocurrency exchanges?

CHANGE IN BITCOIN VALUE



Source: <http://fortune.com/2017/06/26/bitcoin-blockchain-cryptocurrency-market/>

Anti-money laundering – current landscape

- FATF Mutual Evaluation in 2018
- Regulatory response
- Criminal activities and enforcement

“If you want to invest in Bitcoin be prepared to lose your money”

– Andrew Bailey, CEO of the FCA

Criminal activities and enforcement actions related to cryptocurrencies



Jamie Dimon's (developing) views on Bitcoin

Do you agree with Jamie Dimon that Bitcoin has no legitimate role to play in developed economies?

- A. Completely agree
- B. Completely disagree
- C. If Bitcoin is properly regulated and recognised by regulators, why not?

"...there is a use for Bitcoin. If you live in Venezuela, North Korea, if you're a criminal, great product. I mean that. It's better than cash or deposits in that country."



Key risk for 2018: enforcement action / regulatory change

- Decentralized nature of cryptocurrencies makes them prone to abuse
- Interaction with fiat currencies is likely flashpoint
- Enforcement action / changes to Hong Kong's AML framework seems likely

“You can’t go somewhere and look up the record of who owns Bitcoin”

– Andrew Bailey,
CEO of the FCA

End of session 1

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MiFID2 and EU Benchmarks Regulation: Asian Impact

Simon McKnight

Did the implementation of MiFID2 go smoothly?

- A. Yes, no problems whatsoever
- B. Yes, it involved a fair bit of work but generally went smoothly
- C. No, it involved more work and stress than anticipated
- D. No, it was an absolute nightmare
- E. MiFID2 did not have a significant effect on my firm

MiFID2 Implementation

- **MiFID2** came into effect on 3 January 2018
 - Comprises Regulation (EU) No 600/2014 (**MiFIR**) and Directive 2014/65/EU (also **MiFID2**)
 - 5 **Delegated Acts**, 35 **RTS** + 11 **ITS** adopted so far, more to come
 - Lots of Level 3 measures being issued by ESMA (7 **Guidelines**, 8 **Q&As/FAQs**, 6 **Opinions** and 10 **Instructions** at latest count)
 - EU Member State implementation – **gold plating**
 - Third country reactions
- **Very broad application**
 - Applies across financial services industry – covers investment banks, private banks, brokers, wealth managers, asset managers, exchanges, markets, data providers
 - **Direct** and **indirect** impact on Non-EU third country firms
- **Implementation generally smoother than anticipated**
 - Some technological teething issues and other common difficulties

Some MiFID2 Themes/Trends affecting APAC

- Greater disclosures of costs/charges and other information for funds
 - Some non-EU funds opting out of EU fund of funds investments
 - New target market information for specific funds leading to them being removed from certain fund platforms
 - Many EU fund managers dropping their MiFID status (i.e. focusing on fund management only, which is not directly caught by MiFID2)
- Contraction of EU research industry connected to research unbundling
 - Much focus on commission sharing arrangements in APAC
 - Need for additional local licences? e.g. Japan/South Korea/Taiwan?
- Many consent forms provided and terms of business updated
- Some exchanges moved out of EU (e.g. some ICE futures)
- MiFID2 product governance legends
 - Still trying to get an industry standard position (ICMA drafts)

Some Implementation Difficulties affecting APAC

- Not all Member States have implemented all MIFID2 (~14 of 28 have not)
- **Legal Entity Identifiers** (LEIs) behind schedule – 6 months grace
- Some technology issues
 - Connectivity issues between FCA (and other competent authorities) and approved reporting mechanisms
 - Teething issues with new IT platforms needing temporary manual work-arounds
- Some ISIN discrepancies (e.g. FX forwards confusing cash v physical)
- Derivatives trading issues
 - Uncertainty on **package orders**
 - Some traders uncertain if particular **OTFs** are authorised
 - Some brokers reporting trading **OTC** when in fact **SI**
- Regulatory interpretation uncertainties
 - Flaws in methodology for calculating fund costs
 - Some events badged as MiFID2 compliant but not consistent with inducement rules

APAC MiFID2 Risks

- Teething issues to be resolved
- Trading/hedging affected
- Greater costs and effort to sell into EU
 - Direct access:
 - (a) **registration** (services to eligible counterparties and per se professionals); or
 - (b) **branch** (services to retail or elective professionals)
 - Indirect access: contractual obligations
- Possible further regulatory misinterpretations uncovered?
 - Will see if relevant authorities start taking enforcement actions soon



Has your firm implemented the IOSCO Principles for Financial Benchmarks where relevant?

- A. Yes, we have spent a lot of time on this
- B. Yes, but it did not involve much work
- C. No, we do not think the principles are worth following
- D. No, it does not affect us

EU Benchmarks Regulation (“BMR”): Overview

- Came into force on 1 January 2018
 - Regulation (EU) 2016/1011
 - Many Level 2 regulations (some final, some in draft)
- Prohibits **use** of an unregulated **benchmark** in the EU by supervised entities from 1 January 2020
- Benchmarks provided by non-EU **Administrators** will need to be registered in the EU by 1 January 2020 in order to be used after that date
- Three modes of access:
 - Equivalence
 - Recognition
 - Endorsement



EU Benchmarks Regulation: Risks

- Use of Asian benchmarks may be prohibited in EU after 1 January 2020
 - Currently no APAC jurisdiction would meet the “equivalence” test
 - HK at present has no intention to introduce a benchmarks regulation regime
 - Difficulties with the “Recognition” and “Endorsement” regimes
- Contingency planning in documents means EU users already starting to move away from use of APAC benchmarks?
- Detailed provisions for compliance with BMR
- Sanctions



Is your firm looking at the application of the EU Benchmarks Regulation in the APAC region?

- A. Yes, it is an important focal point for us
- B. Yes, it does affect us a fair bit
- C. Not yet, but we need to look into it soon as it will affect us
- D. No, it is not relevant for us

End of session 2

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AI Caramba! The adoption of AI in the financial market and risks

Ian Wood

Melissa Chim

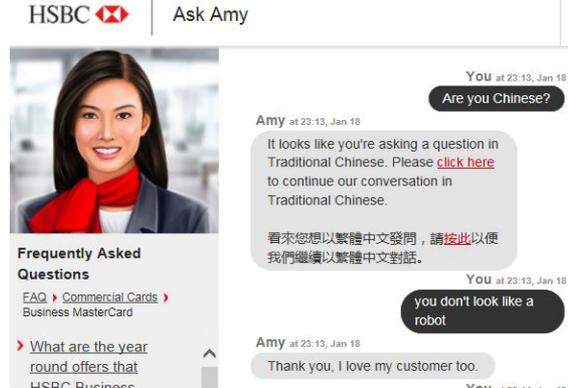
Which financial service area will see the fastest adoption of AI?

(choose one)

- A. Robo advisory
- B. Quantitative trading
- C. Assessment of credit quality
- D. Compliance

AI in the financial sector

Banking, chatbots



Compliance, fraud detection



Big data, quantitative & algorithmic trading



Robo-advisors



Robo-advisors: Why the hype?



WARNING

This advisor ceases to be fit and proper under SFC requirements if battery charge falls below 20%

What factors would you consider when deciding whether to use robo-advice services?

(Choose multiple)

- A. Price
- B. Convenience
- C. Reliability
- D. Less sales pressure
- E. Curiosity
- F. I will not use robo-advisors

Robo-advisors: The race and the risk

SUITABILITY



Platform design
Client profile | question design
Product due diligence | disclosure

GOVERNANCE



Licencing
KYC
Fit & properness

RISK MANAGEMENT



Cyber security | Data protection
Mis-selling litigation

Algorithm design

AlphaGo Zero

No prior knowledge of the game and only the basic rules and reward system as an input.

Has learnt fundamentals of more advanced Go strategies such as influence and territory.

Surpasses the performance of AlphaGo (which had taken 18 months to develop to this stage)

0 days

3 hrs

19 hrs

70 hrs

2 days

40 days

Plays like a human beginner, forgoing long term strategy to focus on greedily capturing as many stones as possible

Plays at superhuman-level. The game is disciplined and involves multiple challenges across the board.

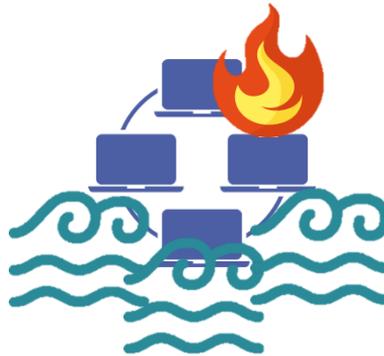
Defeats original AlphaGo 100-0, arguably becomes unbeatable by any human player past, present or future.

AI Caramba!

Risks of AI implementation

Regulatory risk

- Auditability
- Accountability



Market risk



Ke Xu
A/B/Dollar Brain



Human risk

- Integration
- Theft, hack & crack



Who do you trust more?

- A. Humans
- B. Computers

End of session 3

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**Published, public and
priced-in? All or none
of the above.**

Tom Fyfe

Sarah Ho

SFO s285

“inside information, in relation to a corporation, means specific information that—

(a) is about—

(i) the corporation;

(ii) a shareholder or officer of the corporation; or

(iii) the listed securities of the corporation or their derivatives; and

(b) is not generally known to the persons who are accustomed or would be likely to deal in the listed securities of the corporation but would if generally known to them be likely to materially affect the price of the listed securities;”

Which of the following satisfies the test for being “generally known”? (choose multiple)

- A. Announcements on the SEHK
- B. Available on Bloomberg or similar
- C. Shows up when you Google the company
- D. Invitation-only analysts meeting summary circulated by emails

Inside? Public? What is the test?

not generally known to those accustomed / likely to deal in the shares of the particular company

- Who are the investors?
- Information published on SEHK only?
- A bright-line test
 - NB the onus of proof

How general is “generally known”?

not generally known to those accustomed / likely to deal in the shares of the particular company

- Published on subscription services with a readership of 100,000?
- Circulated in the financial community?
- Widespread media coverage?

It's more than “well, everyone knows” ...

- Tribunals will consider evidence, factual and/or expert, to show “generally known”
- Acknowledgment that some names may only be of interest to limited classes of investors but “difficult to sustain”
- “everyone is talking about it” or “information priced-in”
 - analysed using 20/20 hindsight

What to do?

- Onus on person trading to show “generally known”
- Generalisations will not be enough (e.g. “price-in”)
- Know the investor base
- Demonstrate how that investor base has access to the information
- Analysis of factors other than the information which may affect the share price
- Accuracy and completeness

What other test would you suggest in place of the current bright line test (ie. published on SEHK)?

- A. Reported on newspapers
- B. Published on subscription services
- C. Repeatedly found on the internet
- D. Known to certain percentage of the brokerage community

End of session 4

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Mission Responsible: Hong Kong's New Manager in Charge Regime

Sarah Berkeley, Simmons
& Simmons

Mabel Chiu, Jardine Lloyd
Thompson

What's your view of the introduction of the MIC regime?

- A. It's all a big fuss about nothing
- B. Too early to tell what the impact will be
- C. It's a bit of a concern, but I'm not too worried
- D. It's a step change in the enforcement landscape

MIC Regime

Modelled after the SMR

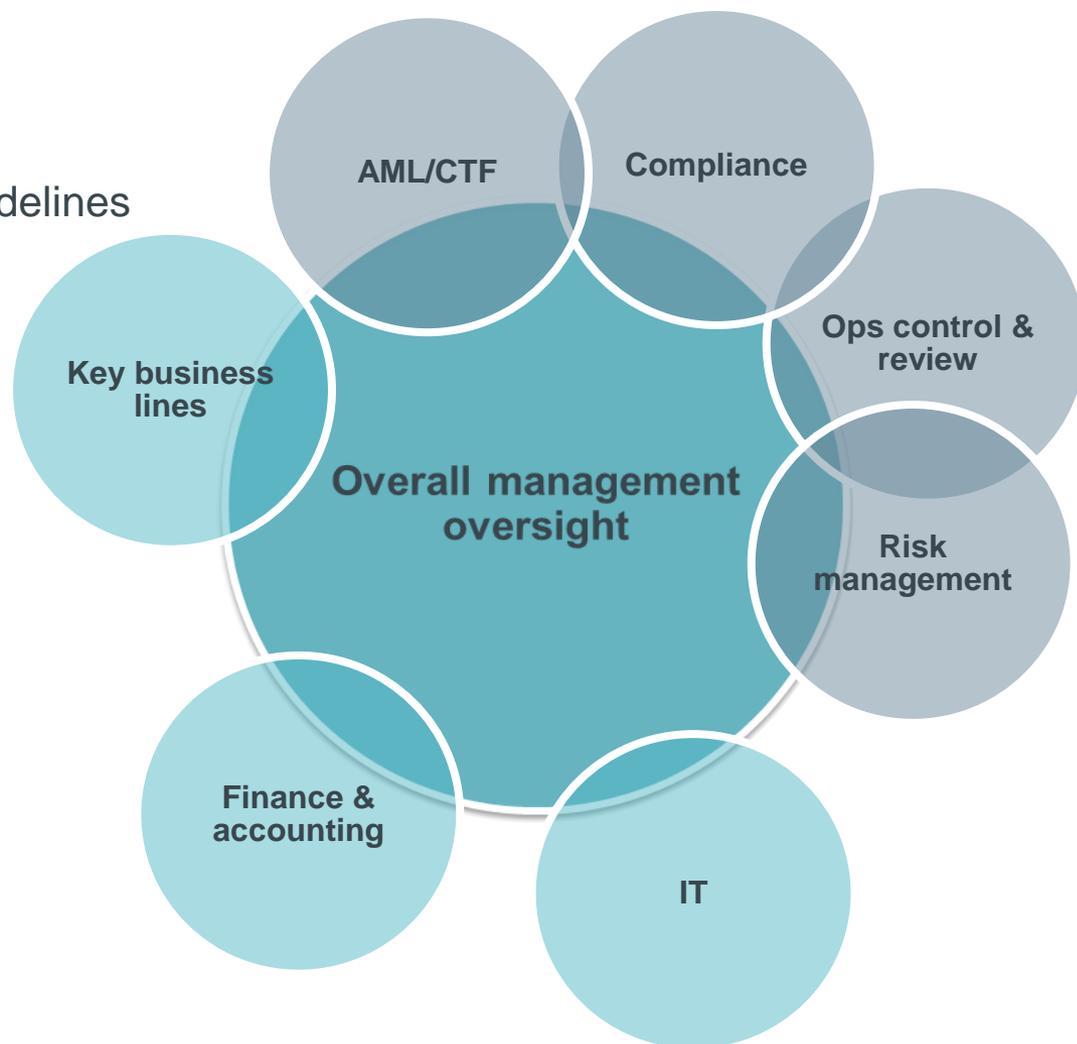
- Existing legislation, codes and guidelines

Covers 8 functions

- At least one MIC for each core function, but it can be the same person across different functions

Who can be an MIC?

- Employed in HK?
- Authority
- Seniority
- Fit and proper
- Licensed?



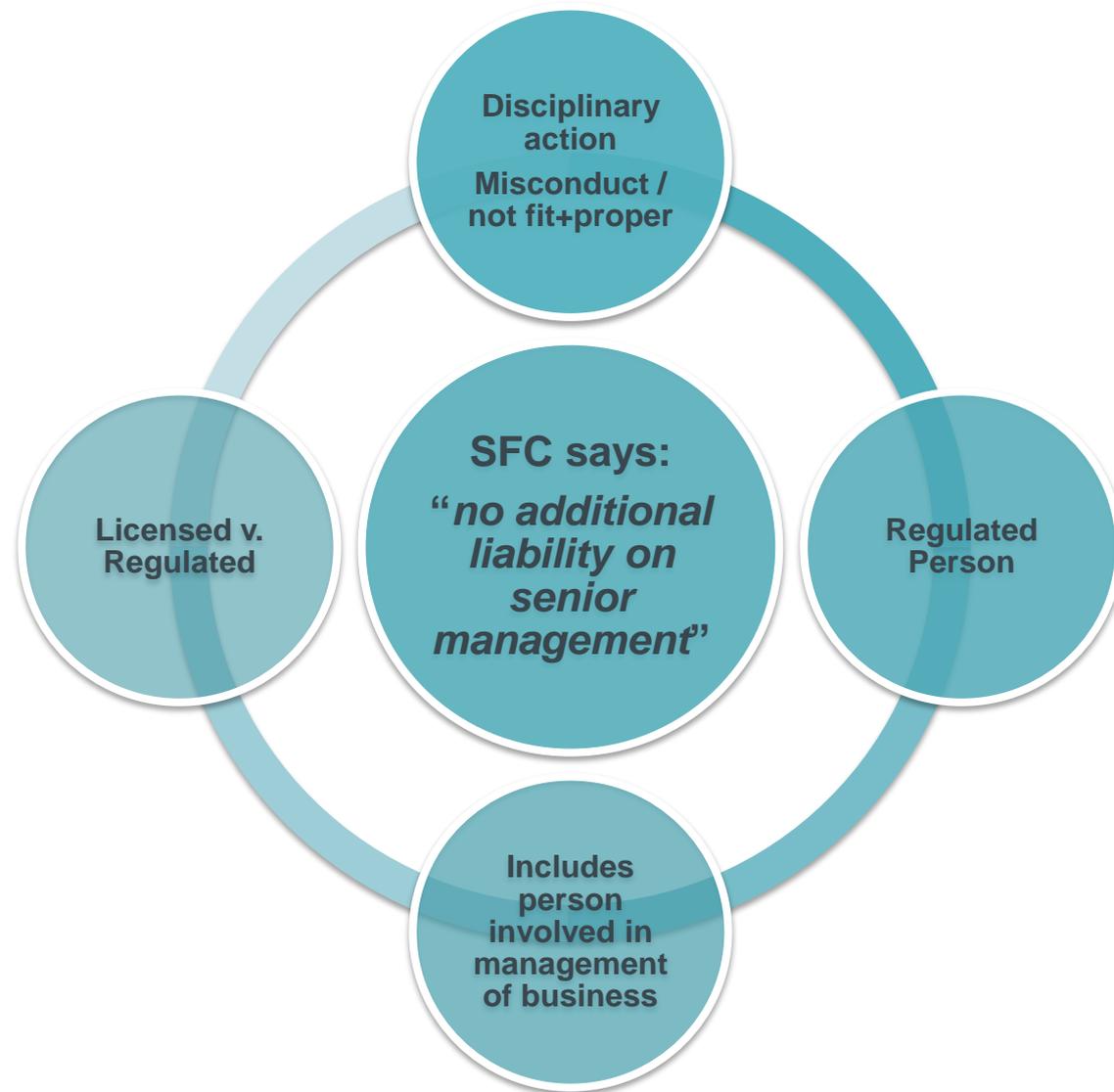
What's changed

No change in substance?

- Existing legislation, codes and guidelines

Change of attitude

- Shift in focus from the LC to the individual
- Presumption of liability?
- Wider enforcement net to include non-licensed individuals



What are your MICs doing to manage the risk of enforcement action?

(choose multiple)

- A. Nothing
- B. Stress-testing systems and processes within their function and ensuring the governance framework is adequate
- C. Ensuring all decision making is clearly recorded and documented
- D. Regular staff training
- E. Not my problem – I am not an MIC!

What does this mean for 2018

- Mapping: SFC & HKMA
- Potential legal liability of senior management
- Enforcement trend:
 - Past: LCs, CEOs, ROs
 - Future: MIC



"At the heart of any firm is a group of individuals at the top who call the shots. If we want to improve conduct and change behaviour, it should start from the top by clarifying who has responsibility for what, and holding them accountable for the conduct and behaviour of the firm"

Julia Leung (4 May 2017)



"You can assume that we will make use of this additional information [on MICs] to hold responsible individuals accountable"

Tom Atkinson
(11 Oct 2017)

In the event of enforcement action, who acts for your MIC?

- A. They defend themselves, because of potential conflict with the firm
- B. They use the firm's usual panel lawyers
- C. They appoint lawyers of their choice, funded by the firm
- D. They appoint lawyers of their choice, funded by D&O insurance

Risk management: what is available

■ Directors & Officers Liability vs Professional Indemnity insurance



PI triggers:

Corporate liabilities

Professional duties

With deductible

Professional services to third parties (and often extends to regulatory)

VS



D&O triggers:

Personal liabilities

Fiduciary duties

Nil deductible (for individual when no co. reimbursement)

Applies to all business activities

JLT Risk management: D&O insurance

Coverage	Exclusion
Who	
Directors and officers * Includes MICs	LCs
What	
Personal legal liabilities from activities within capacity	Dishonest and fraudulent acts
	Intentional and deliberate acts
Associated costs – defence costs, investigation costs, damages, civil fines and penalties	Illegal remuneration or personal profits
	Professional services (covered under PI)

Do you consider your firm has in place adequate insurance cover against MICs' liabilities?

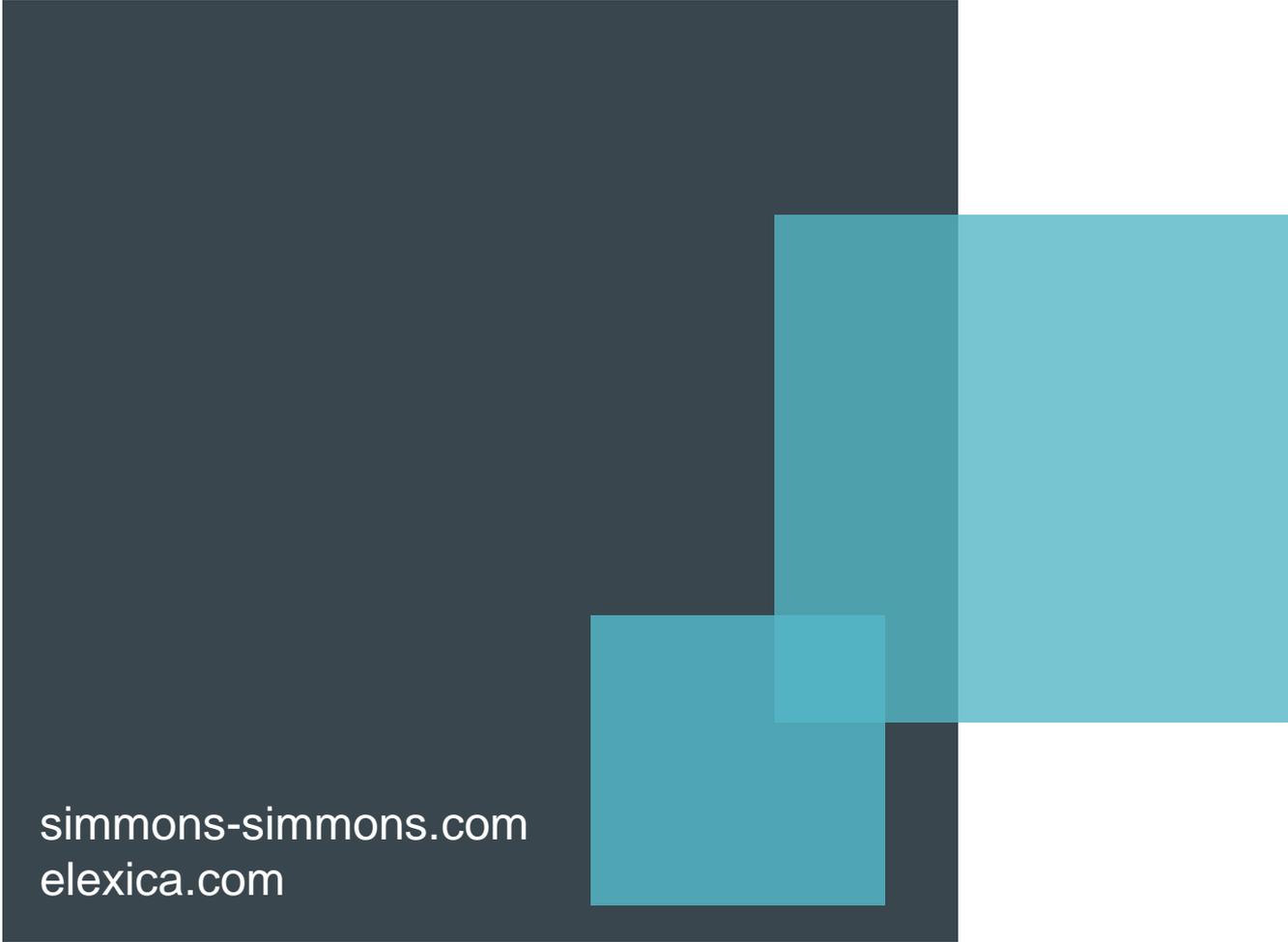
- A. Yes
- B. No
- C. I don't know

End of presentation

Asterisk Roundtables

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