

Hong Kong Financial Regulatory Newsletter.



Hong Kong Financial Regulatory Newsletter is the latest initiative of Deloitte Global Financial Services Industry (GFSI) practice. This Issue highlights some significant regulatory developments of the SFC, HKMA, HKEx, OCI, HKFI and MPFA since our last edition.

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SFC

Circular to Licensed Corporations and Associated Entities - Anti-Money Laundering / Counter-Terrorist Financing - Money Laundering and Terrorist Financing Risks Associated with Virtual

Commodities

In view of the recent attention of overseas and local regulators over the money laundering and terrorist financing (“ML/TF”) risks associated with virtual commodities such as Bitcoin, the Commission would like to remind licensed corporations (“LCs”) and associated entities (“AEs”) to take all reasonable measures to ensure proper safeguards exist to mitigate the ML/TF risks that they may face in this regard taking into consideration the related developments. As provided in paragraph 3.5 of the Guideline on Anti-Money Laundering and Counter-Terrorist Financing (“Guideline on AML/CFT”), services that inherently have provided more anonymity present higher ML/TF risks. Virtual commodities that are transacted or held on the basis of anonymity by their nature pose significantly higher inherent ML/TF risks.

Where relevant to their business, LCs and AEs should therefore guard against the ML/TF risks associated with potential or existing customers that are operators of schemes related to virtual commodities (“VC operators”), by increased vigilance in assessing the ML/TF risks of customers as well as monitoring and detecting unusual or suspicious transactions. In particular, LCs and AEs when accessing ML/TF risk should take into account the ML/TF risks associated with virtual commodities mentioned above and all other relevant factors including, where relevant, whether the customer that is a VC operator has established and implemented effective controls against ML/TF involving the virtual commodities.

Read more:

<http://www.sfc.hk/edistributionWeb/gateway/EN/circular/openFile?refNo=14EC2>

SFC proposed to strengthen regulation of alternative liquidity pools

The SFC began a two-month consultation concerning the future regulation of alternative liquidity pools (ALPs), which are also known as alternative trading systems and “dark pools”. The SFC proposed to enhance and standardise the regulatory obligations imposed on Hong Kong licensed corporations that operate ALPs, by including within the Code of Conduct comprehensive requirements governing their operation. As a consequence of doing this, the SFC would cease its current practice of imposing conditions on the licences of ALP operators on a case-by-case basis. The SFC’s proposals draw on initiatives for the regulation of ALPs that have been developed in other major markets and also reflect regulatory responses that the SFC considers desirable within the particular context of the Hong Kong market.

The proposals set out in the SFC’s consultation paper cover the following key areas: (1) Restricting access to ALPs to institutional investors only; (2) Enhancing the level of disclosure to ALP users; (3) Ensuring the priority of agency orders over proprietary orders initiated by ALP operators and their affiliates; (4) Limiting the level of visibility of trading information available to the staff of ALP operators; (5) Maintaining system adequacy; (6) Introducing additional control, record keeping and reporting requirements.

Read more:

<http://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=14PR25>

Circular to all licensed and registered persons relating to Paragraphs 8.3 and 8.3A of the Code of Conduct

The purpose of introducing disclosure requirements under Paragraphs 8.3 and 8.3A of the Code of Conduct is to mitigate conflicts of interests between clients and licensed or registered persons, as well as to enhance transparency. Under Paragraphs 8.3 and 8.3A, licensed or registered persons are required to make disclosure of transaction related information to their clients. The purpose of the circular is to clarify the application of these requirements.

Paragraph 8.3 Part A (a)(ii) covers situations where a licensed or registered person enters into “back-to-back transactions” concerning an investment product. The Commission would like to clarify that when a client sells an investment product to an intermediary under a back-to-back arrangement i.e. when the intermediary purchases the product from the client and sells it to a third party, potential conflicts of interest, similar to a “purchase” order scenario, may also arise. As such, “sell” order transactions are also covered under the phrase “back-to-back transactions”. For Paragraph 8.3A, the Commission would like to clarify that the disclosure of transaction related information should not be limited to transactions where the intermediary is acting as the initial distributor of an investment product. To do so would deny investors carrying out other transactions information concerning the benefits received by intermediaries and prevent them from making an informed investment decision.

Read more:

<http://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=14EC11>

Circular to issuers of SFC-authorized investment products concerning the US Foreign Account Tax Compliance Act

The SFC reminded issuers of SFC-authorized funds, investment-linked assurance schemes, unlisted structured investment products and real estate investment trusts (collectively, the “SFC-authorized investment products”) to critically consider and assess the potential implications of the US Foreign Account Tax Compliance Act (“FATCA”) on their SFC-authorized investment products. According to the IRS, FATCA requires, amongst others, foreign financial institutions (“FFIs”) to comply with certain obligations (such as to finalise the registration with the IRS to appear on the FFI list before 1 July 2014 (where applicable)) in order to avoid a range of implications, including the imposition of a 30% withholding tax on certain payments made to them.

The Government of the Hong Kong Special Administrative Region (the “HKSAR”) has been in discussions with the US Treasury, with the objective of concluding an inter-governmental agreement (“IGA”) designed to facilitate compliance with FATCA by FFIs in Hong

Kong. The extent to which issuers of SFC-authorized investment products (“Issuers”) might be affected and exempted will depend on the final scope of the IGA and its terms. As such, please pay close attention to any updates and announcements which may be made by the HKSAR as regards the conclusion of the IGA with the US Government.

Read more:

<http://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=14EC15>

Circular to Licensed Corporations - Selling of complex bonds and high-yield bonds

From recent on-site inspections, SFC have identified some common issues suggesting that certain areas of the selling process for bonds with special features and high-yield bonds (collectively referred to as “Complex/HY Bonds”) need better attention of some LCs. The Commission reminded all LCs that sell Complex/HY Bonds of their obligations to: conduct proper product due diligence to ensure that the firm understands the important aspects of Complex/HY Bonds; explain the key features and risks of Complex/HY Bonds and provide relevant and material information to the client; implement a proper suitability assessment process to ensure that Complex/HY Bonds which the firm solicits or recommends a client to buy are reasonably suitable to the client in all the circumstances; disclose the trading profit made from a back-to-back transaction to the client prior to or at the point of entering into the transaction; and put in place adequate supervisory controls to ensure compliance with all relevant regulatory requirements in relation to the sale of Complex/HY Bonds. LCs should pay due regard to the issues and guidance set out, and critically review their policies and procedures to address any issues that are relevant to their firms with a view to improving compliance.

Read more:

<http://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=14EC18>

HKMA

Risks associated with virtual commodities

In view of recent global attention over virtual commodities such as Bitcoin and their associated money laundering and terrorist financing (“ML/TF”) risks, HKMA would like to remind all AIs the need for exercising prudent risk management taking into consideration the related developments.

As provided in paragraph 2.3 of the Guideline on Anti-Money Laundering and Counter-Terrorist Financing, AIs should assess the extent to which their services are vulnerable to ML/TF abuse. This issue is especially relevant where emerging technological developments may facilitate anonymity. Virtual commodities that are transacted or held on the basis of anonymity fall into this category and pose significantly higher inherent ML/TF risks, including risks associated with potential or existing customers that may use AIs’ accounts or other services for any activities relating to virtual commodities. AIs should therefore ensure an escalated level of vigilance commensurate with these risks when considering whether to establish or maintain business relationships with customers who are operators of schemes related to virtual commodities. Among other controls, AIs should critically take into account whether such operators have established continuously effective controls against money laundering involving the virtual commodities when assessing the ML/TF risks associated with the operators. As in the case of any new business development, HKMA also expect AIs to conduct comprehensive risk identification and assessment, taking into account potential regulatory requirements locally and overseas, when considering to offer any new banking or investment products relating to virtual commodities.

Read more:

<http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2014/20140210e1.pdf>

Risk Management of Personal Lending Business

The HKMA noticed a persistent trend of rising household indebtedness since the global financial crisis. The level of household indebtedness as a percentage of GDP has reached a level that may prove unsustainable should global monetary conditions normalise and interest rates increase. Data further suggest that personal loans represent one of the key drivers behind this trend. In view of this, the HKMA has recently conducted a review of the risk management practices that Authorised Institutions (AIs) adopt in underwriting personal loans. The circular sets out (i) the observations of the HKMA in respect of the macro-prudential environment of Hong Kong, (ii) the growth and competition of personal lending business, and (iii) the supervisory requirements of the HKMA on risk management of personal lending business by AIs.

The HKMA recognised that in certain circumstances AIs might need to exercise flexibility to cater for the needs of individual customers and allow exceptions to their standard underwriting policies or practices. The HKMA considered this acceptable provided that such flexibility has been managed prudently within the personal loan portfolio and governed by clear policies and guidelines. Among other things, the number of exceptions must be subject to stringent limits and all exceptions must be properly approved with clear audit trails evidencing the justifications for the approval.

Read more:

<http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2014/20140114e1.pdf>

Basel Committee on Banking Supervision's Paper on "Sound management of risks related to money laundering and financing of terrorism"

The Basel Committee on Banking Supervision ("BCBS") published on 15 January 2014 a paper "Sound management of risks related to money laundering and financing of terrorism" which describes how banks should include risks related to money laundering and the financing of terrorism ("ML/TF") within their overall risk management framework. The paper is available on the BCBS's website (<http://www.bis.org/publ/bcbs275.pdf>).

The paper describes the essential elements of sound ML/TF risk management, provides increased focus on the risks associated with the usage by banks of third parties to introduce business and the provision of correspondent banking services, and is consistent with the International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation issued by the Financial Action Task Force ("FATF") in 2012. As previously indicated, HKMA will undertake a review of local legal and regulatory anti-money laundering and counter-terrorist financing ("AML/CFT") requirements for AIs in order to implement the revised international standards and will also have regard to this paper during that review.

Read more:

<http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2014/20140210e1.pdf>

BCBS Guidance on A Sound Capital Planning Process

The Basel Committee on Banking Supervision (BCBS) issued on 23 January 2014 a document on A Sound Capital Planning Process: Fundamental Elements (see <http://www.bis.org/publ/bcbs277.pdf>) setting out observed sound practices for banks' capital planning processes. Sound capital planning by banks is a necessary complement to a robust regulatory framework, and is critical for determining the amount, type and composition of capital that should prudently be held by banks so that they will be able to continue pursuing their business objectives, while also withstanding stressful situations. Reflecting on lessons from the global financial crisis in relation to the strengthening of capital planning, the BCBS identifies four fundamental components for a sound capital planning process in its paper, viz. (i) internal control and governance, (ii) capital policy and risk capture,

(iii) forward-looking view, and (iv) management framework for preserving capital. The paper then explores sound practices observed at some banks in relation to these four components, with a view to fostering overall improvement in banks' capital planning processes.

The HKMA's supervisory review process covers authorised institutions' capital planning practices. In the light of the sound practices guidance issued by the BCBS, the HKMA would consider the extent to which the existing guidance on capital planning in the Supervisory Policy Manual module "Supervisory Review Process" (CA-G-5) should be enhanced to incorporate the sound practices identified. All authorised institutions were encouraged to review their capital planning process against the four fundamental components identified by the BCBS and take appropriate action to address any material deficiencies or gaps identified.

Read more:

<http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2014/20140207e1.pdf>

Supervisory Policy Manual (SPM) Revised Module IC-6 – The Sharing and Use of Consumer Credit Data through a Credit Reference Agency (CRA)

HKMA have slightly revised SPM module IC-6 in view of the changes introduced by the Office of the Privacy Commissioner for Personal Data to the Code of Practice on Consumer Credit Data ("the Code") with effect from 1 January 2013. The revised version of the above SPM module would be issued by notice in the Gazette under section 16(10) of the Banking Ordinance. On-line access to the SPM module is available to AIs under the icon for "Supervisory Policy Manual" on the HKMA's public (<http://www.info.gov.hk/hkma>) and private (<http://www.stet.iclnet.hk/index.htm>) websites.

Read more:

<http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2014/20140214e1.pdf>

Foreign Exchange Accumulators ("FX accumulators") and Non-leveraged Renminbi ("RMB")-Linked Deposits

HKMA provided guidance and clarification on the regulatory requirements governing the sale of FX accumulators and non-leveraged RMB-linked deposits by AIs, in particular the: framework for assessing customers' expected exposure to FX accumulators; treatment of FX accumulators for hedging purpose; sale of FX accumulators to corporate customers; classification of FX accumulators; and risk disclosure for roll-over and repeated placement of non-leveraged RMB-linked deposits.

In view of the link between the Hong Kong dollar ("HKD") and the US dollar ("USD") as well as relatively low volatility of HKD and USD against eight other major currencies², after consultation with the Hong Kong Association of Banks ("HKAB") and the DTC Association ("DTCA"), the HKMA has decided to allow AIs to use a flexible approach in the calculation of asset concentration for FX accumulators involving major currency pairs. A new framework has been set out for measuring the expected exposure to FX accumulators in major currency pairs being developed for this purpose. Also, only the properly hedged amount of a customer's exposure in a FX accumulator contract is exempted from inclusion in the calculation of concentration risk. Having regard to the difference in the risks of FX products as compared with equities and the nature of corporate banking customers, it is considered reasonable to allow more flexibility in respect of the sale of FX accumulators to corporate banking customers. HKMA has decided to extend the operational flexibility in complying with the risk disclosure requirements for roll-over and repeated placement of non-leveraged FX-linked deposits in major currencies to non-leveraged RMB-linked deposits. However, such flexibility does not discharge AIs from the obligation to ensure the suitability of the product for the customer in each transaction.

Read more:

<http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2014/20140307e1.pdf>

HKMA announced outcome of investigations into HIBOR fixing

The HKMA announced the outcome of its investigations into the Hong Kong Interbank Offered Rate (HIBOR) fixing. The HKMA found evidence of misconduct in the submission of HIBOR rates by only one bank, and no evidence of collusion between these banks to rig the HIBOR fixing. In the investigation of UBS AG (UBS), the HKMA found about 100 communication records during 2006 to 2009, in the form of internal chat messages, which contained change requests by several UBS traders to the UBS HIBOR submitter with a view to rigging the HIBOR fixing. The HKMA investigation also found that UBS failed to report to the HKMA misconduct of its staff relating to the change requests when the bank became aware of these activities. Further, the investigation found material weaknesses in UBS's internal controls and governance in managing the HIBOR submission process and in other areas.

In May 2013, the HKMA promulgated a statutory guideline on "Code of Conduct for Benchmark Submitters" to enhance the robustness of the benchmark fixing mechanism, including HIBOR. The HKMA expects all benchmark-setting banks to maintain proper oversight for such activities and put in place adequate and effective systems of control."

Read more:

<http://www.hkma.gov.hk/eng/key-information/press-releases/2014/20140314-3.shtml>

Treat Customers Fairly Charter

Further to the circular of 28 October 2013 setting out the high level principles contained in the Treat Customers Fairly (TCF) Charter, HKMA attach a list of examples in the circular to assist AIs in the implementation of these principles. The examples set out were designed to enhance AIs' understanding of the spirit of each principle, and illustrate how the principles may be implemented. AIs were encouraged to consider these examples and come up with specific measures appropriate to their businesses to implement the principles. The implementation of these measures will assist AIs in developing a customer centric culture which ensures customers are treated fairly and their interests are taken into account in everyday business decisions at all levels of AIs. Also, the measures should be documented for the purpose of staff training. HKMA also encouraged other AIs (that is, AIs which are not retail banks) to follow the TCF principles to the extent relevant to their institutions' businesses. As a general principle, AIs and their authorised agents are expected to uphold financial consumer protection, and AIs are responsible and accountable for the actions of their authorised agents.

Read more:

<http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2014/20140328e1.pdf>

HKEx

Exchange Provides Information on New Listing Applications received since the New Sponsor Regulation Took Effect on 1 October 2013

The Stock Exchange of Hong Kong Limited (the Exchange) provided the information on the new listing applications it has received since the Securities and Futures Commission's (SFC) new regulation on sponsors became effective on 1 October 2013, to assist sponsors and other market participants in understanding its related rule changes and streamlined regulatory commenting process.

The purpose of the new sponsor regulation is to enhance the quality of disclosure in the Application Proof thereby shortening the vetting process. To enable market practitioners to familiarise themselves with all related requirements and procedures before the publication regime is implemented, the Exchange put in place certain transitional arrangements, including the Initial 3-day Check, from 1 October 2013 to 30 September 2014 (Transitional Period). As stated in the Exchange's announcement of 23 July 2013, the Exchange and the SFC would review the effectiveness of the Initial 3-day Check during the first six-months of the Transitional Period to see if the arrangement should continue for the remainder of or after the Transitional Period. As of 31 January 2014, the Exchange had completed the Initial 3-day Check for 18 new listing applications. The deficiencies noted in Initial 3-day Check and in qualitative assessment were included in the news release.

Read more:

<http://www.hkex.com.hk/eng/newsconsul/hkexnews/2014/140228news.htm>

Exchange to Change Some of its Connected Transaction Rules

The Stock Exchange of Hong Kong Limited published its consultation conclusions on the proposed changes to the Listing Rules (the Rules) set out in the consultation papers of 26 April 2013 on: Proposed changes to the connected transaction Rules; and Proposed changes to align the definitions of connected person and associate in the Rules. The Exchange would implement the two sets of proposals with some modifications to take into account the respondents' comments. The Rule amendments will be effective from 1 July 2014 to give sufficient time for issuers and market practitioners to familiarise themselves with the changes. "The Rule amendments will simplify and improve the clarity of the connected transaction Rules and ease the compliance demands on issuers while maintaining the same level of investor protection," said David Graham, HKE's Chief Regulatory Officer and Head of Listing.

Read more:

<http://www.hkex.com.hk/eng/newsconsul/hkexnews/2014/140321news.htm>

Contacts

If you would like to discuss any of the subjects covered in this Newsletter or our financial services in Hong Kong, please contact:

Eric Tong

Partner
GFSI Leader
Southern China Region
Tel: +852 2852 6690
Email: ertong@deloitte.com.hk

Maria Xuereb

Partner
Financial Services
Tel: +852 2852 1008
Email: marxuereb@deloitte.com.hk

For further information, visit our website at www.deloitte.com/cn

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