



Jeffrey Mak Law Firm
麥振興律師事務所
www.jmaklegal.com

Hong Kong Licensed Corporations Alert

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Hong Kong Monetary Authority and Securities and Futures Commission Conclude Consultation on Further Enhancements to the OTC Derivatives Regulatory Regime

On June 27, 2018, the Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC) issued conclusions to a joint consultation on further enhancements to the over-the-counter (OTC) derivatives regulatory regime in Hong Kong.

HKMA and SFC have concluded that the proposed adjustments should be implemented, after taking consideration of market feedback to the joint consultation embarked in March 2018. A summary of the key conclusions is at the following:

Mandating the use of Legal Entity Identifiers (LEIs) for reporting obligation

1. Scope of entities: the first phase only applies to parties on the reporting entity's side of a transaction. Reporting entities are not required to verify whether their counterparty to a transaction falls under the list of entities to which the first phase applies.
2. Scope of transaction reports: the mandatory use of LEIs in trade reporting will only apply to new trades and daily valuation information only. This gives reporting entities more flexibility to deal with existing entity identifiers for outstanding trades.
3. Implementation timeline: the implementation for the first phase of mandating the use of LEIs will be commencing from April 1, 2019.

Expanding the clearing obligation

1. Expansion of product scope: the clearing obligation will only be expanded to include specified standardized interest rate swaps denominated in Australian Dollars (AUD IRS) and the revised list of

Financial Services Providers will be published for implementation on January 1, 2019.

2. Implementation timeline: the mandatory clearing of AUD IRS would not be commenced before Quarter 4 2019.
3. Scope of Prescribed Person: the current scope of Prescribed Person is maintained.

Adoption of trading determination process for introducing a platform trading obligation

1. Trading determination process and criteria: the trading determination process and criteria proposed in the joint consultation paper are adopted and are being used in the process to determine which products may be appropriate for Hong Kong to introduce a platform trading obligation.

The process and criteria should take into account of the following factors:

- (a) whether the product is suitable standardized for platform trading;
- (b) the nature, depth and liquidity of the market for the product;
- (c) the availability of trading venues that may be designated for trading that product;
- (d) whether the product is already subject to the central clearing obligation in Hong Kong;
- (e) whether regulators in other jurisdictions consider such a product to be suitable for platform trading; and
- (f) the impact on the market and market participants of imposing a platform trading obligation for the product.

2. Implementation timeline: after completing analysis and formulating appropriate proposals, further consultation will be conducted on the feasibility, scope and timing for implementing a platform trading obligation in Hong Kong.

HKMA and SFC will work with the government on drafting the necessary legislative amendments to the Securities and Futures (OTC Derivative Transactions – Clearing and Record Keeping Obligations and Designation of Central Counterparties) Rules (Clearing Rules) to implement the relevant changes.

Source:

<https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=18PR70>

Hong Kong Securities and Futures Commission Proposes Margin Requirements for Non-centrally Cleared Over-the-counter Derivatives

On June 19, 2018, Hong Kong Securities and Futures Commission (SFC) launched the two-month consultation proposals to impose margin requirements for non-centrally cleared over-the-counter (OTC) derivatives.

The proposals are part of comprehensive reforms to implement international standards and enhance Hong Kong's regulatory regime for OTC derivatives. Under the proposals, a licensed corporation which is a contracting party to a non-centrally cleared OTC derivative transaction entered into with an authorized institution, a licensed corporation or another defined entity would be required to exchange margin with the counterparty.

The key proposals set out in the Consultation Paper are at the following:-

1. The proposed initial margin (IM) requirements will apply to a licensed corporation if the average aggregate notional amount of non-centrally cleared OTC derivatives on a group basis exceeds HK\$60 billion.
2. The proposed variation margin (VM) requirements will apply to a licensed corporation when the licensed corporation itself or the group to which it belongs has an average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK\$15 billion.
3. IM should be called at the earliest time possible after either execution of a transaction or upon

changes in measured potential future exposure. The IM amount for a given counterparty has to be recalculated at least every ten business days.

4. VM should be calculated at least on a daily basis and be called at the earliest time possible after the trade date and from time to time thereafter.
5. A licensed corporation may agree with its counterparty not to exchange margin if the amount of margin due is equal to or lower than a specified minimum transfer amount not exceeding HK\$3.75 million.
6. IM and VM should be collected as soon as practicable within the standard settlement cycle for the relevant collateral type.
7. The proposed margin requirements will apply to all derivative transactions not cleared by a central counterparty; except (a) physically settled foreign exchange (FX) forwards and FX swaps, and the "FX transaction" embedded in cross-currency swaps associated with the exchange of principal, be exempt from IM requirements; and (b) these instruments also be exempt from VM requirements, except when the covered entity is an authorized institutions, a licensed corporation or an entity that carries on a business outside Hong Kong engaged in banking, securities, derivatives or asset management.
8. As margin for both IM and VM, the eligible collateral instruments, subject to appropriate haircuts in order to address their potential volatility, include (a) cash in any currency; (b) marketable debt securities issued or fully guaranteed by a sovereign or a relevant international organization; (c) marketable debt securities issued or fully guaranteed by a multilateral development bank; (d) marketable debt securities issued or fully guaranteed by a public sector entity; (e) other marketable debt securities; (f) gold; and (g) listed shares which are subject to a haircut percentage of 15%.
9. Haircuts should be applied to the market value of eligible collateral for margin purposes. A licensed corporation should apply risk-sensitive haircuts as set out in a standardized haircut schedule. Whenever the eligible collateral posted (as either IM or VM) is denominated in a currency other than the designated currency, an additive haircut of 8% is applied to the market value of any

IM collateral (cash and non-cash) and non-cash VM collateral.

10. Intragroup transactions will be exempt from the proposed margin requirements, subject to the conditions that: (a) the licensed corporation and the affiliates are accounted for on a full basis in the group consolidated financial statements; and (b) the risk evaluation, measurement and control procedures applicable to the licensed corporation and the affiliates are centrally overseen and managed within the group of companies to which they belong.

The effective date of the IM requirements should be phased in starting from September 1, 2019, and that the VM requirements take effect from September 1, 2019.

Source:

<https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=18CP5>

Hong Kong's Securities and Futures Commission Concludes Consultation on Prescribing Professional Investors

On May 18, 2018, Hong Kong's Securities and Futures Commission (SFC) released consultation conclusions on proposed amendments to the Securities and Futures (Professional Investor) Rules (PI Rules) to standardize the rules for prescribing professional investors and to incorporate modifications the SFC has previously granted under section 134 of the Securities and Futures Ordinance (SFO).

The amendments to the PI Rules (Revised PI Rules) pertain to the following:

- (a) allowing portfolios held in joint accounts with persons other than associates and investment corporations owned by individuals to be counted to ascertain whether individuals meet the monetary threshold to qualify as professional investors;
- (b) expanding the definition of corporations as professional investors, where the categories of professional investors will include corporations which have investment holding as their principal business and are wholly-owned by one or more professional investors, as well as corporations which wholly own another corporation which is a qualified professional investor; and

- (c) allowing alternative forms of evidence demonstrating qualification as professional investors.

It is of the view of the SFC that the changes to the rules for prescribing professional investors are in the best interest of the industry to ensure a level-playing field and consistent application of the regulations. It is submitted that they will introduce consistency and flexibility and this will better serve the interests of both firms and their clients.

The proposed amendments, as gazetted, will be submitted to the Legislative Council for negative vetting. Subject to the legislative process, the SFC expects the amended rules to come into effect on July 13, 2018.

Source:

<http://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/corporate-news/doc?refNo=18PR54>

Hong Kong's Securities and Futures Commission Concludes Consultation on New Securities and Futures (Open-ended Fund Companies) Rules and Code on Open-ended Fund Companies

Hong Kong's Securities and Futures Commission (the SFC) released consultation conclusions on the proposed Securities and Futures (Open-ended Fund Companies) Rules (the OFC Rules) and Code on Open-ended Fund Companies (the OFC Code) which set out detailed legal and regulatory requirements for the new open-ended fund company (the OFC) structure on May 18, 2018. This will enable investment funds to be established in corporate form in Hong Kong, in addition to the current unit trust form.

After considering market feedback, the SFC will implement the proposals set out in the consultation paper including the requirements relating to an OFC's formation, its key operators, ongoing maintenance, termination and winding-up with certain modifications and clarifications. These include streamlining the approval requirements for private OFCs and setting out a one-stop arrangement for the establishment, ongoing corporate filings and termination of OFCs.

According to Mr. Ashley Alder, the SFC's Chief Executive Officer, the introduction of a new corporate fund structure will enrich the choice of investment vehicles and facilitate the distribution of Hong Kong funds internationally. In the meantime, the SFC will continue to enhance market infrastructure to enable Hong Kong's sustained growth as a full-service international asset management center and a preferred fund domicile.

The OFC Rules and the Securities and Futures (Open-ended Fund Companies) (Fees) Regulation, both subsidiary legislation under the Securities and Futures Ordinance, were gazetted on May 18, 2018 and will be submitted to the Legislative Council for negative vetting. Subject to the legislative process, the OFC regime is targeted to come into effect on July 30, 2018. The OFC Code will be gazetted following the completion of the legislative process for the OFC Rules and Securities and Futures (Open-ended Fund Companies) (Fees) Regulation. The SFC will provide guidance to the industry on the implementation of the regime.

Source:
<http://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/corporate-news/doc?refNo=18PR53>

Hong Kong's Securities and Futures Commission Concludes Consultation on Disclosure Requirements for Discretionary Accounts to Make it Easier for Investors to Compare Benefits Which Discretionary Account Managers will Receive from Product Issuers

Hong Kong's Securities and Futures Commission (SFC) released, on May 23, 2018, consultation conclusions on proposed disclosure requirements for intermediaries providing discretionary account management services. New disclosure requirements to make it easier for investors to make better decisions, especially by comparing benefits which discretionary account managers will receive from product issuers, will be implemented through amending the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission, which will be come into effect six months after the gazettal date of May 25, 2018.

Source:
<http://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=18PR55>

Hong Kong's Securities and Futures Commission Publishes Second Issue of "Regulatory Bulletin: Listed Corporations" on its Real-time Regulation Over Securities Issuances

Hong Kong's Securities and Futures Commission (SFC) published, on May 23, 2018, the second issue of its "SFC Regulatory Bulletin: Listed Corporations" to provide an update on how it exercises its powers under the Securities and Futures (Stock Market Listing) Rules to fulfil its statutory objective of protecting investors, by intervening in serious cases at an early stage to safeguard the interests of investors and suppress illegal, dishonorable

and improper market practices involving issuances of securities.

Source:
<https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=18PR56>

Hong Kong Securities and Futures Commission Issues Circular to Intermediaries Regarding Client Orders Received Through Instant Messaging

Most instant messaging service providers do not provide users with tools for saving, retrieving or monitoring instant messaging content. Before allowing the use of instant messaging applications to receive customer transaction instructions, intermediaries should properly understand the application's features and limitations and carefully evaluate the risks involved. Therefore, the Hong Kong Securities and Futures Commission issued a circular to provide guidance on the main control and procedures that should be implemented when intermediaries using instant messaging applications to receive client trading instructions.

1. Centralized record keeping

(a) Messages relating to client orders (order messages) and the IM accounts and devices for storing and processing them should be properly maintained and centrally managed to reduce the possibility of error and minimize the risk of record tampering.

(b) Appropriate arrangements should be in place and sufficient capacity should be available to store and back up order messages in a form which could not be inappropriately modified or erased.

(c) All order messages should be fully recorded and properly maintained for a period of not less than two years³.

2. Security and reliability

(a) The identities of clients who send order messages should be properly authenticated and validated⁴. In case of doubt, direct confirmation should be obtained by calling clients at their registered phone numbers. Where appropriate, intermediaries should obtain a written acknowledgement from the client that order messages received via his mobile phone number originate from the client.

(b) Intermediaries should keep abreast of threat intelligence and fraud trends relating to IM applications and ensure that adequate and appropriate security safeguards⁵ are implemented to prevent unauthorized access or security attack. These safeguards should cover

end-to-end data transmission as well as the IM accounts and devices used for storing and processing the order messages. The highest level of security available in the IM applications should be activated where appropriate.

(c) Client instructions received through IM applications for fund transfers to a third party account should only be approved on an exceptional basis after authentication of the identities of clients such as by making proper enquiries with clients through a different communication channel.

(d) A written contingency plan should be established to cope with emergencies and disruptions relating to IM applications. The contingency plan should be appropriately tested, regularly updated and communicated to clients.

3. Compliance monitoring

(a) All order messages should be readily accessible and appropriate equipment and facilities should be available for compliance monitoring and audit purposes.

(b) Regular compliance reviews should be performed to compare order messages against their clients' account activities to detect irregularities and potential malpractice.

(c) Intermediaries should ensure proper monitoring of unusual or questionable transactions, such as changes in trading patterns or trading large volumes of low turnover stocks, and verify them with clients where appropriate.

4. Internal policies and procedures

(a) Intermediaries should put in place written policies and procedures for the use of IM applications to receive client orders and these should be clearly communicated to staff. Monitoring procedures should be put in place to ensure that client orders received through IM applications are executed promptly.

(b) Staff members should be prohibited from making, sending or receiving electronic communications relating to client orders unless the intermediary has full control over the recording and retention of order messages.

(c) Appropriate and adequate training should be provided to staff regarding internal policies and procedures, regulatory requirements and security precautions for using IM applications for receiving client orders.

5. Client awareness

(a) Intermediaries should take appropriate steps to raise the security awareness of their clients and ensure that they fully understand all the potential security risks, such

as phishing, malware, account theft and impersonation, as well as operational risks, before allowing them to use IM applications to place orders. It may not be suitable for clients with inadequate security awareness to place orders through IM applications.

(b) The terms and conditions for using IM applications to place orders should be fully communicated and agreed with clients.

Source:

<http://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=18EC30>

Hong Kong's Requirement for Publication of Full Property Valuation Reports on the Stock Exchange Website When Summary Valuation is Included in Takeovers Code Document

Rule 11.1 of the Hong Kong Codes on Takeovers and Mergers and Share Buy-backs (Takeovers Code) provides that when valuations of assets are given in connection with an offer, details of the valuation or an appropriate summary must be included in the offer document, offeree board circular or other documents. Rule 11.1(f) of the Takeovers Code sets out when a valuation report of properties will be required. Commonly, when such a property valuation report is required, the full property valuation report is included in the document. However, there may be situations (e.g., where the offeree company has a large portfolio of properties) where a summary of the property valuation report is included in the document instead. In the March 2018 issue of its Takeovers Bulletin, the Securities and Futures Commission (SFC) clarifies that, in such circumstances, the full valuation report must be made available as a document on display in accordance with Note 1 to Rule 8 and Rule 11.5(d) of the Takeovers Code.

To facilitate transparency and ensure consistency with other cases where the full valuation report has been included and continues to be publicly available after completion of the Code transaction, where only a summary property valuation report is included, the SFC would expect the full version to be published on the Stock Exchange's website by way of an announcement at the same time as the offer document, offeree board circular or the relevant shareholders circular is dispatched to shareholders and published on the Stock Exchange's website.

Source:

http://www.sfc.hk/web/EN/files/CF/pdf/Takeovers%20Bulletin/Takeovers%20Bulletin%2020180328_E.pdf

The Hong Kong Securities and Futures Commission Concludes Consultation on Online Platforms and Further Consults on Offline Requirements for Complex Products

The Securities and Futures Commission (SFC) released consultation conclusions on proposed Guidelines on Online Distribution and Advisory Platforms.

The guidelines provide tailored guidance to the industry on the design and operation of online platforms, including specific guidance on the provision of automated or robo-advice. The guidelines also clarify that the posting of factual, fair and balanced materials on online platforms should not in itself trigger the suitability requirement.

The SFC will implement the requirement for platform operators to ensure the suitability of complex products sold, recognizing that retail investors should be in a position to take responsibility for their decisions to invest in simple products which they can reasonably be expected to understand.

The guidelines will become effective 12 months after gazettal. The SFC will publish frequently asked questions to provide further guidance to the industry.

Source:
<http://www.sfc.hk/web/EN/faqs/intermediaries/supervision/guidelines-on-online-distribution-and-advisory-platforms/guidelines-on-online-distribution-and-advisory-platforms.html>

The Hong Kong Securities and Futures Commission and The Stock Exchange of Hong Kong Sign Addendum to Memorandum of Understanding Governing Listing Matters

The Hong Kong Securities and Futures Commission (SFC) and The Stock Exchange of Hong Kong (Exchange), have signed an addendum (Addendum) to the Memorandum of Understanding (MOU) Governing Listing Matters.

Pursuant to arrangements under the Addendum, a new Listing Policy Panel (LPP) has been established as an advisory, consultative and steering body to initiate and centralize discussions on listing policy with broader regulatory or market implications. The LPP was set up based on the Joint Consultation Conclusions on Proposed Enhancements to the Exchange's Decision-making and Governance Structure for Listing Regulation (Joint Consultation Conclusions).

The role of the SFC as a statutory regulator has evolved to have a more direct presence in more serious listing matters. The Joint Consultation Conclusions clarified the role of the SFC as the statutory regulator in (i) administering the Securities and Futures Ordinance and the Securities and Futures (Stock Market Listing) Rules (SMLR), and (ii) supervising, monitoring and regulating the activities of the Exchange, including the Exchange's role as the regulator in administering the Listing Rules. The Exchange is the primary front-line regulator and remains the contact point for all listing applications, save in respect of concerns raised by the SFC under the SMLR. The SFC is the direct contact point on issues raised under the SMLR. The Addendum reflects the amendments to the MOU based on these clarifications.

Source:
<http://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=18PR24>

Third SFC Regulatory Forum Discusses Hong Kong's Competitiveness

The Securities and Futures Commission (SFC) hosted on March 14, 2018 the third SFC Regulatory Forum which focused on initiatives to enhance the competitiveness of Hong Kong as a capital-raising center amidst rapid technological innovation and increasing connectivity with the Mainland and other markets. The SFC organizes the event biennially to promote dialogue with a wide range of stakeholders.

Mr Paul Chan Mo-po, Financial Secretary of the Hong Kong Special Administrative Region Government, delivered the keynote address. "The financial services industry, contributing almost 18% to our GDP, has long been the linchpin of the Hong Kong economy. The Government has launched a number of new initiatives in recent years to further promote the development of financial services and enhance Hong Kong's competitiveness as an international financial center."

"At the same time, we are highly committed to protecting investors as well as our global reputation. We will continue to review our regulatory mechanisms in order to ensure the smooth and robust functioning of our financial system and markets, and the overall financial stability of Hong Kong," Mr Chan said.

"We took on some of the most pressing questions we face, such as what is the right regulatory response to increasing market connectivity and the best way for Hong Kong to

deal with emerging challenges and risks," Mr Carlson Tong, the SFC's Chairman, said in his opening remarks.

The first of four panel discussions addressed ongoing reforms to listing regulation in Hong Kong in the context of the SFC's front-loaded, real-time regulatory approach. It also examined Mainland and Hong Kong market integration, including the expansion of the Connect schemes and opportunities presented by the Belt and Road initiative.

"Our ability to ensure Hong Kong's competitiveness as an international financial center hinges on how we manage the risks we face," said Mr Ashley Alder, the SFC's Chief Executive Officer, during the first panel. "Effective regulation and reciprocal, balanced regulatory cooperation are vital to further market integration and expanding global investment flows."

Another panel considered the opportunities and challenges facing the asset management industry as Asia's growing middle class and new financial technologies transform the investment landscape. In addition, the panel discussed the potential for Hong Kong to develop as the region's premiere risk management center and derivatives hub.

The role of regulation in changing corporate behavior was the subject of a separate panel which looked closely at the evolution of the Hong Kong market over the past decade and considered the need for changes in listing regulation to deal with shell manufacturing, backdoor listings, dilutive rights issues and other corporate governance problems.

A final panel considered the SFC's recent efforts to ensure firms' compliance and deter corporate fraud and market misconduct. These include promoting senior management accountability, investigating initial public offering sponsor work and encouraging cooperation in investigations and enforcement proceedings.

The full-day event was attended by more than 900 leaders from the financial industry, listed companies, professional services firms and industry associations.

Source:
<http://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=18PR27>

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