REGULATORY NEWSLETTER

2019 Vol.4

A Busy Month!

March has been a busy month for the SFC on all fronts: several record-breaking fines, cracking down on sponsor failures; the recommencement of collection of annual licensing fees; the new online forms and new online platform (WINGS) taking effect in April; updates on the investor protective measures in selling complex products; the SFC's latest target to take on the challenge of climate change… staying on top of all these regulatory changes could be challenging, but fear not! We at ComplianceDirect have summarised the changes for you here.

REGULATORY UPDATES

Supplemental Circular on Leveraged and Inverse Products

14 Mar 2019

The SFC issued the circular as supplemental to the SFC's Circular on Leveraged and Inverse Products which was first issued in February 2016 and was last amended in December 2018 (the "L&I Products Circular"):

Background

The L&I Products Circular sets out the requirements under which the SFC would consider authorizing L&I Products for public offering in Hong Kong under sections 104 and 105 of the Securities and Futures Ordinance. The L&I Products Circular required, among others, that Inverse Products shall be

subject to a maximum leverage factor of one time (-1X) and that such leverage factor will be subject to review going forward.

Product Structure

The SFC is prepared to relax the leverage factor cap of Inverse Products to two-time (-2X) and accept applications for -2X Inverse Products.

The SFC will continue to keep in view the eligible indices of L&I Products but, at this stage, the SFC will only accept applications for L&I Products tracking commodities indices on a case by case basis where there is no potentially outsized impact from roll costs on the performance of the products.

In considering applications of L&I Products, the SFC will generally assess, among others, (i) liquidity of underlying assets; (ii) costs internalized by the products; and (iii) fairness of product design.

View Circular

Implementation of online platform guidelines and offline requirements for complex products

Background

On 28 March 2018, the SFC issued new *Guidelines on Online Distribution and Advisory Platforms (Guidelines)*. Amongst other requirements, Chapter 6 of the Guidelines provides for additional protective measures for the sale of complex products in an online environment. On 4 October 2018, the SFC further announced that under a new *paragraph 5.5 of the Code of Conduct*, the additional protective measures will also apply to the sale of complex products in an offline environment.

From the effective date, additional protection will be provided to investors when they purchase a complex product without a solicitation or recommendation. If an intermediary solicits the sale of or recommends a financial product to a client, it should comply with paragraph 5.2 of the Code of Conduct and ensure that the product is suitable for the client regardless of whether it is complex or non-complex.

Extension of Deadline

Both the Guidelines and paragraph 5.5 of the Code of Conduct were due to become effective on 6 April 2019. The SFC considered feedback from the industry and agreed to extend the effective date for three months to **6 July 2019**.

FAQs on implementation of additional protective measures for complex products

In regard to the classification of funds into complex and non-complex products for both online and offline transactions, the SFC has provided further guidance by way of Frequently Asked Questions (FAQs) on the Guidelines on Online Distribution and Advisory Platforms (Guidelines). The FAQs should also be referred to when implementing paragraph 5.5 of the Code of Conduct for offline transactions.

The full set of FAQs on the Guidelines is available here.

Seminars on the Implementation

The SFC will host three seminars to facilitate the industry to gain a better understanding of how to implement the regulatory requirements for online and offline sales of complex products. The seminars will be held on 18 April, 2 and 14 May 2019 respectively at the SFC's office at 35/F, Cheung Kong Center, 2 Queen's Road Central. Please refer to the SFC circular for the enrolment details.

View Circular

Arrangements for the collection of annual licensing fees

25 Mar 2019

The SFC has decided to resume the collection of annual licensing fees from all intermediaries and licensed individuals. A concession rate will apply for a two-year period in accordance with the following timetable.

Period	Concession rate of annual licensing fees
1 April 2019 to 31 March 2021	50%
1 April 2021 onward	0%

All annual licensing fees payable by each licensed corporation, registered institution, responsible officer and licensed representative (including licensed individuals whose accreditations are transferred from one licensed corporation to another) are eligible for the concession rate. The following table details the concessions for each type of intermediary and regulated activity.

Type of intermediary	Regulated activity (RA)[1]	Original fee[2]	Fee after 50% concession
Licensed corporation	RAs other than RA 3	$4,740	$2,370
	RA 3	$129,730	$64,865
Registered institution[3]	RAs other than RAs 3 and 8	$35,000	$17,500
Responsible officer	RAs other than RA 3	$4,740	$2,370
	RA 3	$5,370	$2,685

Licensed representative	RAs other than RA 3	$1,790	$895
	RA 3	$2,420	$1,210

For the avoidance of doubt, the payment of all other fees due and payable to the SFC, including licence application and transfer fees, will not be affected.

As an environmentally-friendly practice and for operational efficiency, reminders of outstanding annual fees will only be issued electronically via the SFC Online Portal. Whilst conventional payment methods (by cheque, bank deposit or remittances) may still be used to pay annual fees, all intermediaries and licensed individuals are strongly encouraged to pay fees electronically.

Section 138(2) of the Securities and Futures Ordinance requires that all intermediaries and licensed individuals shall pay annual fees within one month after each anniversary date of their licences or registrations. Failure to make full payment of the annual fee before the due date will attract a surcharge on the outstanding amount and possible suspension and revocation of a licence or registration.

The SFC has also prepared a user guide for handling annual fee matters on its Online Portal. Please refer to the "Quick User Guide on Annual Fee Payment" for details.

View Circular

Revised financial return

29 Mar 2019

The SFC published a revised form for the submission of financial returns by licensed corporations as from **1 May 2019**.

The revisions were made to reflect changes effected by the Securities and Futures (Financial Resources) (Amendment) Rules 2018, which will come into effect on **1 April 2019**.

The electronic version of the revised form is available on the SFC website:

https://www.sfc.hk/web/EN/forms/intermediaries/financial-returns.html

A Gazette notice was published to specify that the above electronic form shall be used for a return required to be submitted under section 56 of the Securities and Futures (Financial Resources) Rules with effect from 1 May 2019. On this date, the new form will supersede all previous versions.

View Circular

Statement on Security Token Offerings

29 Mar 2019

The SFC has issued the Statement on Security Token Offerings on 28 March 2019. This Statement serves as a reminder about the legal and regulatory requirements applicable to parties engaging in security token offerings.

Regulation of STOs

STOs typically refer to specific offerings which are structured to have features of traditional securities offerings, and involve Security Tokens which are digital representations of ownership of assets (eg, gold or real estate) or economic rights (eg, a share of profits or revenue) utilising blockchain technology. Security Tokens are normally offered to professional investors only.

In Hong Kong, Security Tokens are likely to be "securities" 1 under the Securities and Futures Ordinance (SFO) and so subject to the securities laws of Hong Kong.

Where Security Tokens are "securities", unless an applicable exemption applies, any person who markets and distributes Security Tokens (whether in Hong Kong or targeting Hong Kong investors) is required to be licensed or registered for Type 1 regulated activity (dealing in securities) under the SFO. It is a criminal offence for any person to engage in regulated activities without a licence unless an exemption applies.

Intermediaries which market and distribute Security Tokens are required to ensure compliance with all existing legal and regulatory requirements. In particular, they should comply with paragraph 5.2 of the Code of Conduct2 as supplemented by the Suitability FAQs3. Under the Guidelines on Online Distribution and Advisory Platforms and paragraph 5.5 of the Code of Conduct4, Security Tokens would be regarded as "complex products" and therefore additional investor protection measures also apply.

Further, intermediaries are expected to observe requirements which are similar to those set out in the Circular to intermediaries on the distribution of virtual asset funds dated 1 November 2018. The requirements are highlighted as follows:

(A) Selling restrictions

Where an intermediary market or distributes Security Tokens, it must be licensed or registered for Type 1 regulated activity (dealing in securities) and the Security Tokens should only be offered to professional investors.

(B) Due diligence

Intermediaries distributing Security Tokens should conduct proper due diligence in order to develop an in-depth understanding of the STOs. This should include, but is not limited to, the background and financial soundness of the management, development team and issuer as well as the existence of and rights attached to the assets which back the Security Tokens. Intermediaries should also scrutinise all materials relevant to the STOs including published information such as the whitepaper and any relevant marketing materials. Intermediaries should also ensure that all information given to their clients is accurate and not misleading.

(C) Information for clients

To help clients make informed investment decisions, intermediaries should provide the information in relation to STOs in a clear and easily comprehensible manner. Intermediaries should also provide prominent warning statements covering risks associated with virtual assets. Intermediaries are reminded to implement adequate systems and controls to ensure compliance with the requirements before they engage in the distribution of STOs. Failure to do so may affect their fitness and properness to remain licensed or registered and may result in disciplinary action by the SFC. Intermediaries are reminded to discuss with the SFC before engaging in any activities relating to STOs.

View Circular

Survey on Integrating Environmental, Social and Governance Factors in Asset Management

29 Mar 2019

The SFC has commenced the Survey on Integrating Environmental, Social and Governance Factors in Asset Management (the "Survey").

Who should complete the questionnaire?

All corporations licensed for asset management are requested to complete the online survey. The objective of the survey is to gain a better understanding of whether and how asset managers integrate environmental and climate change-related factors into their investment and risk management processes, post-investment ownership practices and disclosures. The survey will also gauge their expectations for listed companies' environmental, social and governance disclosures.

How to submit the questionnaire?

The survey should be completed and submitted online, the SFC will send a separate email with the survey link and login instructions.

Deadline of submission

All corporations licensed for asset management are requested to complete the online survey on or before **23 April 2019**.

View Circular

ENFORCEMENT NEWS

SFC reprimands and fines Standard Chartered Securities HK$59.7 million, Morgan Stanley Asia Limited HK$224 million, Merrill Lynch Far East Limited HK$128 million, and UBS HK$375 million and suspends its licence for one year for sponsor failures

Standard Chartered Securities ("SCS") and UBS acted as joint sponsors in relation to China Forestry Holdings Company Limited's ("China Forestry") listing application.–

Summary of facts

Failure to verify the existence of China Forestry's forestry assets: UBS did not conduct any site inspection of the forests after they became sponsors; while SCS did conduct site inspections, material inconsistencies were found such that it was difficult to ascertain which forest locations disclosed in the prospectus SCS actually visited.

Failure to verify the forestry rights: the relevant forestry right certificates used to evidence China Forestry's ownership of the trees. The certificates were, despite SCS and UBS's claims that they have been checked by Mainland Chinese lawyers, not verified and checked. Upon the SFC's inspections, it was discovered that the certificates accounting for over 90% of the forestry assets had no corresponding records with the relevant forestry bureaus.

SCS and UBS failed *to verify China Forestry's compliance with relevant forestry laws and regulations.*

Inadequate due diligence on the insurance coverage for the forestry assets: the SFC made inquiries with the purported insurer and the insurer confirmed that none of the insurance contracts that China Forestry provided was issued by it.

Inadequate due diligence on China Forestry's customers: SCS and UBS conducted telephone interviews with China Forestry's customers using information provided by China Forestry. SCS and UBS did not conduct independent searches to confirm the customers' identity, nor did they verify the identity and contact details of the interviewee. Important information about the interviews were not recorded, and important questions relating to the Yunnan Earthquake were not asked.

Breaches

The SFC found that SCS and UBS had:

- failed to conduct adequate and reasonable due diligence inquiries to ensure that the information and representations provided in the prospectus were true, accurate and not misleading;
- failed to keep a proper audit trail/written record of the work done in relation to the due diligence;
- breached the sponsor's undertaking to the SEHK and/or filed untrue statements in the sponsor's declaration to the SEHK; and
- failed to comply with all regulatory requirements applicable to the conduct of a sponsor, including the Rules Governing the Listing of Securities on the SEHK ("Listing Rules") and Practice Note 21 of the Listing Rules.

Morgan Stanley Asia Limited ("MSAL"), Merrill Lynch Far East Limited ("MLFEL") and UBS acted as joint sponsors to Tianhe Chemicals Group Limited's ("Tianhe") listing application. The breaches were due to the inadequacies of the customer interview part of the due diligence inquiries. The interviews were arranged and all customer information were provided by Tianhe, and when red flags were raised during an interview, the LCs did not address them. The questions asked during the interview were unclear and thus not conducive to allowing the LCs

ensure that the disclosure in the listing document and information provided to the SEHK were true.

Breaches

The SFC found that MSAL, MLFEL and UBS had failed to:

- conduct adequate and reasonable due diligence inquiries in relation to Tianhe's listing application and use all reasonable efforts to ensure that the information and representations provided in the Tianhe Prospectus were true, accurate and not misleading;
- perform adequate and reasonable due diligence inquiries in relation to Tianhe's customers, in that it had:
    i. failed to carry out customer interviews directly with the person or entity selected for interview with minimal involvement of Tianhe;
    ii. failed to confirm the bona fides of all interviewees to satisfy themselves that the interviewees had the appropriate authority and knowledge for the interviews;
    iii. failed to identify and ensure that all irregularities noted during the interviews were adequately explained and resolved; and
- comply with all regulatory requirements applicable to the conduct of a sponsor, including the Listing Rules and PN21.

View News (SCS) | View News (MSAL) | View News (MLFEL) | View News (UBS)

SFC reprimands and fines BOCI Securities Limited HK$10 million for regulatory breaches in selling investment products

Summary of facts

BOCI Securities Limited ("BOCI") allowed clients to upgrade their investment strategy from lower risk tolerance levels to higher ones ("Upgrade") without providing any justification. Clients therefore were allowed to buy products that had a higher risk rating without resulting in a "mismatch" between the client's investment strategy and the product risk rating. There was no policy requiring relationship managers ("RM") to evaluate the appropriateness of the Upgrade, document the evaluation and obtain approvals from supervisors.

RM, when justifying the recommendation of Mismatch Transactions to clients, were only required to select one or more of the pre-set investment rationales which were overly broad and general and failed to sufficiently explain why a product was considered to be suitable for a client despite a Product Mismatch and/or High Asset Concentration.

RM were required to give verbal warning and obtain client's written acknowledgement of the mismatch, but the SFC considers that such procedures were not sufficient to discharge BSL's suitability obligation.

BOCI's Product Marketing Department ("PMD") was responsible for carrying product due diligence and profiling exercise. The SFC found that BOCI heavily relied on the credit rating of the bond or the bond's issuer/guarantor in deriving the product risk rating, and they did not require PMD to conduct independent assessment on the financial soundness of the bonds' issuers/guarantors. In the product risk rating exercise, BOCI prescribed a limited set of factors to be considered and did not require PMD to consider other factors which might directly or indirectly impact on the risk return profiles.

The product due diligence performed by PMD and the rationale underlying its assessment results were not properly

documented. There is no record to show that PMD has considered and given due weight to all relevant factors during the product due diligence and profiling exercise.

The risk ratings for ELNs and AQ/DQ were determined based on the asset class and tenor of the product. BOCI failed to have systems and controls in place to ensure all relevant factors and features of each individual product were appropriately taken into account in the risk rating process; and BOCI failed to maintain sufficient documentation to demonstrate that proper due diligence was conducted on the products. BOCI had underrated the complexity level of complex products by classifying them as “simple” products, leading to the sale to clients with limited investment knowledge without triggering the mismatch control mechanisms.

Breaches

The SFC found that BOCI, in selling Chapter 37 Bonds and ELNs, mutual funds, bonds and AQ/DQ, had failed to:

- properly assess and determine its clients’ risk tolerance level and investment strategy in certain cases;
- ensure the investment recommendations and/or solicitations made to its clients were reasonably suitable in all the circumstances of each of its clients;
- ensure the clients had sufficient net worth to be able to assume the risks and bear the potential losses of trading in derivative products and/or leveraged transactions;
- conduct proper and adequate product due diligence on certain investment products; and
- implement and maintain adequate and effective internal controls and systems to diligently supervise its sale and distribution of investment products to clients and to ensure its compliance with the regulatory requirements.

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