The guidelines issued by regulators in the last six months have contributed to the strengthening of Hong Kong financial services sector.

In this third edition of Regulatory Hot Issues, we have covered the following key developments:

**Culture and Governance**
In December 2018, the Hong Kong Monetary Authority (“HKMA”) issued a second circular on bank culture detailing a series of supervisory measures including a “self-assessment”, “focus reviews”, and “culture dialogues”. With these supervisory measures, it is clear that Bank Culture Reform will continue to be one of the regulatory focusses in the coming years.

**Risk Governance**
Over the past 6 months, focus on governance arrangements and the adequacy of the three lines of defence has increased. For instance, the HKMA issued the circular “Contraventions of the Banking Ordinance” in October 2018, which highlighted areas where contraventions of the notification requirements were being observed.

**Capital Requirements**
In the fourth quarter of 2018, the Basel Committee on Banking Supervision (“BCBS”) issued the final version of its Stress Testing Principles (BCBS 450), which the HKMA intends to incorporate into Supervisory Policy Manual module IC-5.

Moreover, the HKMA plans to release a consultation paper in the second quarter of 2019 on the new market risk capital charge calculation requirements which will be effective from 1 January 2022, aligning with other Pillar 1 Basel III requirements.

Finally, the concluded amended Securities and Futures (Financial Resources) Rules will come into effect on 1 April 2019.

**Asset and wealth management updates**
The regulatory space for the asset and wealth management industry continues to be enhanced with the following updates from the Securities and Futures Commission (“SFC”):

- The online distribution and advisory platforms guidelines will come into effect on 6 July 2019;
- The SFC’s finalised amendments and enhancements within the revised UT Code became effective on 1 January 2019; and
- The SFC announced a revamp of its license application process as well as mandatory electronic submission of all annual returns and notifications, which becomes mandatory on 11 April 2019.
**Digitalisation and technology**

Hong Kong regulators are constantly focusing on cybersecurity, with the new mandatory requirements stipulating that organisations strengthen the controls over the cybersecurity coming into effect.

As financial institutions continue to innovate and adopt emerging technologies, regulators in Hong Kong have been issuing a number of guidelines and circulars to ensure that financial institutions can better manage technology risks.

**Updates on Anti-Money Laundering/ Counter-Financing of Terrorism ("AML/CFT")**

The revised Guideline on AML/CFT (For Authorised Institutions), published by the HKMA, came into effect on 1 November 2018. Moreover, the onsite evaluation of Hong Kong’s AML/CFT regime by the Financial Action Task Force ("FATF") took place in late-2018, the evaluation report of which is expected in June 2019. In addition, the HKMA issued a circular in February 2019 to set out its expectation on remote on-boarding of individual customers.

**Regulatory updates on virtual assets**

In response to the virtual asset boom, the SFC issued a conceptual framework for licensing and regulating virtual asset trading platforms on 1 November 2018. In addition, the SFC also issued a statement on the regulatory approach for virtual asset portfolio managers and fund distributors.

**Taxation**

A number of changes to the Hong Kong tax regime are expected to have a potential significant impact on financial institutions, including the profits tax exemption for funds, fair value accounting treatment of financial instruments for tax purposes and the research and development tax deduction regime.

**Insurance regulatory reform updates**

The Insurance Authority (IA) has released consultation papers on three draft guidelines and two set of rules in the last few months of 2018. These include ‘Guidelines for Fit and Proper Criteria and Continuing Professional Development for Licensed Insurance Intermediaries’, ‘Guideline on Exercising Power to Impose Pecuniary Penalty in Respect of Regulated Persons Under the Insurance Ordinance’, ‘Insurance (Maximum Number of Authorised Insurers) Rules’, among others.
It can become difficult to keep track of regulatory updates when new regulations and guidelines are issued on a piecemeal basis almost everyday. “Regulatory Hot Issues” aims to provide you with a recap on some of the most pertinent areas that are challenging financial institutions. This publication will be released periodically as a reminder of key regulatory updates impacting the financial services industry.

The 3rd edition touches on a range of trending topics that the Hong Kong regulators are focused on for 2019, including culture and governance, capital and digitalisation, and also provides a view on the continued reform and updates for insurance regulations.
The recent conclusion of the Royal Commission in Australia into Misconduct in the Banking, Superannuation and Financial Services Industry means that culture and conduct are front of mind for the industry as a whole. Regulators and financial institutions are also considering how this impacts them and their ongoing interactions on this topic.

As a follow up to the “Bank Culture Reform” circular issued in March 2017, the December 2018 circular “Supervision for Bank Culture” sets out the HKMA’s expectation that banks should make reference to this and other serious misbehaviour incidents outside Hong Kong as they assess whether they have similar issues.

### Bank Culture Supervision

The December 2018 circular details a series of supervisory measures the HKMA will take. These measures include self-assessments, focus reviews, and cultural dialogues.

These circulars clearly set out the expectation that the bank culture reform initiative should not be treated as a “check the box” exercise. This requires a holistic reflection, across the organisation, of progress to date, key challenges and future plans to enhance culture.

### HKMA Supervisory measures for Bank Culture

<table>
<thead>
<tr>
<th>Self-assessment</th>
<th>Supervisory focus reviews</th>
<th>Cultural dialogues</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Report on the enhanced measures implemented with respect to the “Bank Culture Reform” circular&lt;br&gt; • Review governance arrangements as well as policies and procedures relevant to corporate culture&lt;br&gt; • Reflect on any insights, lessons learnt and issues encountered&lt;br&gt;</td>
<td>• Conduct site visits and/or off-site reviews with respect to key areas of bank culture&lt;br&gt; • Assess the efficiency and effectiveness of implementation of enhancement measures&lt;br&gt; • Benchmark Als’ practices and general progress in bank culture reform</td>
<td>• Conduct dialogues with senior management and board members responsible for bank culture&lt;br&gt; • Gather perspectives, insights and lessons learnt from Als&lt;br&gt; • Understand the Als current status and discuss the next steps in implementing cultural reform initiatives</td>
</tr>
</tbody>
</table>
Culture Self Assessment

The HKMA’s questionnaire is comprised of a series of questions that are directed to the Board and senior management. These relate to steps they have taken to drive and monitor culture as well as their priorities over the next 12 months.

As a first phase, the HKMA have selected 30 AIs to complete the self-assessment questionnaire and they have 6 months to submit it to the HKMA. AIs that are not covered in the first phase are still expected to reflect on their insights, lessons learnt and issues encountered in their culture enhancement initiatives.

This is likely to form the starting point as the HKMA further develops their approach and areas of focus for their on-site reviews and off-site monitoring.

Key challenges

Other previous types of self-assessments have only required further explanation to be provided where a “no” response is given in respect of compliance with the HKMA’s requirements. However, this self-assessment has been modified such that where “yes” answers are provided, banks are required to respond with examples and elaboration of why.

This change of format of this self-assessment as compared to other previous types and the highly qualitative nature of the questions asked mean that significant effort will be needed to compile and socialise the final deliverable with key stakeholders. This will need to balance the need to articulate culture initiatives, conduct frameworks and the type of behaviours observed.

Organisations are currently working through the complexity of managing bank-wide responses to this self-assessment. This is critical to ensure that the responses provided are thorough, reflective on successes / challenges and there is explanation of the next steps in the cultural journey.

This will also require clarity on responsibilities across the three lines of defence to ensure there is sufficient balance and independence in the preparation and challenge of the responses to the self-assessment.

What’s next?

Whilst all banks should now be performing their self-assessment, for submission to the HKMA or for their own reference, they should also be preparing for the cultural dialogues.

The December 2018 circular reinforces the market’s expectation that the bank culture reform initiative is a multi-year journey which will continue to evolve with the industry. It is expected that there will be both positive and negative outcomes thus far and banks should ensure they have protocols in place to identify information / data which can be used to assess the effectiveness of actions taken to determine next steps.
Over the past 6 months, there has been an increasing focus on governance arrangements and the adequacy of the three lines of defence. The renewed focus from the industry is being driven by continued maturity of accountability frameworks, and culture/conduct initiatives.

This is particularly relevant to institutions who are currently subject to heightened scrutiny due to recent regulatory failings, significant operational incidents and matters resulting in significant client impact.

We have set out below specific matters the HKMA has drawn to AIs’ attention and key areas which we believe management should re-evaluate in their governance and risk management frameworks.

**Contravention of notification provisions under the Banking Ordinance**

On 8 October 2018, the HKMA issued the circular “Contraventions of the Banking Ordinance,” which highlighted areas where contraventions of the notification requirements were being observed. It further stated that, if necessary, they may commission an auditor’s report under s59(2) of the Banking Ordinance to evaluate the adequacy of internal systems and processes.

The provisions noted as being contravened most frequently were:

- Changes in relation to particulars of “relevant individuals” involved in AIs’ regulated activities under the Securities and Futures Ordinance (section 20(4)(b));
- Alterations to an AI’s memorandum of association, articles of association or other instruments under which the AI is incorporated (section 65);
- Information regarding persons becoming, or ceasing to be, “specified persons” — including controllers, directors, chief executives, executive officers or relevant individuals (section 72A(2A)); and
- The appointment/cessation of the appointment or change in responsibilities of “managers” (section 72b, with reference to the definition of “managers” contained in section 2(1)).

In light of the circular, AIs should review their processes and procedures in relation to record keeping, management of joiners, movers and leavers, and the respective roles of Human Resources and Compliance teams in relation to the notification requirements.

**Key regulatory expectations**

The HKMA’s expectations in relation to corporate governance, risk management and internal audit are set out in various Supervisory Policy Manuals (“SPMs”) including:

- CG-1 Corporate Governance of Locally Incorporate Authorised Institutions
- IC-1 Risk Management Framework
- IC-2 Internal Audit Function
Where contraventions of regulations are identified, institutions are required to notify the HKMA of the nature and details of the incident, details of any internal investigations and the remedial actions and preventative measures implemented.

In response to these incidents, “deep dive” assessments should be performed on specific deficiencies and their root causes. AIs should also reassess the adequacy of their broader governance and risk management frameworks, in particular where repeated / prolonged breaches are identified or where remedial activities are subsequently proven to be insufficient.

To provide guidance on this directors and senior management should be evaluating the matters on the right as part of the annual assessment of their effectiveness.

In addition to the internal assessment of these matters, boards and senior management should also reflect on other local and global events to determine what lessons, if any, should be drawn from them.

Areas of focus in respect of governance and the three lines of defence

Governance arrangements

- The extent to which roles and responsibilities of directors and senior management have been formalised and documented;
- The clarity and appropriateness of the reporting lines of senior management, including matrix reporting to local management and to overseas head offices where applicable;
- The terms of reference for key governance committees, membership, their standing agenda items and management information reported; and
- The timeliness and effectiveness of supervision, oversight and decision-making within business units and control functions.

The second and third lines of defence

- The adequacy of the role of risk management in identifying, monitoring and reporting on risks;
- Processes and controls relevant to the identification of new and updated regulations, and incorporation into policies and procedures;
- The monitoring and testing processes that reside in the second line of defence to identify risk, compliance and operational issues that may warrant escalation internally or externally to regulators; and
- The level of independent testing performed by internal audit in respect of their business as usual audit plan and any targeted reviews.
A focus for the HKMA in 2019

As published in “Hong Kong Banking Sector: 2018 Year-end Review and Priorities for 2019” in January 2019, the HKMA indicated its focus areas in relation to credit, liquidity and market risk.

For credit risk management, it would be focussed in particular around (i) Counterparty credit risk management; (ii) Loan classification and provisioning; and (iii) Lending to large corporates and SMEs.

For liquidity and market risk management, the HKMA would focus on (i) Assessment of banks’ capability to cope with possible liquidity shocks, in particular banks’ internal liquidity stress test and contingency funding management; and (ii) Review of banks’ management practice for algorithmic trading.

BCBS Stress Testing Principles

In the fourth quarter of 2018, the BCBS issued the final version of its Stress Testing Principles (BCBS 450), which replaces the BCBS’s 2009 Principles for sound stress testing practices and supervision. While the 2009 standard addressed the key weaknesses in stress testing practices as highlighted by the global financial crisis, the updated principles have been streamlined and defined at a higher level. This ensures that these principles can be applied across banks and jurisdictions hence remaining relevant as stress testing practices continue to evolve.

The principles focus on the core elements of stress testing frameworks: their objectives, governance, policies, processes, methodology, resources and documentation that guide stress testing activities and facilitate the use, implementation and oversight of stress testing frameworks.

The HKMA announced the intention to incorporate the updated BCBS Stress Testing Principles into Supervisory Policy Manual module IC-5 on stress-testing in due course, subsequent to a consultation with the industry. In the meantime, AIs are expected to review and strengthen their stress testing frameworks and practices as necessary, taking account of the applicable principles set out in the BCBS document.
HKMA consultation on equity investments in funds

On 18 January 2018, HKMA issued a consultation on the proposed amendments to the Banking (Capital) Rules (“BCR”) to implement the capital requirements for banks’ equity investments in funds, implementing the respective standard issued by BCBS in 2013 (BCBS 266).

The proposed framework provides three approaches to determine the capital requirements from a bank’s equity investments in funds under the basic and standardised approach for credit risk: The “look-through” approach requires a bank to risk weight each of the fund’s underlying exposures as if they were held directly by the bank. Under the “mandate-based” approach, the applicable risk weight is determined based on the investment policies of the fund. If a bank is unable to apply these approaches, it is required to use the “fall back” approach, which assigns 1,250% risk weight to the entire fund position to account for insufficient transparency of a fund’s investment activities. The treatment under the IRB approach for credit risk will be covered in another consultation.

Interest Rate Risk in the Banking Book (“IRRBB”)

The new IRRBB standards and the corresponding revised regulatory return are set to be effective from 1 July 2019. The new requirements demand much heavier modelling capabilities that span both cash flow projections incorporating customers’ behaviours and fair valuation of interest rate options, which pose implementation challenges in both data availability and model construction.

The HKMA has issued frequently asked questions documents in December 2018 and February 2019 to provide more clarity in the details of the requirements. However, as the characteristics of the banking book portfolio can differ widely across AIs, individual AIs may need to communicate with the HKMA directly to discuss and agree on the treatments of specific items.

Market Risk Reform

The new market risk capital charge calculation requirements will be effective from 1 January 2022, aligning with other Pillar 1 Basel III requirements.

The HKMA has announced the plan to release a consultation paper in the second quarter of 2019. The new requirements, commonly known as “Fundamental Review of the Trading Book” (“FRTB”), shift the standardised approach from notional amount based to sensitivity based. AIs will need to possess capability in calculating the fair values and relevant sensitivities measures for all products subject to market risk.

The internal models approach in FRTB is subject to a higher level of regulatory scrutiny as it requires approval on a desk level that relies on continuous profit and loss attribution tests and back-testing.

Despite the potential simplified alternative to standardised approach for non-domestic systematically important AIs, the current proposal will likely pose challenges to AIs for overall FRTB compliance — but the final rules are still dependent on BCBS final standards and the national discretion set by the HKMA.
Amendments to SFC Financial Resources Rules (“FRR”)

The SFC released conclusions to the further consultation on proposed amendments to update the Securities and Futures (Financial Resources) Rules (“FRR”) in October 2018. The concluded amendments relate to non over-the-counter derivative (“OTCD”) specific changes which apply generally to all licensed corporations (“LCs”).

For other proposed modified and additional FRR changes relating to OTCD activities, the drafting of amendment rules for implementing the OTCD capital regime is ongoing together with the ongoing consultation other proposed refinements on various areas for the OTC derivatives regime for Hong Kong.

The concluded amended rules will come into effect on 1 April 2019, except for one provision with regards to a new accounting standard (IFRS/HKFRS16) was implemented earlier on 1 January 2019. The provision was introduced to avoid imposing additional capital charges on LCs as a result of the change in accounting treatment and to allow LCs to exclude the amount of recognised liabilities arising from a tenancy agreement entered into for any premises used in carrying on regulated activity that is equal to the total value of its assets arising from the tenancy agreement which are not included in the liquid assets under any provision in Division 3 of Part 4 of the FRR.

The other key highlights of the concluded amendments are:

• Rename “controlled currency” as “non-freely floating foreign currency” and modify the definition of this term;
• Replacing the proposed cap on aggregate uncollateralised receivables from affiliated banks and brokers with a proposed control requirement;
• An asset which is qualified to be included as liquid assets should be subject to the applicable haircut or other deduction required under other provisions of the FRR;
• Allow LCs to include client prepayments for securities transactions in their liquid assets;
• The FRR has only one list of specified exchanges which includes both overseas stock and futures exchanges. In order to ensure that all the markets operated by the exchanges on the list are covered, the amended FRR will continue to provide a reference in the rules to an exchange includes a reference to any market operated by that exchange;
• In order to facilitate LCs’ participation in the China Connect Market and use of third party clearing, and in view of the non-mutualised nature of Mainland Settlement Deposit (“MSTD”) and Mainland Security Deposit (“MSCD”), LCs are allowed to include in its liquid assets amounts receivable from a general clearing participant (“GCP”) in respect of MSTD and MSCD paid to the GCP and have incorporated this into revised section 23 of the FRR;
• Allow LCs to include in their liquid assets any underwriting fee accrual or receivable which remains outstanding beyond the normal time limit prescribed in the FRR, up to the amount of the corresponding sub-underwriting fee liability to sub-underwriters, the settlement of which is contingent upon the collection of underwriting fees by the LCs;
• Allow LCs to calculate on a weighted average basis (subject to the SFC’s approval) the haircut percentage of: (i) a tradable securities index underlying a structured note, and (ii) a basket of shares underlying a convertible debt security or bond with non-detachable warrants;
• Subject constituents of Hang Seng Composite Large Cap Index which are not Hang Seng Index constituents to a haircut percentage of 20% and exempt them from being classified as illiquid collateral; and
• To require, for valuation purposes, the use of fair value determined in accordance with generally accepted accounting principles if no published market price is available.
Updates to licensing

Revamped license application process and mandatory electronic submission of annual returns and notifications

On 1 February 2019, the SFC announced a revamp of its license application process as well as mandatory electronic submission of all annual returns and notifications. The revamped application process, available for use from 11 February 2019, becomes mandatory on 11 April 2019. Furthermore, from 11 April 2019, all intermediaries will be required to submit their annual returns and notifications electronically through the SFC’s Online Portal.

The revamp focused on four major areas, namely:

I. business profile and clientele;
II. financial strength and sustainability of substantial shareholders;
III. management (including corporate governance, responsible offices and managers-in-charge of core functions); and
IV. risk management and internal control measures.

Each of the new forms is designed for a specific purpose as set in the table below.

In addition to modernising the license application process, the revamp is a continuation of the SFC’s front-loaded, risk-based approach to regulation. Specifically, the two newly introduced questionnaires (“A — General Business Profile and Internal Control Summary” and “B — Specific Business Profile and Internal Control Summary”) have been designed to allow the SFC to detect possible regulatory issues earlier in the application process.

<table>
<thead>
<tr>
<th>Form</th>
<th>Designed for</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Corporate license applications</td>
</tr>
<tr>
<td>B</td>
<td>Existing licensed corporations</td>
</tr>
<tr>
<td>C</td>
<td>Registered institution applicants and existing registered institutions</td>
</tr>
<tr>
<td>D</td>
<td>Substantial shareholder applicants</td>
</tr>
<tr>
<td>E</td>
<td>Approved substantial shareholders</td>
</tr>
<tr>
<td>F</td>
<td>Associated entities of intermediaries</td>
</tr>
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Revamped Business Risk Management Questionnaire (“BRMQ”) and new online portal

On 4 January 2019, the SFC launched a revised BRMQ, which LCs and associated entities are required to complete for financial years ending on or after 31 March 2019.

The SFC has revamped the BRMQ with the objective of collecting significantly more information regarding LCs and associated entities business operations, as well as their established internal policies, procedures and controls surrounding risk management practices. The revised BRMQ will likely take a significant amount of time for LCs and associated entities to prepare and discuss internally, prior to approval and submission to the SFC. Entities are strongly encouraged to review the incremental questions raised within the revised BRMQ well in advance of their first submission deadline.

At the same time, the SFC also launched a new online portal, WINGS, for entities to make electronic submissions to the SFC. Whilst the revised BRMQ is required to be submitted through WINGS, the SFC plans to transition other submissions, currently on the existing SFC Online Portal, to WINGS in phases.

Re-commencement of annual licensing fees

On 25 March 2019, the SFC announced that it is bringing to an end its seven year waiver of annual licensing fees. From 1 April 2019, the SFC will resume collection of annual licensing fees from all intermediaries and annual licensing fees from all intermediaries and licensed individuals. To ease the burden on intermediaries and licensed individuals the SFC has introduced a 50% concession rate for next two years (i.e. from 1 April 2019 through 31 March 2021).

Updates to licensing (continued)

Amendments to the Code on Unit Trusts and Mutual Funds (“UT Code”)

In December 2017, the SFC proposed substantial amendments and enhancements to the UT Code. These amendments and enhancements were finalised within the revised UT Code published by the SFC on 6 December 2018, which became effective on 1 January 2019.

Revisions have potentially far-reaching impacts across the asset management industry. Following themes promulgated within the revised Fund Manager Code of Conduct, the revised UT Code expects management companies to be responsible for the overall operations of their funds. For trustees and custodians, the revisions to Appendix G within UT Code significantly expands the scope of the annual external review of the suitability and operating effectiveness of internal controls and systems.

Authorised funds with a net exposure exceeding 50% of net asset value from derivative investments will be classified as derivative funds, which could have knock-on impacts to the sale and distribution of such funds. Additionally, authorised funds must include enhanced disclosure regarding derivative investments within their key facts statement.

For money market funds, the SFC has introduced revisions within the UT Code to accept high quality government securities with favourable credit quality assessments as collateral for reverse repurchase transactions. Whilst there is a twelve-month transition period for existing funds, given the extent of revisions made, existing funds and operators are strongly encourage to start preparing now for compliance with the revised UT Code. However, for new funds, most of the provisions under the UT Code have immediate effect.

Guide on the Use of Financial Derivative Instruments for Unit Trusts and Mutual Funds

On 17 December 2018, the Investment Products Division of the SFC issued a Guide on the use of Financial Derivative Instruments for Unit Trusts and Mutual Funds (the “Derivative Guide”). The Derivative Guide provides additional information and guidance to industry players in supporting them complying with new and enhanced requirements, relating to use of derivatives, which were introduced in the revised UT Code.

Specifically, the Derivative Guide provides extensive additional guidance to industry players on the calculation of net derivative exposure. Furthermore, the Derivative Guide also provides further guidance to industry players on the additional disclosures from the revised UT Code that are required to be included within product key facts statements on the use of derivatives.
Continued enhancements to investor protection

Hong Kong’s regulatory framework continues to evolve as regulators look to instil further measures designed to protect investors. We have highlighted some of the key changes below:

**Impending effective date of guidelines on Online Distribution and Advisory Platforms (“ODAP”)**

The SFC’s ODAP guidelines were originally due to come into effect on 6 April 2019. On 19 March 2019, the SFC pushed this date back by three months to 6 July 2019. As a recap, the SFC’s guidelines specify requirements for intermediaries that will offer investment products on an Online Platform, including:

- Tailored guidance on the design and operation of an Online Platform; and
- Clarifications on how Suitability Requirements on the sale of investment products would be triggered in an online environment.

Intermediaries should by now have completed their compliance journey in preparing for compliance with these guidelines.

**Alignment of the regulatory requirements for the distribution of complex products online and offline**

Published on 28 March 2018, the SFC’s ODAP guidelines included protective measures applicable to the distribution of complex products through an online platform. At the same time, the SFC issued a further consultation on requirements applicable to the offline sale of complex products.

On 4 October 2018, the SFC finalised this further consultation and published its conclusions. Through these conclusions, the SFC has aligned the requirements for the sale of complex products in an offline environment with those for an online environment.

The resulting amendments to the Code of Conduct for Persons Licensed by or Registered with the SFC come into effect on 6 July 2019.

**Requirements applicable to online and offline distribution and advisory platforms of non-SFO regulated structured investment products**

Following the SFC’s issuance of its online and offline distribution and advisory platforms guidelines, the HKMA adopted the same principles to online and offline distribution and advisory platforms for structured investment products not regulated by the Securities and Futures Ordinance (“SFO”) on a risk-based basis. The detailed requirements were finalised on 30 October 2018 and will become effective on 23 August 2019.

Under the HKMA’s requirements, AIs should adopt the core principles and specific guidance on robo-advice in the SFC’s ODAP guidelines for non-SFO regulated structure investment products to the extent these are relevant and appropriate.

The requirements also clarify that suitability requirements will be triggered where there is either solicitation or recommendation provided in relation to non-SFO regulated structure investment products. AIs should also provide sufficient information about the key nature, features and risks of the product to enable customers to understand the product before making an investment decision.
The financial services industry continues its trend of digitalisation and innovation. The HKMA has announced on 27 March 2019 that it has granted banking licenses under Banking Ordinance to Livi VB Limited, SC Digital Solutions Limited and ZhongAn Virtual Finance Limited for them to operate in the form of a virtual bank. The remaining 5 virtual bank applications are still in progress.

With the first batch of virtual banking licenses being issued in Hong Kong, the competition within the digital space will only continue to grow. Digitalisation brings with it great benefits but also risks. In this section, we will cover the key regulatory and industry trends that we anticipate will have significant impact on the financial services industry going forward:

**Cybersecurity**

Technology is fast-moving, ever-changing and seemingly impossible to stay ahead of. Cybersecurity remains one of the biggest concerns and financial institutions are always playing catch up with the evolving digital world. Organisations have been hit by new ways of cyberattack and digital fraud such as impersonation, which led to unauthorised fund transfer over the e-wallet and data leakage for personal credit information. These attacks triggered the concerns from the public and regulators.

Although financial institutions have realized the need for investing in cyber defense, one of the key challenges is the lack of sufficient cybersecurity risk professionals in the market to help mitigate the risk of service disruptions and leakage of corporate and customer information due to cyber attack.

HKMA’s Professional Development Programme (“PDP”) under the Cybersecurity Fortification Initiative (“CFI”) may help to reduce the talent gap. With the HKMA aiming to start granting virtual banking licences in the first quarter of 2019, it is imperative for these institutions to continue develop robust systems and internal controls to protect themselves and their customers.

Hong Kong regulators are also continuously addressing the cybersecurity risks through strengthening regulatory requirements and due diligence obligations, especially when financial institutions implement emerging technologies.

In this regard, mandatory cyber security requirements have been introduced for conventional banks, virtual banks and stored value facilities licensees regulated by the HKMA (e.g., Cyber Resilience Assessment Framework (“C-RAF”)), and licensed corporations regulated by the SFC. These organizations are required to implement appropriate cybersecurity controls, including regular cyber attack simulation test for organisations with higher inherent risk, in accordance with the timeline set out by the regulators. We anticipate that similar cybersecurity requirements will be formalised by other local financial regulators soon.
Adoption of emerging technologies

Financial institutions continue to innovate and adopt emerging technologies to improve customer experience, expand client segments and service offerings, and enhance efficiencies. With the fast pace of digital transformation and adoption of advanced technologies, technology risk management approach must be elevated to address the new risks.

Below are some examples of risks that need to be addressed during the adoption of emerging technologies:

<table>
<thead>
<tr>
<th>Emerging technologies</th>
<th>Examples of risks to be addressed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Remote account onboarding</td>
<td>• Inaccurate facial recognition, liveness detection and identification documents checking&lt;br&gt;• Impersonation risk&lt;br&gt;• Risk of changing customer profile</td>
</tr>
<tr>
<td>Open API</td>
<td>• Unsecure third party service provider and business partners&lt;br&gt;• Inadequate protection for customers interest&lt;br&gt;• Customer data privacy concerns</td>
</tr>
<tr>
<td>Cloud computing</td>
<td>• Inadequate confidentiality and segregation of data&lt;br&gt;• Insufficient contingency measures and termination arrangement&lt;br&gt;• Undesired server locations</td>
</tr>
<tr>
<td>Big data analytics</td>
<td>• Customer data privacy concerns</td>
</tr>
<tr>
<td>Artificial intelligence and machine learning</td>
<td>• “Blackbox” and unproven decision making engine</td>
</tr>
<tr>
<td>Robo-advisor</td>
<td>• Inadequate electronic client suitability controls&lt;br&gt;• Insecure systems</td>
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To address some of the new risks introduced by adopting advanced technologies, regulators in Hong Kong have issued a number of guidelines and circulars to ensure that financial institutions can better manage the risks. Examples of such regulatory requirements include the following:

• Remote on-boarding of individual customers (HKMA)
• Online client onboarding (SFC)
• Clarification on Remote Investment Account Opening (HKMA)
• Open API Framework for the Hong Kong Banking Sector (HKMA)
• Guidelines on Online Distribution and Advisory Platforms (SFC)
• Risk Assessment Form on Technology-related Outsourcing (including Cloud Computing) Project (HKMA)
• Customer Data Protection (HKMA)

It is important for the financial services industry to continue assess the evolving risks behind these emerging technologies, and that both IT leaders and regulators are shifting towards a more proactive approach on technology risk management.
SFC’s New Crypto Exchange Framework

The SFC issued a conceptual framework for licensing and regulating virtual asset trading platforms (“Platform Operators” or “Cryptocurrency Exchange”) on 1 November 2018 under a Sandbox environment should they wish to be eligible to obtain a Type 1 (dealing in securities) and/or Type 7 (providing automated trading services) license in Hong Kong.

Scope of Supervision

Any Platform Operator that runs an online trading platform in Hong Kong and offers trading of at least one virtual asset falling under the definition of securities pursuant to the SFO may choose to apply and participate in the Sandbox. The SFC will observe the participants in the Sandbox environment, consider new risks relating to virtual assets and explore additional terms and conditions and regulatory standards that it may impose upon Platform Operators.

In particular, the SFC will focus on regulation of cryptocurrency exchanges that provide trading, clearing and settlement services for virtual assets, and those that have control over investors’ assets. This means that only centralised exchange platforms would be regulated as the SFC’s actions are limited to governing securities and they are not able to regulate exchanges that deal solely with utility tokens as an example. Furthermore, Platform Operators under this Conceptual Framework can only provide services to professional investors so retail investors are not covered under this scope.

Requirements under Sandbox Environment

The following conditions and criteria must be met for Platform Operators in the Sandbox environment:

- comply with KYC procedures and suitability requirements under the Code of Conduct and Guidelines on Anti-Money Laundering and Counter-Financing of Terrorism;
- comply with the SFC (Client Money) Rules, including the requirement to establish and maintain in Hong Kong one or more segregated accounts for client money in a designated trust account or client account;
- maintain a reserve equivalent to 12 months’ operating expenses as a financial buffer to ensure financial soundness of the cryptocurrency exchange;
- take out an insurance policy for risks associated with custody of virtual assets;
- perform all reasonable due diligence on the virtual assets before listing them on its platform including establishing criteria for admitting a virtual asset to be traded;
- only admit a virtual asset issued at least 12 months after the completion of the Initial Coin Offering (“ICO”) or when the ICO project has started to generate profit, whichever is earlier;
- establish and implement written policies and procedures to identify, prevent and report malicious actors behind any market manipulative or abusive activities; and
- allow the SFC to closely monitor Platform Operators and establish requirements with respect to regular reporting including any changes in scope and details of services, new virtual assets for trading, monthly volume, identities and locations of clients, and other statistics on trading, clearing and settlement activities, as applicable.
The SFC also issued a statement on the regulatory approach for virtual asset portfolio managers and fund distributors on 1 November 2018, which impacts both Virtual Asset Fund Distributors who hold Type 1 (dealing in securities) license and Virtual Asset Portfolio Managers who hold the Type 1 or Type 9 (asset management) license as they will be subject to SFC’s oversight through the imposition of licensing conditions.

Specifically, a Type 9 license is required for asset and wealth managers who plan on managing virtual assets and securities / future contracts and a Type 1 license is required to manage virtual assets as funds. These LC must clearly state the investment objective to invest in virtual assets and with an intention to invest more than 10% of the gross asset value (“GAV”) of the portfolio in virtual assets and meet the following terms and conditions:

- allow only professional investors under the SFO to invest;
- exercise due skill, care and diligence in selecting and monitoring third-part custodians;
- exercise due care in selecting valuation principles, methodologies, models and policies best suited for the investors;
- set appropriate limits for the (i) product and market; (ii) counterparty exposure; and (iii) individual virtual asset exchange exposure;
- ensure independent auditor is appointed to perform financial statements audit of the funds being managed; and
- maintain liquid capital of at least HK$3 million for Type 9 LC that hold client assets.
The Insurance Authority ("IA") is in the process of taking over the regulation of insurance intermediaries from the three self-regulatory organisations ("SRO"). As part of this process, it is currently developing a new set of rules, codes and guidelines for supervising insurance intermediaries. The IA has released consultation papers on three draft guidelines and two set of rules in the last few months of 2018 and they are as follows:

Guidelines for Fit and Proper Criteria and Continuing Professional Development for Licensed Insurance Intermediaries

Any person carrying on regulated activities will be required to be licensed under the IA. There will be five categories of Licensees and they are: (i) Insurance Agency ("Agencies"); (ii) Individual Insurance Agent; (iii) Technical Representative (Agent); (iv) Insurance Broker Company ("Brokers"); and (v) Technical Representative (Broker).

Fit and Proper Criteria ("F&P")

The draft guideline for F&P outlines the various factors which the IA will consider when determining whether or not the Licensees are ‘fit and proper’, including (i) professional competence, (ii) reputation, character, reliability and integrity; and (iii) financial status or solvency. The guideline further lists out the criteria and matters which the IA will normally consider for each category. The IA will also consider whether any disciplinary action has been taken against the Licensees and the state of affairs of any other business which the Licensees carry on.

The Licensees will need to satisfy the IA that they are “fit and proper” upon the submission of licence applications/ renewals and on an on-going basis.

Continuing Professional Development ("CPD")

The draft CPD guideline sets out the CPD related requirements for licensees and their principals.

Agencies, Brokers and authorised insurers need to ensure adequate controls and procedures to monitor compliance with CPD requirements of its appointed individuals. They should request, check and verify documentary evidence of those individuals.

The key changes under the new regime mainly relate to the uplift of CPD hours for certain individual Licensees; establishing a minimum CPD hours on “Ethics or Regulations” related activities; broadening of the list of activities that can be qualified; and aligning the assessment period and reporting methods of the existing SROs.

Transitional Arrangements

Based on the draft guidelines, all pre-existing Licensees will be deemed as Licensees for a transitional period of three years. In relation to the CPD requirements, certain individual Licensees will be exempted from the proposed minimum education requirements. For individual Licensees registered with SROs before the commencement date of the guideline, their CPD hours will be calculated on a monthly pro-rata basis.
Guideline on Exercising Power to Impose Pecuniary Penalty in Respect of Regulated Persons Under the Insurance Ordinance (Cap.41)

Under the new regulatory regime, the IA will be the sole regulator for insurance intermediaries in Hong Kong. The IA will be empowered to take various disciplinary actions against regulated persons.

Generally, there are two scenarios in which the IA will take disciplinary actions and they are when a regulated person: (i) is guilty of misconduct; and/or (ii) fails to be fit and proper.

When considering whether or not to impose a pecuniary penalty and the amount of the penalty, the IA will take into account a number of factors that can be grouped into the following categories:

- Nature, seriousness and impact of the conduct;
- Behaviour of the regulated person since the conduct was identified;
- Previous disciplinary record and compliance history of the regulated person; and
- Other relevant factors, including the financial resources of the regulated person and results of any civil or criminal action taken against the regulated person in respect of the conduct.

Insurance (Maximum Number of Authorized Insurers) Rules (“Insurer Number Rules”)

The proposed Insurer Number Rules specify the cap on the number of authorised insurers by which a licensed individual insurance agent or Agency (collectively referred to as “Insurance Agent”) may be appointed under the new regime. Under new Insurer Number Rules, the maximum number of licensed insurers that may be represented by an Insurance Agent will increase from four to five, but the maximum number of long-term insurers which an agent can represent will remain at two.

When an Insurance Agent is appointed by a composite insurer or by insurers within a group that carry on both general and long term business, it will be considered to have been appointed by two insurers.

Insurance (Financial and Other Requirements for Licensed Insurance Broker Companies) Rules

The IA proposed to revise the minimum requirements for Brokers. The key refinements including the following:

- Amount of minimum paid-up capital and net assets increases from HK$100,000 to HK$500,000;
- Minimum limit of indemnity under a professional indemnity insurance (“PII”) policy increases from HK$3 million to HK$5 million;
- New restriction on the amount of deductibles under a PII policy to be capped at 50% of the Broker’s net assets as at the end of its financial year immediately preceding the commencement date of the PII cover;
- New requirement to perform reconciliation over client monies at least once a month; and
- New disclosure requirements on Broker’s financial statements.

Transitional Arrangements

The IA proposed a transitional period of three years for deemed licensees and the arrangements are as follow:

- The increased in minimum paid-up capital and net assets will be introduced in two phases: (i) for the period beginning on 1 January 2021 and ending on 31 December 2022, the minimum amount will be HK$300,000; and (ii) from the period starting on 2023, the minimum amount will be HK$500,000;
- The increase in the minimum limit of indemnity and the cap on deductible under a PII policy will be effective from 1 January 2023;
- The requirement on client monies requirements will be effective six months after the commencement date of the Insurance (Financial and Other Requirements for Licensed Insurance Broker Companies) Rules; and
- The new disclosure requirements will only apply to the audited financial statements of the deemed licensees from the financial year beginning after 31 December 2020.
Updates on AML/CFT in Hong Kong

Revision of Guideline on Anti-Money Laundering and Counter-Financing of Terrorism

The revised Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (For Authorised Institutions) ("AML/CFT Guideline") published by the HKMA came into effect on 1 November 2018.

AIs should review the revised AML/CFT Guideline and implement appropriate measures consistent with their risk profiles.

What are the key changes in AML/CFT Guideline?

- Formalising the requirements and guidance of institutional money laundering and terrorist financing ("ML/TF") risk assessment
- Introducing the requirements for group-wide AML/CFT systems
- Clarifying the requirements for identification for beneficial owners
- Introducing the international organisation politically exposed persons and relevant risk-based measures
- Revising the measures for the identification and verification of customer via non-face-to-face portals, including the use of technology and checking relevant data against reliable databases / registries
- Clarifying on the definition of correspondent banking relationships and the required due diligence measures

Remote on-boarding of individual customers

The HKMA issued a circular on 1 February 2019 to set out its expectation on remote on-boarding of individual customers.

The HKMA emphasises that appropriate measures of technology solutions should be employed to mitigate any increased risks, particularly impersonation risk when conducting remote on-boarding, i.e. through non-face-to-face channel. Any technology solutions adopted should at least cover the identity authentication and identity matching (e.g. facial recognition and liveness detection).

Prior to the launch of remote on-boarding technologies, AIs should conduct ML/TF risk assessments, and monitor and manage the effectiveness of the adopted technology on an ongoing basis.

Latest updates on the FATF mutual evaluation of Hong Kong

The onsite evaluation of Hong Kong’s AML/CFT regime took place in late-2018, with the scrutiny of the Hong Kong Special Administrative Region government, law enforcement agencies, regulators, financial institutions and designated non-financial businesses and professionals.

It is expected the mutual evaluation report of Hong Kong and its level of effectiveness of AML/CFT system and level of compliance with the FATF Recommendations will be discussed at the FATF plenary discussion in June 2019.
Hong Kong’s profits tax exemption for funds

On 20 February 2019, the bill to amend Hong Kong’s profits tax exemption for privately offered funds was passed by the Legislative Council. It was subsequently enacted as the Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Ordinance 2019 and will come into operation on 1 April 2019.

As noted, the law unifies the profits tax exemptions for privately offered funds (onshore or offshore, regardless of their structure, location of central management and control, or their size) into one comprehensive regime. It also widens the application scope of the profits tax exemption significantly, putting Hong Kong in a much more competitive position as a regional and international asset and fund management centre.

Research and development tax deduction regime

The law on Hong Kong’s research and development (“R&D”) expenditure tax deduction regime (gazetted as Inland Revenue (Amendment) (No. 7) Ordinance 2018) came into operation on 2 November 2018. The R&D tax deduction regime will take retrospective effect for expenditure incurred or payment made on or after 1 April 2018.

We also expect the Innovation and Technology Commission will upload the assessment framework for designated local research institutions on its website and the Inland Revenue Department will issue a Departmental Interpretation & Practice Note to provide more guidance on its interpretation and application of the new regime.

Fair value accounting treatment of financial instruments for tax purposes introduced

The Inland Revenue (Amendment) (No. 7) Bill 2018 was introduced and will apply, upon enactment, for a taxable year beginning on or after 1 January 2018, which may have a significant impact on the tax filing position. Taxpayers can make an election to choose the fair value stated in the financial statements for tax purposes, subject to specific rules on impairment loss and other situations. The election is irrevocable, with a few exceptions.
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