

Hong Kong regulatory update

SFC announces strategic priorities

Regulatory alert
June 2020

The Hong Kong Securities and Futures Commission (SFC) has just published its 2019-20 annual report. The report reiterates the SFC's overarching objective of strengthening the integrity and soundness of Hong Kong's securities and futures markets, safeguarding the interests of investors and minimising fraud and market misconduct, as well as maintaining Hong Kong's financial stability and status as an international financial centre. The report also outlines the SFC's updated strategic priorities.

In this publication, we summarise the strategic priorities that the SFC has set out across six areas: Enforcement, Intermediaries, Asset and Wealth Management, Markets, Green and Sustainable Finance and Technology. While a number of these strategic priorities are carried forward from previous years, others are new as the SFC responds to changing market conditions and technologies. We also include a summary of KPMG's own views on eight key regulatory challenges for the second half of 2020.



Enforcement

The SFC indicated that a key priority will be the following three areas of misconduct:

- **Highly organised corporate fraud** where individuals and firms collude to defraud investors.
- **Failures in handling conflicts of interest** by listed company directors and licensed firms.
- **Market misconduct using complex and sophisticated schemes**. To this end, a Market Misconduct Team has been formed by reorganising the SFC's market surveillance and investigation functions to help detect and investigate these schemes more effectively.

In addition, the SFC referred two other priorities for strengthening its enforcement capabilities:

- **Strategic cooperation with the China Securities Regulatory Commission (CSRC)** to more effectively tackle cross-boundary market misconduct, including tripartite Memorandum of Understanding with the CSRC and the Ministry of Finance on access to audit working papers for Hong Kong-listed Mainland Chinese companies.
- **Review of data strategy** to ensure that the SFC makes the best use of all available information to facilitate its investigations and delivers effective enforcement outcomes in a digital age through benchmarking the SFC's technological capabilities against its international counterparts and developing data analytic tools.



Intermediaries

The SFC announced the following strategic priorities for the supervision of intermediaries:

- Planned consultation on **updated competency framework for licensed individuals**, which has been in place since 2003 (proposed changes to the entry requirements and continuous professional training guideline).
- Thematic review on **operational and data risks, and remote booking**.
- Review of the **risks of using mathematical models**, such as in capital calculations, derivatives pricing and risk exposure measurements, to make or inform business decisions.
- Planned consultation on proposed conduct requirements based on the findings from the SFC's recent thematic inspection of **book-building activities of firms involved in fundraising in the equity and debt capital markets**.
- Inspections of fund managers to focus more on **liquidity risk management practices** in light of market volatility and liquidity issues with some overseas funds.
- A survey of the practices of the controllers of selected brokers to be undertaken to help the SFC understand **group liquidity profiles** and identify potential problems for early supervisory action.
- Ongoing review of brokers' risk management and compliance with the guidelines for **securities margin financing activities** to ensure they maintain robust risk management controls in times of market volatility.
- Collaboration with the Hong Kong Monetary Authority (HKMA) to monitor sales practices. The first annual joint product survey with the HKMA will cover the sale of **non-exchange-traded investment products** by intermediaries during the period from 1 January to 31 December 2020.
- Thematic review on potential for **conflicts of interest and misconduct** when firms manage trades for clients, particularly where sales staff have the discretion to control spread charges which may be in excess of those disclosed to or as agreed with the clients.
- Periodic update to the risk assessment for the securities sector to take forward the recommendations of the **Mutual Evaluation Report of Hong Kong** published by the Financial Action Task Force (FATF) in September 2019.
- Proposed amendments to its **anti-money laundering guidelines** to align them with the latest FATF standards and provide additional risk-based guidance.



Asset and wealth management

The SFC announced the following strategic priorities for Asset and Wealth Management:

- Proposed changes to the **open-ended fund companies (OFC) regime**, including expanding the investment scope for private OFCs and allowing securities brokers to act as their custodians, to encourage more private funds to set up in Hong Kong.
- Proposed new Type 13 regulated activity to regulate firms acting as **depositories of SFC-authorised funds** which will bring them under the SFC's regulatory oversight. SFC will further consult on proposed amendments to subsidiary legislation and SFC codes and guidelines in due course.
- Exploration of **mutual recognition of funds (MRF) arrangements** with a number of jurisdictions.
- Preparations for **enhancing the Mainland-Hong Kong MRF scheme** to offer Mainland investors a more diversified pool of fund products managed in Hong Kong.
- Establishment of a **new limited partnership regime for funds**, providing tax concessions for local private equity funds' carried interest and other initiatives.
- **Greater Bay Area Wealth Connect** scheme which will provide mutual market access for wealth management products. This will improve the renminbi liquidity pool in Hong Kong and strengthen its role as an offshore renminbi centre.
- Measures to enhance market efficiency and liquidity to support the **long-term development of the exchange-traded fund (ETF) market**. Together with Hong Kong Exchanges and Clearing Limited (HKEX), SFC is exploring ways to enhance the ETF market-making regime.
- To allow more cost-effective ETF product line-ups and provide investors with more investment choice, the SFC will work to facilitate issuers' product applications under **new streamlined measures for some SFC-authorised feeder ETFs**.
- The SFC has also been working with the CSRC and other stakeholders to facilitate **ETF cross-listing between the Mainland and Hong Kong** to enrich product offerings.
- To gain greater insight into leverage in funds and the potential risks it may pose to the markets, the SFC plans to **upgrade fund data reporting requirements** based on the latest international trends.
- Planned guidance on the **electronic dissemination of documentation** for SFC-authorised investment products in view of the wider use of electronic media.



Markets

The SFC announced the following strategic priorities for markets supervision:

- **Exchange Bond Connect** initiative for trading eligible bonds listed or traded on the Hong Kong and Mainland stock exchanges.
- **Monitoring the development of global OTC derivative reform initiatives**, such as benchmark reform and the expanded scope of margin requirements for non-centrally cleared derivatives, to assess their impact on the OTC derivatives market.
- Legislative amendments planned to implement **refinements to the scope of regulated activities under the OTC derivatives licensing regime**. The SFC will also work with the HKMA to assess the feasibility of implementing a mandatory trading obligation.
- To detect suspicious trading activities and potential market misconduct in a more timely and efficient manner, the SFC is working with HKEX to implement an **investor identification regime for the Hong Kong securities market**. The SFC aims to consult on the operational model for the regime this year.
- Planned legislative amendments to introduce a **paperless securities market in Hong Kong**. The regime, expected to be implemented from 2022, will provide investors with efficient and meaningful options to hold and transfer securities in their own names electronically.
- Following the SFC's review of HKEX's temporary suspension of the derivatives markets due to system failure in September 2019, the SFC is **monitoring the progress of its implementation of the measures it recommended**.
- The SFC will work with HKEX to improve its decision-making process and market communications to ensure **orderly market operation and prudent risk management**.



Green and Sustainable Finance

The SFC announced the following strategic priorities for Green and Sustainable Finance:

- Efforts to **bolster Hong Kong as a regional hub for green and sustainable finance** led by its new International Affairs and Sustainable Finance team.
- **Promotion of environmental, social and governance (ESG) criteria** in asset management and corporate disclosures.
- Development of expected standards as well as practical guidance and best practices for **incorporating climate-related risks in asset managers' investment and risk management processes** (assisted by the Climate Change Technical Expert Group).
- Focus on **Hong Kong's green and sustainable finance initiatives** which contribute to the development of the Greater Bay Area and financial sector connectivity across the region.
- Promotion of consistency and collaboration in accelerating the development of Hong Kong as a **green and sustainable finance centre** by the Green and Sustainable Finance Cross-Agency Steering Group.

Technology

The SFC announced the following strategic priorities for technology:

- A major focus is on regulating the conduct of intermediaries who leverage technology to deliver financial services through the new licensing framework for **virtual asset trading platforms** announced in November 2019, bringing a largely unregulated area with growing importance under the SFC's supervision.
- The SFC is developing an **internal data analytics platform** to automate the analysis of trading data when inspecting large securities brokers.
- The SFC will revamp the returns required under the **financial resources rules** to collect additional financial and risk information from licensed corporations.
- The SFC has developed its online portal, WINGS5, to enable the passing of data provided by market participants **straight to back-end processing and analysis**.
- The SFC is adopting other new technologies to **organise large volumes of information** to make its investigation and litigation work more efficient.
- The SFC plans to apply more **artificial intelligence-related technology** to expand its automatic risk detection and market monitoring capabilities.
- To strengthen its monitoring framework and mechanisms to identify changing market trends and systemic risks, the SFC has stepped up its efforts to **ensure the integrity of the data it receives from the reporting regimes** for OTC equity derivatives, large open positions in exchange-traded derivatives and short positions in stocks.





KPMG's views on regulatory challenges for the rest of 2020

We set out below our views on eight key regulatory challenges for the second half of 2020.

2020 Eight Key Regulatory Challenges

01 Public policy expectations

- Financial services firms play an essential role in supporting economic and financial stabilisation and recovery
- Ongoing pressure for public policies to help protect businesses, employees, impacted sectors and overall market liquidity
- Multiple pressures to shift evolving supervisory and regulatory focus to areas such as fair access and treatment, best interest principles and data privacy protections

02 Data protection and governance

- A remote workforce has amplified risks related to information barriers, surveillance limitations, communications issues, cyber threats, conflicts of interest and potential misconduct
- Dependence on remote access has increased demand for digital access across multiple channels and systems, increasing technology requirements and the need for third-party oversight
- Rapid deployment of new products and new systems raises data quality, security, privacy and control risks
- Increasing focus on reporting requirements, data validity and documentation associated with stimulus measures, impacting both financial and non-financial regulatory reporting

03 Operational resilience

- Expedited shift to digital service delivery requiring network access and controls, technology and digital capability restructuring; and associated operational changes and focus on effective controls and testing
- Financial services firms must demonstrate business continuity and pandemic planning, including a comprehensive framework for facilities, staffing, systems and critical operations
- Strong third-party management to sustain consumer protection, data privacy and business continuity
- Regulatory focus on resiliency, consumer protection and reputational risk given economic conditions
- COVID-like "sensitivity analyses" and evolving climate-related financial risks to become part of stress tests

04 Credit quality

- New data measures, tracking processes and reporting required in areas such as loan servicing, concentration impacts and ongoing capital impact analysis
- Relief measures add complexity to credit risk management process
- Impact on accounting provisions with focus on underlying models and qualitative adjustments and ongoing need for re-calibration
- Discontinuation of LIBOR is still planned, adding regulatory pressure to address existing credits, systems changes and new products





KPMG's views on regulatory challenges for the rest of 2020

2020 Eight Key Regulatory Challenges

05 Compliance agility

- The economic cycle is increasing reputational and compliance risks related to potential fraud, misconduct and sales practices/incentives
- Regulatory reviews will consider consumer protection in loan approvals, denials, servicing and supporting documentation for relief measures, including eligibility and prioritisation
- Accelerated push for digital platforms and the integration and streamlining of technology systems; approaches should be agile, and should ensure compliance effectiveness and sustainability

06 Financial crime

- Increased risks of fraud and cybercrimes due to remote access and use of multiple channels, including challenges to KYC and CDD requirements, and increased use/misuse of digital platforms and virtual assets for payments and account activity
- Expedited launch of new products and programmes introduces uncertainties and potential control risks, including potential identity theft, misappropriation, money laundering and terrorist financing

07 Customer trust

- Heightened awareness of conflicts of interest, suitability and disclosures related to compliance with consumer protection principles
- The shift toward mobile and online banking, including more rapid adoption across demographic groups, may impact customer trust (positively or negatively based on customer experience)

08 Ethical conduct

- Monitoring/surveillance systems may be strained or require re-engineering for remote workforce, digital platforms and quick adoption of new technology
- New products and programmes, delivery systems and distressed customers increase risk of potential misconduct from fraudulent actors
- In economic downturns, regulatory reviews of consumer protection highlight customer treatment including fair lending and sales practices
- The severity of the economic/financial environment and heightened risks reinforces the importance of complaint and investigation processes
- Awareness of ESG performance, especially "social" factors, is increasing; efforts to meet the health and safety needs of employees and customers will be assessed alongside financial services/operations

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