

Since the global financial crisis of 2008/2009, the global regulatory environment for financial institutions has entered a new era of development and change. As the world economy recovers, new crises have emerged as well as new opportunities for growth. In the current era of uncertainty for financial institutions, this newsletter highlights significant regulatory and legal developments affecting the local financial services sector. Particular focus is paid to changes of interest to professionals in the areas of asset management including both private equity and hedge funds, banking, securities, insurance, and listings. This edition of the newsletter reports on some of the key developments since our last edition.



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## Securities

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### ► SFC inspection reveals deficiencies in work of IPO sponsors

At the end of March the Securities and Futures Commission ("**SFC**"), and at the end of April the Hong Kong Monetary Authority ("**HKMA**"), issued circulars to their respective licensees/registrants reminding them to comply with regulatory requirements for sponsors. This follows on from the SFC's Report on Sponsor Theme Inspection Findings released on 29 March 2011, in which it reported on the shortcomings in the work of some licensed corporations sponsoring initial public offerings ("**IPOs**").

The SFC has been regularly conducting routine inspections on sponsors from time to time. This was the first round of theme inspections conducted by the SFC since the SFC guidelines governing sponsors took effect in January 2007 (i.e. Additional Fit and Proper Guidelines for Corporations and Authorised Financial Institutions applying or continuing to act as Sponsors and Compliance Advisors).

The SFC assessed sponsors' compliance with existing regulatory requirements, focusing primarily on their work undertaken in initial listing applications. Reviewing 17 licensed sponsors of differing sizes, the SFC identified certain deficiencies in the work performed by some sponsors as well as some inadequacies in their internal systems and controls, including:

- unsatisfactory due diligence on listing applicants' business;
- questionable disclosure to The Stock Exchange of Hong Kong Ltd ("**SEHK**") during the listing application process;
- failure to maintain proper documentation of due diligence; and
- inadequate internal systems and controls over sponsor work.

The relevant sponsors have been asked to take appropriate actions to address the SFC's concerns and avoid re-occurrence of similar events. The SFC also stated it would follow up with the SEHK to address any disclosure concerns, and may take further and appropriate regulatory actions. The SFC has also shared its findings with the HKMA, given that banks play a dominant role in the sponsor industry.

**Remarks** - Particular focus of the SFC's inspection had been placed on Chinese companies, which accounted for about 60 percent of Hong Kong's stock market value. The SFC has indicated it is considering making sponsors of Hong Kong IPOs liable for statements in their clients' prospectuses to prevent fraud of locally listed Chinese companies.

The SFC's circular and report can be viewed [HERE](#). The HKMA circular can be viewed [HERE](#).

### ► SFC proceeds with the regulation of credit rating agencies

Starting 1 June 2011, the amendments to the Securities and Futures Ordinance ("**SFO**") to provide for the SFC to license and regulate credit rating agencies ("**CRAs**") and their rating analysts come into effect. The amendments made by the Financial Secretary to Schedule 5 of the SFO were gazetted on 18 February 2011 and introduced a new type of regulated activity (Type 10: providing credit rating services).

In anticipation of the upcoming regulation, from 21 April 2011 both CRAs and their rating analysts intending to provide credit rating services on or after the relevant date may start submitting applications to the SFC for a Type 10 licence. The SFC has stated that it will endeavour to licence by 1 June 2011 those applications received before 12 May 2011.

To assist the industry in making the transition, the SFC has issued a circular highlighting the key requirements. The new CRA Code, a new set of prescribed application forms and a new set of FAQs in relation to Type 10 regulated activity have also been issued by the SFC.

**Remarks** - The creation of a regulatory regime for CRAs follows a month-long public consultation exercise that was conducted by the SFC between 19 July 2010 and 20 August 2010 (This was covered under the article "SFC proposes to regulate credit rating activities" in Issue 15 of this Newsletter, which can be viewed [HERE](#)).

The SFC's circular can be viewed [HERE](#).

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## Banking

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### ► Enhanced Regulatory Requirements on Selling of Investment-Linked Assurance Scheme ("ILAS") Products

On 14 March 2011, the HKMA issued a circular in relation to enhanced regulatory requirements for the sale of ILAS products by Authorised Institutions ("**AIs**").

When selling ILAS products, AIs must comply with the relevant regulatory requirements, and in particular the control measures set out in the Annex to the HKMA's circular. The HKMA has taken existing regulatory practices that have been generally adopted by the industry and formalised them as regulatory requirements in order to ensure their consistent application by all AIs to increase investor protection.

The circular provides specific guidance in relation to:

- competence of staff and registration;
- product due diligence;
- use of gifts;
- selling activities to be conducted inside investment corner;
- product disclosure;
- ensuring customer suitability;
- records maintenance and audio-recording;
- management oversight;
- complaints handling;
- notifications to regulators; and
- disciplinary proceedings.

The HKMA expects the AIs to comply with the control measures set out in the circular as soon as practicable. Where a control measure entails system changes within the AI, the HKMA expects full compliance with that particular measure no later than six months from the date of the circular. In the interim, the AI should take prompt alternative measures to implement the control requirements while system changes are being made.

The HKMA's circular can be viewed [HERE](#).

### ► Implementation of Positive Mortgage Data Sharing ("PMDS")

The HKMA issued a circular on 31 March 2011 on the expanded sharing of mortgage data in connection with the amendments to the Code of Practice on Consumer Credit Data (the "**Code**") announced by the Privacy Commissioner for Personal Data ("**PCPD**") on the same day.

The HKMA requires AIs to comply with the requirements in relation to pre-existing mortgage data and new mortgage loan applications.

With regards to pre-existing mortgage data, AIs are required to issue consent seeking forms to seek the prescribed consent of existing mortgage customers to upload their said data onto the Credit Reference Agency. In connection with this, the Hong Kong Association of Banks ("**HKAB**") has circulated sample consent wording which AIs should adopt as far as possible.

For new mortgage loan applications, AIs are expected to verify the information declared by mortgage applicants in respect of their pre-existing mortgage loans. A new "all in one" consent must be obtained from a customer during an application for a new mortgage (as set out in the sample wording circulated by the HKAB). The consent will then be passed to the Credit Reference Agency to verify the accuracy of the mortgage loan-related information provided in the declaration. AIs should have clear policies to follow-up with the applicant where there are differences between the "declared mortgage count" and the "actual mortgage count" obtained from the Credit Reference Agency. Should this happen, and if the customer cannot provide a satisfactory explanation of the discrepancy in the mortgage count, the AI should reject the mortgage loan application.

The HKMA has stated that in order to ensure the benefits of PMDS are achieved as soon as possible, AIs should prioritise the following lines of action:

- adopt the sample consent wording provided by the HKAB or prepare their own;
- adopt HKAB's sample supplemental Personal Information Collection Statement ("**PICS**") for mortgage loans or prepare their own and amend the existing PICS to meet other requirements of the revised Code;
- brief frontline staff on how to obtain customer consent and respond to customer enquiries;
- arrange for dispatch of the consent seeking forms to the branches or other mortgage business distribution

- channels of AIs as soon as possible; and
- review and revise internal policies and procedures to cater for the PMDS arrangements as soon as practicable.

**Remarks** - For further details on the various amendments to the Code, please see the article on "Amendments to Code of Practice on Consumer Credit Data" in this Newsletter.

The HKMA's circular can be viewed [HERE](#).

### ► Streamlined sales process for investment products

On 6 April 2011, the HKMA announced new measures to streamline AIs' sales process for plain vanilla investment products and to increase the flexibility of vulnerable customers in choosing whether they wish to enjoy certain additional safeguards during the sales process.

The HKMA stated that in light of the strengthened protection available to vulnerable customers with the implementation of the Pre-Investment Cooling-off Period, AIs should allow vulnerable customers to choose during the initial transaction whether they want to bring a companion to witness the sales process and/or have a second front-line staff member to handle the sales. For all investment products, the vulnerable customer can choose to have either, neither or both safeguards, and the AIs should adopt and maintain an audit trail of their choice.

In streamlining the sales process, audio-recording is no longer required for the face-to-face sales process where there is no risk mismatch in respect of:

- plain vanilla investment products (without embedded derivatives or leverage) where the products or product documents have been authorised by the SFC;
- sovereign bonds issued by the Ministry of Finance of the People's Republic of China; or
- bonds issued by the HKSAR Government.

Audio-recording will still be required for (i) bonds where either the issue or the issuer, or both, have a credit rating below an investment grade; (ii) bonds where both the issue and the issuer are unrated; (iii) perpetual bonds; or (iv) subordinated bonds. In addition, audio-recording is still required where there is a risk mismatch and for the customer risk profiling process. Where the sales process is conducted over the telephone (i.e. not face to face) the relevant telephone conversation must be recorded.

**Remarks** - After various measures over recent years to strengthen the sales process for investment products, the HKMA's new measures are an attempt to provide some flexibility to AIs in this area. However, in practice, differentiating between the investment products which require audio-recording for the sales process and those which do not may create more opportunity for errors and compliance breaches to occur. Additionally, various investment products or other investment-related issues may be discussed during a sales process. As a consequence, it may be in the AIs best interests to continue to require their staff to audio-record the sale processes for all investment products to avoid overlooking any relevant products.

The HKMA's circular can be viewed [HERE](#).

### ► Important Facts Statement ("IFS") for Currency-Linked Instruments and Interest Rate-Linked Instruments Issued by Authorized Institutions ("ILCL instruments")

On 18 April 2011, the HKMA issued a circular in relation to a new investor protection measure that requires AIs to produce an IFS for ILCL instruments. The new measure is intended to enhance product disclosure to retail customers purchasing such instruments. ILCL instruments are exempted from the authorisation requirements under the SFO. Furthermore the SFC's Code on Unlisted Structured Investment Products ("**SIP Code**") is not applicable as ILCL instruments are not regarded as "structured investment products" for the purposes of the SIP Code. Nevertheless, the HKMA has stated that in relation to ILCL instruments, AIs should follow standards similar to those issued by the SFC on marketing materials.

Additionally, the HKMA considers that AIs should apply the same principles as the SFC's new Product Key Facts Statement ("**KFS**") measures and produce IFS to enhance product disclosure for ILCL instruments for retail distribution. The SFC's KFS measures require issuers of publicly offered unlisted structured investment products to provide concise product summaries written in plain language to help investors understand the key features and risks of the products.

The HKMA has developed the IFS templates for ILCL instruments to facilitate more standardised disclosure across

Als. The IFS templates are similar in format to the KFS and are included as annexes to the circular. In relation to the IFS requirements, the HKMA notes:

- IFS is required for ILCL instruments distributed to retail customers. Als should not sell ILCL instruments to retail customers without an IFS and should ensure that its distributing agents do not do so either.
- Als should offer to provide IFS to a retail customer in relation to every relevant transaction unless the customer declines it, in which case a proper audit trail of this should be maintained.

The HKMA expects that the IFS arrangements should be implemented by all Als no later than 4 June 2011.

The HKMA's circular can be viewed [HERE](#).

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## Regulatory Investigations

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### ▶ Former directors of Warderly disqualified for failure in making timely disclosure

On 1 March 2011, the SFC obtained orders in the High Court to disqualify Mr Godfrey Hung Kwok Wa ("**Hung**") former executive director, and Mr Hermann Leung Ping Chung ("**Leung**") former alternate non-executive director of Warderly International Holdings Ltd ("**Warderly**") as company directors for failing to make timely disclosures of material information to the market.

Hung has been disqualified from being a director or being involved in the management of any corporation, without leave of the court, for five years, and Leung was disqualified from being a director or being involved in the management of any listed company in Hong Kong for two years. Leung's disqualification is the first time an alternate non-executive director has been disqualified for this type of misconduct.

The SFC alleged that a number of material events concerning the substantially depleted position of Warderly should have been disclosed to the market, including:

- legal proceedings had been commenced in Hong Kong and the Mainland against Warderly and its subsidiaries by banks and creditors to recover overdue loans;
- Warderly's operations had been substantially disrupted by labour strikes in its Mainland factory;
- a financial adviser had been appointed in respect of a proposed debt restructuring and re-organisation;
- a management committee had been appointed to solve Warderly's financial problems;
- an external firm of accountants had been appointed at the request of a bank loan syndicate and had reported on the company's deteriorating financial position; and
- the company had been forced to raise money at high penalty interest rates.

**Remarks** - These two cases bring an end to the SFC's proceedings against the directors of Warderly. The court had earlier made disqualification orders in March and October 2010 against four other former executive directors of Warderly as a result of their misconduct. (These were covered under the articles "Former directors disqualified for failing to ensure timely disclosure" and "SFC obtains court orders to disqualify another two former directors of Warderly for failure to make timely disclosure" in Issues 13 and 16 of this Newsletter, which can be viewed [HERE](#) and [HERE](#).)

The SFC's press release can be viewed [HERE](#).

### ▶ Court of Final Appeal upholds insider dealing convictions

On 15 March 2011, the Court of Final Appeal dismissed an application for leave to appeal made by Sammy Ma Hon Kit ("**Ma**") and his wife Cordelia Tso Kin Wah ("**Tso**") against their convictions for insider dealing in shares of Egana Jewellery & Pearls Ltd ("**Egana**").

Ma's brother (Ma Hon Yeung), in his position as a former Vice President of BNP Paribas Peregrine Capital Ltd (now known as BNP Paribas Capital (Asia Pacific) Ltd, was working on a proposed privatisation of Egana which he knew was confidential, price sensitive information. Within days of becoming privy to the proposed deal, Ma Hon Yeung tipped off the four other defendants who all bought shares in Egana prior to the deal being announced in July 2006. Ma, Tso and the three other defendants were convicted on a total of 12 charges of insider dealing under the SFO.

The Court of Final Appeal's decision follows an earlier ruling by the Court of Appeal which rejected Ma and Tso's appeals against convictions in October 2010.

**Remarks** - This decision marks the end of the first indictable insider dealing prosecution since insider dealing was made a criminal offence under the SFO in 2003. (This was covered under the article "First jail sentence for insider dealing in Hong Kong" in Issue 3 of this Newsletter, which can be viewed [HERE](#)).

The SFC's press release can be viewed [HERE](#).

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## General

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### ► Amendments to Code of Practice on Consumer Credit Data

On 31 March 2011, the PCPD (i.e. Privacy Commissioner for Personal Data) announced 3 sets of major amendments to the Code (i.e. Code of Practice on Consumer Credit Data). The Code provides practical guidance to financial institutions and to the Credit Reference Agency in the handling of consumer credit data.

The first set of amendments, which took effect on 1 April 2011, relate to expanded sharing of mortgage data among credit providers through the Credit Reference Agency to include both positive and negative mortgage data for residential as well as non-residential properties. The financial services industry proposed the expanded data sharing to facilitate comprehensive credit assessment primarily of mortgage loan applicants in order to promote responsible borrowing and prudent lending.

The second set of amendments, which will take effect from 1 July 2011, obliges the credit providers to promptly update the Credit Reference Agency database upon the occurrence of certain events (e.g. repayment in full or in part of any amount in default) and where a request for update is made by an individual, not later than 14 days from the date of the request. Also with effect from the same date, "gender" will no longer be included in the scope of personal data collected and retained by the Credit Reference Agency.

Lastly, with effect from a date to be further notified by the PCPD, the third set of amendments will relate to the retention of data with regards to write-off accounts due to a bankruptcy order being made.

**Remarks** - With respect to the first set of amendments to the Code, the HKMA concurrently issued a circular specifically relating to the expanded sharing and use of mortgage data by credit providers. Please see the article on "Implementation of Positive Mortgage Data Sharing" in this Newsletter.

The PCPD's press release can be viewed [HERE](#).

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If you would like to discuss any of the matters in this newsletter or wish to have further information on our financial institutions practice in Hong Kong, please contact the person at Hogan Lovells whom you usually deal with or:

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