Hogan Lovells

HONG KONG FINANCIAL INSTITUTIONS NEWSLETTER

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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.

Contents

Insurance

- Consultation conclusions and detailed proposals issued on the establishment of an independent Insurance Authority

Securities

- Completion of the transition to the new regulatory regime for investment products and the introduction of the new regulatory regime for CRAs
- Mystery shopping exercise identifies areas for improvement in selling practices of securities sector
- Pre-deal research reports to comply with SFC requirements regarding conflicts of interest
- Securities and Futures (Amendment) Bill 2011 and SFC revised draft guidelines on disclosure of inside information published

Banking

- HKMA issues further guidance on collection, use and transfer of personal data for marketing purposes

Regulatory Investigation

- SFC's enforcement action against Tiger Asia struck out and impacts Hontex proceedings
- SFC reprimands and fines Merrill Lynch and Sun Hung Kai Investment Services for failings in relation to

sale of notes

General

- **Legislation introduced to increase minimum and maximum relevant income levels for Mandatory Provident Fund contributions**

Insurance

- **Consultation conclusions and detailed proposals issued on the establishment of an Independent Insurance Authority**

On 24 June 2011, the Government issued its consultation conclusions and the detailed proposals on the proposed establishment of an Independent Insurance Authority (the "**Consultation Conclusions**"). It also published an FAQ in relation to the Consultation Conclusions.

The Government will proceed with the establishment of the Independent Insurance Authority ("**IIA**"), which will in substance be operationally and financially independent of the Government. Similar to other Hong Kong self regulatory bodies such as the Securities and Futures Commission ("**SFC**"), the IIA will have express powers to initiate investigations, search and seize materials upon the issue of a warrant, prosecute offences summarily and impose a wide range of regulatory sanctions in cases of misconduct.

Further enhanced proposals in the Consultation Conclusions included that the IIA would be directly responsible for licensing and regulation of insurance intermediaries. Once the IIA has been established and relevant legislation implemented, all persons intending to undertake insurance regulated activities would need to be licensed with the IIA. The IIA would also be the primary regulator for the bancassaurance activities of banks instead of the Hong Kong Monetary Authority ("**HKMA**"), although the IIA would enter into a memorandum of understanding with the HKMA to set out the detailed arrangements for regulation of such bancassurance activities (such as the IIA being the sole authority to stipulate conduct standards and regulatory requirements for bancassurance activities and to be responsible for disciplining misconduct relating to bancassurance activities, although the HKMA would participate actively in the disciplinary process to ensure consistency).

The Government would also establish an Insurance Appeals Tribunal to handle appeals against relevant decisions made by the IIA, and set up two industry advisory committees to advise and make recommendations to the governing board of the IIA. This would ensure that the insurance industry could participate in the governing of the IIA. The IIA will be financed by a fixed and a variable fee paid by insurers and insurance intermediaries, certain user fees, and a 0.1% levy on insurance premiums for all insurance policies. It is currently proposed that this levy will be capped on non-life insurance policies with annual premiums at or above HK$5 million and on life insurance policies with single or annualised premiums at or above HK$100,000. Reinsurance contracts would not be subject to the levy.

To facilitate a smooth transition once the IIA is established and to minimise the impact on pre-existing insurance intermediaries who are licensed with the other insurance regulators, the Government has proposed a three year migration period for such pre-existing insurance intermediaries upon establishment of the IIA. During the migration period, these pre-existing intermediaries will be able to carry on their business while applying for licenses from the IIA. The draft legislation for establishing the IIA is expected to be issued in early 2012.

Remarks - It is not at all clear that the history of insurance regulation in Hong Kong or any faults in the performance of the insurance industry under the prevailing "light touch" regime, really calls for the full court dress regulatory authority, but that is now the clear intent. Although "welcomed" by the Hong Kong Federation of Insurers, it is not clear where this will leave the close collaboration and closed door communications now enjoyed between the Commissioner of Insurance and the insurance industry bodies. It is also not clear whether the proposed licensing regime will bring any substantial changes to the requirements and qualifications of persons now operating as insurers or agents.

The establishment of an IIA was previously covered under the article "Update on the establishment of an Independent Insurance Authority" in Issue 16 of this Newsletter, a copy of which can be viewed HERE.

The Financial Services and Treasury Bureau's press release can be viewed HERE and Consultation Conclusions HERE.

Back to top >>

Securities

Completion of the transition to the new regulatory regime for investment products and the introduction of the new regulatory regime for CRAs

June 2011 saw the completion of a major restructuring to the SFC's regulatory regime for investment products and the commencement of the new regulatory regime for credit rating agencies ("**CRAs**").

In June last year, the SFC introduced new regulatory requirements under its new SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Products ("**SFC Handbook**"). SFC-authorised funds and investment-linked assurance schemes ("**ILAS**") were given a 12-month transitional period to comply with certain new requirements such as the provision of product key facts statements to investors. The transitional period ended on 24 June 2011.

The Securities and Futures and Companies Legislation (Structured Products Amendment) Ordinance 2011 ("**Amendment Ordinance**") was also gazetted and took effect on 13 May 2011. The Amendment Ordinance transferred the regulation of public offers of structured products from the prospectus regime of Companies Ordinance ("**CO**") to the regime for public offers of investments under the Securities and Futures Ordinance ("**SFO**"). Together with the introduction of new regulatory requirements on structured products under the SFC Handbook, this completed the restructuring of the SFC's regulation of structured products.

Additionally, the new regulatory regime governing CRAs operating in Hong Kong became effective on 1 June 2011. Under the new regime, CRAs and their rating analysts who provide credit rating services in Hong Kong are required to be licensed for Type 10 regulated activity and are subject to supervision by the SFC. Licensed CRAs are required to comply with the SFC's new Code of Conduct for Persons Providing Credit Rating Services and with other legal and regulatory requirements that are generally applicable to all SFC licensees. As at 1 June 2011, the SFC had licensed five CRAs in Hong Kong.

Enhanced global regulatory requirements on CRAs have required Hong Kong to introduce the new regulatory regime for Hong Kong based CRAs to ensure that the Hong Kong based CRAs are regulated in Hong Kong in a manner that is generally consistent with the enhanced standards that have been adopted in a number of other jurisdictions and so that the Hong Kong licensed CRAs will be recognised internationally.

Remarks - The new regulatory regime for structured products will require the issue of advertisements and offer documents for structured products to be authorised by the SFC (unless exempted under the SFO). Previous reliance on safe harbours in Schedule 17 of the CO (in particular (i) an offer with a minimum denomination/consideration of not less than HK$500,000; and (ii) an offer to not more than 50 persons) will no longer be available to structured products in the form of shares and debentures, instead the exemptions in section 103 of the SFO will apply.

We previously reported on both the Amendment Ordinance in the article "Transfer of structured products supervision" and on the new SFC Handbook in the article "SFC issues conclusions on enhancing protection for the investing public" in Issue 14 of this Newsletter. A copy of Issue 14 of the Newsletter can be viewed HERE.

The SFC's press releases on the Amendment Ordinance and on the new regulatory regime under the SFC Handbook can be viewed HERE and HERE respectively.

We last reported on the new regime for CRAs under the article "SFC proceeds with the regulation of credit rating agencies" in Issue 18 of this Newsletter, a copy of which can be viewed HERE. The SFC's press release regarding CRAs can be viewed HERE.

Mystery shopping exercise identifies areas for improvement in selling practices of securities sector

From July to November 2010, the SFC and HKMA conducted a mystery shopping exercise on the sales practices of authorised institutions and licensed corporations in respect of unlisted securities and futures investment products and structured deposits. The exercise covered three major areas, namely know-your-client process, explanation of product features and disclosure of risks, and suitability assessment.

The SFC and HKMA released their findings on 24 May 2011. Whilst some good practices by sales staff of selected intermediaries were noted, as expected, some deficiencies in selling practices were identified from the exercise. The major deficiencies noted included:

- insufficient understanding of the recommended products;
- inadequate or inaccurate explanation of the features and/ or disclosure of risks of the recommended products;
- inaccurate description of the SFC's requirements or practices;
- inadequacy in the procedures of identifying vulnerable customers with low education; and
- failure to take into account all the relevant personal circumstances of the client when making the suitability assessment.

Both the SFC and HKMA have stated they will liaise directly with the licensed corporation or authorised institution as relevant where major deficiencies have been noted and that they will continue to use the mystery shopping exercise to assess the industry's compliance with requirements in terms of selling practices.

Remarks - For the securities sector, 150 samples were conducted on 10 licensed corporations, which comprised investment advisory firms as well as brokerages. For the banking sector, the exercise covered 350 samples from a mix of 20 small, medium and large authorised institutions which engaged in selling investment products to Hong Kong investors. A particular deficiency in collecting client information was noted with authorised institutions. In its circular, the HKMA stated that authorised institutions were required to collect and document, among other things, education and investment objectives of its clients as part of the KYC process.

The SFC's press release can be viewed HERE and the HKMA's press release HERE.

Pre-deal research reports to comply with SFC requirements regarding conflicts of interest

On 30 June 2011, the SFC published its consultation conclusions on proposals to expand the scope of conflicts-of-interest requirements governing research analysts. The requirements governing analyst conduct in preparing investment research reports will be extended to real estate investment trusts ("**REITs**") and listing applicants.

The SFC made some amendments to its original proposals in its consultation paper of 30 September 2010. In particular, it revised its original proposal to prohibit providing analysts with qualitative forward-looking information not contained in the prospectus or listing document, to prohibiting the provision of material information (both historical and forward-looking) not contained in the prospectus or listing document.

Additionally, in light of the recent interest in listing business operations that are not established in a corporate form (such as business trusts), the SFC decided to extend the conflicts-of-interest requirements to analysts conducting research for business operations that are constituted in a form other than a corporation or a REIT.

Except for the requirements in relation to new listings, the new requirements will come into effect on 1 September 2011. In the case of new listing applicants, the new requirements will apply to any new listing where the listing application is submitted to The Stock Exchange of Hong Kong Ltd on or after 1 August 2011.

To implement the proposals, changes will be made to the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission and the Corporate Finance Adviser Code of Conduct. We previously discussed the proposed changes in the article "SFC consultation on extending scope of analysts' conflicts-of-interests requirements" in Issue 16 of this Newsletter, a copy of which can be obtained HERE.

The SFC's press release and the Consultation Conclusions can be viewed HERE.

Securities and Futures (Amendment) Bill 2011 and SFC revised draft guidelines on disclosure of inside information published

On 22 June 2011, the SFC published its revised draft of the Guidelines on Disclosure of Inside Information ("**Guidelines**"), alongside the Government's issuance of the Legislative Council Brief on the Securities and Futures (Amendment) Bill 2011 ("**Bill**"). The Bill was gazetted on 24 June 2011.

The Guidelines were revised to reflect comments received by the SFC during its 3 month consultation in 2010 as well as the relevant text of the Bill. Further revisions to the Guidelines may be expected once the final form of the Bill has been settled after its passage through the Legislative Council.

Under the Bill, a listed corporation is required to disclose price sensitive information as soon as reasonably practicable after it has become aware of the information. Where the corporation is found to have breached the disclosure requirement, its officer will also be in breach if the corporation's breach is a result of his intentional, reckless or negligent conduct; or if he has not taken all reasonable measures to ensure that proper safeguards

existed to prevent the breach. The alleged breaches will be handled by the Market Misconduct Tribunal and civil sanctions will be imposed on listed corporations and their officers for breach of the disclosure requirement.

Remarks - We last discussed the draft proposals under the article "Government proceeds with proposals to codify disclosure of inside information and price-sensitive information" in Issue 17 of this Newsletter, a copy of which can be viewed **HERE**.

The SFC's press release and Guidelines can be viewed **HERE**. The Financial Services and Treasury Bureau's press release can be viewed **HERE**.

Back to top >>

Banking

HKMA issues further guidance on collection, use and transfer of personal data for marketing purposes

On 24 June 2011, the HKMA issued a press release in relation to the publication by the Privacy Commissioner for Personal Data ("**PCPD**") on 20 June 2011 of its investigation reports with respect to the collection and use of customers' personal data by four banks as well as the findings of its compliance checks on the credit card application forms for ten banks.

The PCPD found that the four banks had contravened Data Protection Principles 1 and 3 on collection and use of personal data by using vague and loose terms to inform customers of the classes of persons who could use their data, providing the personal information collection statements ("**PICS**") in too small font size, and disclosing customers' personal data to third parties for marketing purposes without express and voluntary consent. The PCPD also considered one bank to have contravened section 34(1) of the Personal Data (Privacy) Ordinance ("**PDPO**") in not complying with an opt-out request by poorly handling a customer's request to opt-out from receiving direct marketing.

The PCPD's subsequent compliance checks on selected banks revealed that the banks surveyed were generally compliant with the legal requirements in the collection and use of customers' data for direct marketing.

Nevertheless, the HKMA has stated that it expects all authorised institutions (i.e. banks) to study the PCPD's investigation reports carefully and take note of the issues raised in the reports including in particular:

- PICS should be printed in legible prints;
- appropriate and practicable assistance should be provided to customers to help them understand the PICS;
- classes of transferees of personal data in the PICS should be specified;
- where personal data of existing customers would be shared with any business partners for monetary gain, prior prescribed consent should be obtained; and
- written policy/guideline should be formulated to ensure compliance with customers' direct marketing opt-out requests.

The PCPD also highlighted the following observations and recommendations:

- a corporate-wide privacy strategy that applies in all business processes and operational procedures should be in place;
- considerations should be given to the adoption of good privacy practices recommended in the PCPD's Guidance Note on the Collection and Use of Personal Data in Direct Marketing (issued in October 2010); and
- top management should take the lead to inculcate their staff to share work norms which emphasize compliance with the requirements under the PDPO.

Remarks - The HKMA's circular of 24 June 2011 setting out matters authorised institutions are required to take note of from the PCPD's recent investigation reports, are matters which were raised in earlier guidelines and recommendations issued by the HKMA and the PCPD in October last year. The HKMA's express reminder to authorised institutions of these specific requirements highlights the continuing sensitivity in the market of how

organisations such as banks handle customers' personal data for direct marketing purposes.

With the gazettal of the Personal Data (Privacy) (Amendment) Bill 2011 (the "**Privacy Bill**") on 7 July 2011 and its introduction to the Legislative Council on 13 July 2011, further guidelines and circulars from the PCPD and HKMA (as well as other financial regulators) will be likely in the near future. The Privacy Bill is intended to improve current personal data privacy requirements by, amongst other things, revising selected existing requirements and introducing new requirements on collection and use of personal data for direct marketing purposes and the sale of personal data for monetary gains. However, the PCPD has highlighted concerns with several proposals contained in the Privacy Bill, in particular, the proposal to permit a data user to inform the data subject after collection of their personal data that such data are to be sold, and deeming a data subject's consent to be provided if no express non-consent is provided by the data subject within the required response period. Both proposals appear to be in contradiction with Data Protection Principle 3, which requires the purpose of the use of data to be provided prior to collection of data and for prescribed consent to be obtained prior to sale of the data. No implementation date for the Privacy Bill has yet been proposed and in light of the PCPD's concerns over conflicting proposals, it may be some time yet before the proposals in the Privacy Bill are in effect.

We last discussed the HKMA and PCPD's requirements for handling customers' personal data and the Government's proposals for amendments to the PDPO in Issue 16 of this Newsletter, a copy of which can be viewed HERE.

The HKMA's press release can be viewed HERE and the PCPD's press release HERE.

The Government's press release on the Privacy Bill can be viewed HERE.

Back to top >>

Regulatory Investigations

SFC's enforcement action against Tiger Asia struck out and impacts Hontex proceedings

On 14 July 2011, the Court of First Instance ("**CFI**") struck out the SFC's proceedings against New York-based asset management company, Tiger Asia Management LLC, and three of its officers (together "**Tiger Asia**") on alleged contravention of Hong Kong's insider dealing and market manipulation laws.

The CFI had earlier in June ruled that it had no jurisdiction to determine whether or not Tiger Asia had contravened Hong Kong's insider dealing and market manipulation laws.

The SFC had commenced its action in the CFI directly, under section 213 of the SFO, which empowers the court to make remedial orders where a contravention of a market misconduct provision "has occurred, is occurring or may occur". The SFC sought orders to freeze Tiger Asia's assets and ban Tiger Asia from dealing in any listed securities and derivatives in Hong Kong, pending a final decision on the alleged contraventions. The SFC argued that the relief sought was free-standing and not contingent upon a prior determination of contravention, and that the court could assess whether there was a prima facie case of a contravention. However, the CFI disagreed with the SFC's arguments and held that only a court exercising criminal jurisdiction or the Market Misconduct Tribunal ("**MMT**") has jurisdiction to determine whether a contravention of Hong Kong's insider dealing laws and market manipulation laws has occurred; the CFI did not have jurisdiction to make orders like this on the basis of prima facie evidence of a contravention. In order to pursue relief in the CFI, a contravention must be established by the appropriate proceedings.

The SFC also explained its reasoning for choosing to pursue an application in the CFI under section 213 in place of civil proceedings in the MMT: the commencement of proceedings in the MMT has the effect of preventing criminal proceedings being instituted. By applying directly to the CFI for relief and not commencing proceedings in the MMT, the SFC left open the possibility of criminal prosecution, in the event that the Tiger Asia parties were to enter Hong Kong. However, the Judge dismissed this reasoning as weak, implausible and an attempt to avoid "*what it perceives as the slow and cumbersome procedure* [in the MMT], *which can result in many years passing before a determination of a contravention is reached*".

The SFC has announced that it will be appealing against the CFI's ruling.

In view of the CFI's ruling on Tiger Asia, the CFI adjourned the SFC's proceedings against Hontex International Holdings Company Limited ("**Hontex**"), which were also commenced under section 213 of the SFO. The SFC had brought various allegations under section 213 of the SFO against Hontex relating to disclosure of information in its IPO prospectus in 2009. The CFI considered that the issue of its jurisdiction to make findings in proceedings under

section 213 of the SFO must also be determined in this case. The Hontex hearing has been scheduled for 22 July 2011.

Remarks - The CFI's ruling on the Tiger Asia case has a significant impact on the SFC's use of its powers under section 213 of the SFO to bring actions on insider dealing cases. The findings of the higher Hong Kong courts on their interpretation of this section of the SFO will determine the SFC's future treatment of alleged insider dealing cases. Details of both the Tiger Asia and the Hontex proceedings were covered in Issue 13 of this Newsletter, a copy of which is available HERE.

The SFC's press releases regarding Tiger Asia and Hontex can be viewed HERE and HERE respectively.

SFC reprimands and fines Merrill Lynch and Sun Hung Kai Investment Services for failings in relation to sale of notes

In the past two months the SFC has issued a public reprimand and fined both Merrill Lynch (Asia Pacific) Limited ("**Merrill Lynch**") and Sun Hung Kai Investment Services Ltd ("**SHKIS**") for internal control failings relating to the sale of investment products.

Merrill Lynch was reprimanded and fined HK$3 million for inadequate systems in relation to the sale of two index-linked notes to 72 clients in 2007. The SFC found that Merrill Lynch had failed to properly assess the financial situation and investment objectives of over 40 of its clients, key product information was only provided to clients after they had agreed to invest in the notes, and Merrill Lynch kept inadequate documentation to explain the rationale behind the advice given to their clients.

SHKIS was reprimanded and fined HK$4.5 million for failings relating to its sale of Lehman Brothers related equity-linked notes ("**ELNs**") to its clients between May and August of 2008. The SFC found SHKIS had failed to conduct adequate product due diligence, provide sufficient training and guidance on the ELNs to its sales staff, and disclose material information on the ELNs to its clients.

In determining the penalties for each firm, the SFC had considered Merrill Lynch's agreement to implement a resolution scheme to clients who bought the index-linked notes and to review its client compliant procedures; and in SHKIS' case, its serious deficiencies in its distribution system and SHKIS' disciplinary record. Both Merrill Lynch and SHKIS had also agreed to engage an independent audit firm to review their respective internal distribution systems and controls. The SFC also expressly stated that the reprimands and fines were intended to provide a strong deterrent message to the market that failures to ensure suitability of investment products and disclose material information to clients were not acceptable.

The SFC's press releases regarding Merrill Lynch and SHKIS can be viewed HERE and HERE respectively.

Back to top >>

General

Legislation introduced to increase minimum and maximum relevant income levels for Mandatory Provident Fund contributions

On 14 June 2011, the Government presented to the Legislative Council the Mandatory Provident Fund Schemes Ordinance (Amendment of Schedule 2) Notice 2011 and the Mandatory Provident Fund Schemes Ordinance (Amendment of Schedule 3) Notice 2011 (together the "**Amendment Notices**").

The Amendment Notices propose, amongst other things, to increase the monthly minimum relevant income level ("**Min RI**") from HK$5,000 to HK$6,500 and the monthly maximum relevant income level ("**Max RI**") from HK$20,000 to HK$25,000 for mandatory provident funds ("**MPF**").

Since the implementation of the MPF system in 2000, the Mandatory Provident Fund Authority ("**MPFA**") has reviewed the Min RI and Max RI levels on three previous occasions but has refrained from revising the Min and Max RI levels. Its decision to increase the levels now is in consideration of the introduction of the statutory minimum wage ("**SMW**") from 1 May this year and to take into account the hourly SMW rate and median working hours of the low-income group, so that they continue to be spared the burden of making mandatory MPF contributions.

With the increase in the Min RI and Max RI, approximately an additional 333,600 employees and self-employed persons would be required to make mandatory MPF contributions. It is proposed that the revision to the Min RI would come into effect on 1 November 2011, and the revision to the Max RI would be effective from 1 June 2012.

The Financial Services Branch's press release can be viewed **HERE**.

Back to top >>

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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