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Hong Kong Banks Fight COVID-19 with Tech: Is Regulation Up to the Challenge?

Maurice Hoo
Helen Fok

Our Speakers

Maurice Hoo
Partner
Corporate Business Transactions
Hong Kong

Helen Fok
Partner
Investment Management
Hong Kong

Agenda

1. Hong Kong Regulatory Landscape and Challenges

2. Banks’ Digital Banking and Investment Platforms

3. Operational Resilience

Now. Normal. Next.

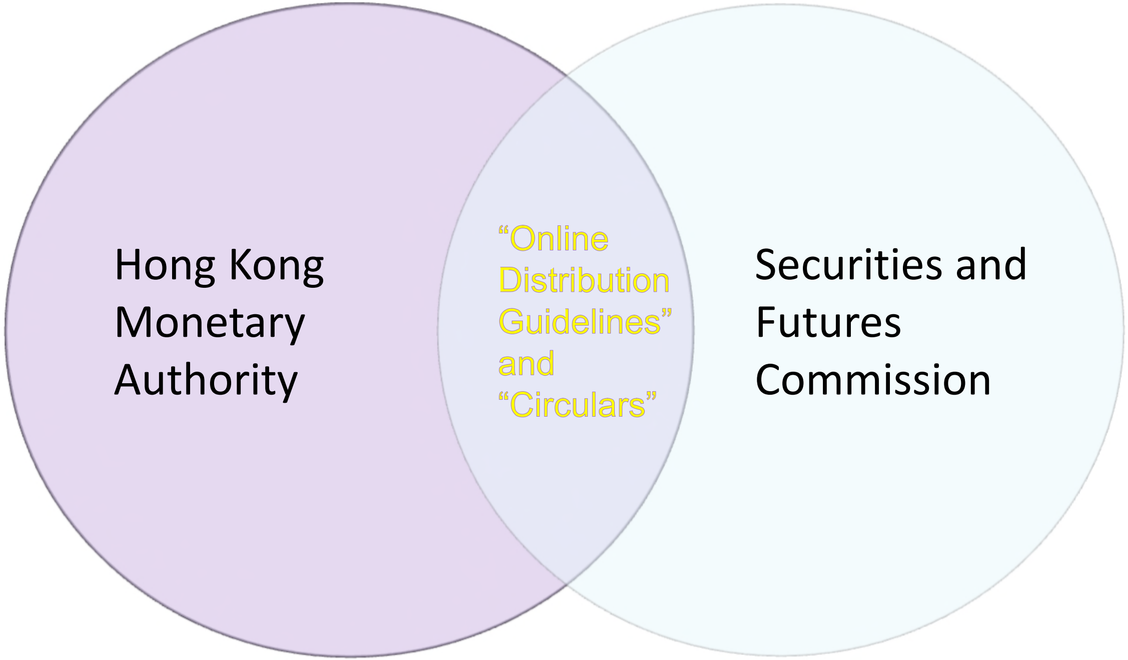
Now.

- Are digital banking and investment platforms the way to go?

Next. Ready: Issues to Consider

- Design of the platform
- Capability of the platform
- Partnering with Fintech companies

Hong Kong Regulators



Distribution and Advisory Activities

Advisory

Distribution

Client suitability

Product complexity

The Online Distribution Guidelines

- Apply to banks that provide order execution, distribution and/or advisory services for investment products through online platforms

- The Online Distribution Guidelines focus on 3 main areas:

Suitability Requirement	Complex Products	Governance and Control (6 Core Principles) *See Appendix 1*

Suitability Requirement

"An intermediary should, when making a recommendation or solicitation, ensure suitability of the recommendation or solicitation for the client is reasonable in all the circumstances having regard to information about the client of which the intermediary is or ***should be aware*** through the exercise of due diligence"

Triggering of Suitability Requirement

The point at which suitability is triggered between the online context and the offline context is different:

Online (no human interaction)

The assessment centres on the materials posted on the platform

Offline (human interaction)

The assessment is made at the point of advice

Mutually exclusive?

See Appendix 2 for examples of when the Suitability Requirement is or is not triggered

Discharging the Suitability Requirement

Once the Suitability Requirement is triggered, banks should:

- Match the risk return profile of investment products with the personal circumstances to ensure suitability
- Perform product due diligence
- Conduct KYC to obtain information on the personal circumstances of the client

Discharging the Suitability Requirement continued

Portfolio based approach

- The SFC has stated that banks may adopt a portfolio based approach to ensure suitability
- A portfolio based approach is an alternative to a transaction-by-transaction approach in conducting suitability assessment adopted by banks
- It allows banks to consider whether a particular investment is suitable for the client by taking into account the client’s entire investment portfolio

Suitability Requirement – Implementation Issues

- Suitability is a dynamic process
- Banks must design the online platforms which capture the nuances of the Suitability Requirement
  - The SFC simply applies the suitability requirement, which is designed for the "offline" environment, to the "online" environment"
  - As a result, unless banks can design platforms that capture all the nuances of the suitability requirement, the online investment platforms may be restricted to plain vanilla investment products, at least in the near future
- Interaction between users of the online platforms/offline environment
- Inconsistencies between the requirements applicable to online platform/offline environment
  - ➢ Information on methodology adopted for assigning ratings to products and clients (c.f. offline environment)
  - ➢ Reject transactions (c.f. offline environment)
- See Appendix 3 for a list of non-exhaustive information to be disclosed to investors of online platforms

Complex Products

- Subject to exemptions, if a bank provides services to a client in complex products, it must ensure that:

A. transaction in a complex product is suitable for the client in all the circumstances

B. sufficient information on the key nature, features and risks of a complex product is provided so as to enable the client to understand the product before making an investment decision

C. warning statements in relation to the distribution of a complex product are provided to the client in a clear and prominent manner

Complex Products continued

SFC's definition of complex products

- Complex products are investment products whose terms, features, and risks are not reasonably likely to be understood by **retail investors** because of its complex structure
- Below are some factors to determine whether an investment product is a complex product:
  1. whether the investment product is a derivative product
  2. whether a secondary market is available for the investment product at publicly available prices
  3. whether there is adequate and transparent information about the investment product available to retail investors
  4. whether there is a risk of losing more than the amount invested
  5. whether any features or terms of the investment product could fundamentally alter the nature or risk of the investment or pay-out profile or include multiple variables or complicated formulas to determine the return
  6. whether any features or terms of the investment product might render the investment illiquid and/or difficult to value
- See Appendix 4 for a list of SFC's examples of complex and non-complex products

Complex Products – Implementation issues

- Definition of complex products – difficult to apply
- Exchange traded derivative products: How to distinguish whether derivative products are traded on an exchange in Hong Kong or in a specified jurisdiction
- Reject transactions

Automated Trading Services
(Type 7 Regulated Activity)

- Definition of "Automated Trading Services"
  - binding transactions executed on the platform
  - persons are regularly introduced or identified in order to negotiate or conclude binding transactions in accordance with established methods
  - securities, futures contracts and OTC derivative products
- Exemption
  - if the offer is made to existing clients to whom the banks or its related corporation (holding company, subsidiary or sister subsidiaries) is already:
    - providing any financial services
    - at any time during the period of 3 years immediately preceding the day on which the offer is made

Operational Resilience

- The UK regulators define operational resilience as:

- "*the ability of firms to provide important business services in times of operational disruption*"

- Two key challenges: (i) identifying important business services; (ii) set impact tolerances

- Operational resilience has become a key agenda item for boards and senior management

- Failure to implement would risk regulatory enforcement against the firms and senior managers

Operational Resilience (continue)

Resilience questions for boards and senior management [1]

Governance	• What is our risk appetite for resilience risk? • Who is accountable in the 1st and 2nd lines of defense for managing, monitoring, and reporting on resilience?
Organizational Focus	• Does the organization understand the dependencies of critical business services on organizational assets? • What are our most critical assets that impact service delivery • How does our approach to resilience change the way we manage operations, technology, and third parties?
Integration	• What is our measure of criticality? • What are our critical business services and why? • How are we leveraging existing definitions of criticality and critical business services (e.g., from resolution planning)? • What is our impact on customers and the financial system?
Measurement	• What are the most important resilience risks for the organization? • How do we monitor and manage the level of resilience of the organization? • How is risk appetite reflected in our impact tolerances? • In which scenarios are we outside of our defined impact tolerances?
Preparedness	• How do we make sure we are effectively prepared for dierent disruption events? • How frequently are we testing our response and recovery capabilities for dierent disruptive scenarios?

[1] Source: Striving for Operational Resilience – The Questions Boards and Senior Management should ask by Oliver Wyman

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Dubai	San Francisco
Frankfurt	Shanghai*
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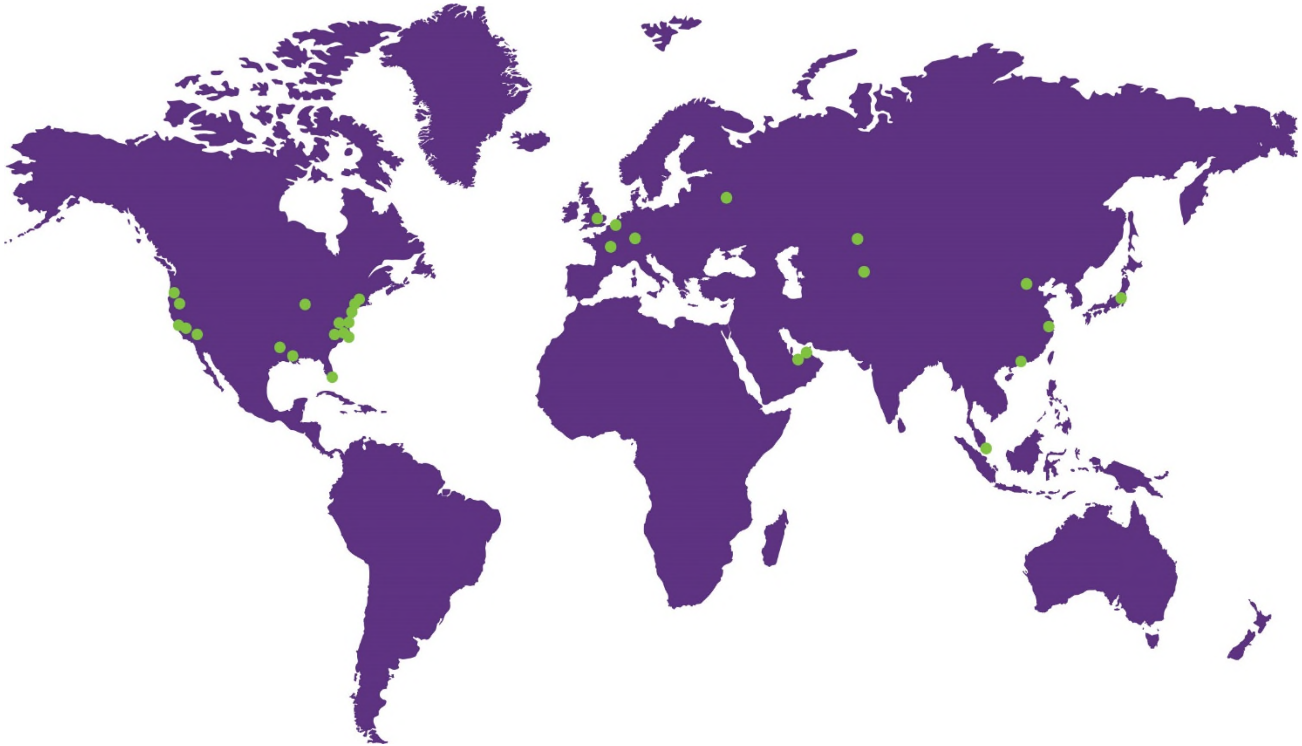

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Please submit your questions to Maurice and Helen using the Q&A tool found on the right side of your screen.

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Maurice is a partner at Morgan, Lewis & Bockius LLP and also a registered foreign lawyer at Morgan, Lewis & Bockius.

Maurice Hoo has more than 25 years of experience advising private equity and venture capital investors, as well as multinationals and strategic investors, in their cross-border mergers, acquisitions, investments, restructurings, and divestments. Maurice is a Registered Foreign Lawyer in Hong Kong and is admitted to practice in California.

With a focus on technology companies that do business in Asia, especially China, Maurice's deal experience spans a wide range of industries, including education, life sciences and medical devices, environmental protection and renewable energy, food, media and entertainment, mobile technology, and retail.

Since 2008, Maurice has been consistently recognized as one of the top private equity lawyers in China by legal industry publications Chambers Asia-Pacific and IFLR1000. Clients have praised Maurice and his team as "innovative," "thinks outside the box," "gives us lots of alternatives," and "offers high-calibre service."

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Helen Fok

With a focus on financial regulatory matters, Helen Fok is a “highly regarded” (The Legal 500) regulatory specialist who has extensive experience in advising banks, financial institutions, asset managers, hedge fund managers, alternative trading platforms, and sovereign wealth funds on all aspects of financial regulation. The breadth of her practice includes advising licensing applications and ongoing regulatory matters under the Securities and Futures Ordinance, the Banking Ordinance, and the Payment Systems and Stored Value Facilities Ordinance, and on conduct of business rules, conflicts of interests, product governance, investor classification, suitability, and corporate governance issues, including the implementation of the Hong Kong Manager-in-Charge regime.

Helen has also been involved in a number of client agreements for securities and futures brokers, private wealth managers (with onshore/offshore booking models), fund managers, custodians, and clearing members. Additionally, she has advised on the regulatory aspects of a number of mergers and acquisitions transactions.

Prior to joining Morgan Lewis, Helen worked at a number of top international law firms in financial regulatory area and spent time in both Hong Kong and Beijing. While in Beijing, Helen advised offshore investment managers interested in gaining a presence in China, as well as China outbound clients looking to establish overseas investment platforms.

THANK YOU

Appendix 1 - Core Principles on Governance and Control of Online Platforms

The SFC has identified six core principles which banks should comply with in the operation the their online platforms:

CP1: Proper design – ensure the online platform is properly designed and operated in accordance with applicable laws and regulations

CP2: Information for clients – make clear and adequate disclosure of relevant materials on its online platform

CP3: Risk management – ensure reliability and security of its online platform

CP4: Governance, capabilities and resources – ensure robust governance arrangements in place as well as adequate human, technology and financial resources available

CP5: Review and monitoring - ongoing supervision and monitoring obligations

CP6: Record keeping - maintain proper records in respect of the online platform

Appendix 2 – Examples of when the Suitability Requirement is or is not Triggered

When the Suitability Requirement is triggered:	When the Suitability Requirement is NOT triggered:
1. Posting of advertisements which include product-specific incentives (e.g., cash rebates, fee discounts) for any transactions in a specific investment product. 2. Posting of product-specific research reports on an investment product which include words such as "Don't Miss Out!" or "Act Now!". 3. Persistent pop-ups or flashing in connection with a specific investment product. 4. Presenting a specific list of investment products with an accompanying statement such as "product of risk rating X or below may suit your or match your risk tolerance level" or "these products may suit your or match your risk tolerance level" to clients immediately after the online platform conducts a risk profiling of clients.	1. Provision of a direct facility to input stock codes to place orders for exchange-traded products for secondary market trading on the relevant exchange. 2. Posting of lists of, and provision of access to, investment products and posting of factual information such as corporate information (e.g., announcements, circulars or annual reports) issued by listed issuers or the provision of a link to such information on the SEHK's website or other factual information (e.g., offering documents, notices to investors, annual reports and fact sheets). 3. Posting of lists of investment products that are selected using objective criteria (e.g., performance data, sales figures, research data). 4. Posting of advertisements of fee discounts not tied to any specific investment product (e.g., lower subscription fees during a client's birthday month, time-limited reduced rates or loyalty discounts to reduce transaction fees in general).

Appendix 2 – Examples of when the Suitability Requirement is or is not Triggered (con't)

When the Suitability Requirement is triggered:	When the Suitability Requirement is <u>NOT</u> triggered:
5. Upon a client's completion of the know-your-client process or provision of information through a client profiling tool or upon a client providing updates to his or her information, generating a specific model portfolio with a list of investment products or generating a list of selected investment products which may be perceived to be based on a consideration of the information provided by the client.	5. Provision of objective filters for self-directed research on investment products (e.g., geographical location, underlying assets, one-year, three-year, five-year performance data or performance data since launch, risk categories and third party or in-house risk ratings).
6. Presenting a model portfolio that allocates a percentage of the portfolio to a class of products (e.g., bonds) but there is only one product in that class of product offered by the platform.	6. Posting of non-product-specific information such as market news or updates, industry and sector trends, and education materials.
	7. The simple flashing of a "new" icon next to newly published research reports (which may contain views on buy, hold or sell with target prices) or newly available investment products.
	8. Posting of model portfolios that are constructed using objective criteria (e.g., research data, performance data, asset allocation strategies/models) which are not linked to or generated based on information provided by the client.

Appendix 2 – Examples of when the Suitability Requirement is or is not Triggered (con't)

When the Suitability Requirement is triggered:	When the Suitability Requirement is NOT triggered:
7. Showing the performance of a model portfolio offered by the platform against the performance of the client's current portfolio held with the platform without the client requesting for such comparison.	9. Posting statistics or trends in customer activities involving a particular product that are factual and based on objective criteria and do not put pressure on a client to proceed with a transaction (for example, setting out a list of investment products with a description that "Other clients who bought product A also looked at these products".) 10. Posting of educational materials that are product-specific as long as such materials do not include (standing alone or in combination with other communications) a recommendation of the specific investment product.

Appendix 3 – Non-exhaustive List of Material Information that should be Disclosed on the Online Investment Platform

- Up-to-date product offering documents or information
- Material information to be provided as soon as reasonably practicable to enable clients to appraise the position of their investments
- Information on the methodology adopted for assessing and assigning ratings to investment products and categorizing clients on the online platform, if any. Such information should also be accompanied by an explanation of the risk profiles of investment products and clients.
- Where selected list(s) of investment products are posted on the online platform, the information on the objective criteria by reference to which such investment products are selected
- The scope and limitations of services and investment products that are provided through and on the online platform (e.g., banks could inform clients of how the online platform deals with cancellation of orders and services, and whether the availability of investment products is limited to those issued by related companies
- Any remuneration to be paid by the client or other persons (for example, product issuers) to the bank, such as commission, brokerage and any other fees and charges, and any other monetary benefits received or receivable by the bank
- The bank’s contact details for handling client enquiries and complaints

Appendix 4 – Examples on non-complex products and complex products

Non-complex products

- Shares traded on the SEHK;
- Non-complex bonds (including callable bonds without other special features) Non-derivative funds authorized by the SFC under the UT Code;
- SFC-authorized non-derivative ETFs traded on the SEHK;
- SFC-authorized REITs traded on the SEHK; and
- Any other investment product the SFC may specify from time to time

Note: SFC may revise the above list of non-complex products from time to time

Appendix 4 – Examples on non-complex products and complex products (con’t)

Complex products - Derivatives traded on an exchange

- Futures contracts traded on the HKFE;
- Equity derivatives traded on the SEHK (eg, DWs, CBBCs and listed share options);
- SFC and traded on the SEHK;
- L&I products authorized by the SFC and traded on the SEHK; and
- Any other investment product the SFC may specify from time to time

Note: SFC states that the above list is non-exhaustive. The purpose of the list is to set out examples of investment products considered as complex products

Appendix 4 – Examples on non-complex products and complex products (con't)

Other complex products

- Complex bonds. Complex bonds are bonds with special features (including, but not limited to, perpetual or subordinated bonds, or those with variable or deferred interest payment terms, extendable maturity dates, or those which are convertible or exchangeable or have contingent write down or loss absorption features, or those with multiple credit support providers and structures) and/or bonds comprising one or more special features;
- Funds authorized by the SFC under the UT Code which are derivative funds;
- Funds authorized by the SFC under 8.7 of the UT Code (i.e. SFC-authorized hedge funds);
- SFC-authorized unlisted structured investment products (including SFC-authorized equity-linked deposits, equity-linked instruments/investments, etc.);
- Other non-exchange-traded structured investment products; and
- Any other investment product the SFC may specify from time to time.

Note: SFC states that the above list is non-exhaustive. The purpose of the list is to set out examples of investment products considered as complex products.