

Risk Management and Regulation Newsletter

Welcome to our second Risk Management and Regulation Newsletter

Welcome to the second issue of this newsletter. As always we are bringing you a summary of interesting and relevant risk management or regulatory developments with an applicability to many clients.

We have to acknowledge the significant impact to many of us in Hong Kong from the coronavirus (Covid-19) and the changes it has brought to our daily working lives. Many of these changes are temporary but some of them – e.g. more flexible working arrangements – could become the new normal. In a regulated industry this will pose some interesting new challenges for firms and regulators to work through. I believe that we have to accept some of these changes and move forward rather than trying to go back to the 'old way'. Another by-product of these challenging times is that many firms will now have challenges in meeting regulatory deadlines or requirements and we have seen some evidence of firms approaching regulators for forbearance. The good news is regulators are listening and are open to some, but probably not all, of these requests.

In this issue we deal with a range of topics:

- **Data standards:** The SFC is seeking to standardise the data that Licensed Corporations need to hold and produce, on request, during examinations. We see this as part of a growing trend as regulators take a more data based approach to regulation as well as using more technology.
- **Pricing and disclosure:** Part of the ongoing focus conduct by regulators is looking at pricing. The origin of this is to improve practices in Private Banking but the principle equally applies to investment sales in retail banking and also sales of OTC financial products to Corporate and Institutional customers.
- **Investor protection measures:** Continuing the focus on Conduct there is new guidance from HKMA on investment, insurance and MPF products.
- **LIBOR reform:** In our last newsletter we asked if you were you ready? Many are not and the focus of regulators is moving to ensure institutions are taking action now.
- **Virtual assets:** Virtual assets and related service providers are becoming more mainstream and we examine some of the recent guidance issued by Hong Kong's regulators.

We hope you enjoy this issue and would love to hear feedback from you.



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Topics in this issue:

1. Data Standards for Order Life ("DS-OL") Cycles
2. Pricing and Disclosure
3. Investor Protection Measures in respect of Investment, Insurance and Mandatory Provident Fund Products
4. LIBOR reform
5. Anti-Money Laundering / Counter-Financing of Terrorism and Sanctions

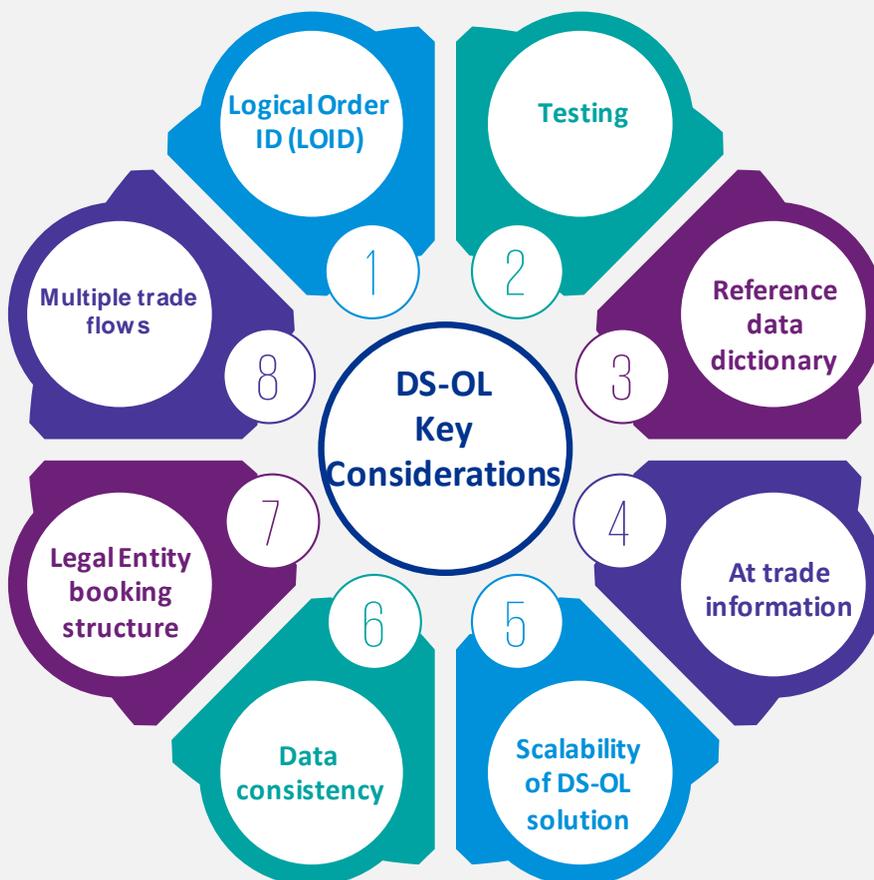
Data Standards for Order Life ("DS-OL") Cycles

The Securities and Futures Commission ("SFC") on **31 July 2019** issued a circular requiring Licensed Corporations ("LCs") to comply with **new data standards** when **submitting trading-related data upon request**. The new requirements will come into effect on **1 October 2020** and are aimed at developing an industry-wide convention for data validation and the submission process.

DS-OL aims to facilitate the reconstruction of the order life cycle from order receipt through final execution or cancellation. DS-OL will decompose the order life cycles into discrete events (excluding post-trade events) and will assign a **unique identifier** to each parent order and be recorded alongside all the events throughout the order life cycle.

Initially, only equities listed on the Stock Exchange of Hong Kong ("SEHK") will be considered "**In-Scope Products**" for the purpose of complying with DS-OL. In addition, only brokers whose trading turnover in SEHK-listed equities in a calendar year reaches 2% of that year's total market trading volume will be considered in "**In-Scope Brokers**".

Some key considerations and challenges of DS-OL include:



For further details, click [here](#) for the full paper KPMG published in September 2019, which delves into the key considerations mentioned above, as well as aspects of data governance that LCs need to consider during implementation.

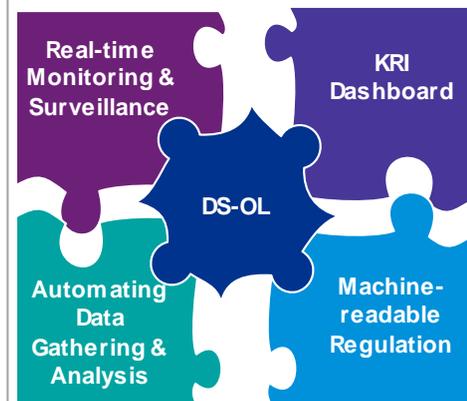
31 July 2019

SFC circular on data standards for order life cycles

LCs to implement the DS-OL requirements by **1 October 2020**.

Know the Context... Supervisory Technology

SFC has prioritised the use of SupTech in its inspections to identify irregularities, systemic controls deficiencies and compliance issues which may otherwise go undetected.



How can KPMG help?

- Advice/ workshops to support you in your interpretation of the application of these new reporting requirements
- Assessment of a test submission of reporting data once your DS-OL reporting engine is built
- Support to design a compliance monitoring programme which uses DS-OL data to identify potential non-compliance with relevant sections of the SFC Code of Conduct.

Pricing Framework

Clients and regulators alike expect pricing to be consistent, fair and transparent. Regulators expect that conflicts of interest with respect to pricing are well managed; this includes disclosure and controls in relation to retrocessions, rebates and trailer fees. Transparency is also required with respect to pre-trade and post-trade disclosure, in line with the SFC Code of Conduct and client expectations. Conflicts of interest should be clearly identified and managed.

Management and tone from the top to create the right culture of pricing is crucial. Regulators will review programmes from a Manager-In-Charge lens, and expect that the right principles of acting in the interest of clients are rewarded, while bad practices are identified and discouraged. There is also a need for clear responsibilities with respect to pricing, including an overall governance structure, and a three lines of defence model.

Increasing regulatory expectations

Pricing is at the crux of regulatory agendas: operating in the best interests of clients; operating with transparency; and managing conflicts of interest.



SFC Code of Conduct, Circulars, FAQs

- Fair and reasonable pricing of monetary benefits.
- Adequate representations to clients on features and risks of investment products.
- Appropriate pre- and post-trade disclosure on fees, commissions, mark-ups, spreads, retrocessions, and other non-monetary benefits for all investment products.
- In particular, certain monetary benefits should be disclosed to the nearest whole percentage point and/or the dollar amount.
- Avoid conflicts of interest or at least treat clients fairly where conflicts cannot be avoided



Singapore Private Banking Code

- Enhanced [disclosure standards](#) on Private Banks to disclose all fees, charges, and other quantifiable benefits at account opening.
- All rebates received from selling new bond issuance must be disclosed pre-trade.
- Clients to be informed of all key terms of transactions.
- Expectation to exercise care and have reasonable basis for recommending products and leverage to clients.



International

- Financial Services Royal Commission
- Substantial failures with imposition of ongoing fees, including widespread fees for no services.
 - Operational/processing errors increasingly seen as reflective of poor conduct, rather than purely operational issues.

FCA Fair Treatment Of Customers

- The principles and objectives of fair client treatment should be enforced within all firms.
- Steps to be taken by firms to create an embedded culture of treating customers fairly.

Pricing and Disclosure



Key questions for you:



How comfortable are you with your overall systems and controls to ensure pricing agreements are adhered to, and that pricing improvement is handled in a controlled and fair manner?



Do you have a governance framework in place that challenges, monitors, and enhances pricing related risks and controls?



Do you have a culture of transparency and fairness in pricing?

Pricing Framework - Key elements

We have worked closely across the Wealth Management industry on this topic, from both a review standpoint, to deep implementation. We understand the pain points, hidden challenges, and cultural shift required on this topic.

Client Disclosures

- Ensuring accuracy in pre-trade and post trade disclosure, including in relation to trading capacity.
- System controls to accurately reflect executed prices and fees charged

Price Setting & Review

- Ensuring pricing reflects fair outcomes for clients with respect to products, volumes and client pricing bands
- Ensuring pricing is maintained in a controlled environment

Discounting:

- Developing a discounting framework that is consistent and controlled with respect to client types

System and process controls

- System controls that ensure pricing is between allowed bands, with respect to commissions, spreads and rebates/retrocessions
- Ensuring executed prices are accurately reflected, controlled, including controls related to post-trade amendments
- Appropriate system governance with pricing, especially in relation to systems change management



Internal communications and policies

- Policies, procedures and training to enable a culture of pricing adherence

Ongoing review and monitoring

- Consequence management to ensure individual accountability
- A monitoring framework to identify exceptions, and raise issues to management attention
- Sufficient oversight and challenge by 2 LoD on activities of the front line staff
- 3 LoD providing independent assurance in process and control design and operational effectiveness

Leading Practices



Dedicated teams

- Clearly denoted as having the ultimate responsibility over pricing framework and controls.
- Covering operational implementation of pricing and disclosure control framework, and reviewing and resolving pricing disclosure control framework related issues.
- Ability to identify break even pricing, optimise profit maximisation, while ensuring fair treatment of clients and pricing benchmarked to industry.
- Performing independent reviews and controls.



Management Information

- Monthly exceptions reporting to identify potential overcharges, areas of abnormally high revenue.
- Ability to identify trends in pricing and discounting by product and line of service.



Client first mentality

- Regular communication and training on pricing and disclosure principles.
- Staff are able to demonstrate a culture of fairness and transparency to clients.
- Demonstrated consequence management/penalties in instances where policy has not been followed.
- Incorporating the right culture and avoiding conflicts of interests to act in the best interests of clients.

Pricing and Disclosure



How KPMG can help:



Governance. Is there sufficient oversight and challenge of pricing, discounting, and pricing controls? Is there awareness and training in place at all key levels?



Systems Controls and processes. What controls do you have to ensure commission, spreads, transaction fees, retrocessions, rebates and other pricing components (e.g. all-in fees) are appropriately charged?



Monitoring & Ongoing Review. What is your MI on pricing? How do you know if your bank has issues?



Discounting. What is your criteria and documentation of granting discounts? How do you know if they're adhered to?



Internal Comms & Policies. How is your pricing framework documented?



Client Disclosures. What are your pre-trade and post-trade disclosures? How do you know if they are in line with regulatory expectations, and being consistently made?

Investor Protection Measures in respect of Investment, Insurance and Mandatory Provident Fund Products

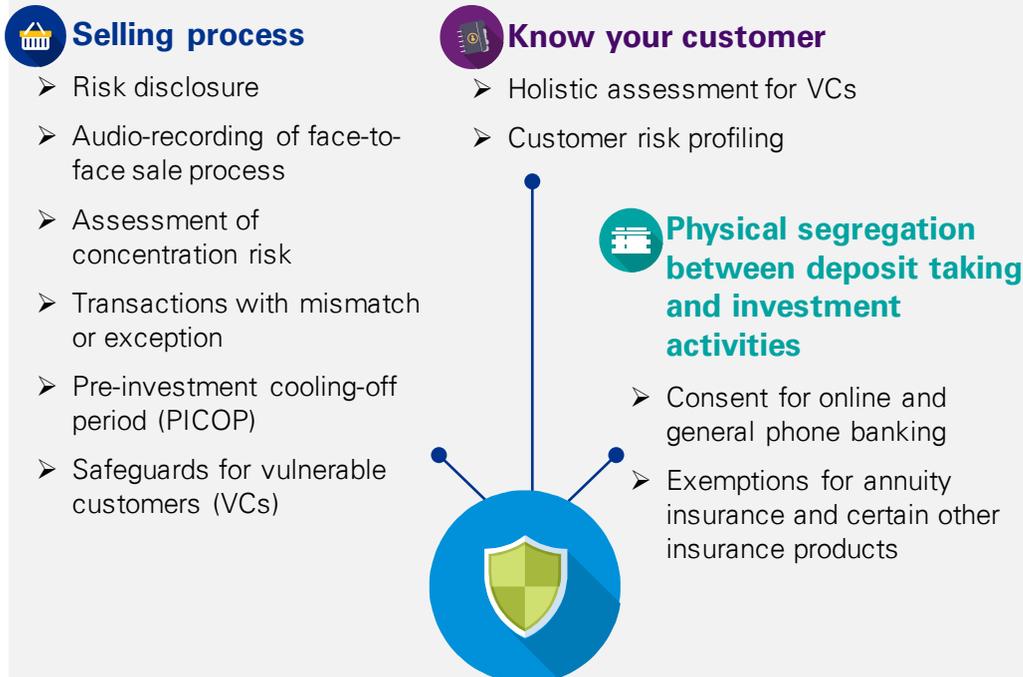
Refinements to investor protection measures

Investor protection remains a top focus for financial regulators in Hong Kong, with mis-selling of investment products a key consideration. The Hong Kong Monetary Authority (HKMA) has introduced a number of investor protection measures to facilitate the provision of suitable investment, insurance and mandatory provident fund (MPF) products by Authorized Institutions (AIs).

In response to changing sales models, the HKMA conducted a holistic review of the current investor protection measures with an objective to refine some of the key measures, considering prevailing industry practices, applicability to different business models and the customer experience.

On 25 September 2019, HKMA issued "**Investor Protection Measures in respect of Investment, Insurance and Mandatory Provident Fund Products**" (the Circular) to introduce the refined investor protection measures, which will supersede previous related circulars. AIs should comply with the Circular not later than 25 September 2020, except for sections (A)(III.2) and (B)(VIII), which should be implemented not later than 25 March 2021.

The Circular covers refinements in the following three areas:



KPMG released a publication which summarises the key changes from the Circular. Click [here](#) to view the publication for more details on the updates.

25 Sep 19

HKMA Circular on Investment Protection Measures



Key effective dates:



AIs to implement the requirements in the Circular by **25 September 2020**.



AIs to implement the requirements in sections (A)(III.2) and (B)(VIII) of the Circular by **25 March 2021**.

Regulatory updates on benchmark interest rates

During Q3 2019, the market principally agreed on the fallback language for various types of financial instruments. Over the last quarter, there were a number of key developments on LIBOR transition driven by regulators and industry bodies – mainly in the US and UK. Additional consultation papers and guidance have been issued to address market participants' highest priority questions: what is the credit adjustment spread methodology and how can the lack of term rates be addressed? These updates show that industry leaders acknowledged banks' concerns and started to tackle technicality issues before banks had more confidence to kick-start the transition work.

Key insights

HKMA survey on interest rate benchmarks reform

On 18 November 2019, the HKMA circulated a survey on reform of interest rate benchmarks to collate information on the progress made to date by Authorized Institutions in their preparation to transition to alternative reference rates. It is worth noting that the scope of interest rate benchmarks not only includes LIBOR, but also HIBOR and other IBORs of which its calculation has a dependency on LIBOR (e.g. SOR, THBFX). This sets the regulatory expectations that AIs should not only prepare for LIBOR transition, but also to start contemplating the future replacements of the other IBORs.

The HKMA has indicated that they will monitor banks' progress in the interest rate benchmark reform on an ongoing basis, so this survey may not be the only one. For banks which have responded "No" or "No but planning to" to the governance and transition plan readiness questions in the survey, they should have initiated the process of forming a governance group and transition plan to demonstrate progress to the HKMA in the next survey round.

FCA guidance on mitigating conduct risk during LIBOR transition

Conduct risk remains one of the key risks faced by banks throughout the transition. A key component of managing conduct risk is to take reasonable steps to treat customers fairly. The Financial Conduct Authority (FCA) issued guidance to set regulatory expectations on what banks should do to address the risk. This is one of the first guidelines released by an official organisation globally. Although the FCA is not a regulator of Hong Kong banks, it provides useful insights to the regulator's expectations and we suggest banks in Hong Kong make a reference to this publication. We have highlighted a few key points:

- Banks **should not** move customers with continuing contracts to replacement rates that are expected to be higher than what LIBOR would have been, or otherwise introduce inferior terms.
- Banks **should** communicate with their customers effectively how these fallback provisions are expected to operate
- Banks **should** avoid writing new LIBOR contracts that mature after the end of 2021;
- Banks **should not** defer conversations with customers to the point the client is left with insufficient time to understand their options because the bank is not certain about the technicality of the transition.

2021
LIBOR ceases at
the end of 2021

 Priority Actions in Q1 2020:

 **Quickly** mobilise and conduct impact assessments

 **Quantify** exposures for product inventory referencing LIBOR

 **Rework** contracts and develop client outreach strategy to communicate to clients on the impact of the LIBOR transition

 **Implement** monitoring procedures, including quantitative and qualitative tools and metrics to assess the impacted exposure to LIBOR over time

 **Deliver** internal training programmes to increase awareness and impact across the organisation

 Click [here](#) for all the issues of KPMG's monthly LIBOR newsletter, which provides updates on LIBOR and other benchmark interest rate developments that directly impact banks and considers the potential implications of the related regulatory requirements.

Guidance from HKMA and SFC in relation to virtual asset service providers ("VASP")

The SFC issued a position paper on 6 November 2019 which sets out the regulatory framework for VASPs operating in Hong Kong. Licences will only be granted to platforms that are capable of meeting the regulatory standards which are comparable to those applicable to licensed securities brokers and automated trading venues. Under the framework, trading platforms are required to establish adequate and effective policies, procedures and controls to manage money laundering risks. The framework also suggested the need for the trading platforms to deploy tools to enable tracing of specific virtual asset ownership history. Click [here](#) to view the position paper.

On 16 December 2019, HKMA issued a circular - *Managing ML/TF risks associated with virtual assets (VAs) and virtual asset service providers (VASPs)* to provide guidance to Authorized Institutions (AIs) in relation to Financial Action Task Force (FATF) Recommendation 15 that applies in the case of VAs and VASPs. AIs are reminded to conduct appropriate risk assessments and consider additional customer due diligence measures when establishing and/or maintaining relationships with VASPs. AIs are reminded to undertake ML/TF risk assessment and implement appropriate risk mitigating measures before offering any new banking or investment products relating to VAs. Click [here](#) to view the circular.

KPMG issued a publication - *The new frontier: Applying AML compliance to cryptocurrencies* in April 2019 which discussed the key trends and risks surrounding cryptocurrencies, and emphasises the need to move beyond traditional AML compliance when implementing processes and controls. Click [here](#) to view the publication.

HKMA hosted the first AML/CFT RegTech Forum

HKMA hosted the first AML/CFT RegTech Forum on 22 and 25 November 2019. The forum was participated in by regulators, banks, and other stakeholders within Hong Kong's AML/CFT system with experts in the RegTech sector. The participants shared experience and identified opportunities in how technology can be applied to further enhance the effectiveness of AML/CFT efforts. A series of panel discussions were held, during which topics such as the innovations in money laundering and terrorist financing risk management, challenges and opportunities in the adoption of AML/CFT RegTech and results regarding the AML/CFT RegTech adoption industry survey were discussed. Click [here](#) to view the record of discussion.

In June 2019, KPMG issued a publication - *There's a revolution coming: Embracing the challenge of the new RegTech era* - which discussed the key drivers of RegTech investment and adoption in the financial sector to be Compliance, Cost and Complexity. The publication shares real-world examples of RegTech adoption and explored different models for RegTech adoption. Click [here](#) to view the publication.

Anti-Money Laundering / Counter- Financing of Terrorism and Sanctions



Key points from SFC and HKMA on VASPs:



VASPs are required to meet SFC's AML/CFT requirements applicable to Licensed Corporations.



Consider applying additional customer due diligence measures when establishing business relationships with VASPs.



Undertake ML/TF risk assessment and appropriate risk mitigating measures before offering VA products.



Key drivers of RegTech adoption in the financial sector:



Compliance



Cost



Complexity

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