

# Legal Commentary

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## A New Era for Regulatory Margins for Derivatives Transactions

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### Overview and background

Following the economic and financial crisis in 2007, in view of the significant weakness in the resiliency of banks and other market participants to financial and economic shocks, in particular from over-the-counter (OTC) derivatives transactions, the Group of Twenty (G20) agreed on the necessity of improved transparency in the OTC derivatives markets and further regulation of OTC derivatives, and initiated a reform programme in 2009 to reduce the systemic risk from OTC derivatives which comprise of the following four elements:

- All standardised OTC derivatives should be traded on exchanges or electronic platforms, where appropriate.
- All standardised OTC derivatives should be cleared through central counterparties (CCPs).
- OTC derivatives contracts should be reported to trade repositories.
- Non-centrally cleared derivatives contracts should be subject to higher capital requirements.

In 2011, the G20 agreed to add margin requirements on non-centrally cleared derivatives to the reform programme, and the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) were called upon to develop consistent global standards for these margin requirements. After several rounds of consultations and revisions, the final margining framework for non-centrally cleared derivatives set out in the *Margin Requirements for Non-centrally Cleared Derivatives* (《非集中清算衍生品保证金要求》) (“**Global Margining Framework**”) were released by BCBS and IOSCO on 4 April 2020.

To implement the Global Margining Framework in China, the National Financial Regulatory Administration (NFRA) released the *Administrative Measures on Margins for Non-centrally Cleared Derivatives Transactions of Financial Institutions* (《金融机构非集中清算衍生品交易保证金管理办法》) (“**NFRA Margin Rules**”) on 6 January 2025, which will come into effect on 1 January 2026.

We set out below the key requirements under the NFRA Margin Rules and potential implications for Covered Entities (as defined below) and their counterparties, also taking into consideration the comparison between the NFRA Margin Rules and the Global Margining Framework.

## Key requirements under the NFRA Margin Rules

### I. IM vs VM

The NFRA Margin Rules establish a comprehensive framework for initial margin (**IM**) and variation margin (**VM**), which is generally consistent with the requirements under the Global Margining Framework. We have prepared a summary of key regulatory requirements around IM and VM with reference articles under the NFRA Margin Rules in the table below.

Item and Ref. article	IM	VM
Purpose	IM protects the trade parties from the potential future exposure that could arise from future changes in the mark-to-market value of the contract during the time it takes to close out and replace the position in the event that one or more counterparties default. The amount of IM reflects the size of the potential future exposure. It depends on a variety of factors, including how often the contract is revalued and VM exchanged, the volatility of the underlying instrument, and the expected duration of the contract closeout and replacement period, and can change over time, particularly where it is calculated on a portfolio basis and transactions are added to or removed from the portfolio on a continuous basis.	VM protects the trade parties from the current exposure that has already been incurred by one of the parties from changes in the mark-to-market value of the contract after the transaction has been executed. The amount of VM reflects the size of this current exposure. It depends on the mark-to-market value of the derivatives at any point in time and can therefore change over time.
Calculation frequency (Art. 12, 13)	IM shall be calculated based on the netting set at the end of a business day, and shall be calculated at least every 10 days and be recalculated in the event of a change in the netting set, including, but not limited to, the initiation of a new transaction, the termination of an existing transaction, or the expiration of an existing transaction in such netting set.	VM shall be calculated on at least daily basis and based on the netting set at the end of a business day.
	While the NFRA Margin Rules do not provide for the definition of netting set, Covered Entities may take reference to the <i>Rules on the Measurement of Credit Risk-weighted Assets of Counterparties</i> , Annex 9 to the <i>Administrative Measures for the Capital of Commercial Banks</i> (《商业银行资本管理办法》附件九《交易对手信用风险加权资产计量规则》), where the netting set shall refer to the collection of all transactions between a commercial bank and a single counterparty under the same valid netting agreement, e.g., ISDA Master Agreement, NAFMII Master Agreement, or SAC Master Agreement.	
Timing of margin call (Art. 12, 13)	A margin call notice shall be issued by close of business ( <b>COB</b> ) on the next business day following the valuation date, with the margin exchange completed by COB on the second business day following the issuance of the notice.	

Item and Ref. article	IM	VM
Margin exchange (Art. 12, 13)	IM must be exchanged by transacting parties on a gross basis and there should be no offsetting of IM exchanged between transacting parties.	VM is exchanged by transacting parties on a net basis and shall be provided by the estimated loss-making party to the estimated gain-making party.
Methodologies for margin calculation (Art. 14, 15, 26)	<p>The required amount of IM may be calculated by reference to either (x) a standardised margin schedule (标准法), which is set forth in Annex 1 to the NFRA Margin Rules and consistent with the calculation methodology under the Global Margining Framework; or (y) a quantitative portfolio margin model (模型法), the setting and governance requirements of which are set forth in Annex 2 to the NFRA Margin Rules. When IM is calculated by reference to a quantitative portfolio margin model, such model must be approved by NFRA or its local office.</p> <p>Covered Entities under the NFRA Margin Rules may apply different methodologies for IM calculation for different asset classes, but the methodology must be consistent for the same asset class within the same netting set, and they are not allowed to switch between model- and schedule- based margin calculations in an effort to “cherry pick” the most favourable IM terms.</p> <p>Transacting parties shall agree on the methodology before the onset of the transaction.</p>	There is no pre-determined methodology for VM calculation. Transacting parties shall agree on the methodology before the onset of the transaction.
Threshold (Art. 16)	<p>No more than RMB 400 million (or its equivalent in foreign currency). The IM actually exchanged between transacting parties should subtract the threshold amount as agreed by them. The Global Margining Framework provides a threshold amount of no more than €50 million.</p> <p>The threshold shall be applied at the level of the consolidated group to which the threshold is being extended and the consolidated group which is extending the threshold. It is yet to be clarified by NFRA on (x) how the “consolidated group” should be interpreted, in particular for foreign-funded banks in China, whether the consolidated group should take into account their parents and affiliates in other jurisdictions; and (y) how asset management</p>	Zero threshold, i.e., all Covered Entities that engage in non-centrally cleared derivatives must exchange, on a bilateral basis, the full amount of VM on a regular basis.

Item and Ref. article	IM	VM
	<p>products should be consolidated.</p> <p>Under the Global Margining Framework, the consolidated group should extend to parents and affiliates across all jurisdictions, and asset management products managed by an investment advisor/manager shall be considered distinct entities that are treated separately when applying the threshold as long as the products are not collateralised by or are otherwise guaranteed or supported by other products or the investment advisor/manager in the event of product insolvency or bankruptcy.</p>	
<p>Minimum transfer amount (Art. 16)</p>	<p>No more than RMB 4 million, which may be allocated between IM and VM. Only when the transfer amount required from the transferor exceeds the minimum transfer amount as agreed between the transferor and transferee, will the transferor be obliged to transfer such transfer amount to the transferee.</p> <p>The Global Margining Framework provides a minimum transfer amount of no more than €500,000.</p>	

## II. Scope of Covered Entities

The Global Margining Framework provides that non-centrally cleared derivatives transactions between two covered entities are governed by the margin requirements thereunder, and covered entities include all financial firms and systemically important non-financial firms; central banks, sovereigns, 11 multilateral development banks, the Bank for International Settlements, and non-systemic non-financial firms are not covered entities.

However, the NFRA Margin Rules shall only govern the non-centrally cleared derivatives to which at least one counterparty is one of the following NFRA regulated financial institutions or products (each a “**Covered Entity**” and collectively the “**Covered Entities**”):

1. Banking financial institutions, which shall include legally established commercial banks, urban and rural credit cooperatives, policy banks, and other financial institutions that absorb public deposits according to Article 2 of the *Interim Measures for the Administration of Derivatives Trading by Banking Financial Institutions* (《银行业金融机构衍生产品交易业务管理暂行办法》) (“**Interim Measures**”). Foreign bank branches and subsidiary banks are included within the scope of banking financial institutions, thus are also Covered Entities under the NFRA Margin Rules;
2. Insurance financial institutions, which shall include insurance groups (holding companies), insurance companies, and insurance asset management companies, according to Article 2 of the *Measures for the Participation of Insurance Funds in Financial Derivatives Trading* (《保险资金参与金融衍生产品交易办法》);
3. Financial holding companies approved by People’s Bank of China (**PBoC**); and
4. Asset management products issued by the entities listed in 1 to 3 above.

Notably, the NFRA Margin Rules do not apply to non-centrally cleared derivatives between non-NFRA regulated financial institutions (i.e., financial institutions regulated by the China Securities Regulatory Commission (**CSRC**) such as securities firms, futures firms, mutual fund managers, etc., or their managed asset management products) and/or non-financial institutions.

### III. Coverage of transactions subject to the margin requirements and exemptions

The Global Margining Framework provides that, except for physically settled FX forwards and swaps, the margin requirements shall apply to all non-centrally cleared derivatives, provided that:

1. The BCBS and IOSCO recognize that VM requirement for physically settled FX forwards and swaps is a common and established practice among significant market participants, and helps in limiting the build-up of systemic risk;
2. IM requirements for cross-currency swaps do not apply to the fixed physically settled FX transactions associated with the exchange of principal of cross-currency swaps; and
3. Derivatives for which a firm faces no (i.e. zero) counterparty risk require no IM to be collected and may be excluded from the IM calculation.

The NFRA Margin Rules have also incorporated the above exemptions, and all non-centrally cleared derivatives to which at least one counterparty is a Covered Entity shall be subject to the margin requirements (including both IM and VM requirements) under the NFRA Margin Rules, provided however the following exemptions shall apply:

#### 1. Physical settlement

Physically settled FX forwards and swaps, and physically settled gold forwards and swaps may not apply the IM requirements, and the exchange of fixed principal of physically settled cross-currency swaps may be excluded from the IM calculation.

#### 2. No counterparty risk

Derivatives for which a firm faces zero counterparty risk may be excluded from the IM calculation, e.g., an option writer faces no counterparty risk in front of the option purchaser so long as the option premium has been paid in full by the option purchaser, while from the option purchaser's perspective, the option purchaser still faces counterparty risk in front of the option writer, so the option writer and the option purchaser shall implement different IM calculation for the same option transaction.

#### 3. Counterparty not being a Covered Entity

For non-centrally cleared derivatives between a Covered Entity and a non-Covered Entity, the Covered Entity is only obliged to collect IM and VM from the counterparty, but is not obliged to post IM and VM to the counterparty.

#### 4. AANA below threshold

##### ■ Exemption of IM requirements for any Covered Entity and its counterparty

Subject to the phase-in implementation of the IM requirements discussed in Section 4 below, any

Covered Entity and its counterparty will not be subject to the IM requirements if such Covered Entity and its counterparty, each of which belongs to a group whose month-end aggregate average notional amount (“AANA”) of non-centrally cleared derivatives for March, April, and May of the most recent year does not reach the relevant threshold.

■ **Exemption of both IM and VM requirements for any Covered Entity transacting with non-financial institutions**

Any Covered Entity will not be subject to the IM or VM requirements if its non-financial institution counterparty belongs to a group whose month-end AANA of non-centrally cleared derivatives for March, April, and May of the most recent year does not reach RMB60 billion.

**5. Transactions for hedging purpose**

■ **Transacting with non-financial institution counterparty**

Any Covered Entity and its non-financial institution counterparty can be exempted from the IM and VM requirements where the non-centrally cleared derivatives between them are (x) compatible with the risk-tolerance capacity of the non-financial institution counterparty and (y) carried out with genuine risk-hedging needs.

In practice, as required under applicable laws, e.g., Article 45 of the Interim Measures, commercial banks are required to carry out derivatives trading with clients that have actual needs and transaction backgrounds, and the derivatives trading must be compatible with the clients’ risk-tolerance capabilities, therefore commercial banks should be able to rely on this exemption for their derivatives trading with corporate clients, regardless of the AANA discussed in subparagraph (4) above.

That said, it is yet to be clarified by NFRA on the scope of the non-financial institutions mentioned above, in particular whether private fund managers would be included. For private funds managed by private fund managers, they are generally permitted to trade derivatives for either risk hedging purpose or asset allocation purpose, thus whether private fund managers can rely on this exemption would be uncertain.

■ **Transacting with finance company of a corporate group**

Any non-centrally cleared derivatives carried out by a finance company of a corporate group on behalf of the group and group members with genuine risk-hedging needs shall be exempted from IM and VM requirements.

**6. Sovereign entities**

The IM and VM requirements are exempted for non-centrally cleared derivatives between Covered Entities and central banks, government organisations, public sector entities, multilateral development banks, the Bank for International Settlements, or China’s policy banks; and

**7. Intragroup trading**

The non-centrally cleared derivatives between entities that are included in the same consolidated

financial statements of a group shall be exempted from both IM and VM requirements.

#### **IV. Phased-in implementation of margin requirements**

In alignment with the Global Margining Framework, the margin requirements under the NFRA Margin Rules are also implemented on a phased-in basis so that the systemic risk reductions and incentive benefits are appropriately balanced against the liquidity, operational and transition costs associated with implementing the margin requirements.

Specifically, the VM requirements will be put into practice from 1 September 2026, and the IM requirements will be phased in over 3 stages as follows:

- From 1 September 2027: any Covered Entity and its counterparty, each of which belonging to a group whose month-end AANA of non-centrally cleared derivatives for March, April, and May of the most recent year exceeds RMB500 billion, will be subject to the IM requirements;
- From 1 September 2028: any Covered Entity and its counterparty, each of which belonging to a group whose month-end AANA of non-centrally cleared derivatives for March, April, and May of the most recent year exceeds RMB300 billion, will be subject to the IM requirements; and
- From 1 September 2029: any Covered Entity and its counterparty, each of which belonging to a group whose month-end AANA of non-centrally cleared derivatives for March, April, and May of the most recent year exceeds RMB60 billion, will be subject to the IM requirements.

After each relevant implementation date, where the AANA falls below relevant threshold above, the IM requirements shall cease to apply from the 1 September of that year, until the AANA reaches relevant threshold again then the IM requirements shall resume to apply.

When calculating the AANA, —

- All non-centrally cleared derivatives should be included, including the physically settled FX forwards and swaps, and physically settled gold forwards and swaps; and
- Similar with the application of threshold at the group level as discussed in Section 1 above, it is yet to be clarified by NFRA how to interpret the scope of “group” for the purpose of calculating the AANA, e.g., whether the notional amounts of non-centrally cleared derivatives to which the parents and offshore affiliates of foreign-funded Covered Entities in China are parties should be included. It is notable that under the Global Margining Framework, the group shall comprise group members across all jurisdictions.

#### **V. Transitional arrangement for new transactions and existing transactions**

Subject to the phase-in implementation of the margin requirements discussed in Section 4 above, the IM requirements shall apply to new transactions on or after the phased implementation date of IM requirements, and the VM requirement shall apply to new transactions on or after 1 September 2026.

NFRA further clarifies that the existing transactions, and confirmation or non-substantial amendments to existing transactions do not qualify as a new transaction, and any substantial amendments to



existing transactions or any amendment that is intended to extend an existing transaction for the purpose of avoiding margin requirements will be treated as a new transaction. For existing transactions, parties thereto may also, within their discretion, apply margin requirements.

## **VI. Eligible collateral**

According to Article 18 of the NFRA Margin Rules, eligible collateral to satisfy the IM and VM requirements include:

1. Cash;
2. Government bonds issued by China's Ministry of Finance, bills issued by the PBoC, and bonds and bills issued by China's policy banks;
3. Bonds issued by China's provincial people's governments (including autonomous regions and direct-administered municipalities) and cities under separate state planning;
4. High-quality bonds issued by other national or regional governments and their central banks, sovereign-equivalent public sector entities, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Union, the European Stability Mechanism and the European Financial Stability Mechanism, and multilateral development banks;
5. High-quality corporate credit bonds;
6. High-quality financial bonds;
7. Gold; and
8. Other eligible collateral recognized by NFRA.

Compared to the Global Margining Framework, equities included in major stock indices are not enlisted as eligible collateral, even though the Covered Entities and their counterparties may seek separate approval from NFRA for using other types of assets as eligible collateral. The NFRA Margin Rules further require Covered Entities to prudently evaluate the risk mitigating effect of collateral to ensure compliance with their internal risk management requirements when using other types of assets as collateral.

## **VII. Management of provided collateral and margins**

The NFRA Margin Rules provide several management requirements in terms of the provided collateral and margins as follows:

### **1. Application of haircut**

Consistent with the Global Margining Framework, the collected collateral, should, after accounting for an appropriate haircut, be able to hold their value in a time of financial stress. Accordingly, Article 19 of the NFRA Margin Rules requires Covered Entities to use either (x) the standardised haircuts set forth in Annex 3 to the NFRA Margin Rules; or (y) internal or third-party haircut calculation models, which must be approved by NFRA or its local office, to calculate the value of collected collateral. The choice of haircut calculation should be consistent across the same type of collateral.



## 2. Management of collateral risk

### ■ FX risk

The Global Margining Framework requires that, in addition to having good liquidity, eligible collateral should not be exposed to excessive credit, market and FX risk. To address the potential excessive FX risk, Article 20 of the NFRA Margin Rules requires Covered Entities to apply extra FX haircut in the case of differences between the currency of the collateral asset and the termination currency of relevant transactions or the base currency in the relevant collateral document.

### ■ Concentration risk

The Global Margining Framework provides that accepted collateral should be reasonably diversified. Article 20 of the NFRA Margin Rules thus requires Covered Entities to ensure that collected collateral is not overly concentrated in the same issuer, same type of issuers or same asset class, and to have policies in place to manage the concentration risk of non-cash collateral. High-quality bonds issued by sovereign and sovereign-equivalent public sector entities, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Union, the European Stability Mechanism and the European Financial Stability Mechanism, or multilateral development banks are exempted.

### ■ Wrong way risk (错向风险)

Consistent with the Global Margining Framework, Article 20 of the NFRA Margin Rules requires Covered Entities to avoid using collateral as margin that exhibit a significant correlation with the creditworthiness of the counterparty or the value of the underlying non-centrally cleared derivatives portfolio in such a way that would undermine the effectiveness of the protection offered by the margin collected. Specifically, marketable securities issued by the counterparty or by institutions the financial statements of which are consolidated into the same group as the counterparty shall not be used as margin.

## 3. Substitution of collateral

Article 21 of the NFRA Margin Rules permits the substitution of collateral, provided that the alternative collateral must meet the conditions for eligible collateral, and the value of the alternative collateral, after the application of haircuts, must be sufficient to meet the margin requirement.

## 4. Segregation of provided IM

The Global Margining Framework provides that IM collected should be held in such a way as to ensure that (i) the margin collected is immediately available to the collecting party in the event of the counterparty's default, and (ii) the collected margin must be subject to arrangements that protect the posting party to the extent possible under applicable law in the event that the collecting party enters bankruptcy. Accordingly, to achieve the effect of bankruptcy remoteness of the IM, Article 22 of the NFRA Margin Rules requires that, collateral used as IM shall be custodied by a qualified third-party custodian, and shall be effectively segregated from the proprietary assets of the parties to the transaction, proprietary assets of the third-party custodian and the collateral of other counterparties

under their management.

In practice, to ensure the bankruptcy remoteness of the IM collected and to ensure the immediate availability of the IM, the IM will be exchanged by way of creating security interest (as opposed to absolute title transfer).

There is no segregation requirement for the VM, so the VM collected can either be managed by the parties to the transaction themselves or be entrusted to a qualified third-party custodian. Accordingly, in practice, the VM are normally exchanged on a title transfer basis.

### **5. Rehypothecation, repledge and reuse of provided margins**

Article 25 of the NFRA Margin Rules provides that the provided IM shall, in principle, not be rehypothecated, repledged or reused, and the provided VM can be rehypothecated, repledged or reused.

NFRA does not provide further guidance on what would constitute an exception to the principle of prohibition of rehypothecation, repledge and reuse of provided IM. The Global Margining Framework provides that cash and non-cash collateral collected as IM from a customer may be re-hypothecated, re-pledged or re-used to a third party only for purposes of hedging the IM collector's derivatives position arising out of transactions with customers for which IM was collected and it must be subject to conditions that protect the customer's rights in the collateral, to the extent permitted by applicable national law. In this context, customers should only include "buy-side" financial firms as well as non-financial entities, but shall not include entities that regularly hold themselves out as making a market in derivatives, routinely quote bid and offer prices on derivative contracts and routinely respond to requests for bid or offer prices on derivative contracts. We trust NFRA will permit similar exception.

## **VIII. Report on disputes over margins**

Article 28 of the NFRA Margin Rules provides a new regulatory requirement that Covered Entities should record the duration of disputes over margins, the counterparties and the disputed amount. Where a margin dispute with a single counterparty remains unresolved for more than 15 business days, and the disputed amount exceeds RMB 100 million (or its equivalent in other currencies), Covered Entities should clarify the reporting line through internal management rules.

## **IX. Cross-border applicability**

NFRA appreciates that different jurisdictions have their own regulatory margin requirements for non-centrally cleared derivatives, and a Covered Entity could be subject to different set of regulatory margin regimes at the same time due to the counterparty to the cross-border derivatives transactions or the home jurisdiction of its parent. To address potential conflicts, Articles 29 and 30 of the NFRA Margin Rules provides the followings:

### **1. Application of equivalent or more prudent margin requirements**

Where a Covered Entity conducts cross-border non-centrally cleared derivatives and is subject to margin requirements of a foreign jurisdiction, such Covered Entity may choose to apply the margin

requirements of that foreign jurisdiction, provided that such margin requirements are consistent with the Basel margin requirements and are equivalent to, or are more prudent than those under the NFRA Margin Rules.

## 2. Foreign branches of Covered Entities

The foreign branches of Covered Entities may apply the margin requirements in the jurisdiction where they are located when conducting non-centrally cleared derivatives.

## 3. Foreign institutions transacting in China

Foreign institutions conducting non-centrally cleared derivatives transactions directly in the domestic financial market in China shall comply with the relevant requirements for onshore transactions.

## 4. No legally enforceable netting agreement or collateral agreement

If netting agreements or collateral agreements are not legally enforceable in the jurisdiction of foreign institution counterparties with which a Covered Entity conducts non-centrally cleared derivatives transactions, such Covered Entity may not exchange margins with such foreign institution counterparties, and the notional amount of non-centrally cleared and uncollateralized derivatives transactions between such Covered Entity and all the counterparties in that jurisdiction should not exceed 2.5% of the total outstanding notional amount of derivatives transactions carried out by the group to which such Covered Entity belongs.

## X. Documentation

The NFRA Margin Rules do not specify the documentations that should be used to document the exchange of margins. On 14 September 2024, the National Association of Financial Market Institutional Investors (NAFMII) released the consultation draft of the *Title Transfer Type Performance Assurance Document (Variation Margin) for Financial Derivatives Transactions in CIBM* (《中国银行间市场金融衍生产品交易转让式履约保障文件(变动保证金)征求意见稿》) (“VM PAD”) to solicit comments among a small group of market participants. The VM PAD is equivalent to the VM CSA in the context of ISDA documentations, and would constitute a confirmation under the NAFMII Master Agreement, and the transaction contemplated under the VM PAD would constitute a transaction under the NAFMII Master Agreement as well, which will be included in the scope of close-out netting regime applicable to all transactions under the single agreement. Upon the finalization of the VM PAD, Covered Entities may use the VM PAD to document the exchange of VM with their counterparties.

NAFMII also mentioned in the drafting notes to the VM PAD that they will release the documents for IM exchange at a later stage.

## Outlook

The promulgation of the NFRA Margin Rules marks a significant milestone in the implementation of the regulatory margin framework in China, and will help align the China market with international practice.

However, there are still several uncertainties around the NFRA Margin Rules that need further clarification

by NFRA, such as the definition and scope of “group”, “non-financial institution”, how the asset management products should be treated for the purpose of IM and VM requirements applicable at the group level, etc. Also, the regulatory framework for non-NFRA regulated financial institutions is pending CSRC’s further action, and it is yet to be seen how these two regulatory frameworks would interact with each other.

Han Kun will closely monitor any progress in the regulatory margin regimes and keep clients posted.

## ***Important Announcement***

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