

Intermediaries

Our regulation of intermediaries commences with the licensing of those who we determine to be fit and proper for the regulated activity or activities they plan to conduct. We then monitor their financial soundness and ensure that their conduct and activities comply with the relevant ordinances, codes and guidelines. Our supervisory approach and scope evolve with market developments over time. As such, global economic instability and the failure of a global institution continued to shape our monitoring priorities last year.

Licensing

Expansion of our licensing regime

In response to global moves to intensify the regulation of CRAs, a regulatory regime governing CRAs came into effect in Hong Kong on 1 June 2011. Under the new regime, both CRAs and their rating analysts conducting the business of providing credit rating services in Hong Kong, are obliged to acquire Type 10 licences from us and are subject to our ongoing supervision. This expansion of our regulatory role coincided with similar developments in a number of other jurisdictions following international recognition of the need to more clearly define the obligations of CRAs and to enhance supervision of their activities. In the period leading up to 1 June 2011, we worked closely with the five CRAs operating in Hong Kong and succeeded in avoiding any interruption to their operations by issuing licences to them, and to their 156 rating analysts, on that day.

Granting more licences

Despite global economic uncertainty, licence applications from local and overseas intermediaries registered significant growth, bringing the total number of SFC licensees to a record high of 39,590 as at 31 March 2012.

The hedge fund industry in Hong Kong continued to expand during the year. The number of licensed hedge fund managers/advisers increased by 9% to reach an historical high of 354 as at 31 March 2012, underscoring Hong Kong's attraction as an international financial centre with a favourable business environment for the hedge fund industry.

In 2011, five banks that had been conducting sponsor work in Hong Kong decided to transfer this activity to licensed corporations within their respective groups. The process was largely completed by 31 March 2012. As a consequence of this reorganisation, approximately 630 individuals who were previously responsible for the conduct of sponsor work within these banks as executive officers and relevant individuals, have recently been licensed by us as responsible officers and representatives accredited to licensed corporations.

Enhancing licensing efficiency

The SFC Online Portal was launched in September 2009, permitting our licensees to have online access to their information and to submit their annual returns and notifications online. Subsequently, the payment of annual fees was able to be made online. In November 2011, the functions of the SFC Online Portal were further enhanced to permit the online submission to us of all types of licensing applications and the electronic payment of all licensing related fees. As at 31 March 2012, approximately 95% of licensed corporations, registered institutions and licensed individuals had activated their portal accounts.

In response to difficult market conditions and the unclear outlook and to lessen the regulatory cost burden on the industry, we waived the annual licensing fees for intermediaries for two years starting from April 2012.

Supervision

Supervising by inspections, stress tests

We conducted 252 risk-based inspections of licensed corporations at their premises last year. The financial soundness of individual firms and their custody of client assets, amongst other risk areas, have been our focus in many of our inspections. Some inspections covered specific areas of regulatory compliance across different firms, such as, the anti-money laundering regulations, selling practices requirements and conduct requirements for fund managers.

The European debt crisis raised market volatility, which might expose licensed corporations to higher financial risks. We also assessed the financial risk exposure of licensed corporations by conducting stress tests and analysing the reported risks. A cross-unit taskforce was set up to consider issues arising from the crisis. To prepare for the eventuality that the European sovereign debt problem worsens, the taskforce conducted desktop contingency rehearsals under hypothetical scenarios. We also shared information with the Hong Kong Monetary Authority (HKMA) regarding those licensed corporations affiliated with banking groups that may have exposure to European sovereign debts.

Managing closure of MF Global

On 1 November 2011, immediately after cessation of operation of MF Global Group, we took prompt action to preserve assets of clients by issuing a restriction notice to MF Global Hong Kong Ltd. We needed to act quickly to achieve an orderly resolution of the outstanding clients' positions and settlement obligations. We directed the company to take all necessary steps to preserve the integrity of clients' assets. On 2 November 2011, the court appointed provisional liquidators to take charge. We maintained close dialogue with the provisional liquidators, who obtained the court's sanction in December 2011 for an interim distribution of clients' funds.

In addition, we monitored the risks arising from the failure of MF Global Group with a view towards minimising the impact on Hong Kong investors and the local market.

Promoting compliance

During the year, we implemented the following initiatives to oversee the conduct of licensed corporations:

- Placing great emphasis on the industry's compliance with the selling practices requirements, the SFC and HKMA conducted a mystery shopping programme, focusing on various areas, including the "know-your-client" procedures, product features explanation and risks disclosure as well as suitability assessment. Deficiencies identified in the selected licensed corporations during the programme included:
 - insufficient understanding of the recommended products;
 - inadequate/inaccurate explanation of the features and/or disclosure of risks of the products;
 - inaccurate verbal representation of the SFC's requirements or practices; and
 - failure to take into account all the relevant personal circumstances of a client when making the suitability assessment.

Detailed findings of the programme regarding the securities sector were published in May 2011. Licensed corporations were reminded to review critically their systems and controls in light of the findings to ensure full compliance with the relevant regulatory requirements. We will continue to use the programme from time to time to help assess licensed corporations' compliance with the selling practices requirements.

- We published new guidelines to assist licensed corporations to comply with the requirements of the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance applicable to specified financial institutions. The ordinance came into effect on 1 April 2012. Developed with industry engagement and in collaboration with other authorities, the new guidelines assist licensed corporations and associated entities in designing and implementing appropriate and effective policies, procedures and controls so as to comply with the relevant legal requirements and/or other applicable regulatory requirements. To enhance implementation readiness, we conducted training seminars for more than 1,100 industry professionals.
- To support the implementation of the proposed regulatory reform on OTC derivatives, we are conducting a review to update the capital requirements related to OTC derivatives under the Securities and Futures (Financial Resources) Rules, with reference to the international standards. We will consult the public on the subject in 2012.