

## Intermediaries

Our gatekeeping functions include setting standards and qualifying criteria for corporations and individuals licensed to operate in our markets under the Securities and Futures Ordinance (SFO). As part of our ongoing supervision, we conduct on-site inspections and off-site monitoring of licensed corporations (LCs)<sup>1</sup> and explain our regulatory focus and concerns to the industry. We closely monitor market and technological developments and adapt our approach accordingly.

### Licensing

As of 31 March 2021, the number of licensees and registrants remained steady at 47,178 as compared to last year, including the number of LCs which increased 2% to 3,159. During the year, we approved 177 new corporate licence applications. We received a total of 5,575 new licence applications, down 20% from the previous year.

### Competency framework

In December 2020, we consulted the public on proposed enhancements to the competency framework, including updating the entry requirements for corporations and individuals as well as the ongoing competency and training standards for individual practitioners. The consultation period ended in February 2021 (see sidebar below).



Ms Julia Leung, Deputy Chief Executive Officer and Executive Director, Intermediaries, at the Asian Financial Forum 2021

### Virtual assets

In December 2020, we granted the first licence to a virtual asset (VA) trading platform in Hong Kong. It only serves professional investors under our close supervision and is subject to tailor-made requirements which are comparable to those which apply to securities brokers and automated trading venues. We are considering other applications (see sidebar on page 49).

In May 2021, the Financial Services and the Treasury Bureau concluded a public consultation on a new legislative framework under which we would regulate all centralised VA exchanges, including those which only trade types of VAs which currently fall outside our jurisdiction.

### Updating the competency framework

To ensure the competency framework keeps up with the changing regulatory landscape and the development of new financial products, we proposed updates and enhancements in a consultation launched in December 2020.

Key proposals included raising the minimum academic qualification requirements, recognising a broader range of qualifications, allowing applicants more flexibility for meeting the industry qualification and regulatory examination requirements and enhancing

the continuous professional training requirements. To address our concerns about the quality of work performed by some financial advisers on matters regulated by the Codes on Takeovers and Mergers and Share Buy-backs, competence requirements would be upgraded for individuals who are to advise on these matters.

To adopt a balanced approach when formulating the proposals, we consulted stakeholders including the Academic and Accreditation Advisory Committee, the Hong Kong Monetary Authority (HKMA) and various industry associations.

<sup>1</sup> Broadly, LCs include securities brokers, futures dealers, leveraged forex traders, fund managers, investment advisers, sponsors and credit rating agencies.

## Family offices

Further to a January 2020 circular which discussed how our licensing regime applies to family offices, we published a set of frequently asked questions (FAQs) in September 2020 to provide additional guidance on the implications of the licensing regime for both single and multi-family offices and also participated in industry seminars to clarify regulatory issues. We received a number of new licence applications and enquiries from operators of family offices.

## Annual licensing fee waiver

In view of current market conditions, we waived the annual licensing fees for all intermediaries and licensed individuals for the 2021-22 financial year. This measure will help the industry save approximately \$230 million.

## Prudential risks

### Securities margin financing

Markets remained volatile over the past year as concerns grew about the economic impact of COVID-19. Share prices of some stocks, particularly those with small market capitalisation, plummeted within a short period of time. Our review of securities

margin financing risks indicated that, following the implementation of the new margin financing guidelines in October 2019, brokers were more aware of these risks and remained generally resilient even in times of extreme market volatility. We also performed stress tests to gauge the financial exposure of brokers, especially those engaged in securities margin financing, to assess their financial resilience and monitor their settlement status.

### Liquidity risk management

We conducted inspections of selected public and private fund managers with a focus on whether their risk management frameworks could enable them to act as required to meet liquidity demands under unexpected or stressed market conditions, including their use of special liquidity management tools to deal with significant redemption requests arising from market fluctuations and liquidity crunches. We also reviewed how fund managers regularly monitor and assess funds' liquidity profiles, conduct stress testing and design stress scenarios.

## Licensees

	Corporations <sup>^</sup>		Representatives		Responsible Officers			Total <sup>^</sup>	
	As at 31.3.2021	As at 31.3.2020	As at 31.3.2021	As at 31.3.2020	As at 31.3.2021	As at 31.3.2020	As at 31.3.2021	As at 31.3.2020	Change
Stock exchange participants	595	604	11,931	12,208	2,157	2,196	14,683	15,008	-2.2%
Futures exchange participants	108	113	839	870	192	200	1,139	1,183	-3.7%
Stock exchange and futures exchange participants	88	84	4,912	4,862	669	612	5,669	5,558	2%
Non-stock/non-futures exchange participants	2,368	2,308	16,973	16,934	6,231	6,064	25,572	25,306	1.1%
<b>Total</b>	<b>3,159</b>	<b>3,109</b>	<b>34,655</b>	<b>34,874</b>	<b>9,249</b>	<b>9,072</b>	<b>47,063</b>	<b>47,055</b>	<b>-</b>

<sup>^</sup> These figures exclude 115 registered institutions as at 31 March 2021 and 112 as at 31 March 2020.

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### Digitalised licensing process

In December 2020, we previewed new licensing functions on WINGS<sup>a</sup>, our online platform for electronic forms and submission services. The new features include web-based licensing forms, upgraded administration capabilities and electronic signatures.

These functions provide greater convenience for the industry and allow us to better integrate our front-loaded, risk-based approach into our licensing work and prepare for the implementation of a fully digital licensing process later this year.

<sup>a</sup> Web-based INteGrated Service.



We sought views from the industry when developing the new functions and organised three virtual workshops to introduce them to over 1,000

participants from LCs, banks, compliance advisory firms and law firms. Over 70% of intermediaries have activated their new portal accounts since the preview began in December 2020.

### OTC derivatives

In June 2020, we released consultation conclusions on refinements to the regulatory scope of the over-the-counter (OTC) derivatives licensing regime as well as the competence and continuous professional training requirements under the regime. Legislative amendments to implement the refinements are in progress.

Variation margin requirements for non-centrally cleared OTC derivative transactions took effect on 1 September 2020. In view of the COVID-19 pandemic, we aligned the implementation of the initial margin requirements with the revised international timetable<sup>2</sup>. They will now be phased in starting 1 September 2021.

We also deferred the effective date of margin requirements for non-centrally cleared single-stock options, equity basket options and equity index options by three years until 4 January 2024 to align with the European Union's timeline and prevent market fragmentation and regulatory arbitrage.

### Conduct risks

#### Cybersecurity

In a September 2020 report and circular, we summarised the key findings and observations of our cybersecurity thematic review and provided guidance on our expected standards. The report highlighted deficiencies and instances of non-compliance in areas such as two-factor authentication and data encryption. It also included reminders of other requirements and good practices adopted by securities brokers.

In light of the need to introduce remote working arrangements during the pandemic, we issued a circular in April 2020 to remind LCs to assess their operational capabilities and implement appropriate measures to manage the cybersecurity risks associated with these arrangements.

#### Commodity futures brokers

In light of the extreme movements in the prices of crude oil futures, we issued a circular in April 2020 to remind commodity futures brokers to control their risk exposures and warn against opening new positions for clients who do not have sufficient financial capacity to bear the potential losses.

<sup>2</sup> The Basel Committee on Banking Supervision and the International Organization of Securities Commissions announced in April 2020 a one-year extension of the deadlines for completing the final implementation phases.

### Leveraged foreign exchange trading

In April 2020, we issued a report summarising the findings of our survey of LCs’ leveraged foreign exchange trading activities and setting out our expected standards of conduct and internal controls.

### Spread charges

In a joint circular issued with the HKMA in May 2020, we announced a concurrent thematic review to assess intermediaries’ spread charges and their compliance with requirements governing the disclosure of trading capacity and monetary benefits, with a focus on

the distribution of non-exchange traded investment products. We will consider the need to provide further guidance.

### Corporate professional investors

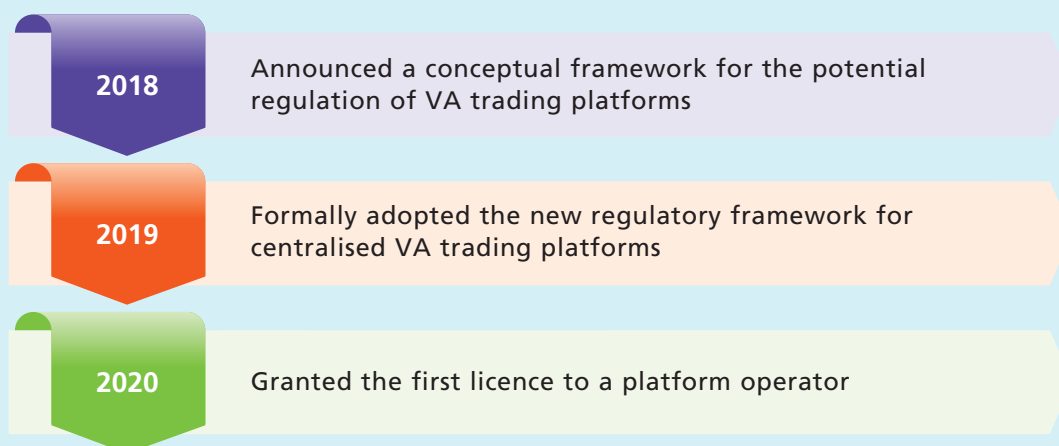
In September 2020, we issued a circular and updated FAQs to provide guidance on assessing the criteria for an intermediary to be exempted from certain Code of Conduct<sup>3</sup> requirements when dealing with corporate professional investors, particularly investment vehicles which are owned by family trusts or offices and managed by professionals.

## Regulation of VA trading platforms

We adopted a new regulatory framework for centralised VA trading platforms in November 2019 as part of our efforts to provide a clear, well-defined regulatory environment to support the development of the Fintech industry.

Licensed VA platforms are required to comply with existing regulatory requirements which are applicable to LCs, such as the competence requirements and fit and proper criteria.

They are also required to observe additional requirements to address specific risks associated with VAs, for example, safe custody of assets, anti-money laundering and prevention of market manipulation as well as criteria for the inclusion of VAs to be traded. Only clients with sufficient product knowledge may be allowed to trade.



<sup>3</sup> Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.

## Intermediaries



### Suitability requirements for complex products

In December 2020, we issued a circular and updated FAQs to provide guidance on how to conduct suitability assessments, explain product risks to clients with different degrees of financial sophistication and comply with the Code of Conduct requirements governing the distribution of complex products.

### Regulatory enhancements

#### Equity and debt capital raisings

We launched a consultation in February 2021 on proposed conduct requirements for equity and debt capital raisings in Hong Kong. The requirements would help clarify the roles played by intermediaries in these transactions and set out the standards of conduct expected of them in book building, pricing, allocation and placing activities. A separate “sponsor coupling” proposal would require that, for an initial public offering of shares, at least one head of syndicate also act as a sponsor which is independent of the issuer.

#### Anti-money laundering

In September 2020, we launched a three-month consultation on proposals to amend our anti-money laundering and counter-financing of terrorism (AML/CFT) guidelines to align with the latest international standards and provide guidance on applying AML/CFT

measures in a more risk-sensitive manner. The proposed amendments also address some areas for enhancement identified in the September 2019 Mutual Evaluation Report of Hong Kong published by the Financial Action Task Force.

In December 2020, we issued a circular to share the findings of our inspections of AML/CFT controls and compliance practices. The circular highlighted several areas to which firms should pay priority attention as well as the roles and responsibilities of their senior management in putting in place effective AML/CFT controls to manage risks effectively and ensure regulatory compliance.

### External electronic data storage

We published FAQs in December 2020 to address industry comments about operational difficulties in implementing the requirements in our October 2019 circular on the use of external electronic data storage. For example, some firms had difficulty obtaining undertakings from overseas external electronic data storage providers. By allowing the use of a Manager-In-Charge undertaking as an alternative, the FAQs address the industry’s feedback without undermining our regulatory objectives and ensure our prompt access to electronic regulatory records stored outside of Hong Kong. The FAQs also facilitate the keeping of electronic regulatory records with overseas affiliates.

### Supervisory approach

We adopt a front-loaded, risk-based approach focusing on the greatest threats and the most significant or systemic risks. Our supervision of LCs focuses on financial risks and how they conduct business. We also closely monitor the operation and risk management of LCs and conduct stress tests particularly in times of extreme market conditions. We provide timely guidance to intermediaries to help them comply with regulatory requirements.

## On-site reviews

On-site reviews are a key supervisory tool for us to understand an LC's business operations, risk management and internal controls and gauge its compliance with legal and regulatory requirements. During the year, we conducted 304 risk-based on-site inspections, including those conducted remotely due to the pandemic, and noted more than 1,300 breaches of the SFC's rules.

# 925

on-site inspections in the past three years

This year's thematic inspections covered AML/CFT, asset managers' liquidity risk management, intermediary misconduct in listed markets, foreign exchange activities, remote booking and operational and data risk management.

## Off-site monitoring

We conduct off-site monitoring by analysing the information in regulatory filings as well as intelligence from other sources. We maintain regular interaction with LCs to assess their financial strength, internal controls and risk management practices.

This year, we conducted a limited survey of selected brokerage groups to understand their liquidity profiles and risk management at the group level. This facilitates our supervision of the financial integrity of the LCs within these groups.

## Breaches noted during on-site inspections

	2020/21	2019/20	2018/19
Internal control weaknesses <sup>a</sup>	515	451	443
Breach of Code of Conduct <sup>b</sup>	262	273	275
Non-compliance with anti-money laundering guidelines	208	331	201
Failure to safekeep client money	35	42	28
Failure to safekeep client securities	28	31	32
Others	302	361	257
Total	1,350	1,489	1,236

a Comprising deficiencies in management review and supervision, operational controls over the handling of client accounts, segregation of duties, information management and adequacy of audit trails for internal control purposes, among other weaknesses.

b Commonly related to risk management, client agreements, safeguarding of client assets and information for or about clients.

Note: See Table 4 in Breakdown of SFC activity data on page 162 for more details.



## Intermediaries

**+17%**

New licensed corporations (2018-2021)

### Financial returns

We updated the financial return form to collect additional financial and risk data to enhance our supervision of LCs. The effective date for the revised form will be 1 January 2022, after enhancements to WINGS are completed (see sidebar on page 48).

### SFC-HKMA joint product survey

Jointly with the HKMA, we launched a new annual survey covering the sale of non-exchange traded investment products by intermediaries. The findings from the survey will help us better understand market trends, identify risks and coordinate responses to address areas of common concern. The survey began with the period from 1 January to 31 December 2020 and its findings will be published later this year.

### Industry guidance

We maintain close communication with the industry and regularly provide guidance through circulars. In survey results and thematic reports, we highlight best practices and our regulatory concerns with actual cases. When introducing a significant regulatory measure, we hold seminars to explain and clarify our policies and expectations.

### Client facilitation

To provide further guidance on the provision of facilitation services to clients in the execution of residual odd lots<sup>4</sup>, we issued FAQs in December 2020

which set out that LCs may pre-arrange standing agreements with clients under certain circumstances and be exempted from the requirement to obtain explicit client consent on a trade-by-trade basis prior to each client facilitation trade.

### Client asset protection

FAQs issued in October 2020 provided guidance to intermediaries on the requirements for client asset acknowledgement letters. Intermediaries were reminded that they should perform due diligence to assess and ensure that client assets held outside Hong Kong are adequately protected by the rules and regulations in the overseas jurisdiction as those assets might fall outside the ambit of the Hong Kong account opening rules.

### Compliance Forum

In October 2020, we organised the SFC Compliance Forum on a virtual platform for 1,200 registrants to exchange views with our senior executives and industry leaders on the risks and opportunities facing the securities industry and capital markets, the management of liquidity, prudential and market risks, AML/CFT, family offices, private wealth management and sustainable finance.



The SFC Compliance Forum 2020 was held virtually

<sup>4</sup> See details in the circulars issued on 14 February 2018 and 14 May 2019.

## Statistical information and financial position of the Hong Kong securities industry

	As at 31.12.2020	As at 31.12.2019	As at 31.12.2018
Securities dealers and securities margin financiers	1,391	1,379	1,312
Active clients	3,207,677	2,024,849	1,874,289
Total assets (\$ million)	1,812,475	1,322,911	1,226,532

(\$ million)	12 months to 31.12.2020	12 months to 31.12.2019	12 months to 31.12.2018
Total value of transactions <sup>^</sup>	129,651,195	85,831,384	89,678,389
Total operating profit	30,904	11,962	23,548

<sup>^</sup> Data were extracted from the monthly financial returns submitted under the Securities and Futures (Financial Resources) Rules by corporations licensed for dealing in securities or securities margin financing.

Note: Also see Table 8 in Breakdown of SFC activity data on page 166 for more details.