Strategic Priorities

Strengthening the integrity and soundness of Hong Kong's securities and futures markets is at the heart of our mission to advance Hong Kong's position as a leading international financial centre. We strive to enhance our regulatory regime and establish closer cooperation with counterparts in Hong Kong, mainland China and overseas. In our daily operations, we seek to enhance efficiency and make optimal use of our resources.

Our approach

One year on, we are moving forward with our "front-loaded" regulatory approach which emphasises earlier, more targeted and systematic intervention to tackle market irregularities and corporate misconduct. This means delivering fast and responsive regulation and maximising the impact of our actions, with a particular focus on the greatest threats and systemic risks. Our new approach has already made an immediate, positive impact on the market.

Applying this approach to intermediary supervision helps promote earlier and more targeted behavioural change. Increasingly, we conduct thematic reviews of high-risk areas in addition to our routine inspections. We also issue more thematic guidance to keep the market informed about our priorities in a transparent manner and ensure that the reasons for our actions are clearly and promptly understood.

As the challenges we face continue to cut across all of our regulatory functions, we now adopt a "One SFC" approach, introducing organisational changes and cross-divisional teams to achieve closer collaboration and better efficiency at an operating level. One example of this is the establishment of "ICE" (Intermediaries, Corporates, Enforcement), a cross-divisional working group to tackle corporate misconduct and protect investors.

Our capital markets are increasingly sophisticated and technology-driven. We deploy resources to keep up with rapid technological innovation and understand how it intersects with our work. New initiatives help us manage evolving risks and analyse data for regulatory purposes. This will be a major theme in the years to come.

Current initiatives

The overall aim of our strategic priorities is to maintain quality markets, protect investors and ensure sustainable market development whilst addressing emerging threats and risks.

Listing matters

In response to changing market conditions and evolving risks, we exercise our statutory powers under the Securities and Futures (Stock Market Listing) Rules (SMLR)[1] and more generally under the Securities and Futures Ordinance (SFO) in the regulation of listing matters to intervene in serious cases at an early stage. This helps protect the investing public and suppress illegal and improper market practices. It also complements our enforcement work aimed at pursuing wrongdoers, seeking remediation and deterring misconduct.

At the policy level, we are conducting a review of listing regulation with The Stock Exchange of Hong Kong Limited (SEHK) to maintain market quality and address problematic listed company behaviour. The review covers regulatory issues relating to GEM[2], capital raisings, backdoor listings, continuing listing criteria and the delisting framework. As a result of this review, SEHK conducted public consultations on Listing Rules amendments[3] and will consult the public on backdoor listings and continuing listing criteria.

[1] Under the SMLR, we may raise objections to listing applications or direct SEHK to suspend trading in a listed company's shares.
[2] Formerly known as the Growth Enterprise Market.
[3] The public consultations cover Listing Rules amendments relating to GEM, capital raisings and the delisting framework.

We also worked with Hong Kong Exchanges and Clearing Limited (HKEX) to introduce a new listing regime allowing the listings of biotechnology companies which do not meet the financial eligibility requirements of the Main Board and innovative and high growth companies with weighted voting rights (WVR) structures. In addition, the new regime creates a new concessionary route for secondary listings to attract innovative companies which are primary-listed elsewhere.

We have adopted an enhanced audit approach to our statutory oversight of SEHK's listing function, including the vetting of initial public offerings, to focus on whether it is discharging its duties under the SFO, whether its systems and processes for performing its listing function are adequate and how well it manages conflicts of interest as a regulator and as part of a for-profit organisation. This approach clearly delineates the roles of the SFC as a regulator and of SEHK and HKEX as regulatees under the SFO. We will publish periodic supervisory review reports as we have done in the past.

Further to the conclusion of the joint SFC-SEHK consultation on proposed enhancements to SEHK's decision-making and governance structure for listing regulation, a new Listing Policy Panel has been set up as an advisory, consultative and steering body outside the SFC and SEHK to initiate and centralise discussions of listing policies with broader regulatory or market implications.

Our cross-divisional "ICE" working group tackles problems affecting the quality of our markets, initially focussed on price volatility in GEM stocks and GEM placings with a high concentration of shareholders. The "ICE" mission has now been broadened to cover more serious instances of misconduct in the listed market. Combining expertise and resources from across the organisation enables us to identify emerging problems and formulate strategies to address them proactively at an early stage.

We are analysing public responses to a consultation on proposed amendments to the Codes on Takeovers and Mergers and Share Buy-backs which ended in April 2018. The proposed changes aim to afford fair treatment for shareholders and protect the interests of those who participate in Hong Kong's securities markets.

Intermediaries

Over the past few years, the number of corporate and individual licensees reached new highs, whilst licensed firms and individuals engaged in more SFC-regulated activities. To achieve better regulatory outcomes, we refined our approach to licensing applications to focus on key risks. We also take a proactive supervisory approach to reducing conduct and prudential risks involving intermediaries and enhancing their governance and accountability.

A study we conducted last year showed that brokers' total margin loans had grown nine times between 2006 and 2017 with a significant deterioration in quality. We are reviewing brokers' securities margin financing business to identify ways to enhance risk management. We also conducted a review to assess the adequacy of large and medium-sized brokers' internal controls over the supervision of account executives who mainly serve retail investors. We will share our observations from these reviews with the industry.

In our daily supervision, we place a great deal of emphasis on senior management accountability to ensure proper conduct. Under the Manager-In-Charge (MIC) regime, more than 10,000 individuals were appointed by licensed corporations as MICs responsible for managing important functions. In addition, firms have taken concrete measures to enhance their governance structures, better delineating responsibilities amongst staff at the local and global levels and aligning the Responsible Officers' regime with the MIC regime. We will review firms' compliance with the MIC regime during inspections.

On the policy side, we have now finalised proposed amendments to the Securities and Futures (Professional Investor) Rules to enhance market transparency and standardise the rules for prescribing professional investors. In May 2018, we concluded a consultation on the disclosure requirements for monetary and non-monetary benefits applicable to discretionary accounts, providing a six-month grace period for implementation. We also consulted the public on changes to the Securities and Futures (Financial Resources) Rules and on the application of suitability and other disclosure requirements to sales of complex products[4] in an offline environment.

The use of instant messaging poses new supervisory and record-keeping challenges and we have provided guidance on the controls and procedures which firms are expected to put in place when receiving clients' orders via instant messaging services.

To more effectively monitor compliance during our inspections of brokers with high turnover, we commenced a data analytics project to develop standards for capturing and storing trading-related data. We also plan to release a revamped Business and Risk Management Questionnaire[5] to enhance our collection of data on licensed corporations' business activities and risk exposures.

Asset management

Developing Hong Kong as an international, full-service asset management centre is one of our key strategic objectives. This is complemented by maintaining robust local regulations which align with international standards.

Over the years, we expanded the potential markets for Hong Kong public funds by entering into Mutual Recognition of Funds (MRF) arrangements with the Mainland, Australia, Malaysia, Taiwan, Switzerland and recently France. They allow Hong Kong's fund industry to tap overseas markets and provide additional investment opportunities for both local and overseas investors. We are exploring similar MRF arrangements with other overseas jurisdictions.

We will publish consultation conclusions on proposed amendments to the Code on Unit Trusts and Mutual Funds to update the regulatory regime for SFC-authorised funds and to address the risks posed by financial innovation and fast-moving market developments. We will also introduce enhanced fund data reporting requirements which will expand the scope, depth and frequency of the data submitted to us by Hong Kong-domiciled, SFC-authorised funds with regard to asset allocation, liquidity and securities financing and borrowing transactions.

For retail funds, we remain focussed on expanding distribution channels and enhancing market infrastructure. For example, we concluded a consultation in March 2018 on proposed Guidelines on Online Distribution and Advisory Platforms which will allow investors more flexibility to manage their investments online whilst providing additional protection for complex products.

We are also working with the China Securities Regulatory Commission (CSRC) and the Mainland and Hong Kong exchanges and clearing houses to broaden our mutual market access arrangements to include exchange-traded funds as eligible securities. In ongoing discussions with HKEX, industry participants and stakeholders, we continue to explore a viable business model for an exchange-based fund distribution platform.

We have been working intensively with the Financial Services and the Treasury Bureau on the introduction of the open-ended fund company (OFC) regime, which will provide the industry with an additional choice of investment fund vehicle. The new regime is expected to take effect in 2018 after the completion of the legislative process and the issuance of an OFC regulatory code.

Markets

We actively engage with Mainland authorities on initiatives which will bring mutual benefits to our markets and ensure the smooth operation of cross-border trading links. Trading via Stock Connect has grown over the past few years and we announced

4 These refer to products whose terms, features and risks are not reasonably likely to be understood by retail investors because of their complex structures.

5 All licensed corporations are required to submit the completed Business and Risk Management Questionnaire to the SFC every year.

increases in the daily quotas in April 2018[6]. We have also been working closely with the CSRC and other parties to widen the scope of Stock Connect, including expanding the coverage of eligible stocks.

The recently concluded SFC-CSRC memorandum of understanding (MoU) to facilitate regulatory and enforcement cooperation in the Mainland and Hong Kong futures markets laid the foundation to develop Hong Kong as a centre for managing exposure to the Mainland market. It recognises the importance of developing appropriate financial instruments and tools for investors in both markets to manage the risks underlying larger two-way capital flows. Through the MoU, we formalised arrangements to enhance supervisory assistance and information exchange on cross-boundary derivatives, futures exchanges and futures brokers.

We are developing an investor identification model for northbound trading under Stock Connect for implementation in the third quarter of 2018. For a similar regime for southbound trading to be introduced later, we will work with HKEX to establish an operational model.

Hong Kong is well placed to serve as Asia's booking hub for derivatives. It is uniquely positioned to host markets for exchange-traded and over-the-counter (OTC) derivatives spanning equities, currency, fixed income and commodities for retail and wholesale risk management.

In line with other markets, an OTC derivatives regime is being implemented in phases in Hong Kong. In July 2017, we concluded a consultation on a proposed regulatory capital regime for licensed corporations engaged in OTC derivatives activities. We launched a joint consultation with the Hong Kong Monetary Authority (HKMA) in March 2018 to introduce trading determination criteria and Phase 2 clearing as well as the use of Legal Entity Identifiers in OTC derivatives trade reporting. Separately, we consulted the market to refine the scope of regulated activities under the OTC derivatives licensing regime. We will consult on margin requirements for non-centrally cleared OTC derivatives in the second quarter of 2018 and amendment rules for implementing OTC derivatives reform at a later stage.

We established a cross-divisional Risk Review Group to identify and assess the opportunities and risks we face as well as to engage with stakeholders to understand the potential business and regulatory implications of new and emerging issues.

Together with HKEX, we are reviewing the Volatility Control Mechanism[7] (VCM) to ensure that it is aligned with international standards and to cope with local market developments. We are also working with key stakeholders to identify the changes needed to implement a paperless securities market and plan to consult on the proposed operational model in 2018.

Enforcement

To protect the interests of the investing public and send strong deterrent messages, we use the full spectrum of sanctions and remedies available to us under the SFO through criminal, administrative, compensatory and disciplinary actions. Under our new "front-loaded" approach, SFC divisions work together closely to tackle increasingly complex regulatory problems as "One SFC" and focus our resources on the most serious enforcement cases which pose the greatest threats to our markets.

We completed a reorganisation of the Enforcement Division and realigned its priorities with those of the SFC as a whole. Corporate fraud remains our top enforcement priority and we will target groups which

6 With effect from 1 May 2018, the new daily quota for each of the northbound trading links is RMB52 billion and the new daily quota for each of the southbound trading links is RMB42 billion.
7 The VCM imposes a price limit for trading in major constituent stocks and futures contracts for short periods under extreme price movements. HKEX introduced the VCM to its cash and derivatives markets in August 2016 and January 2017.

collude to defraud investors. Our work also focuses on insider dealing and market manipulation, intermediary and sponsor misconduct and money laundering. In addition, we pool resources from across the organisation to combat mis-selling of financial products.

We encourage firms to report to us any suspected breaches of rules or regulations. Prompt and complete self-reporting demonstrates the soundness of a firm's internal control systems and helps detect trading misconduct. In enforcement investigations and proceedings, we recognise and reward firms and individuals' cooperation as this helps us investigate more serious legal or regulatory breaches and achieve timely and desirable enforcement outcomes.

We actively encourage the public to assist us with our investigation work by providing information about persons we seek but cannot trace in relation to our inquiries. Our website also provides an online form for the public to report corporate fraud and insider dealing.

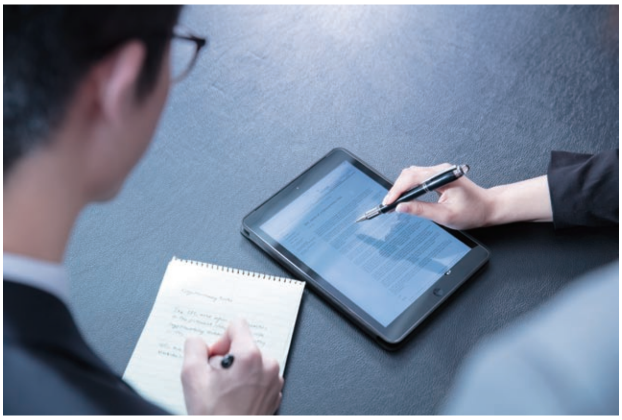
Investors

Protecting investors is one of our main regulatory objectives. To safeguard the interests of investors, we act as a standard setter, a gatekeeper and an enforcer of the laws governing the securities and futures markets.

In the conduct of our day-to-day work, we perform gatekeeping functions in licensing qualified corporations and individuals to ensure that they are fit and proper and authorising investment products offered to the public. We also supervise intermediaries and monitor their compliance with laws and regulatory standards, with a particular focus on their business conduct and financial soundness. We maintain fair and orderly markets for investors through our oversight of listing and takeovers matters as well as our supervision and monitoring of exchanges, clearing houses, share registrars and automated trading services providers. Where appropriate, we take enforcement action to combat misconduct and malpractice in our markets and seek redress for investors.

We maintain a robust regulatory regime for SFC-authorised funds and regularly enhance it to provide investors with appropriate safeguards. To address risks posed by financial innovation and fast-moving market developments, we recently proposed amendments to the Code on Unit Trusts and Mutual Funds to strengthen requirements for key operators, provide flexibility for funds' investment activities with enhanced safeguards and introduce new fund types.

In light of significant investor interest in cryptocurrencies[8] and the use of initial coin offerings (ICOs) to raise funds in Hong Kong, we took regulatory action against a number of cryptocurrency exchanges and ICO issuers and issued two statements alerting investors to their potential risks. We will remain vigilant in policing the market and monitor the latest developments.



As suitability obligations are the cornerstone of investor protection, we introduced new guidelines for online distribution and advisory platforms to provide retail investors with additional protection in relation to complex products. The guidelines also allow more flexibility for investors to manage their investments online.

In recognition of the potential risks to investors associated with WVR structures, there are important safeguards in HKEX's rules for the new listing regime which took effect on 30 April 2018, including the introduction of measures to protect non-WVR holders' right to vote and enhancements to corporate governance and disclosure requirements.

We completed a study of possible enhancements to the investor compensation regime and launched a consultation on proposed changes, including raising the compensation limit per investor in case of broker default, in April 2018.

[8] Cryptocurrencies which are "securities" are subject to the securities laws of Hong Kong and fall within the jurisdiction of the SFC.

Improving financial literacy is essential to equip investors with the necessary knowledge and skills to make well-informed financial and investment decisions. The Investor Education Centre, an SFC-funded subsidiary, provides comprehensive financial information, tools and educational resources to help individuals manage their money wisely.

Technology

The accelerating pace of technological change and increasingly complex financial markets have transformed the way our markets operate, requiring the use of new regulatory technologies to keep pace. We now adopt a more structured approach to monitor market risks and opportunities and gather market intelligence.

During the year, we established the cross-divisional Market Intelligence Programme and a Data Analytics Group to draw on expertise from across the organisation to analyse data for regulatory purposes and address new technological developments.

To facilitate the use of innovative technology in delivering financial services, we launched the SFC regulatory sandbox in September 2017 to enable qualified firms[9] to conduct regulated activities under some licensing conditions.

Regulatory collaboration

In keeping with Hong Kong's status as an international financial centre, it is vital that we work closely and build strong relationships with our regulatory counterparts, locally and around the world, and take an active role in global regulatory initiatives, including through our involvement in global regulatory bodies, information sharing and cooperation arrangements[10].

Led by our Chief Executive Officer Mr Ashley Alder, the Board of the International Organization of Securities Commissions (IOSCO) aims to make IOSCO's work more relevant to its wider membership, promote interaction between members from emerging and developed markets and clarify the intersection between IOSCO's policy work and that of the Financial Stability Board (FSB). Recent discussions within IOSCO have focussed on cryptocurrencies, ICOs, cybersecurity and financial technologies. Mr Alder is also a member of the FSB's Plenary and Steering Committee and our senior staff actively participate in IOSCO's and FSB's committees and working groups.

Locally, we work closely with the HKMA and HKEX on both policy and operational levels. Over the past year, we joined hands with the Independent Commission Against Corruption (ICAC) and the Hong Kong Police in some of our operations. To formalise and strengthen cooperation in combating financial crime, we entered into an MoU with the Hong Kong Police in August 2017 for case referrals and joint investigations as well as the exchange and use of information and the mutual provision of investigative assistance.

As the Mainland and Hong Kong markets integrate, the expansion of cross-border capital flows and intermediary activity must be safeguarded by a strong regulatory partnership. To manage common risks and seek regulatory assistance and enforcement cooperation, we strengthened our relationships with the CSRC and other Mainland regulatory authorities, with whom our regulatory interests are increasingly aligned.

[9] To qualify, a firm must either be a licensed corporation or a start-up firm which intends to carry on a regulated activity. It must be fit and proper, utilise innovative technologies and be able to demonstrate a genuine and serious commitment to carry on regulated activities through the use of financial technologies.

[10] These include developing protocols for joint actions with the ICAC and the Hong Kong Police.