

Operational Review

We endeavour to ensure stability, competitiveness and orderliness in the financial markets through our principal areas of work: intermediaries, investment products, listings and takeovers, market infrastructure and trading, and enforcement.

Intermediaries

We license qualified corporations and individuals to operate as intermediaries 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 corporations¹ and explain our regulatory focus and concerns to the industry. We closely monitor market and technological developments and adapt our approach accordingly.

Licensing

We received 8,294 new licence applications during the year, an increase of 6% from a year earlier. As of 31 March 2018, the number of licensees and registrants totalled 44,358, up 3% from last year, while the number of licensed corporations increased 9% to 2,702 in the same period. These were both record highs since the implementation of the regulatory regime under the SFO on 1 April 2003.

We extended the annual licence fee waiver for one year to 31 March 2019.

Regulatory enhancements

Senior management accountability

The Manager-In-Charge (MIC) regime for licensed corporations was fully implemented on 16 October 2017 following a six-month transition period (see sidebar on page 41).

Also on 16 October 2017, the Hong Kong Monetary Authority (HKMA) issued a circular requiring registered institutions to submit their up-to-date management structure information and organisational charts to both the HKMA and the SFC by April 2018.

¹ Broadly, licensed corporations include securities brokers, futures dealers, leveraged forex traders, fund managers, investment advisers, sponsors and credit rating agencies.

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Suitability obligations

To provide tailored guidance to the industry on the design and operation of online platforms and clarify how the suitability requirement would operate in an online environment, we concluded a public consultation in March 2018 on proposed guidelines for online distribution and advisory platforms. The guidelines will become effective in April 2019. We also launched a further consultation on requirements applicable to the offline sale of complex products.

In a January 2018 circular, we reminded intermediaries of their obligations to comply with the suitability requirement and in particular about the SFC's expected standards for product due diligence, measures to identify whether the suitability obligation has been triggered, assessments of suitability frameworks and the retention of compliance records.

Cybersecurity

To reduce and mitigate hacking risks associated with internet trading, we launched a two-month public consultation in May 2017. Subsequently, we held cybersecurity awareness workshops and presentations for licensed corporations including two workshops co-hosted with the Hong Kong Police and Hong Kong Computer Emergency Response Team Coordination Centre.

Upon concluding the consultation in October 2017, we issued guidelines on cybersecurity baseline requirements, including two-factor authentication for system login, along with a circular on good industry practices for cybersecurity and information technology risk management. The two-factor authentication requirement took effect on 27 April 2018 and other requirements will become effective on 27 July 2018.

Asset managers

Following the publication of consultation conclusions in November 2017, enhancements to asset management regulation in light of international developments will take effect in November 2018 and enhancements to point-of-sale transparency to better address conflicts of interest in the sale of investment products will become effective in August 2018. A further consultation on disclosure requirements applicable to discretionary accounts was concluded in May 2018.

In view of the growing number of firms licensed for asset management activities, we issued circulars in July and September 2017 to highlight irregularities and common instances of non-compliance in managing funds and discretionary accounts. Asset managers were reminded of the SFC's expected standards, including to perform their roles responsibly with due skill, care and diligence, in the best interests of their clients and the integrity of the market.

Licenseses

	Corporations [^]		Representatives		Responsible Officers		Total [^]		
	As at 31.3.2018	As at 31.3.2017	As at 31.3.2018	As at 31.3.2017	As at 31.3.2018	As at 31.3.2017	As at 31.3.2018	As at 31.3.2017	Change
Stock exchange participants	563	512	12,096	11,068	2,043	1,830	14,702	13,410	9.6%
Futures exchange participants	115	112	884	921	188	196	1,187	1,229	-3.4%
Stock exchange and futures exchange participants	74	69	4,831	4,914	536	522	5,441	5,505	-1.2%
Non-stock/non-futures exchange participants	1,950	1,791	15,784	16,086	5,174	4,730	22,908	22,607	1.3%
Total	2,702	2,484	33,595	32,989	7,941	7,278	44,238	42,751	3.5%

[^] These figures exclude 120 registered institutions as at 31 March 2018 and 121 as at 31 March 2017.

MIC regime

The objective of the MIC regime is to heighten awareness of senior management accountability and enhance corporate governance. Under the regime, licensed firms are required to submit management structure information, including about MICs of eight core functions and organisational charts, in a standardised format. MICs of overall management oversight (OMO) and key business line (KBL) are

expected to be responsible officers (ROs) in respect of the regulated activities they oversee.

Since the launch of the MIC regime, many firms have taken concrete measures to enhance their governance structures, including strengthening the composition of their boards, clearly delineating the job responsibilities and reporting lines of individual senior managers and better aligning senior management accountability with the RO regime.

10,600
MICs

62%
of MICs are licensees

2,000
RO applications from
MICs of OMO or KBL

Note: Data as of 31 March 2018. Some MICs are not required to be licensed because they do not conduct regulated activities. They are primarily responsible for managing operations or control functions such as compliance, risk management, finance, information technology and anti-money laundering.

Over-the-counter derivatives

As part of comprehensive reforms to enhance Hong Kong's regulatory regime for over-the-counter (OTC) derivatives activities and to strengthen the management of conduct and financial risks in transactions and business dealings with related parties, we launched a public consultation in December 2017 on proposed refinements to the scope of regulated activities under the OTC derivatives regime. Other proposals related to licensing fees, insurance, competence and training requirements under the regime and, more broadly, requirements for licensed corporations to properly manage financial exposures to group affiliates and other connected persons.

Financial Resources Rules

In July 2017, we published consultation conclusions on the proposed regulatory capital regime for licensed corporations engaged in OTC derivatives activities and other changes to the Securities and Futures (Financial Resources) Rules (FRR). In parallel, we further consulted on a number of modified and additional proposals as well as draft FRR amendments which are not specific to OTC derivatives activities.

Financial resolution regime

The financial resolution regime under the Financial Institutions (Resolution) Ordinance, which came into operation on 7 July 2017, vests the SFC with powers to effect the orderly resolution of certain licensed corporations.

We worked with the HKMA, the Insurance Authority and the Financial Services and the Treasury Bureau on the 2017 Financial Stability Board Peer Review which examined the framework for the resolution of financial institutions in Hong Kong.

Anti-money laundering

In February 2018, we gazetted revised guidelines to incorporate provisions reflecting the amendments in the recently enacted Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) (Amendment) Ordinance 2018. A circular was issued on the same day to draw licensed corporations and affiliates' attention to the need to review their existing policies and procedures and ensure continued compliance. The revised guidelines came into effect in March 2018.

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Credit rating agencies

After assessing information provided by the SFC, the European Securities and Markets Authority announced in November 2017 that Hong Kong would retain its status as one of the equivalence jurisdictions for credit rating agencies (CRA) under the new requirements in the European Union (EU) CRA Regulation effective 1 June 2018. Accordingly, financial institutions in the EU may continue to use credit ratings prepared by SFC-licensed CRAs for regulatory purposes.

Monitoring compliance

We employ various tools, including on-site reviews and off-site monitoring, in supervising licensed corporations with a focus on their financial risks and how they conduct business.

On-site reviews

On-site reviews, which include prudential visits and routine, special and thematic inspections, are a key supervisory tool for understanding a firm's business operations, risk management and internal controls and gauging its compliance with legal and regulatory requirements. This includes assessing whether it acts with due skill, care and diligence and adopts proper business conduct, procedures and practices.

During the year, we conducted 301 risk-based on-site inspections, including thematic inspections on a range of issues. We enhanced our case management system and implemented a new risk assessment system to improve the efficiency of our inspections.



Ms Julia Leung, Deputy Chief Executive Officer and Executive Director of Intermediaries, speaks at an industry seminar

Off-site monitoring

We conduct off-site monitoring through regular interaction with licensed corporations to understand their business models and their plans to identify and assess risks. We assess the financial soundness of licensed corporations mainly through analysis of the regular financial returns they submit. We also utilise intelligence from a variety of sources and follow up on complaints and self-reported breaches. In addition, we examine applications by licensed corporations for subordinated loans and rule modifications or waivers. This helps us form a holistic view of the business profiles of licensed corporations.

Breaches noted during on-site inspections

	2017/18	2016/17	2015/16
Internal control weaknesses ^a	535	598	571
Breach of Code of Conduct ^b	320	441	388
Non-compliance with anti-money laundering guidelines	175	201	223
Failure to safekeep client money	59	62	45
Failure to safekeep client securities	38	58	41
Others	349	395	416
Total	1,476	1,755	1,684

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

^b Commonly related to risk management, record keeping, client agreements, safeguarding of client assets and management responsibilities.

Note: Also see Table 4 in Breakdown of SFC activity data on pages 163-169 for more details.

Statistical information and financial position of the Hong Kong securities industry

	As at 31.12.2017	As at 31.12.2016	As at 31.12.2015
Securities dealers and securities margin financiers	1,222	1,104	1,002
Active clients	1,657,931	1,556,695	1,501,816
Total assets (\$ million)	1,337,404	1,078,521	1,089,976

	12 months to 31.12.2017	12 months to 31.12.2016	12 months to 31.12.2015
Total value of transactions ^a (\$ million)	73,901,390	63,495,134	84,787,467
Total operating profit (\$ million)	23,539	14,131	26,404

^a The total value of transactions includes trading in equities, bonds and other securities in Hong Kong and overseas.

Note: 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. Figures reported by an overseas-incorporated licensed corporation that carries out its principal business activities outside Hong Kong and operates in Hong Kong as a branch office were excluded. Also see Table 8 in Breakdown of SFC activity data on pages 163-169 for more details.

Industry guidance and communication

We stay on top of market developments and explain our supervisory focus to the industry through circulars, frequently-asked questions (FAQs) and other communications. Where necessary, we also publish reports to highlight deficiencies and good practices observed during our thematic inspections. We also met with various industry associations during the year.

Securities brokers

To examine the accuracy of brokers' records of client assets and balances, we engaged an independent accounting firm to conduct a circularisation exercise for selected client accounts. We notified the industry of the exercise in a July 2017 circular and will share key findings from the exercise after it is completed.

We also conducted a review to assess the adequacy of internal controls over the supervision of account executives by large- and medium-sized brokers mainly serving retail investors. Where appropriate, we will share our observations and provide further guidance to the industry on areas of concern.

Securities margin financing

In light of the volatility in small-cap stocks and some licensed corporations' excessive exposure to securities collateral which was highly concentrated and illiquid, we issued a circular in October 2017 to firms providing securities margin financing to remind them to vigilantly monitor risks and adopt prudent margin lending and risk management policies. We also communicated our concerns to the broker community through industry seminars and conferences.

Liquidity risk management

In December 2017, we issued a circular to provide additional guidance on establishing and maintaining prudential risk management practices for client money, liquidity and the concentration risks of funding sources within group affiliates.

Best execution

Further to the best execution rules laid down in the Code of Conduct², we issued a circular with a thematic report in January 2018 to provide more guidance to the industry on our expected standards of firms' conduct and internal controls in delivering best

² Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.

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Ms Leung explains the SFC's policy initiatives in a radio interview

execution. The report highlighted observations from a thematic review and provided examples of good industry practices as well as those which did not meet our expected standards.

Client facilitation

Although we highlighted common deficiencies associated with client facilitation in a 2014 supervisory briefing, we identified a number of inconsistent practices in recent routine inspections. In light of this, we issued a circular in February 2018 to provide more guidance to the industry on our expected standards for firms' conduct and internal controls in this area.

Sponsors

Following a thematic inspection of sponsors, we issued a circular in March 2018 to remind licensed corporations carrying out sponsor work of the expected standards of conduct and due diligence practices and to urge them to critically review and enhance their internal systems and controls. The deficiencies we identified from the inspection were discussed in an accompanying report.

Prime services and equity derivatives

In October 2017, we commenced a thematic review of prime services and related equity derivatives business conducted by major investment banks in Hong Kong to obtain an overview of the industry landscape, business practices, key risks and the investment banks' controls and identify potential issues for future policy and supervision initiatives. We will share our observations with the industry.

Futures brokers

Following the publication of our *Report on the fact-finding exercise on retail futures brokers* in April 2017, we issued a circular to futures brokers in June 2017 setting out key areas of regulatory concern, including the assessment criteria for established clients under the rules of the Hong Kong Futures Exchange Limited and setting-off arrangements between a client's different trading accounts, along with expected standards of conduct and internal controls.

Cryptocurrencies

We issued a statement and a circular on initial coin offerings (ICOs) in September 2017 to make the industry aware of the potential regulatory implications of fundraising using cryptocurrencies or digital tokens in view of their growing popularity. In a December 2017 circular on cryptocurrency-related products and derivatives, we reminded cryptocurrency operators of the legal and regulatory requirements in Hong Kong.

In February 2018, we urged investors to be cautious about the associated risks as we took regulatory action against a number of cryptocurrency exchanges and issuers of ICOs. Subsequently, in March 2018, an issuer halted its ICO to the Hong Kong public and agreed to unwind ICO transactions for Hong Kong investors.

Conflicts of interest

In a November 2017 joint circular with the HKMA, we reminded intermediaries about our expected standards for managing conflicts of interest arising from the sale of in-house products in the same financial group. The circular also provided examples of good practices observed during joint thematic reviews of selected conglomerate financial groups.

Alternative liquidity pools

From 2016 to 2017, we undertook a thematic review of the operations of selected licensed corporations' alternative liquidity pools (ALPs) to assess whether they complied with the requirements in the Code of Conduct and to gather market information. In April 2018, we published a circular together with a report summarising the findings and good practices identified in the thematic review and providing an overview of the ALP landscape in Hong Kong.

SFC Compliance Bulletin

We launched the *SFC Compliance Bulletin: Intermediaries* to provide guidance to intermediaries and other market practitioners on the SFC's regulatory and supervisory priorities. The first issue, published in December 2017, highlighted the importance of managing conflicts of interest in selling practices and asset management and provided an overview of industry demographics.

Algorithmic trading

We held a forum in May 2017 for around 180 industry experts and representatives from licensed corporations to share their observations and good practices for algorithmic trading.

Anti-money laundering

We gave presentations to about 1,800 management and compliance practitioners on anti-money laundering and counter-terrorist financing at three SFC seminars and six others organised by industry associations.

Licensing Handbook

To provide easier access to licensing information, we published a new *Licensing Handbook* in April 2017 which consolidates information contained in various publications and FAQs. We also revamped the licensing section of the SFC website. Hyperlinks were included in the handbook and webpages for convenient cross-referencing of statutory provisions.

A framework for Fintech

Financial technology (Fintech) continues to evolve rapidly with the active participation of both start-ups and incumbent financial institutions. We closely monitor these developments with a focus on how they intersect with our rules and regulations. Through various forms of engagement, we keep track of the emergence of new business models which have implications for our regulatory work.

We are open to discussions with firms utilising innovative technologies who demonstrate a serious commitment to carry out regulated activities which may enhance investment choice and quality as well as benefit investors and the Hong Kong markets at large. Accordingly, we launched the SFC Regulatory Sandbox in September 2017 to provide a confined regulatory environment for qualified firms to operate regulated activities under the SFO before their technologies are applied on a full scale.

In September 2017, we issued a circular to clarify the "relevant industry experience" requirement for ROs of Fintech companies looking to be licensed.

We consider all relevant factors in assessing an RO application, including the firm's principal business model, governance structure and the competence of its key personnel. For instance, where the regulated activity carried out by a licensed corporation is based on the utilisation of a highly innovative technology, an RO applicant's direct experience with the technology may be essential for integrating the technology into the regulated activity.

In October 2017, we co-organised a full-day programme with the HKMA to discuss Fintech-related regulatory issues. The event was part of Hong Kong Fintech Week sponsored by InvestHK.

During the year, we worked with the Investor Education Centre to publish educational materials and also participated in public educational campaigns on risks associated with ICOs and cryptocurrencies.

To foster cross-border collaboration, we entered into Fintech cooperation agreements with the UK, Australia, Malaysia, Dubai and Switzerland.

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Investor compensation

We completed a study of ways to enhance Hong Kong's investor compensation regime and in April 2018 launched a public consultation on proposed enhancements for better investor protection.

The Investor Compensation Company Limited, a wholly-owned SFC subsidiary, received one claim against the Investor Compensation Fund and processed six claims during the year.

Investor compensation claims

	2017/18	2016/17	2015/16
Received	1	10	39
Processed	6	19	450
– Compensation payments made	3	14	413
– Rejected	3	4	19
– Withdrawn	0	1	4
– Reconsidered	0	0	14



Net asset value of compensation funds

	As at 31.3.2018 (\$ million)	Change	As at 31.3.2017 (\$ million)	Change	As at 31.3.2016 (\$ million)
Unified Exchange Compensation Fund ^a	75.8	4%	72.9	2.1%	71.4
Investor Compensation Fund ^b	2,361.2	3.5%	2,280.4	3.1%	2,210.9
Total	2,437	3.5%	2,353.3	3.1%	2,282.3

^a See pages 149-162 for the financial statements of the Unified Exchange Compensation Fund (UECF). The Investor Compensation Fund (ICF) was established by the SFO on 1 April 2003 to replace the UECF. After settlement of all claims against the UECF and its other liabilities, any remaining balance will be transferred to the ICF.

^b See pages 130-148 for the financial statements of the ICF.