Operational Review

We maintain stability, competitiveness and orderliness in the financial markets through our principal areas of work: intermediaries, products, corporates, markets and enforcement.

Intermediaries

We set 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[1], 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 2019, the number of licensed corporations totalled 2,960, up 10% from last year. The number of licensees and registrants increased 5% to 46,678 in the same period. We received 8,942 new licence applications during the year, an increase of 8% from a year earlier. These were both record highs since the implementation of the regulatory regime under the SFO on 1 April 2003.

Revamped licensing process

To enhance efficiency and transparency and to keep ahead of the evolving financial market landscape, we revamped our licensing process and introduced new measures to sharpen our focus on key risks and achieve better regulatory outcomes. In May 2018, we restructured the Licensing Department to improve operational efficiency. In addition, we redesigned our licensing forms to introduce an enhanced risk-based approach. In September 2018, we held three consultation sessions to discuss the revamped licensing process with industry participants, including fund managers, brokers, investment banks and compliance consultants.

Starting 26 November 2018, approval letters to individual licence applicants are only sent electronically, copying their accredited licensed corporations. Also on the same date, the delegation of the SFC Online Portal function was adjusted to allow directors of licensed corporations or registered institutions and persons authorised by their boards to submit corporate notifications and annual returns. Previously, only responsible officers and executive officers were allowed to submit these documents.

[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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In February 2019, new forms and a new edition of the SFC's Licensing Handbook were released. After a two-month transitional period, both the use of the new forms and the electronic submission of annual returns and notifications via the SFC Online Portal were made compulsory from 11 April 2019. (See sidebar on the licensing reform on page 44.)

Annual licence fees

From 1 April 2019, we resumed the collection of annual licence fees after a seven-year period when these fees were waived. A fee concession of 50% was provided for two years. Annual fees will be fully reinstated from 1 April 2021. We issued a circular in March 2019 to set out the annual fee collection arrangements for the industry.

Prudential risks

Securities margin financing

In April 2019, we concluded a public consultation on proposed guidelines which set out the expected risk management standards for securities margin financing (SMF) activities. The guidelines include qualitative requirements and quantitative benchmarks for margin lending policies and key risk controls. The consultation was launched in August 2018 and followed a 2017 review of SMF activities which indicated dramatic growth in total margin loans over the last decade, with significant deterioration in the quality of loans and widespread imprudent lending practices among brokers. A report summarising the review findings was also published in August 2018.

OTC derivatives

We launched a two-month consultation in June 2018 on proposals to impose margin requirements for non-centrally cleared over-the-counter (OTC) derivatives. The proposals specify the categories of licensed corporations, counterparties and instruments subject to the requirements for margin exchange, as well as the assets eligible as margin. We plan to publish consultation conclusions later this year.

In December 2018, we released consultation conclusions on proposals to enhance the OTC derivatives regime and address conduct risks posed by dealings with group affiliates and other connected persons. New risk mitigation requirements for non-centrally cleared OTC derivative transactions will take effect on 1 September 2019. Client clearing requirements for OTC derivative transactions will become effective when the new Types 11 and 12 regulated activities come into effect. The effective date for the conduct requirements to address risks posed by group affiliates and other connected persons is 14 June 2019.

Licensees

	Corporations^		Representatives		Responsible Officers		Total^		
	As at 31.3.2019	As at 31.3.2018	As at 31.3.2019	As at 31.3.2018	As at 31.3.2019	As at 31.3.2018	As at 31.3.2019	As at 31.3.2018	Change
Stock exchange participants	581	563	12,397	12,096	2,155	2,043	15,133	14,702	2.9%
Futures exchange participants	114	115	849	884	199	188	1,162	1,187	-2.1%
Stock exchange and futures exchange participants	81	74	5,002	4,831	576	536	5,659	5,441	4%
Non-stock/non-futures exchange participants	2,184	1,950	16,655	15,784	5,769	5,174	24,608	22,908	7.4%
Total	2,960	2,702	34,903	33,595	8,699	7,941	46,562	44,238	5.3%

^ These figures exclude 116 registered institutions as at 31 March 2019 and 120 as at 31 March 2018.

Financial resources rules

In October 2018, we issued consultation conclusions on proposed amendments to the Securities and Futures (Financial Resources) Rules to update the computation basis for the financial resources requirements and ensure the rules are compatible with the latest market developments. The new requirements were enacted on 12 December 2018. Amendments related to a new accounting standard took effect on 1 January 2019 and the remaining amendments came into effect on 1 April 2019.

Conduct risks

Professional investors

In May 2018, we issued consultation conclusions on proposals to standardise the rules for prescribing professional investors and ensure consistent application of our regulations. The amended rules came into effect on 13 July 2018. We also explained the professional investor regime on the website of the Investor and Financial Education Council[2].

Strategic licensing review

Our licensing processes are a key element of our gatekeeping function. By collecting more relevant information from applicants upfront, this can help us make decisions faster and identify issues earlier.

During the year, we completed a thorough review to make our licensing functions more transparent, speed up our workflow and improve communication with the industry. To this end, we introduced a three-pronged strategic reform to modernise our licensing processes.

First, we reorganised our licensing functions and re-engineered the operational flow to make it more efficient. After the restructuring, we observed general improvement in overall efficiency in processing individual licensing applications.

Next, we refined our assessment approach by focusing on five key risks of a corporate licence applicant, namely its business, controller, management, financial strength and internal control. To demonstrate its financial strength, the applicant must provide a projection of its operating expenses in the first six months after having been licensed.

We also published self-assessment questionnaires for corporate applicants to match SFC-regulated activities with their business profiles as well as to evaluate the soundness of their risk management and internal control measures. These allow us to identify potential regulatory issues at an early stage.

Thirdly, we improved our interaction with licensees and applicants by introducing a series of redesigned licensing forms, along with user-friendly instructions and navigation guides, to collect the information we need to assess an applicant's fitness and properness upfront. To enhance the efficiency and transparency of the application process, we revised some questions set out in the licensing forms and streamlined the information requirements.

We also released a new edition of the Licensing Handbook and updated the licensing section on the SFC website to provide additional guidance on these enhancements as well as recent policy updates.

Licensing workshops

2 Formerly known as the Investor Education Centre.

Alternative liquidity pools

In April 2018, we issued a circular and thematic report to highlight the key areas of concern and good practices noted during a thematic review of alternative liquidity pools (ALPs) which identified a number of deficiencies including in ensuring that ALP users are qualified investors. The report also provides an overview of the ALP landscape in Hong Kong.

Sale of complex products

We issued consultation conclusions in October 2018 on requirements for intermediaries to apply additional protective measures to the sale of complex products in an offline environment. Intermediaries have to ensure the suitability of complex products and provide product information and warning statements to clients when the complex products are sold on an unsolicited basis. Accordingly, identical protective measures will apply to both the online and offline sale of complex products with effect from 6 July 2019. This ensures better investor protection, provides a level playing field for industry participants and avoids potential regulatory gaps.

Disclosure

In May 2018, we concluded a public consultation on proposed disclosure requirements applicable to discretionary accounts to address potential conflicts of interest where product issuers provide incentives to discretionary account managers. We also published frequently asked questions on the requirements, which became effective in November 2018.

"Nominees" and "warehousing" arrangements

In light of the increasingly prevalent use of "nominees" and "warehousing" arrangements which may play a part in market and corporate misconduct, we issued a circular in October 2018 reminding intermediaries to be vigilant in identifying potential red flags which may suggest the use of these arrangements for illegitimate purposes, make follow-up enquiries with clients and report suspicious transactions promptly to us and other authorities where necessary.

Financial technology

Online client onboarding

We issued a circular in July 2018 to provide guidance to intermediaries on using electronic signatures to onboard individual clients online. The alternative procedures specified in the circular provide safeguards to contain the risks while enabling intermediaries to onboard clients more efficiently and better serve customers without compromising their regulatory responsibilities.

Breaches noted during on-site inspections

	2018/19	2017/18	2016/17
Internal control weaknesses[a]	**443**	535	598
Breach of Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission[b]	**275**	320	441
Non-compliance with anti-money laundering guidelines	**201**	175	201
Failure to safekeep client money	**28**	59	62
Failure to safekeep client securities	**32**	38	58
Others	**257**	349	395
Total	**1,236**	1,476	1,755

[a] Comprised 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: See Table 4 in Breakdown of SFC activity data on page 166 for more details.

Client orders via instant messaging

We issued a circular in May 2018 to provide guidance on the controls and procedures intermediaries are expected to implement when they receive clients' orders through instant messaging services. They are encouraged to take adequate measures, such as keeping proper records of messages relating to client orders, ensuring all records are accessible for monitoring and audit purposes, validating client identities and maintaining adequate safeguards to prevent unauthorised access and security attacks.

Ms Julia Leung (right), Deputy Chief Executive Officer and Executive Director, Intermediaries, at Freshfields Bruckhaus Deringer's Asia In-House Counsel Forum 2018

Virtual assets

In June 2018, we issued a circular to remind intermediaries to inform us of any plans to provide trading and asset management services involving virtual assets or robo-advisory services. Intermediaries were also advised to discuss their plans with the SFC before they engage in these services.

We published regulatory standards for managers of funds which invest in virtual assets in November 2018. The sale of these unauthorised funds was limited to professional investors. We also developed a conceptual framework for exploring whether we should regulate virtual asset trading platforms in consideration of serious investor protection issues. If implemented, this regulatory approach could provide a path for compliance for those platform operators capable and willing to adhere to a high level of standards and practices, and set them apart from others which do not seek a licence. (See sidebar on page 47.)

In March 2019, we issued a statement clarifying the legal and regulatory requirements applicable to parties engaging in security token offerings. We also reminded investors to be wary of the risks associated with virtual assets, including tokens which are the subject of security token offerings.

Anti-money laundering

In July 2018, we launched a public consultation on proposed amendments to the Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (For Licensed Corporations) as well as the Prevention of Money Laundering and Terrorist Financing Guideline Issued for Associated Entities to align them with the latest international standards and provide additional guidance in light of industry developments. The amended guidelines came into effect on 1 November 2018.

We issued a circular in April 2018 to draw licensed corporations' attention to the findings of the Government's *Hong Kong Money Laundering and Terrorist Financing Risk Assessment Report* and provide guidance on measures that they should take to mitigate any money laundering and terrorist financing risks identified in the report. We conducted three seminars for around 700 industry participants in June 2018 on the implications of the report's findings for licensed corporations.

In August 2018, we issued a circular highlighting deficiencies in anti-money laundering and counter-financing of terrorism (AML/CFT) measures and controls identified during our inspections. The circular provided guidance with practical examples for complying with the legal and regulatory requirements and enhancing AML/CFT policies, procedures and controls.

A mutual evaluation was carried out by the Financial Action Task Force and Asia/Pacific Group on Money Laundering in 2018[3]. Following completion of its on-site review of Hong Kong last year, we will continue to update our AML guidance notes to align with the latest international standards.

[3] See Regulatory engagement on pages 73-76.

Fintech developments

In this fast-moving technological landscape, we take a facilitative approach to innovation when Fintech can be used to provide better customer experience, increase financial inclusion or make markets more efficient and reliable. One example is the growth of online platforms which provide more choices and offer better service and convenience to investors. In this regard, we issued the Guidelines on Online Distribution and Advisory Platforms which came into effect in April 2019.

We also engage with firms, industry organisations, startups and other stakeholders through the SFC Fintech Contact Point, which handled over 200 enquiries during the year.

Where a Fintech activity poses serious risks to investor protection, we take a more cautious stance. Virtual asset activities are associated with risks arising from illiquidity, volatility, opaque pricing, hacking, money laundering and fraud. A prudent approach is therefore required. We announced a conceptual framework for the potential regulation of virtual asset trading platforms in November 2018 and are currently considering our regulatory approach towards virtual assets.

On a day-to-day basis, we closely monitor licensed corporations' risk management practices to determine whether they need to be strengthened in response to technological developments or to address cybersecurity risks, data privacy breaches or other concerns. We mandate two-factor authentication and other baseline requirements for internet brokers and conduct inspections on a sample basis to assess compliance.

We are now considering how to enhance data collection and analysis using supervisory technology. As a trial, we analysed licensed corporations' algorithmic trading and dark pool operations to assess their compliance with business conduct standards. We identified non-compliance and are consulting the industry on standards to prescribe trading data to be submitted to us.

We update our regulation to cover business models created by new technologies and avoid potential regulatory gaps. We provided tailored guidance on the design and operation of online platforms, including the provision of automated or robo-advice, as well as on opening accounts for individual clients who are not physically present and accepting client orders via instant messaging applications.

Supervisory approach

We adopt a front-loaded and risk-based approach by focusing on the greatest threats and the most significant or systemic risks. We employ a variety of tools to supervise 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 304 risk-based on-site inspections, including thematic inspections on a wide range of issues identified.

In recent years, we have increased the use of thematic inspections as a tool to assess the scale and nature of particular cross-sector risks. These inspections may be triggered by the identification of trends, emerging risks and compliance lapses that require prompt regulatory responses. We highlight to the industry key areas of concern noted during a thematic inspection as well as provide guidance on the standards of conduct and internal controls expected of licensed corporations. As in other inspections, where major breaches or non-compliance are identified, we may conduct enquiries or an enforcement investigation into the case and take disciplinary action.

This year, thematic inspections included AML/CFT, cybersecurity, intermediary misconduct in listed markets and selling practices. Other topics, including brokers' internal controls and supervision of account executives as well as risks relating to remote booking models, were also covered during the year.

In December 2018, we issued a comprehensive self-assessment checklist along with a thematic review of brokers' internal controls to help them assess their control policies and procedures and improve their supervision of account executives.

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 evaluate their financial soundness mainly through analysis of their regular financial returns. 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 their business profiles.

Data analytics

We are enhancing our analysis of data for regulatory purposes and our capability to monitor current trends, emerging issues and risks using new technologies.

Stress-testing brokers

We launched an automated system in July 2018 to conduct stress tests to identify thinly capitalised brokers following increased extreme price movements and trading suspensions of small-cap stocks held by licensed corporations as securities collateral. We also introduced a stress test system for futures and options brokers in December 2018.

Business and Risk Management Questionnaire

A revamped Business and Risk Management Questionnaire (BRMQ) launched in January 2019 collects information about the business operations of firms and their specific measures to ensure sound risk management and proper internal controls. This will enable us to supervise licensed corporations and associated firms more effectively. For financial years ending on or after 31 March 2019, firms are required to complete and electronically submit the revamped BRMQ within four months after the end of each financial year.

Statistical information and financial position of the Hong Kong securities industry

	As at 31.12.2018	As at 31.12.2017	As at 31.12.2016
Securities dealers and securities margin financiers	**1,312**	1,222	1,104
Active clients	**1,874,289**	1,657,931	1,556,695
Total assets ($ million)	**1,226,532**	1,337,404	1,078,521

($ million)	12 months to 31.12.2018	12 months to 31.12.2017	12 months to 31.12.2016
Total value of transactions[a]	**89,678,389**	73,901,390	63,495,134
Total operating profit	**23,548**	23,539	14,131

[a] Data 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 which carries out its principal business activities outside Hong Kong and operates in Hong Kong as a branch office were excluded.

Note: Also see Table 8 in Breakdown of SFC activity data on page 169 for more details.

Industry guidance

We have broadened how we communicate with and give guidance to the industry. Published circulars are still the principal means through which we set out our regulatory expectations. In addition, in survey results, thematic reports and industry newsletters, we provide anonymised examples to illustrate best practices and our regulatory concerns. We also hold more frequent workshops when we are introducing a significant new regulatory measure.

Compliance Bulletin

We publish a newsletter, the *SFC Compliance Bulletin: Intermediaries,* to provide guidance on the SFC's regulatory and supervisory priorities. Through illustrative case studies, the May 2018 issue highlighted our regulatory focus and areas of concerns when considering licensing applications and provided an update on the implementation of the Manager-In-Charge regime. The November issue focused on the SFC's Fintech initiatives and the use of technology in our supervisory work.

Compliance Forum 2018

The SFC Compliance Forum 2018 was held in June. Over 500 industry participants attended the half-day event to exchange views on the SFC's recent guidance on best execution, client facilitation, sponsors and ALPs as well as the use of innovative technology to deliver financial services and the associated risks. (See Stakeholders on pages 77-81.)

Investor compensation

The enhancements to the investor compensation regime[4] we proposed in an April 2018 consultation received strong support. Key proposals include increasing the compensation limit from $150,000 to $500,000 per investor per default and covering northbound trading under Mainland-Hong Kong Stock Connect. We are working towards issuing the consultation conclusions in the second half of 2019.

The Investor Compensation Company Limited, a wholly-owned SFC subsidiary, received five claims against the Investor Compensation Fund and processed 10 claims during the year.

Investor compensation claims

	2018/19	2017/18	2016/17
Received	5	1	10
Processed	10	6	19
– Compensation payments made	0	3	14
– Rejected	7	3	4
– Withdrawn	2	0	1
– Reconsidered	1	0	0

Net asset value of compensation funds

	As at 31.3.2019 ($ million)	Change	As at 31.3.2018 ($ million)	Change	As at 31.3.2017 ($ million)
Unified Exchange Compensation Fund[a]	79.3	4.6%	75.8	4%	72.9
Investor Compensation Fund[b]	2,391.5	1.3%	2,361.2	3.5%	2,280.4
Total	2,470.8	1.4%	2,437	3.5%	2,353.3

[a] See pages 150-163 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 131-149 for the financial statements of the ICF.

[4] Claims against the Investor Compensation Fund may be made for exchange-traded products in the event of broker default.