

## SFC Compliance Forum 2019

### Opening Remarks – Afternoon session

**Ms Julia Leung**

**Deputy Chief Executive Officer and Executive Director, Intermediaries**

**17 June 2019**

Good afternoon and welcome to the third SFC Compliance Forum. This is now an annual event for you to share compliance practices and ask your regulator questions.

To set the stage for our discussions this afternoon, I first want to take you through the SFC's current supervisory priorities. As many of you know, the “front-loaded” approach we introduced two years ago has helped us focus on the greatest risks facing our market and intervene at an earlier stage to address persistent problems and pre-empt the fallout from emerging threats.

#### **Enhanced gatekeeping**

One example of this is how we have enhanced our gatekeeping function. To keep up with the rapidly-changing industry landscape, we need to keep our blades sharp, and that goes for both our hardware, that is, the tools we use, and our software, the approach we take.

So you could say that our new licensing forms which became mandatory in April were a kind of software update. The new forms allow us to collect and analyse the relevant data upfront. This makes the licensing process more efficient and transparent, and helps us get a proper handle on some recurring problems.

We also flattened our organisational structure to streamline our workflow processes. The result is that we are now more efficient when processing your licensing applications.

#### **Driving proper behaviour**

Another of our functions is to promote, encourage and enforce proper conduct among our licensed firms and individuals. In the panel coming up next, we will talk more about the Manager-In-Charge (MIC) regime, which was introduced two years ago to drive proper conduct and increase awareness of individual responsibility and accountability. It allows us to quickly identify the individuals to whom we could communicate our supervisory concerns and who could be held accountable for control failures or conduct issues.

---

Note: This is an expanded version of the speech Ms Leung delivered.

The panel will also take up the SFC's recent initiative to keep better track of "rolling bad apples". These are people with a record of misconduct which is wiped clean when they change jobs, allowing them to potentially repeat their misbehaviour at another firm. To tackle this problem, we introduced a new requirement for licensed corporations (LCs) to disclose whether a licensed individual who ceases to be employed with the firm was the subject of an internal investigation begun within six months prior to the cessation of accreditation.

We take seriously the proper conduct of an LC's controlling entity. It came to our attention that some LCs' related parties may be associated with alleged illegal activities. For example, soliciting Mainland investors to trade on an online platform for foreign exchange margin trading, which unless approved is illegal on the Mainland, or being associated with alleged fraudulent London gold activities in Hong Kong. Later today, we will issue a circular to remind LCs and their controlling entities to review the legality of the services they and their related parties offer in Hong Kong and elsewhere, and to stop illegal activities and mitigate any risks they identify. This includes ceasing any co-location or resource sharing arrangements with the related party and demanding the clear segregation of regulated activities from the alleged unauthorised or illegal activities.

Failure to take appropriate action may have implications for the fitness and properness of the LC, its senior management and its controllers, and may result in regulatory action. You can read more about this in the latest *SFC Compliance Bulletin*.

## **Prudential and conduct regulation**

Now with the rapid changes taking place in our markets, it is essential that we stay vigilant in our prudential and conduct supervision. For example, in our off-site monitoring and on-site inspections of LCs, we are closely monitoring credit and market risks, especially those associated with securities margin financing<sup>1</sup>.

One concern is where a group company of an LC provides financing to the major shareholders of listed companies through a series of complex transactions. This lending may be disguised as investments made into special purpose vehicles, investment funds or discretionary accounts. Another concern is where a money lender within the same group as an LC provides financing to the major shareholders of listed companies with their shares of doubtful quality as collateral.

We recognise that structured finance has its place, but firms should be mindful that complex structures and opaque financing arrangements may conceal embedded financial risks and bypass rigorous risk assessments. In a recent circular, we cautioned firms to note the regulatory guidance for the management of financial risks. Holding companies and controllers of LCs need to prudently manage the group's overall financial risk exposure, including that posed by subsidiaries and their financing arrangements.<sup>2</sup>

---

<sup>1</sup> New Guidelines for Securities Margin Financing Activities will take effect on 4 October 2019.

<sup>2</sup> Circular issued jointly by the SFC and the Hong Kong Monetary Authority (HKMA) on 24 April 2019 titled "[HKMA and SFC adopt a coordinated approach to supervise banks and licensed corporations](#)".

Selling practices are another key priority for us, in particular the suitability requirement. A survey we conducted recently<sup>3</sup> found more complex products were being sold, but their terms, features and risks were not well understood by retail investors. So it is particularly crucial for firms to take steps to comply with the suitability obligations and other requirements which will soon take effect for both the online and offline distribution of complex products. I am sure there will be more to say about this in the breakout session on distribution of investment products later this afternoon.

Last week, we issued a circular on prime services, the theme of a breakout session this afternoon. The operating models for prime services are fragmented by nature, with multiple affiliates of a financial institution involved in different aspects of client relationships. Prime brokers are reminded that if clients are serviced in Hong Kong or if they are carrying out their prime services in Hong Kong, we expect them to comply with the applicable rules and regulations in Hong Kong regardless of where the risk positions are booked.

We also looked at the wholesale markets. Common deficiencies associated with client facilitation include traders who misrepresented a house or client facilitation trade as an agency trade, were silent or not transparent about whether facilitation would be involved in a trade or failed to obtain explicit pre-trade consent from clients<sup>4</sup>. LCs providing these services should critically examine whether they have the appropriate policies and procedures in place to comply with our expected standards.

## **Innovation and technology**

As innovation and technological advancement lead to the emergence of new business and operational models, the SFC works hard to keep our policies and processes up-to-date. A current priority is to facilitate more efficient remote onboarding of clients under current regulations. For example, we are studying an online approach to onboard individual clients overseas which uses biometrics along with safeguards for mitigating technology risks. We will be publishing more guidance in this area.

On a related topic, we have repeatedly made it clear that virtual assets pose significant risks for investors. Last November, we issued guidance to remind LCs of the regulatory requirements when they engage in virtual asset portfolio management and fund distribution<sup>5</sup>. We also issued a policy statement setting out a conceptual framework for the potential regulation of virtual asset trading platforms.

In view of the rapid growth of technology-enabled businesses in the securities and futures industry, we now make use of new, innovative supervisory technology, otherwise known as Suptech. This has helped us manage the significant increase in the volume of trading data and the complexity of data relationships. For instance, we use Suptech in our inspections to identify irregularities, systemic control deficiencies and significant compliance issues which would otherwise go undetected.

---

<sup>3</sup> [Survey on the Sale of Non-exchange Traded Investment Products](#) released on 7 December 2018.

<sup>4</sup> Circular issued by the SFC on 14 May 2019 titled "[Recent inspection findings related to client facilitation](#)".

<sup>5</sup> Circular issued by the SFC on 1 November 2018 titled "[Statement on regulatory framework for virtual asset portfolios managers, fund distributors and trading platform operators](#)".

We are also embracing data analytics. Order lifecycles are a core part of the data we need for this, so we are developing a common industry standard to prescribe the content and format of trading-related data to be kept by LCs, and we will provide a way for this to be easily uploaded to the SFC's platform. The next steps will be to streamline the data validation and submission process. We look forward to seeing the industry follow our lead in this area. Once the data becomes available, we hope you use it for your own compliance testing, surveillance and exception reporting.

Another priority is to update our data collection and analytical frameworks for our prudential risk assessments. We run an automated stock alert and stress test system to identify thinly capitalised brokers. This requires more data. To collect it, we already made changes to the Business and Risk Management Questionnaire and will soon revamp the financial returns submitted at regular intervals under the Securities and Futures (Financial Resources) Rules.

### **Professional Investor Rules**

We will also conduct an internal review of the monetary thresholds under the Professional Investor Rules, which are intended to help identify those investors who are sufficiently financially sophisticated to participate in private placement activities such as investments in private companies and private equity funds. The professional investor regime is part of a much broader regulatory framework governing the sale of investments in Hong Kong, including the private placement market, which is vital for economic development.

### **Thematic reviews**

Let me now say something about some of our current and upcoming thematic reviews. In recent years, we stepped up the use of thematic inspections as a tool to assess cross-sector risks. A themed inspection may be triggered when we identify trends, emerging risks or compliance lapses that require a prompt regulatory response.

#### *Remote booking and transfer pricing, operational and data risk management*

We are now conducting a thematic review which focuses on remote booking frameworks and transfer pricing methodologies as well as operational and data risk management practices. Some local and overseas regulators have expressed interest in participating in the onsite inspection phase of this review, particularly regarding remote booking and transfer pricing, and have also offered to provide any information or assistance required. Therefore, we are now considering making this a joint review with other regulators.

#### *Book building exercises*

We are also conducting a thematic review of book building processes in equity and debt capital markets. Underwriting syndicates use the book building process to gauge market interest for an issue, and they play a dual role in providing services to clients on both the buy and sell sides.

Conflicts of interest may arise at various stages of the book building process, including when underwriting syndicates produce connected research. If they submit fictitious and inflated orders or provide inducement to investors, they would undermine the discovery of IPO prices, the fair allocation of securities to subscribers, and ultimately investor confidence in the integrity and transparency of the capital market.

### *Cybersecurity*

Another thematic review now underway assesses internet brokers' compliance with the 20 baseline cybersecurity requirements which came into effect in July 2018. This includes two-factor authentication for system login. As part of this review, we sent questionnaires to selected securities and futures dealers. We chose a range of different-sized firms with systems of varying levels of sophistication. Given the increased use of mobile devices for securities trading, the review is mainly focused on security controls for mobile apps, but we are also looking at data privacy and vendor management.

### *Spreads charged in bond trading*

One more issue I want to mention is the risk of possible misconduct when LCs' interests in price movements may conflict with those of their clients. The trading of over-the-counter products may be opaque and complex, making it easier for LCs to conceal information and charge mark-ups or spreads without proper disclosure to clients. In particular, sales staff may have discretion to control the spreads charged in bond trading, giving them the opportunity to charge more than clients might have agreed to or expected. So let this serve as a reminder that firms are expected to properly disclose their trading capacity, take measures to address conflicts of interest and act in the best interests of clients.

That was a quick run-through of our current priorities, in the spirit of communicating our regulatory expectations to the industry clearly and transparently. Today's forum offers a channel to conduct a two-way dialogue, and I look forward to a fruitful discussion this afternoon.

Thank you.