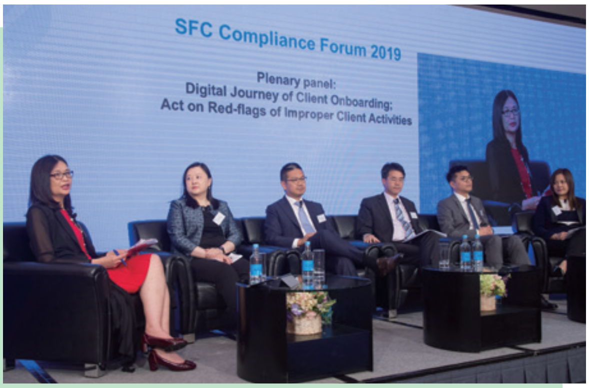
Intermediaries

We set standards and qualifying criteria for corporations and individuals licensed 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 corporations (LCs)[1].

+25%
New licensed corporations (2017-2020)

During the year, intermediaries reconfigured their staffing arrangements and overcame many operational challenges to maintain "business as usual" in response to significant disruptions arising from social events and the COVID-19 outbreak. We stepped up our supervisory work and regular stress tests to monitor LCs' financial and operational resilience in times of market turbulence and volatility. We also conducted special inspections to ensure compliance with our internal control and risk management requirements, and engaged with the industry to provide regulatory flexibility without lowering standards or compromising investor protection.



Ms Julia Leung (left), Deputy Chief Executive Officer and Executive Director, Intermediaries, at the SFC Compliance Forum 2019

Licensing

As of 31 March 2020, the number of licensees and registrants totalled 47,167, up 1% from last year, including the number of LCs which increased 5% to 3,109 as 254 new corporate licence applications were approved. We received a total of 6,962 new licence applications[2], down 22% from the previous year.

Licensees

	Corporations^		Representatives		Responsible Officers		Total^		
	As at 31.3.2020	As at 31.3.2019	As at 31.3.2020	As at 31.3.2019	As at 31.3.2020	As at 31.3.2019	As at 31.3.2020	As at 31.3.2019	Change
Stock exchange participants	604	581	12,208	12,397	2,196	2,155	15,008	15,133	-0.8%
Futures exchange participants	113	114	870	849	200	199	1,183	1,162	1.8%
Stock exchange and futures exchange participants	84	81	4,862	5,002	612	576	5,558	5,659	-1.8%
Non-stock/non-futures exchange participants	2,308	2,184	16,934	16,655	6,064	5,769	25,306	24,608	2.8%
Total	3,109	2,960	34,874	34,903	9,072	8,699	47,055	46,562	1.1%

^ These figures exclude 112 registered institutions as at 31 March 2020 and 116 as at 31 March 2019.

1 Broadly, LCs include securities brokers, futures dealers, leveraged forex traders, fund managers, investment advisers, sponsors and credit rating agencies.
2 The figure does not include applications for provisional licences.

COVID-19 response

Beginning in January 2020, we responded actively to the impact of the COVID-19 outbreak to ensure that Hong Kong's international financial markets function efficiently, effectively and resiliently amidst extreme volatility and operational challenges[a]. We maintained close communication with firms and industry associations and issued guidance which set out our regulatory expectations during a critical time[b].

At the same time, we took a flexible approach to ease pressure on the industry. We deferred regulatory timetables by six months[c] and reminded intermediaries of alternative order receiving and recording options to comply with the regulatory requirements when working out of office. Firms required to submit their audited accounts to us were advised that they may apply for an extension.

a See press release dated 21 April 2020.
b See press release dated 5 February 2020.
c See circular dated 31 March 2020.

We published FAQs on licensing matters and application procedures for fund authorisations, and issued joint guidance with The Stock Exchange of Hong Kong Limited to address market concerns about listed companies' preliminary earnings results, publication of annual reports and shareholder meetings.

To ensure that firms and financial market infrastructures manage their risks and operate in a normal manner, we stepped up our supervisory efforts to address potential vulnerabilities, including investment fund liquidity and redemption profiles.

In March, we launched a dedicated page on our corporate website to provide centralised access to up-to-date regulatory information related to the COVID-19 situation.

Enhanced licensing processes

In April 2019, our enhanced risk-based licensing process came into effect. New licensing forms collect more information to assess an applicant's fitness and properness, reducing the need for us to request additional information. Processing times have decreased and the number of applications outstanding for over 90 days dropped 38% during the year.

We engaged with the industry throughout the design and implementation of the revamped licensing process. In May 2019, we published frequently asked questions (FAQs) to clarify the new disclosure requirement for internal investigations of licensed individuals[3], which has helped us identify potential misconduct. We also consulted the industry on our next generation of online licensing portal services, which we aim to launch in late 2020.

PE firms and family offices

We issued circulars to provide licensing guidance to private equity (PE) firms and family offices in January 2020 in response to enquiries from industry participants and their professional advisers. The circular on PE firms explained the licensing requirements for general partners and investment committee members when conducting co-investment and fund marketing activities. The circular on family offices discussed how our licensing regime applies to them when carrying out asset management or other services in Hong Kong and explained the potential implications for both single and multi-family offices. We also set up designated email addresses for interested parties to enquire about our licensing requirements or discuss their business plans with us.

Annual licensing fees

The collection of annual licensing fees resumed on 1 April 2019 with a 50% fee concession. In view of a challenging market environment, we waived the annual licensing fees for all intermediaries and licensed individuals for the 2020-21 financial year.

3 The requirement applies to internal investigations commenced within six months preceding the individual's cessation of accreditation.

Prudential risks

Securities margin financing

In times of extreme market volatility such as that triggered by the widespread concern about COVID-19, it is particularly important for brokers engaging in securities margin financing activities to maintain robust risk management controls. Our guidelines for securities margin financing activities which took effect on 4 October 2019 provide guidance on concentration risks, margin calls, stress tests and other key risk controls.

Improved stress test results suggest that brokers' resilience to market volatility was enhanced following the implementation of the new guidelines. Also, securities collateral concentration risk was reduced with brokers reporting fewer concentrated and illiquid stocks. To facilitate the implementation of the new guidelines, we published FAQs to clarify the application and interpretation of some requirements in September 2019. We also held training sessions for the industry and posted an e-training video on our website.

Complex financing arrangements

We issued a joint circular with the Hong Kong Monetary Authority in April 2019 on complex and opaque financing arrangements within a Mainland-based financial group's LC, bank and another affiliate in Hong Kong. Through arrangements such as an investment in a fund, the group's credit risk could be disguised as an investment risk and the financial risks associated with the underlying investments could be concealed.

We also identified financial risks in the controllers of a few brokers. If these risks materialise, they may spill over to the licensed brokers and cause financial and reputational damage. A survey of the liquidity management of the controllers of selected brokers which we commenced in January 2020 will help us understand the liquidity profiles of these groups and identify potential financial problems so that we can take early supervisory action to protect investor interests. Controllers of LCs were reminded to prudently manage overall group financial risks and contain contagion risks which may affect the LCs' financial integrity.

Managing liquidity risk in funds

Our August 2019 circular highlighted deficiencies noted in fund managers' liquidity risk management practices. We reminded them to perform more frequent stress tests to assess the liquidity profiles of funds' assets and liabilities as well as the adequacy of their action plans and liquidity risk management tools.

In light of the volatility in equities and bond markets arising from the COVID-19 outbreak, we issued a circular on 27 March 2020 to remind intermediaries of their obligation to ensure suitability when they make a solicitation or recommendation. This includes performing due diligence having regard to an investment product's liquidity and credit quality. Intermediaries were also reminded to disseminate notices and other communications about investment products in a timely manner where they hold them directly or indirectly on behalf of their clients.

OTC derivatives

New risk mitigation requirements for non-centrally cleared over-the-counter (OTC) derivative transactions covering trade confirmation, valuation and portfolio reconciliation took effect on 1 September 2019.

We concluded a consultation in December on proposals to impose margin requirements for non-centrally cleared OTC derivative transactions. Variation margin requirements will take effect on 1 September 2020. In view of the COVID-19 situation, we aligned the implementation of the initial margin requirements with the revised international timetable and they will be phased in starting 1 September 2021.

Conduct risks

Client facilitation

A May 2019 circular shared our inspection findings related to client facilitation and reiterated that licensed brokers and their traders should obtain explicit client consent prior to each client facilitation trade. It also clarified that client consent should never be uni-directional, blanket, implied by the making of disclosure or obtained after the trade.

Credit rating agencies

We highlighted our concerns about credit rating model risk management in a circular to credit rating agencies in May 2019. The circular elaborated on our expected standards which cover the governance and use of credit rating models, model validation and data quality.

Prime brokers

Following our thematic review of prime services and related equity derivatives business in Hong Kong, we issued a circular and a report in June 2019 setting out our expected standards of conduct and internal controls for prime brokers, and sharing examples of good industry practices. In particular, prime brokers are expected to comply with the applicable rules and regulations in Hong Kong if they service clients or carry out prime services in Hong Kong, regardless of where the risk positions are booked.

Anti-money laundering

In April 2019, we updated the anti-money laundering and counter-terrorist financing (AML/CFT) Self-Assessment Checklist on our website to provide a structured framework for LCs and associated entities to assess their compliance.

In September 2019, the Financial Action Task Force published the *Mutual Evaluation Report of Hong Kong* which recognised that we have a reasonable risk-based supervisory framework for AML/CFT and commended our sanctions to enforce requirements for the securities sector. It assessed Hong Kong's AML/CFT regime as compliant and effective overall and recommended some priority actions. In the same month, we issued a circular informing LCs about the assessment results and areas for strengthening Hong Kong's AML/CFT regime.

Third-party deposits and payments

In May 2019, we issued a circular on our expected standards in areas where LCs failed to implement adequate policies and controls to mitigate the risks of client assets misappropriation, money laundering and other financial crime associated with third-party deposits and payments. We also provided examples of effective measures to promote compliance.

Presentation at a Hong Kong Venture Capital and Private Equity Association seminar in November 2019

Dubious fund arrangements

In a November 2019 circular, we provided guidance to asset managers considering private fund and discretionary account arrangements or transactions proposed or directed by investors. We emphasised that we would not hesitate to take regulatory action against asset managers and senior management if they fail to detect dubious arrangements or transactions or if they facilitate illegal or improper conduct due to inadequacies in their procedures and controls.

Regulatory enhancements

Online client onboarding

Amendments to the Code of Conduct[4] took effect on 5 July 2019 to cater for intermediaries' need to adapt their practices as business activities are increasingly conducted online. To facilitate compliance, we specified acceptable account opening approaches on the SFC website and explained them in circulars and FAQs. A new approach to onboarding overseas individual clients online took effect on the same date.

Safeguarding client assets

Our July 2019 circular reminded intermediaries of their obligations to adequately safeguard client assets. They are required to have in place acknowledgement letters which stipulate that authorised institutions would not have any right of set-off or lien against intermediaries' client assets. The deadline for implementing the new requirement was extended by six months to February 2021.

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

External electronic data storage

In October 2019, we issued a circular on the use of external electronic data storage to set out the approval and other requirements applicable to LCs which keep regulatory records exclusively with external electronic data storage providers. Where a data centre was approved under section 130 of the SFO before 31 October 2019, the deadline for the LC to provide us with the confirmation and documentation was extended by six months to 31 December 2020.

922
on-site inspections in the past three years

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.

In light of the business disruption and increased market volatility worldwide across equities, commodities and fixed income amid the COVID-19 outbreak, we closely monitored the operation and risk management of LCs, conducted stress tests and followed up with high-risk LCs. We also provided 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 317 risk-based on-site inspections and noted more than 1,400 breaches of the SFC's rules.

This year's thematic inspections covered AML/CFT, cybersecurity, intermediary misconduct in listed markets, complex and opaque financing arrangements, remote booking and operational and data risk management as well as book-building activities.

Off-site monitoring

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

Breaches noted during on-site inspections

	2019/20	2018/19	2017/18
Internal control weaknesses[a]	**451**	443	535
Breach of Code of Conduct[b]	**273**	275	320
Non-compliance with anti-money laundering guidelines	**331**	201	175
Failure to safekeep client money	**42**	28	59
Failure to safekeep client securities	**31**	32	38
Others	**361**	257	349
Total	**1,489**	1,236	1,476

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 trail 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.

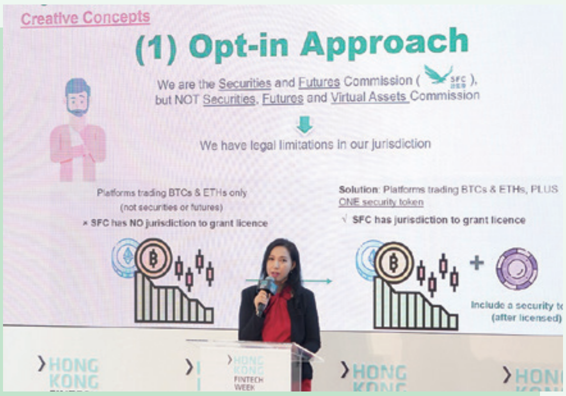
Note: See Table 4 in Breakdown of SFC activity data on page 162 for more details.

Virtual asset trading platforms, futures and funds

On 6 November 2019, we published a licensing framework for centralised virtual asset trading platforms operating in Hong Kong which only serve professional investors and offer trading in at least one security token. We considered that it was in the public interest to introduce this framework to set standards for platforms which are willing to be licensed and compliant and at the same time give investors more choice and protect their interests.

Platform operators can apply to be licensed if they are capable of meeting regulatory standards comparable to those which apply to securities brokers and automated trading venues. However, platforms which chose not to be regulated by us would remain outside the scope of our supervision if they only offer trading in non-security tokens. We reminded investors to be aware of the risks of dealing with unregulated entities.

In a November 2019 statement, we set out our concerns about unregulated platforms offering highly leveraged virtual asset futures contracts to the public. Average investors may have difficulty understanding these complex products, and their high leverage may expose them to high risks. Further, these platforms may be illegal under the SFO or the Gambling Ordinance.



Presentation at the Hong Kong FinTech Week 2019

Given the inherent risks, licensed fund managers intending to invest in virtual assets are subject to our regulatory requirements even when managing portfolios invested solely in virtual assets which fall outside the definition of securities or futures contracts in the SFO. Accordingly, these fund managers are expected to comply with a proforma set of terms and conditions which we published in October 2019.

We will monitor developments in this evolving, dynamic industry and work with the Hong Kong Government to explore the need for legislative changes in the longer term.

Data standard for order life cycle

We issued a circular in July 2019 to set out our standards for the minimum content and presentation format of trading data to be submitted to us upon request. This facilitates our use of new technology to better supervise securities brokers' trading behaviour by identifying irregularities which suggest potential breaches or control deficiencies. The deadline for implementing the new requirement was extended by six months to May 2021.

SFC online portal

Starting from May 2019, intermediaries can submit notifications under the Code of Conduct[5] via a new service which is available on our online portal, WINGS[6].

In August 2019, we launched a new platform on WINGS to collect and analyse key risk indicator (KRI) data from 22 global financial institutions which are considered systemically important. The KRI platform helps to enhance our information gathering and analytical capabilities to facilitate supervision. Effective in January 2020, LCs from these global financial institutions are required to submit KRI data regularly.

5 Intermediaries must immediately report to the SFC upon the occurrence of any incident under paragraph 12.5 of the Code of Conduct.
6 Web-based INteGrated Service.

Financial Resources Rules (FRR) returns

The financial returns for LCs to report their liquid capital calculations were revised with effect from 1 April 2019, with the exception of changes related to a new accounting standard, which took effect on 1 January 2019.

To enhance our supervision of LCs, we will launch revamped FRR returns which collect additional financial and risk information periodically.

Industry guidance

We maintain close communication with the industry and provide guidance mainly through published circulars. In survey results, thematic reports and industry newsletters, we provide examples to illustrate best practices and our regulatory concerns. When introducing a significant new regulatory measure, we hold seminars or briefings to explain and clarify our policies and expectations.

Compliance Bulletin

The May 2019 issue of the *Compliance Bulletin* provided an update on our revamped licensing process, highlighted our efforts to track "bad apples" and stressed that the fitness and properness of an LC's controllers and affiliates may have an impact on the firm.

The January 2020 issue emphasised the importance of sound risk management for brokers and fund managers amid market volatility and also warned investors to be cautious when investing in high-risk investment products and funds with a high concentration of illiquid assets.

Compliance Forum

In June 2019, more than 700 industry participants attended the SFC Compliance Forum to exchange views on our guidance on securities margin financing, prime brokerage business, client onboarding and transaction monitoring as well as regulatory issues noted in selling practices. Management accountability, internal controls and supervision of account executives were also discussed.

Statistical information and financial position of the Hong Kong securities industry

	As at 31.12.2019	As at 31.12.2018	As at 31.12.2017
Securities dealers and securities margin financiers	**1,379**	1,312	1,222
Active clients	**2,024,849**	1,874,289	1,657,931
Total assets ($ million)	**1,322,911**	1,226,532	1,337,404

($ million)	12 months to 31.12.2019	12 months to 31.12.2018	12 months to 31.12.2017
Total value of transactions^	**85,831,384**	89,678,389	73,901,390
Total operating profit	**11,962**	23,548	23,539

^ 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 165 for more details.