SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

SFC
證監會

Approach to Supervision of Intermediaries

June 2011

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Introduction

1. The Commission has set out in its paper entitled *"Regulatory Framework for Intermediaries"* its role and approach in regulating intermediaries through: (i) initial gate keeping or licensing; (ii) ongoing supervision; and (iii) enforcement actions to combat misconduct.

2. This paper focuses more particularly on the supervisory function of the Commission in respect of regulated activities[1] carried out by licensed corporations. This function is primarily undertaken by the Intermediaries Supervision Department of the Commission.

3. This paper is organized as follows:

- Part I outlines the Commission's supervisory mission and focus; and

- Part II explains the supervisory framework adopted by the Commission, that is, how supervision is performed in practice. It describes the different types of risks and issues that are particularly relevant for the purpose of supervision, both at individual firms' level (**"firm-specific risks"**) and at the higher, broader sector-crossing level (**"sector-crossing risks"**). It then describes how such risks are identified and assessed, the supervisory approach underpinning the framework, as well as the possible types of supervisory outcomes / results.

Part I: Supervisory mission and focus

4. The Hong Kong securities market has experienced a rapid growth over the recent years. Licensed corporations have increased both in number and their level of sophistication. The recent global financial crisis has substantially raised market volatility and increased the financial risks of licensed corporations. The selling practices of licensed corporations have also become increasingly important as more retail investors have invested in non-conventional investment products. In addition, the global regulatory landscape is fast evolving with possible implications on our regime.

5. Taking the above into consideration, the following departmental mission statement as regards intermediary supervision has therefore been developed:

   "To contribute towards the SFC's mission[2] by adopting a balanced approach in supervising intermediaries with particular focus on their business conduct and financial soundness, for the benefit of investors and the industry."

6. By adopting a balanced approach, the Commission seeks to:

- Secure an appropriate degree of protection for the investing public, without stifling market development; and

- Achieve proportionate risk-based supervision whereby greater supervisory effort can be directed to licensed corporations that are classified as high risk or high impact

[1] As defined under the Securities and Futures Ordinance (Cap. 571).

[2] The SFC's mission is *"to strengthen and protect the integrity and soundness of the Hong Kong securities and futures markets for the benefit of investors and the industry"*.

and places more emphasis on dealing with regulatory issues that may significantly affect investors and/or the market at large.

"High risk firms" generally refers to licensed corporations that warrant closer supervisory attention on account of their management style and the state of their systems and controls, whereas **"high impact firms"** generally refers to licensed corporations whose roles and volume of activities in the market, number of clients served, and amount of client or fund assets held are so significant that any instability in their operations may have a significant impact on the investors' confidence and market stability.

7. When no regulatory regime can ensure zero-failure, our overall supervisory framework has been designed with a view to minimising any adverse impact on the investors and the market when a licensed corporation goes out of business. We generally refrain from over-regulation and micro-management. The senior management of each firm is responsible for the licensed corporation's activities and for properly managing the risks associated with such activities. Appropriate measures should be implemented and maintained for ensuring that the licensed corporation complies with the relevant legislative and regulatory requirements. To this end, senior management of licensed corporations are required to, among other things:

- Develop and implement appropriate systems and controls commensurate with the scale and depth of the licensed corporation's business activities;

- Continually and timely appraise the status of the licensed corporation's operations and financial position, including qualitative and quantitative risks posed thereto or weaknesses detected therein;

- Ensure that management and supervisory functions are performed by qualified and experienced individuals; and

- Ensure that its staff acts honestly, fairly and in the best interests of clients and the integrity of the market.

8. The Commission's supervisory activities primarily focus on the following two areas:

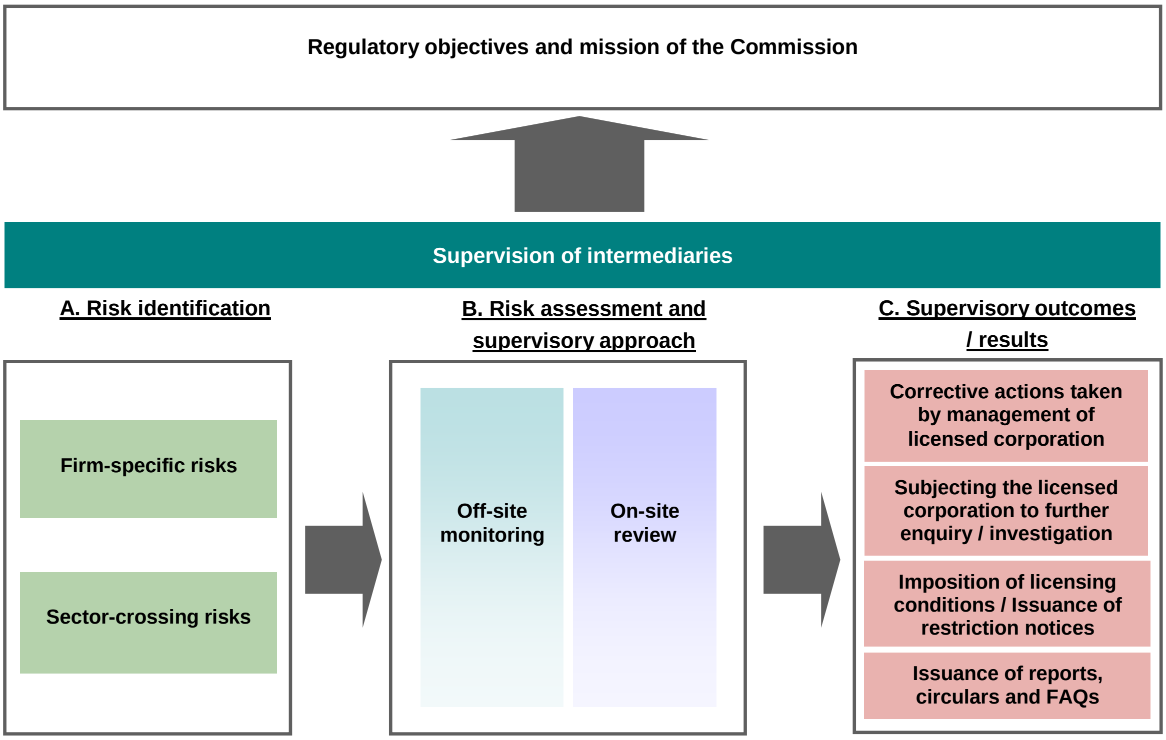
- <u>Prudential supervision</u>

  All licensed corporations are required to properly manage their financial risks and maintain at all times financial resources commensurate with the level of risk undertaken for the proper performance of their business, including ensuring compliance with certain minimum requirements set out in the Securities and Futures (Financial Resources) Rules (**"FRR"**). The FRR requires each licensed corporation to maintain at all times adequate liquid capital, after making provision for market and counterparty risks, so as to enable it to meet all of its liabilities. Various tools are employed to assess and monitor licensed corporations' financial risks and subjects high impact firms to closer scrutiny, given that their financial distress may bring about significant contagion effects on other licensed corporations.

- <u>Business conduct supervision</u>

  All licensed corporations are required to properly supervise their business conduct and remain fit and proper. In particular, they should comply with, *inter alia*, the requirements under the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**"Code of Conduct"**) and the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission and abide by general principles such as acting with due skill, care and diligence and dealing with their customers in a fair and honest manner. The Commission identifies, assesses and monitors licensed corporations' business conduct through on-site inspections and following up on complaints and self-reported breaches. As for high risk and high impact firms, they are generally subject to more frequent on-site inspections and closer scrutiny.

Part II: Supervisory framework



A. Risk identification

(a) Firm-specific risks

9. Licensed corporations may present different kinds of risks to their clients and to the market at large. The more common types of risks fall into two categories: (i) financial risks; and (ii) business conduct risks.

- Financial risks

  This is normally associated with licensed corporations that have inadequate liquidity, ineffective credit management systems, unsustainable business models or high leverage. Financial risks typically include credit/counterparty risk, liquidity risk and market risk where licensed corporations may be exposed to losses caused by default by clients / counterparties, inadequate liquid funds and adverse market movements.

- Business conduct risk

  This generally covers the risk of loss to the licensed corporation, its clients and/or counterparties stemming from inappropriate or undesirable business conduct or violation of applicable laws and regulations by a licensed corporation.

(b) Sector-crossing risks

10. The term "sector-crossing risks" refers to risks that may affect the whole securities industry or a significant segment of the industry instead of isolated licensed corporations. These are normally associated with the following three areas:

- Economic and market performance

  The Commission strives to monitor risks arising from major changes in the economic / market environment that would have significant impact on the business operation of licensed corporations. For example, when the stock market was booming in 2007, a detailed analysis was carried out on the margin financing business of major firms to assess their risk management control and compliance with related regulation.

  The Commission also conducts market surveys and analyses consolidated industry data so as to identify trends and emerging risks / issues that require regulatory response.

- Market evolution

  The Commission is mindful of the dynamism present in today's financial markets. For some time, the Commission has been reviewing the selling practices of licensed corporations and notably in 2007, issued the *"Questions and Answers on Suitability Obligations of Licensed and Registered Persons who are engaged in Financial Planning and Wealth Management Business Activities"*, in order to provide additional guidance to the industry.

- Regulatory

  From time to time, surveys and special reviews are conducted on areas of particular regulatory importance. A regulatory area that is kept under constant review is anti-money laundering. We conducted a special review in 2011 on selected licensed corporations focusing on their customer due diligence – initial and ongoing, record keeping and identification and reporting of suspicious transactions.

B. Risk assessment and supervisory approach

11. The risk assessment and supervisory approach for all licensed corporations is premised upon the following:

- The senior management bears primary responsibility for ensuring proper management of risks associated with the licensed corporation's business, maintenance of appropriate standards of conduct and adherence to proper procedures by the licensed corporation on a day-to-day basis; and

- The level and nature of risks and impact that a licensed corporation poses to the regulatory objectives of the Commission essentially determine the intensity of supervision to be applied in respect of that corporation.

12. Various supervisory methodologies and tools have been established to help us identify, assess and monitor the relevant risks of a licensed corporation. They can be broadly categorised as:

    - **Appropriate regulations and early warnings mechanism:** By providing detailed risk management guidance for senior management of licensed corporations, imposing various regulatory limits (e.g., re-pledging limits that cap the amount of client collateral that can be re-pledged by licensed corporations with banks) and the FRR (with its early warning systems[3]), licensed corporations are able to properly monitor and manage their financial position and business themselves.

    - **Auditor certification:** Pursuant to the Securities and Futures (Accounts and Audit) Rules and Practice Note 820 issued by the Hong Kong Institute of Certified Public Accountants, external auditors of a licensed corporation are required to provide assurance to the Commission on the financial information provided by the licensed corporation, and on the systems of control operated by the licensed corporation in relation to its stewardship of client assets.

    - **Proactive monitoring:** This can be broadly categorised into off-site monitoring and on-site review. Off-site monitoring primarily entails maintaining ongoing dialogues with senior management of licensed corporations, performing regular sensitivity / stress testing and other detailed analyses of financial and non-financial intelligence, when key business conduct and compliance risks are typically subject to further assessment during an on-site review.

13. A proportionate supervisory approach is taken on individual licensed corporations commensurate to their risks and the extent of their impact on the Hong Kong securities and futures markets. Effectively, each licensed corporation is subject to review of regular financial returns and other submissions to the Commission as well as our on-site review from time to time.

14. More intensive supervision will, however, be adopted towards licensed corporations that pose higher regulatory risks or have significant impact to the market. For example, they may be subject to more frequent inspections and the breadth and depth of the inspection scope may be adjusted, depending on our risk assessment of the firm. Off-site monitoring may also be stepped up.

(a) Off-site monitoring

15. For the purpose of off-site monitoring, the Commission maintains regular interactions with licensed corporations in order to understand their business models, latest plans and aspirations, and the risks inherent in such activities, with a view to identifying and assessing the risks arising from their business activities. The Commission also taps intelligences from different sources, follows up on complaints and self-reported breaches as well as considers applications for subordinated loans and rule modifications/ waivers

[3] Where, for example, a licensed corporation is required to report to the Commission when its liquid capital falls below a certain level).

upon application by licensed corporations. Through consolidating information gathered from various sources, the Commission would be in a better position to form a holistic view of the business profile of the licensed corporation.

16. A major part of our off-site monitoring is to assess the financial soundness of licensed corporations, mainly through analysis of regular financial returns submitted by licensed corporations, and identify any licensed corporations that may potentially be in financial difficulties. This is achieved by:

- the use of system-aided risk indicators (including trend analyses and peer comparisons) to identify firms showing apparent out of sync performance for follow-up actions; and

- performance of sensitivity and stress testing in a timely fashion to identify particular financially vulnerable firms. Increased vigilance will be placed on such identified firms, and where warranted, they may be required to develop and implement appropriate contingency or remedial plans.

17. In addition, other information about licensed corporations' risks is collected from time to time through licensed corporations' filings with the Commission, including but not limited to annual audited accounts, compliance reports, business and risk management questionnaires, etc. Any issue raised or qualified opinion expressed by the external auditor of a licensed corporation will be followed up and where applicable swift actions will be taken to contain the situation and protect clients which may involve working with the auditor.

18. To enhance our data analysis, intelligence from other sources is also collected that include:

- market news or media reports;
- actions taken by other divisions of the Commission;
- sharing with or referrals from fellow regulators (such as the Hong Kong Monetary Authority, Office of the Commissioner of Insurance and Mandatory Provident Fund Schemes Authority);
- frequent dialogue with market practitioners / industry and trade associations; and
- industry surveys (including mystery shopping programs) conducted by the Commission from time to time.

19. Following up on complaints against licensed corporations and self-reported breaches are other important aspects of our supervisory function because they may potentially uncover deep seeded issue inherent thereto. Typically, the process encompasses initial fact-finding, detailed analysis and follow-up actions. Where a regulatory breach is suspected to have been committed by the firm or its staff, such may be subject to further enquiry and/or investigation depending on the seriousness of the breach. Assessment will also be made if the firm has since taken appropriate remedial actions to prevent the self-reported breaches from recurring in the future.

20. Another important task is handling applications for subordinated loans as well as modification / waivers of rules to facilitate the specific business needs of licensed corporations. These applications will be carefully considered and approval will be granted only when the interests of the investing public are not prejudiced.

(b) On-site review

21. An on-site review is a key supervisory tool that helps us understand a firm's business operation, risk management and internal controls, and gauge the level of compliance with relevant laws and regulatory requirements. This should enable us to assess whether, and to what extent, licensed corporations act with due skill, care and diligence and adopt proper business conduct, procedures and practices in accordance with the relevant laws and regulations. However, it should be noted that on-site reviews cannot identify and correct all breaches and deficiencies, bearing in mind the following factors:

    - The scope of review must be limited to selected areas of relatively high importance based on professional judgement and therefore may not reveal all breaches, deficiencies and irregularities that may exist; and

    - The findings of an on-site review only represent a snap-shot of the firm's business activities at a particular point of time.

22. There are four types of on-site review, namely:

    - Routine inspection;
    - Special inspection;
    - Thematic inspection; and
    - Prudential visit.

23. Different inspection checklists and programs have been developed to cover the different business activities conducted by licensed corporations, which are used as guidance only as the scope and depth of each review is tailor-made to suit the specific circumstances of each case, thereby maximising the effectiveness of our supervision.

    <u>Routine inspection</u>

24. All licensed corporations are subject to our routine inspections. These inspections are general checks on the firms' systems and controls, as well as their compliance with the relevant rules and regulations, in the area(s) of relatively high importance. Typically, before the inspection is due to commence, the inspection team will identify the key potential risk areas and formulate an inspection plan.

25. In most cases, a balanced top-down and bottom-up approach is adopted which is set to assess the overall effectiveness of a licensed corporation's systems and controls for ensuring compliance with key legal and regulatory requirements applicable thereto. This is achieved by:

    - First gaining a high-level understanding of the licensed corporation's business activities, operations, systems and controls, as well as future aspirations, based on information collected and analysis prepared as part of off-site monitoring work and through discussions with senior management; and

    - Taking appropriate examination steps to ascertain how the firm's systems and controls have been implemented in practice, such as -
        - Performing walk-through tests on key control procedures and processes;
        - Reviewing selected underlying documentation (such as bank and custodian statements to confirm the existence and valuation of assets held) and

performing sample compliance tests; and
- Interviewing relevant staff to assess the control environment of the firm.

Special inspection

26. Special inspections are performed on licensed corporations suspected to pose imminent risks to the market or to their customers, for example, where there is reason to suspect misappropriation of client assets. In this case, inspection steps are tailor-made to cater for the specific circumstances of each case. Normally, a special inspection involves carrying out detailed substantive testing and forensic reviews to assist in gauging any potential losses to investors.

27. Special inspections are also performed on licensed corporation where its financial position is considered vulnerable. In this case, an on-site inspection will be arranged as soon as practicable to assess its latest financial and liquidity positions, as well as determine if client interests may be at risk, so that the Commission can move to ring fence the licensed corporation if necessary.

Thematic inspection

28. Thematic inspection is the primary tool used to assess the scale and nature of a particular sector-crossing risk, which may be triggered upon the Commission identifying trends, emerging risks and compliance lapses that require prompt regulatory response. A sample of licensed corporations will be selected for review in each round of thematic inspection. The review steps are normally tailor-made, which typically revolve around analysing certain sector-specific business aspects, activities or practices, such as the 2009 review of due diligence work performed by sponsors in the preparation of listing documents in initial public offering activities.

Prudential visits

29. Prudential visits are part of our continuous supervisory process. Through visiting the office of the licensed corporation and meeting with their management team, we can obtain a high level understanding of the licensed corporation's latest business developments, business outlook and how it manages the challenges it faces. In particular, information on both firm-specific events and significant market / industry events would be discussed during the meeting to assist us to ascertain their impact on the licensed corporation and the industry as a whole.

30. Such visits also serve as a platform that enables us to build rapport with the senior management of the licensed corporations. They provide an opportunity for sharing views on the market and regulatory environment and discussing any regulatory issues or concerns.

31. Different from inspections, prudential visits are less formal and are generally directed at information gathering. The information obtained may enable a better assessment of the risk profile of the licensed corporations and would be taken into consideration in determining if an inspection or further review is required.

C. Supervisory outcomes / results

32. Strong emphasis is placed in early detection and management of potential risks so as to contain the damage that may arise in case the potential risk crystallises. It also strives to

ring fence risky firms to minimise the spread of contagion risks. In the event that non-compliance with applicable laws and regulations or control deficiencies have been identified, or where a licensed corporation is considered to be running its business aggressively without properly managing the corresponding financial risks, such findings and/or concerns will be communicated to the licensed corporation. The licensed corporation will also be required to take prompt and effective remedial actions, or where appropriate, implement contingency plans (such as injection of capital or subordinated loans), to deal with the problems.

33. At times there may be a need to alert the Hong Kong Exchanges and Clearing Limited for their consideration of the need for additional risk management measures, such as imposing appropriate trading caps, etc. on the licensed corporation.

34. Where major breaches or non-compliance have been identified, our Enforcement Division may conduct further enquiry / investigation into the case and, where appropriate, take disciplinary actions (which include reprimands, revocations or suspension of licenses and monetary fines).

35. In cases where internal controls are poor and client assets may be exposed to misappropriation risks, apart from requiring the firm's senior management to tighten related controls, the firm may be required to appoint external consultants to conduct internal control review or circularisation of client balances and positions. The Commission may also impose appropriate licensing conditions on the licensed corporation. If investors' interests are proven to be at imminent risk, expeditious restrictive actions will be taken to preserve the client assets and to contain the damage that could be caused by the firm as far as possible. This can include arranging for the issuance of a notice (after securing approval from our Board) to restrict the way the firm conducts its business or deals with its property.

36. When there are particular issues which should usefully be shared with the industry (for example, some unsatisfactory practices noted from its thematic inspection, survey work and/or other regulatory exercises), the Commission generally issues a report, circular or compiles a list of frequently asked questions and answers to remind the industry of particular legal or regulatory requirements and/or to better communicate the expected standards. Upon identifying more fundamental concerns (including new or emerging risks) which require a regulatory response, the Commission may initiate a detailed review of the regulatory framework for the relevant areas.