



# PEOPLE'S REPUBLIC OF CHINA— HONG KONG SPECIAL ADMINISTRATIVE REGION

## REPORT ON THE OBSERVANCE OF STANDARDS AND CODES

May 2014

In the context of the Financial Sector Assessment Program, a team of IMF staff and experts prepared the Report on the Observance of the Standards and Codes on People's Republic of China—Hong Kong Special Administrative Region.

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# PEOPLE'S REPUBLIC OF CHINA—HONG KONG SPECIAL ADMINISTRATIVE REGION

FINANCIAL SYSTEM STABILITY ASSESSMENT

April 25, 2014

## REPORTS ON OBSERVANCE OF STANDARDS AND CODES

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Markets Department**

This background material presents the Reports on Observance of Standards and Codes (ROSCs) that serve as the background for the Financial System Stability Assessment (FSSA). These reports were prepared during the missions of the Financial Sector Assessment Program (FSAP) led by Carlos Medeiros that visited Hong Kong SAR in September and November 2013.

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## Glossary

AI	Authorized Institution
AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
ATS	Automated trading service
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principle
BO	Banking Ordinance
CE	Chief Executive in Council
CEHK	Chief Executive of Hong Kong
CEO	Chief Executive Officer
CEPA	Close Economic Partnership Arrangement
CIS	Collective investment scheme
CFR	Council of Financial Regulators
CLAF	Consumer Legal Action Fund
CO	Companies Ordinance
CoB	Conduct-of-business
CP	Core Principle
CRA	Credit rating agency
CRO	Chief Risk Office
DoJ	Department of Justice
DPP	Director of Public Prosecutions
DPS	Deposit Protection Scheme
DPSO	Deposit Protection Scheme Ordinance
DST	Dynamic Solvency Testing
ELA	Emergency Liquidity Assistance
ERM	Enterprise risk management
FATF	Financial Action Task Force
FDRC	Financial Dispute Resolution Centre Limited
FDRS	Financial Dispute Resolution Scheme
FRC	Financial Reporting Council
FS	Financial Secretary
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSBCC	Financial Services Branch Coordination Centre
FSC	Financial Stability Committee
FSTB	Financial Services and the Treasury Bureau
GEM	Growth Enterprise Market of SEHK

G-SIB	Global Systemically Important Bank
HKEx	Hong Kong Exchanges and Clearing Limited
HKFE	Hong Kong Futures Exchange Limited
HKFI	Hong Kong Federation of Insurers
HKFRS	Hong Kong Financial Reporting Standards
HKICPA	Hong Kong Institute of Certified Public Accountants
HKMA	Hong Kong Monetary Authority
HKMC	Hong Kong Mortgage Corporation
HKSA	Hong Kong Standards on Auditing
HKSAR	Hong Kong Special Administrative Region
HSBC	Hong Kong and Shanghai Banking Corporation Limited
IA	Insurance Authority
IAS	Insurance Accounting Standards
IAASB	International Auditing and Assurance Standards Board
IIA	Independent Insurance Authority
IAIS	International Association of Insurance Supervisors
ICO	Insurance Companies Ordinance
ICP	Insurance Core Principle
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
ISA	International Standards on Auditing
MA	Monetary Authority
MMT	Market Misconduct Tribunal
MOCE	Margin over current estimate
MOU	Memorandum of Understanding
MPFA	Mandatory Provident Fund Schemes Authority
OCI	Office of the Commissioner of Insurance
ORSA	Own Risk and Solvency Assessment
PCR	Prescribed capital requirement
PFMI	CSS-IOSCO Principles for Financial Market Infrastructures
RBC	Risk-based capital
RMC	Risk Management Committee
R&S	SFC's Risk and Strategy Unit
SEHK	Stock Exchange of Hong Kong
SFC	Securities and Futures Commission
SFLC	Securities and Futures Liaison Committee
SFO	Securities and Futures Ordinance
SFST	Secretary for Financial Services and the Treasury

SRO	Self-regulatory organization
ULP	Unit-linked policies
UTC	Code on Unit Trusts and Mutual Funds

# BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

## A. Summary

**1. Hong Kong Special Administrative Region (HKSAR) has a very high level of compliance with the Basel Core Principles (BCPs) for Effective Banking Supervision.** The Hong Kong Monetary Authority (HKMA) complements its high supervisory standards with a sustained commitment to the international regulatory reform agenda where it is an early adopter of many standards. HKMA supervises a major international financial center which was affected, though not significantly so, by the financial crisis. The banking system is characterized by the dominant presence of institutions with foreign ownership, including the systemic banks, which puts a premium on the HKMA's role as a host supervisory authority. The HKMA is an authoritative supervisor, operating with de facto independence and conducting a close and continuous supervisory approach which places strong weight on clear communication with the industry and the expectation of high standards of corporate governance. Despite safeguards, however, the independence of the HKMA is not as fully protected by law as it could be. Some regulatory tightening is warranted to ensure the HKMA has a full suite of supervisory powers and is using the most appropriate regulatory definitions.

## B. Information and Methodology Used for Assessment

**2. This assessment of the BCP for Effective Supervision is part of the 2013 FSAP update for HKSAR.** The assessment of the HKMA was conducted during an IMF mission that visited HKSAR during November 7–26, 2013.<sup>1</sup> HKSAR is among the early jurisdictions to be assessed against the BCP methodology issued by the Basel Committee on Banking Supervision (BCBS) in September 2012. In their self-assessment, the authorities addressed both essential and additional criteria and the assessors have based their conclusions on compliance with both criteria. The last BCP assessment was conducted in 2002.

**3. This assessment is not directly comparable to previous assessments.** The assessment methodology had been revised twice, in 2006 and again in 2012, since the last assessment and HKSAR was not assessed against the 2006 methodology. In revising the Core Principles (CPs) to reflect the lessons from the recent financial sector crisis, the BCBS has sought to raise the bar for sound supervision and to update the principles on the basis of emerging supervisory best practices. In particular, the revised BCPs strengthen the requirements for supervisors, the approaches to supervision and supervisors' expectations of banks. While the BCP set out the powers that

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<sup>1</sup> The assessment team comprised Katharine Seal (IMF) and Elizabeth Roberts (former Financial Stability Institute, Consultant).



supervisors should have to address safety and soundness concerns, it provides a heightened focus on the actual use of the powers, in a forward-looking approach through early intervention.

**4. The standards were evaluated in the context of the Hong Kong financial system's sophistication and complexity.** An assessment of a country or special administrative area against the CPs must recognize that its supervisory practices should be commensurate with the complexity, interconnectedness, size, and risk profile and cross-border operation of the banks being supervised. In other words, the assessment must consider the context in which the supervisory practices are applied. The concept of proportionality underpins all assessment criteria. For these reasons, an assessment of one jurisdiction will not be directly comparable to that of another.

**5. An assessment of compliance with the BCPs is not, and is not intended to be, an exact science.** Reaching conclusions required judgments by the assessment team. Banking systems differ from one country or area to another, as do their domestic circumstances. Furthermore, banking activities are undergoing rapid change after the crisis, prompting the evolution of thinking on, and practices for, supervision. Nevertheless, by adhering to a common, agreed methodology, the assessment should provide the Hong Kong authorities with an internationally consistent measure of the quality of their banking supervision in relation to the revised CPs, which are internationally acknowledged as minimum standards.

**6. The assessment team reviewed the framework of laws, rules, and guidance and held extensive meetings with officials of the HKMA, and additional meetings with the Financial Services and the Treasury Bureau (FSTB), auditing firms, professional bodies, and banking sector participants.** The authorities provided a comprehensive self-assessment of the CPs, as well as detailed responses to additional questionnaires, and facilitated access to supervisory documents and files on a confidential basis as well as staff and systems.

**7. The team appreciated the very high quality of cooperation received from the authorities.** The team extends its thanks to staff of the authorities, who provided excellent cooperation, including extensive provision of documentation and technical support, at a time when many other initiatives related to domestic and global regulatory initiatives were in progress.

## C. Overview of the Institutional Setting and Market Structure

**8. HKSAR has a large and well developed financial system.** At the time of the assessment, Hong Kong banks were well capitalized, profitable and had extremely low levels of nonperforming loans. The banking sector includes 201 institutions—156 licensed banks, 21 restricted license banks, and 24 deposit taking companies—with assets equivalent to over 705 percent of GDP. The assets of the four largest banks—the Hong Kong and Shanghai Banking Corporation Limited (HSBC), Hang Seng Bank Limited (a subsidiary of HSBC), Bank of China (Hong Kong) Limited, and Standard Chartered Bank (Hong Kong) Limited—account for almost half of the total consolidated assets of the banking system. Lending to the corporate sector represents around half of the banking system's total lending, while property-related lending accounts for about 30 percent.

**9. HKSAR is an open banking market with significant foreign participation.** Of the 156 licensed banks, 135 are foreign branches and 14 are foreign subsidiaries. There is a strong presence from the global systemically important banks (G-SIBs) as 27 out of the 29 G-SIBs identified by the Financial Stability Board (FSB) in November 2013 undertake banking activities in HKSAR. Accounting for about 35 percent of total assets of the banking system, foreign branches operate a diversity of business models in HKSAR: some act as group liquidity hubs, some conduct investment banking activities, others are active in corporate lending or the local interbank market, and a few of them also have a substantial retail engagement.

**10. In HKSAR, there are three tiers of deposit-taking institution.** These institutions, collectively referred to as Authorized Institutions (AIs), are regulated and supervised by the Monetary Authority (MA), through his office of the HKMA. These are: (i) licensed banks—which can carry on the full range of banking business; (ii) restricted license banks—mostly merchant or investment banks—which may take deposits of at least HK\$500,000 (or an equivalent amount in any other currency) without limit on term; and (iii) deposit-taking companies—principally consumer and trade finance companies—which may take deposits of at least HK\$100,000 (or an equivalent amount in any other currency) of a tenor of not less than three months.

**11. The stability of the system is underpinned by the Exchange Fund.** The Fund includes assets backing the monetary base (HK\$1.3 trillion as of June 2013), the fiscal and other government reserves (HK\$0.9 trillion), plus other assets. While the primary objective of the Fund is to sustain the currency stability (through the Linked Exchange Rate System), it can also be used to maintain the stability and integrity of Hong Kong's monetary and financial systems. In particular, it can be used to provide both liquidity and capital to the banking system in circumstances where there are implications for systemic stability and provides the backstop for the Deposit Protection Scheme (DPS). A swap facility with the People's Bank of China provides a renminbi liquidity backstop (of HK\$0.5 trillion).

## D. Preconditions for Effective Banking Supervision

**12. An assessment of preconditions is beyond the scope of the BCP assessment itself.** However, a factual review facilitates an understanding of the environment in which the banking system and the supervisory framework operate. This section discusses the following preconditions: sound and sustainable macroeconomic policies, a well established framework for financial stability policy formulation, a clear framework for crisis management, recovery and resolution, an appropriate level of systemic protection (or public safety net), while maintaining effective market discipline, and a well developed public infrastructure.

**13. HKSAR has a well-established framework of fiscal, monetary and other macroeconomic policies.** HKSAR has a highly externally-oriented economy, resulting in a high correlation to changes in global economic conditions, particularly those affecting the regional markets and its major trading counterparts in the Asian region and the United States. The nature of its economy underlies the importance of the stability of the external value of its domestic currency. In this connection, the primary monetary policy objective of HKSAR is to maintain currency stability,

in terms of a stable exchange rate of the Hong Kong dollar against the U.S. dollar at a linked exchange rate. The linked exchange rate system was established in 1983, and the Exchange Fund had assets of US\$391 billion as at end-December 2013.

**14. In HKSAR, responsibilities for supervision of financial institutions and markets are divided among four principal financial regulators.** The banking, securities and insurance industries and the operation of the Mandatory Provident Fund and occupational retirement schemes are primarily regulated by four financial regulators, namely, the Monetary Authority (MA), the Securities and Futures Commission (SFC), the Insurance Authority (IA), and the Mandatory Provident Fund Schemes Authority (MPFA). Each of the financial services sectors is subject to a licensing/registration regime and a regulatory framework for ensuring the on-going safety and soundness of regulated entities and the conduct of their business in a proper, prudent manner. The supervisory authorities and agencies seek to ensure effective supervisory cooperation to ensure cross-sectoral issues of mutual concern can be dealt with in an effective manner.

### **Financial stability coordination**

**15. Interagency coordination on financial stability is supported by the Financial Stability Committee (FSC).** The MA, the IA, the SFC, and the FSTB meet frequently to discuss regulatory issues, monitor cross-market risks and review issues that may have implications for financial stability. For the financial sector as a whole, FSC was set up in 2000 to monitor the functioning of the financial system in HKSAR, including the banking, debt, equity, derivatives, insurance and related markets, and deliberate on issues with possible cross market and systemic implications. It reports to the Financial Secretary (FS) regularly and at any time where necessary. The committee, which meets on a monthly basis, is chaired by the Secretary for Financial Services and the Treasury (SFST) of the HKSAR Government, and comprises the MA, the Chief Executive Officer (CEO) of the SFC, and the IA. The FSC meets on a monthly basis and provides regular reports to the FS. Where regulatory action is needed, the FSC refers matters to the CFR.

**16. The Council of Financial Regulators (CFR) has been established to minimize gaps or duplication in the regulation and supervision of financial institutions.** The CFR facilitates sharing of information and views as well as identification of important trends. It also serves as a platform to review regulatory and supervisory issues with cross-sectoral implications. The CFR is chaired by the FS and consists of the SFST, the MA, the CEO of the SFC, the IA, and the Managing Director of the MPFA. The CFR meets on a quarterly basis.

**17. The HKMA has established the Macro-Surveillance Committee to focus on financial stability and macro prudential analysis.** The committee is chaired by the MA and its members include Deputy Chief Executives and Executive Directors drawn from both the banking and monetary sides of the HKMA's operations. The committee identifies potential risks and threats to the monetary and financial system in HKSAR and discusses possible measures to address such risks, and reviews existing measures for managing risks in the monetary and financial system to identify possible gaps and ensure the adequacy of these measures. As part of its macro-financial surveillance, the HKMA

publishes a Half-Yearly Monetary and Financial Stability Report. The other major financial sector regulators also have statutory financial stability mandates.

### **A well developed public infrastructure**

**18. HKSAR is a common law jurisdiction where the courts are operated by a Judiciary independent of the executive organ of the government and the legislature.** When Hong Kong became a Special Administrative Region of the People's Republic of China in 1997, the Basic Law, which sets out the constitutional framework of the Special Administrative Region, came into effect. The Basic Law, enshrines the principle of "one country, two systems" and provides that all the laws previously in force (that is, the common law, rules of equity, ordinances, subordinate legislation and customary law) in HKSAR shall be maintained, except for any that contravene the Basic Law and subject to any amendment by the legislature of the Hong Kong Special Administrative Region. Judicial appointment under the Basic Law is by the Chief Executive of HKSAR on the recommendation of an independent statutory body composed of judges and professionals.

**19. The accounts are audited according to the Hong Kong Standards on Auditing (HKSA), issued by the Hong Kong Institute of Certified Public Accountants (HKICPA).** The HKSA are based on the International Standards on Auditing (ISA) issued by the International Auditing and Assurance Standards Board (IAASB). The accounts are prepared based on the Hong Kong Financial Reporting Standards (HKFRS) issued by the HKICPA. The HKFRS are in line with the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board.

### **Framework for crisis management, recovery and resolution**

**20. The Exchange Fund can be used in a crisis affecting the banking system.** The Exchange Fund is a discrete Government fund, separate from the general revenue, established, used and controlled in accordance with the Exchange Fund Ordinance, which may be deployed to provide capital or liquidity support where the failure of an AI is assessed to have systemic consequences. The HKMA has published a policy on its role as lender of last resort for the granting of emergency liquidity assistance (ELA) to banks.<sup>2</sup> The basic precondition is the judgement of the MA that the failure of an AI incorporated in HKSAR, if it is deprived of liquidity assistance, would damage the stability of the exchange rate, monetary or financial systems of HKSAR (i.e., systemic risk). Under this policy framework, ELA can only be granted to a solvent bank and provided, among other preconditions, that there is no prima facie evidence that the management of the bank is not fit and proper or that the distress is a result of fraud. ELA may be provided for a period of a maximum 30 days, with a possible 30 days extension. However, in addition to liquidity support, the Exchange Fund may also be used to provide capital support to a problem bank.

<sup>2</sup> "Policy Statement on the Role of the Hong Kong Monetary Authority as Lender of Last Resort" issued by the HKMA (March 2009) available at: <http://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2009/loir.doc>

**21. The FSTB coordinates in a crisis situation and may activate a Financial Services Branch Coordination Centre (FSBCC).** The FSBCC facilitates communication in circumstances of high market volatility, or if a contingency occurs in the financial sector. The FSBCC facilitates information flow to government departments that under normal circumstances would not be involved in financial sector matters. Also, the FSBCC serves as a focal point of communication or assistance seeking between regulators and relevant government departments. The FSBCC has been activated on several occasions in recent years. Further, Memoranda of Understanding (MOUs) support bilateral information exchange and coordination between regulatory authorities.

**22. The HKMA is developing formal requirements for AIs in relation to recovery and resolution plans.** In late 2012, the HKMA began a consultation process on the requirements for Recovery and Resolution Planning and expects to issue guidance on recovery planning in early 2014. At the time of the assessment, the HKMA was engaged in working to introduce a domestic resolution regime to meet the FSB's standards in its Key Attributes. The HKMA was also working towards a domestic framework for recovery and resolution planning for AIs, which will support the resolvability assessments. The HKMA participates in Crisis Management Groups for the G-SIBs that have significant operations in HKSAR.

### **Adequacy of systemic protection (safety nets)**

**23. The DPS and the Deposit Protection Scheme Fund are governed by the Deposit Protection Scheme Ordinance (DPSO).** Membership of the DPS is compulsory for all licensed banks unless the deposits are covered by a home country deposit guarantee scheme commensurate with Hong Kong standards. The DPS is funded by annual contributions collected from member banks on a differential premium basis. An ex-ante funding approach, with a target fund size of 0.25 percent of covered deposits, is adopted to provide for the operating costs and reserve for absorbing the payout costs. The Hong Kong Deposit Protection Board is empowered to impose a surcharge if the fund size falls below 70 percent of the target fund size. In addition, there is a standby liquidity facility of HK\$120 billion (US\$15.4 billion) from the Exchange Fund. The MA is empowered, after consultation with the FS, to trigger payment of compensation pursuant to the DPSO.

**24. Deposits are compensated up to a net amount of HK\$500,000 (US\$64,000) per depositor and bank.** Deposits under five years' maturity for depositors, including individuals and corporates other than AIs, are covered. Off-shore deposits, structured deposits, bearer form deposits (e.g., bearer certificates) and deposits from an excluded person such as a related company of the Scheme member, an AI or a director or controller of the Scheme member or its related company, are not covered by the DPS.

### **Effective market discipline**

**25. The corporate governance regime in HKSAR is founded on a combination of common law, statute, and codes of practice.** Common law establishes directors' fiduciary duties and their duty of skill and care, while the Companies Ordinance (CO) sets out the rights and obligations of

shareholders and officers of the company, respectively. In addition, the Companies Registry has issued non-statutory guidelines on Directors' Duties. Companies that are listed on the Stock Exchange of Hong Kong (SEHK) are subject to additional requirements under the Listing Rules of the SEHK. Recent developments include (i) updating of the SEHK Corporate Governance Code in January 2012; and (ii) passage of a new CO in July 2012 which came into effect in March 2014. The new CO includes enhancements related to corporate governance and shareholder protection.

**26. HKSAR has well-developed arrangements promoting market discipline.** General requirements for disclosure of financial information (i.e., audited annual accounts including balance sheet and profit and loss account) by companies incorporated in HKSAR to their shareholders are set out in the CO. AIs are also subject to the disclosure requirements under the Banking Ordinance (BO), the Banking (Disclosure) Rules made under the BO, and the relevant guidelines laid down by the HKMA. Listed companies are subject to disclosure requirements under the Listing Rules of the SEHK. The requirement to disclose price sensitive information in a timely manner has had statutory backing under the Securities and Futures Ordinance (SFO) since January 2013.

## E. Main Findings

**27. HKSAR has a very high level of compliance with the BCPs for Effective Banking Supervision.**

**28. The HKMA is maintaining its commitment to the international regulatory reform agenda and is an early adopter of many standards.** Supervisory practices, standards and approaches are well integrated, risk-based and of very high quality. A number of the HKMA practices around corporate governance issues, including close and continuing attention to fit and proper standards and to the role played by the Board of an AI deserve particular commendation.

**29. One area in relation to the overarching legislative framework and powers warrants further attention.** The HKMA enjoys clear de facto but not de jure operational independence. Taken as a whole, there is much very good practice and certain important safeguards are in place, such as the potential for judicial review of decisions taken by government authorities. Nonetheless, the independence of the HKMA is not as fully protected by law as it could be.

**30. There are two important cross border dimensions for HKSAR as an international financial center.** One is related to HKSAR's significant position as a host supervisor. The second is the increasing importance of Mainland China in the current portfolios and future prospects of the locally incorporated institutions, and indeed in the choice of HKSAR as a platform for overseas institutions to establish relationships with the Mainland. The HKMA is alert to the potential risks of these dimensions and reflects this awareness in its supervisory planning, activities and relationships with other authorities. Nonetheless, techniques of cross border oversight continue to evolve and the HKMA is urged to remain in the forefront of, and contribute to, developing international supervisory practice, as it already recognizes it needs to do.

**31. There are minor regulatory gaps both in respect of the HKMA's powers and regulatory definitions.** At present, the good practices surrounding lending to parties related to the AI do not apply to its management. Consequently, the definition of related party (or the equivalent term in the BO) needs to be expanded. In relation to external auditors, the HKMA does not have the explicit power to remove the auditor of an AI or to have direct access to the external auditor's working papers. While the HKMA has been able to work around these restrictions, amendments to the appropriate legislation should be made.

**Table 1. Summary Compliance with the Basel Core Principles**

Core Principle	Comments
1. Responsibilities, objectives and powers	<p>The responsibilities and objectives of the HKMA related to banking supervision are both clear and comprehensive, supported by an underlying statutory framework. In using the Exchange Fund, the HKMA may have a view to maintaining Hong Kong's status as an international financial centre, but the Exchange Fund may only be used to support development if this will maintain the stability and the integrity of the monetary and financial systems of Hong Kong.</p> <p>It is clear from discussions with the authorities, supported by the exchange of letters between the MA and FS in 2003, that the HKMA mandate is interpreted in terms of promoting financial stability and ensuring a high quality of regulatory and supervisory standards, as well as robust, up to date financial market infrastructure. It is also clear that despite references to a regard for the status of HKSAR as an international financial center this concept is subsidiary to the mandate for financial stability. In other words, the authorities are strongly committed and required to deliver the highest regulatory and prudential standards.</p> <p>However, the authorities should be mindful of the need to avoid any "objectives creep" such that competitive considerations in promoting HKSAR as an international financial centre risk being viewed as an objective in their own right, decoupled from the financial stability objective. As demonstrated and experienced in other financial centres, the potential exists for a conflict between objectives focused on dimensions of both stability and the status of a financial centre and there is continued need to be vigilant to ensure that, in the future, developmental and even competitive considerations are not allowed to impinge upon and impair prudential standards in order to maintain Hong Kong's status as a vibrant open market.</p>
2. Independence, accountability, resourcing and legal protection for supervisors	<p>The HKMA enjoys clear de facto but not de jure operational independence. While the HKMA has autonomy over its day-to-day operations and in the methods it uses to pursue its public policy objectives this is not underpinned by the law. There is a power in the BO (section 10) for the Chief Executive (CE) of the HKSAR government to give directions to the MA with respect to the exercise of the MA's functions under the BO. While no instance of the use of the power could be cited, the possibility of future use cannot be completely ruled out. In addition, there is no statutory provision that specifies the circumstances under which the MA can be removed from office, or that requires the public disclosure</p>



	of the reasons for the dismissal of the MA. Overall, there is much evidence of good practice, and important safeguards are in place, such as the potential for judicial review of decisions taken by government authorities, which mitigates the risk of any abuse of power. Nonetheless, the independence of the HKMA could be more fully protected.
3. Cooperation and collaboration	The HKMA has strong working relationships with other domestic financial sector supervisory authorities, with an ongoing exchange of information and discussions regarding issues of mutual interest and concern. The HKMA also demonstrated that they have good working relationships with other relevant foreign supervisory authorities, both those with which they have a formal MOU and those with which they continue to deal on a more informal basis. The HKMA also participates in supervisory colleges for foreign AIs that have a significant presence in Hong Kong.
4. Permissible activities	<p>The BO clearly defines the term bank and prohibits the use of the term and any derivations for institutions that are not licensed and supervised as banks (with some exemptions being permitted at the discretion of the MA). The taking of deposits from the public is clearly reserved for licensed AIs that are subject to ongoing supervision by the HKMA.</p> <p>The permissible activities of banks are defined quite broadly; however, the MA has the clear authority to judge the prudence and legality of the activities conducted by individual institutions.</p>
5. Licensing criteria	The HKMA has established a framework of rigorous policies and procedures to carefully review applications for entry into the domestic banking system, whether by a domestic or foreign entity. The HKMA has recently instituted the commendable initiative to meet key individuals as part of the licensing process. This will help to ensure that proposed candidates for Board or senior management positions are fit and proper for their respective positions.
6. Transfer of significant ownership	The BO clearly defines “significant ownership” and “controlling interest” and there are clear requirements for supervisory approval and notification in the case of any changes to the ownership structure. The HKMA expects locally incorporated AIs to consult with them regarding proposed changes in controllers in advance so that any prudential concerns can be addressed at an early stage.
7. Major acquisitions	The HKMA has broad supervisory powers under the BO to review and approve or deny acquisitions or investments by AIs. In conducting its review of proposals submitted by AIs, the HKMA analyzes various criteria to ensure that the AI will not be exposed to undue risks. It also determines that the acquisition or investment will not negatively impact the HKMA’s ability to conduct effective consolidated supervision.
8. Supervisory approach	The HKMA executes an excellent supervisory approach which combines sound risk analytical techniques and a broad range of inputs. The use of thematic exams and the integration between the Supervisory Review Process and CAMEL methodology provides a clear and forward looking basis for a holistic risk assessment process. The HKMA has created a disciplined and responsive approach on the “continuous” risk based principle and intervenes quickly with institutions when issues start to emerge. The supervisory process is informed by active consideration of the wider macro context and tools and techniques to



	enhance this approach continue to be developed, which is important as this is a general area for development within the supervisory community.
9. Supervisory techniques and tools	The HKMA conduct a well balanced supervisory approach, with an emphasis on preventative approaches, carefully integrating on and off-site surveillance techniques. Supervisory teams and specialists demonstrate a close knowledge of and insight into individual AIs and of the system wide dimensions. The annual risk assessment process enables the HKMA to adjust its supervisory priorities and as necessary its resources. The HKMA sets and communicates clear expectations to the industry and balances a readiness to challenge AIs' practices with an openness to and understanding of AIs' legitimate business concerns.
10. Supervisory reporting	The HKMA has wide powers of information gathering which it uses effectively. The authority receives standard prudential data from firms as well as much management information and supplementary data from surveys and ad hoc data as necessary. The HKMA is alert to the potential of seeking redundant information and reviews the necessity of its information requests periodically. Equally, when new returns are required (such as the new return with respect to exposures to the Mainland) considerable care is taken in identifying comprehensive and granular data points to be reported in order to facilitate thorough analysis. The annual discipline of commissioning reports into the accuracy of returns and the potential to commission reports when needed from the external auditor on the underlying control systems for the preparation of information that is submitted to the HKMA provides a further level of control.
11. Corrective and sanctioning powers of supervisors	The HKMA has a strong set of powers under the BO and the HKMA has developed a firm reputation of being a reasonable but assertive authority which does not hesitate to act or to escalate its actions if necessary. In practice, the HKMA prefers preventative measures to remedial measures whenever possible, a stance that was confirmed by the assessors in dialogue with the industry. There is, however, no evidence of supervisory forbearance and the assessors' review of extensive material provided by the HKMA, in addition to industry dialogue, indicated that the HKMA can and does use its range of powers in a timely manner.
12. Consolidated supervision	The HKMA has a strong legal and regulatory framework for consolidated supervision that it applies in practice. The HKMA carefully monitors actual and potential risks across the entire group structure, placing emphasis on corporate governance and robust risk management policies and procedures. The HKMA analyzes AIs on both a solo and consolidated basis.
13. Home-host relationships	HKSAR is a major international financial center and the HKMA is a significant host jurisdiction, which puts a premium on the quality of home-host supervisory relationships. The HKMA participates in supervisory colleges and seeks to foster close bilateral relationships with key home state supervisors. Importantly, the HKMA is conscious of the need to continue developing relationships and evolving modes of communication and shared analysis for cross border groups.
14. Corporate governance	The HKMA places a great deal of emphasis on the importance of sound and effective corporate governance at AIs, irrespective of whether they are a local institution or the branch or subsidiary of a foreign bank. Their oversight of the quality of corporate governance serves as the basis for their on- and off-site work and they endeavor to develop a sound understanding of the effectiveness of Boards, Board Committees and senior management. This process includes

	periodic meetings with Board members, especially those who are independent directors and an interview process on a selective basis for candidates for Board positions.
15. Risk management	The HKMA has developed a supervisory process that focuses intensely on the risk management standards, policies and procedures at individual AIs. The emphasis on the quality and thoroughness of risk management is reflected in the SPM and guidance notes, the on- and off-site supervisory work, as well as the CAMEL rating process and Supervisory Review Process. The HKMA has been developing specialist teams to ensure that they can adequately assess the risks incurred by AIs and act as needed.
16. Capital adequacy	The HKMA has adopted the various components of Basel 2, 2.5, and 3 on or ahead of schedule. It has taken a more conservative approach for certain items recognized as regulatory capital than is required by the Basel standards. The HKMA applies both the three Basel ratios (common equity tier 1, tier 1 and total capital) as well as a trigger for each of these ratios on an individual AI basis, taking into consideration the unique characteristics of each institution. Supervisory staff regularly assesses AIs' capital management and planning and uses stress testing to assess the adequacy of capital.
17. Credit risk	The HKMA pays close attention to the credit risk policies and exposures of AIs and initiates discussions with management whenever issues arise. Supervisors conduct regular detailed on-site review of AIs' credit portfolios and require corrective actions on a timely basis if problems are detected. Market and macroeconomic conditions are taken into account when analyzing the credit risk within the banking system. Due to the size of Hong Kong AIs' exposure to residential mortgages and non-bank Mainland, the HKMA has a system in place to carefully monitor these activities. The HKMA recently revised its reporting requirements for exposures to Mainland to obtain much more granular information to support in-depth analysis on system-wide and individual AI bases.
18. Problem assets, provisions, and reserves	Through the use of reports submitted on a regular basis, the review of external auditor reports and on-site examinations, the HKMA closely monitors problem assets at individual AIs. Supervisory staff evaluates the adequacy of AIs' classification and provisioning policies for both on- and off-balance sheet exposures. Very importantly, the HKMA has addressed the conceptual difference between the accounting (incurred loss) and supervisory approaches to provisioning by requiring Hong Kong AIs to maintain a "regulatory reserve" to help neutralize the effect of accounting changes implemented in 2005. This has helped to ensure that AIs maintain adequate loan loss provisions.
19. Concentration risk and large exposure	The HKMA utilizes reports received from AIs on a quarterly basis to monitor large exposures (defined as equal to or exceeding 10 percent of the AI's capital base) and risk concentrations. Through on-site examinations, supervisory staff determines that AIs' management information systems identify and aggregate on a timely basis risk concentrations and that senior management and Boards of AIs utilize this information to actively oversee risk concentrations. In addition, AIs are required to include significant risk concentrations in their stress testing programs for risk management purposes.
20. Transactions with related parties	The HKMA reviews the policies of AIs related to connected lending and reviews the credit files of connected exposures to ensure that facilities granted to connected parties are extended on an arm's length and prudent basis. The BO

	places restrictions on the amount of unsecured exposures, including loans, that an AI may have with a related party; however, the current legal definition of “connected party” (or the equivalent term under the BO) does not explicitly cover an AI’s senior management or the senior management of affiliates. In addition, boards of AIs are currently not required to provide prior approval to the write-off of exposures to related parties exceeding specified amounts or otherwise posing special risks to the AI.
21. Country and transfer risks	The HKMA requires AIs to actively manage country and transfer risks and it receives information on a quarterly basis in order to monitor the exposure of AIs to such risks. It has recently been giving heightened attention to the risk involved in AIs’ exposure to certain European countries that have been experiencing difficulties, as well as to the Mainland. In addition, the Banking Supervision Department makes use of the work being done by the HKMA’s Financial Stability Surveillance Division and Macro Surveillance Committee, which are responsible for monitoring emerging macro-prudential risks facing the Hong Kong banking sector.
22. Market risk	The HKMA has implemented a comprehensive approach to the supervision of market risk, including the introduction of the most recent Basel amendments (Basel 2.5). While overall levels of market risk are modest for the international financial center, at less than 5 percent of risk weighted assets, the HKMA has ensured that all AIs with internal models approvals have been subject to reassessment to ensure they continue to meet standards for approval. The HKMA is particularly mindful of the need to tailor models to local market environment and puts a premium on new product processes and internal controls.
23. Interest rate risk in the banking book	Interest rate risk is, currently, a low impact risk for the banking sector in HKSAR but the HKMA demonstrates a cautious approach to ensuring that standards of risk management are maintained.
24. Liquidity risk	The HKMA has adopted a vigorous approach to liquidity risk supervision. Preparations are well underway for the timely introduction of the Basel liquidity framework and the intensity of on-site examinations and thematic reviews is increasing. The HKMA has a track record of challenging the liquidity assumptions and liquidity risk management behavior of the banking sector and encouraging and enforcing greater conservatism as necessary.
25. Operational risk	The HKMA has developed a balanced program for assessing operational risk management, utilizing on and off-site techniques and applying a risk based approach. Specialist teams for operational risk and technology risk have been created and there is a strong focus on raising awareness and encouraging industry wide good practice, such as through the issuance of circulars.
26. Internal control and audit	The HKMA’s supervisory practices pay close attention to the adequacy of internal risk control and compliance functions within firms. Off-site techniques complement regular direct contact with Audit Committees and other control functions.
27. Financial reporting and external audit	The HKMA devotes effort to ensuring effective communication channels with the external auditors. Furthermore, the HKMA’s use of its powers to commission reports on AIs to be carried out by the external auditors for supervisory purposes further supports the nature of the relationship and the understanding of the

	HKMA's supervisory concerns. However, there are two areas in which the HKMA lacks powers and where the legislative framework could therefore be enhanced, in relation to powers to reject the appointment of an external auditor, when there are concerns over competence or independence, and direct power to access to the working papers of the external auditor even though the HKMA has, to date, been able to address issues that have arisen by indirect means.
28. Disclosure and transparency	The HKMA has implemented all Pillar 3 requirements in a timely manner through the Banking (Disclosure) Rules and has promoted the recommendations of the FSB's Enhanced Disclosure Task Force to the local market. The HKMA is also monitoring actual practice and is sensitive to the possible need to provide additional guidance to the AIs to ensure effective disclosure.
29. Abuse of financial services	The HKMA has demonstrated a high degree of commitment to enhanced regulatory and supervisory practice in relation to Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT). In addition to recent legislative revision and issuance of guidelines, the HKMA has strongly promoted awareness of AML/CFT concerns. The effectiveness of these measures will be assessed by the Financial Action Task Force (FATF) in 2017.

## F. Recommended Actions and Authorities' Comments

<b>Table 2. Recommended Actions to Improve Compliance with the Basel Core Principles and the Effectiveness of Regulatory and Supervisory Frameworks</b>	
<b>Reference Principle</b>	<b>Recommended Action</b>
1. Responsibilities, objectives and powers	As demonstrated and experienced in other financial centers, the potential exists for a conflict between objectives focused on dimensions of both stability and the status of a financial centre and there is continued need to be vigilant to ensure that, in the future, developmental and even competitive considerations are not allowed to impinge upon and impair prudential standards in order to maintain Hong Kong's status as a vibrant open market.
2. Independence, accountability, resourcing and legal protection for supervisors	It is recommended that amendments to the BO be made to eliminate or specify the circumstances under which the legal authority of the CE to give directions to the MA may be exercised. It is also recommended that legislative amendments be made to confirm the reasons for which the MA could be dismissed and to provide for the public disclosure of the reasons for the dismissal of the MA in the BO. In the interim, an exchange of letters between the authorities would address both the use of section 10 powers under the BO and the appointment/dismissal of the MA.
7. Major acquisitions	It is recommended, as the HKMA has noted, that supervisory practices be enhanced with respect to assessing whether major acquisitions and investments by other entities in the banking group will hinder effective implementation of corrective measures in the future, in particular the resolvability of the AI.

8. Supervisory approach	It is recommended that, in keeping with its existing plans, the HKMA continue to intensify its focus on business models and strategy and providing greater consideration to cross sectoral issues. Please see also the recommendation for CP13.
9. Supervisory techniques and tools	It is recommended that the HKMA pay close attention to the frequency of on-site review of the AIs which are incorporated overseas, ie the foreign branches in HKSAR. Similarly, the HKMA should consider a review and as necessary a revision of internal guidance relating to foreign branches.
12. Consolidated supervision	It is recommended that the HKMA consider formalizing its process for analyzing non-financial activities of Ultimate Holding Companies.
13. Home-host relationships	It is recommended that the HKMA maintain momentum on establishing its domestic resolution regime so that it is able to focus on domestic resolution plans in relation to institutions that are part of international groups. This recommendation is part of a wider initiative that also concerns CP8.
20. Related parties	It is recommended that the HKMA execute its plans to seek legal reform to expand the definition of “connected party” (or the equivalent term under the BO) to include senior management, as well as make the corresponding changes to the supervisory policy manual. In addition, current plans to incorporate the requirement that write-offs of related party exposures exceeding specific accounts are subject to prior approval by an AI’s board should be completed.
27. Financial reporting and external audit	It is recommended that the HKMA is granted the direct power to reject and rescind the appointment of an external auditor who is deemed to have inadequate expertise or independence, or is not subject to or does not adhere to established professional standards. Second, it is recommended that a supervisor be granted the direct power to access external auditors’ working papers, where necessary.
28. Disclosure and transparency	It is recommended that the HKMA review best practices in other countries and consider publication of time series data sourced from its regulatory returns, disclosed on an individual institution bases, that would enhance the public and financial community’s understanding of AIs’ operations and risk profile.

## G. Authorities’ Response to the Assessment

**32. The Hong Kong authorities appreciate the comprehensive and positive assessment of Hong Kong’s banking sector and welcome the IMF’s view that HKSAR, as a major international financial centre, maintains a very high level of compliance with the BCPs for Effective Banking Supervision.** The assessment contains some observations and recommendations (for example those in relation to banks’ external auditors and connected parties) that could help further enhance banking supervision in Hong Kong SAR. The authorities will review these recommendations and give due consideration to their adoption, as HKSAR remains committed to the highest standards of banking regulation and supervision.

**33. In relation to BCP 2, the authorities concur with the IMF that MA enjoys clear de facto operational independence in the performance of his functions.** In respect of the question of de jure independence, however, the authorities would like to reiterate (as on the occasion of the 2003 FSAP assessment of Hong Kong SAR) that the reserve power vested in the CE of HKSAR to give directions to the banking regulator reflects the Government's ultimate responsibility to formulate monetary and financial policies and regulate and supervise financial markets as enshrined in the Basic Law. The power, which appears in section 10 of the BO, has never been used and would only be used as a tool of last resort to implement specific remedial measures in the most critical and extreme circumstances. In order to exercise the reserve power, the CE of HKSAR would have to be satisfied that any direction given is in the public interest and consistent with the objectives of the BO and with the Basic Law, and the CE of HKSAR's decision to issue a direction may be subject to judicial review. Hence there are safeguards against arbitrary use of the reserve power, and, given these qualifications, the authorities consider that the power does not in fact substantively compromise the operational independence of the MA as banking supervisor.

**34. Also in connection with BCP2, the authorities consider that the existing arrangements for the removal of the MA as (the head of) the banking supervisor are in practice adequate to preserve his independence.** The FS is empowered to revoke the appointment of the MA and, should he consider doing so, he will be required under the common law to act reasonably and take all relevant factors into consideration. The FS's decision may be subject to judicial review. The letter of appointment between the FS and the MA makes it clear that it is not the intention to terminate the MA's employment except for cause, such as his inability to discharge, or adequately carry out, his functions or duties; serious misconduct; conviction of a criminal offence punishable by imprisonment; or bankruptcy. In the interests of transparency, the HKMA makes public announcements of all of its staff changes at the level of Executive Director or above; including the reasons for such staff changes.

**35. Encouraged by the IMF's overall assessment of banking supervision in HKSAR, the Hong Kong authorities will continue to refine and strengthen the local regulatory and supervisory framework in line with international best practice to promote the stability and effective working of the banking system in HKSAR.**

## ASSESSMENT OF INSURANCE CORE PRINCIPLES

### A. Summary

**36. The regulatory regime in HKSAR, supported by robust supervision by the IA, has a high level of observance of the Insurance Core Principles (ICPs).** The IA is highly regarded by the industry and its strong supervisory practices compensate for most of the legal gaps under the Insurance Companies Ordinance (ICO). The proposed Independent Insurance Authority (IIA) will have enhanced legal capacity, financial and operational independence, as well as a transparent system of accountability, in line with international best practice. The operational autonomy of the proposed IIA could be further strengthened, and it should have a clear mandate to supervise public disclosures by insurers.

**37. The legal regime needs to be updated and the plan to move towards a risk-based capital (RBC) regime is welcome.** The ICO needs to be strengthened to provide clear legal backing to the IA's supervision in a number of areas, particularly in establishing a comprehensive framework for group supervision. Pending the introduction of the RBC, the IA is advised to establish solvency margin requirements for all classes of long term business, provide supervisory guidance on insurers' obligations to meet policyholders' reasonable expectation, and enhance the current dynamic solvency tests. The proposed IIA's new mandate on thematic research and studies will contribute to more comprehensive and structured macroprudential analysis. The proposed enhancements in the prudential regime need adequate technical support of experienced supervisors and technical specialists.

**38. The mission strongly supports direct supervision of intermediaries by the proposed IIA and strengthening the conduct of business (CoB) requirements.** The current self-regulatory regime for intermediaries involves significant duplication of efforts. In addition, industry codes and standards issued by the self-regulatory organizations (SROs) are not legally binding and the SROs are not full-fledged supervisors. Direct supervision would minimize the potential conflict of interests arising from self-regulation, and is more in line with international best practices. In addition to the proposal to introduce fundamental CoB principles in the ICO, the authorities should formalize existing practices in promoting professional conduct by insurers and intermediaries to fill current regulatory gaps.

### B. Introduction and Scope

**39. This assessment provides an update on the regulatory and supervisory developments in the insurance sector of HKSAR since 2003.** HKSAR undertook an initial FSAP in 2003, which included a formal assessment of its observance with the ICPs issued by the International Association of Insurance Supervisors (IAIS) in 1999. The current assessment is benchmarked against the ICPs issued by the IAIS in October 2011, as revised in October 2012.<sup>3</sup> The scope of the assessment covers

<sup>3</sup> The assessment team comprised Su Hoong Chang and Philipp Keller (External Consultants).



the supervision of insurers exercised by the IA as well as the oversight of intermediaries' CoB by SROs.

**40. The assessment is based solely on the laws, regulations and other supervisory requirements and practices that were in place at the time of the assessment in September 2013.** Ongoing regulatory initiatives are noted by way of additional comments. The authorities have provided a full and well-written self-assessment, supported by anonymized examples on actual supervisory practices, which enhanced the robustness of the assessment. Technical discussions with, and briefings by, officials from the IA have also enriched this report, as did discussions with industry participants.

### C. Institutional Setting and Market Overview

**41. The IA is responsible for regulating and supervising the insurance industry of the HKSAR.** It is supported by the Office of the Commissioner of Insurance (OCI), a government department in the HKSAR. A self-regulatory system is used to supervise the CoB of intermediaries. Currently, three SROs supervise insurance intermediaries in accordance with non-statutory codes approved by the IA. In practice, the IA supervises the SRO's oversight of intermediaries, and conducts spot checks and independent inspections of insurance intermediaries for quality assurance on the effectiveness of the SROs.

**42. Supervisory coordination among the regulatory agencies in HKSAR is facilitated by the CFR and the FSC.** The FS oversees the financial sector of HKSAR, with policy support by the FSTB, headed by the Secretary for Financial Services and the Treasury (SFST). The CFR is chaired by the FS, and includes the heads of SFC, HKMA, and the IA, and serves as a platform to review regulatory and supervisory issues with cross-market implications. The FSC monitors the functioning of the financial markets in HKSAR and deliberates on issues with possible cross-market and systemic implications. It is chaired by the Secretary for Financial Services and the Treasury and comprises heads of the SFC, HKMA, and the IA.

**43. The authorities have proposed establishing an IIA, scheduled to be implemented in 2015.** The proposed IIA will have enhanced legal capacity, financial and operational independence as well as a transparent system of accountability, in line with international best practice. It will have explicit legal authority for inspections, investigation, and prosecution, as well as broader sanction powers. In addition, direct licensing and supervision of intermediaries by the proposed IIA will replace the current self-regulatory regime.

**44. The insurance sector in HKSAR is mature and diversified.** The insurance penetration and density in HKSAR is among the top 10 in the world. Assets held by insurers totaled about HK\$1,519 billion as of end-2012, accounting for about 9 percent of the total assets of the financial sector. Foreign-owned insurers are dominant in the HKSAR insurance sector, and account for about 72 percent of total assets as at end-2012. The long-term insurance industry is highly concentrated, while the market share of general insurance industry is more evenly distributed. All except one of the top 10 insurance groups are all foreign-owned, with much larger consolidated operations



compared to their operations in HKSAR. A number of insurers are part of financial conglomerates headed by parent banks where HKMA is the lead supervisor.

**45. While there had been some consolidation in the number of insurers, the industry as a whole has seen strong growth in the last three years.** As of end-2012, there were 155 authorized insurers, comprising 43 long-term insurers, 79 general insurers, 13 composite insurers, 19 reinsurers, and one captive insurer. Double-digit growth in the long-term industry for the last three years has been underpinned by increasing affluence and an aging population. Sale of policies to visitors from the Mainland accounted for almost 13 percent of new business premiums in 2012, more than doubling the market share recorded in 2008. The sale of endowment and protection products denominated in renminbi has also been rising rapidly. For the general insurance industry, expansion in the dominant accident and health insurance has been sustained by increased awareness of the need to plan for future healthcare needs. Liability business, comprising the mandatory employees' compensation insurance, also grew over the past five years, mainly due to the increase in construction projects and the general increase in the wage levels.

**46. The Hong Kong Mortgage Corporation (HKMC) is wholly owned by the HKSAR Government through the Exchange Fund and regulated by the IA.** Established in 1999, the HKMC offers insurance coverage to most mortgage banks in HKSAR. In response to escalating property prices in recent years, the HKMC has been revising the maximum loan amounts it will insure. The latest change in February 2013 lowered the loan-to-value ratio (maximum of 90 percent), which varies with the property value (up to HK\$6 million). As of end-July 2013, the total loan drawdown recorded by the HKMC was HK\$240 billion and the reported delinquency ratio of its loan portfolio (0.003 percent as at June 2013) was lower than the general mortgage market delinquency. The HKMC has launched several new products since 2011: (i) SME Financing Guarantee Scheme in January 2011; (ii) Reverse Mortgage Insurance<sup>4</sup> in July 2011; and (iii) microfinance scheme in June 2012. The three core missions of the HKMC are enhancing the stability of the banking sector by offering a reliable source of liquidity; promoting wider home ownership in HKSAR; and facilitating the growth and development of the debt security and mortgage-backed security markets in HKSAR.

**47. Insurers in HKSAR typically adopt a multi-channel distribution strategy.** As of end-2012, there were 37,608 tied individual insurance agents, 2,419 agencies (including 38 banks) with 27,830 responsible officers and technical representatives, as well as 604 brokers with 8,798 chief executives and technical representatives. The proportion of general insurance business distributed by the various channels has been stable over the past three years—about 41 percent of the gross premiums of general insurers were produced by brokers; 21 percent by agents; 12 percent via *bancassurance*; 13 percent from direct sales; and the remaining from other channels. For long-term business, a survey conducted in 2012 indicated that approximately 15 percent of in-force unit-linked policies (ULPs) were sold through banks, 42 percent by agents, and 43 percent via brokers.

<sup>4</sup> Reverse mortgage insurance enables the elderly people to utilize their self-occupied and residential properties as collateral to borrow loans in return for a stream of monthly payouts while staying at their original residences for the rest of their life. Under certain conditions, the elderly may also apply for a lump sum payout.

**48. The insurance sector enjoys certain concessions under the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA) although the impact has not been material so far.** The CEPA, which came into effect on January 1, 2004, is an arrangement that forms a free trade area between the Mainland and HKSAR. It covers three broad areas—trade in goods, trade in services, and trade and investment facilitation.

**49. On average, the insurance sector reported solvency positions above the minimum and prescribed requirements.** The ICO sets minimum solvency margin requirements for various classes of business (the relevant amounts). In practice, the IA requires insurers to maintain 150 percent of the relevant amounts, which is deemed to be the prescribed capital requirement (PCR). As at end-2012, long-term insurers recorded available capital resources over the PCR of more than 190 percent, while the general insurers and reinsurers reported higher ratios of 560 percent and 639 percent, respectively. The existing solvency regime is rules-based, largely modeled on the European Union's current Solvency I framework.

**50. Long-term insurers are vulnerable to low interest rates and potential pandemic risks, while general insurers are confronting keen competition in the market.** A prolonged low interest climate has a particular negative impact on savings insurance products (especially guaranteed products with long duration) since investment income is the main profit source for these type of products. Intense competition in the general insurance market has kept premium rates low, which may lead to some insurers compromising their underwriting discipline. The more vulnerable lines of business are employees' compensation and motor insurance, where aggressive insurers may try to gain market share through rate cutting. To uphold underwriting discipline, the IA has maintained close vigilance and requires actuarial certification on the adequacy of technical provisions for these two classes of business.

## D. Key Findings

**51. The proposed IIA could be further strengthened in a number of areas by:** (i) granting delegated authority to issue enforceable rules via administrative means; (ii) requiring public disclosure of the reasons for removing the head of the agency; and (iii) granting clear authority to establish and supervise public disclosures by insurers. The authorities are also advised to consider eliminating or specifying the circumstances under which the legal authority of the CE in Council to give directions to the IA and to exempt/vary the provisions of the ICO for certain insurers, without impinging on the Basic Law.

**52. The ICO needs to be updated to better reflect current international best practices.** The staff of the IA has a good understanding of the industry and markets, facilitated by open communication and close dialogue with directors and management of insurers. Established internal procedures and checklists promote the consistency and effectiveness of supervision. The current gaps under the ICO could be addressed by: (i) extending the fit and proper regime to cover Senior Management and Key Persons in Control Function; (ii) establishing clear definition of control and pre-determined control levels; (iii) updating risk management requirements; (iv) the authority to remove or disqualify persons on fit and proper grounds; and (v) requiring insurers to implement

contingency plans. In addition, the list of entities exempted from authorization should be reviewed, and there are merits for clarifying the priority of claims of long term policyholders. A number of guidance notes could also be updated, while more clearly differentiating minimum requirements from supervisory guidance.

**53. Given the presence of insurance groups in HKSAR, it is timely that the IA formulates and implements a clear and comprehensive regulatory regime for insurance groups.** Key elements of the regime should cover the scope of the group to be subjected to group-wide supervision, as well as prudential and market conduct requirements at the group level. Going forward, it is advised that the authorities: (i) ensure adequate supervisory resources to effectively supervise insurance groups; and (ii) consider legal authority to take measures at the level of the holding company, in line with emerging international best practices.

**54. The IA's plan to move towards an RBC regime is welcome and a structured process for macroprudential surveillance is recommended.** The RBC regime should establish a clear and consistent valuation standard (including explicit best estimates of technical provisions and risk margins) and risk sensitive capital requirements. As a stop-gap measure, the IA is advised to establish solvency margin requirements for all classes of long-term business, and to provide supervisory guidance on insurers' obligations to meet policyholders' reasonable expectation. Pending the introduction of explicit enterprise risk management (ERM) requirements, the current dynamic solvency tests could be enhanced in the interim. The proposed IIA's new mandate on thematic research and studies will contribute to more comprehensive and systematic macroprudential analysis, which could be supported by a framework for assessing the systemic risk of insurers. The proposed enhancements in the prudential regime need adequate technical support of experienced supervisors and technical specialists.

**55. To enhance the protection of policyholders, the mission strongly supports the authorities' initiative to transfer the supervision of intermediaries to the proposed IIA, and to strengthen Code of Business (CoB) requirements in the ICO.** Direct supervision of intermediaries will enhance supervisory effectiveness and minimize the potential conflict of interests arising from self-regulation, which is more in line with international best practices. The CoB regime under the ICO should be strengthened, complemented by supervisory guidance to promote professional conduct by insurers and intermediaries.

<b>Table 3. Summary of Compliance with the Insurance Core Principles</b>	
<b>Insurance Core Principle</b>	<b>Overall Comments</b>
1. Objectives, Powers and Responsibilities of the Supervisor	<p>The authorities responsible for insurance regulation and supervision and the objectives of insurance supervision are clearly defined in the ICO. The IA has taken action to recommend amendments to the ICO when conflicts between legislation and supervisory objectives were identified. While the IA is authorized to issue guidance on its supervisory expectation, it is not empowered to issue enforceable rules by administrative means.</p> <p>The ICO does not explicitly address the objectives and authority for the supervision of insurance groups. Under the current institutional arrangement, close coordination between the IA and the relevant SROs exercising CoB supervision of intermediaries is critical to achieving the overall objectives of insurance supervision. The responsibility for supervising insurance intermediaries is to be transferred to the proposed IIA.</p>
2. Supervisor	<p>The Commissioner/IA is appointed by the CE and the OCI is currently an agency of the government. The ICO does not explicitly provide for criteria for the appointment of the IA and there is no legal provision on the disclosure of the reasons for the dismissal of the IA. In addition, the CE may give direction to the IA on the performance of the functions under ICO and has authority to exempt/vary the provisions of the ICO for certain insurers. Although such reserve powers have not been exercised by the CE, these powers could potentially be exercised in a manner that could compromise the operational autonomy of the IA. While substantially funded by the government, the IA has adequate financial and supervisory resources and the discretion to allocate resources in accordance with supervisory priorities. There is adequate legal protection of confidential information and a robust code of conduct applies to the IA staff. The IA and staff members have appropriate legal protection.</p>
3. Information Exchange and Confidentiality Requirements	<p>The IA is empowered to exchange information of regulated entities with regulatory authorities based on the statutory gateways provided under the ICO. The information exchange is typically done via a framework of cooperation agreements. To this end, the IA has entered into cooperation agreements with local and relevant overseas regulators and is also one of the signatories to the IAIS Multilateral MOU. In exchanging regulatory information, the IA and its staff are required to observe the confidentiality requirements under the ICO. While the IA does not have explicit legal authority to obtain and share information with respect to non-regulated entities within an insurance group, such information may be accessed indirectly through the regulated entity if necessary.</p>

4. Licensing	The ICO clearly defines the insurance activities that require authorization and sets out the authorization requirements. The IA has issued guidance notes explaining clearly the authorization criteria as well as the required information, process and timing in considering an application. The licensing process involves significant interaction with the applicants and the IA exercises appropriate due diligence. The IA also visits an applicant that has received in-principle approval before issuing a Certificate of Authorization.
5. Suitability of Persons	The ICO establishes fit and proper requirements on controllers and directors. The IA has issued guidance on its supervisory assessment of the fitness and propriety of controllers and directors. However, the fit and proper requirements do not apply to Senior Management (other than the Managing Director or the CEO) and Key Persons in Control Functions. The IA is empowered to issue notice of objection on the proposed appointments (or the continued appointment) of controllers or directors although there has not been a need to issue such an objection in recent years.
6. Changes in Control and Portfolio Transfers	While there is no explicit definition of control under the ICO, the IA approves shareholder controllers of locally-incorporated insurers and monitors changes in their particulars including increase/decrease in their shareholdings. Portfolio transfers are subject to court sanction (long term insurance) or approval from the IA (general insurance).
7. Corporate Governance	The IA has issued the guidance note on corporate governance in 2002, which is largely in line with ICP7. GN10 was being reviewed at the time of this assessment to better reflect current international best practices. The IA monitors and assesses insurers' corporate governance as part of its on-going supervision, including evaluating the effectiveness of corporate governance in practice. There are no explicit requirements on the corporate governance of groups.
8. Risk Management and Internal Controls	<p>GN10 provides high-level guidance on risk management systems and internal audit function. GN13 covers risk management functions relating to insurers' investments operations and asset liability management. GN14 establishes requirements on risk management relating to outsourcing. GN10 does not have explicit provision on the establishment of an effective risk management function covering all material risks. Although the ICO adopts the Appointed Actuary system, there is no explicit requirement on insurers to establish an effective actuarial function. There is also no explicit provision on insurers having a compliance function.</p> <p>A majority of large insurers have investment, reinsurance and risk management committees. While there is no requirement to have a dedicated Chief Risk Officer (CRO), nevertheless a majority of the large insurers have such a function. The majority of CROs report to the CEO or to the Risk Committee of the Board of Directors. Equally, a majority of large insurers have a head of compliance.</p>

9. Supervisory Review and Reporting	<p>The ICO empowers the IA to require insurers to provide comprehensive supervisory information, including on off-balance sheet guarantees, material outsourcing activities, and corporate governance framework/practices. Notwithstanding the lack of explicit legal authority, the IA has been conducting inspections of insurers regularly. To promote consistency and effectiveness of supervisory assessments, the IA has established an internal operations manual that sets out procedures and relevant checklists to guide supervisory staff in assessing insurers' financial condition and risk profiles.</p> <p>The supervisory approach of the IA involves close communication and dialogue with management and the Board of insurers, to facilitate understanding of their strategies and operations. The IA takes account of the evolving risks profiles of insurers as part of its on-going supervision, notwithstanding that a formal risk-based supervision has not been implemented. The CoB supervision of insurance intermediaries will be transferred to the proposed IIA.</p> <p>The ICO has not established an explicit group-supervision framework, but it requires that an insurer that is a holding company must submit its consolidated financial statement. The IA has no explicit power to obtain information from non-regulated entities within an insurance group, in order to supervise insurance groups in a holistic manner.</p>
10. Preventive and Corrective Measures	<p>Carrying insurance business in HKSAR without an authorization from the IA is an offence under the ICO. The IA would investigate any suspicious unauthorized activities and refer the matter to the police for further investigations, where appropriate. The ICO confers powers on the IA to take a broad range of proportionate corrective and preventive measures under specified grounds. The IA's policy is to make timely intervention and communicate its actions to the insurer in a transparent manner.</p>
11. Enforcement	<p>The IA is empowered to take supervisory interventions in a progressive approach that is commensurate with the severity of the offence. It monitors insurers' compliance with the enforcement actions imposed and may take further actions, as appropriate. There are established internal guides as well as arrangements to ensure consistent and fair application of enforcement actions and sanctions. The proposed IIA will have enhanced enforcement powers to initiate and conduct investigations, prosecute offences summarily, and enhanced sanctions powers.</p>
12. Winding-up and Exit from the Market	<p>The procedures governing the winding-up of insurers are provided in the ICO and CO. An insurer shall not be wound up voluntarily unless ordered by the Court. The Court may make an order on the petition of 10 or more policyholders or the IA on specified grounds. Claimants of general insurance are given preferential priority of distribution of assets in liquidation under</p>

	<p>the CO. Long term insurers are required to ensure proper segregation of applicable insurance funds, and the assets belonging to respective funds can only be applied to liabilities attributable to that part of that business to which the fund relates. The insurance fund concept is intended to protect long term policyholders' entitlement to assets belonging to each fund. While it is highly likely the court would rule in favor of policyholders vis-à-vis unsecured creditors, it is preferable that an explicit priority ranking of long term policyholders vis-à-vis unsecured creditors be established under the relevant laws.</p>
<p>13. Reinsurance and Other Forms of Risk Transfer</p>	<p>One of the authorization conditions under the ICO is the adequacy of reinsurance arrangement. The IA supervises insurers' governance of their reinsurance arrangements and encourages the establishment of Reinsurance Committee. It also examines reinsurance treaties provided by insurers annually, and assesses the adequacy of the reinsurance programs. Insurers are required to obtain prior approval of the IA for financial reinsurance. The proposed guidance note on reinsurance will bring the reinsurance regime in line with ICP 13.</p> <p>GN 12 exempts insurers who meet certain requirements from limits on reinsurance beyond which collateral are required. This could potentially lead to an excessive concentration or liquidity risk to related companies. To mitigate this risk, the IA adopts a restrictive supervisory practice that discourages the excessive use of intra-group reinsurance.</p>
<p>14. Valuation</p>	<p>The valuation of assets and liabilities is based on an amortized cost approach for long term insurance, while for general insurance the valuation of assets is based on a fair value approach but liabilities are not discounted. Decision usefulness is enhanced by the Dynamic Solvency Testing (DST) for long-term business.</p> <p>For general insurance, insurance liability cash flows are not discounted (this is not mandated by ICP 14), and the valuation of assets is based on market values with haircuts. For long term business, technical provisions are based on current assumptions and discounted with the expected asset return, with haircuts to take into account credit risk and bonds are valued at amortized cost. For Class G business (investment guarantees), technical provisions must be adequate to cover most of the adverse situations with a 99 percent level of confidence.</p> <p>While due regard has to be given to the reasonable expectations of participating policyholders, there is no guidance on what this means in practice and how the interest of different policyholder generations and other stakeholders are taken into account – both in a going-concern and distress situation.</p> <p>The requirements for estimating technical provisions take into account the specifics of the different underlying risks. However</p>



	<p>there is no clear overarching methodology used for the valuation. This makes it difficult to assess the overall sufficiency of technical provisions of insurers. Except for employees' compensation and motor business, there is no requirement to have an explicit margin over current estimate (MOCE). Rather, the MOCE is implicit, via no discounting for general insurance business and using prudent assumptions for long term business.</p> <p>The valuation used for long term business is generally perceived by industry to be prudent, in particular due to the fact that no allowance can be made for the voluntary discontinuance of contracts if the amount of the liability so determined would be reduced. However, the discount rate which is linked to the expected asset yield might not necessarily be prudent, in particular in an environment with falling interest rates. On the other hand, the reinvestment yield component of the discount rate reflects the current spot rate which mitigates the effect to a certain extent. These inconsistent levels of implicit prudence make it challenging to assess the overall margin for risk. While the valuation standard might introduce the potential for unintended investment incentives: to go into risky assets to increase the discount rate or to remain invested in risky and non-performing assets in time of financial market stresses, there is no evidence that insurers have done so. The existing DST includes testing the impact on solvency under prescribed scenarios of drop in values of equities, but it needs to be strengthened to take into consideration the above.</p>
15. Investment	<p>The IA has issued guidance setting out its supervisory expectation on insurers' investment management including formulating sound investment strategy, well documented investment policies and limits, asset-liability management, investment risk management and policy on the use of financial derivatives. Insurers are required to submit their investment policy and information on their investment portfolio to the IA for review. The guidance is qualitative and principles-based.</p> <p>HKSAR is one of the leading international financial centres and insurers have a broad choice of investment instruments for assets-liability management. However, insurers have indicated that the market for long dated bonds is not very deep, making the management of liabilities with long duration challenging.</p>
16. Enterprise Risk Management for Solvency Purposes	<p>The ICO has only set out capital adequacy requirements. It has not provided for ERM or own risk and solvency assessment (ORSA) requirements, which are integral parts of a risk-based regime. Risk management is addressed separately through the DSTs. Under the DST, insurers writing long term business are required to capture certain elements of an ORSA. However, for general insurers and for insurance groups, there are no ORSA requirements. In addition, there are currently no explicit requirements on insurers to:</p>



	<p>a) implement an ERM framework for solvency purposes. Currently, the asset-liability management guidance note focuses on investment risks while GN10 defines risk management practices as high level principles;</p> <p>b) adopt a risk management policy that details how all relevant and material risks are managed on a regulatory and economic basis; and</p> <p>c) establish and maintain a risk tolerance statement and risk tolerance limits which take into account all relevant and material categories of risk.</p>
17. Capital Adequacy	<p>The ICO sets out the existing capital adequacy framework, which is in essence a rules-based solvency regime with a set of standardized methods for calculating the required amount of capital. The law does not permit the use of tailored approaches (i.e., partial or full internal models).</p> <p>The capital requirement is not based on a clear, transparent underlying methodology. Some risks are reflected in the required amount of capital, some are reflected in haircuts applied to assets and others in prudent margins in liabilities, while others are treated via qualitative requirements; differing on the lines of business.</p> <p>There is no capital adequacy test on a group-wide basis and the current capital requirement is purely legal entity based. It is also not able to reflect potential group risks to which subsidiaries are exposed to, e.g., via intra-group transactions.</p>
18. Intermediaries	<p>HKSAR currently adopts a self-regulatory regime for insurance intermediaries, with three SROs responsible for the licensing and CoB regulation of insurance agents and brokers. The IA has been supervising the SROs' oversight, including conducting its own spot checks, inspections and mystery shopping to ensure that the SROs discharge their duties effectively and equitably. While the IA's proactive engagement has provided a safety net and critical quality assurance on the SRO regime, it involves significant duplication of efforts. In addition, industry codes and standards issued by the SROs are not legally binding and the SROs are not full-fledged supervisors, in the absence of a statutory mandate. These constraints dilute the effectiveness of the SRO regime. The move towards direct supervision by the proposed IIA would also minimize the potential conflict of interests arising from a self-regulatory regime, and is more in line with international best practices.</p>
19. Conduct of Business	<p>The ICO does not provide for any explicit requirements on CoB of insurers, other than fit and proper criteria of controllers and directors. Nonetheless, some aspects of the CoB standards are covered under the corporate governance guidelines issued by the IA and the Code of Conduct for Insurers issued by the Hong Kong Federation of Insurers (HKFI). While the CoP and the minimum</p>

	<p>requirement for insurance brokers establish industry standards for insurance intermediaries on disclosures, proper advice, professional claims and complaints handling etc., these standards are not legally binding. Furthermore, the Code of Conduct for Insurers would not apply to insurers who are not members of the HKFI although its members account for more than 90 percent of the premiums in the insurance market in HKSAR. Personal data collected by insurers and intermediaries are subject to confidentiality safeguards under the Personal Data (Privacy) Ordinance.</p>
20. Public Disclosure	<p>The current public disclosure regime is largely based on the accounting standards adopted in HKSAR, which is not fully aligned with the disclosure standards under ICP 20. All annual audited accounts of insurers are accessible to the public. While insurers submit more granular information to the IA, with some selected information published by the IA on individual and industry aggregate level. The proposed RBC framework will incorporate disclosure requirements in line with IAIS standards. In addition, the IA will keep in view the second phase development of HKFRS4 on Insurance Contracts regarding disclosure requirements on insurance risks exposures.</p>
21. Countering Fraud in Insurance	<p>Fraud is an offence punishable by law. As part of its ongoing supervision, the IA assesses insurers' risk management frameworks to determine their adequacy and effectiveness for managing fraud risk exposures. Domestically, the IA collaborates closely with the insurance industry, law enforcement agencies and other relevant financial regulators. Recognizing the potential for cross-jurisdictional frauds, the IA also works with regional supervisors and is in discussion with supervisors in China and Macau the signing of an MOU specifically on fraud prevention.</p>
22. Anti-Money Laundering and Combating the Financing of Terrorism	<p>The AML/CFT statutory obligations of insurance institutions are enshrined in the AML Ordinance and the guidelines issued by the IA. Currently, the AML/CFT regime covers insurers, reinsurers, and insurance intermediaries engaged in long term insurance business specifically. The IA is a designated AML/CFT competent authority and is empowered to conduct AML/CFT inspections.</p> <p>The IA has a good understanding of the money laundering/financing of terrorism risks in the insurance sector through AML/CFT surveys, on-site inspections, insurance business statistics, market intelligence, liaison with industry bodies, and suspicious transaction reports data from Joint Financial Intelligence Unit etc. This supports its risk-based approach to supervising insurance institutions' compliance with their AML/CFT obligations. The IA supports the industry's AML/CFT compliance through industry seminars, briefing sessions, training course, website portal and publications, and responding to telephone and written enquiries etc. The IA has sufficient resources to carry out its AML/CFT mandate and monitors the effectiveness of the</p>

	<p>regulatory regime and its supervisory approach in this area. The IA cooperates and exchanges information with local and overseas supervisory authorities, facilitated by a network of bilateral MOUs and the IAIS Multilateral MOU, subject to confidentiality safeguards. Regular dialogue and meetings with the industry is maintained to promote effective implementation of AML/CFT measures. The effectiveness of these measures will be assessed by the FATF in 2017.</p>
23. Group-wide Supervision	<p>The ICO does not have an explicit definition for insurance group nor the scope of an insurance group for the purpose of group-wide supervision. Nonetheless, the IA has identified one insurance group that is based in HKSAR.</p> <p>The IA exercises indirect supervision of an insurance group based in HKSAR through the approval conditions of its holding company as shareholder controller. It actively monitors developments in this group and communicate regularly with other host supervisors of this group either through the supervisory college or on an informal basis. The IA has obtained information from non-regulated entities through the regulated insurer or its holding company, when necessary.</p>
24. Macprudential Surveillance and Insurance Supervision	<p>The IA identifies, monitors and analyses various market and financial developments, as well as other environmental factors, which have implications for insurers and the insurance market in HKSAR. It discusses emerging issues or concerns with the industry or individual insurers to facilitate timely preventive actions. As a member of the CFR and the FSC, the IA benefits from the discussions on macro-economic developments, market vulnerabilities and financial stability issues at the meetings of the CFR/FSC. There is no formal process to assess the potential systemic importance of insurers.</p>
25. Supervisory Cooperation and Coordination	<p>The IA places much emphasis on supervisory cooperation both domestically and with foreign supervisors. Domestically, the IA liaises closely with all relevant agencies involved in the financial sector of HKSAR, bilaterally as well as at the CFR and FSC level. It has formalised some of the arrangements through bilateral and joint MOUs.</p> <p>Despite the lack of an explicit group supervision framework, the IA has formally assumed the role of the group-wide supervisor of a large insurance group based in HKSAR with significant cross-border operations. It has organized regular supervisory college meetings and takes the lead in coordinating supervisory work for the group. The IA also contributes actively to relevant supervisory colleges as a host supervisor and participated in more than 50 supervisory colleges since 2010. In exchanging information with other regulators on group issues, the IA is required to preserve confidentiality requirements under the ICO.</p>

26. Cross-border Cooperation and Coordination on Crisis Management	The IA has maintained positive relationship with foreign supervisors, which contributes to effective, coordinated cross-border crisis resolution in the event of need. It has demonstrated its openness and commitment in working collaboratively with relevant foreign home and host supervisors during the global financial crisis in 2008. In addition, the IA has been reviewing and discussing the common tools for managing a cross-border financial crisis with the relevant supervisory colleges. However, there is currently no explicit requirement for insurers to maintain recovery or resolution plans.
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## E. Recommendations

<b>Table 4. Recommendations to Improve Observance of the Insurance Core Principles</b>	
<b>Insurance Core Principle</b>	<b>Recommendations</b>
1. Objectives, Powers and Responsibilities of the Supervisor	The impending implementation of the proposed IIA regime will enhance the legal capacity and enforcements powers of the IIA, when implemented. The IIA will also exercise direct CoB supervision of insurance intermediaries. To further improve observance of ICP1, the authorities are advised to: <ul style="list-style-type: none"> <li>a) Consider delegating to the IIA the authority to issue enforceable rules by administrative means, in accordance with specified legal parameters in the ICO; and</li> <li>b) Establish explicit supervisory objectives for group-wide supervision, supported by adequate legal powers to conduct group-wide supervision.</li> </ul>
2. Supervisor	The proposed IIA will have enhanced operational and financial independence, subject to adequate accountability mechanisms including the Process Review Panel and Insurance Appeals Tribunal. The authorities are advised to: <ul style="list-style-type: none"> <li>a) provide for the public disclosure of the reasons for the dismissal of the IA in the ICO; and</li> <li>b) eliminate or specify the circumstances under which the legal authority of the CE to give directions to the IA and to exempt/vary the provisions of the ICO for certain insurers may be exercised, without impinging on the Basic Law.</li> </ul>
3. Information Exchange and Confidentiality Requirements	The authorities are advised to empower the IA to obtain information from non-regulated entities of an insurance group and to share such information with relevant authorities subject to appropriate confidentiality safeguards.
4. Licensing	The authorities are advised to consider updating the provision in the ICO on the entities exempted from authorization in line with current international best practices.
5. Suitability of Persons	The authorities are advised to extend the scope of the fit and proper requirements under the ICO to cover Senior Management and Key Persons in Control Functions.

<p>6. Changes in Control and Portfolio Transfers</p>	<p>The authorities are advised to consider:</p> <ul style="list-style-type: none"> <li>a) Establishing clear definition of “control” and transparent pre-determined control levels under the ICO; and</li> <li>b) Empowering the IA to approve the change of a mutual company to a stock company, or <i>vice versa</i>.</li> </ul>
<p>7. Corporate Governance</p>	<p>The authorities are advised to:</p> <ul style="list-style-type: none"> <li>a) Promulgate minimum corporate governance requirements as enforceable rules (e.g., establishment of Audit Committees and the Board’s oversight of risk management), supplemented by supervisory guidance; and</li> <li>b) Expedite the revision of GN10 aimed at reflecting current international best practices, incorporating explicit requirements on: <ul style="list-style-type: none"> <li>- The role of the Board in setting risk strategy and risk appetite, in line with an insurer’s long-term interests and viability;</li> <li>- The Board having adequate powers and resources to be able to discharge its duties fully and effectively;</li> <li>- Individual directors to act in the best interest of the insurer and policyholders;</li> <li>- Remuneration policy of directors, Key Persons in Control Functions and major risk-taking staff;</li> <li>- The Board’s policies and procedures to have effective oversight of Senior Management; and</li> </ul> </li> </ul> <p>Extend the requirements and make specific to insurance groups, in particular relating to the checks and balances between different parts and legal entities of groups, group-internal outsourcing and potential conflicts of interests within a group.</p>
<p>8. Risk Management and Internal Controls</p>	<p>The authorities are advised to:</p> <ul style="list-style-type: none"> <li>a) Widen the scope of the risk management requirements to cover all key risks (i.e. underwriting, market, credit, operational and liquidity risks, at the minimum);</li> <li>b) Establish minimum requirements on risk management systems and key control functions as enforceable rules;</li> <li>c) Require insurers to have compliance and actuarial functions.</li> </ul> <p>These requirements could be supplemented by supervisory guidance to facilitate compliance by insurers.</p>
<p>9. Supervisory Review and Reporting</p>	<p>The proposed IIA will have explicit legal authority for on-site inspections and exercise direct CoB supervision of insurers and intermediaries. The authorities are advised to:</p> <ul style="list-style-type: none"> <li>a) Establish a formal and comprehensive group-wide supervision regime. This should include more granular regulatory reporting (e.g. intra-group transactions and risk concentrations) and empowering the IA to obtain information from material non-regulated entities in order to monitor their impact on regulated insurance entities and the group as a whole; and</li> </ul>

	b) Consider the introduction of a formal risk-based supervision framework, which will be supported by the impending implementation of the proposed RBC framework.
11. Enforcement	The authorities' initiatives in reviewing the current level of penalties and in strengthening the investigation and enforcement powers of the proposed IIA are commendable. In addition, it is recommended that the authorities empower the IA to require an insurer to replace or restrict the power of Board Members, Senior Management, Key Persons in Control Functions, significant owners and external auditors.
12. Winding-up and Exit from the Market	It is recommended that the authorities consider providing greater legal certainty on the priority of claims for long term policyholders vis-à-vis the unsecured liabilities attributable to the same insurance fund.
13. Reinsurance and Other Forms of Risk Transfer	It is recommended that the authorities <ol style="list-style-type: none"> <li>a) Establish formal regulatory requirements on reinsurance arrangements, including the formulation of reinsurance strategies appropriate to the nature, scale and complexity of their business, sound reinsurance management frameworks, and prompt documentation and finalization of reinsurance contract;</li> <li>b) Adopt a systematic approach to evaluating the nature of supervision of reinsurers and other counterparties used by insurers;</li> <li>c) Strengthen the requirements on reinsurance with related companies, including:             <ul style="list-style-type: none"> <li>• management of liquidity risk, concentration risk, conflicts of interests, contagion risk etc.;</li> <li>• assessing the acceptability of reinsurance with related companies based not only according to external ratings but in a more comprehensive manner; and according also to other metrics;</li> <li>• introducing risk-based limits on reinsurance exposures to related companies.</li> </ul> </li> </ol>
14. Valuation	The IA is currently revamping its capital and solvency regime, and a new RBC framework is being developed which will include changes in the valuation of assets and liabilities. It is recommended that the proposed RBC framework will be based on an economic valuation standard that <ul style="list-style-type: none"> <li>• Is consistent between assets and liabilities such that equal or similar cash flows lead to equal or similar values;</li> <li>• Is responsive to changes in relevant risk factors (including interest rates, spreads, mortalities, etc.);</li> <li>• Provides for an explicit current estimate and a MOCE; and</li> <li>• Is clearly linked to the capital requirement i.e. the capital requirement will be defined as a risk measure applied to the change in the value of assets and liabilities over a given time horizon.</li> </ul>

	<p>It is also recommended that the IA requires insurers to give due regard to the reasonable expectations of participating policyholders, and how the interests of different policyholder generations and other stakeholders are taken into account — both in a going-concern and distress situation.</p> <p>It might be beneficial for the IA and the ASHK to compare the current technical provisions with an economic valuation standard, e.g., a market consistent one, to obtain more insight into the actual level of prudence.</p>
<p>15. Investment</p>	<p>While a principles-based regime as currently implemented for investments is appropriate for the mature insurance market in HKSAR, some additional quantitative restrictions might nevertheless be useful to consider, particularly with respect to the treatment of more risky or concentrated investments under the proposed RBC framework.</p>
<p>16. Enterprise Risk Management for Solvency Purposes</p>	<p>It is recommended that the proposed RBC framework includes explicit ERM requirements applicable to all insurers. This would include the requirement to articulate a risk tolerance statement with associated risk tolerance limits, the ability for insurers to measure risks based on a consistent economic assessment, and an explicit requirement for insurers to conduct an ORSA on both a regulatory and economic basis. The requirements should be formulated also for insurance groups and subsidiaries of insurance groups.</p> <p>Since the DST that is currently being conducted by long term insurers contains a number of elements of an ORSA, the authorities may wish to consider extending the DST requirements to bring it more in line with a full ORSA: for example by requiring all insurers and insurance groups to conduct a DST, by requiring multi-year solvency assessment on an economic basis and by linking it more explicitly to an overarching ERM framework.</p> <p>The authorities are also encouraged to consider extending the DST to general insurers and to annually review the set of scenarios being used.</p>
<p>17. Capital Adequacy</p>	<p>It is recommended that the authorities:</p> <ol style="list-style-type: none"> <li>a) Extend the current solvency margin requirements to long term Class C business.</li> <li>b) Formulate the proposed RBC framework such that the capital requirements: <ul style="list-style-type: none"> <li>• Are clear in the risks that are quantified explicitly and those that are treated through other means</li> <li>• Are consistent with the valuation standard being used for both assets and liabilities</li> <li>• Are based on a consistent underlying methodology for</li> </ul> </li> </ol>

	<p>both long term and general insurance business</p> <ul style="list-style-type: none"> <li>• Take into consideration the differences of long term and general insurance business via specific requirements for the quantification of the capital requirements (be it implemented via standard formulae, standard models or internal models) rather than by having different underlying methodologies</li> <li>• Are responsive to a changing risk landscape to which HKSAR insurers are exposed to</li> <li>• Take into account group-risks, e.g. from intra-group transactions</li> <li>• Define intervention levels with clearly associated supervisory actions to be taken.</li> </ul> <p>c) Develop a group-wide solvency regime based on a sound and consistent underlying methodological framework (including the valuation standard) and that explicitly addresses risks emanating from group structures, intra-group transactions and from potential limited capital mobility in case of financial stress.</p> <p>It is advisable to consider the implementation of a consistent stress testing framework for all insurers that would indicate the resilience of the capital requirements in response to the insurers' exposure to market wide risks, e.g. via common scenarios that all insurers have to evaluate. The impact of the scenarios on the insurers' balance sheets should be based on a consistent economic valuation standard and take into account potential contagion from groups. Such a stress testing framework would also support the IA in its macro-prudential surveillance.</p>
<p>18. Intermediaries</p>	<p>The mission strongly supports the authorities' initiative to transfer the supervision of intermediaries to the proposed IIA, with a clear legal mandate and adequate legal authority to license, supervise and take proportionate corrective, preventive and enforcement measures.</p>
<p>19. Conduct of Business</p>	<p>The mission welcomes the authorities' proposal to introduce fundamental CoB principles in the ICO. It is also recommended that the authorities formalize existing industry or supervisory practices in promoting professional conduct by insurers and intermediaries to address current regulatory gaps, (e.g., requirements on fair treatment of customers by insurers and intermediaries, including insurers' marketing, investment, charging and profit distribution strategies for participating policies and ULPs; the need for insurers and intermediaries to handle claims and complaints professionally; and the need for intermediaries to compare and advise customers of different insurance options, such as participating policies vis-à-vis ULPs). The implementation of the proposed IIA regime will bring the CoB regime in line with the IAIS standards.</p>



20. Public Disclosure	The authorities are advised to empower the IA in establishing disclosure requirements in line with ICP 20 and to supervise insurers' compliance with the disclosure requirements.
22. Anti-Money Laundering and Combating the Financing of Terrorism	While the AML/CFT regime is in line with the FATF standards in terms of covering life insurance and other investment-related insurance, the authorities are advised to periodically assess the potential money laundering and financing of terrorism risk in the general insurance industry to take account of evolving money laundering and financing of terrorism typologies and consider whether to apply the FATF standards to general insurance.
23. Group-wide Supervision	It is recommended that the authorities formulate and implement a clear and comprehensive regulatory regime for insurance groups under the ICO. Key elements of the regime should cover the scope of the group (including material non-regulated entities) to be subject to group-wide supervision (ICP 9) as well as prudential and market conduct requirements at the group level. Going forward, it is advised that the authorities consider empowering the IA to take necessary remedial and enforcement measures at the level of the holding company, in line with emerging international best practices.
24. Macroprudential Surveillance and Insurance Supervision	<p>The authorities are advised to formulate macroprudential surveillance framework appropriate to the nature, scale and complexity of the insurance sector. Enhancements could be made by:</p> <ul style="list-style-type: none"> <li>a) Requiring insurers to conduct periodic comprehensive industry-wide standardized scenario testing exercises, to provide the IA with an additional tool for assessing the build-up of industry-wide risks/ vulnerabilities;</li> <li>b) Establishing clear and structured internal processes for identifying, assessing, monitoring and reporting on emerging risks in the industry;</li> <li>c) Developing more robust indicators for assessing systemic risk of insurers;</li> <li>d) Reviewing whether the current mainly sector-based approaches of the sectoral supervisors is adequately complemented by consideration of cross-sectoral linkages e.g., <i>bancassurance</i>, ULPs and mortgage insurers; and</li> <li>e) Inclusion of risks arising from system-wide market conduct issues, including reputational risks.</li> </ul>
26. Cross-border Cooperation and Coordination on Crisis Management	<p>It is recommended that the authorities:</p> <ul style="list-style-type: none"> <li>a) Establish clear requirements for insurers to maintain and test contingency plans and procedures for use in a going- and gone-concern situations; and</li> <li>b) Regularly review the existence of practical barriers to efficient and internationally coordinated resolutions and collaborate with the relevant supervisor to resolve these issues.</li> </ul>

## F. Authorities' Responses to the Assessment

**56. The IA greatly appreciates the opportunity to be assessed by the IMF against the new set of IAIS ICPs.** The entire FSAP process has provided an opportunity for the IA to thoroughly review the insurance regulatory framework of Hong Kong SAR and pave ways for further improvement. The implementation plan of IMF's recommendations is elaborated as below:

- The HKSAR Government is strongly committed to establishing an IIA which is a statutory body independent of the government. A Bill to amend the ICO was introduced into the Legislative Council on April 30, 2014 for establishing the IIA in 2015;
- Through this exercise, the HKSAR Government would also update other aspects of the regulatory regime so as to observe international best practices, e.g., empowering the IIA to give prior approval and revoke insurers' appointment of controllers, directors and key persons in control functions;
- Upon the establishment of the IIA, the existing self-regulatory regime for insurance intermediaries will be replaced by a statutory direct licensing regime. The IIA would exercise direct supervision of insurance intermediaries through the statutory licensing regime. The fundamental principles in respect of conduct requirements will be set out in the legislation, with details to be promulgated in subsidiary legislation as well as codes and guidelines to be issued by the IIA. The IIA will be given statutory powers to impose disciplinary sanctions on insurance companies and insurance intermediaries;
- The IA fully agrees with the need to strengthen the existing regulatory regime for insurance groups with operations in Hong Kong SAR. For insurance groups based in Hong Kong SAR, although the ICO does not have explicit provisions on groups, the IA has assumed the role of group-wide supervisor, responsible for leading supervisory colleges and coordinating all periodic meetings with other supervisors to discuss and monitor issues related to the groups. The IA will continue to play this role and will fully collaborate with other supervisors for effective cross-border cooperation and coordination. The IA will also consider how to amend the ICO to provide for group supervision; and
- The IA is developing a RBC framework for Hong Kong SAR. The new RBC framework will be applicable to insurers, both on a solo and group basis, and will encompass the requirements under the relevant ICPs, particularly in the aspects of valuation of assets and liabilities, technical provisions, capital requirements, and other requirements for solvency purposes.

# IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION

## A. Summary

**57. HKSAR has developed a sound framework for the regulation of securities markets, which exhibits a high level of implementation of the International Organization of Securities Commission (IOSCO) Principles.** Both the SFC and the HKMA are sophisticated regulators, and have been able to leverage from domestic and international expertise to develop sound supervisory practices. Further, while traumatic, the Lehman minibond experience has led to material improvements in conduct supervision that have permeated both the SFC and the HKMA.<sup>5</sup> Continuing efforts by the SFC to build up its capacity to identify and monitor emerging risks should increase the SFC's ability to react in a timely manner to an evolving landscape, marked by an increased interconnection with the Mainland, an active presence by international players and increased regional competition as an international finance center.

**58. In the short term, the regulatory and supervisory framework would benefit from strengthening:**

- Regulation and supervision of markets: As recognized by the SFC, Hong Kong Exchanges and Clearing Limited (HKEx) has an evolving business model, making it critical that the SFC continues to implement a stronger oversight regime for the HKEx, including a review of the governance of the HKEx as well as of the composition of the HKEx risk management committee—the latter to ensure an arm's length relationship of the regulatory authorities vis-à-vis the HKEx. In addition, while the SFC has been open in its discussions with applicants, it is important that it further develops and makes public a comprehensive regulatory framework for trading platforms of all kinds.
- Auditors' oversight: Its geographic position and its open architecture have made HKSAR a preferred venue for listings from the Mainland and from other jurisdictions. A key challenge arising from this environment is the need to ensure robust disclosure by issuers from different jurisdictions, with different legal traditions, governance and accounting frameworks. Reasonably, the SFC (and the HKEx) have relied on expert gatekeepers, such as auditors and listing sponsors, to verify and attest to the quality of issuers' information. However, the current framework does not ensure the independence of the HKICPA, which is the body in charge of the supervision of auditors, nor provides it with powers to oversee foreign auditors who audit companies listed in HKSAR, nor establishes a strong enforcement framework. This places pressure on the reputation

<sup>5</sup> This involved sales of a relatively complex derivatives product, based on underlying Lehman obligations, to retail investors. This ultimately resulted in distributing agents compensating certain investors.

of the SFC in particular and the HKSAR in general as an international financial center which requires robust disclosure practices.

- Enforcement of securities regulation: Enforcement is a critical component of a robust supervisory regime, as it allows regulators to provide the right signals to the market as to the practices that are not tolerated. The SFC can use different avenues to pursue enforcement actions. However, for licensed or registered intermediaries who are in breach of the Code of Conduct, in circumstances where the conduct does not also involve a contravention of the law enabling the SFC to seek remedial orders from the civil courts, the SFC has no means to impose both punitive action and secure compensation for clients (remedial action) without having to make difficult trade-offs. In addition, while the SFC has been active in pursuing criminal cases, coordination arrangements with the Director of Public Prosecutions (DPP) could be strengthened to enhance the effectiveness of enforcement. The HKSAR should tackle these challenges as a matter of priority and are under their control. The SFC and the Department of Justice (DoJ) agree that an efficient and unreserved cooperation between the SFC and DoJ is both conducive of the proper administration of justice and in the interest of the public. The SFC and the current DPP (who assumed office in September 2013) are taking steps to strengthen coordination on enforcement, including through high-level meetings between the SFC (led by its Chairman, CEO and Executive Director of Enforcement) and the DoJ (led by the Secretary for Justice and the current DPP). The openness of the HKSAR also makes it extremely dependent on international cooperation, in particular from the Mainland. The SFC has actively sought to build strong cooperation arrangements and they are bearing fruit. However, practical challenges remain that can only be addressed if the international community continues to make a strong commitment towards cooperation.

**59. Finally, it is important to give consideration to translating the operational independence that the regulators have enjoyed into de-jure independence,** through modifications in the current legal governance arrangements for both SFC and HKMA.

## B. Introduction

**60. An assessment of the HKSAR securities market was conducted August 26–September 13, 2013 as part of the FSAP by Ana Carvajal, Monetary and Capital Markets Department, and Malcolm Rodgers, External Expert.** The assessment was conducted based on the IOSCO Principles and Objectives of Securities Regulation approved in 2010 and its Methodology adopted in 2011. Principle 38 was not assessed since this principle is now covered under the Principles for Financial Market Infrastructures (PFMI). As a result issues related to the central counterparties as SROs are not covered in this assessment.

**61. The recent global financial crisis has reinforced the need for assessments to be more critical, both in terms of the robustness of regulation as well as the intensity of supervision.** On the regulatory side, assessors are required to look more closely at the extent to which the regulations in place adequately capture the risks undertaken by different participants. On the

supervisory side, assessors are required to look more deeply into the licensing process, the off-site monitoring and on-site inspection programs as well as how the supervisor follows-up on findings, including the use of enforcement actions, to make an informed judgment on the overall quality of supervision. In jurisdictions that rely extensively on SROs such critical analysis also must be applied to them. In many jurisdictions, this enhanced approach has had an impact on grades. In addition, experience has been gained in connection with Principles 6 and 7 which allows assessors to delve deeper into the analysis of the processes in place to identify emerging and systemic risk. Furthermore through the Assessment Committee, IOSCO itself is developing further guidance for the assessment of these Principles.

**62. The assessors relied on** (i) a self-assessment and a report on market data, which were prepared by the SFC, with the collaboration from the HKMA and the FSTB for the relevant principles; (ii) the review of relevant laws, regulations, codes, guidelines and other documents provided by the regulatory agencies including licensing, inspection and enforcement files; (iii) meetings with the CEO of the SFC, and senior staff from both the SFC and the HKMA, and other public authorities, in particular representatives of the FSTB, the Financial Reporting Council (FRC), as well as the HKICPA; and (iv) meetings with the HKEx, banks and securities intermediaries, auditing firms, a credit rating agency, and a law firm.

**63. The assessors want to thank staff of the SFC and the HKMA for their full cooperation as well as their willingness to engage in very candid conversations regarding the regulatory and supervisory framework of HKSAR.** The assessors also want to extend their appreciation to all other public authorities and market participants with whom they met.

## C. Institutional Structure

**64. Under the current legal framework, the SFC is the main authority responsible for the regulation and supervision of securities markets.** The mandate from the SFC stems from the SFO (Cap. 571 of the Laws of Hong Kong) which charges it with the development and the regulation of the securities and futures markets, and the reduction of systemic risk in such markets. The SFC is a statutory body, with a board of directors of 14 appointed by the Chief Executive of Hong Kong SAR (CEHK) or by the FS under delegated authority. It is funded from levies on market participants, but its budget must be approved by the FS.

**65. The HKMA is the responsible authority for the supervision of banks in the provision of securities business.** Overall HKSAR follows a model of universal banking whereby banks can provide most securities services within the banking entity—except that they cannot be members of the exchange. Under the BO and the SFO, the supervision in the provision of such services is the responsibility of the HKMA, both from a prudential as well as a business conduct perspective. For the latter, the Banking Conduct Department and the Enforcement Department were created within the HKMA in 2010, after the Lehman minibond incident. The HKMA has a Superintendent structure, and the MA is appointed by the FS. It is funded through the Exchange Fund. The enforcement of

breaches by bank entities of securities laws is conducted by the SFC, while there are shared responsibilities in connection with breaches by banks' executive officers and relevant individuals.

**66. The HKEx has important regulatory responsibilities, mainly in connection with the authorization of prospectuses.** The HKEx has a unique position as it holds a legal monopoly in operating a stock exchange in the jurisdiction and also operates the only futures exchange. Two MOUs provide a framework for the discharge of regulatory functions by the HKEx and for its oversight by the SFC. Under The MOU on Listing, the HKEx approves offering documents for equity and debt issuers that want to make a public offering, as well as for structured products, with the SFC having power to object to HKEx's decision. This approval is done jointly with the review by the HKEx of the listing requirements. For all other products offered to the public (mainly collective investment schemes (CIS) and non listed structured products) the SFC approves offering documents. In addition to this function, the HKEx conducts market surveillance for purposes of ensuring fair and orderly trading, while the SFC conducts surveillance for purposes of detecting market abuse and other unfair trading practices.

**67. Responsibility for accounting standards, auditing standards and auditors' oversight is outside of the purview of the SFC.** The HKICPA is in charge of accounting and auditing standards, as well as for establishing admission criteria for auditors registered in HKSAR, their ethical standards, and their oversight, including the imposition of disciplinary actions. The governance structure of the HKICPA has evolved over time, and it is currently governed by a Council composed of its members, lay persons, and two government representatives. The enforcement function is conducted by separate panels made up of both lay persons and accounting practitioners. The HKICPA is funded primarily from member subscriptions, student fees, firm registration fees and fees for practising certificates. In 2006, the power to investigate irregularities in accounting and auditing of listed issuers was transferred to the FRC. The FRC is an independent statutory body established by the FRC Ordinance (Cap. 588). Its governing body comprises members appointed by the Government, a majority of whom (including the Chairman) are lay members. In addition to being entrusted with comprehensive statutory powers for conducting independent investigations into reporting and auditing irregularities in relation to listed issuers, the FRC also has the statutory responsibility to enquire into possible non-compliances with accounting requirements on the part of listed entities. It is currently funded in equal parts by the HKSAR Government, the HKICPA, the HKEx, and the SFC. The Government has expressed its intention to continue strengthening the oversight and independence of the regulation of auditors of listed bodies.

**68. Several mechanisms are in place to foster coordination and cooperation.** At a formal level several committees exist to bring together governmental and regulatory authorities. Of particular importance are the (i) FSC, which is in charge of monitoring the functioning of financial markets, assessing events that might have systemic implications and reporting to the FS on such events; (ii) the CFR, which focuses on cross sector regulatory matters with a view to minimizing regulatory gaps or duplications; (iii) the Securities and Futures Liaison Committee (SFLC), where major policy initiatives are discussed; (iv) the FS meetings which is used by the SFC to report any major issue to the FS, and the SFST; and (v) the tripartite meetings between FSTB, SFC and HKEx that

facilitate coordination and understanding on HKEx issues. In addition, there are MOUs in place between the SFC and the HKMA, and between the SFC and the HKEx, as explained above. These provide the basis for cooperation among the parties, as well as oversight for the HKEx. Finally, regular contact takes place at a technical level between the SFC, HKMA, and HKEx.

## D. Market Structure

### Issuers

**69. As of April 2013 there were 1,558 companies listed on the SEHK, of which 1378 were listed on the Main Board and 180 on the Growth Enterprise Market (GEM).** Market capitalization of the GEM remains small in relation to the main board and accounts for only 0.39 percent of the total market capitalization.

Listed Companies and Market Activity						
Year	Units	2009	2010	2011	2012	At April 2013
Listed companies	Number	1,319	1,413	1,496	1,547	1,558
Market capitalization	US\$m	2,297,469	2,709,121	2,254,146	2,821,353	2,875,895
Market capitalization	As % GDP	1077	1186	906	1076	N/A <sup>1</sup>
Market capitalization of top 10 companies	US\$m	925,395	1,000,458	839,785	1,026,936	1,032,019
Market capitalization of top 10 companies	As % of GDP	434	438	337	392	N/A
Annual turnover	HK\$m	15,515,249	17,210,078	17,154,074	13,301,050	5,555,559
Average daily turnover	HK\$m	62,310	69,117	69,732	53,850	70,324
New companies listed <sup>1</sup>	Number	73	113	101	64	12

<sup>1</sup> Figures include the number of transfers of listing from GEM to Main Board.  
Source: Stock Exchange of Hong Kong.

**70. SEHK's stock market is dominated by issuers based in the Mainland, with Mainland companies accounting for 47 percent of listings and 56 percent of total market capitalization.**

<b>Issuers by Country/Region of Origin, as at April 30, 2013</b>		
<b>Region</b>	<b>Number</b>	<b>Percent</b>
Mainland Enterprises	737	47.3
Of which:		
H shares	175	11.2
Red Chip	120	7.7
Mainland Private Enterprises	442	28.4
Hong Kong	722	46.3
Others	99	6.4
<b>Total</b>	<b>1,558</b>	<b>100</b>

Classification Criteria:

- (1) H Shares and Red Chips classified as Mainland enterprises;
- (2) Spin-offs classified same as Mother Company;
- (3) Origin of establishment, if not in (1) and (2) above, is to be classified; and
- (4) Place of headquarters of companies to support criteria (3) if necessary or if (1), (2) & (3) above are not applicable.

**71. The bond market is largely an institutional market, both for primary issuance and for secondary trading.** The market has grown in recent years, but still remains small compared with the equity market.

<b>All Debt Securities</b>						
<b>Year</b>	<b>Units</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>At Apr 2013</b>
Companies with outstanding issues	Number	157	169	192	269	319
Outstanding volume	US\$m	50,374	62,779	75,691	113,597	134,163
Outstanding volume	As % of GDP	24	27	30	43	N/A
Annual turnover	HK\$m	4	2	843	2,771	670
New issuing companies	Number	23	38	50	109	61

Source: Stock Exchange of Hong Kong.



Corporate Bonds <sup>1</sup>						
Year	Units	2009	2010	2011	2012	At Apr 2013
Companies with outstanding issue	Number	48	58	78	134	179
Outstanding volume	US\$m	18,685	27,793	36,728	65,500	85,675
Outstanding volume	As % of GDP	9	12	15	25	N/A
Annual turnover	HK\$mil	0.00	0.00	0.98	0.02	0.40
Number of new companies	Number	7	16	27	65	49

<sup>1</sup> Excludes debt securities issued by a bank, state, state corporation and supranational  
Source: Stock Exchange of Hong Kong.

## Trading Platforms

**72. The HKEx group has a monopoly by law in operating a stock market in HKSAR and a de facto monopoly in domestic exchange traded futures.** Hong Kong Futures Exchange Limited (HKFE) offers a relatively large number of futures contracts, mainly based on equities, including equity indices. SEHK operates an actively traded stock options market. Other trading venues are available in HKSAR. Twenty five intermediaries (including 13 dark pool operators) are permitted to operate automated trading services (ATS) for trading in securities. The volume in the trading venues that operate dark pools is small and in total is about 2.5 percent of trading in listed securities. The remaining ATS platforms operated by intermediaries are primarily for trading pre-IPO stocks, equity-linked notes and/or fixed income securities. Only a couple of them (including one lit pool operator and one odd lot stock trading operator) are primarily involved in SEHK listed shares. Regarding trading volumes, as far as SEHK listed shares are concerned, the transactions executed by these platforms are not significant. In addition, 21 international exchanges and trading platforms, already licensed/authorized by their respective home regulator, including stock markets, futures and commodity markets, fixed income and structured products markets, are authorized to provide trading services in HKSAR.

## Intermediaries

**73. As of March 2013, 1,905 firms were licensed to carry out regulated securities market activities, including asset management.** A further 117 banks are registered to conduct securities business. Of the licensed firms, many are smaller Hong Kong firms but the market is dominated by a few large Hong Kong entities and global firms. As of December 2012, the top 10 firms accounted for

48 percent of the total value of transactions in securities, and 59 percent of transactions in futures and options. Many of the top firms have affiliations with other financial institutions.

#### Breakdown of Ownership (Domestic vs. Foreign) of Licensed Corporations

	March 31, 2013	March 31, 2012	March 31 2011
Total number of licensed corporations	1,905	1,840	1,752
Domestic ownership (In percent)	60	62	62
Foreign ownership (In percent)	40	38	38

Source: Securities and Futures Commission.

#### Ownership (by Business Type) of Licensed Corporations

	March 31, 2013	March 31, 2012	March 31, 2011
Total number of licensed corporations	1,905	1,840	1,752
Affiliates of banks (in percent)	10	11	12
Affiliates of insurance companies (in percent)	2	3	3
Affiliates of other financial institutions (in percent)	36	35	35
Others (in percent)	52	51	50

Source: Securities and Futures Commission.

**74. As of March 2013, there were 316 firms managing SFC authorized funds, of which 80 were firms licensed by SFC and 236 were based in other jurisdictions.** Banks dominate the distribution process for funds, but bank and non-bank entities share responsibility for funds management. As of December 2012, the top 10 fund managers managing SFC-authorized funds accounted for 50.1 percent of total AUM of SFC-authorized funds.

#### Collective investment schemes

**75. As of March 2013, there were 1,847 funds authorized by the SFC for public offering in the Hong Kong market, of which 305 (17 percent) were Hong Kong domiciled funds.** Of the remainder, 1,045 (57 percent) were Luxembourg-domiciled funds; 277 (15 percent) were domiciled in Ireland; 151 (8 percent) were domiciled in the Cayman Islands; and 53 (3 percent) were domiciled in the United Kingdom. Bond and equity funds are the predominant fund types.

**AUM of SFC Authorized Funds by Type of Funds**

<b>AUM In US\$ m</b>	<b>Dec. 31, 2012</b>	<b>% of total</b>	<b>Dec. 31, 2011</b>	<b>% of total</b>	<b>Dec. 31, 2010</b>	<b>% of total</b>
Bond	467,175	37.75	324,078	31.96	360,944	30.38
Equity	498,959	40.32	436,280	43.03	571,859	48.13
Diversified	45,726	3.69	32,345	3.19	43,005	3.62
Money market	83,609	6.76	100,535	9.92	86,854	7.31
Fund of funds	9,332	0.75	7,817	0.77	7,898	0.66
Index	126,127	10.19	105,118	10.37	106,192	8.94
Guaranteed	515	0.04	712	0.07	1,287	0.11
Hedge	630	0.05	704	0.07	920	0.08
Other specialized	5,551	0.45	6,284	0.62	9,106	0.77
<b>Total AUM</b>	<b>1,237,624</b>	<b>100</b>	<b>1,013,873</b>	<b>100</b>	<b>1,188,065</b>	<b>100</b>

**E. Preconditions****76. Many of the preconditions for effective securities markets regulation appear to be in place in HKSAR.**

- **Barriers to entry:** Foreign investors can invest in the securities markets on the same conditions as domestic investors, and licensing requirements for all categories of intermediaries are based on fit and proper criteria. However, by law competition in the provision of trading platforms in domestic securities is limited by a monopoly granted to the SEHK.
- **Taxation:** Overall taxation of firms and individuals is low. A stamp duty applies to securities transactions, although certain type of products (mainly options) and transactions (mainly hedging) are exempted.
- **Contract Law:** Contract law in HKSAR is largely based on common law and there is no general statutory code for contract law. Binding precedents from courts is the basis of contract law in HKSAR. The general themes underlying the common law on contracts include the ideas of freedom of contract and sanctity of contracts.
- **Company Law:** The CO (Cap 32) is modeled on the English Companies Act. A significant overhaul took place recently, which provided for a modernized legal framework for incorporation and operation of companies in HKSAR. The updated CO came into effect in March 2014. Overall, the CO remains a high level framework and, thus, needs to be complemented in important respects through the Listing Rules (for example the principle of one share one vote is not imbedded in the CO but in the Listing Rules) and/or the SFO. A unique feature of the HKSAR securities markets is the fact that a significant proportion of the companies listed on it are not

incorporated in HKSAR, but in offshore jurisdictions such as the Mainland, Bermuda, British Virgin Islands, and Cayman Islands. As a result, the Listing Rules and the SFO have greater importance than the CO in providing for shareholders rights, as they apply to all listed companies regardless of their place of incorporation.

- **Insolvency Law:** the CO does not contain a framework to allow for out of the court restructuring.
- **Competition Law:** A Competition law was enacted in 2012. The Ordinance provides for a judicial enforcement model through the establishment of the Competition Commission and the Competition Tribunal. The legislation will be implemented in phases.
- **Accounting and auditing standards:** Accounting and auditing standards are of high international quality as HKSAR has converged to IFRS and IAASB.
- **Protection of investors' rights:** The judiciary is acknowledged to be independent from political influence. Class actions suits are not provided for in the legislation, and the assessors were told it is not common for investors to pursue remedies through the courts. The Consumer Legal Action Fund (CLAF) was set up to give greater consumer access to legal remedies by providing financial support and legal assistance. In practice, however, the CLAF (and the actions available with the framework that created the CLAF such as a "representative" action) may not afford investors' similar protections to a class action suit. A Financial Dispute Resolution Center (FDRC) came into operation in June 2012 to provide an independent and affordable avenue for resolving monetary disputes between individuals and financial institutions by way of "mediation first, arbitration next". The FDRC administers a financial dispute resolution scheme (FDRS); the licensing conditions for HKMA's authorized institutions and the Code of Conduct for Persons Licensed by or Registered with the SFC were amended to require them to become members of FDRS.

## F. Main Findings

**77. Principles for the regulator:** The mandates of the SFC and the HKMA are clearly stated in the law. Both the SFC and the HKMA enjoy sufficient independence in their day-to-day operations; however, specific features in their legislative frameworks potentially threaten such independence. In addition, the SFC's (and HKMA) role in the HKEx risk management committee could create potential conflicts vis-à-vis its supervision role. Both regulators are subject to strong mechanisms of accountability vis-à-vis the government and the public, including judicial review of their decisions. Both agencies work under a high degree of transparency, including in connection with the development of policy, which is subject to consultation. Strong ethical requirements apply to both institutions, including in connection with securities transactions. The Risk and Strategy Unit (R&S), created in 2012, has added centralization and focus to processes in place at the SFC to identify and monitor risks. The R&S conducts risk-focused industry meetings, participates in the IOSCO Committee on Emerging Risks, and implements an internal risk register. Conflicts of interest are adequately addressed by the regulatory framework.

**78. Principles for SROs:** The governance of the HKEx and the composition of its Risk Management Committee (RMC) could create potential conflicts of interest for oversight. The SFC has established a strong supervisory program in connection with the listing functions of the HKEx, which include separation of the listing function, approval of rules by the SFC, the four eye principle in connection with individual decisions on listing, and on-site inspections. Supervision of market functions is discussed under Principle 34.

**79. Principles for Enforcement:** The SFC and the HKMA have broad licensing, supervisory and investigation powers in line with their respective mandates. Different avenues can be used by the SFC to seek enforcement actions. In practice, however, two domestic challenges limit enforcement efforts. First, for misconduct that does not constitute a crime, the current framework does not easily allow the SFC to seek both remedial and punitive actions. In practice the SFC then finds itself having to make difficult trade-offs. Second, challenges in the coordination with the DPP could limit the effectiveness of criminal enforcement. The SFC and the DoJ agree that an efficient and unreserved cooperation between the SFC and DoJ is both conducive of the proper administration of justice and in the interest of the public. High level discussions and meetings are being held between the DoJ and the SFC with the view to enhancing co-operation. In addition, the cross-border nature of the market, whereby many participants, including issuers and their auditors, are located off-shore, is a challenge that the SFC manages through international cooperation.

**80. Principles for Cooperation:** The SFO contains a robust framework that obliges the SFC to cooperate and exchange information both domestically and with foreign regulators. Domestically, the SFC has MOUs in place with the HKMA and the HKEx, and cooperation takes place at all levels of the organizations on a regular basis. Internationally, the SFC is the body responsible for cooperation in securities markets matters. The SFC is signatory of the IOSCO Multilateral MOU, as well as a significant number of bilateral MOUs, and evidence was provided that it cooperates effectively with other foreign regulators.

**81. Principles for Issuers:** Issuers of public offerings are required to submit an offering document the content of which is in line with the requirements set out in the IOSCO Principles. There are arrangements in place for the review of offering documents whereby for all listed products (other than listed CIS) the HKEx acts as the front line regulator, with the SFC having the power to object. For CIS and unlisted securities the SFC is responsible for the authorization of the offering documents. Listed securities are subject to periodic and ongoing obligations, including annual and semiannual reporting as well as a strong framework for the dissemination of price sensitive information. Review of compliance with these reporting obligations lies mainly with the HKEx, while the review of compliance with price sensitive information is now undertaken both by the SFC and the HKEx. A separate regime of periodic reporting obligations exists for structured products, whereby for both listed and unlisted products annual and semi annual reporting applies, as well as the obligation to disseminate inside information (for listed products) or material adverse changes (for unlisted products) compliance with which is monitored by the SFC. Financial statements to be included both in the prospectus and periodic reports must be prepared according to IFRS, HKFRS which are fully aligned with IFRS, or the Chinese accounting principles, which appear to be

consistent with IFRS. Other accounting principles have been considered acceptable, but in such cases a reconciliation must be submitted. Review of financial statements is carried out by three authorities—HKICPA, FRC, and HKEx. Overall, there is effective monitoring of issuers' compliance with their obligations, though enforcement is challenged by the cross border nature of the market.

**82. Principles for auditors, credit rating agencies (CRAs) and other information service providers:**

Auditors domiciled in HKSAR are subject to competence requirements set by the HKICPA. The HKICPA has established a review program for the oversight of auditors domiciled in HKSAR. However, its current governance structure does not ensure its independence from the accounting profession, and its enforcement framework is weak. Auditing standards applicable to domestic companies are of high international quality as HKSAR has converged with IAASB. The HKICPA has established robust independence requirements for auditors. Mainland companies with dual listing can use auditors registered in the Mainland, under a special arrangement between the authorities. Mainland auditors must use the Chinese Auditing Standards which have also converged to International Accounting Standards (IAS). For non-overseas companies the Exchange accepts non-Hong Kong audit firms on a case-by-case basis based on a set of predefined criteria. Non-Hong Kong auditors must be independent in the same way as required for local auditors; the HKICPA does not have any oversight jurisdiction over them but HKEx expects non-Hong Kong reporting accountants and auditors to be subject to independent oversight by a regulatory body of a jurisdiction that is signatory to the IOSCO Multilateral MOU. The provision of credit rating services and the issuance of analysis or reports on securities and futures contracts are regulated activities (as defined under the SFO) that are subject to the licensing requirements. Firms that carry any of these activities are subject to the same requirements as any other intermediaries, as well as specific requirements established by the SFC for each category. Ongoing supervision of both types of intermediaries is conducted within the overall program for securities intermediaries, and involves both off-site monitoring (based on regular interactions such as periodic reporting and meetings) and on-site prudential visits and inspections.

**83. Principles for Collective Investment Schemes:** The operation and distribution of CIS in HKSAR are regulated activities that are required to be licensed or registered. CIS managers operating in HKSAR and licensed/ registered by the SFC are subject to the same requirements as all other intermediaries, and to additional requirements established in the Fund Managers Code of Conduct and the Unit Trust Code. The offering of CIS to the public in HKSAR requires authorization of the fund by the SFC, even if the fund has been authorized by a foreign regulator. The authorization of a CIS requires the submission of a prospectus, the content of which must comply with the requirements set forth in the Principles. CIS are subject to ongoing obligations, including annual reports with audited financial statements and semiannual reports, and the disclosure of material events. Material changes must be approved by investors and/or the SFC depending on the circumstances, and all material changes must be notified to investors. CIS must be valued on a fair value basis, and there are clear guidelines in connection with pricing errors. The winding up of CIS must be carried out as provided for in its constituent documents or with the approval of a general meeting of holders. Hedge fund managers are subject to the same licensing requirements as any other manager of CIS. Hedge funds that are offered to the public must comply with the same

requirements as other CIS, and a set of additional requirements set by the SFC. Ongoing supervision of CIS managers, including hedge fund managers, is conducted within the overall program for securities intermediaries, and involves off-site monitoring (based on regular interactions with licensed firms such as periodic reporting and meetings), on-site prudential visits, and on-site inspections.

**84. Principles for Intermediaries:** The SFO defines a series of regulated activities, including dealing and advising on securities and futures that are subject to the licensing requirements. The SFC has established a common framework for the licensing of all regulated activities that is based on fit and proper criteria. The review of applications is robust. Banks conducting securities business are subject to a separate registration process, but the regulatory framework that applies to them is the same as for SFC licensed entities. Ongoing supervision for all intermediaries including banks involves both off-site monitoring (based on regular interactions with licensed firms such as periodic reporting and meetings as appropriate) as well as on-site prudential visits and inspections, which are planned using a risk-based approach. This monitoring gives particular attention to conduct obligations including selling practices. The SFC makes significant use of thematic inspections to complement its inspections of individual firms. Licensed intermediaries are subject to capital requirements based on a net capital rule which has embedded charges for market, credit risk and concentration risk, while the minimum buffer required subsumes other risks that have not been specified (mainly operational risk). Licensed intermediaries are subject to an early warning system. The SFC has in place a contingency plan which covers the failure of an intermediary and market wide simulation exercises are conducted on a biannual basis.

**85. Principles for Secondary Markets:** There are provisions in the law concerning exchanges and ATS and the SFC has issued guidelines in connection with ATS. However, the current framework does not provide sufficient guidance to potential applicants in connection with the differences in nature nor in the requirements applicable to different types of trading platforms—although as part of the application process the SFC has been open in its discussions with actual applicants. The HKEx has in place strong arrangements for real time supervision of the markets it operates. The SFC has established a program of oversight of the HKEx on both its listing and market function that comprises approval of rules, meetings, and periodic and ad-hoc reporting. On-site inspections have only been a regular part of the oversight arrangements for the listing function, but an inspection of the market function is planned for 2014. Resources devoted to the supervision of ATS are in line with their current importance. There is strong pre- and post-trade transparency, which is fostered by the current market structure as ATS trading volumes are not significant. The supervisory program in place to detect market abuse and other unfair trading practices is robust, though cross border challenges remain, as well as domestic challenges in connection with effective criminal enforcement. The HKEx has in place arrangements for the management of large exposures, including robust reporting obligations and position limits. More generally, there are risk management mechanisms in place that include margining, and default procedures are transparent. A robust framework for both short selling and settlement leads to a minimal rate of settlement failures.



## G. Summary Table of Implementation

<b>Table 5. Summary Implementation of the IOSCO Principles</b>	
<b>Principle</b>	<b>Findings</b>
Principle 1. The responsibilities of the Regulator should be clear and objectively stated.	The responsibilities of the SFC and the HKMA are established by law. There are robust arrangements for cooperation which are anchored in MOUs and include regular meetings at different levels of the organizations and sharing of information. There do not appear to be major gaps in regulation. However there currently is a disparity in connection with the distribution of investment-linked insurance products.
Principle 2. The Regulator should be operationally independent and accountable in the exercise of its functions and powers.	Both the SFC and HKMA operate under a high degree of operational independence. However current features of their governance frameworks, pose a threat to independence, including the power of the CEHK to provide direction to both agencies, the power of the CEHK to remove the members of the SFC without a clear framework that constrains such power, the role of the FS in connection with decisions related to exchanges and the participation of part time members on the board of the SFC which can be members of regulated entities. The SFC (and HKMA) role in the HKEx's RMC could create potential conflicts vis-à-vis its supervision role. Both the SFC and HKMA have a stable source of funding. Both regulators are subject to a strong framework of accountability vis-à-vis the government and the public, including judicial review of their decisions.
Principle 3. The Regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.	Both the SFC and the HKMA have broad licensing, supervisory and investigation powers. Enforcement powers are in line with the Principles, though in practice SFC powers in disciplinary proceedings present important challenges as discussed in Principle 12. Both regulators have sufficient resources and steps have been taken in recent years to strengthen resources for conduct supervision.



<b>Principle</b>	<b>Findings</b>
Principle 4. The Regulator should adopt clear and consistent regulatory processes.	The development of regulations and more generally policy (in the form of codes and guidelines) is subject to consultation—the former by legal requirement, the latter by market practice. Overall requirements to carry out regulated activities and to issue securities are clear, transparent, and sufficiently detailed, except in the case of the recognition of exchanges and the authorization or licensing of ATS, where internal policies need to be made more transparent to the market. This issue has been taken into consideration for the grade of Principle 33. Both regulators must provide reasons for their decisions, affected parties must be afforded due process, and decisions of the regulators are subject to review, including judicial review.
Principle 5. The staff of the Regulator should observe the highest professional standards, including appropriate standards of confidentiality.	Both regulators have strong codes of ethics that impose obligations on board members (SFC) and staff. Specific obligations exist in connection with securities markets transactions. The SFC and the HKMA are subject to strong rules of confidentiality.
Principle 6. The Regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate.	Current arrangements to identify and monitor systemic risk mainly rely on a bottom up approach. The recently created R&S has added centralization and focus to these arrangements through participation in the IOSCO Committee on Emerging Risk, risk-focused industry meetings and a risk register.
Principle 7. The Regulator should have or contribute to a process to review the perimeter of regulation regularly.	The SFC has relied on a bottom up approach explained in Principle 6 to identify emerging risks stemming from regulated and unregulated activities, and to review past decisions on the perimeter of regulation. That is, through their day-to-day work, the operational divisions identify risks and issues of concern. Internal input is complemented by external sources, including information from the HKMA and risk meetings with market participants.

Principle	Findings
	Since its inception in 2012, the R&S has added centralization and focus to these arrangements through participation in the IOSCO Committee on Emerging Risk, risk-focused industry meetings and a risk register, which includes an assessment of the perimeter of regulation if new risks are identified.
Principle 8. The Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed.	The regulatory framework for different categories of intermediaries requires them to put in place processes to identify and address conflicts of interest. The SFC and HKMA supervise compliance with these requirements via the licensing process and ongoing supervisory program. Overall, issuers are required to disclose conflicts of interest, and a strong framework for connected transactions is in place.
Principle 9. Where the regulatory system makes use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, such SROs should be subject to the oversight of the Regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.	The governance of the HKEx and the composition of the RMC could create potential conflicts of interest for oversight. The SFC has established a strong supervisory program in connection with the listing functions of the HKEx, which include separation of the listing function, approval of rules by the SFC, the four eyes principles in connection with individual decisions on listing and on-site inspections. Supervision of market functions is discussed under Principle 34.
Principle 10. The Regulator should have comprehensive inspection, investigation and surveillance powers.	Both regulators have comprehensive powers to supervise and inspect regulated entities.
Principle 11. The Regulator should have comprehensive enforcement powers.	The SFC, as the main body responsible for enforcement, has broad powers to investigate breaches of the securities laws, including requesting information from third parties. Different avenues can be used by the SFC in conducting enforcement actions for breaches of securities laws, including criminal and proceedings in front of the Market Misconduct Tribunal (MMT), civil proceedings and administrative/disciplinary proceedings. Formal powers afforded to the SFC are in line with the IOSCO Principles. However, the SFC faces challenges with their practical use which are discussed in Principle 12.

<b>Principle</b>	<b>Findings</b>
Principle 12. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.	The SFC and the HKMA have put in place robust supervisory regimes. The SFC, as the main body responsible for enforcement of breaches to securities laws, has been active in using all avenues available to it to take enforcement action. However, two domestic challenges affect its enforcement efforts. First, for licensed or registered intermediaries who are in breach of the Code of Conduct in circumstances where the conduct does not also involve a contravention of the law enabling the SFC to seek remedial orders from the civil courts, the SFC cannot easily secure both remedial and disciplinary outcomes, and in practice has been confronted with difficult trade-offs. Second, coordination arrangements with the DPP have faced challenges, but the current DPP (who assumed office in September 2013) and the SFC are working to strengthen coordination. In addition, the cross border nature of the market poses challenges for effective enforcement which the SFC manages through international cooperation.
Principle 13. The Regulator should have authority to share both public and non-public information with domestic and foreign counterparts.	The SFC and the HKMA have the power (and obligation) to cooperate both domestically and internationally. Cooperation at the international level does not require the existence of an independent interest.
Principle 14. Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.	Domestically, the SFC has MOUs in place with the HKMA and the HKEx that provide the foundation for effective coordination and sharing of information. Internationally the SFC is signatory to the IOSCO Multilateral MOU, as well as a significant number of bilateral MOUs, and evidence was provided that in practice it cooperates effectively with other foreign regulators. The SFC is responsible for responding to all requests for information from foreign regulators, including by seeking information from HKMA if required.

Principle	Findings
Principle 15. The regulatory system should allow for assistance to be provided to foreign Regulators who need to make inquiries in the discharge of their functions and exercise of their powers.	The SFC has the authority to cooperate with foreign authorities and collect information for them that is not currently in its files. HKMA can also supply information of this kind to the SFC for transmission, or directly, to foreign regulators, in accordance with the BO.
Principle 16. There should be full, accurate and timely disclosure of financial results, risk and other information that is material to investors' decisions.	Issuers of securities in a public offering must submit a listing document that is subject to review and authorization. Issuers of listed securities (other than structured products) are subject to ongoing obligations including annual and semiannual reports, and the dissemination of price sensitive information. Deadlines for submission of annual reports are long, but in line with other major jurisdictions. Issuers of structured products are subject to a separate reporting regime whereby both listed and unlisted products are subject to annual and half yearly reporting and disclosure of price sensitive information (for listed products) and material adverse changes (for unlisted products).
Principle 17. Holders of securities in a company should be treated in a fair and equitable manner.	The CO and the Listing Rules provide for shareholders to be treated fairly. The Takeovers Code provides a framework for changes of control transactions to be conducted fairly and with full disclosure. Prompt notification of holdings by substantial shareholders and insiders is required.
Principle 18. Accounting standards used by issuers to prepare financial statements should be of a high and internationally acceptable quality.	Financial statements to be included in the prospectus and in the annual and semiannual reports must be prepared according to (i) HKFRS which are fully aligned with IFRS, (ii) IFRS, or (iii) China Accounting Standards for Business Enterprises. Other accounting standards are permitted but a reconciliation to HKFRS is required. Current mechanisms to supervise compliance with accounting standards include review of financial statements by the HKEx, the HKICPA, and the FRC.

<b>Principle</b>	<b>Findings</b>
Principle 19. Auditors should be subject to adequate levels of oversight.	<p>Oversight of domestic auditors is a responsibility of the HKICPA. The current governance structure of the HKICPA does not ensure its independence from the accounting profession. Further, the enforcement framework is weak: (i) the governance of the disciplinary committee does not ensure sufficient independence, nor foster the development of expertise, and precedents; and (ii) the range of sanctions is limited.</p> <p>Companies from the Mainland with dual listing can choose an auditor domiciled in the Mainland under a special arrangement signed in 2010. The relevant authorities have set up cooperation mechanisms for conducting post-approval regulation/investigation of the endorsed audit firms.</p> <p>For overseas companies the Exchange may accept a non-Hong Kong audit firm on a case by case basis. A firm would be considered acceptable if it (i) has an international name and reputation; (ii) is a member of a recognized body of accountants; and (iii) is subject to independent oversight by a regulatory body of a jurisdiction that is signatory of the IOSCO Multilateral MOU.</p>
Principle 20. Auditors should be independent of the issuing entity that they audit.	<p>The Code of Ethics of the HKICPA establishes robust independence requirements for domestic auditors. Supervision of compliance with such requirements involves monitoring by the firm itself; the audit committees of listed issuers; and the review program of the HKICPA. Overseas auditors must be independent in the same terms as domestic auditors. In their case oversight is performed by the domestic oversight body as indicated in Principle 19.</p>

Principle	Findings
Principle 21. Audit standards should be of a high and internationally acceptable quality.	HKSAR has converged to ISA. Supervision of compliance with such standards involves monitoring by the firm itself; the HKICPA—mainly through its practice review program, but also through its program of review of financial statements—and the FRC, through its program of review of financial statements. Auditing standards apply by non-HKSAR audit firms must be comparable to those used in HKSAR. Oversight of compliance with such standards is a responsibility of the home oversight body as indicated in Principle 19.
Principle 22. Credit rating agencies should be subject to adequate levels of oversight. The regulatory system should ensure that credit rating agencies whose ratings are used for regulatory purposes are subject to registration and ongoing supervision	The provision of credit rating services is a regulated activity subject to the licensing requirements irrespective of whether the ratings are used for regulatory purposes or not. CRAs are subject to the general regulatory framework applicable to all intermediaries, and to specific requirements set out in the Code of Conduct for CRAs which is modeled on the IOSCO's Code of Conduct for CRAs. Ongoing supervision of CRAs includes off-site monitoring as well as on-site inspections.
Principle 23. Other entities that offer investors analytical or evaluative services should be subject to oversight and regulation appropriate to the impact their activities have on the market or the degree to which the regulatory system relies on them.	The issue of analyses or reports on securities and futures contracts falls under the definition of regulated activities subject to the licensing requirements. Firms that provide analysis and the analysts themselves are subject to the general regulatory framework applicable to all intermediaries, and to additional requirements that deal more specifically with the threats to independence arising from these activities. Ongoing supervision of firms that provide analysis is conducted as part of the supervisory program for intermediaries and includes both off-site monitoring as well as on-site inspections.

<b>Principle</b>	<b>Findings</b>
Principle 24. The regulatory system should set standards for the eligibility, governance, organization and operational conduct of those who wish to market or operate a collective investment scheme.	The operation and distribution of CIS fall under the definition of regulated activities subject to the licensing requirements. CIS operators licensed by or registered with the SFC are subject to the same requirements as that of any other intermediaries, and to additional specific requirements set forth in the Fund Manager Code of Conduct. Ongoing supervision of fund managers is conducted as part of the supervisory program for intermediaries and includes both off-site monitoring as well as on-site inspections.
Principle 25. The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.	Currently, CIS established in HKSAR can only be constituted as unit trusts. Segregation requirements apply. Further all CIS must appoint a custodian/trustee. Custodians/ trustees can be entities affiliated with the CIS operator; however, additional safeguards apply including the requirement that custodians/trustees must be regulated entities themselves, they cannot be subsidiaries of nor share directors with the fund manager.
Principle 26. Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.	CIS that are publicly offered must submit a prospectus for authorization by the SFC. In addition, they are subject to ongoing obligations which include annual and semiannual reporting and disclosure of material events. Certain changes as specified in the SFO and the Code on Unit Trusts and Mutual Funds (UTC) require approval by investors or the SFC, and material changes must be notified to investors prior to their implementation.
Principle 27. Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.	The constitutive documents of CIS must set out the rules for valuation of scheme assets. These rules, including rules for valuing illiquid assets, are consistent with IFRS. Independent auditors are required to assess compliance of the valuations with accounting standards.

<b>Principle</b>	<b>Findings</b>
Principle 28. Regulation should ensure that hedge funds and/or hedge funds managers/advisers are subject to appropriate oversight.	Hedge fund managers/advisers are subject to the same licensing requirements as any other CIS operators. Thus they are subject to the same requirements applicable to all intermediaries. Only the hedge funds that are offered to the public are subject to authorization by the SFC; in such cases the SFC has established additional requirements for both the manager and the fund itself. Hedge fund managers are subject to off-site monitoring as well as on-site inspections, as part of the general program of supervision of intermediaries.
Principle 29. Regulation should provide for minimum entry standards for market intermediaries.	The SFO defines regulated activities that are subject to the licensing requirements. Such requirements apply to both firms and individuals. Licensing requirements are based on fit and proper criteria, and this assessment applies to all directors, managers and substantial shareholders of the firms. Licence applications are reviewed thoroughly. Investment advisers are subject to the full licensing regime.
Principle 30. There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.	Licensed intermediaries are subject to minimum and ongoing capital requirements. Ongoing capital requirements of licensed intermediaries are based on a net capital rule that has imbedded charges for market risk, credit risk and concentration risk, while a minimum buffer is used to address other risks (mainly operational risk). Licensed intermediaries must submit regular financial returns.
Principle 31. Market intermediaries should be required to establish an internal function that delivers compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters.	Licensed or registered persons are required to maintain appropriate internal controls including risk management and compliance systems. Codes of conduct require intermediaries to act in the interests of clients and provide requirements for the handling of conflicts of interest. Client asset protection rules, know-your customer and suitability rules, record-keeping requirements and key conduct of business requirements apply. Ongoing supervision programs that include both off-site monitoring and on-site inspections are carried out by the regulators.



Principle	Findings
Principle 32. There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.	The SFC has established contingency plans that include plans for dealing with the failure of a licensed intermediary and a market wide exercise is conducted on a biannual basis. Licensed intermediaries are subject to an early warning system whereby they must notify the SFC when their capital falls below a specified threshold.
Principle 33. The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.	The HKEx has been granted a monopoly for the operation of a stock exchange in HKSAR. Other exchanges can be established and are subject to recognition by the SFC. ATS can also be established and, depending on their nature, are subject to either authorization or licensing by the SFC. The SFC has been open in its discussions with applicants; however, there is a need for a more formal and transparent policy to guide potential applicants when choosing between recognition as a recognized exchange company or an authorization as a Type III ATS. The same consideration applies in connection with Type V ATS, for which requirements have evolved overtime via licensing conditions but have not yet been incorporated into the ATS Guidelines.
Principle 34. There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.	The HKEx conducts real time supervision of the markets it operates for purpose of ensuring fair and orderly trading, while the SFC conducts market surveillance for the purpose of detecting misconduct. The SFC has established arrangements for the supervision of the HKEx, which include meetings at different levels of the organization, reporting obligations, and on-site inspections for the listing function. The SFC has planned an onsite inspection for the market function for 2014. Currently, market supervision focuses on the markets operated by the HKEx, which is reasonable in light of the size of ATS.

<b>Principle</b>	<b>Findings</b>
Principle 35. Regulation should promote transparency of trading.	The trading rules of the HKEx require both pre and post trade transparency. In addition exchange participants are required to report to the HKEx off exchange trades within 15 minutes. Iceberg orders are not allowed and block trades are only allowed in the futures exchange, but they must be communicated to the exchange immediately. ATS that manage dark pools do not provide pre-trade transparency but they must report all trades to the HKEx within 1 minute of their execution. In any event they are not significant in size. Of the remaining ATS only a couple involve SEHK listed shares (one lit and one odd lot trading operator) and their trading volumes are not significant.
Principle 36. Regulation should be designed to detect and deter manipulation and other unfair trading practices.	Market manipulation, insider trading, and unfair trading practices are prohibited misconduct under the SFO and front running is a misconduct under the Code of Conduct. Appropriate remedies are available, which include criminal prosecution, except for front running. The SFC has in place robust mechanisms for market surveillance that are based on automated systems that generate alerts. There is a dedicated team to investigate these alerts. However, enforcement actions face challenges resulting from the cross border nature of the market, which requires significant cooperation from foreign regulators, and domestically from challenges in coordination between the SFC and the DPP. On the latter, the SFC and the current DPP are working to address these challenges. Challenges in enforcement have been taken into consideration for the grade of Principle 12.

<b>Principle</b>	<b>Findings</b>
Principle 37. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.	Exchange participants are subject to position reporting and position limits. The exchanges have a wide range of powers to deal with large exposures, including the power to require participants to reduce their positions, and, in the event of non-compliance, they have the power to close out or transfer positions. Additional risk management mechanisms are in place, including additional capital requirements for clearing participants, day and intraday margin, and a default fund. Default rules are transparent and provide the HKEx with a wide range of powers to close out, settle or transfer positions. There are robust rules for short selling which prohibit naked short selling and require reporting of short positions. A mandatory buy in is required for a failed settlement and the intermediary must also pay a fine. The result is a minimal rate of settlement failures.
Principle 38. Securities settlement systems and central counterparties should be subject to regulatory and supervisory requirements that are designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.	Not assessed.

## H. Recommended Actions

<b>Table 6. Recommended Actions – IOSCO</b>	
Principle	Recommended Action
Principle 1	<ul style="list-style-type: none"> <li>• Authorities should proceed with the current initiatives that will ensure consistent conduct regulation of selling/distribution relating to investment-linked insurance products and other investments. Authorities should consider having periodic reviews of the supervisory and enforcement outcomes of both SFC and HKMA to ensure that, regardless of which regulator is involved, poor conduct by intermediaries and their managers and representatives, is treated in a consistent fashion, especially in terms of remedial, disciplinary and enforcement responses.</li> </ul>
Principle 2	<ul style="list-style-type: none"> <li>• Authorities should consider strengthening the independence of the regulators by explicitly limiting the circumstances in which the CEHK can give directions to them, for example by precluding directions relating to specific cases. The circumstances in which the CEHK can remove Commission members of the SFC should be articulated, preferably in legislation.</li> <li>• Consideration should be given to moving away from government appointees on the board of the HKEx.</li> <li>• SFC and HKMA should not be members of the HKEx's RMC to ensure an arms' length relationship.</li> <li>• Authorities should consider the desirability of moving away from part time Commissioners, or at least adopt a policy of not appointing directors of regulated entities as Commissioners.</li> </ul>
Principle 3	<ul style="list-style-type: none"> <li>• Authorities should give consideration to increasing the maximum fines that the SFC can impose and providing a mechanism for compensating investors that can be used alongside the disciplinary process.</li> <li>• Authorities should give consideration to providing the HKMA with fining powers over EOs and ReIs.</li> </ul>
Principle 4	<ul style="list-style-type: none"> <li>• SFC should further develop and formalize internal policies for publication of a comprehensive policy on the recognition of exchange markets and the authorization/licensing of other trading platforms.</li> <li>• HKMA circulars about policy (rather than compliance guidance) should continue to be subject to consultation.</li> </ul>
Principle 6-7	<ul style="list-style-type: none"> <li>• SFC should continue to implement the mandate for the R&amp;S to comply with Principle 6 and over time assess the level of resources required for such compliance.</li> </ul>

Principle	Recommended Action
Principle 9	<ul style="list-style-type: none"> <li>• Consideration should be given to moving away from government appointees on board of HKEx and RMC.</li> <li>• SFC and HKMA should not be members of the HKEx's RMC to ensure an arms' length relationship.</li> <li>• Decisions on the admission of participants by HKEx should be subject to an appeal process (for example by SFC).</li> <li>• SFC should proceed with its plans to carry out regular on-site inspections of the HKEx's market functions.</li> </ul>
Principle 11	<ul style="list-style-type: none"> <li>• Authorities should give consideration to increasing the maximum fines that SFC can impose; and providing a mechanism for compensating investors that can be used as part of the disciplinary process.</li> <li>• Authorities should give consideration to providing the HKMA with fining powers over EOs and ReIs.</li> </ul>
Principle 12	<ul style="list-style-type: none"> <li>• The authorities should continue working to enhancing coordination on the criminal arena.</li> <li>• The authorities should consider having periodic reviews of the supervisory and enforcement outcomes of both SFC and HKMA to ensure that, regardless of which regulator is involved, poor conduct by intermediaries and their managers and representatives is treated in a consistent fashion, especially in terms of remedial, disciplinary and enforcement responses.</li> </ul>
Principle 16	<ul style="list-style-type: none"> <li>• The SFC and the Exchange should implement shorter deadlines for the submission of periodic information, in particular interim reports.</li> </ul>
Principle 18	<ul style="list-style-type: none"> <li>• The authorities should consider centralizing the function of monitoring issuers' compliance with accounting standards into one single authority.</li> </ul>
Principles 19-21	<ul style="list-style-type: none"> <li>• The authorities should proceed with their proposals to establish a fully independent authority with responsibility for the oversight of the audit profession and with strong enforcement power. Such authority should have jurisdictions over all auditors that audit companies listed in HKSAR.</li> </ul>
Principle 33	<ul style="list-style-type: none"> <li>• SFC should further develop and formalize internal policies for publication of a comprehensive policy on the recognition of exchange markets and the authorization/licensing of other trading platforms.</li> </ul>
Principle 34	<ul style="list-style-type: none"> <li>• The SFC should proceed with its plan to conduct regular on-site inspections of the market function of the SEHK.</li> </ul>
Principle 35	<ul style="list-style-type: none"> <li>• The criteria under which ATS that operate as dark pools are not required to provide pre-trade transparency should be kept under review, especially if trading volumes in off-market venues increase.</li> </ul>

## I. Authorities' Comments

**86. The Hong Kong authorities appreciate the comprehensive and positive assessment of Hong Kong's securities sector, and welcome the IMF's view that Hong Kong has developed a sound framework for the regulation of securities markets and exhibited a high level of implementation of the IOSCO Principles.** The assessment contains some useful observations and

recommendations which could help further enhance regulation of securities markets in HKSAR. The authorities will review these recommendations, and give due consideration to their adoption where appropriate, as we remain committed to enhancing market quality and efficiency. Our responses to some specific recommendations are set out in the ensuing paragraphs.

### **Operational Independence of the Regulators.**

**87. The authorities concur with the IMF that both the SFC and HKMA enjoy clear de facto operational independence in the performance of their respective functions.** In relation to Principle 2, the authorities would like to reiterate (as on the occasion of the 2003 FSAP assessment of Hong Kong) that the reserve power vested with the CE of the HKSAR to give directions to the SFC reflects the Government's ultimate responsibility to formulate financial policies and regulate and supervise financial markets as enshrined in the Basic Law. Like the reserve power in the Banking Ordinance, the power provided for in section 11 of the SFO has never been invoked and would only be used as a tool of last resort to implement specific remedial measures in the most critical and extreme circumstances. The exercise of this reserve power is subject to the following restrictions under the SFO: (i) that the direction must be in the public interest; (ii) that it must further the SFC's regulatory objectives or the performance of any of its functions; and (iii) that the CE of the HKSAR must first consult the CEO of the SFC to afford the SFC an opportunity to be heard. Also, the decision to issue a direction may be subject to judicial review. Hence, there are safeguards against any arbitrary use of the reserve power, and given these qualifications, the authorities consider that the power should not be seen as having the potential for interference in the day-to-day operations of the regulators.

**88. Regarding the recommendation under Principle 2 that the authorities should consider the desirability of moving away from part time SFC Commissioners, or adopting a policy of** not appointing directors of regulated entities, the authorities would like to emphasize that when appointing non-executive directors ("NEDs") to the SFC, the Government has taken into account the various considerations including the avoidance of conflict of interests. On the appointment of the Chairman, the Government requires that he/she should not be a director of any company listed in Hong Kong SAR, and that he/she should not have any material interest in any principal business activity or be involved in any material business dealing with a company listed in Hong Kong SAR or any person or company engaged in activities regulated by the SFC. For NEDs, due consideration has been given to the background and experience of the candidates, so as to ensure that their experience gained from various senior positions in major corporations and bodies would enable them to make positive contribution to and keep an independent eye on the performance of functions by the SFC. There are internal procedures in the SFC to guard against conflict of interests.

### **Regulation and Supervision of Markets**

**89. The Hong Kong authorities appreciate the positive assessment that both the SFC and HKMA are sophisticated regulators, and have been able to leverage from domestic and international expertise to develop sound supervisory practices.**

**90. In view of the comment under Principle 9 on the role of the SFC and HKMA in the RMC of the HKEx, the authorities are reviewing the composition of the RMC to enhance the effectiveness of the RMC's performance in relation to the HKEx's statutory functions.**

Separately, the appointment of a number of members to the Board of Directors of the HKEx by the FS is necessary as a safeguard to ensure adequate reflection of public interests and interests of the investing public in the decision making body of the HKEx, which has important public functions of ensuring an orderly and fair market in securities and futures trading as well as prudent risk management of activities of the HKEx.

**91. In relation to Principles 33–35, the SFC has begun reconfiguring its approach in relation to the supervision of the HKEx in view of its latest strategic plan and business model.**

The SFC will also issue further guidelines on recognition of exchanges and authorization of automated trading services.

#### **Monitoring of issuers' compliance with accounting standards**

**92. In response to the IMF's recommendation for centralizing the function of monitoring issuers' compliance with accounting standards into one single authority under Principle 18,** we would like to point out that the Financial Reporting Council Ordinance has vested in the FRC the statutory function and power to enquire into non-compliance with accounting requirements by issuers under our regulatory regime for financial reporting. In discharging its statutory duty, the FRC leads and coordinates with other relevant regulators in respect of the work to monitor issuers' compliance with accounting standards. We believe that, in the context of our regulatory regime which is working well, it is not necessary to make a fundamental change to transfer the statutory role of the FRC to the SFC.

#### **Oversight of external auditors of listed companies**

**93. In relation to the IMF's recommendation for strengthening the oversight of external auditors of listed companies under Principles 19–21, the Hong Kong Government is preparing** proposals to enhance the independence of the regulatory regime for auditors of listed entities from the accountancy profession itself, with a view to ensuring that the regime is benchmarked against international standards. In drawing up the proposals, we will take into account the IOSCO Objectives and Principles of Securities Regulation as well as the IMF's recommendations. Our plan is to conduct a public consultation on the reform proposals in mid-2014 and, subject to the consultation outcome, to introduce the legislation into the Legislative Council in the 2014–15 legislative session.

#### **Enforcement of securities regulation**

**94. In relation to Principle 12, the authorities appreciate the IMF's recognition that the SFC and HKMA have put in place robust supervisory regimes.** The authorities note that the IMF has identified a few issues in relation to the effectiveness of the enforcement process of the SFC. We would like to offer our views in the next few paragraphs.

- *Coordination between Department of Justice and SFC.* The authorities acknowledge that the coordination arrangements between the SFC and the DoJ can be further improved to enhance the effectiveness of enforcement. To this end, there is a consensus between the DoJ and the SFC that an efficient cooperation between the two institutions is both conducive to the proper administration of justice and in the interest of the public. For this purpose, high-level meetings between the SFC (led by its Chairman, its CEO and Executive Director of Enforcement) and the DoJ (led by the Secretary for Justice and the current Director of Public Prosecutions (who assumed office in September 2013)) are being held with a view to further improving the existing arrangements. We expect that the ongoing discussions will bear fruitful results.
- *Level of sentence.* As with all other criminal cases, the result of each market misconduct case is monitored, and the propriety of sentences is considered under the guidance laid down in the Prosecution Code, irrespective of whether it is the DoJ or the SFC which prosecutes. There is in place in the Hong Kong's judicial system an appeal procedure whereby a sentence can be reviewed by a court higher than the court which passed the sentence. This applies to sentences which are wrong in law or in principle or are manifestly inadequate or excessive, as opposed to merely lenient or heavy, in light of all the circumstances of the case. Where appropriate, prosecutors will not hesitate to invoke such a procedure.
- *Remedial and punitive actions.* In relation to the findings under Principle 12, the authorities note the IMF's observation regarding the choice between punitive and remedial actions in case of breach of the Code of Conduct by licensed or registered intermediaries in circumstances where the conduct does not also involve a contravention of the law. The authorities also note that in terms of remedial actions, section 213 of the SFO empowers the SFC to seek court order requiring a person who has contravened specified parts of the CO and the SFO to take such steps as the Court of First Instance may direct to remedy the contraventions, including steps to restore the affected parties to any transaction to the position in which they were before the transaction was entered into. Aside from bringing the cases to the Court, investors may also seek to settle monetary disputes with financial institutions through the Financial Dispute Resolution Centre, which was established in November 2011.
- *Periodic review of supervisory and enforcement outcomes of the SFC and the HKMA.* We note the recommendation under Principle 1 about periodic reviews of the supervisory and enforcement outcomes of both the SFC and HKMA to ensure the consistency of the conduct regulation of intermediaries, especially in terms of remedial, disciplinary and enforcement responses. Currently, a memorandum of understanding between the two regulators operates to ensure a consistent application of regulatory measures, irrespective of whether an intermediary is supervised by the SFC or HKMA. The two regulators are also maintaining a close dialogue to discuss supervisory and enforcement matters. We share the objectives of ensuring consistency in terms of supervisory and enforcement outcomes. While the current cooperation mechanism is working constructively and effectively, the authorities will keep in view the need to further enhance the cooperation and information exchange arrangements between the two regulators as appropriate.