



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

## FINANCIAL SECTOR ASSESSMENT PROGRAM

July 2014

### IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION—DETAILED ASSESSMENT OF OBSERVANCE

This IOSCO Objectives and Principles of Securities Regulation Detailed Assessment Report was prepared in the context of the Financial Sector Assessment Program for the People's Republic of China—Hong Kong Special Administrative.

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June 2014

## DETAILED ASSESSMENT OF OBSERVANCE

IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES  
REGULATION

Prepared By  
**Monetary and Capital  
Markets Department**

This Detailed Assessment Report was prepared in the context of an IMF Financial Sector Assessment Program (FSAP) mission in People's Republic of China—Hong Kong Special Administrative Region (HKSAR) during September 2013, led by Carlos Medeiros, IMF and overseen by the Monetary and Capital Markets Department, IMF.

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## Glossary

Advertising Guidelines	Advertising Guidelines Applicable to Collective Investment Scheme Authorized under the Product Codes
AI	Authorized institution
AIR	Acceptable inspection regime
AMLO	Anti-Money Laundering and Counter-Terrorist Financing (Financial Institution) Ordinance
ATS	Automated trading service
BO	Banking Ordinance
CASBE	China Accounting Standards for Business Enterprises
CCASS	Central Clearing and Settlement System
CCP	Central counterparty clearing facility
CEHK	Chief Executive of Hong Kong
CFR	Council of Financial Regulators
CIS	Collective investment scheme
Claims Rules	Securities and Futures (Investor Compensation–Claims) Rules
Client Money Rules	Securities and Futures (Client Money) Rules
Client Securities Rules	Securities and Futures (Client Securities) Rules
CO	Companies Ordinance
CRA	Credit rating agency
CRA Code	Code of Conduct for Persons Providing Credit Rating Services
CSRC	China Securities Regulatory Commission
DoJ	Department of Justice
DPP	Director of Public Prosecutions
EO	Executive officer
ESC	SFC's Enforcement Steering Committee
ExCo	Executive Committee
ETF	Exchange traded fund
FDRC	Financial Dispute Resolution Centre Limited
FMCC	Fund Manager Code of Conduct
FoHF	Fund of hedge funds
FRC	Financial Reporting Council
FRR	Securities and Futures (Financial Resources) Rules
FS	Financial Secretary
FSC	Financial Stability Committee
GAAP	Generally Accepted Accounting Principles
GEM	Growth Enterprise Market of SEHK
HF	Hedge fund
HKCC	HKFE Clearing Corporation Limited
HKEx	Hong Kong Exchanges and Clearing Limited
HKFE	Hong Kong Futures Exchange Limited
HKFRS	Hong Kong Financial Reporting Standards

HKICPA	Hong Kong Institute of Certified Public Accountants
HKSAR	Hong Kong Special Administrative Region
HKSCC	Hong Kong Securities Clearing Company Limited
IA	Insurance Authority (now the Office of the Commissioner of Insurance, OCI)
IASB	International Accounting Standards Board
ICAC	Independent Commission Against Corruption
ICG	Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission
IFRS	International Financial Reporting Standards
ILAS	Investment-linked assurance schemes
IOSCO	International Organization of Securities Commissions
KFS	Product Key Facts Statements
LC	Licensed corporation as defined in the SFO
LegCo	Legislative Council of Hong Kong
MA	The person holding the office of Monetary Authority
MCP	SFC's Market Contingency Plan
Methodology	Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation
MMoU	Multilateral Memorandum of Understanding
MMT	Market Misconduct Tribunal
MoU	Memorandum of understanding
MPF	Mandatory provident fund
MPFA	Mandatory Provident Fund Schemes Authority
MPFSO	Mandatory Provident Fund Schemes
MSS	Market Surveillance System
OCI	Office of the Commissioner of Insurance
OP	Overarching Principle
PAO	Professional Accountants Ordinance
PFMI	Principles for Financial Market Infrastructures
PRP	Process Review Panel for the SFC
R&S	SFC's Risk and Strategy Unit
REC	Recognized exchange company
REIT	Real estate investment trust
ReI	Relevant individual
RI	Registered institution
RMC	Risk Management Committee

RO	Responsible officer
SEHK	The Stock Exchange of Hong Kong Limited
SEOCH	The SEHK Options Clearing House Limited
SFAT	Securities and Futures Appeals Tribunal
SFC	Securities and Futures Commission
SFLC	Securities and Futures Liaison Committee
SFO	Securities and Futures Ordinance
SFST	Secretary for Financial Services and the Treasury
SIP Code	Code on Unlisted Structured Investment Products
SOM	SFC's Supervision of Markets Division
SMLR	The Securities and Futures (Stock Market Listing) Rules
SRO	Self-regulatory organization
UTC	Code on Unit Trusts and Mutual Funds

## SUMMARY

**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 Commissions (IOSCO) Principles.** Both the Securities and Futures Commission (SFC) and the Hong Kong Monetary Authority (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. 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 China, an active presence by international players and increased regional competition as an international finance center.

**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 Hong Kong Institute of Certified Public Accountants (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 of the SFC and more generally of the HKSAR as an international financial center which is built on 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) can be boosted to tackle challenges so as to further enhance the effectiveness of enforcement. These are challenges that the HKSAR should tackle as a matter of priority and are under their control. In that regard, it is noted that 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. It is further noted that there have been high level meetings between the SFC (led by its Chairman, Chief Executive Officer (CEO) and Executive Director of Enforcement) and the DoJ (led by the Secretary for Justice and the current DPP (who assumed office in September 2013)). The SFC also reports that the SFC and the current DPP are taking steps to strengthen coordination on enforcement. On the other hand, the openness of the HKSAR 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.

**Finally, it is important to consider 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.**

## INTRODUCTION

**1. An assessment of the HKSAR securities market was conducted August 26 to 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 self-regulatory organizations (SROs) are not covered in this assessment.

**2. 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.

**3. 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 Financial Services and the Treasury Bureau (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, (iv) meetings with the HKEx, banks and securities intermediaries, auditing firms, a credit rating agency (CRA) and a law firm.

**4. 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.

## INSTITUTIONAL STRUCTURE

**5. 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 Securities and Futures Ordinance (Cap. 571 of the Laws of Hong Kong) (SFO) which charges it with the development and the regulation of the securities and futures markets, and the reduction in 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 (CEHK) or by the Financial Secretary (FS) under delegated authority. It is funded from levies on market participants, but its budget must be approved by the FS.

**6. The HKMA is the responsible authority for the supervision of banks in the provision of securities business.** Overall the 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 Banking Ordinance (BO) and the SFO, their 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 Monetary Authority (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 (EOs) and relevant individuals (ReIs).

**7. 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 securities exchange in the jurisdiction and also operates the only futures exchange. Two memoranda of understanding (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.

**8. 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 practicing 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. Besides 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 independence and oversight of the regulation of auditors of listed entities.

**9. 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) Financial Stability Committee (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 Council of Financial Regulators (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 Secretary for Financial Services and the Treasury (SFST); and (v) the tripartite meetings between FSTB, SFC, and HKEx, which 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.

## MARKET STRUCTURE

### Issuers

**10. As of April 2013 there were 1,558 companies listed on The Stock Exchange of Hong Kong Limited (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.

**11. SEHK's stock market is dominated by issuers based in the Mainland and the Mainland companies account 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.

**12. 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 to 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

**13. 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 which are mainly based on equities such as 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 an automated trading service (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 were 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

**14. As of March 2013, 1,905 firms were licensed to carry out regulated securities market activities, including asset management.** A further 117 banks were registered to conduct securities business. Of the licensed corporations, 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.

**15. 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 funds management is shared between bank and non-bank entities. In fact, at 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**

**16. 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 UK. 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>

## PRECONDITIONS

### 17. 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 Companies Ordinance, CO (Cap. 32) is modeled on the English Companies Act. A significant overhaul took place last year,<sup>1</sup> which provided for a modernized legal framework for incorporation and operation of companies in HKSAR. The new CO has come 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. On the other hand 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 IAAS.
- **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 Limited (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 HKMAs authorized institutions (AIs) and the Code of Conduct for Persons Licensed by or Registered with the SFC were amended to require them to become members of FDRS.

## MAIN FINDINGS

**18. 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 (RMC) could create potential conflicts vis-à-vis its supervision role. Both regulators are subject to strong mechanisms of accountability vis-a-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) that was created in 2012 has added centralization and focus to processes in place at the SFC to identify and monitor risks through R&S conducting of risk-focused industry meetings, its

participation in the IOSCO Committee on Emerging Risks and the implementation of an internal risk register. Conflicts of interest are adequately addressed by the regulatory framework.

**19. Principles for SROs:** The governance of the HKEx and the composition of its 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.

**20. 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.

**21. 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 Memorandum of Understanding (MMoU), as well as a significant number of bilateral MoUs, and evidence was provided that in practice it cooperates effectively with other foreign regulators.

**22. Principles for Issuers:** Issuers of public offering 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 International

Financial Reporting Standards (IFRS), Hong Kong Financial Reporting Standards (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.

**23. 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 the International Auditing and Assuring Standards Board (IAASB) standards. The HKICPA has established robust independence requirements for auditors. Mainland companies with dual listing can use auditors registered in the Mainland who are approved for the purpose 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 is required for local auditors; the HKICPA does not have any oversight jurisdiction over them but the exchange 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 MMoU. 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.

**24. 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 (HF) managers are subject to the same licensing requirements as any other manager of CIS. HFs 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 HF 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.

**25. 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.

**26. 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.

## SUMMARY TABLE OF IMPLEMENTATION

**Table 1. Summary of Implementation—ROSC**

Principle	Grade	Findings
Principle 1. The responsibilities of the Regulator should be clear and objectively stated.	BI	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 the regulatory requirements 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.	PI	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.	FI	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

Principle	Grade	Findings
		resources for conduct supervision.
Principle 4. The Regulator should adopt clear and consistent regulatory processes.	FI	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.	FI	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.	BI	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.	BI	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.  Since inception in 2012, R&S has added

Principle	Grade	Findings
		centralization and focus to these arrangements through participation in the IOSCO Committee on Emerging Risk, risk-focused industry meetings and a risk register, each of 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.	FI	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 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.	BI	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 eye 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.	FI	Both regulators have comprehensive powers to supervise and inspect regulated entities.
Principle 11. The Regulator should have comprehensive enforcement powers.	FI	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.

Principle	Grade	Findings
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.	BI	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.	FI	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.	FI	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 MMoU, 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 15. The regulatory system should allow for assistance to be provided to foreign Regulators who need to make inquiries in the	FI	The SFC has the authority to cooperate with foreign authorities and collect information for them that is not currently in its files. HKMA can

Principle	Grade	Findings
discharge of their functions and exercise of their powers.		also supply information of this kind to the SFC for transmission to, or directly to, foreign regulators in accordance with the Banking Ordinance.
Principle 16. There should be full, accurate and timely disclosure of financial results, risk and other information that is material to investors' decisions.	FI	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.	FI	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.	FI	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 (CASBE). 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.
Principle 19. Auditors should be subject to adequate levels of oversight.	PI	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

Principle	Grade	Findings
		<p>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 Mainland with dual listing can choose an auditor domiciled in 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 MMoU.</p>
<p>Principle 20. Auditors should be independent of the issuing entity that they audit.</p>	<p>BI</p>	<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>
<p>Principle 21. Audit standards should be of a high and internationally acceptable quality.</p>	<p>BI</p>	<p>HKSAR has converged to International Standards on Auditing (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.</p> <p>Auditing standards apply by non-Hong Kong 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.</p>
<p>Principle 22. Credit rating agencies should be subject to adequate levels of oversight. The regulatory system should ensure that credit</p>	<p>FI</p>	<p>The provision of credit rating services is a regulated activity subject to the licensing requirements irrespective of whether the</p>

Principle	Grade	Findings
rating agencies whose ratings are used for regulatory purposes are subject to registration and ongoing supervision.		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.	FI	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.
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 CIS.	FI	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 (FMCC). 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 CIS and the segregation and protection of client assets.	FI	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	Grade	Findings
Principle 26. Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a CIS for a particular investor and the value of the investor's interest in the scheme.	FI	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 CIS.	FI	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.
Principle 28. Regulation should ensure that HFs and/or HFs managers/advisers are subject to appropriate oversight.	FI	HF 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 HFs 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. HF 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.	FI	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. License 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.	FI	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 embedded charges for market risk, credit risk and concentration risk, while a minimum buffer is used to address other risks (mainly

Principle	Grade	Findings
		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.	FI	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 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.	FI	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.	PI	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 a recognition as a recognized exchange company (REC) 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	BI	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

Principle	Grade	Findings
appropriate balance between the demands of different market participants.		<p>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.</p> <p>Currently, market supervision focuses on the markets operated by the HKEx, which is reasonable in light of the size of ATS.</p>
Principle 35. Regulation should promote transparency of trading.	FI	<p>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.</p>
Principle 36. Regulation should be designed to detect and deter manipulation and other unfair trading practices.	FI	<p>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.</p>

Principle	Grade	Findings
Principle 37. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.	FI	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.	NA	Not assessed.
Fully Implemented (FI) – 26; Broadly Implemented (BI) – 8; Partly Implemented (PI) – 3; Not Implemented (NI) – 0; Not Applicable (NA) – 1.		

## RECOMMENDED ACTIONS

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 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 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>• Consideration should be given to subjecting decisions on the admission of participants 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	Recommended Action
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. 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>

## AUTHORITIES' RESPONSE

**27. 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.

**28. 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 Chief Executive (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.

**29. 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 HKSAR, 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 HKSAR 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**

**30. 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.**

**31. 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.

**32. 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 ATS.

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

**33. 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 FRC 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**

**34. 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**

**35. 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 DoJ 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 DPP (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 FDRC, 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, an MoU 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.

## DETAILED ASSESSMENT REPORT

**36. The purpose of the assessment is primarily to ascertain whether the legal and regulatory securities markets requirements of the country and the operations of the securities regulatory authorities in implementing and enforcing these requirements in practice meet the standards set out in the IOSCO Principles.** The assessment is to be a means of identifying potential gaps, inconsistencies, weaknesses and areas where further powers and/or better implementation of the existing framework may be necessary and used as a basis for establishing priorities for improvements to the current regulatory scheme.

**37. The assessment of the country's observance of each individual Principle is made by assigning to it one of the following assessment categories: fully implemented, broadly implemented, partly implemented, not implemented and not applicable.** The IOSCO assessment methodology provides a set of assessment criteria to be met in respect of each Principle to achieve the designated benchmarks. The methodology recognizes that the means of implementation may vary depending on the domestic context, structure, and stage of development of the country's capital market and acknowledges that regulatory authorities may implement the Principles in many different ways.

<b>Principles Relating to the Regulator</b>	
<b>Principle 1.</b>	The responsibilities of the regulator should be clear and objectively stated.
Description	<p><b>Structure of the securities regulation regime</b></p> <p>Regulation of the financial sector in Hong Kong is broadly along sectoral lines, with separate regulatory authorities for each of:</p> <ol style="list-style-type: none"> <li>the securities and futures industry (henceforth the securities industry)— SFC;</li> <li>banks—HKMA;</li> <li>the insurance industry—the Office of the Commissioner of Insurance (OCI, previously the Insurance Authority (IA));</li> <li>the mandatory provident fund, MPF (pension fund) industry—the Mandatory Provident Fund Schemes Authority (MPFA).</li> </ol> <p>SFC has primary responsibility for the regulation and supervision of the securities industry in Hong Kong. However, the securities industry activities of licensed banks and deposit taking institutions are supervised by the HKMA, although the legislative and rule framework that applies to them is supplied almost wholly by the SFO and related legislation and by codes of conduct issued by SFC. The SFC is in charge of taking enforcement actions against banks for breaches of securities laws, mainly through referrals of the HKMA; while enforcement actions on EOs and ReIs are a shared responsibility.</p> <p>Regulation and supervision of auditors is carried out by a combination of the FRC and the HKICPA. The FRC is responsible for investigating and reporting on auditing and reporting irregularities and potential non-compliance with relevant standards in relation to listed companies. The HKICPA's responsibilities include ongoing supervision of audit firms domiciled in Hong Kong which provide services to listed and non-listed companies.</p> <p>The HKEx group plays a self-regulatory role in relation to listed companies, and supervises the orderly conduct of trading on its markets.</p> <p>A specialist tribunal, the MMT, conducts administrative proceedings relating to market misconduct (Part XIII of the SFO) and breaches of a company's obligation to disclose material events ("inside information") (Division 3 of Part XIVA).</p> <p><b>SFC responsibilities, powers and authority</b></p> <p>The SFC's responsibilities, powers and authority are set out in legislation. Its powers and authority are enforceable.</p> <p>The most important piece of legislation is the SFO including its subsidiary instruments (Rules made under the SFO). SFC also has functions and powers under other laws, such as:</p> <ol style="list-style-type: none"> <li>Parts II and XII of the CO;</li> <li>the Anti-Money Laundering and Counter-Terrorist Financing, AML/CFT (Financial Institutions) Ordinance (AMLO); and</li> <li>the Mandatory Provident Fund Schemes Ordinance (MPFSO).</li> </ol> <p>Section 4 of the SFO sets out the regulatory objectives of the SFC (which includes the integrity</p>

of markets, investor protection, the prevention of financial crime and the reduction of systemic risk) and section 5 sets out its general functions (defined as powers and duties). Specific powers and duties of the SFC are set out throughout the relevant provisions. Section 6 of the SFO sets out a number of matters that the SFC must have regard to in performing its functions.

### **HKMA responsibilities, powers and authority**

HKMA's responsibilities, powers and authority are set out in the BO. Some powers are also conferred on it by the SFO.

HKMA's supervision functions are specified in section 7 of the BO. Entities authorized to carry on banking business or a business of taking deposits (called AIs in the BO) that wish to engage in securities industry activities ("regulated activities" as defined under SFO) must be registered with SFC to become Registered Institutions (RIs) before they can conduct those activities. RIs are subject to obligations imposed by the SFO and rules and codes made by the SFC while the HKMA is the frontline supervisor. HKMA also gives consent to the appointment of EOs and maintains a register containing particulars of ReIs of RIs in connection with their securities industry activities.

The powers and authority of HKMA to supervise RIs' regulated activities are set out by law and enforceable.

HKMA's responsibilities are also set out in a 2003 exchange of letters between the FS and the HKMA. This exchange is published on HKMA's website.

### **Discretion to interpret authority**

Both SFC and HKMA can interpret their authority but must do so according to established principles of statutory interpretation and in accordance with the provisions of the relevant legislation. Section 6 of the SFO sets out the general duties of SFC, and any exercise of discretion by it must be consistent with them.

An exercise of regulatory discretion by SFC (and HKMA in relation to decisions it makes about EOs and ReIs) can be challenged by:

- a. appealing to the Securities and Futures Appeals Tribunal (the SFAT);
- b. in appropriate cases, applying to the court for judicial review;
- c. complaining to the Office of the Ombudsman, which has power to investigate complaints about maladministration by government departments/agencies and relevant public bodies, including against SFC and HKMA and its staff in respect of the discharge of their duties

SFC and HKMA operations can also be reviewed by the anti-corruption agency (the Independent Commission Against Corruption, ICAC).

**Gaps or overlaps**

There do not appear to be any gaps in the overall scheme of regulation, subject to what is said below about the regulation of selling practices for investment-linked assurance schemes (ILAS)

HKMA adopts the same regulatory standards as SFC in supervising RIs. For example, both SFC and HKMA make use of the same set of standards set out in the Fit and Proper Guidelines issued by SFC in September 2006 (Fit and Proper Guidelines) and the Guidelines on Competence published by SFC, in respect of licensing/registration of securities intermediaries. The MoU between HKMA and SFC delineates the respective regulatory and supervisory roles and responsibilities of both parties with a view to ensuring consistency in the supervisory approach and preventing regulatory overlap.

**Consistent regulation of like services and products**

The disclosure rules that apply to securities under the SFO also apply to the offer of other investment products such as ILAS and MPF products (including MPF schemes and approved pooled investment funds under the MPFs regime and pooled retirement funds under the occupational retirement schemes regime). SFC is responsible for the authorization of disclosure documents before these products can be offered to the public (sections 103 and 105 of the SFO). These products are, however, not “securities” under the SFO and the SFO licensing provisions do not apply to those who distribute them to the public.

*Investment-linked insurance products*

Insurers and insurance intermediaries who *only* promote, offer or sell insurance products to the public (i.e. products that are not “securities” under the SFO) are not required to be licensed under the SFO. For example, although ILAS is an insurance contract with investment features and the issue of documentation relating to ILAS requires SFC’s authorization, promoting, selling or giving advice about the sale of ILAS does not require an SFC licence. Insurance SROs provide some standards but there are not strong suitability rules in their codes. For sale of ILAS by AIs, the HKMA introduced further requirements in addition to those required by the insurance SROs as it treats ILAS products on par with other investment products offered by AIs.

The Government and the financial regulators are working on options to address the disparity in the regulatory requirements in connection with the distribution of ILAS products. The authorities highlighted that the establishment of a statutory licensing regime under the independent IA will help to strengthen regulation of conduct of insurance intermediaries, including those selling ILAS. Further the IA is introducing other enhanced disclosure and consumer protection measures for ILAS in 2014.

*MPF products*

The situation is different for MPF products. Although these activities are not regulated activities under the SFO, the MPFSO (following its amendment in 2012) makes the SFC, HKMA and IA frontline regulators of these intermediaries and confers statutory powers on each of

them to supervise and investigate the conduct of the intermediaries who are licensed or authorized by them when they are selling MPF products.

#### **Coordination and cooperation between regulatory authorities**

SFC has a duty under section 5(1)(h) of the SFO to co-operate with and provide assistance to regulatory authorities or organizations, whether formed or established in Hong Kong or elsewhere. Similar provisions apply to HKMA under section 7(2)(e) of the BO. Section 5(3) permits SFC to rely in performing any function in relation to an RI on supervision of the RI by HKMA.

HKMA and SFC are required by legislation to consult each other on specified regulatory matters. A range of matters requires one authority to consult the other before taking action. These include, for example:

- a. SFC must consult HKMA before making rules, codes or guidelines that apply to RIs (sections 398(4) and 399(9) of the SFO);
- b. mutual consultation obligations in relation to disciplinary matters (see for example section 196 of the SFO; sections 58A(1) and 71C(4) of the BO);
- c. SFC must consult HKMA before directing an AI to produce books and records (section 179(10)(a) of the SFO), or commencing an investigation of an RI (section 182(1)(e)(i)).

The SFC and HKMA have entered into an MoU which provides a framework for cooperation and coordination. The MoU sets out the regulatory and supervisory roles and responsibilities of the two regulators, and establishes the channels and mechanism for the exchange of information between them, including, for example, periodic meetings, and the sharing of particular types of information. In addition, if HKMA becomes aware of a material breach by an RI or its staff of any applicable provision of the SFO or any rules, codes or guidelines made or published by SFC under the SFO, the MoU provides that HKMA will refer the matter to SFC. SFC may (after consultation with HKMA) commence an investigation under section 182 of the SFO. In practice there seems to be regular engagement between the authorities beyond what is set out under the MoU, on issues of policy, as well as on findings from their off and on-site programs, and referrals do take place.

Relations between SFC and the HKEx are dealt with under Principle 9 and Principles 32–36. MoUs between SFC and the HKEx set out the agreed arrangements on various topics, including SFC's oversight, supervision of exchange participants and market surveillance, and the supervision of listed entities.

#### **Coordination with other authorities for purpose of ensuring coordination and level playing field across the financial sector, and financial stability**

The SFO also imposes obligations on SFC to consult with the IA in a number of circumstances. The IA and the MPFA are also under statutory obligations to co-operate with other financial sector regulators and to consult with them in specified circumstances. The MPFSO requires the MPFA to consult SFC before issuing guidelines that apply to licensed corporations (LCs) or their representatives that are also registered with the MPFA.

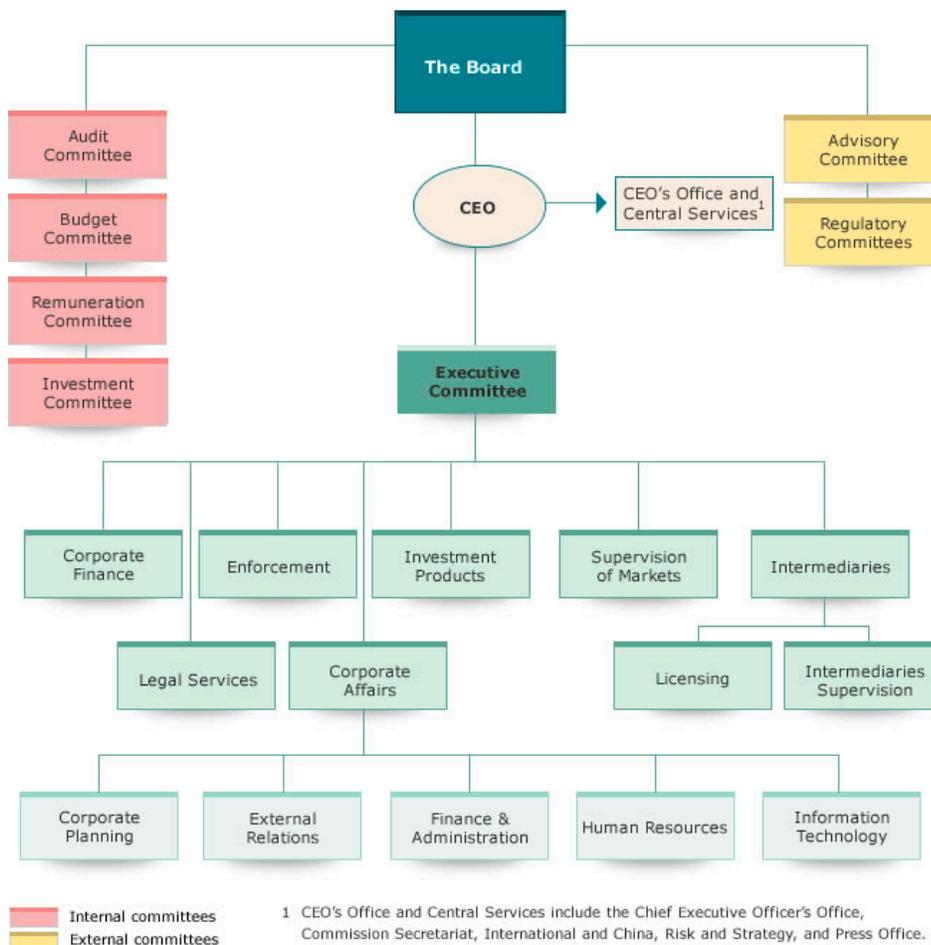
A variety of MoUs have been entered into between the financial sector regulators. In addition to the MoU with the HKMA, the SFC has entered into MoU with the IA. It is also a party to an

	<p>MoU between the MPFA, SFC, IA and HKMA on the regulation of MPF intermediaries, and a tripartite MoU with the HKMA and the FDRC.</p> <p>The CFR comprising the FS, the SFST, the Chief Executive Officer of SFC (CEO), the Chief Executive of HKMA, the Managing Director of the MPFA and the Commissioner of Insurance meets regularly to discuss cross-market regulatory and supervisory issues. In addition, various MoUs have been entered into between the domestic regulators to ensure that there are no regulatory gaps or inequities.</p>
Assessment	Broadly Implemented
Comments	<p>The reason for the grade relates to the distribution ILAS vis-à-vis Question 2 b) of the IOSCO Methodology. As explained in the description currently there is a disparity in the requirements in connection with distributors of ILAS, whereby the sale of ILAS by banks and non-bank insurance intermediaries respectively are not subject to the same standard of conduct obligations. The assessors acknowledge that the government and regulatory authorities are working on options to address this issue.</p> <p>Overall the assessors found that there is active cooperation and sharing information between the SFC and the HKMA. However, the assessors encourage the authorities to 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 and enforcement responses. This issue has not been taken into consideration in reaching the grade.</p>
<b>Principle 2.</b>	The regulator should be operationally independent and accountable in the exercise of its functions and powers.
Description	<p><b>Independence – SFC</b></p> <p>SFC is a non-governmental statutory body. It was established by the SFC Ordinance (now repealed) and is continued in existence under the SFO as a statutory corporation. SFC is not part of the Government and its employees are not civil servants.</p> <p>The CEHK is empowered to give SFC written directions (see section 11 of the SFO), but has not done so since the establishment of SFC in 1989. Senior SFC staff indicated that, in the explanatory material prepared when the provision was enacted, it was explained that this power would only be used by the Government as a last resort, in extreme circumstances. Further as set out in the SFO Ordinance, such power is subject to the following restrictions: (i) the direction must be in the public interest, (ii) it must further SFC regulatory objectives or the performance of any of its functions and (iii) the CEHK must first consult the SFC Chair to afford the SFC a formal opportunity to be heard.</p> <p>The authorities emphasized that the CEHK would not give directions to the SFC unless necessary in the public interest and that in doing so would have sought appropriate advice and take into account all circumstance prevailing at the time. These may include whether there is a major malfunction on the part of the SFC, whether financial stability of Hong Kong is at risk or its reputation as an international financial centre is at stake, the urgency of remedial actions required of the SFC and whether other checks and balances are performed effectively in the circumstance.</p>

	<p>Under section 1 of Part 1 of Schedule 2 to the SFO the chairman, executive directors and non-executive directors of SFC are appointed by the CEHK. The Government plays no part in the appointment of other staff.</p> <p><i>Governance</i></p> <p>Section 1 of Part 1 of Schedule 2 to the SFO provides that the number of non-executive directors of the Commission must be more than the number of executive directors. In practice, the board of directors of SFC (Board) meets at least once a month. The non-executive directors are not involved in SFC's day-to-day operations.</p> <p>All Board members are appointed for a fixed term by the CEHK or by the FS under delegated authority. There must be a minimum of 8 members of the Commission. Currently there are 8 non-executive directors, including the Chairman and 6 executive directors (EDs), including the CEO. The posts of Chairman and CEO have been separated since 2006 by legislation.</p> <p>The letter of appointment of the SFC Chairman stipulates that he or she must not be a director of a listed company. Further, the Government requires him/her not to have any material interest in any principal business activity or be involved in any material business dealing with a company listed in Hong Kong or any person or company engaged in activities regulated by the SFC.</p> <p>On the other hand, non-executive directors may have other occupations (for example, currently one is a director of a listed company and 3 are legal practitioners). Potential conflicts of interest involving board members are dealt with by a code of conduct. The authorities stated that when appointing non-executive directors the Government will take into account the various considerations including the avoidance of conflict of interests. In this regard, due consideration has been given to 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 contributions, as well as keep an independent eye on the performance of functions by SFC.</p> <p>Section 13, Part 1 of Schedule 2 to the SFO gives CEHK power to remove any member of the Commission whose removal appears to him to be desirable for the effective performance by the Commission of its functions. SFC senior staff emphasized, however, that the exercise of this power may be constrained by procedural fairness rules at common law; further, to date the power has not been exercised. In addition, the authorities indicated that such a decision can be challenged under general administrative law on the grounds that the CEHK acted unreasonably in the exercise of his powers or his decision was not appropriate.</p> <p>EDs' contracts also specify other circumstances in which they may be removed, for example for misconduct.</p> <p>The Chairman leads the Board in setting the overall direction, policies and strategies of SFC and monitoring the performance of the executive arm in fulfilling the objectives, policies and strategies set by the Board. The CEO has the executive responsibility for the day-to-day running of SFC, in accordance with objectives, policies and strategies agreed by the Board.</p>
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Some functions of the board are not delegable to executives, including enforcement decisions such as the decision to seek court orders under section 213 or to refer a matter to the MMT, and the power to make rules. A long list of non-delegable decisions is set out in Part 2 of Schedule 2 of the SFO.

SFC structure is as follows:



*Interaction with government*

SFC is required by law to consult with the Government on a number of matters. In particular, the SFO requires prior consultation with the FS on a range of matters. These include:

- a. a number of decisions relating to the recognition and regulation of exchanges and clearing houses, including for example requesting an exchange company or clearing house to make rules (sections 23(4) and 40(4));
- b. making rules regulating the listing of securities (section 36(1));
- c. a number of matters relating to the establishment and operation of an investor compensation company;
- d. making rules requiring LCs to maintain certain financial resources (section 145);
- e. making rules to prescribe the circumstances in which any conduct that would

	<p>otherwise constitute market misconduct under Part XIII or Part XIV shall not be regarded as constituting market misconduct (sections 282(2) and 306);</p> <ul style="list-style-type: none"> <li>f. publishing guidelines for the exemption of a person from the provisions of Part XV (Disclosure of interests in shares) (section 309(1)); and</li> <li>g. intervening in proceedings (section 385(1))</li> </ul> <p>The consent or approval of the FS is also required in a limited range of circumstances:</p> <ul style="list-style-type: none"> <li>a. the appointment of SFC's auditors (section 16(1));</li> <li>b. the investment of funds of SFC (section 17);</li> <li>c. recognizing a company as an exchange controller (section 59(2));</li> <li>d. withdrawing recognition of a company as an exchange controller (section 72(1));</li> <li>e. appointing a person other than an employee of SFC to conduct an investigation under section 182 (1); and</li> <li>f. borrowing from a bank for the purposes of the investor compensation fund (section 237(2)).</li> </ul> <p>The circumstances under which the SFC is required to consult the FS or seek its approval/consent are set out in the legislation. They generally involve cross-sector issues which may have system implications. The authorities stated that the step of consultation with or seeking approval/consent of the FS is part of the process which aims at ensuring accountability of the SFC.</p> <p>The consent of the Secretary for Justice is required before:</p> <ul style="list-style-type: none"> <li>a. publishing a report of an investigation prepared under section 183 (6) ; and</li> <li>b. commencing proceedings before the MMT (section 252A(1)). The Secretary of Justice can only withhold consent if criminal proceedings for market misconduct are contemplated in respect of the same conduct; or proceedings for other indictable offences are contemplated, or have been instituted, in respect of the same conduct and the institution of MMT proceedings would be likely to cause serious prejudice to the investigation or prosecution of that offence.</li> </ul> <p>The SFC's power to make or amend rules that constitute subsidiary legislation is subject to procedural requirements under section 34 of the Interpretation and General Clauses Ordinance (IGCO). This requires that amendments must be:</p> <ul style="list-style-type: none"> <li>a. published in the Hong Kong Gazette (a weekly publication available to the general public and accessible from the Government's website); and then</li> <li>b. tabled before the Legislative Council of Hong Kong (LegCo) which may then approve, amend or reject the proposed subsidiary legislation.</li> </ul> <p><i>Interaction with HKEx</i></p> <p>SFC and the HKMA are members of the RMC of the HKEx, a statutory committee established under the SFO to formulate policies on risk management matters relating to the HKEx. The RMC provides recommendations to the HKEx board on risk management issues, including matters which may result in the need for the SFC to make regulatory decision or take</p>
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	<p>regulatory actions, including changes to HKEx rules.</p> <p><i>Funding</i></p> <p>SFC has a stable and adequate source of funding. The SFC's budget is approved by the FS. Detailed budgets that include staffing levels for each operational area are prepared as part of this approval process. See the details under Principle 3.</p> <p><i>Legal protection</i></p> <p>Board members and staff of SFC and persons assisting SFC in the performance of its duties are accorded legal protection for the bona fide discharge of their governmental, regulatory or administrative functions by section 380 of the SFO. This precludes actions in contract, tort, defamation, equity or otherwise. Arrangements are in place to indemnify Board members and SFC staff which include cover for costs and expenses in obtaining legal advice and/or representation in relation to any potential criminal and/or civil proceedings against or involving employees, whether or not the proceedings ultimately take place, provided that the advice/representation is with a view to preventing the action. The relevant costs and expenses are settled directly from the litigation budget.</p> <p><b>Independence - HKMA</b></p> <p>The MA is the Chief Executive of the HKMA, and is appointed by the FS under section 5A(1) of the EFO on such terms and conditions as he thinks fit. The MA is a public officer. Section 5A(2)(b) and (c) of the EFO requires the MA to perform such functions as the FS may direct and perform functions imposed on or assigned to the MA by any other Ordinance. For example, the BO assigns various functions to the MA, including principally the promotion of the general stability and effective working of the banking system.</p> <p>The supervisory powers in the BO are exercisable by the MA independently although prior consultation with the FS is necessary for some major decisions such as revocation of authorization and intervention under sections 22 and 52 of the BO.</p> <p>Section 10 of the BO gives the CEHK the right to give to the FS and the MA such directions as the CEHK thinks fit with respect to the exercise of the MA's function under the BO, either generally or in any particular case.</p> <p>Some powers exercised by the MA are delegated to him by the FS, but others are conferred on the MA by the BO.</p> <p><i>Governance</i></p> <p>The existing MA was appointed for a term of 5 years, which was determined after consultation with the Exchange Fund Advisory Committee (EFAC) Governance Sub-Committee.</p> <p>The FS has the power to revoke appointment of the MA in the exercise of his or her statutory discretion pursuant to section 42 of the IGCO. The MA's letter of appointment provides that it is not the FS's intention to terminate the MA's employment except for cause, such as the MA's inability to discharge, or not adequately carrying out, his functions or duties; serious</p>
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	<p>misconduct; conviction of a criminal offence punishable by imprisonment; or bankruptcy.</p> <p>In common with all other members of the MA's staff, his employment may be terminated for "gross misconduct".</p> <p>HKMA does not have a board per se but the EFAC carries out many of the functions of a management board. The EFAC established under section 3(1) of the EFO advises the FS on matters related to the control of the Exchange Fund, a fund under the control of the FS which shall be used primarily for such purposes as the FS thinks fit affecting either directly or indirectly the exchange value of the currency of HK and for other purposes incidental thereto. In addition to using the Exchange Fund for its primary purpose, the FS may, with a view to maintaining HK as an international finance centre, use the Exchange Fund as he thinks fit to maintain the stability and integrity of HK's monetary and financial systems. The FS is the ex officio chairman of the EFAC and the MA is a member of the Committee. Other members are appointed by the CEHK under section 3(1) of the EFO. The members of the EFAC are appointed ad personam for the expertise and experience such as knowledge of financial and economic affairs. Current members consist of representatives from the banking, legal, accounting, business and academic fields.</p> <p>EFAC has a number of subcommittees, including a governance subcommittee. Members from the banking sector, however, do not sit on the EFAC Governance Subcommittee which monitors HKMA's performance, oversees governance matters and provides advice on annual administration budget and remuneration policies for the HKMA.</p> <p>EFAC does not provide advice on matters relating to the supervision functions of the HKMA.</p> <p><i>Interaction with government</i></p> <p>The supervisory powers in the BO are exercisable by the MA independently although prior consultation with the FS is necessary for some major decisions (e.g. revocation of authorization and intervention under sections 22 and 52 of the BO). Section 10 of the BO gives the CEHK a right to give to the FS and the MA such directions as he thinks fit with respect to the exercise of their respective functions under the BO and which are consistent with the objectives and specific powers and duties contained in the BO.</p> <p>Section 132A gives persons aggrieved by decisions specified in the section to appeal the decision to the Chief Executive in Council.</p> <p><i>Funding</i></p> <p>HKMA has a stable and adequate source of funding. See under Principle 3.</p> <p><i>Legal protection</i></p> <p>Section 127(1) of the BO provides that no liability shall be incurred by the MA and his staff as a result of anything done or omitted to be done by him or his staff bona fide in the exercise or purported exercise of any functions under the BO.</p>
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In line with the Civil Service Regulations of the Government, the MA will provide legal representation for his staff members for claims made against them with respect to actions or omissions made in the course of conducting their duties provided they acted in good faith.

### **Accountability - SFC**

SFC is accountable to LegCo, the FS and various other bodies on an ongoing basis.

Accountability mechanisms include:

- a. Section 12 of the SFO that requires SFC to provide to the FS such information regarding the “principles, practices and policy” it is pursuing or proposes to pursue in the performance of any of its functions as he may specify. In practice, SFC also submits a quarterly report on its operations to the FS. It also appears before the LegCo Panel on Financial Affairs when the need arises.
- b. Section 13 that requires
  - i. SFC to submit its estimates of income and expenditure for the next financial year to CEHK for approval. The CEHK delegated this power of approval to FS in 2004; and
  - ii. the approved estimates to be placed before the legislature for discussion, but not approval.
- c. Section 15 that requires SFC to publish an annual report which is sent to the FS, who places it before the legislature. In addition, SFC has published quarterly reports since 2011.
- d. Section 16 that requires SFC to send audited financial statements to the FS, and empowers the Government auditor to examine SFC’s books and records.
- e. An independent, non-statutory Process Review Panel established by the CEHK that reviews and monitors SFC’s processes and internal procedures.

### *Transparency*

Section 169 of the SFO empowers SFC to issue codes of business conduct for intermediaries and section 399 creates a general power to issue codes and guidelines. SFC has used these powers to create an extensive range of codes and guidelines that are available on its website.

As a matter of practice, SFC consults the industry and public on changes to these guidelines/codes or proposed new guidelines and codes. SFC is also required by law to consult the public on any subsidiary legislation (and any changes to subsidiary legislation) it proposes to make.

### **Accountability - HKMA**

Through section 5A of the EFO (which specifies that the MA shall perform such functions as the FS may direct or functions imposed on or assigned to the MA by any other Ordinance (including the BO)) and section 9 of the BO (which specifies the reporting matters that the MA shall prepare and furnish to the FS annually), the MA is directly accountable to the FS. The MA is a public officer and his office is regarded as a part of Government.

Though not specifically required by law, HKMA periodically provides briefings to the Legislative Council Panel on Financial Affairs to explain the work of HKMA and to answer

	<p>questions.</p> <p>Section 9(1) of the BO requires the MA to send a report to the FS on the working of the BO and the activities of his office yearly. The FS may, under section 9(5), publish the report as he thinks fit.</p> <p>HKMA's receipt and use of funds is subject to review and audit (section 7 of the EFO). The Audit Sub-committee of EFAC is responsible for ensuring the proper and smooth running of the HKMA operation and management of the Exchange Fund. The Audit Commission of the HKSAR Government audits the financial statement of the Exchange Fund.</p> <p><b>Review of SFC and HKMA decisions</b></p> <p><i>SFC</i></p> <p>Natural or legal persons adversely affected by SFC's decisions or exercise of administrative authority can normally apply for judicial review of the decision. However, if the decision is a "specified decision" (see below) the review is undertaken by the SFAT (whose decision is also subject to higher appeal to the Court of Appeal on a point of law) rather than the Court of First Instance.</p> <p>The SFAT, a full-time and independent tribunal established under Part XI of the SFO, hears appeals against "specified decisions" made by SFC. The SFAT consists of a chairman (who is a judge) and two other members (who cannot be public officers but are expected to be market practitioners with appropriate knowledge and experience of the industry). "Specified decisions" principally are decisions relating to the licensing, discipline and operations of intermediaries, objections to listing applications and other decisions relating to listing matters (See Part 2 of Schedule 8 for a list of specified decisions). Reviews by the SFAT are a review on the merits, meaning a full review of the case and the decision is conducted.</p> <p>Other means of challenging SFC's decisions include making a complaint to the Ombudsman, Privacy Commissioner or the ICAC depending on the subject matter of the decision.</p> <p>An appeal to the Chief Executive in Council may be made in relation to a number of decisions relating to exchange bodies and clearing houses, such as withdrawal of recognition or an order to cease operating facilities (e.g. see section 33 of the SFO). Such an appeal is also available in relation to a decision to withdraw recognition of an investor compensation company (section 86).</p> <p><i>HKMA</i></p> <p>Decisions of HKMA are amenable to judicial review.</p> <p>Under section 132A of the BO, a person or an AI may appeal to the CEHK in Council against a decision made by the MA, for example, the refusal by the MA to give consent to a person to become the chief executive of an AI under section 71(1) of the BO, and the proposed revocation of an AI's authorization under section 22(1).</p>
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	<p>An EO or ReI aggrieved by a disciplinary decision of HKMA may apply to the SFAT for review of the decision.</p> <p><b>Confidentiality</b></p> <p><i>SFC</i></p> <p>Section 378(1) of the SFO requires SFC to protect the confidentiality of information coming to its knowledge in the performance of its functions. Exceptions to confidentiality are set out in section 378(3) Section 378(3) permits the disclosure of non-public information in summary form, and disclosure to a comprehensive list of domestic regulators and authorities specified in that section , and under section 378(3)(g) to overseas authorities.</p> <p><i>HKMA</i></p> <p>Except as may be necessary for the exercise of any function under the BO or for carrying into effect its provisions, the MA and HKMA staff are required by section 120(1) of the BO to preserve secrecy with regard to all matters relating to the affairs of any person that come to their knowledge in the exercise of any function under the BO.</p> <p>Sections 120(5)(f) and (fa) of the BO permit disclosure to domestic regulatory authorities such as SFC, IA and MPFA and the FRC. For disclosure under sections 120(5)(f), HKMA must be satisfied, among other things, that the disclosure will enable the recipient of the information to exercise its functions. Section 121 allows HKMA to disclose information to overseas supervisory authorities under the conditions that the authority exercises the functions of supervising banks or the securities and futures industry in its jurisdiction, and is subject to adequate secrecy provisions.</p>
Assessment	Partly Implemented
Comments	<p>The grade stems from governance issues on both regulatory agencies in connection with questions 1a (HKMA) and 1a and b of the Methodology (SFC).</p> <p>The assessors acknowledge that de facto both regulatory authorities enjoy sufficient independence in their day to day operations. However there are features in the system that can become pressure points for political or commercial influence. Those relate to:</p> <ul style="list-style-type: none"> <li>• The power of the Chief Executive to provide directions to both agencies. This power has the potential for interference in day to day operations as such directions can be about the handling of individual cases. The authorities have emphasized, however that to date these powers have not been used, and they will only be used as a last resort in extreme circumstances</li> <li>• The power of the CEHK to remove SFC board members without the existence of a clear framework to constrain such dismissal. The authorities have emphasized, however, that some constraint would be imposed by common law and that a dismissal could be challenged under general administrative law.</li> <li>• In the case of the SFC, the fact that key decisions concerning exchanges must be consulted with (and a few approved by) the FS. The assessors acknowledge that this is an area where many countries still keep some level of involvement in the hands of governmental</li> </ul>

	<p>authorities, anchored in a concept that exchanges have a key strategic role. That is particularly true in the case of Hong Kong where exchanges are considered a public utility. However in other countries there is a detailed policy framework for the recognition of exchanges that frames the participation of the Government in the recognition process. In addition, SFC (and HKMA) membership of the statutory committee on HKEx's risk management could affect its ability to exercise independent oversight of critical aspects of HKEx's operation. This is because, through the RMC, it contributes to the decision making process of the HKEx's board. See further under Principle 9. The authorities have informed that they are currently reviewing this issue.</p> <ul style="list-style-type: none"> <li>• In the case of the SFC, the potential for conflict arising from the participation of part-time members in the board, especially given that the current framework would allow them to be members of regulated entities and listed issuers. The assessors acknowledge that their participation can allow the SFC to bring to the table expertise that otherwise would be more difficult to obtain. At the same time this structure might be more open to conflict of interest, especially as a large number of decisions including enforcement decisions must be exercised directly by the board. While a recusal process exists to that effect, managing these conflicts in practice can become more challenging (if for example a member has to be recusing himself/herself too often). Other regulatory agencies address issues of expertise by establishing advisory committees (indeed SFC has an advisory committee established under section 7 of the SFO), which do not take part in formal decision making by the regulator.</li> </ul> <p>At the outset of the assessment, the current process of approval of the budget of the SFC raised concerns vis-à-vis independence, as it includes approval of the number of positions allocated to different departments. However conversations with the authorities left the assessors satisfied that in practice this issue has not affected the ability of the SFC to enjoy a stable source of funding, and to reallocate staff if necessary in light of emerging risks. Only if those risks lead to a major "overhaul" of resources then the SFC would require an authorization from the FSTB. This would be in line with an oversight role. In practice, a contingency of about 10 percent is included in the SFC's annual budget, which provides some flexibility to meet unforeseen demands on resources.</p>
<b>Principle 3.</b>	The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.
Description	<p><b>Power and authorities</b></p> <p>The powers of the SFC and HKMA stem from the SFO, the BO and by other legislation administered by the authorities. Overall they both have broad licensing and supervision and investigations powers commensurate to their respective mandates. The SFC has different avenues available to conduct enforcement actions, including criminal and MMT proceedings, and civil and administrative/proceedings. Thus, from a formal perspective the enforcement powers afforded are in line with the Principles. Practical challenges are discussed in Principle 12. Enforcement powers of the HKMA are more limited; however as will be further discussed in Principle 10, enforcement of securities laws and regulations is mainly a responsibility of the SFC.</p> <p><i>Rules and codes</i></p> <p>SFC has power to make rules under section 398 of the SFO. Matters on which it may make</p>

	<p>rules are enumerated, and these include a very general provision permitting the SFC to make rules on “any other matters for the better carrying out of the objects and purposes of” the SFO (section 398(1)(p)). Rules are subsidiary legislation and have the force of law. Their making is subject to procedural safeguards including mandatory public consultation and a requirement to place rules before LegCo which can approve or amend them (see under Principle 2).</p> <p>SFC has a general power (section 399 of the SFO) to issue codes and guidelines to provide guidance for the furtherance of its regulatory objectives, in relation to any matters pertaining to any of its functions, and in relation to the operations of any provision of the SFO., It has issued a wide range of guidance to explain the regulatory requirements to regulated persons and the public.</p> <p>For intermediaries and their representatives, SFC also has specific powers to make rules (section 168 of the SFO) and codes (section 169).</p> <p>SFC makes extensive use of its rule making and code making powers.</p> <p>Codes do not of themselves have the force of law, but they set out what the SFC “expects” from regulated entities and persons, and non-compliance with them is generally relevant to SFC’s consideration of whether a person has complied with provisions of the legislation. More specifically, in relation to codes made under section 169, the legislation provides (section 169(4)) that a failure on the part of an intermediary, or a representative of an intermediary, to comply with the provisions of a code may be taken into account in considering whether the intermediary or representative is fit and proper and should remain licensed or registered.</p> <p>Codes made under both sections 169 and 398 are admissible in evidence in proceedings under the SFO before any court, and if any provision set out in the code appears to the court to be relevant to any question arising in the proceedings the court must take it into account in determining that question. However, according to recent jurisprudence, a violation of a Code does not create a third party right. That is, an investor cannot sue a licensed firm for violation of a code unless the obligation set out in that code is also an obligation contained in the contract between the investor and the firm. To address this gap, the SFC is proposing to require intermediaries to include a provision in all of their contracts with their clients to that effect.</p> <p>HKMA has power to make rules in a limited number of circumstances specified in the BO, for example the power to make rules about capital and liquidity requirements for AIs (sections 97C and 97H when it comes into operation). HKMA also uses Circulars to influence conduct by institutions it regulates, For example, it has required RIs to adopt measures additional to those required under the SFO in relation to AI’s selling of investment products, for example by requiring AIs engaging in retail securities business to audio record the sale process in branches, and to physically segregate their retail securities business from their general banking business in branches.</p> <p><b>Funding</b></p> <p>SFC is funded by the levies for transactions recorded on exchanges. It also receives its funding from fees or other charges in relation to share purchases, takeovers and mergers and</p>
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applications for registration, authorization, approval, exemption, waiver or modification under the SFO. SFC also has investment income in the form of interest income derived from the investment of its reserves. SFC's income for the 2012-3 year is budgeted at HK\$1.170 billion and it now has accumulated surpluses in excess of HK\$7 billion. Budgets have been sufficient to enable significant increases in staff levels, especially in supervision and enforcement.

Section 395 of the SFO provides that fees prescribed by the rules may be fixed at levels sufficient to cover expenditure incurred, or likely to be incurred, by SFC in providing the services or performing the functions to which the fees relate. However, they are not limited to this criterion.

The annual budget process is subject to scrutiny by the Administration and by LegCo.

HKMA is funded from the Exchange Fund pursuant to sections 5A(3), 5A(4) and 6 of the EFO. Annual license fees paid by AIs under section 19 of the BO also form part of the annual revenue of HKMA.

HKMA draws up its annual budget to ensure that sufficient resources are available for carrying out its functions. Budgeting takes into account both the continuing operations of HKMA and its strategic development set out in a three-year plan approved by the FS on the advice of the EFAC. Budgets have been sufficient to make the necessary increases in staff levels, especially in conduct supervision and enforcement.

Both regulators control the operational allocation of their resources.

#### **Staff resources**

SFC's remuneration levels are broadly competitive with those of the market. To maintain pay competitiveness to retain and recruit qualified employees, the Commission regularly reviews remuneration levels to calibrate the pay practices with that of a pre-determined peer group.

SFC staffing levels are as follows:

<b>Division/Department</b>	<b>Staffing level at end May 2013</b>
CEO's Office and Central Services	30
Corporate Finance	63
Enforcement	145
Investment Products	89
Intermediaries	207
Licensing      79	
Supervision   128	
Supervision of markets	33
Legal Services	32
Corporate Affairs	103
<b>Total</b>	<b>702</b>

<p>Approximately 28 percent of SFC staff have professional qualifications in accountancy and 17 percent in law.</p> <p>HKMA has increased and centralized the supervisory resources dedicated to conduct supervision. A Banking Conduct Department with a current total of about 100 staff members (of which about 50 are specialized in the supervision of AIs' conduct of securities, insurance and MPF intermediary activities) and an Enforcement Department with a current headcount of around 100 were established in April 2010. In general, staff members possess relevant working experience in the banking or financial industry with tertiary education.</p> <p><i>Training</i></p> <p>Both SFC and HKMA provide training for staff. SFC staff all have individual development plans in which training needs are set out.</p> <p><b>Policies and governance practices</b></p> <p>SFC has extensive policies and practice manuals and a rule book that govern the way regulatory work is carried out. These include "PRP Manuals" that set out procedures to be followed in performing SFC functions (see further under Principle 4).</p> <p>Non-executive directors of SFC sit on SFC's audit, remuneration, budget and investment committees. Executive directors also sit on the budget committee (as non-voting members) and the investment committee.</p> <p>HKMA also has an extensive policy manual (Supervisory Policy Manual {SPM}), two parts of which set out its approach to supervising AIs' securities and leveraged foreign exchange businesses. Staff members follow the Operations Manual for Banking Conduct Department Division 1 which spells out the approach and procedures adopted by HKMA in carrying out its supervisory functions.</p> <p>HKMA has also in place a set of enforcement procedural controls in governing the exercise of its investigation and disciplinary powers. Among other things, when a complaint is made to, or an event is identified by, HKMA that may indicate potential grounds for discipline, HKMA assesses the information available and submits the matter to an internal standing committee (Event Review Committee) to decide whether a case should be opened and the scope of any investigation.</p> <p><b>Investor education</b></p> <p>SFC conducts investor and public education by using multiple media, ranging from print materials, TV and radio programmes, to outreach programmes and a dedicated investor education website. The format of its investor education programmes also varies from conventional publications, talks and advertising campaigns to non-conventional game shows and story competitions.</p> <p>SFC's statutory education mandate set out in the SFO was recently broadened following public consultation and legislative amendments. The Investor Education Centre (IEC) was</p>
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	<p>established as a wholly-owned subsidiary of SFC in November 2012. It is a dedicated education organization to oversee the needs of investor education and delivery of related initiatives for the entire financial sector in Hong Kong with the aim of improving the financial literacy and capability of the general public.</p> <p>The IEC is governed by an independent Executive Committee (IEC ExCo), consisting of representatives of each of the four regulators (SFC, HKMA, OCI and MPFA), the Education Bureau, a representative of the financial services industry and the General Manager of the IEC. The Chair of the IEC ExCo is a non-executive director of SFC. The IEC has established working level arrangements with each of the financial regulators to facilitate communication and cooperation, and provide technical support and advice, for example on draft education materials. The IEC aims to be the focal point for financial education in Hong Kong.</p> <p>To promote consumers' understanding of their rights and obligations, HKMA in December 2012, launched a "Consumer Corner" on its website providing information on local banking consumer issues and the HKMA's role in banking conduct regulation. With the aim of better equipping the general public to be "smart and responsible" in the use of banking products and services, HKMA is also formulating a consumer education work plan involving the use of multiple channels to communicate effectively with the public on topics of interest.</p>
Assessment	Fully implemented
Comments	<p>Overall the assessors consider that the regulatory authorities have been given broad licensing, supervisory powers and investigative powers vis-à-vis their respective mandates.</p> <p>In addition, the assessors acknowledge that the SFC has access to different avenues to seek enforcement actions for breaches to securities laws, including criminal and MMT proceedings, civil and administrative/disciplinary proceedings. However, as further explained in Principle 12, for misconduct that does not constitute a crime the current framework does not easily allow the SFC to secure both remedial and punitive actions and in practice finds itself having to make difficult trade-offs. As this is an issue that affects effectiveness of enforcement it has been taken into consideration for the grade of Principle 12 only.</p> <p>An important question in a jurisdiction that relies heavily on codes is their enforceability. Based on conversations held, there appear to be sufficient precedents that establish that codes are enforceable for administrative and disciplinary proceedings.</p>
<b>Principle 4.</b>	The regulator should adopt clear and consistent regulatory processes.
Description	<p><b>Clear and equitable procedures</b></p> <p><i>Procedures rules and regulations</i></p> <p>Each operational division of SFC is required to have one or more procedures manuals that set out the procedures that must be followed in exercising its powers and discharging its functions in the vast majority of SFC's work.</p> <p>The Process Review Panel (PRP), an independent, non-statutory, body comprising representatives from various community segments, the non-executive SFC Chairman and a representative from the Secretary for Justice (both in an ex-officio capacity). Its function is to</p>

	<p>review SFC's internal operational procedures, including procedures for ensuring consistency and fairness, and to determine and report on the adequacy of SFC's internal procedures and operational guidelines; and by conducting reviews of files, whether those procedures are followed in practice.</p> <p>PRP's terms of reference cover procedures for complaint handling, licensing and inspection of intermediaries, corporate finance, disciplinary action etc. but not regulatory procedures and actions in relation to regulated markets. The Financial Services Branch of FSTB supports PRP members in carrying out these reviews.</p> <p>The PRP reports at least annually to the FS. These reports are made public on the FSTB website.</p> <p>SFC also has performance pledges which set out time frames for regulatory approvals.</p> <p>The BO is supplemented by HKMA's SPM which sets out the best practice in risk management the HKMA expects AIs to follow, elaborates on its supervisory approach to monitoring compliance, and lays down the minimum standards which HKMA expects AIs to attain.</p> <p>The assessors' review of files indicate that the regulators' powers are exercised and the processes described above are applied consistently.</p> <p><i>Consultation and transparency</i></p> <p>SFC is obliged to consult publicly on any proposal to make or amend rules under any provision of the SFO (section 398 of the SFO). As a matter of practice, it also consults, both formally and informally, on proposals to adopt new policy or new non-statutory codes and guidelines. It does so in accordance with the Public Consultation Procedures published on its website.</p> <p>HKMA is required to conduct a public consultation before making rules. Its standard practice is also to consult the banking industry before any amendments to the SPM or guidelines are made, or any new SPM modules or guidelines are issued. HKMA senior staff indicated that, while not as formal as the consultation process for rules, where appropriate, they also consult the banking industry on circulars involving new regulatory measures related to securities activities. In fact, HKMA staff stated that the HKMA consulted the banking industry before each circular (about policy) was issued over the past two years.</p> <p><i>Transparency of requirements to conduct regulatory activities</i></p> <p>Overall the SFO, BO and the rules, codes, guidelines and circulars establish clear and sufficiently detailed criteria for the requirements and obligations of regulated activities. The only important exception is the recognition of exchanges and the authorization of ATS, where the current framework is very high level. (See the discussion under Principle 33.) SFC senior staff has indicated their plans to work on consultation papers that would allow them to develop a more detailed framework for these two areas.</p>
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	<p><i>Procedural fairness</i></p> <p>SFC is required by the legislation to provide reasons for its regulatory decisions, and to provide an opportunity to be heard, in relation to:</p> <ol style="list-style-type: none"> <li>a. recognition of exchanges etc and their rules under Part III of the SFO;</li> <li>b. authorization of products under Part IV;</li> <li>c. licensing decisions under Part V;</li> <li>d. disciplinary decisions under Part IX;</li> <li>e. compensation decisions if it proposes to provide compensation less than the amount claimed (Part XII and section 8 of the Securities and Futures (Investor Compensation – Claims) Rules (Claims Rules));</li> <li>f. decisions to object to a proposed listing (section 6(7) of the Securities and Futures (Stock Market Listing) Rules (SMLR) (Cap. 571V)).</li> </ol> <p>It is the policy of the Takeovers Panel to publish its rulings (section 16.1 of the Introduction to the Takeovers Code).</p> <p>The HKMA is required under the BO to give reasons for any:</p> <ol style="list-style-type: none"> <li>a. refusal to give consent to a person to act as an EO (under section 71C(3)(b)); and</li> <li>b. suspension or revocation of registration or consent to act as an EO or a ReI (sections 58A and 71C).</li> </ol> <p>While there is no specific obligation to give reasons for conditions attached to a consent under section 71C(3)(a), the MA is required to specify such conditions. In practice, the HKMA issues “letters of mindedness” to the person before giving consent, specifying the proposed conditions and setting out the reasons for them.</p> <p><i>Cost of compliance</i></p> <p>SFC is not obliged to carry out detailed cost/benefit economic analysis, but uses both the formal and informal consultation processes to inform itself about cost of compliance issues. It takes these into account in finalizing rules, policy or codes and guidelines.</p> <p>HKMA has no obligation to carry out formal cost/benefit analysis of proposed rules or guidelines. Like the SFC, it takes account of comments it receives, including on the cost of compliance, in both formal and informal consultations.</p> <p><i>Review of decisions</i></p> <p>See under Principle 2.</p> <p><b>Confidentiality</b></p> <p><i>Investigations</i></p> <p>SFC and HKMA are subject to confidentiality/secretcy obligations (section 378 of the SFO; section 120 of the BO), the only exceptions to which are set out in the legislation.</p> <p>SFC may publish press releases concerning criminal actions and civil proceedings commenced</p>
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	<p>by SFC or against SFC, once there has been a decision by the court in question and the information is public.</p> <p>In addition, under section 194(6A) and 196(6A) of the SFO, SFC has statutory authority to disclose to the public details of disciplinary action taken against a regulated person, the reasons for it and any material facts relating to the case. It typically does so when the time for appeal against the disciplinary action has expired.</p> <p>Section 120 of the BO aids in preserving secrecy with regard to all matters relating to the affairs of any person that may come to the HKMA's knowledge in the exercise of any function under the BO, subject to specific gateways of disclosure provided in the general exception in section 120(1) and section 120(5), in particular section 120(5)(i) with regard to public information. Information on legal proceedings (if any) and judgments (if any) in relation to actions commenced by, or against, the HKMA may be published by the HKMA where such information is publicly available.</p> <p>Also, the HKMA has statutory authority under sections 58A(4A) and 71C(7A) of the BO to disclose to the public the details of any decision the HKMA has made under section 58A(1) and section 71C(4) against a ReI or an EO, the reasons for which the decision was made and any material facts relating to the case. In June 2013, the HKMA published a press release concerning the disciplinary action taken by the HKMA against a ReI for misconduct committed by such ReI in the selling of an investment linked assurance scheme.</p>
Assessment	Fully implemented
Comments	<p>Overall the current legal and regulatory framework and processes in place have provided a high level of transparency and consistency to day to day decisions. The only area that raises concerns relate to the recognition of exchanges and the authorization/licensing of ATS, where the current framework would benefit from additional detail and transparency. The authorities are aware of this challenge and plan to "formalize" existing internal policies –which have developed overtime—into the corresponding code for ATS and potentially guidelines for the recognition of exchanges. These issues have been discussed more in depth under Principle 33 and have been taken into consideration for the grade of such Principle.</p> <p>The assessors note the use that the HKMA makes of circulars as a way to impose additional conduct requirements on securities markets activities conducted by banks. In such context it is critical that such circulars be subject to consultation.</p>
<b>Principle 5.</b>	The staff of the regulator should observe the highest professional standards, including appropriate standards of confidentiality.
Description	<p>Staff of SFC are required to comply with any statutory provisions and with the provisions of:</p> <ul style="list-style-type: none"> <li>a. SFC Employee Handbook; and</li> <li>b. SFC Code of Conduct.</li> </ul> <p>Staff of HKMA are required to comply with HKMA Code of Conduct, Rules on Appointment and Discipline, and HKMA Administration Circular No. 2/2012 - Rules on Restrictions on Investments by HKMA Staff.</p>

	<p><i>Conflicts of interest</i></p> <p>Section 379 of the SFO makes it a criminal offence for staff of SFC (including directors) to enter (directly or indirectly) into transactions which would create a conflict of interest. A transaction will create a conflict of interest if it is the subject of any investigation or proceedings by SFC or if the staff member knows it is otherwise being considered by the Commission. The section also requires a staff member to inform SFC immediately if he is required to consider any matter relating to a transaction or corporation in which he has an interest, or in relation to person by whom he was employed, who is or was an associate, or of whom he is or was a client.</p> <p>Paragraph 2.1 of SFC Code of Conduct requires staff of SFC to take appropriate steps to avoid actual and potential conflicts of interest, including the appearance of loss of impartiality in the performance of his duties. SFC Code of Conduct obligations also extend beyond section 379 of the SFO to cover transactions that a staff member knows are the subject of an investigation by an overseas financial regulator. Other areas covered by SFC Code of Conduct include social contacts, loans, dealings with outside parties (including former SFC colleagues), accepting or offering gifts or benefits, accepting hospitality, relations with suppliers and contractors, gifts between colleagues, reporting of bribery, etc.</p> <p>HKMA Code of Conduct provides guidelines and advice on the main issues that may have a bearing on the integrity of HKMA and its staff, which includes acceptance of advantages, conflict of interest, investment restrictions and confidentiality of information.</p> <p>Staff of both SFC and HKMA are also subject to the provisions of the Prevention of Bribery Ordinance.</p> <p><i>Securities trading by SFC and HKMA staff</i></p> <p>SFC Code of Conduct contains restrictions on holding or trading listed Hong Kong securities and requirements to disclose financial affairs and interests in securities or futures contracts. These include:</p> <ol style="list-style-type: none"> <li>a. Initial Disclosure Obligation – on commencement of employment or, for EDs taking up an appointment, staff must declare all direct or indirect holdings of securities and futures contracts (page 13);</li> <li>b. Ongoing Disclosure Obligation - all transactions in securities or futures contracts, must be disclosed within 2 trading days of the transaction (page 14);</li> <li>c. Restrictions on dealing by EDs -       <ol style="list-style-type: none"> <li>i. No ED may deal in any securities except the Pilot Programme Securities [the Pilot Programme For Trading US Securities on SEHK] and securities held through the medium of CIS or investment companies (whether or not such CIS or investment companies are listed); and</li> <li>ii. No ED shall in any manner transact any trading in any securities (other than through a CIS and certain US securities) and any futures contract as (page 17);</li> </ol> </li> <li>d. Restrictions on dealing by staff -       <ol style="list-style-type: none"> <li>i. Minimum Holding Period – staff must hold each investment for a minimum of 30 days after it has been purchased;</li> <li>ii. Index List – for securities, staff may invest only in securities included in the index</li> </ol> </li> </ol>
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- list prescribed by SFC;
- iii. Derivatives – staff must not engage in derivatives transactions (some narrow exceptions apply);
- iv. IPOs – staff must not subscribe for shares of corporations or interests in real estate investment trusts (REITs) or exchange traded funds (ETFs) unless authorized by the Commission; and
- v. Margin Financing – staff must not use margin financing.

The Rules on Restrictions on Investments by HKMA Staff and paragraph 4.6 of the HKMA Staff Handbook contain detailed instructions on how to handle private investment activity and sets out the relevant reporting requirements. All HKMA staff are required to report any purchase of shares or warrants and structured products, as well as purchases of foreign currency and funds involving HK\$100,000 or more. Staff in the Banking Departments and designated staff having access to data on AIs are prohibited from purchasing shares or warrants of any AI.

#### *Use of information*

Paragraph 25 of the HKMA Code of Conduct states that staff of the HKMA who have access to or are in control of proprietary information should provide adequate safeguards to prevent its abuse or misuse. Staff should not use any such information made available to them in the course of their duties in return for monetary rewards or personal interest or to disclose such information which is not in the interest of the public or the HKMA. Disclosing proprietary information without authority may constitute a criminal offence or disciplinary case.

Paragraph 26 of the HKMA Code of Conduct states that staff of the HKMA should also be mindful in handling information containing personal data. Unauthorised disclosure of such data may result in a breach of the provisions of the Personal Data (Privacy) Ordinance.

#### *Confidentiality and secrecy*

SFC and HKMA staff are both subject to confidentiality obligations under the SFO and the BO. HKMA staff are also subject to the Parts III and IV of the Official Secrets Ordinance. Paragraph 5.1 of the HKMA Staff Handbook deals with obligations relating to classified information.

#### *Procedural fairness*

SFC and HKMA staff are bound by the principles of procedural fairness under common law in the performance of their functions. See also under Principles 2 and 4.

#### **Processes for dealing with violations and sanctions**

Complaints about misconduct by SFC staff are examined by the Senior Director, Corporate Affairs, who is the most senior officer not responsible for an operational division. If misconduct is found, a staff member may be subject to disciplinary action, or to criminal sanctions such as those that apply to breaches of confidentiality obligations.

The SFC staff informed that there has been only one case related to a violation of the ethics code. In such case the employee was issued a written warning. Consultation with the SFC Legal Services Department determined that no additional disciplinary action was needed.

	<p>In HKMA, complaints about misconduct are examined by an appointed person at least one rank senior than the person in question. Staff guilty of misconduct are liable to disciplinary action, including criminal sanctions.</p> <p>The HKMA informed that no cases have been presented of violations to the ethical codes.</p>
Assessment	Fully implemented
Comments	
<b>Principle 6.</b>	The Regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate
Description	<p><b>Entity responsible for systemic risk in securities markets</b></p> <p>The SFC is responsible for the administration of the laws governing the securities and futures markets in Hong Kong. In what relates to this principle, the SFO gives the SFC the objective of reducing systemic risks in the securities and futures industry; and assisting the FS in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the securities and futures industry.</p> <p>The SFC has relied mainly on a bottom up approach to identify emerging and systemic risk, via its operational departments, with coordination achieved via periodic meetings at different levels of the organization. In 2012, the R&amp;S was created, in order to bring a centralized approach to risk which would “help the SFC to more effectively coordinate its overall strategy to deal effectively with the range of risks affecting market participants and investors”.</p> <p><i>Internal inputs</i></p> <p>Supervision of markets: the daily market monitoring conducted by this division plays a key role in the identification of risk to the orderly functioning of markets. It has access to several sources of information, including trading data, which it analyzes based on a series of indicators; settlement reports from the central counterparties (CCPs); large open position and short position reports; and flow of funds data. Exceptional market drop reports are provided to FS and SFC ExCo when there are significant market corrections.</p> <p>Corporate Finance and Investment Products: these divisions are key contributors to the identification of risks emerging from products available to HK retail investors. First, through the authorization function, the division collects information on new products authorized, which is also shared with the HKMA and the OCI; and its ongoing monitoring allows it to identify trends in products, as well as issuers of concern. For example, in view of the sovereign debt crisis in Europe, the Investment Products Division has been collecting information, on a regular basis, from major fund managers on their schemes’ exposure to, among others, European countries. It has held meetings with major fund managers to understand the crisis’ impact on them and their contingency plans.</p> <p>Intermediaries Supervision: through its off and on-site monitoring of licensees, this department assists the SFC in identifying risks particular to a specific intermediary. Its thematic reviews contribute to gaining an understanding of risks that cut across a sector of licensees. In addition, it conducts surveys from time to time to assist it to identify risk emerging in different sectors: for example, on the distribution of unlisted products, the</p>

	<p>activities of HF managers, etc.</p> <p><i>External inputs</i></p> <p>The HKMA: the HKMA provides inputs to the SFC on risks arising from the securities markets activities of banks. Of particular importance are the results of the quarterly survey on products distribution that the HKMA shares with the SFC. In addition, MoU meetings are used also to raise issues of concern and there are also informal mechanisms of communication.</p> <p>Meetings with industry participants: Starting in March 2013 the R&amp;S conducted risk-focused industry meetings with ten global institutions to ascertain evolving business models, market structure, product innovation, emerging risks and risk governance trends, which resulted in the publication of a report entitled “<i>Risk-focused Industry Meeting Series: G-SIFI Trends in Risk and Risk Mitigation</i>” (<a href="http://www.sfc.hk/web/EN/files/ER/Reports/20140109_RIM(EN).pdf">http://www.sfc.hk/web/EN/files/ER/Reports/20140109_RIM(EN).pdf</a>). In addition to the risk-focused meetings, the R&amp;S also monitors industry trends through a variety of other approaches, including but not limited to: liaison meetings with other regulators, industry associations and industry representatives; subscription to real time market data and news sources; industry research; and market intelligence through the network of R&amp;S members. The R&amp;S produces a global regulatory and macro newsletter that incorporates topical global and regulatory risks developments.</p> <p><i>Internal Coordination</i></p> <p>Through meetings at different levels of the organization the inputs coming from all these sources are shared among the divisions to achieve a common view of risk.</p> <ul style="list-style-type: none"> <li>• Weekly management meetings: these are the main vehicle for the divisions to share information on emerging issues that are of concern; these are relatively “unscripted” meetings.</li> <li>• Biweekly meetings of the ExCo: these are more formal meetings that are used to prepare issues that need to be discussed at board level. Senior staff of the SFC indicated that a “spotlight on risk” is being added to these meetings.</li> <li>• Quarterly Policy Meetings of the Board: These meetings were instituted recently to provide the Board more room to discuss policy and risk issues. These meetings are an at early stage (so far only six have taken place) thus senior management expect them to get more focused as the risks capabilities of the institution itself grow.</li> <li>• Cross-department/functional working groups for specific policy projects.</li> </ul> <p>Increasingly R&amp;S is taking a greater role in supporting the risk identification function of the SFC and allowing it to get a centralized/focused view of risk. As stated above, it currently supports risk identification through its meetings with external participants.</p> <p>An example of risk identified by the R&amp;S relates to the implications of the tightening of US monetary policy. The R&amp;S identified this as an emerging risk theme in mid-2012, on the basis of (i) large bond fund sales volumes in Hong Kong and globally, and (ii) a rapid rise in the</p>
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	<p>volume of issuance of high yield bonds, especially by Chinese enterprises.</p> <p>The R&amp;S raised this risk theme within the SFC, with the HKMA and others. As a member of the IOSCO Committee on Emerging Risks, the Head of R&amp;S also raised this as an emerging risk theme at the IOSCO Emerging Risk Discussion in September 2012 and supplemented it with further market data and information in later IOSCO Emerging Risk Discussions. Based on a consensus with Intermediaries Supervision Department of the relevance of this topic from a sales practices and investor standpoint, on 19 November 2012 the SFC issued a circular to LCs and RIs entitled "Selling of Fixed Income Products." The circular was based on joint inputs from the SFC and HKMA and set out the risks associated with fixed income products in the "search for yield" environment. The HKMA similarly issued a circular on the Selling of Fixed Income Products on the same date. In the first half of 2013, R&amp;S actively discussed the search for yield and interest rate risk in meetings with a series of global financial institutions that are active in Hong Kong, in the context of a dialogue on emerging risk themes and risk governance.</p> <p>In December 2013, R&amp;S has published a report on the outcome from its risk-focused industry meetings. The report is entitled "G-SIFI Trends in Risk and Risk Mitigation" (<a href="http://www.sfc.hk/web/EN/files/ER/Reports/20140109_RIM(EN).pdf">http://www.sfc.hk/web/EN/files/ER/Reports/20140109_RIM(EN).pdf</a>). This report followed a series of meetings conducted by the R&amp;S between March and August 2013 with senior executives of G-SIFIs on topics focused on the evolution of risk and on measures for risk mitigation, against the backdrop of changing business models and market structure as well as product innovation. The report highlights (1) aspects of best practices adopted by G-SIFIs for the purpose of risk identification and risk mitigation; and (2) forward-looking themes to achieve continuous improvement by G-SIFIs in risk governance and risk culture.</p> <p>In January 2014, R&amp;S produced a report on Bitcoin that was shared with regulatory counterparties in Hong Kong and formed the basis for a regulatory dialogue on this topic. The take-aways from the report were also shared with members of the IOSCO Committee on Emerging Risk.</p> <p>Another key project of the R&amp;S is the development of a risk register. The risk register has been implemented. Because it is a "living" document, it will require periodic liaising by R&amp;S with the SFC operating divisions with a view to ensuring that the Risk Register is up to date, accurate and complete and that the Heat Map is properly calibrated. The Risk Register and associated Risk Heat Map will be used for strategic planning purposes and for periodic reporting to ExCo/ the Board and will be tabled for periodic emerging risk discussions at ExCo/ the Board. One target of these discussions will be to assess whether any additional steps should be taken that straddle operating divisions and may require more frequent sharing of data and information. The risk register is automated and accessible on the internal R&amp;S portal.</p> <p>The R&amp;S portal integrates all key aspects of the work of R&amp;S, including the report published pursuant to the risk-focused industry meetings, the internal risk register, reports published as a result of collaboration on the IOSCO Committee on Emerging Risks, the R&amp;S Global Regulatory and Macro newsletter and other ad hoc projects and research.</p>
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**Development of expertise**

With the establishment of the R&S qualified staff were hired. The unit comprises four professional staff with legal, front office derivatives trading, prudential and conduct risk governance experience.

SFC staff participate in the IOSCO Emerging Risk Committee which helps gain a better understanding of initiatives of other regulators in the area of identification and measurement of risk. In this regard, three relevant products are: the IOSCO Risk dashboard; the annual IOSCO Securities Markets Risk Outlook (public report) and the guidance paper on methodologies for the identification, monitoring and assessment of risk by securities regulators.

**Coordination in connection with financial stability**

There are several committees that allow the sharing of information among regulators.

*FSC*

The key committee for purposes of systemic stability is the FSC, in which the SFST (chair), the SFC (CEO, ED, SOM), the HKMA (CE) and the OCI (Commissioner) participate. The FSC is responsible for monitoring the functioning of the financial system and any events or developments with cross-sector and systemic implications. Its responsibilities include:

- regular monitoring the functioning of the financial system of Hong Kong, including the banking, debt, equity, insurance and related markets;
- deliberating on events, issues and developments with possible cross market and systemic implications, and where appropriate, formulating and co-ordinating responses; and
- reporting regularly and as necessary to the FS regarding matters in (a) and (b) above.

The FSC meets monthly. It is mainly used by the regulators to update the FS and each other on key developments that can affect systemic stability, and to coordinate any necessary actions. All regulators can influence/shape the agenda. The meetings work on a free flow discussion. For example, the FSC discussed the proposed tapering of quantitative easing by various central banks and the effect that it could have in HK.

*CFR*

The CFR is made up of the FS (Chair), SFC (CEO,ED/SOM), HKMA (CE), OCI (commissioner), MPFA (managing Director), and SFST. It focuses on cross-sector regulatory matters with a view to minimizing regulatory gaps or duplications. Its objectives are to:

- facilitate cooperation and coordination among its members;
- share information and views on regulatory and supervisory issues and important trends in the financial system, particularly those that may have a cross-sectoral impact;
- minimize duplication or gaps in the regulation and supervision of financial institutions, paying close attention to the need to keep regulatory costs to a minimum;
- review international developments in financial sector regulation and to draw lessons for

	<p>Hong Kong;</p> <ul style="list-style-type: none"> <li>• discuss regulatory and supervisory issues relating to individual financial institutions that may have a cross-sectoral impact; and</li> <li>• oversee trends, issues and developments which may have implications for financial stability in Hong Kong.</li> </ul> <p>The CFR meets quarterly. The FS is the secretariat and is in charge of setting up the agenda. SFC senior management considers that the CFR has been very useful to discuss issues of concern to all the regulators, such as the ILAS. Another topic currently on its agenda is the development of a resolution framework.</p> <p><i>Securities and Futures Liaison Committee (SFLC)</i></p> <p>The SFLC is made up of the SFST and SFC (CEO, EDs of all divisions, Chief Counsel, Commission Secretary).</p> <p>The SFLC meets monthly. Major policy proposals (for example, those that would require legislative changes) are discussed. The agenda is proposed by the FSTB, but senior management of the SFC indicated that the SFC can add issues to the agenda if they see the need.</p> <p><i>FS Meetings</i></p> <p>Monthly meetings take place that are attended by the FS, SFST and SFC (Chairman, CEO). Similar topics to those discussed at the SFLC are discussed here</p> <p><i>Tripartite meetings</i></p> <p>Bi-monthly meetings take place among the SFST, SFC (Chairman, CEO, ED, Corporate Finance Division/ED, SOM) and the HKEx. The meetings focus on current topics of common interest. Examples include the new regulations concerning the sponsor regime, the regulation of overseas companies, the new business model of the exchange and how the SFC is responding to it.</p> <p><i>RMC</i></p> <p>This is a statutory committee, created after the merger of the exchanges. Under the SFO, it is composed of the HKEx Board Chairman and seven other members, 3-5 appointed by the FS while the HKEx appoints not more than two. It meets monthly and focuses on risk management issues at the HKEx. A current topic on the agenda relates to the enhancement of the risk management of the CCP in light of the PFMI.</p>
Assessment	Broadly implemented
Comments	<p>The initial assessments conducted under the new methodology focused on the analysis of three high level issues in connection with the existence of a process to identify systemic risk or to review the perimeter of regulation which is required pursuant to question 1 of the respective principles: (i) whether the arrangements in place allow for a holistic (across products, entities, and markets) view of risk, (ii) whether they allow for periodic reassessment of risk (iii) and whether they allow for proper follow up (actions). The experience gained over</p>

	<p>the last year allows assessors to delve deeper into these issues, for example, by looking at the type of data and analysis that is used by the authorities to identify such risks, and the degree to which the processes implemented allow for proper accountability. Such rigorous analysis is in line with the recommendations included in the report of the Assessment Committee of IOSCO. Accordingly and based on question 1 in the methodology this principle has been graded broadly implemented.</p> <p>The assessors acknowledge that the authorities are making significant progress in improving existing arrangements for the identification of both emerging and systemic risks. Operational divisions are indeed key players in the identification of risks; they have a foot in the ground and are able to see what is happening at the microlevel. However, the risk of a bottom up/decentralized approach is that the view of risk is more likely to be fragmented. Thus the assessors welcome SFC initiatives to complement this approach with a stronger top down component. In this regard, the examples provided indicate that the addition of the R&amp;S is already bearing fruit, as it is bringing much needed centralization and focus to the existing framework. The risk register adds further “structure” to the process as it assists in the integration of the views on risks from different parts of the organization as well as in achieving a ExCo/ Board level discussion of risks. It should also help to conduct appropriate monitoring of actions taken and whether they are being effective in addressing the risks identified.</p>
<p><b>Principle 7.</b></p>	<p>The Regulator should have or contribute to a process to review the perimeter of regulation regularly</p>
<p>Description</p>	<p><b>Identification of risks</b></p> <p>The SFC has mainly relied on the 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.</p> <p>Issues of concern are discussed at different levels of the organization, through the weekly meetings, and the biweekly ExCo meetings. If issues are of sufficient concern they are brought to the consideration of the board and when appropriate, also to the HKMA and other public authorities through the relevant committees.</p> <p>As indicated in Principle 6, the Board has recently instituted quarterly policy meetings to provide an opportunity for more substantive discussions.</p> <p><i>External Committees</i></p> <p>The SFC operates a number of committees, comprised of SFC senior executives and market professionals, which play an important role in enabling the SFC to review its regulatory perimeter.</p> <ul style="list-style-type: none"> <li>• The Advisory Committee was established under section 7 of the SFO, and meets quarterly to advise the SFC on a broad range of policy initiatives and market issues including consultation proposals by the Government and SFC, listing-related matters and Mainland and international regulatory developments. Non-official members are drawn from</li> </ul>

different sectors, including brokers, funds, listed companies, legal, and banking.

- There are several committees that specialise in particular regulatory areas such as market supervision, investment products and public shareholders' rights and interests. Examples include:
  - The Committee on REITs that advises the SFC on general policy matters or regulatory issues that are related to the Code on REITs, the overall market development of REITs, the property or securities market or investment management in Hong Kong or elsewhere, professional practices or guidelines that are involved in the operation of REITs, and fund investment or management in general.
  - The Products Advisory Committee that may be consulted by the SFC on a wide range of matters relating to the Products Handbook, the SFC Code on MPF Products and the Code on Pooled Retirement Funds, overall market environment, industry practices and novel product features.
  - The Public Shareholders Group that advises the SFC on aspects of the regulatory framework relating to shareholders' interests and investor protection, in order to promote (i) a level playing field among all shareholders, (ii) increased accountability by directors and management of listed companies to shareholders, and (iii) proper functioning of the securities market. The Group is chaired by the ED of Corporate Finance Division, and met three times in 2012 to discuss issues including the SFC's review of the IPO regime and a proposal on the new prospectus regime.
  - The Takeovers and Mergers Panel one of the functions of which is to review the provisions of the Takeovers Code and the Rules of Procedure and to make recommendations to the SFC on any necessary or appropriate amendments.

#### *The R&S*

As indicated in Principle 6, a key addition to the SFC's activities has been the creation of the R&S, which will strengthen the development of a centralized view on risks. The risk register is a tool that allows all divisions to provide input to the process of risk identification. It allows for prioritization, and proper follow up of decisions made in regard to actions to be taken, including when appropriate a review of the perimeter of regulation. The Risk Register includes an assessment of "Perimeter" and R&S will work further with other divisions, including the Legal Services Division, on items that require perimeter analysis and/ or extension.

#### **Revisions to the perimeter of regulation**

Through the arrangements described above the SFC identifies risks that require adjustments to the perimeter of regulation. In some cases the adjustments can be done directly by the SFC through changes to its codes, and/or supervisory programs; while others require coordination with other authorities and/or legislative changes. In the latter case, the SFC raises such issues in the SFLC and cross-regulatory meetings. Senior staff from all relevant authorities (SFC, FSTB) indicated that the FSTB is generally supportive of SFC initiatives, which it forwards to the LegCo. Further, the authorities use the period before the start of a new legislative term to map all changes that are needed to the legislative framework.

	<p>Two examples of emerging risks that have led to adjustments in the perimeter of regulation relate to:</p> <ul style="list-style-type: none"> <li>• ILAS: as this involves a case of disparity in the regulatory requirements across sectors in connection with the distribution of ILAS, actions are being taken in a coordinated manner by the Government along with the financial regulators, as explained in Principle 1.</li> <li>• Enhancements to the initial public offering (“IPO”) sponsor regime: this case stems from concerns over the quality of disclosure in IPOs. The SFC considered it necessary to strengthen the obligations of sponsors. Further the SFC has requested that legislative amendments also be pursued to clarify the civil and criminal responsibility of sponsors for the due diligence that they are required to perform.</li> </ul> <p>In addition, the authorities highlighted the existence of several projects that will entail adjustments to the perimeter of regulation. Some of them have been triggered by the lessons from the crisis and the global regulatory reform agenda (such as, the OTC derivatives reform and the development of a resolution framework). Others respond to micro challenges that have arisen from the current structure of the HK securities markets, including (i) the increased interconnection of the HK market with the Mainland (initially via listings and more recently also through the entrance of intermediaries), and (ii) the new business strategy of the HKEx.</p>
Assessment	Broadly implemented
Comments	<p>The grade stems from the need to further strengthen the processes in place for the identification and monitoring of emerging risks and to address issues of the perimeter of regulation as already planned by the SFC. This issue has been explained in Principle 6.</p> <p>The assessors note that the SFC has been active in identifying risks arising both from the macro as well as from the microenvironment. On the latter, the assessors encourage the SFC to continue to take a proactive stance to identify and address challenges arising from the increased interconnection with the Mainland, in particular in connection with the effectiveness of enforcement, as well as from the new business strategy of the HKEx, its implications vis-à-vis the supervision of the HKEx, but also vis-à-vis competition.</p>
<b>Principle 8.</b>	The Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed.
Description	<p><b>Regulated entities</b></p> <p>The existing regulatory framework requires regulated entities to put in place mechanisms to identify, monitor and mitigate conflicts of interest.</p> <p>Overall, the framework for intermediaries is principles based, and establishes three types of actions that intermediaries can take to address conflicts of interest: avoidance, control and disclosure (see Principle 31).</p> <p>Conflicts of interest obligations exist also for specific types of participants including auditors (see Principle 20), credit rating agencies (see Principle 22), sell side analyst (see principle 23), and SROs (see Principle 9).</p> <p>The SFC (and the HKMA) reviews compliance with the conflict of interest obligations through its licensing and ongoing supervisory program. At the licensing stage, an applicant's policies</p>

	<p>and procedures to identify and manage conflicts of interest are reviewed and if necessary changes are requested. On an ongoing basis, if problems with compliance are identified the SFC can take different type of actions including issuing of guidelines if problems are common across many participants and taking enforcement actions against individual participants.</p> <p>To strengthen the regulatory regime, in 2010, the SFC introduced measures to enhance intermediary conduct, in particular, on practices relating to the sale of investment products. These required enhanced disclosure to clients of sales related information, such as the capacity (principal or agent) in which an intermediary is acting; the affiliation of the intermediary with the product issuer; and the monetary and non-monetary benefits received by the intermediary for the distribution of investment products. This disclosure must be made prior to or at the point of sale.</p> <p>Also in 2010 the HKMA established a separate Banking Conduct Department to respond to the need to strengthen its supervision of banks. The HKMA has also complemented SFC codes (and the obligations therein concerning distribution of products) with circulars that establish additional obligations on that banks, including, for example, requiring AIs engaging in retail securities business to audio record the sale process in branches and to physically segregate their retail securities business from their general banking business in branches.</p> <p>Investor education is also one of the SFC's regulatory focuses and is an important complement to the regulation of intermediaries. It helps investors protect themselves, allowing them to acquire better knowledge of market operations, product features and associated risks and thereby make informed investment decisions. For example, the SFC has published articles, newsletters and booklets to illustrate the new regulatory requirements on the disclosure of sales related information, including information regarding the potential conflicts of interest between the product issuers and distributors, to assist investors to safeguard their interests.</p> <p><b>Issuers</b></p> <p>In the case of issuers, the main mechanism used to address misalignment of incentives is disclosure to the public.</p> <p>Through the discussions with authorities and market participants the assessors have identified family owned structure of the majority of listed companies as a key source of conflicts of interest in HKSAR. This risk is well known to the authorities. In fact a very strict framework for transactions between related parties is in place, as discussed under Principle 17.</p> <p>Another area of potential misalignment of incentives relates to structured products. In this regard the SFC has issued a Code for non listed structured products that requires manufacturers to design products fairly and appropriate for the markets for which they are intended.</p>
Assessment	Fully implemented
Comments	

<b>Principles for Self-Regulation</b>	
<b>Principle 9.</b>	Where the regulatory system makes use of 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.
Description	<p><b>SROs</b></p> <p>The HKEx and the exchanges that are members of the HKEx group perform an SRO function in the Hong Kong market. Similarly, the clearing houses owned by the HKEx play a supervisory function in relation to the clearing and settlement of transactions on the exchanges.</p> <p>No other Hong Kong-based entities operate exchange markets in Hong Kong. The Hong Kong Mercantile Exchange operated a futures exchange as an ATS authorized under Part III (sections 95-101) of the SFO but its authorization was withdrawn in May 2013.</p> <p><i>The HKEx group</i></p> <p>HKEx is a recognised exchange controller under the SFO. It owns and operates the only stock exchange and a futures exchange in Hong Kong and their related clearing houses. Historically, the exchanges operated by HKEx pre-dated the legislation and their recognition under the SFO was grandfathered. These exchanges are:</p> <ol style="list-style-type: none"> <li>a. <i>The SEHK</i> operates a stock market in Hong Kong and under section 19(1)(a) of the SFO is the only exchange permitted to trade equity securities in Hong Kong.</li> <li>b. <i>HKFE</i> is a REC under the SFO. HKEx also wholly owns the London Metal Exchange.</li> </ol> <p>HKEx owns and operates 3 clearing houses that are recognised clearing houses under the SFO:</p> <ol style="list-style-type: none"> <li>a. <i>Hong Kong Securities Clearing Company Limited (HKSCC)</i> provides services for the clearing and settlement of securities;</li> <li>b. <i>The SEHK Options Clearing House Limited (SEOCH)</i> provides services for the clearing and settlement of stock options; and</li> <li>c. <i>HKFE Clearing Corporation Limited (HKCC)</i> provides services for the clearing and settlement of transactions on HKFE.</li> </ol> <p><i>Governance</i></p> <p>HKEx is a listed company, with the Government of Hong Kong retaining 5.8 percent of the shares.</p> <p>Under section 77 of the SFO, the FS has the power to appoint up to eight directors of HKEx where the FS is satisfied that it is appropriate to do so in the interest of the investing public or in the public interest. The authorities highlighted that apart from its commercial interests the HKEx also has important public functions of ensuring an orderly and fair trading in securities and futures trading as well as prudent risk management, noting that the HKEx has the right to operate the only stock market in HKSAR. The appointment of a number of directors by the FS is therefore necessary to ensure adequate reflection of public interest and interest of the investing public in the decision making body of HKEx. Directors are appointed by the FS from</p>

	<p>among, inter alia, market professionals and distinguished members of the community. No government officials have been appointed by the FS as members of the board of directors of HKEx. Of the current board of 13 directors, 6 (including the Chairman) were appointed by the FS. The Chief Executive is the only executive director.</p> <p>The boards of SEHK and HKFE are appointed by HKEx as the sole shareholder.</p> <p>Section 26 of the SFO provides that the approval of SFC is required for the appointment of the chief executive of a recognized exchange company (i.e. SEHK and HKFE).</p> <p>The RMC established by law advises and provides recommendations to the board of HKEx on risk management issues. The FS appoints the majority of the members, and a representative of each of SFC and HKMA are members. Changes the HKEx needs to make to meet the new PFMI is an example of the type of issue on which the RMC would provide recommendations.</p> <p><i>Division of responsibilities between SFC and HKEx</i></p> <p>The CEHK has power under section 25(1) of the SFO, at the request of SFC, to delegate to a recognized exchange some specified regulatory functions, including licensing of participants and approval of prospectuses. In practice, only the power to approve prospectuses is delegated.</p> <p>Under the legislation, SFC has direct responsibility for:</p> <ol style="list-style-type: none"> <li>a. licensing of all market participants;</li> <li>b. monitoring market participants' compliance with the SFO and subsidiary legislation, and SFC codes, and acting on non-compliance;</li> <li>c. monitoring the market and acting on suspected market abuse and insider dealing;</li> <li>d. monitoring issuers' compliance with the obligation to disclose inside information and acting on non-compliance;</li> <li>e. monitoring compliance with the disclosure of interests provisions in Part XV of the SRO (substantial shareholding and short positions) and acting on non-compliance;</li> <li>f. approving prospectuses and offer documents other than for listed equity and debt securities and listed structured products. (Offer documents for listed CIS products are approved by the SFC);</li> <li>g. approving new exchange products through the rule approval process;</li> <li>h. monitoring exchanges' compliance with obligations under the SFO.</li> </ol> <p>HKEx and its exchanges are responsible for:</p> <ol style="list-style-type: none"> <li>a. deciding applications for admission as an exchange participant;</li> <li>b. monitoring compliance by market participants with exchange rules and acting on non-compliance;</li> <li>c. admitting issuers to listing;</li> <li>d. under delegated authority, approving prospectuses and offer documents for listed equity and debt securities, and for listed structured products;</li> <li>e. monitoring compliance by issuers with the Listing Rules and acting on non-compliance;</li> </ol>
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f. monitoring the market to ensure that trading is orderly.

In practice, HKEx and the exchanges in the group perform a self-regulatory function primarily in relation to the listing function performed by SEHK. Other regulatory functions are performed by SFC.

#### *Admission of participants*

An entity that wants to participate directly in the trading of the products listed on SEHK or HKFE must apply to become an exchange participant of the relevant market. The SEHK or HKFE has the right to admit or refuse to admit any person or company as an exchange participant. The eligibility requirements and ongoing obligations of exchange participants etc. are stipulated in the Rules and Regulations of HKFE and SEHK. The decisions are final and cannot be appealed against.

One of the eligibility criteria established by the exchanges and clearing houses for their participants is that the persons should be corporations licensed by the SFC.

#### *Admission to listing*

The SEHK is the front line regulator of listed companies. It is responsible for admitting companies and products for listing, granting waivers associated with listing and monitoring and enforcing disclosure requirements under the listing rules.

#### *Rules*

The recognized exchange companies (SEHK and HKFE) establish and enforce binding rules of trading, business conduct and qualification for membership.

All exchange participants must comply with the rules and regulations of the exchanges of which they are a participant. Any breaches of the rules and regulations are subject to the disciplinary actions of the exchange.

#### **Recognition of Exchange Companies**

Section 19 of the SFO provides for the recognition of exchange companies. The SFC must be satisfied that recognition is appropriate in the interest of the investing public or in the public interest; or for the proper regulation of markets in securities or futures contracts.

Before it grants recognition, SFC must consult with the public and the FS. It can impose conditions as it considers appropriate.

Under section 63(1) of the SFO, it is the duty of a recognized exchange controller which is a controller of a recognized exchange company or recognized clearing house to ensure so far as reasonably practicable:

- a. an orderly, informed and fair market in securities or futures contracts traded on the stock market or futures market operated by the recognized exchange company or through the facilities of the company;

	<p>b. that there are orderly, fair and expeditious clearing and settlement arrangements for any transactions in securities or futures contracts cleared or settled through the facilities of the recognized clearing house;</p> <p>c. that risks associated with its business and operations are managed prudently;</p> <p>d. that the recognized exchange company or recognized clearing house (as the case may be) complies with any lawful requirement placed on it under any enactment or rule of law and with any other legal requirement placed on it.</p> <p>Section 21(1) of the SFO provides that it is the duty of a recognized exchange company to ensure:</p> <p>a. so far as reasonably practicable, an orderly, informed and fair market:</p> <p>(i) for a stock market, in securities that are traded on that stock market or through the facilities of that company; or</p> <p>(ii) for a futures market, in futures contracts that are traded on that futures market or through the facilities of that company; and</p> <p>b. that risks associated with its business and operations are managed prudently.</p> <p>Section 21(2) provides that, in discharging this duty, a recognized exchange company must:</p> <p>a. act in the interest of the public, having particular regard to the interest of the investing public; and</p> <p>b. ensure that the interest of the public prevails where it conflicts with the interest of the recognized exchange company.</p> <p><i>Market Rules</i></p> <p>Under section 23(1) of the SFO a recognized exchange company may make rules for such matters as are necessary or desirable:-</p> <p>a. for the proper regulation and efficient operation of the market which it operates;</p> <p>b. for the proper regulation of its exchange participants and holders of trading rights;</p> <p>c. for the establishment and maintenance of compensation arrangements for the investing public.</p> <p>Section 23 set out a detailed of list of what may be covered in such rules.</p> <p>Section 24 of the SFO provides that no rule of recognized exchange companies (whether or not made under section 23) or any rule amendment has effect unless it has the approval in writing of the SFC. In addition, section 36 gives SFC, after consulting the FS and the relevant exchange, the authority to make statutory rules on a variety of matters relating to market activity, for example the listing of securities and on persons who may be admitted as exchange participants. If exchange rules are inconsistent with these statutory rules, they are ineffective to the extent of the inconsistency.</p> <p>SEHK and HKFE have Trading Rules governing participation in its markets. Rules apply equally to all participants.</p> <p><i>Listing Rules</i></p> <p>The SEHK administers the Rules Governing the Listing of Securities on SEHK (Main Board Listing Rules) and the Rules Governing the Listing of Securities on the GEM (GEM Listing</p>
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	<p>Rules) (collectively the Listing Rules).</p> <p>Under sections 23 and 24 of the SFO, the SEHK must submit any proposed rule or change of the Listing Rules to the SFC for prior approval before any rule change is implemented.</p> <p><i>Disciplinary powers</i></p> <p>SEHK and HKFE have disciplinary rules enabling them to impose sanctions for non-compliance with the trading rules. The disciplinary action includes censure, fines, suspension or withdrawal of trading rights.</p> <p><i>Co-operation with SFC</i></p> <p>By section 21(5) of the SFO, a recognized exchange company has a duty to immediately notify SFC if it becomes aware:</p> <ol style="list-style-type: none"> <li>a. that any of its exchange participants is unable to comply with any exchange rules or any financial resources rules; or</li> <li>b. of a financial irregularity or other matter which in the opinion of the exchange may indicate that the financial standing or integrity of an exchange participant is in question, or that an exchange participant may not be able to meet its legal obligations.</li> </ol> <p>SFC has MoUs with HKEx governing the relationship between the two organizations. A 2001 MoU deals with matters relating to SFC oversight, supervision of exchange participants and market surveillance. It sets out the terms of cooperation and obligations of both parties, including the responsibilities of HKEx and its exchanges and clearing houses, the review of HKEx's operations by the SFC, data and information that should be provided to the SFC on a regular or ad hoc basis. It provides that if HKEx becomes aware of a serious matter as set out in Appendix I of the MoU, it will, to the extent permitted by law, notify the SFC as soon as practicable.</p> <p>A 2003 MoU deals with matters relating to listing.</p> <p><i>Avoiding anti-competitive situations and misuse of oversight role</i></p> <p>Potential misuse of power by HKEx as the sole operator of exchange markets in Hong Kong is dealt with by:</p> <ol style="list-style-type: none"> <li>a. SFC's role in the approval of all exchange rules;</li> <li>b. Section 76 of the SFO, which requires that fees imposed by HKEx (as a recognized exchange controller) or SEHK and HKFE (as recognized exchange companies) must be specified in rules approved by SFC. In making its decision on fee rules, SFC must have regard to: <ol style="list-style-type: none"> <li>i. the level of competition, if any, in Hong Kong for the matter for which the fee is to be imposed; and</li> <li>ii. the level of fee, if any, imposed by another recognized exchange controller, recognized exchange company or recognized clearing house or any similar body</li> </ol> </li> </ol>
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	<p>outside Hong Kong for the same or a similar matter to which the fee relates.</p> <p><b>Oversight</b></p> <p><i>Market functions</i></p> <p>SFC's market supervision functions and activities are described under the Principles for Secondary Markets. In carrying out these functions, SFC has constant contact with the exchanges and is able to monitor their activities on an on-going basis.</p> <p>The 2001 MoU provides that SFC may carry out onsite reviews on the operations of HKEx, the exchange companies and clearing houses. The MoU sets out the cooperation and assistance that HKEx must provide and the procedures for conducting an onsite inspection.</p> <p>The SFC is planning to conduct its first such onsite review of HKEx and its exchanges and clearing houses in 2014. The purpose of the onsite review is to assess how well HKEx and its exchanges and clearing houses are discharging their respective statutory duties specified in the SFO including arrangements for monitoring compliance with and enforcing their trading and clearing rules, and handling conflicts of interest.</p> <p>In addition to the supervision functions described above, there is a schedule of regular meetings between SFC, HKEx and others that deal with matters relating to markets. This schedule includes:</p> <ol style="list-style-type: none"> <li>meetings between senior management of HKEx and SFC (monthly or bimonthly);</li> <li>RMC meetings (monthly includes other parties as well as SFC and HKEx)</li> <li>meetings between SFC, HKEx and FSTB (bimonthly);</li> <li>meetings between SFC market supervision team and HKEx IT team (quarterly).</li> </ol> <p><i>SEHK's listing function</i></p> <p>The SEHK submits a monthly report to the SFC on the activities of the SEHK with respect to its listing responsibilities in relation to the Main Board and GEM.</p> <p>Pursuant to the 2003 MoU, the SFC and the SEHK hold monthly meetings to discuss matters arising from the monthly report, any matters or issues relating to the SEHK's regulation of listed companies or the SFC's oversight of the SEHK in listing related matters, and any policy or other matters relating to any of the SEHK's functions and responsibilities.</p> <p>SFC conducts annual reviews of the SEHK's listing related functions in accordance with the 2003 MoU (see further under Principle 34). The SFC's annual review reports are published on the SFC website.</p> <p>The process focuses on the procedures and processes used by SEHK's Listing Division as a whole. The SFC reviews sample cases to understand how the division's policies work in practice and to verify whether the division's practices follow its policies.</p> <p>As part of the review process, SFC interviews each of the Heads of Departments, including the Head of Listing, to obtain understanding of their assessment of the effectiveness and efficiency of their respective department's decision-making processes and operational</p>
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procedures.

In 2012, the SFC performed thematic review on the Listing Division's processes and procedures in respect of:

- a. processing listing applications in respect of Initial Public Offering (IPO) of equity securities;
- b. processing structured products listing applications; and
- c. dissemination of listed company information.

### **Professional standards**

A recognized exchange controller, recognized exchange company and recognized clearing house must fulfill the statutory duties stipulated in the SFO. They are required to observe the secrecy provisions set out in Section 378 of the SFO. Under the rules of these entities, the disciplinary procedures include the right to appeal. In addition, laws of natural justice will apply and the right to judicial review is available.

### **Conflicts of interest**

Potential conflicts of interest are dealt with by a number of mechanisms.

#### *The listing function*

SEHK admits issuers to listing and, under delegated authority, makes the formal decision on the adequacy of disclosure documents, including the prospectus. Potential conflicts associated with this role are dealt with as follows:

- a. the dual filing system means that the SFC also reviews prospectuses and has a power of veto;
- b. the Listing Committee makes the formal decision on listing applications. The Listing Committee comprises 28 individuals, including 8 investor representatives; 19 persons who provide a balance of representatives of listed companies and market practitioners; and the HKEx's CEO. Rules for conflicts of interest are set out in paragraph 9 of the Guidance for Member of the Board and Committees of HKEx and require a member to declare any conflicting interest and not to take part in any matter where there is such a conflict. Individuals are nominated by a Nominating Committee comprised of three HKEx directors, and the SFC's Chairman, CEO and Executive Director Corporate Finance;
- c. HKEx's Listing Division is separated from the rest of HKEx by an information barrier (Chinese wall). The head of listing is not permitted to discuss listing applications with any other part of HKEx, except the CEO in his capacity as a member of the Listing Committee. HKEx board may from time to time make comment on the Listing Rules and proposals for changes to them;
- d. The Listing Division is the sole gateway for applicants for listing. If the SFC wants to inquire about a listing application, that request is channeled through the Listing Division.

HKEx, as a company listed on its own stock market, is regulated by the SFC to avoid any conflict of interest and to ensure a level playing field between HKEx and other listed

	<p>companies subject to the Listing Rules of the Main Board and GEM. Regulation by the SFC is imposed through two sets of provisions:</p> <ol style="list-style-type: none"> <li>a. Chapter 38 of the Main Board Listing Rules and Chapter 36 of the GEM Listing Rules contain provisions dealing specifically with the listing of HKEx. They set out the requirements that must be satisfied for the securities of HKEx to be listed on SEHK as well as the powers and functions of the SFC in the event of a conflict of interest;</li> <li>b. a 2001 MoU between the SFC, HKEx, and SEHK deals specifically with the self-listing of HKEx. It sets out the way the parties to it will relate to each other in relation to:             <ol style="list-style-type: none"> <li>i. HKEx's and other applicants' and issuers' compliance with the Listing Rules;</li> <li>ii. the SEHK's enforcement of its rules in relation to HKEx's securities and those of other applicants and issuers;</li> <li>iii. the SFC's supervision and regulation of HKEx as a listed issuer and, where a conflict of interest arises, other applicants and issuers;</li> <li>iv. conflicts of interest which may arise between the interests of HKEx as a listed company and companies of which it is the controller, and the interests of the proper performance of regulatory functions by such companies; and</li> <li>v. market integrity.</li> </ol> </li> </ol> <p>Section 75 of the SFO provides that where the SFC is satisfied that a conflict of interest does or may exist, the SFC has the powers and functions with respect to the performance of regulatory powers and functions by HKEx or any company of which it is the controller. HKEx's status as a listed entity is an example of where these powers apply.</p>
Assessment	Broadly implemented
Comments	<p>The view that the HKEx is a “public utility” and the monopoly granted by the SFO has triggered a level of involvement of the Government with the HKEx that is uncommon in developed jurisdictions. Such level of involvement manifests not only in the consultation and approval of certain measures concerning exchanges by the FS, but also on the appointment of a significant number of board members of HKEx by the FS. Such involvement in turn could pose conflict vis-a-vis the implementation of a strong framework of oversight of the HKEx. In such context, it is important that the process for appointment of directors be rigorous and transparent and that the persons selected are not government officials. The assessors note that no government officials have been appointed.</p> <p>Another manifestation of the close relations between authorities and the HKEx is the RMC. This has positive benefits in that it enables a coordinated approach to policy issues. On the other hand, it results in a situation where the SFC and the HKMA are involved in a decision making process on matters which at a later stage the SFC will be required to make regulatory decisions or take regulatory actions. Some matters, for example the PFMIs, will result in the need for rule changes. The involvement of the regulatory authorities in the RMC, with the functions it currently has, does not foster an appropriate arms' length relationship between the regulators and the HKEx as a regulated entity.</p> <p>The review of the oversight framework led assessors to conclude that current arrangements in connection with the most direct SRO functions of the exchange, as well as requirements in place to handle conflict of interest in this function, are robust. In this regard such arrangements require separation of the listing function, approval of the HKEx rules by the SFC, the four eye principle for decisions on new listings (whereby the SFC can object to decisions</p>

	<p>made by the HKEx) and on-site inspections of the listing function. On the market function, the SFC should consider whether decisions on the admission of participants should be subject to an appeal process (for example by SFC), particularly in the light of the monopoly position of HKEx. Furthermore, as the HKEx implements its new business strategy, ensuring that robust arrangements are in place in connection with the market function become more relevant.</p> <p>Issues of concern remain in connection with the limitations to competition, but those do not arise from the rules of the exchange, rather from policies embedded in the SFO as it granted a monopoly to the SEHK. Thus these issues are not considered for purposes of the grade of principle 9.</p>
<p><b>Principles for the Enforcement of Securities Regulation</b></p>	
<p><b>Principle 10.</b></p>	<p>The regulator should have comprehensive inspection, investigation and surveillance powers.</p>
<p>Description</p>	<p><b>Information gathering and inspection powers</b></p> <p>Both SFC and HKMA have broad powers to obtain books and records, seek information and carry out on-site inspections of regulated entities. A failure by a regulated entity to comply with SFC requests or directions made using these powers is a criminal offence.</p> <p><i>General powers</i></p> <p>Section 180 of the SFO creates a general power to obtain information from and inspect the business operations and the books and records of regulated institutions and their associated entities at any reasonable time. This power is available both to SFC and to HKMA. HKMA also has powers under the BO to require production of books and records and to conduct inspections of AIs, including AIs that are also RIs (sections 55 and 56). HKMA routinely uses both SFO and BO powers in its dealing with RIs.</p> <p>On-site inspections can be carried out without notice but the exercise of the power must be reasonable in the circumstances. Judicial action is not required and inspections may be carried out on a routine basis as well as in response to a particular inquiry. There is no requirement for the regulator to suspect misconduct before exercising these powers.</p> <p>Section 181 of the SFO gives SFC power to require a shareholder, a person who holds an interest in an investment product (securities, futures, CIS etc), a person who has conducted a transaction in an investment product, or an LC or RI to provide identity, transaction and holding details.</p> <p>LCs and RIs have extensive reporting obligations under the SFO, including both regular reports (such as annual reports and financial and capital requirements reports), as well notifications of specified events. See further under Principles 29-32.</p> <p><i>Stock exchange transactions</i></p> <p>Under section 71 of the SFO, SFC can require any exchange company or clearing house to provide trade and client information, including information in its possession or under its control that relates to the affairs of any of its members. MoUs between SFC and the HKEx set out the arrangements and procedures for facilitating the performance of their functions,</p>

	<p>including surveillance of trading activities.</p> <p>SFC conducts real-time surveillance of the trading activities of both the stock market and the futures market at the HKEx. Specialised systems are deployed to monitor the markets on a real-time basis every day.</p> <p><b>Record keeping requirements</b></p> <p>Securities and Futures (Keeping of Records) Rules (Record Keeping Rules) require all SFC intermediaries and RIs and their associated entities to keep records containing sufficient details to explain their business activities and operations and account of their client assets, and to keep these records for not less than 7 years.</p> <p><b>Customer identity</b></p> <p>SFC's Code of Conduct requires LCs and RIs to obtain and keep information on the ownership and control of transaction accounts and prohibits them from executing transactions on behalf of clients unless they hold the required information (see paragraph 5.4 of the Code and further under Principle 31). SFC's Client Identity Rule Policy sets out SFC's approach to these requirements, in particular providing for a no action approach where it is not practicable to obtain details of an ultimate beneficiary before a transaction, for example where the client is an overseas financial institution's omnibus client account. In that case, it is sufficient if the relevant information is provided to SFC or one of the Hong Kong exchanges within 2 days of a request.</p> <p>In addition to their general obligations under Record Keeping Rules, section 20 of Schedule 2 to the AMLO requires financial institutions (including LCs and RIs), in relation to each transaction carried out by them, to keep the original or a copy of the documents and a record of the data and information obtained in connection with the transaction. The Guideline on Anti-Money Laundering and Counter-Terrorist Financing requires that the records be sufficient to permit reconstruction of individual transactions and establish a financial profile of any suspect account or customer. These records must be kept for 6 years from transaction date, and SFC can require a longer period.</p> <p>SFC has access to this information using its information gathering powers.</p> <p><i>Issuers</i></p> <p>Section 179 of the SFO gives SFC the power to require production of records and documents concerning listed corporations (see further under Principle 12).</p> <p><b>Inspections outsourced to SROs and other third parties</b></p> <p>SFC does not outsource or grant inspection or enforcement authority to any third party. It may occasionally engage external consultants to assist in performing inspections on LCs in some specialised areas. Generally, in such cases, detailed scope of work and procedures to be followed for performing the inspection are set out in the letter of engagement between the SFC and the external consultants, and the SFC's prior agreement is required for any material</p>
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	<p>adjustments by the external consultants to the scope of work and procedures. Consultants are bound by the confidentiality obligations under section 180 of the SFO.</p> <p>HKMA also uses its own staff to carry out inspections.</p>
Assessment	Fully Implemented
Comments	
<b>Principle 11.</b>	
Description	<p><b>SFC Powers of investigation</b></p> <p><i>Issuers</i></p> <p>Section 179 of the SFO gives SFC the power to compel a corporation that was or is listed, its related companies, banks, auditors and any other person to produce records and documents specified by the SFC investigator. The SFC also has the power to require the person providing the records or documents to provide or make any explanation or statement in respect of the record or documents (section 179(3)). This power can be exercised in the circumstances listed in the section, including where it appears to the SFC that there are circumstances suggesting that:</p> <ol style="list-style-type: none"> <li>a. the business of the corporation (which is or was listed) has been conducted; <ol style="list-style-type: none"> <li>i. with intent to defraud its creditors, or the creditors of any other person;</li> <li>ii. for any fraudulent or unlawful purpose; or</li> <li>iii. in a manner oppressive to its members or any part of its members;</li> </ol> </li> <li>b. the corporation was formed for any fraudulent or unlawful purpose;</li> <li>c. persons concerned in the process by which the corporation became listed (including the public issue of securities) have engaged, in relation to such process, in defalcation, fraud, misfeasance or other misconduct;</li> <li>d. persons involved in the management of the affairs of the corporation have engaged, in relation to such management, in defalcation, fraud, misfeasance or other misconduct towards it or its members or any part of its members;</li> <li>e. members of the corporation or any part of its members have not been given all the information with respect to its affairs that they might reasonably expect.</li> </ol> <p><i>General investigation power</i></p> <p>Under section 182 of the SFO, the SFC has the power to direct one or more of its employees to conduct an investigation. This power can be exercised to investigate possible offences, when the SFC has reasonable cause to believe that:</p> <ol style="list-style-type: none"> <li>a. a person may have engaged in defalcation, fraud, misfeasance or other misconduct in connection with: <ol style="list-style-type: none"> <li>i. dealing in any securities or futures contract or trading in any leveraged foreign exchange contract;</li> <li>ii. the management of investment in any securities, futures contract or leveraged foreign exchange contract;</li> <li>iii. offering or making any structured product, leveraged foreign exchange contract or CIS;</li> <li>iv. giving advice in relation to the allotment of securities, or the acquisition or</li> </ol> </li> </ol>

	<p>disposal of, or investment in, any securities, structured product, futures contract, leveraged foreign exchange contract, or an interest in any securities, structured product, futures contract, leveraged foreign exchange contract or collective investment scheme; or</p> <p>v. any transaction involving securities margin financing;</p> <p>b. market misconduct may have taken place;</p> <p>c. the manner in which a person has engaged or is engaging in any of the activities referred to in paragraph (a)(i) to (v) is not in the interest of the investing public or in the public interest.</p> <p>Once an investigation under section 182 of SFO has been started, the powers under section 183 of the SFO become available. Under section 183 of the SFO, the SFC has the power to compel both unregulated and regulated natural and non-natural persons to produce information and documents relevant to the investigation, including bank records, telephone and any electronic records. This power applies to both persons under investigation or whom the SFC has reasonable cause to believe has information relevant to the investigation.</p> <p>The SFC has the power to compel regulated and unregulated individuals to attend interviews and provide statements (section 183 of SFO) – see further below.</p> <p>The SFC also has power to apply to the court for search warrants to be executed at the premises of both supervised and unregulated natural and non-natural persons, including listed companies (section 191 of SFO).</p> <p><b>SFC Power to require information</b></p> <p>As described under Principle 10, SFC has broad powers to obtain records and information from regulated entities and other persons, including details about the owners and beneficiaries of transaction accounts, dealing instructions, transactions etc.</p> <p>Section 183 of the SFO allows the SFC when conducting an investigation to compel the production of information and documents relevant to its investigation, including contemporaneous records sufficient to reconstruct all securities and derivatives transactions, including records of all funds and assets transferred into and out of bank and brokerage accounts relating to those transactions. The information gathering power under section 183 of the SFO is wide and applies to both regulated and unregulated persons and entities.</p> <p><i>Telecommunications data</i></p> <p>Using its powers under section 183, the SFC has access information from telecommunications providers, such as information about whether telephone calls between parties under investigation and others have occurred.</p> <p><i>Bank records</i></p> <p>Under section 183(4) of the SFO, the SFC can require a bank to disclose any information or produce to the SFC any record or document relating to the affairs of a customer where the SFC is satisfied that:</p>
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- a. the customer is a person whom the SFC has reasonable cause to believe may be able to give information relevant to the investigation; and
- b. this disclosure or production is necessary for the purposes of the investigation and certifies in writing that this is the case.

*Power to compel a person to provide information*

Under section 183(1) of the SFO, the SFC has the power to require a person under investigation or any person whom the SFC believes has in possession or under his control the relevant information to attend an interview and answer truthfully and to the best of his ability such questions relating to the matters under investigation as the SFC investigator may put to him (regardless of whether the person is regulated and unregulated by the SFC, and regardless of whether he is a suspect or a witness).

Individuals must answer questions but may claim privilege in respect of the information they provide so that answers they give may not be used in evidence against them in subsequent criminal proceedings.

SFC can also require the interviewee to:

- a. verify the statements so made in the interview by statutory declaration; or
- b. verify by a statutory declaration that he was unable to provide information required because the information was not within his knowledge or was neither in his possession nor under his control (sections 183(2) and (3)).

**HKMA powers of investigation**

HKMA powers to investigate are contained in:

- Section 55, 63(2) and 72A(2) of the BO which empower the HKMA to conduct examination and investigation of the books, accounts and transactions of AIs and to require ReIs and EOs to submit information to the HKMA; and
- Section 180(1)(c) of the SFO which gives similar powers to the HKMA to make inquiries of (i) an intermediary or an associated entity, (2) a related corporation of the intermediary or the associated entity, (3) any other person, whether or not connected with the intermediary or the associated entity, whom it has reasonable cause to believe has information relating to, or is in the possession of, any record or document relevant to the investigation. These persons are required under section 180(4) to give access to such record or document and produce the record and document and answer any question raised by the HKMA.

Under the BO or the SFO the HKMA does not have some of the investigation powers available to the SFC under section 183 of the SFO, such as the power to compel a regulated or unregulated person to give a written statement.

Senior staff from the HKMA indicated that the absence of this power does not constitute a limitation in practice, given that under the current legal framework the enforcement function in connection with breaches arising from the securities markets activities of banks belongs to the SFC (as will be explained below).

**SFC enforcement powers**

As indicated above, the SFC is the main authority in charge with taking enforcement actions for breaches to the securities laws. The SFC has a range of enforcement powers to take criminal, MMT, civil, administrative and other actions.

*Criminal prosecutions*

The SFC has power to initiate criminal prosecutions at the Magistrates' Court for offences which are to be tried summarily (section 388(1) of the SFO). For more serious offences triable on indictment, the SFC refers the cases to the DoJ. Article 63 of the Basic Law provides that the DoJ has overall control over criminal prosecutions, free from any interference.

Many breaches of the SFO are criminal offences, including:

- a. market misconduct – there are six types of misconduct, including insider dealing, false trading, price rigging, disclosure of information about prohibited transactions, disclosure of false or misleading information inducing transaction, and stock market manipulation (Part XIII and Part XIV of the SFO);
- b. the conduct of unauthorized markets (e.g. section 19(1));
- c. unauthorized offers of investment products (section 103(1)); and
- d. unlicensed conduct of regulated activities (section 114).

Under the legislation, all market misconduct offenses are indictable offenses and thus can be tried either summarily or upon indictment. Offences tried as summary offences carry lighter penalties than those tried on indictment. For example, convictions for market abuse offences carry a maximum penalty of HK\$1 million dollars and 3 years' imprisonment if tried summarily, and HK\$10 million and 10 years imprisonment if tried on indictment (section 303(1) of the SFO). The power to decide the venue of trial is vested in the DoJ.

In addition to the penalties described above, in criminal proceedings the court may:

- a. ban a convicted person from being a director or manager of any listed corporation or from taking part in the management of any listed corporation for a maximum period of 5 years;
- b. ban a convicted person from dealing in securities in Hong Kong for a maximum period of 5 years; and
- c. issue an order recommending that any professional body of which the convicted person is a member to discipline him (section 303 of the SFO).

*MMT proceedings*

For breaches of market misconduct provisions, the SFC can institute proceedings in the MMT (sections 252 and 252A of the SFO). The MMT is an alternative to criminal prosecution for market misconduct offences. Under section 307 of the SFO, the institution of proceedings bars the taking of criminal proceedings against a person in relation to the same conduct.

The MMT is an independent quasi-judicial body established under section 251 of the SFO. It is chaired by a judge or former judge of the High Court who sits with two members. MMT jurisdiction covers all six types of market misconduct listed above, and is empowered to make

various orders. Decisions are reached using the civil burden of proof (i.e., has the case been proven on the balance of probabilities). The SFC can also institute proceedings in the MMT for listed corporations' breaches of the requirements to disclose price sensitive information.

The MMT can make various prohibition and cease and desist orders (section 257 of SFO), but cannot impose fines. It can make a disgorgement order for an amount not exceeding the amount of any profit gained or loss avoided as a result of the market misconduct. The MMT may also give a copy of the report of its proceedings to anybody (such as the SFC) which may take disciplinary action against that person.

Failure to comply with orders made by the MMT is an offence and the maximum sanction is a fine of \$1,000,000 and imprisonment for 2 years (section 257(10) of SFO).

#### *Civil proceedings*

The SFC has the power to initiate civil proceedings by applying to the civil court for injunctive or other remedial civil orders (section 213 of the SFO). These orders include injunction and remedial orders, and any ancillary order which the court considers necessary (including freezing of assets or the appointment of an administrator or receiver). The court can also make an order that a transaction be reversed (in effect a statutory rescission power). The powers under section 213 apply to both regulated and unregulated persons.

The SFC also has the power to apply for orders to remedy unfair prejudice in a listed company, including injunction orders, disqualification orders, order to pay compensation to the company, and order to the listed company to bring action against directors of the listed company (section 214 of the SFO).

The SFC may also present a petition to court for a bankruptcy order against a licensed or registered person or apply to the Court of First Instance for a company to be wound up (section 212 of the SFO).

#### *Administrative/Disciplinary proceedings*

The SFC has administrative power to impose disciplinary sanctions against persons licensed or registered with the SFC. Sections 194 and 196 give SFC the power to take disciplinary action against regulated entities (including LCs and their responsible officers (ROs) and representatives, and RIs and their EOs and ReIs) for failure to supervise properly subordinate personnel whose activities violate the securities laws. These include the power to:

- a. revoke a license or registration wholly or in part;
- b. suspend or partially suspend a license or registration;
- c. revoke approval to be a RO;
- d. suspend approval to be a RO;
- e. prohibit a person from applying for a license or registration;
- f. prohibit a person from applying to become a RO, EO or ReI;
- g. impose a fine (up to the maximum of HK\$10 million or 3 times of the profit gained/loss avoided, whichever is the higher);
- h. reprimand.

	<p>The SFC has power to impose restrictions on a licensed or registered person as regards its business activities or dealing with assets or maintenance of assets (sections 204 to 210 of the SFO).</p> <p>The SFC does not have the power to impose disgorgement or to require compensation of clients that have suffered losses.</p> <p><i>Power to enter remedial agreements</i></p> <p>Section 201(3) of the SFO also gives SFC formal power to enter into an agreement with an LC, and RI or a licensed individual who is the subject of administrative or disciplinary proceedings under section 194, 195, 196 or 197 of the SFO. These agreements allow the SFC to seek undertakings from regulated entities to achieve outcomes it could not achieve under its other statutory powers, notably the payment of compensation and the appointment of auditors to conduct an internal control review. These agreements can be enforced.</p> <p><i>Takeovers Panel</i></p> <p>Under the Hong Kong Takeovers Codes (the Takeovers Code and the Share Repurchase Code), the SFC, acting as the Executive, may refer suspected breaches of the Codes to the Takeovers Panel (a committee of the SFC made up of independent persons). The Panel can inquire into the breach and impose various penalties, such as public censure or “cold shoulder” orders, on regulated entities and individuals (paragraphs 12.1-12.3 of the Introduction to the Takeovers Codes). A cold shoulder order is an order that denies any person who has failed to comply with the Takeovers Codes access to the securities markets for a specified period. The SFC also has the power to impose cold shoulder orders.</p> <p><i>Suspension of trading</i></p> <p>SFC has the power to suspend trading in a security listed on the stock exchange if the SFC believes that:</p> <ol style="list-style-type: none"> <li>there has been inadequate disclosure;</li> <li>it is necessary or expedient to maintain a fair and orderly market;</li> <li>it is in the public interest, the interest of the investing public or appropriate for the protection of investors; or</li> <li>there has been a breach of a condition imposed by the SFC when allowing a previously suspended security to recommence trading</li> </ol> <p>(Rule 9 of the Securities (Stock Exchange Listing) Rules).</p> <p>If an exchange fails to comply with certain statutory requirements, the SFC may direct the exchange to be closed for the transaction of dealings (section 28 of the SFO).</p> <p><b>HKMA enforcement powers</b></p> <p>As indicated above the SFC is the main authority responsible for taking enforcement actions for breaches to securities laws. Thus, in general, the HKMA refers cases involving the securities activities of its regulated entities to the SFC.</p>
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	<p>HKMA has two powers which are specific to its securities regulation functions:</p> <ol style="list-style-type: none"> <li>a. Under section BO 71C of the BO HKMA has the power to consent to the appointment of EOs by RIs. In circumstances set out in the section, which include misconduct by an EO, it may withdraw or suspend that consent after consultation with the SFC;</li> <li>b. Under section 58A of the BO, the HKMA has power to remove or suspend ReIs (staff of RIs engaging in regulated activities) from the register in the prescribed circumstances after consultation with the SFC.</li> </ol> <p>HKMA does not have a power to impose fines on individuals or on ReIs, but it can use “naming and shaming” as a disciplinary measure. Further, as stated above the HKMA can refer cases to the SFC, which in turn can impose fines on executive directors and ReIs of banks in relation to securities breaches under section 196 of the SFO.</p> <p><b>Private rights of action</b></p> <p>Private persons can seek their own remedies for misconduct relating to the securities laws. Under section 281(1) of the SFO, an affected person has the right to bring an action to recover compensation whether the loss arises from having entered into a transaction or dealing at a price affected by market misconduct. There need not be market misconduct proceedings before the MMT and a person need not have been found by the MMT to have engaged in market misconduct to be liable under section 281(1) (section 281(5) of SFO).</p> <p>In addition, section 305 of the SFO gives a person who suffers pecuniary loss as a result of any form of market misconduct the right of civil action to seek compensation.</p> <p>The SFC has power to intervene in proceedings between private litigants (section 385 of the SFO).</p> <p><b>Information sharing</b></p> <p>SFC’s investigatory powers under Part VIII of the SFO are generally sufficient for it to obtain all the information it needs for its investigatory purposes. The SFC rarely has to rely on other authorities in Hong Kong to obtain information for it.</p> <p>As described under the Principles on Co-operation, SFC has broad power to share information with other authorities, including other financial market regulators, the Commissioner of Police, the Commissioner of the ICAC, the MMT and the SFAT, and prosecutorial authorities.</p> <p>Other regulators can provide information to SFC if it is required. In particular, HKMA has power to share information with SFC about RIs and individuals acting for RIs such as EOs and ReIs. Information sharing arrangements are set out in MoUs, but there is no requirement for there to be an MoU for an exchange of information to take place.</p>
Assessment	Fully implemented
Comments	Overall the assessors consider that the regulatory authorities have been given broad licensing, supervisory powers and investigative powers vis-à-vis their respective mandates.

	<p>The assessors acknowledge that the SFC can make use of different avenues to seek enforcement actions, including criminal and MMT proceedings, and civil and administrative/disciplinary proceedings. Further from a formal perspective the enforcement powers afforded to the SFC are in line with the Principles –as they do not require regulatory agencies to have disgorgement or restitution powers. However, there have been practical challenges with the use of these avenues that could have an impact on the effectiveness of enforcement. As this is an issue of effectiveness, rather than formal powers, it has been taken into consideration for the grade of Principle 12.</p> <p>The assessors took note of the difference in investigative and enforcement powers of the HKMA vis-à-vis the SFC. The assessors concur with the HKMA that the absence of broader investigative powers does not create a gap in the system given the current allocation of responsibilities. A similar conclusion applies in connection with HKMA enforcement powers over ReIs and ReIs. While the HKMA cannot impose certain penalties on them, in particular fines, cases can be referred to the SFC which in turn can impose these penalties. Taken altogether the system can be considered “complete”. Therefore, no downgrade was applied. However, the assessors would recommend the authorities consider granting the HKMA with fining powers over EOs and ReIs as this would allow for more efficient prosecution of breaches.</p>												
<b>Principle 12.</b>	The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.												
Description	<p><b>Inspection, surveillance and compliance monitoring</b></p> <p><i>Licensed intermediaries</i></p> <p>SFC’s general approach to supervision of intermediaries is set out in the SFC’s publicly available Approach to Supervision. How it uses its powers to carry out supervision of licensed entities, including its risk-based approach, is described under Principles 24 and 31. HKMA’s approach to supervision of RIs is also described in detail under Principle 31.</p> <p>SFC and HKMA use both robust off site monitoring and regular on-site inspections. SFC regularly carries out thematic inspections as well as routine and for-cause inspections. HKMA has focused heavily in recent years on the selling practices of RIs in the distribution of investment products, including products such as ILAS that do not fall under the definition of securities under the SFO.</p> <p><b>Referrals to Enforcement Division resulting from SFC on-site inspections and off-site monitoring</b></p> <table border="1" data-bbox="410 1675 1417 1818"> <thead> <tr> <th></th> <th><b>2008/ 2009</b></th> <th><b>2009/ 2010</b></th> <th><b>2010/ 2011</b></th> <th><b>2011/ 2012</b></th> <th><b>2012/ 2013</b></th> </tr> </thead> <tbody> <tr> <td><b>Referrals to Enforcement</b></td> <td>19</td> <td>34</td> <td>27</td> <td>22</td> <td>29</td> </tr> </tbody> </table> <p><i>Source: SFC</i></p>		<b>2008/ 2009</b>	<b>2009/ 2010</b>	<b>2010/ 2011</b>	<b>2011/ 2012</b>	<b>2012/ 2013</b>	<b>Referrals to Enforcement</b>	19	34	27	22	29
	<b>2008/ 2009</b>	<b>2009/ 2010</b>	<b>2010/ 2011</b>	<b>2011/ 2012</b>	<b>2012/ 2013</b>								
<b>Referrals to Enforcement</b>	19	34	27	22	29								

*Corporate finance*

SEHK reviews all prospectuses and offer documents for listed securities and listed structured products. SFC reviews all IPO prospectuses and listing documents, and, where SEHK asks it to do so, listing documents for listed structured products and debt securities, including where listing is sought for novel structured products or debt securities. In many cases the disclosure is improved as a result of these reviews. SFC directly monitors issuers' obligations to disclose inside information, disclosure of substantial shareholdings, related derivatives and short positions, and directors and executives shareholdings.

SFC staff, as the Takeovers Executive, review all documentation relating to takeovers and other changes of control transactions.

Financial statements of issuers are reviewed by HKEx, HKICPA and the FRC on a risk based selection process (see under Principle 18).

*Investment activity*

All disclosure documents for investment products, including CIS, structured products, ILAS and MPF products are reviewed by the SFC's Investment Products Division.

**Unusual transactions on regulated markets**

The SFC uses dedicated automated systems, using adjustable parameters, to detect any unusual orders and transactions. A specialized team of staff within the SFC monitors and follows up exception reports generated by these systems. A 2001 MoU between the HKEx and SFC sets out arrangements and procedures for facilitating the performance of each organization's functions. SFC has real time electronic access to HKEx's SMARTS system, and to daily Market Surveillance System (MSS) data containing trading and other information; and for options and futures trading SFC has real time access to HKEx's CIBOIS terminal and a daily data feed.

**Requirements for supervisory and compliance systems**

Intermediaries (LCs and RIs) are required to have adequate supervisory and compliance systems. In particular, paragraph 14.1 of the Code of Conduct for Persons Licensed by or Registered with the SFC (Code of Conduct) requires the senior management of intermediaries to manage properly the risks associated with their business, including by performing periodic evaluation of its risk management processes.

Part I of the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC (ICG) requires an effective management and organizational structure which ensures that the operations of the business are conducted in a sound, efficient and effective manner to be established, documented and maintained. It requires that there are regular and effective communication within the firm which ensures that management is continually and timely apprised of the status of the firm's operations and financial position, including qualitative and quantitative risks posed or weaknesses detected, non-compliance with legal and regulatory requirements, and the overall adherence to the firm's defined

	<p>business objectives.</p> <p>Part V of the ICG requires intermediaries to have policies and procedures to ensure the firm's compliance with all applicable legal and regulatory requirements and the firm's internal policies, and sets out detailed requirements for the policies and procedures, and organizational arrangements. These include, where practicable, an independent compliance function.</p> <p>For further details, see under Principle 31.</p> <p>SFC tests the adequacy of these arrangements, and their functioning in practice, in on-site inspections.</p> <p><i>Supervision of employees</i></p> <p>Under Paragraph 4.2 of the Code of Conduct (Capabilities – Staff supervision), a licensed or registered person must ensure that it has adequate resources to supervise diligently and does supervise diligently persons employed or appointed by it to conduct business on its behalf.</p> <p>Sections 194 and 196 give SFC the power to take disciplinary action against regulated entities and their management for failure to supervise properly subordinate personnel whose activities violate the securities laws. These powers under these section is described in Principle 11</p> <p><b>Mechanisms to detect and investigate insider trading and other forms of market abuse</b></p> <p>The SFC has a team in the Enforcement Division dedicated to market surveillance. They use specialized systems with adjustable parameters to monitor market activity and staff review and follow-up exception reports in real time. The team also holds daily and regular meetings to discuss market news and intelligence. If staff members consider further enquiries should be made, they prepare a recommendation for the head of the team, who may commence a formal enquiry under section 181 of the SFO to seek details about the identity of persons involved in and other details about the trade.</p> <p>If, after a section 181 enquiry, it is considered that there is suspicion of market or price manipulation, the RO of surveillance team will prepare a case assessment report to set out the suspicions and recommend referring the matter to the Division's investigation team.</p> <p><b>Intelligence and investor complaints</b></p> <p>Intelligence received by the SFC is logged in its Investigation Management System. The Investigation Management System is a case management and intelligence system that provides an integrated platform for users to create, maintain and enquire about cases. It also provides electronic filing function for case related documents and for intelligence database.</p> <p>All public complaints received are logged in the Investigation Management System by the External Relations Department of the SFC, along with a summary of the complaint prepared by officers that department.</p>
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Complaints are tabled at the Complaints Control Committee (CCC), which meets weekly. The CCC is comprised of senior executives from each operational division and is chaired by the Senior Director of Corporate Affairs. During the meeting, the CCC discusses, assesses and decides how each complaint should be dealt with, for instance whether further enquiries should be made by Intermediaries Supervision, or an investigation should be commenced by Enforcement. Minutes of the meetings are distributed to the Complaints Liaison Officers of each division, who log the case and send details to the case officers assigned for further action.

SFC also receives intelligence from the Joint Financial Intelligence Unit of the Hong Kong Police Force (JFIU), other domestic law-enforcement agencies and overseas regulators. The JFIU manages the suspicious transaction reports (STRs) regime for Hong Kong and its role is to receive, analyse and store STRs and disseminate them to the appropriate investigative unit. When SFC receives referrals from JFIU or other agencies and regulators, the intelligence is logged and an assessment prepared. The assessment is referred to senior management to decide if further action is warranted, such as commencing a formal investigation.

### **SFC Enforcement**

#### *Investigations*

Enforcement at SFC has four teams - Surveillance, Investigation, Disciplinary, and Policy & International. As of August 2013, there are 145 staff members in Enforcement. Enforcement staff members come from multidisciplinary backgrounds with legal, accounting, finance and forensic and investigative skills. The SFC's Legal Services Division provides professional legal advice and support. The IT Department also has a team of forensic IT experts who provide assistance to investigators.

When an SFC division detects possible breaches of regulatory requirements in their inspections or other monitoring activities, they assess the matter and may recommend referring the case to Enforcement for investigation. The SFC has internal criteria to assist staff members to make decisions about what should be referred.

If, after gathering information through use of sections 180 or 181 of the SFO, the SFC suspects an actionable breach of legislation, code or guideline may have occurred (such as market or price manipulation, intermediary misconduct or the unauthorized conduct of regulated business), the relevant SFC staff member prepares a case assessment report to set out the suspicions and recommend referring the matter to the investigation team in Enforcement. The case assessment report is considered by the Enforcement Steering Committee (ESC) of the SFC which is comprised of senior executives from the investigation, surveillance, policy & international and disciplinary teams in Enforcement. ESC meets weekly. Once approved by ESC, the investigation can be commenced under section 182 of the SFO.

The investigation case officer then prepares an investigation plan, which sets out the detailed investigations steps, timeline and resources required to complete the investigation. This plan is also presented to the ESC.

Once the investigation plan is approved by the ESC, a section 182 Direction to Investigate is

issued by a senior executive (Director or above) in the investigation team. A team of investigation staff is appointed and these officers are empowered to exercise SFC's investigative powers to elicit evidence, including those under section 183 of the SFO (such as compelling the production of information and documents, and compelling the attendance of interviews and taking of statements). In urgent cases, a section 182 direction authorising investigation can be issued before the ESC approves an investigation plan under the authorization of the most senior staff within Enforcement.

ESC receives regular reports about the progress of investigations and monitors and gives directions as an investigation proceeds.

When an investigation has gathered enough evidence to show that there is an actionable breach of the legislation, code or guideline, a decision is made about what action should be taken.

#### Number of SFC investigations – by type of misconduct

Financial year	2009-2010		2010-2011		2011-2012		2012-2013	
Nature	Opened	Completed	Opened	Completed	Opened	Completed	Opened	Completed
Corporate governance issues	19	14	27	19	28	16	27	22
Disclosure of interests	26	16	23	27	23	24	22	18
Insider dealing	23	21	28	24	33	20	37	28
Intermediary misconduct	68	73	63	47	74	58	65	68
Market manipulation	50	34	35	36	58	33	51	59
Unlicensed activities	44	26	32	46	18	17	19	17
<b>Total</b>	<b>230</b>	<b>184</b>	<b>208</b>	<b>199</b>	<b>234</b>	<b>168</b>	<b>221</b>	<b>212</b>

Source: SFC

#### Enforcement remedies - strategy

As a general principle, SFC's approach is that if the evidence suggests a criminal offence can be proved, it will not take administrative or civil proceedings as a substitute for taking criminal action. In important cases, both types of remedy may be necessary and are used.

SFC does not have a power, as part of a formal disciplinary process against an intermediary, to require it to compensate clients for losses resulting from the intermediary's misconduct (such as mis-selling). The maximum fine it can impose in disciplinary proceedings is only HK\$10 million or 3 times of the profit gained/loss avoided, whichever is higher. It has therefore

adopted a policy that, where client losses are significant, it is prepared to use its power under section 201 of the SFO to enter into agreements with an intermediary to achieve client compensation and other remedial actions (such as the appointment of independent experts to review internal controls, compliance systems etc). To reach agreement, it has proved necessary for the SFC to agree not to take formal disciplinary action in these cases. The fact of these agreements and their contents are made public.

*Enforcement remedies – criminal enforcement*

The current SFO came into operation on 1 April 2003. The SFC and the DPP agreed in 2007 that the SFC would refer the more serious cases and in particular those related to market misconduct to the DPP. In practice, SFC submits a brief of evidence and often a recommendation as to whether the case should be prosecuted by the DPP in the District Court or a higher court, or by the SFC in the Magistrates Court.

The DPP reviews the evidence provided by the SFC and in each referral makes a decision as to whether a prosecution should be initiated in accordance with the prevailing prosecution policy (currently called "Prosecution Code") and if so, whether the case should be tried summarily in the Magistrates Court (with jurisdictional limit of 3 years' imprisonment for market misconduct cases) or on indictment in the District Court or above. In this process, the DPP will advise on the sufficiency of evidence contained in the brief. If the DPP decides that the trial venue should be the Magistrates Court then the case is referred back to the SFC to conduct the prosecution. If the DPP decides that the trial venue should be the District Court or above, then the DoJ will prosecute the case. Among the criteria used for this decision is whether in the DPP's view there is a reasonable prospect of conviction, whether it is in the public interest to initiate a prosecution and whether it is likely that the sentence will be one only a higher court can impose. These criteria are set out in detail in the established and published prosecution policy known as the Prosecution Code. (See DoJ's official website at <http://www.doj.gov.hk/eng/index.html> for the current Prosecution Code.) Similar arrangements are in place between the DoJ and other law enforcement agencies such as the Police, the ICAC and the Customs and Excise Department, albeit in these cases the DoJ conducts all the prosecutions. The DoJ considers these arrangements a healthy check and balance on the law enforcement agencies required in a democratic society.

In the first few years after these arrangements commenced, the DPP prosecuted a number of cases on indictment and some substantial prison sentences were achieved (including a sentence of six years for insider trading). However, in the last 2 years or so, the former DPP has decided not to prosecute any new cases on indictment as the DPP was of the view that none of the cases warranted such a course. The former DPP highlighted that the subsequent sanctions imposed by the magistrates were well within the maximum limits available to the Magistrates courts. The SFC disagreed with this assessment, and considered that the relatively low sentences were just a reflection of the limited jurisdiction of the courts rather than the degree of general deterrence required for such offences. Further, the SFC noted that market misconduct cases are complex, and, that in recent cases, the SFC has had to appeal what it considered to be poor decision by magistrates, with the High Court sending back the cases to magistrates for retrial. In its opinion this demonstrates that these cases should be decided by courts that are experienced in handling difficult cases.

These differences in opinions resulted in a very public disagreement between the SFC and the former DPP. The SFC and the current DPP are taking constructive steps to strengthen coordination.

#### Number of SFC cases referred to DOJ

	2008	2009	2010	2011	2012	2013 Up to 6 Sept
Number of cases referred	10	13	17	17	9	5
Number of cases DPP decided to prosecute on indictment	3	3	1	1	0	0

#### Number of SFC cases prosecuted by DOJ

	2008	2009	2010	2011	2012	2013
District Court cases (date of plea)	5	1	1	-	-	-
Convictions (date of conviction)	-	3	2	-	1	-
Acquittals	-	-	-	-	1	-

Source: DoJ

#### Number of SFC cases prosecuted – by offence category

	2008	2009	2010	2011	2012	2013
Market manipulation	2	1	1	-	-	-
Insider dealing	2	-	-	-	-	-
Other	1	-	-	-	-	-

Source: DoJ

**Charges, convictions, imprisonment and acquittals in higher courts**

	2008	2009	2010	2011	2012	2013
Number of people charged	13	1	1	-	-	-
Number of people convicted	-	11	4	-	1	-
Number of people sentenced to imprisonment	0	8	4	-	1	-
Number of people acquitted	-	-	-	-	1	-

*Note:* The total number of people convicted is larger than the total number of people charged because one person was convicted in two separate cases in two years.

*Source:* DoJ

The SFC emphasized that it has conducted over 300 criminal prosecutions in the Magistrates Courts in the period from January 2007 to March 2013. While many of such cases involve relatively minor criminal offences, including some strict liability offences such as the failure to lodge a disclosure notice on time, 50 of such cases involve more serious securities crimes (insider dealing and market manipulation). Out of such 50 cases, in 21 imprisonment sentences were ordered, of which (i) 16 involve sentences of less than 6 months, (ii) 4 of less than 1 year and (iii) 1 case a sentence between 1 and 2 years. Immediate custodial sentences were only imposed in 4 cases, and suspended sentences in 17.

**Number of entities on trial and convicted**

<b>Criminal Proceedings</b>	2008/09	2009/10	2010/11	2011/12	2012/13
No. of entities (individuals and non-natural persons) on trial	36	35	52	40	40
No. of entities convicted	33	32	51	37	36
No. of entities acquitted	3	3	1	3	4

*Enforcement remedies – civil*

The following tables illustrate SFC's activity in using civil remedies.

**Applications for civil remedies - by type of remedies sought**

	<b>2008/09</b>	<b>2009/10</b>	<b>2010/11</b>	<b>2011/12</b>	<b>2012/13</b>
Injunction and other remedial orders (section 213 of SFO)	6	24	6	5	6
Listed companies: banning and other remedial orders (section 214 of SFO)	9	10	6	13	8
Others	2	3	1	0	2
<b>Total</b>	<b>17</b>	<b>37</b>	<b>13</b>	<b>18</b>	<b>16</b>

*Source: SFC*

**Court orders granted**

	<b>2008/09</b>	<b>2009/10</b>	<b>2010/11</b>	<b>2011/12</b>	<b>2012/13</b>
Section 213 orders	1	2	1	0	7
Section 214 orders	2	9	5	13	5
Others	2	3	1	0	0
<b>Total</b>	<b>5</b>	<b>14</b>	<b>7</b>	<b>13</b>	<b>12</b>

*Source: SFC*

These civil cases deal with insider dealing, market manipulation, failures by listed companies to keep the market properly informed, undisclosed related party dealings and other breaches of duty by listed company directors. The SFC has secured various orders under this route including rescission orders to reverse the consequences of misconduct. For instance, in the Hontex case, a section 213 of SFO proceeding, the SFC secured orders reversing the share subscriptions of several thousand investors who had subscribed for shares on the basis of a prospectus that contained false or misleading information. Around HK\$1 billion was returned to shareholders under these court orders.

*Enforcement remedies – administrative***SFC disciplinary actions****Number of licensees disciplined****By type of misconduct**

<b>Type of Misconduct</b>	<b>2008/09</b>	<b>2009/10</b>	<b>2010/11</b>	<b>2011/12</b>	<b>2012/13</b>
Improper trading activities in breach of Code of Conduct	5	13	8	3	2
Other trading malpractices	6	9	7	1	2
Internal control weaknesses	21	8	9	9	5
Misappropriation	5	3	1	2	3
Facilitating unlicensed activities	0	6	1	7	0
Breach of client identity rules	0	1	7	2	1
Corporate finance related matters	6	1	0	0	3
Breach of Financial Resources Rules	0	2	2	2	0
Other miscellaneous misconduct	11	15	13	12	12
<b>Total</b>	<b>54</b>	<b>58</b>	<b>48</b>	<b>38</b>	<b>28</b>

*Note:* Licensees includes individuals, such as representatives, as well as LCs.

*Source:* SFC

**Fines and costs recovered from defendants****SFC disciplinary actions****(\$HK)**

<b>Type</b>	<b>2008-09</b>	<b>2009-10</b>	<b>2010-11</b>	<b>2011-12</b>	<b>2012-13</b>
Disciplinary fines	63,648,652	26,125,496	21,438,800	35,210,000	83,500,000
Prosecution fines	1,519,000	25,032,535	677,000	1,159,000	1,420,455
MMT - fines	7,981,156	-	74,474	-	21,167,913
MMT - costs orders	7,792,470	6,780,013	1,800,863	4,180,270	8,365,043
<b>Total</b>	<b>80,941,278</b>	<b>57,938,044</b>	<b>23,991,136</b>	<b>40,549,270</b>	<b>114,453,411</b>

*Source:* SFC

The SFC has meted out fines ranging from HK\$100,000 to HK\$6 million for corporations and from HK\$1,500 to \$1.46 million for individuals. In three cases the fines exceeded HK\$10 million. These cases involve multiple and separate acts of misconduct.

**MMT Proceedings**  
(insider dealing, market manipulation, etc)

<b>Number of people found culpable by MMT</b>	<b>2008/09</b>	<b>2009/10</b>	<b>2010/11</b>	<b>2011/12</b>	<b>2012/13</b>
Insider dealing	3	3	2	1	2
Market manipulation	6	0	0	0	2
Disclosure of false or misleading information	3	0	0	0	0
<b>Total</b>	<b>12</b>	<b>3</b>	<b>2</b>	<b>1</b>	<b>4</b>

*Source: SFC*

*Use of agreements under section 201 of the SFO*

A number of large compensation agreements have been entered into using section 201 of the SFO. For example, from 2008 to 2011, compensation payments of around HK\$10 billion were made to clients of distributors of Lehman related investment products. In two separate cases in 2012, parties agreed to make compensation to clients of more than HK\$85 million.

**HKMA enforcement**

HKMA's Enforcement Department deals with investigation and enforcement actions in relation to AIs, including those who are RIs. The Department consists of approximately 100 people. It currently has around 800 outstanding cases. Some of these are general banking complaints, but most are investigations into mis-selling by AIs and RIs of investment products, including securities and ILAS.

Cases are referred to the Enforcement Department by the Banking Conduct and other supervisory areas of the HKMA. Criteria used for referrals include whether the offending conduct is continuing, the number of complaints received and the impact on customers.

In conducting investigations, HKMA routinely uses both its powers under the BO and powers under section 180 of the SFO.

Because of the current allocation of responsibilities, enforcement of breaches of conduct rules by firms and by former EOs and ReIs are dealt with by the SFC, and HKMA focus on current EOs and ReIs. HKMA enforcement staff will ordinarily carry out the investigation of all conduct, and then pass appropriate cases to the SFC. Procedures for the referral of cases and their investigation were set up as a result of the commencement of the SFO in 2003. HKMA Enforcement Department handles the cases in accordance with the Disciplinary Procedures Manual, which mirrors the SFC procedures as far as practicable. In general, HKMA

	<p>Enforcement will assess the information available and submit the case to an internal standing committee (Event Review Committee) to decide whether an investigation should be opened. If the Event Review Committee considers it appropriate to open an investigation, HKMA Enforcement will notify the SFC and keep the SFC informed of the progress and result of the investigation.</p> <p>In determining whether to take a disciplinary action and the level of disciplinary sanctions, the Disciplinary Committee of the HKMA applies the criteria set out in the Disciplinary Proceedings at a Glance issued by the SFC and consider the actions taken by the SFC or the HKMA in precedent cases.</p> <p>HKMA's Enforcement Department is still dealing with a large backlog of cases from the Lehman's issue, but is in the process of reducing that backlog. It is also streamlining procedures in the light of its experience in dealing with these cases.</p> <p><b>HKMA referrals to SFC</b></p> <table border="1" data-bbox="451 789 1373 953"> <thead> <tr> <th></th> <th>2010</th> <th>2011</th> <th>2012</th> <th>To August 2013</th> </tr> </thead> <tbody> <tr> <td>Number of referrals</td> <td>691<sup>1</sup></td> <td>7</td> <td>22</td> <td>12</td> </tr> </tbody> </table> <p><sup>1</sup> Lehman minibond related referrals Source: HKMA</p> <p>A number of these referrals resulted in significant enforcement remedies being obtained by the SFC.</p> <p><b>Mechanisms in place that seek to ensure consistent outcomes at the enforcement level</b> There are several mechanisms designed to ensure consistent outcomes, as described below:</p> <ul style="list-style-type: none"> <li>• Under the law, the HKMA will consult the SFC before exercising disciplinary powers or refer the cases to the SFC for taking disciplinary actions. Similarly if the SFC initiates an investigation or proposes to impose disciplinary sanction on a registered institution (RI) or its staff, the SFC will consult the HKMA.</li> <li>• The SFC and the HKMA will exchange views and share information on major investigations cases from time to time during regular MoU meetings.</li> <li>• For cases closed by the HKMA the SFC may from time to time, review samples of such cases to ensure consistency of standards</li> <li>• In addition, persons aggrieved by a decision of the SFC or the HKMA may apply to the SFAT for review. Decisions of both authorities are also subject to the review of the Office of the Ombudsman, the Court of Appeal as well as judicial review (where appropriate) depending on the subject matter of the decision.</li> </ul>		2010	2011	2012	To August 2013	Number of referrals	691 <sup>1</sup>	7	22	12
	2010	2011	2012	To August 2013							
Number of referrals	691 <sup>1</sup>	7	22	12							
Assessment	Broadly implemented										
Comments	The grade for this Principle stems from challenges to the effectiveness of the enforcement process in connection with Q 9 of the Methodology.										

	<p>There are two key considerations.</p> <p>The first concerns the effectiveness of the system in producing robust outcomes in cases of serious misconduct, especially market misconduct, such as market manipulation and insider trading.</p> <p>As indicated in the description, there has been a public disagreement between SFC and the former DPP in connection with the handling of criminal cases, and in particular whether the cases referred met the threshold to be prosecuted in higher courts –which could lead to higher sentences. The SFC and the current DPP are taking constructive steps to strengthen cooperation on matters of enforcement.</p> <p>The assessors acknowledge that the DPP should be free to decide on prosecutorial matters and that, as the DoJ commented, the independent exercise of its prosecutorial powers is a healthy and necessary check and balance on law enforcement agencies. Further, it is not the assessors' role to assess the adequacy of DPP decisions.</p> <p>Looking strictly from an outcomes perspective, the assessors note that criminal enforcement is being used; however what is a cause of concern is that the strong deterrence message that it should have might not be effectively conveyed, given the relatively low level of sanctions imposed and the fact that, in the majority of the cases, suspended sentences were imposed. The assessors, however, note that in common law jurisdictions such as the Hong Kong SAR, the prosecutors do not seek any particular sentence, and that sentencing is a matter for the court.</p> <p>The second issue affecting the grade goes more to the practical challenges that the SFC faces in connection with 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, and its ability to secure both remedial and punitive actions. As explained in the description, the SFC does not have powers to require disgorgement or restitution. The result is that in cases where client losses are significant, the SFC has used its power under section 201 of the SFO to reach negotiated agreements as a means of securing compensation for affected clients. Some remedial actions such as changes to internal controls and compliance arrangements are often part of the agreement, but it is invariably necessary for the SFC to agree not to take disciplinary action against the LC/RI and its management and staff.</p> <p>This means that, to secure the very proper outcome of ensuring clients are compensated, the opportunity to take disciplinary action has to be foregone. In appropriate cases, it is highly desirable that both routes - compensation and disciplinary sanctions – be available in a practical way to the regulator. Otherwise, the message that the disciplinary sanctions are intended to send is fettered.</p> <p>In addition, the assessors note the backlog of cases at the HKMA, and encourage it to continue its efforts to address this situation.</p> <p>Two other matters should be mentioned in this Principle.</p>
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	<p>The cross border character of Hong Kong’s financial markets and in particular its close interactions with the Mainland pose significant and continuing challenges in maintaining a robust and effective enforcement process. The challenge results not from a lack of willingness to act on the part of both Hong Kong and Mainland regulators and authorities. It relates more to the inherent complexity of running enforcement cases in this environment, such as obtaining evidence in a country as large and diverse as the Mainland, and the interaction between two systems of law. This is and will continue to be an important issue for the effectiveness of the enforcement process as a whole in the Hong Kong securities markets.</p> <p>Because responsibility for supervision of securities market activity by intermediaries is divided between SFC and HKMA, it is important to ensure a level playing field between the banks supervised by HKMA and the securities firms supervised by SFC. To achieve this, there needs to be a high level of transparency between the regulators and a continuing flow of information about regulated entities and supervisory strategies. There also needs to be a high level of confidence that the same approach is taken in response to non-compliance with obligations. There appears to be a good flow of information between SFC and HKMA. However, it is important that from time to time an assessment is made to ensure that consistency is being achieved in practice.</p>
<p><b>Principles for Cooperation in Regulation</b></p>	
<p><b>Principle 13.</b> The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.</p>	
<p>Description</p>	<p><b>Domestic information sharing and co-operation</b></p> <p>Section 378 of the SFO imposes an obligation on SFC and its staff to preserve the secrecy of information that comes into its possession in the performance of its functions. This obligation is subject to exceptions. These exceptions give the SFC authority to share information with a variety of domestic authorities including:</p> <ul style="list-style-type: none"> <li>• prosecutorial authorities (section 378(2)(b))</li> <li>• a variety of financial regulators such as HKMA, the IA and MPFA (section 378(e) and (f));</li> <li>• the MMT and the SFAT (section 378(3)(c) and (d)); and</li> <li>• a recognized exchange company, a recognized clearing house, a recognized exchange controller and a recognized investor compensation company (section 378(3)(f).</li> </ul> <p>Information in the SFC’s possession that can be shared includes information about:</p> <ul style="list-style-type: none"> <li>• matters of investigation and enforcement;</li> <li>• determinations in connection with licensing and authorization;</li> <li>• surveillance;</li> <li>• market conditions and events;</li> <li>• client identification, including beneficial ownership information;</li> <li>• regulated entities; and</li> <li>• listed companies and companies seeking listing;</li> </ul> <p>This information can be shared without the need for external approval.</p> <p>SEHK is also bound by the secrecy provisions in section 378 relation to its supervisory functions under the legislation. It has more limited power to share this information but can</p>

provide it to prosecutorial authorities and others mentioned in sections 378(2) of the SFO, as well as to SFC. To share information in these circumstances, it does not require SFC's approval.

### **International information sharing and cooperation**

The SFC is responsible for responding to all requests for information from foreign regulators in the area of securities markets.

Section 378(3)(g) of the SFO permits SFC to share any information in its possession with foreign regulators. To do so, SFC must be satisfied that the overseas regulatory authority:

- performs a function similar to a function of the SFC or the Registrar of Companies, or regulates, supervises or investigates banking, insurance or other financial services or the affairs of corporations; and
- is subject to adequate secrecy provisions (section 378(6) of the SFO).

The SFC can only disclose information to an overseas regulatory authority if satisfied that :

- the information is disclosed in the interest of the investing public or the public interest; or
- the disclosure will enable or assist the overseas regulatory authority to perform its functions and it is not contrary to the interest of the investing public or the public interest that the information should be so disclosed (section 378(5) of the SFO).

In practice, overseas requests are likely to satisfy the second of the two alternatives. Using this provision, SFC can share all the information described above under domestic information sharing.

#### *External approval*

No external approval is required for the SFC to share information in this way.

### **Unsolicited information**

SFC can provide information to domestic and foreign regulators on an unsolicited basis.

### **No requirement for breach of domestic laws**

SFC can share information with foreign counterparts even if the alleged conduct would not constitute a breach of the laws of Hong Kong if conducted within Hong Kong. There are no "dual illegality" requirements for information sharing under section 378(3)(g)(i) of the SFO or for investigatory cooperation under section 186 of the SFO.

### **Bank account information**

SFC can share with domestic regulators information and records identifying the person or persons beneficially owning or controlling bank accounts related to securities and derivatives transactions and brokerage accounts as well as the information necessary to reconstruct a transaction, including bank records (sections 378(2)(b), (3)(e), (3)(f), (3)(g)(ii) and 378(3)(i) of SFO).

	<p>Using 378(3)(g)(i) of the SFO, SFC can also share information of this kind with foreign regulatory organizations.</p> <p><b>Confidentiality</b></p> <p>See under Principle 14.</p>
Assessment	Fully implemented
Comments	
<b>Principle 14.</b>	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.
Description	<p><b>Power to enter into information sharing agreements</b></p> <p>Section 5(1)(h) of the SFO provides that one of the functions of the SFC is to co-operate with and provide assistance to regulatory authorities or organizations, whether formed or established in Hong Kong or elsewhere. To carry out this function, the SFC can, and has, entered into MoUs with both domestic and foreign regulators.</p> <p><b>Information sharing mechanisms</b></p> <p><i>Domestic</i></p> <p>SFC has entered into MoUs with HKMA, HKEx and IA. It is also a party to an MoU between the MPFA, SFC, IA and HKMA on the regulation of MPF intermediaries, and a tripartite MoU with the HKMA and the FDRC.</p> <p><i>International</i></p> <p>SFC has been a full signatory to the IOSCO MMoU since March 2003. In addition, it has entered a large number of bilateral MoUs and other information sharing arrangements with foreign regulators: 37 MoUs, 11 confidentiality understandings or arrangements, and nine market or product-related arrangements with foreign securities regulators.</p> <p><b>Confidentiality</b></p> <p>The legislation provides for the confidentiality of information shared by, and received by, the SFC to be maintained, other than in specified circumstances.</p> <p><i>Domestic regulators</i></p> <p>Under section 378(7) of the SFO, domestic authorities receiving confidential information from the SFC must not disclose except if:</p> <ol style="list-style-type: none"> <li>the SFC consents to the disclosure;</li> <li>the information or the part thereof (as the case may be) has already been made available to the public;</li> <li>the disclosure is for the purpose of seeking advice from, or giving advice by, counsel or a solicitor or other professional adviser acting or proposing to act in a professional</li> </ol>

- capacity in connection with any matter arising under any of the relevant provisions;
- d. the disclosure is in connection with any judicial or other proceedings to which the person or the recipient is a party; or
- e. the disclosure is in accordance with an order of a court, or in accordance with a law or a requirement made under a law.

#### *Foreign regulators*

Section 378(6)(b) of the SFO requires that before the SFC discloses non-public information to foreign regulators, the SFC has to be satisfied that the foreign regulator is subject to adequate secrecy provisions.

To satisfy this requirement, the SFC assesses the secrecy provisions before disclosing non-public information to a foreign regulator. For those regulators with which the SFC has co-operative agreements, this assessment is performed during the negotiation stage of bilateral co-operative arrangements or by the IOSCO MMoU Screening Group (for IOSCO MMoU signatories). For those regulators with which the SFC does not have co-operative arrangement, the SFC will assess the secrecy provisions of the foreign regulator on a case-by-case basis.

For every disclosure, the SFC specifies the permissible use of the information disclosed and reminds the recipient authority of its duty to preserve the confidentiality of the information and that prior written consent from the SFC is required before any onward disclosure by the recipient overseas authority other than in the circumstances set out in the IOSCO MMoU or the bilateral co-operative agreement.

#### *SFC*

Information received by the SFC from foreign regulators is subject to the general obligation of confidentiality under section 378(1) of the SFO. If it is required to disclose information contained in the request from a foreign regulator in order to give effect to the request, the SFC will first consult with the requesting authority.

In the event of a legally enforceable demand for disclosure, the SFC will notify the requesting foreign authority prior to making the disclosure, and will make use of available legal exemptions and privileges to resist disclosure.

Recipients of SFC's notices to produce issued under section 183 of SFO, such as banks or brokers, are people assisting the SFC. Under section 378 of the SFO, they too are prohibited from informing their clients about the existence and content of the notice to produce.

#### **Practice**

The International & Policy team in SFC's Enforcement Division handles and acts as the liaison point for requests for assistance from overseas regulators. If investigatory assistance is requested, the International team refers the request to the Investigation team for further actions.

During the three years from 1 April 2009 to 31 March 2012, the SFC handled 306 licensing-

	<p>related requests for assistance from foreign regulators and made 2,879 licensing-related requests for assistance.</p> <p>In the three years from 1 April 2009 to 31 March 2012, the SFC handled 370 requests for assistance, and made 179 requests of assistance to overseas regulators.</p>
Assessment	Fully implemented
Comments	
<b>Principle 15.</b>	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.
Description	<p><b>Assistance to foreign regulators</b></p> <p>Any information that SFC holds or can acquire through the use of its information gathering powers (described under Principle 10) can be shared with foreign regulators. In addition, section 186 of the SFO enable the SFC to use its powers of investigation (sections 182 and 183 of the SFO) to obtain information, including documents and records, and require both regulated and unregulated persons to answer questions and make statements under oath.</p> <p>These powers enable SFC to require the production of books and records that permit the reconstruction of securities and derivatives transactions, and records of funds and assets transferred into and out of banks accounts and details of securities and derivatives transactions.</p> <p><i>Court orders</i></p> <p>SFC cannot obtain court orders (such as injunctive and other remedial orders under section 213 of the SFO) if only a breach of a relevant law in a requesting foreign jurisdiction is suspected or alleged. But it could provide assistance to a foreign regulator in these circumstances, such as assisting a foreign regulator to secure local legal representation.</p> <p><b>No requirement for independent interest</b></p> <p>As noted under Principle 13, the use of SFC's powers to compel the production of documents or to require persons to provide information does not require it to have an independent interest in the subject of a foreign regulator's request for information.</p> <p><b>Information on regulatory processes</b></p> <p>SFC can provide information about regulatory processes, including the authorization process, investigations in progress and sanctions imposed.</p> <p><b>Financial conglomerates</b></p> <p>SFC can provide information in its possession, and use its information gathering and investigation powers to obtain information from regulated entities. Its investigation powers also allow it compel information from unregulated persons. These powers can be used to compel information about financial conglomerates subject to its supervision.</p>

	<p><b>Information from other domestic authorities</b></p> <p>If information is held by other domestic authorities, SFC can assist by asking the relevant authority on a foreign regulator's behalf. Under domestic information sharing arrangements and in accordance with applicable laws, other regulators can supply this information if requested by SFC.</p>
Assessment	Fully implemented
Comments	
<b>Principles for Issuers</b>	
<b>Principle 16.</b> There should be full, accurate and timely disclosure of financial results, risk and other information that is material to investors' decisions.	
Description	<p><b>Background</b></p> <p><i>Market context</i></p> <p>Most Hong Kong listed companies are incorporated outside Hong Kong and are "overseas issuers" under the CO and the Listing Rules. As at 31 January 2013, about 87 percent (1,346 out of 1,555) of Hong Kong listed companies were incorporated outside HK: 11 percent in the Mainland; 42 percent in the Cayman Islands; and 32 percent in Bermuda. A further 2 percent were incorporated in other jurisdictions. Most of the Cayman Islands and Bermuda incorporated listed companies are Chinese companies that have operations and headquarters in Hong Kong or the Mainland.</p> <p>HKEx operates a Main Board, and a Second board, the GEM. Around 200 companies are listed on GEM.</p> <p>Public issues of shares or debt by non-listed entities (other than for structured products) are rare - there were ten issues in the period 2005-2010, most of them bond issues. There have been none since 2010.</p> <p>Structured products issued and traded in HK are mostly equity linked products such as derivatives over stock indices etc.</p> <p><i>Legislative and rule framework</i></p> <p>The CO is the source of the legislative obligation to issue a prospectus for any offer of securities to the public. Although it generally applies only to HK incorporated companies, Part XI (establishment of place of business in HK) and Part XII (prospectuses) specifically apply to overseas companies.</p> <p>Public offers of securities are governed by:</p> <ol style="list-style-type: none"> <li>Parts II and XII of the CO – Part II applies to Hong Kong incorporated companies; Part XII to overseas companies;</li> <li>Part IV of the SFO which applies to public offers of structured products (defined in section 1A of Schedule 1 of the SFO);</li> <li>the Listing Rules of HKEx, being the Main Board listing rules and the GEM listing rules.</li> </ol>

These rules apply to all listed companies, regardless of their place of incorporation, and to listed structured products. Chapter 15A of the Listing Rules deals specifically with structured products.

Overseas issuers seeking a primary listing on the SEHK must satisfy the SEHK that they are incorporated or otherwise established in a jurisdiction where the standards of shareholder protection are at least equivalent to those in Hong Kong. The SEHK accepts Hong Kong, the Cayman Islands, Bermuda and the Mainland, as “Recognized Jurisdictions”. Issuers incorporated in these jurisdictions can meet the equivalence requirement by complying with the additional contents requirements for their constitutional documents set out in Main Board Listing Rule Appendix 13 (GEM Listing Rule Appendix 11).

#### *Regulatory responsibilities*

A prospectus for securities must be authorized for registration and registered with the Registrar of Companies. The SFC is empowered to authorize prospectuses for registration under Sections 38D or 342C of the CO. The formal power to authorize prospectuses offering shares in or debentures of companies that are to be listed has been delegated to the SEHK. The SFC is responsible for vetting and considering applications for authorization to prospectuses in respect of public offers of unlisted shares or debentures. For structured products, SEHK approves listing documents for listed products under the Listing Rules, and SFC approves public offering documents for unlisted products.

Under the “dual filing” regime established by the SMLR, an applicant for listing of its securities for trading on the SEHK must file copies of its listing application with the SFC after it is submitted to the SEHK. The SFC may seek further information about the listing application by asking SEHK to request the information, and may object to the listing if the applicant fails to comply with requirements, if it appears to the SFC that the applicant has supplied false or misleading information in its application, or the listing is not in the interest of the investing public.

The SMLR provides similar dual filing requirements for public announcements and other on-going public disclosure of information by listed corporations pursuant to requirements under the Listing Rules or other applicable laws.

#### **Disclosure requirements**

For securities, the public offering regime includes disclosure and reporting requirements consisting of:

- a prospectus for public offerings of equity and debt securities;
- annual reporting requirements;
- half-yearly reporting requirements;
- for some listed entities, quarterly reporting requirements;
- inside information (material event) disclosure obligations.

#### *Public offerings of securities*

An offer to the public of shares or debentures of a company must be made through a

	<p>prospectus that complies with Part II (for Hong Kong incorporated companies) or Part XII (for foreign companies) of the CO. Requirements for prospectus content are set out in detail in the Third Schedule of the CO. There also is a general requirement that the prospectus must contain sufficient particulars and information to enable a reasonable person to form as a result thereof a valid and justifiable opinion of the shares or debentures and the financial condition and profitability of the company at the time of the issue of the prospectus, taking into account the nature of the shares or debentures being offered and the nature of the company, and the nature of the person likely to consider acquiring them.</p> <p>Where an issuer is seeking a listing of its equity or debt securities on the SEHK, it must also comply with the disclosure requirements in the Listing Rules. These are set out in Appendix 1 to the Listing Rules and comprise detailed requirements for issuers new to listing (Part A), for already listed issuers (Part B), for debt securities where listing is sought (Part C), and for depositary receipts (Parts E and F). Rule 11.07 requires listed companies to include in their listing documents, as an overriding principle, such particulars and information which, according to the particular nature of the company and the securities for which securities is sought, are necessary to enable an investor to make an informed assessment of the activities, assets and liabilities, financial position, management and prospects of the company and its profits and losses and of the rights attaching to such securities.</p> <p>Disclosure requirements in Appendix 1 of the Listing Rules is largely the same as those of the Third Schedule of the CO, but in some areas additional disclosure is required, for example about group activities and finances. Some additional disclosures are also required for companies incorporated in the Mainland (see Chapter 19A of the Listing Rules and in particular Rule 19A.42).</p> <p>All new applications for listing of equity securities must have a sponsor (Rule 2.09 and Chapter 3A of the Listing Rules). The sponsor must be a corporate adviser licensed under the SFO and must use reasonable endeavors to ensure that all information provided to SEHK during the listing application process is true in all material respects and does not omit any material information. New provisions in the SFC's Corporate Finance Adviser Code of Conduct require the sponsor, among other things, to review compliance with all relevant rules and regulations.</p> <p>Structured products are subject to a separate, specific regime, both in the legislation and the Listing Rules. Before an unlisted structured product can be offered to the public it must be authorized by the SFC under section 104A of the SFO. SEHK approves listed structured products.</p> <p>Part D of Appendix 2 of the Listing Rules contains specific disclosure requirements for structured products. In addition, Rule 15A.66 of the Listing Rules requires that listing documents must, as an overriding principle, contain such particulars and information necessary to enable an investor to make an informed assessment of the assets and liabilities and financial position of the structured products issuer and of the structured products.</p> <p>Disclosure requirements for unlisted structured products to be authorized for public offering are set out in a Code issued by the SFC under section 399 of the SFO, the Code on Unlisted Structured Investment Products (the SIP Code). Under paragraph 6.1 of the Code, an offering document must contain the information necessary for investors to be able to make an</p>
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informed judgment of the investment which is the subject matter of the authorization.

Paragraph 6.3 of the Code also requires every offering document to contain a Product Key Fact Statement, which forms part of the offering document and must contain information to enable investors to comprehend the key features and risks of the product.

If, after a prospectus or listing document has been issued, there are significant changes affecting any matter in the prospectus or new matters arise which require disclosure, an issuer must provide the disclosure in a supplemental prospectus or listing document approved by the SEHK.

#### *Annual reports*

Section 122 of the CO requires directors of public companies to lay before its shareholders at its annual general meeting a profit and loss account and a balance sheet. The accounts must not be more than 6 months out of date. By section 129D, the balance sheet must include a directors' report containing the information specified in that section. This requirement applies only to HK incorporated companies. Overseas companies that are registered with the Companies Registrar must deliver their latest published accounts which comply with the laws of their place of incorporation to the Registrar.

For listed companies (both Main board and GEM), Rule 13.46 of the Listing Rules requires every listed company to send to its shareholders a copy of either:

- a. its annual report including its audited annual or group accounts; or
- b. its summary financial report (provided that it complies with Section 141 of the CO and the Companies (Summary Financial Reports of Listed Companies) Regulation);

not less than 21 days before the company's Annual General Meeting and in any event not more than four months after the end of the financial year to which they relate.

The company's annual report must comply with the disclosure requirements set out in Appendix 16 to the Listing Rules.

For structured products:

- a. for listed products, Rule 15A.21 of the Listing Rules requires the annual report of the issuer and, where appropriate, the guarantor, to be submitted to SEHK within 4 months after the date to which the financial statements relate. The issuer must also make the reports publicly available;
- b. for unlisted products, SIP Code 7.6 (a) requires the issuer to make available to investors not later than four months after the date to which they relate, the annual report and audited financial statements in respect of the issuer, the guarantor and/or the key product counterparty, as applicable, and where group accounts are prepared, the relevant group accounts, together with the auditor's report.

#### *Half yearly and quarterly reports*

The Listing Rules require listed companies to send to shareholders either an interim report or a summary interim report that complies with the Companies (Summary of Financial Reports

for Listed Companies) Rules. For main board companies this must be done within 3 months after the end for the half year. However they are required to publish their preliminary half-year results announcements within two months from the end of the half-year. The main difference between the contents of the half-year results announcement and the half-year report is that the half-year report will contain the cashflow statement and a statement of changes in equity, and comparative figures for the corresponding previous period. Generally the half-year report and the results announcement will contain similar information, except for the Chairman's statement. The authorities explained that HK listed companies require more time to issue their half-year report as they are required to send hard copies of their half-year report to their shareholders (although shareholders have the choice of receiving electronic copies instead of printed copies).

For companies listed on GEM, the report must be published within 45 days of the end of the relevant half year.

Main board companies are not required to prepare quarterly reports, but it is one of the recommended best practices under the Corporate Governance Code and Corporate Governance Report in Appendix 14 to the Main Board Listing Rules (Recommended Best Practices C.1.6 and C.1.7 of the Corporate Governance Code). Companies are encouraged to but not required to comply with recommended best practices.

Companies listed on GEM must provide to shareholders quarterly reports for each of first 3 and nine month period of the financial year by no later than 45 days after the period end. Content requirements for quarterly reports are set out in GEM Listing Rules 18.68-18.77.

For listed structured products, Rule 15A.21 of the Listing Rules requires the annual report and half yearly report of the issuer and, where appropriate, the guarantor, to be submitted to SEHK within 4 months after the date to which the financial statements relate. The issuer must also make the reports publicly available

For unlisted structured product issuers must provide half yearly reports, to investors as soon as practicable and not later than four months after the close of the relevant period (SIP Code 7.6(a)(ii)). In practice, many unlisted structured products are short dated instruments, with a life of 6 to 9 months. The material adverse event disclosure regime has more application to these products (see below).

*Disclosure of inside information (material events)*

Part XIVA of the SFO sets out requirements for listed companies to disclose material information as soon as reasonably practicable when the information has, or ought to reasonably have come to the knowledge of their directors, managers or company secretary. Section 307B of the SFO requires listed companies to disclose to the public price sensitive information (called "inside information") as soon as reasonably practicable.

"Inside information" is defined to mean specific information that:

- a. is about:
  - i. the corporation;
  - ii. a shareholder or officer of the corporation; or

- iii. the listed securities of the corporation or their derivatives; and
- b. is not generally known to the persons who are accustomed or would likely to deal in the listed securities of the corporation but would if generally known to them be likely to materially affect the price of the listed securities. (See Section 307A of the SFO)

The requirement to disclose inside information under Part XIVA came into effect on 1 January 2013. The Listing Rules also provide for material event disclosure in terms broader than the SFO definition of inside information, as they require an issuer to announce any information needed to correct or prevent a false market in its securities (Listing Rule 13.09(1)).

SFC senior staff indicated that the main reason for bringing the requirement to disclose price sensitive information under the SFO has been to provide “teeth” to the regime, as under the Listing rules strong enforcement actions are not available. Market participants interviewed indicated that the change in the regime has in fact translated into more rigorous processes in issuers to determine what type of information needs to be communicated to the market.

For structured products

- a. for listed products, the provisions of Part XIVA of the SFO apply. The Listing Rules also require an issuer to announce information necessary to avoid a false market in the securities. A specific rule in the Listing Rules applies to guaranteed products and requires the guarantor to make announcements about any information that may have a material effect on its ability to meet obligations (Paragraphs 2 and 2A of Appendix 7H) ;
- b. for unlisted products, SIP Code 7.6 requires the issuer to inform the SFC and all investors in the structured products as soon as reasonably practicable of changes in the financial condition of the issuer or other circumstance which could reasonably be expected to have a material adverse effect on the ability of the issuer or, if applicable, the guarantor or a key product counterparty, to fulfill its commitments of the structured product.

*Shareholder voting decisions*

Sections 114 and 116 of the CO set out the timing requirements for notices of general meetings:

- a. annual general meeting - 21 days' notice in writing;
- b. meetings at which it is proposed to pass a special resolution - 21 days; and
- c. meetings that are neither an annual general meeting nor a meeting for the passing of a special resolution - 14 days.

For listed companies, the Listing Rules provide detailed provisions dealing with disclosure to shareholders in relation to matters requiring shareholder approval. These include certain types of “notifiable transactions” (Chapter 14 of the Listing Rules) and “connected transactions” (Chapter 14A). Notifiable transactions include major and very substantial transactions (as defined in the Listing Rules) that require shareholder approval. Connected transactions are related party transactions (see further under Principle 17).

If a transaction requires shareholders’ approval, the listed company concerned must send a

	<p>circular to its shareholders at the same time or before the company gives notice of the general meeting to approve the transaction.</p> <p>Rule 14.41 of the Listing Rules require that the circular to be dispatched to shareholders at the same time as or before the listed company gives notice of the general meeting to approve the transaction.</p> <p>If any material information comes to the directors' attention after the issue of the circular on the transaction, a listed company must send to its shareholders a revised or supplementary circular and provide at least 10 business days before the date of the relevant general meeting (see Rules 13.73, and 14.42 of the Listing Rules).</p> <p>Detailed content requirement for circulars about transactions requiring shareholder approval are set out in Listing Rules 14.66-14.71A. (See further description in Principle 17)</p> <p>Rule 13.39 of the Listing Rules requires listed companies to announce the results of their general meetings as soon as possible, but in any event at least 30 minutes before the earlier of either the commencement of the morning trading session or any pre-opening session on the business day after the meeting.</p> <p><i>Advertising</i></p> <p>The SFO, the CO and the Listing Rules all contain provisions relating to advertisements.</p> <p>Section 103(1) of the SFO makes it an offence to issue advertisements, invitations or documents which are or contain a public offer of securities or structured product unless it falls within one of the safe harbors in Section 103(2) or (3) of the SFO. Safe harbors include a complying prospectus or an advertisement, invitation or document relating to securities the listing of which SEHK has approved and which comply with the Listing Rules.</p> <p>Section 38B of the CO makes it unlawful to publish an advertisement unless it has been approved by the SFC or it is within the exemptions in Schedule 19 of the CO. The Schedule sets out the contents and publication requirements for advertisements. The advertisement must contain:</p> <ol style="list-style-type: none"> <li>a. a statement to the effect that the advertisement is issued by the company to which the advertisement relates;</li> <li>b. a warning statement that potential investors should read the prospectus for detailed information about the company and the proposed offering before deciding whether or not to invest in the shares or debentures concerned; and</li> <li>c. a statement that the advertisement does not constitute an offer or an invitation to induce an offer by any person to acquire, subscribe for or purchase the shares or debentures concerned.</li> </ol> <p>Rules 9.08 and 24.08 of the Listing Rules require all publicity material released in HK relating to an issue of securities and debt securities by a new applicant to be reviewed by the SEHK before release. The publicity materials must not be released until the SEHK has confirmed to the applicant that it has no further comments on the materials.</p>
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For structured products:

- a. for listed products, Rule 15A.53 of the Listing Rules permits issuers to release publicity material relating to their products if it complies with all relevant legislation and rules. Issuers are required to adopt the disclosure and presentation principles in the SEHK's Guidelines on Marketing Materials for Listed Structured Products;
- b. for unlisted products, under Part IV of the SFO, advertisements in respect of publicly offered structured products must be authorized by the SFC. The criteria for authorisation are set out in the "advertising guidelines applicable to unlisted structured investment products" set out in Appendix D to the SIP Code (the SIP Advertising Guidelines).

### **Responsibility for information in regulated offer documents**

#### *Civil Liability*

Sections 40 and 342E of the CO those responsible for the issue of a prospectus liable to pay compensation to any person who subscribes for shares or debentures for their losses or damages as a result of any untrue statement in the prospectus. Those made liable are:

- a. directors of the company at the time of the issue of the prospectus;
- b. every person named in the prospectus as a director or prospective director;
- c. promoter of the company; and
- d. every person who authorized the issue of the prospectus. This includes any experts whose statements are incorporated in the prospectus; they will only be liable for any untrue statement they make as an expert.

Section 108 of the SFO provides a statutory right for persons to seek compensation for any pecuniary loss sustained as a result of their reliance on any fraudulent, reckless or negligent misrepresentation made to induce that person to invest in an unlisted structured product.

#### *Criminal liability*

Provisions in the SFO make it a criminal offence to provide false or misleading information or omissions in offer documents, or in offers to induce transactions in securities under the SFO and the CO. See especially sections 107 and 298 of the SFO; and sections 40A and 342E of the CO. Offences under the SFO carry penalties of fines up to HK\$1 million or imprisonment of up to 10 years (under the CO HK\$700,000 and 3 years). Disciplinary penalties also apply under the listing rules (Rules 2A.09 and 2A.10).

Under the CO provisions, criminal liability attaches to any person who authorized the issue of the prospectus. The SFC has publicly consulted about and is currently working on legislative proposals to amend the CO to clarify that sponsors have criminal and civil liability for false statements in a prospectus.

#### *MMT jurisdiction*

The MMT has jurisdiction over the inside information disclosure provisions in the SFO.

	<p><b>Derogations</b></p> <p><i>Prospectuses</i></p> <p>SFC can grant an exemption from the prospectus disclosure requirements in sections 38 and 342 of the CO if it considers that the exemption will not prejudice the interest of the investing public and compliance with any or all of those requirements:</p> <ol style="list-style-type: none"> <li>a. would be irrelevant or unduly burdensome; or</li> <li>b. is otherwise unnecessary or inappropriate.</li> </ol> <p>(section 38A of the CO).</p> <p>In practice, this exemption power is used only in narrow circumstances, for example the period covered by the latest audited financial statements to be included in a prospectus if the prospectus is expected to be issued within a short time after the end of a company's fiscal year.</p> <p>Under Rule 2.04, SEHK can also grant a waiver from Listing Rule requirements, but a waiver of general effect applying to more than one company requires the prior approval of the SFC.</p> <p><i>Inside information</i></p> <p>Section 307D sets out certain exceptions when listed companies would not be required to disclose any inside information:</p> <ol style="list-style-type: none"> <li>a. if and so long as the disclosure is prohibited under, or would constitute a contravention of a restriction imposed by, an enactment or a court order;</li> <li>b. if and so long as the company takes reasonable precaution to preserve the confidentiality of the information and the confidentiality is preserved where: <ol style="list-style-type: none"> <li>i. the information concerns an incomplete proposal or negotiation;</li> <li>ii. the information is a trade secret;</li> <li>iii. the information concerns the provision of liquidity support from the Exchange Fund or the HKMA or other monetary authorities which perform the functions of a central bank to the company or a member of its group of companies; or</li> </ol> </li> <li>c. the SFC has waived disclosure of the information under Section 307E of the SFO.</li> </ol> <p>These safe harbor exceptions are subject to a condition requiring the company to take reasonable measures to preserve the confidentiality of the information.</p> <p>The SFC has not used its powers to grant waivers.</p> <p><i>Suspension of trading</i></p> <p>The inside information provisions in Part XIVA of the SFO do not provide for mandatory suspension of trading. But Rule 13.10A of the Listing Rules requires a company to apply for a trading halt as soon as reasonably practicable where it cannot make an announcement promptly about information necessary to correct or prevent a false market (as required by Rule 13.09) or confidentiality has been lost in respect of information within the inside information safe harbor.</p>
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If a listed company fails to publish periodic financial information within reporting deadlines in the Listing Rules, SEHK normally suspends trading in the company's securities until the information is published (see Listing Rule 13.50).

Under Listing Rule 6.01 SEHK can also direct a trading halt or suspend trading in specified circumstances, including when the SEHK considers that the company materially fails to comply with the Listing Rules.

In addition, under sections 7 and 8 of the SMLR, SFC has power to direct SEHK to suspend dealings in securities of a listed company. This power can be exercised where it appears to SFC that:

- a. a document issued in connection with the listing of the securities, or an announcement, is materially false, incomplete or misleading information; or
- b. a suspension is necessary in the interest of maintaining an orderly and fair market in the securities, or in the interest of the investing public or for the protection of investors.

*Restrictions on trading by persons with superior information*

The insider dealing trading provisions in sections 270 and 291 of the SFO prohibit a person with superior inside information from trading in the securities of the relevant company, and from disclosing that information to a third party.

**Cross border matters**

Given the international character of the listed company sector in Hong Kong, SFC and SEHK have made special provisions relating to listings in Hong Kong by companies domiciled elsewhere.

The prospectus provisions and the continuous disclosure provisions apply in full to all companies, regardless of their domicile.

In addition, companies seeking a listing on the SEHK must satisfy the SEHK that it is incorporated or is otherwise established in a jurisdiction where the standards of shareholder protection is at least equivalent to those in Hong Kong (see Rule 19.05(1)(b) of the Listing Rules).

In 2007, the SFC and the SEHK clarified the Listing Rules requirements regarding primary listing of companies incorporated outside Hong Kong or any of the three jurisdictions recognized under the Listing Rules (Mainland, Bermuda and the Cayman Islands). They issued a Joint Policy Statement setting out a list of shareholder protection standards that are expected of an overseas company when seeking a primary listing on the Main Board or GEM. An overseas applicant is expected to benchmark the shareholder protection standards of its home jurisdiction to those standards of Hong Kong, and in case of any shortfall in the standards of the applicant's home jurisdiction, an overseas applicant can compensate for such shortfalls by making changes to its constitutional documents.

Hong Kong regulators must have reasonable access to information relating to the conduct of

	<p>a listed overseas company in its home or governing jurisdiction to facilitate the taking of any regulatory action against a non-complying listed overseas company. To ensure this, a key requirements for an overseas company to list in Hong Kong is that it must be incorporated or otherwise established in a jurisdiction where the statutory securities regulator has adequate arrangements with the SFC for mutual assistance and exchange of information for the purpose of enforcing and securing compliance with the laws and regulations of that jurisdiction and Hong Kong either by way of the IOSCO MMoU or an adequately comprehensive bilateral agreement with the SFC.</p> <p>The SEHK has published guidance about the jurisdictions which are acceptable places of incorporation for the purposes of the Listing Rules. The SEHK lists these acceptable overseas jurisdictions and the companies incorporated in these jurisdictions that have listed on the Main Board.</p> <p>Currently there are no overseas companies listed on GEM.</p> <p><b>Regulatory practice</b></p> <p><i>Prospectus disclosure</i></p> <p>Under the dual filing system, listing applicants file copies of their listing applications (including the prospectus) with the SFC at the same time as they submit it to SEHK. Prospectuses and other listing information are reviewed both by the SFC and SEHK. SFC queries and comments are channeled through the SEHK. The formal decision to approve listing is made by the SEHK's Listing Committee which takes into account SFC's comments when making its decision.</p> <p>The SEHK has a staff of more than 40 people dealing with listing applications, and the IPO team of the SFC's Corporate Finance Division has 20 staff. In addition, the Primary Market Information, Fixed Interest and Structured Products teams at the SEHK consists of 35 people, 10 of whom deal with applications for listed structured product. The SFC has a team of 13 staff dealing with unlisted structured products.</p> <p>The SFC's review of draft prospectuses or listing documents focuses on the adequacy of information in the prospectuses or listing documents. The SEHK's reviews a listing application and the associated prospectus or listing document to ascertain whether the listing applicant meets the eligibility and suitability for listing requirements and compliance with the Listing Rules, including the adequacy of disclosure.</p> <p><i>Annual and periodic reports</i></p> <p>Reviews of the financial reports of listed entities are carried out HKEx, HKICPA and the FRC – see under Principle 18.</p> <p><i>Inside information</i></p> <p>SFC oversees the inside information disclosure regime. A team of 6 staff monitors compliance with the requirement, for example by reviewing monitoring market announcements and other information, and making written inquiries of companies. They make written inquiries of</p>
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	<p>companies to clarify the content of announcements or query whether an announcement should be made. Some announcements, such as those relating to major transactions, are pre-vetted by the HKEx.</p> <p>By agreement with SFC, the HKEx plays the front line regulatory role in relation to enquiries concerning unusual movements in the price or trading volume of an issuer's listed securities, the possible development of a false market in its securities, or any other matters under Listing Rule 3.10. The HKEx makes daily reports to the SFC on these disclosure issues.</p> <p><i>Cross border enforcement</i></p> <p>The SFC has been active in monitoring issuers' compliance with their obligations, including overseas issuers. In this regard, the remedies available to the SFC under the SFO and the CO are applicable to any foreign issuer listed in HKSAR. In recent years the SFC has taken an important number of enforcement actions involving listed issuers incorporated outside HKSAR. These actions include civil remedial actions against the companies and/or their major shareholders and winding up petitions. For example, against Tack Fiori International Group Limited, Gome Electrical Appliances Holding Limited, China Metal Recycling (holdings) Limited, Qunxing Paper Holdings Company Limited, Hontex International Holdings Company Limited, Styland Holdings Ltd.</p>
Assessment	Fully implemented
Comments	<p>The CO allows annual reports to be made available to shareholders up to 6 months after balance date. This is not timely reporting for the purposes of Key Question 2(c). However, the assessors note that for listed companies, the Listing Rules require the report and related financial statements to be made available within 4 months of balance date. This is in line with other jurisdictions such as those in the EU. While it is acknowledged that the CO allows a longer deadline, in practice all companies who have raised funds from the public are listed and are therefore subject to the shorter deadlines under the Listing Rules.</p> <p>The assessors also note that semi-annual reports for main board companies must be made available within 3 months of the close of the relevant period. However, announcements must be made within two months which is comparable to other jurisdictions. As the content of the announcement is substantially similar than that of the interim report, the assessors do not consider this a deficiency that should trigger a downgrade.</p> <p>Further, the assessors acknowledge that material information about a company's financial position would need to be disclosed as soon as practicable.</p> <p>There is significant concern in the market about the quality and reliability of disclosure by companies from the Mainland, and the capacity of the SFC to enforce compliance with disclosure obligations, including through the use of enforcement actions. The reforms to the sponsor regime seek to address some of the challenges arisen from the cross border nature of these companies. The SFC has demonstrated that it uses the tools at its disposal to enforce compliance of issuers with their obligations, even in the context of overseas companies. However, SFC staff acknowledges that on the enforcement side there are still challenges for effective cooperation, which stem from practical aspects (for example the sheer size of China) rather than from legal impediments or lack of will of the Chinese authorities to cooperate.</p>

	These issues have been further explained under Principle 12.
<b>Principle 17.</b>	Holders of securities in a company should be treated in a fair and equitable manner.
Description	<p><b>Rights and equitable treatment of shareholders</b></p> <p>The CO provides the general framework for the relationship between a company and its shareholders. These general provisions are supplemented by detailed provisions in the Listing Rules.</p> <p>For listed companies, it is a general principle under the Listing Rules that all holders of listed securities must be treated fairly and equally (Rule 2.03(4)). Rule 13.75 of the Listing Rules also requires listed companies to ensure equality of treatment of all holders of securities of the same class who are in the same position. Some special provisions apply to clarify the position of holders of HK traded shares in Mainland companies (H shares), for example by providing for arbitration to resolve disputes between an H share holder and the company or its directors.</p> <p>The Takeovers Code also has a general principle that all shareholders are to be treated even-handedly and all shareholders of the same class are to be treated similarly (see General Principle 1 of the Takeovers Code).</p> <p><i>Election of directors</i></p> <p>Section 157A of the CO provides that all appointments of directors of companies other than a private company or a company not having a share capital must be voted on individually (i.e., slate voting is prohibited).</p> <p>For listed companies, rule 13.70 of the Listing Rules requires that, when a listed company receives a notice from a shareholder proposing a person for election as a director at a general meeting, the company must publish an announcement or issue a supplementary circular where such notice is received after the publication of the notice of the meeting. The company must include particulars of the proposed director in the announcement or supplementary circular.</p> <p><i>Fundamental corporate changes</i></p> <p>Changes to a company's constitutive documents and other fundamental corporate changes (such as variation of rights attaching to a class of shares), require approval at a shareholders meeting (see sections 8, 13 and 63A of the CO). These changes are determined by special resolution (requiring at least 75 percent majority vote in favor) rather than ordinary resolution (simple majority of over 50 percent). Dissenting members are entitled to apply to the court to cancel a resolution relating to:</p> <ol style="list-style-type: none"> <li>an alteration to the company's objects,</li> <li>an alteration to the articles of association,</li> <li>a variation of class rights,</li> <li>giving financial assistance to a company in acquiring its own shares;</li> <li>payment out of capital for the redemption or purchase of a private company's shares,</li> </ol>

- or  
f. any arrangement upon liquidation.

A proposal to delist a company which has its primary listing in Hong Kong requires approval by a special resolution of shareholders if its only listing is on Hong Kong or by ordinary resolution if the company has an alternative listing on another stock exchange (Listing Rules 6.11–12). Companies with only a secondary listing in Hong Kong do not require shareholder approval to delist in Hong Kong but must give at least three months' notice to shareholders (Rule 6.16).

*Corporate transactions requiring shareholder approval*

Chapter 14 of the Listing Rules requires shareholder approval for specified types of transactions (major acquisitions and disposals, very substantial disposals or acquisitions, and certain reverse takeovers). Detailed threshold tests for determining transactions that are subject to shareholder approval are set out in the Chapter.

*Connected transactions*

Chapter 14A of the Listing Rules deals with transactions or continuing transactions with connected parties. A connected transaction is any transaction between a listed company and a connected person (Rule 14A.13). A connected person is defined in Rule 14A.11 to include directors, ex-directors who were directors within the previous 12 months, the chief executive, a substantial shareholder, the supervisor of a Mainland company, and their associates and relatives.

Connected transactions and continuing connected transactions above specified minima require approval by independent shareholders on a simple majority basis.

*General meetings*

Sections 114 and 116 of the CO provide that a company must provide notice of at least:

- a. 21 days' notice in writing for annual general meeting and extraordinary general meetings at which a special resolution is called; and
- b. 14 days' notice in writing for any other general meetings.

Rule 13.73 of the Listing Rules requires listed companies to provide shareholders any further material information that arose after the circular at least 10 business days before the general meeting.

After a general meeting, Rule 13.39(5) of the Listing Rules requires a listed company to announce voting results as soon as possible, but in any event at least 30 minutes before the earlier of either the commencement of the morning trading session or any pre-opening session on the business day after the meeting.

When shares have different rights from those of ordinary shares, section 63A of the CO requires that resolutions adopted by the general meeting of shareholders that prejudice the rights of their holders must also be approved by the special meeting of the holders of these

	<p>shares.</p> <p>Section 113 of the CO gives members who hold at least 5 percent of the paid up capital of a company a right to requisition a general meeting.</p> <p><i>Voting at the general meeting</i></p> <p>By Section 114C of the CO, any member of a company entitled to attend and vote at a meeting of the company is entitled to appoint another person (whether a member or not) as his proxy to attend and vote at shareholder meetings.</p> <p>Rule 13.38 of the Listing Rules requires an issuer to send with the meeting notice to all persons entitled to vote proxy forms, with provision for either directing the proxy to vote in a particular way, or giving the proxy discretion.</p> <p>Investors who hold and trade securities in HK listed companies through their stock account (either an Investor Account or a Stock Segregated Account with Statement Service) in the HKEx's Central Clearing and Settlement System (CCASS) can either give voting instructions or arrange to attend and vote at a listed company's general meetings electronically through the CCASS Internet System.</p> <p><i>Ownership registration and transfer of shares:</i></p> <p>By section 28 of the CO, a member of a company is a member by virtue of having their name entered in its register of members. Section 68 provides for registration of transfers of shares.</p> <p>Rule 8.13 of the Listing Rules requires securities for which listing is sought to be freely transferable. Rule 8.13A requires all securities for which listing is sought to have been accepted as eligible by Hong Kong Securities Clearing Company for deposit, clearance and settlement in CCASS, in accordance with the General Rules of CCASS.</p> <p>Shareholding (at broker level) in each security listed on the SEHK is publicly accessible through the HKEx's website.</p> <p>Rules 13.59 and 13.60 of the Listing Rules require an issuer (or its share registrar) to provide registration services and set out the minimum service levels and maximum fees that can be charged for these services. Share registrars must be members of an association of share registrars that is approved by the SFC under Sections 12-14 of the SMLR.</p> <p>Overseas issuers must make provision for a register of holders to be maintained in Hong Kong (see Rules 19.05(3) and 19.30(4) of the Listing Rules).</p> <p><i>Dividends</i></p> <p>Generally a company's articles of association provide that while directors may recommend a dividend to shareholders of the listed company, the declaration of dividends must be approved by shareholders at a general meeting (see article 115 in the model articles of association in Table A set out in the First Schedule to the CO). All common shareholders of the</p>
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	<p>company are entitled to the distribution once the dividend is declared. There is no requirement when a dividend must be paid after it is declared.</p> <p><i>Disclosure to shareholders</i></p> <p>Rule 2.13 of the Listing Rules requires announcements and corporate communication to be accurate and complete in all material respects, not misleading or deceptive, and be clearly presented in plain language.</p> <p>Rules 14.63 and 14A.58 of the Listing Rules require listed companies to provide in their circulars to shareholders, in respect of transactions that must be disclosed under the Listing Rules (notifiable transactions) and connected transactions that require shareholder approval:</p> <ol style="list-style-type: none"> <li>a. a clear, concise and adequate explanation of the subject matter;</li> <li>b. all information necessary to allow shareholders to make a properly informed decision;</li> <li>c. emphasis of the importance of the document and advice to shareholders to consult appropriate independent advisers;</li> <li>d. a recommendation from directors (or the independent board committee, in the case where independent shareholders' approval is required) as to the voting action that shareholders should take, indicating whether or not the proposed transaction described in the circular, is in the directors' opinion, fair and reasonable and in the interests of the shareholders as a whole; and</li> <li>e. a separate letter from any independent financial adviser (required where independent shareholders' approval is required - see Rules 13.39(7) and 14A.58(3)(d)).</li> </ol> <p>Directors of listed companies must also confirm in circulars relating to notifiable transactions that require shareholders' approval that, to the best of their knowledge, information and belief having made all reasonable enquiry, the counterparty and the ultimate beneficial owner of the counterparty are third parties independent of the listed company and its connected persons (see Rule 14.63(3))</p> <p><b>Takeover bids and other changes of control transactions</b></p> <p>Takeovers and other change of control transactions are governed by the Takeovers Code and the Share Repurchase Code<sup>2</sup>. These Codes were adopted in 1992, and have as a primary purpose the fair treatment for shareholders who are affected by takeovers, mergers and share repurchases. They are intended to achieve fair treatment by requiring equality of treatment of shareholders, mandating disclosure of timely and adequate information to enable shareholders to make an informed decision as to the merits of an offer and ensuring that there is a fair and informed market in the shares of companies affected by takeovers, mergers and share repurchases. (See Introduction to the Codes section 1.2.)</p> <p>The Codes apply to takeovers, mergers and share repurchases affecting public companies in</p>
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<sup>2</sup> The Share Repurchase Code is concerned with share repurchases of all relevant companies. Share repurchases by general offer will be considered to be offers and the Rules of the Takeovers Code will apply, mutatis mutandis, in addition to the Rules of the Share Repurchase Code. Persons engaging in share repurchases by general offer should therefore read the Takeovers Code as well as the Share Repurchase Code. (see Introduction to the Codes 4.4)

	<p>Hong Kong, companies with a primary listing of their equity securities in Hong Kong and REITs with a primary listing of their units in Hong Kong.</p> <p>The Takeovers Code does not have the force of law and there are no statutory powers to enforce its provisions. However, SFC can exercise its powers of investigation where a breach is suspected.</p> <p>A team of 14 SFC staff are the “Takeover Executive” responsible for the daily administration of the Takeovers Code. This includes vetting takeovers-related announcements and documents and giving rulings on applications under the Takeovers Code. The Takeover Executive’s decisions are subject to review by the Takeovers Panel at the request of a dissatisfied party. Members of the Takeovers Panel are appointed by the SFC and currently consist of 31 members drawn from the financial and investment community. A Panel consists of at least 5 persons, including a chairman (who is a legally qualified person) and 4 experts. Disciplinary hearings are held in public, other than in exceptional circumstances. The Panel has heard only 1 or 2 cases a year in recent years.</p> <p>The Takeover Executive may also refer a matter to the Takeovers Panel if it is considered to be novel, important or difficult.</p> <p>The Takeover Executive can initiate proceedings in the Takeover Panel seeking sanctions for breaches of the Takeovers Code. These range from public criticism or public censure to a “cold shoulder” order which denies a person direct or indirect access to the Hong Kong securities markets for a stated period. The Takeovers Panel will give a ruling after the hearing and where appropriate impose sanctions. If the other party agrees, the Takeover Executive can impose these sanctions directly, as an alternative to Panel proceedings. See section 12 of the Introduction to the Takeovers Code.</p> <p>If the bidder is a listed company, the SFC could approach a court to seek remedial or injunctive orders under section 214 of the SFO.</p> <p><i>Takeovers</i></p> <p>Rule 26.1 of the Takeovers Code requires a person who acquires 30 percent or more of the voting shares in a company to make a takeover bid addressed to all holders. Partial bids require the consent of the Takeover Executive (Rule 28.1). An offer must also be made by a person who holds between 30 percent and 50 percent of shares, and increases their holding by more than 2 percent in any 12 month period. These rules apply also to persons acting in concert who collectively meet the thresholds.</p> <p>The offer must be posted within 21 days of the announcement of the terms of the offer (35 days for share exchange offers), Rule 8.2 of the Takeovers Code. The offer must be open for at least 21 calendar days following the date on which the offer document is posted.</p> <p>Rule 26.3 of the Code applies to mandatory offers and requires that the price offered must be not less than the highest price paid by the bidder, and by persons acting in concert with the bidder, for shares acquired during the offer period and within 6 months prior to its commencement. If no purchase against payment of securities of the same class was made in</p>
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the period indicated, the takeover bid is implemented for that class of securities at a price no less than the weighted market average over the previous twelve months or shorter available period.

General Principles 5 and 6 of the Takeovers Code provide that shareholders should be given sufficient information, advice and time to reach an informed decision; and that there should be full and prompt disclosure of all relevant information and precaution should be taken to avoid the creation or continuance of a false market. The Code sets out required content for the bidder's statement and the target statement (Schedules 1 and 2).

The Code requires the target company to establish an independent board committee comprised only of independent directors to make a recommendation to the shareholders as to whether the offer or other transaction is fair and reasonable and as to acceptance and voting. It also requires the appointment of an independent financial adviser to advise the independent board committee. The written advice of the independent financial adviser and the recommendations of the independent board committee must be set out in the circular to shareholders.

The Code (Rule 9.3) also requires all announcements and documents to shareholders to include a statement stating that all directors of the company issuing the announcement or document jointly and severally accept full responsibility for the accuracy of information and confirm that there is no omission of facts which would make any statement in the announcement or document misleading.

Rule 4 of the Code prohibits the use of frustrating actions by a target company. General Principle 8 requires directors, in providing advice to shareholders, to act only in the interests of shareholders and to disregard personal and family shareholdings.

Schedule 9 of the CO provides for "squeeze out" of minority shareholders if a purchaser acquires not less than 90 percent of the shares for which the offer is made, within four months from the date of the offer.

*Other changes of control transactions*

The Takeovers Code also applies to other change of control transactions which are typically subject to shareholders' approval at a general meeting. At these general meetings, the Takeovers Code requires voting to be conducted by way of poll. In general, the principles and rules under the Takeovers Code are equally applicable to these transactions.

Examples of other change of control transactions which require shareholders' approval at a general meeting are:

- a. privatizations by way of a scheme of arrangement under companies law;
- b. "whitewash" transactions involving a waiver of a general offer obligation arising as a result of the issue of new shares by the company (e.g. through subscription of new shares or acquisition of assets by the company with issuance of new shares as consideration etc.); and
- c. waivers of general offer obligation arising from a share repurchase - the same procedure as for "whitewash" transactions are used.

Where a person is seeking to use a scheme of arrangement or capital reorganization to acquire or privatize a company, the scheme or capital reorganization may only be implemented if, in addition to satisfying any voting requirements imposed by law:

- a. the scheme or capital reorganization is approved by at least 75 percent of the votes attaching to the disinterested shares that are cast either in person or by proxy at a meeting of disinterested shareholders; and
- b. the number of votes cast against the proposed scheme or capital reorganization is not more than 10 percent of the votes attaching to all disinterested shares.

Rule 2.10 of the Takeovers Code.

Schemes of arrangement are under the supervision of the court.

### **Holding the company and its directors responsible in case of violations of law**

Part IVA of the CO sets out the provisions for statutory derivative actions. Under sections 168BA to 168BI, a member of a company has a statutory right to bring proceedings on behalf of the company or to intervene in proceedings to which the company is a party if:

- a. the cause of action or right to continue, discontinue or defend the proceedings is vested in the company and relief is sought on behalf of the company;
- b. the bringing of proceedings is in respect of misfeasance committed against the company (misfeasance is defined under section 168BB(2) to include fraud,
- c. negligence, default in compliance with any enactment or rule of law or breach of duty);
- d. the company fails to bring proceedings or diligently continue, discontinue or defend the proceedings; and
- e. leave is granted by the Court to bring or intervene in such proceedings.

The SFC has the power to apply to intervene in proceedings between private litigants (section 385 of the SFO).

SFC can apply to the court for civil orders including injunctions, disqualification orders and other remedial orders if in its view the business or affairs of a listed company have been conducted in a manner:

- a. that is oppressive to its members or any part of its members;
- b. involving defalcation, fraud, misfeasance or other misconduct towards it or its members or any part of its members;
- c. resulting in its members or any part of its members not having been given all the information with respect to its business or affairs that they might reasonably expect; or
- d. that is unfairly prejudicial to its members or any part of its members

(Section 214 of the SFO).

The SFC also has power to apply to the court for injunctive and remedial orders (including rescission and restitution orders) and any ancillary order which the Court considers necessary (including injunctions, freezing of assets or the appointment of an administrator or receiver) (see Section 213 of the SFO). This power is not limited to persons licensed or registered by the SFC, and the power applies to unregulated persons as well.

**Bankruptcy or insolvency of the company**

The CO provides detailed procedures for the winding up of companies, including in the event of their insolvency (Part V of the CO). Any surplus capital after settling all a company's debt is distributed *pari passu* to its shareholders pursuant to Rule 143 of the Companies (Winding-up) Rules.

**Insiders and substantial holdings disclosure of interests in shares of listed corporations***Prospectus disclosure*

Paragraph 30 of the Third Schedule of the CO requires a prospectus to contain a statement of the holdings of persons holding or beneficially interested in a substantial part of the share capital of the company. Although the CO does not define a substantial holding for these purposes, in practice the 5 percent threshold used in Part XV of the SFO is used.

Listing applicants are required to disclose in their listing documents the interests (which include interests in the underlying shares of equity derivatives) and short positions of each of their directors and chief executives and any associated companies in accordance to the disclosure of interest requirements in Part XV of the SFO (Paragraph 45 of Part A of Appendix 1 to the Listing Rules).

Part XV of the SFO contains detailed provisions requiring disclosure of substantial shareholdings in listed companies. A substantial shareholding is 5 percent or more of any class of voting shares. In counting shareholdings for these purposes, derivatives over shares are taken into account (sections 311). Further disclosure is required where increases above specified thresholds occur (for example, a 1 percent change). Disclosure is also required of short positions held by substantial shareholders (section 312).

The disclosure requirements in Part XV apply where there is an agreement between two or more persons which includes provisions for the acquisition by any one or more of them of interests in shares in the relevant share capital of a particular listed corporation (see Sections 317 to 319).

**Holdings of voting securities by directors and senior management**

Section 341 of the SFO requires directors and chief executives of a listed corporation to disclose their interests, and short positions in any shares and any debentures they in the listed company and its associated companies. These disclosures are made public through the SEHK's website.

Holdings of this kind must be disclosed in a prospectus and listing document, and in annual reports.

**Timing of disclosure**

Listed companies are required to disclose in annual reports the interests and short positions of

	<p>substantial shareholders (Listing Rule 13.47 and paragraph 13 of Appendix 16).</p> <p>Upon listing, directors, chief executives and substantial shareholders must disclose their interests within 10 business days of a company being listed. After that, disclosure must be made within 3 business days after the day on the duty to disclose arises (see Sections 325 and 348 of the SFO).</p> <p><i>Supervision</i></p> <p>The SEHK regularly forwards to the SFC details of SFO Part XV disclosures that appear to be late.</p> <p>A team of SFC staff handle late disclosure referrals from the SEHK. SFC officers first check whether the information to which the disclosure relates is already in the public domain, and whether the calculation on the percentage figure of the interest is correct by reference to the issued share capital at the time of the notification. The officer will also check the disclosure history of the director/substantial shareholder.</p> <p>The staff member will make an assessment of each referral and recommend any further actions. The SFC may commence investigation with a view to prosecution if:</p> <ol style="list-style-type: none"> <li>a. the person was involved in late disclosure on a previous occasion;</li> <li>b. the time delay is significant and the aggregated value of the interests is more than HK\$1 million; or</li> <li>c. the late disclosure concealed materially price sensitive information.</li> </ol> <p>The SFC has achieved a large number of convictions in the Magistrates Courts for breaches of these obligations.</p> <p><b>Cross border</b></p> <p>The prospectus provisions, the Listing Rules and the SFO apply to overseas as well as domestic companies. The listing documents of overseas issuers must contain:</p> <ol style="list-style-type: none"> <li>a. a summary of all provisions of the constitutive documents of the overseas issuer in so far as they may affect shareholders' rights and protections and directors' powers (see Rule 19.10(2)); and</li> <li>b. a summary of the relevant regulatory provisions (statutory or otherwise) of the jurisdiction in which the overseas issuer is incorporated or otherwise established (see Rules 19.10 (3) and 19.34(2)).</li> </ol> <p>The SFC Takeovers Code applies to public companies in Hong Kong, companies with a primary listing of their equity securities in Hong Kong and REITs with a primary listing of their units in Hong Kong. Whether a company is a public company in Hong Kong is determined by applying an economic or commercial test which involves the consideration of factors such as the number of shareholders in Hong Kong, the extent of share trading in Hong Kong and so on (Section 4.2 of the Introduction to the Takeovers Code).</p>
Assessment	Fully implemented
Comments	It is common for Hong Kong listed companies to have a dominant shareholder, frequently a

	<p>family. In these circumstances, the rules relating to connected transactions play an important role in regulating the potential conflict between the dominant shareholder and other investors. The rules are strongly policed by SFC and there is good evidence of its willingness to use enforcement remedies to deal with non-compliance.</p> <p>The number of takeovers in Hong Kong is small relative to the size of the market. There were 29 takeovers in 2010-11, 29 in 2011-12, and 24 in 2012-13. Contested takeovers are rare. Privatization transactions – especially with a dominant shareholder taking a company private – are achieved through schemes of arrangement. Notwithstanding the non-statutory nature of the Takeovers and Share Repurchase Codes, the system appears to work effectively in the Hong Kong environment. Appeals to the Takeovers Panel against decisions of the SFC are uncommon.</p>
<b>Principle 18.</b>	Accounting standards used by issuers to prepare financial statements should be of a high and internationally acceptable quality.
Description	<p><b>Audited financial statements</b></p> <p>Audited financial statements must contain all the detail required by the applicable accounting standards (HKFRS, IFRS or CASBE), including a statement of financial position, a statement of operational results and statement of cash flow, and details about changes in equity ownership.</p> <p><i>Public offers of securities</i></p> <p>As stated in Principle 16, issuers of public offering and listed structured products, as well as issuers of unlisted structured products must include their audited financial statements in public offering and listing documents, pursuant to the Listing rules and the SIP code respectively.</p> <p><i>Annual report and financial reports</i></p> <p>As stated under Principle 16 listed companies (Listing Rules), listed structured products (Listing Rules) and unlisted structured products must submit an annual report which should include the audited financial statements. For listed issuers such documents are available via the SEHK website. For unlisted issuers they are available on the SFC website.</p> <p><b>Use of unaudited financial statements</b></p> <p>Half yearly reports and (for GEM listed companies) quarterly reports are not required to be audited. The accounting principles applicable to interim reports are the same as those applying to the annual financial statements.</p> <p><b>Accounting standards</b></p> <p>Pursuant to Rule 4.11 of the Listing Rules, the financial statements included the public offerings or listing documents must normally be drawn up in conformity with:</p> <ol style="list-style-type: none"> <li>a. HKFRS; or</li> <li>b. IFRS; or</li> <li>c. Pursuant to a special arrangement with the Mainland, Mainland incorporated companies listed in HKSAR may choose to prepare their financial statements according to CASBE (41 issuers use these standards).</li> </ol> <p>From 1 January 2005, all HKFRS are word-for-word identical to the IFRS, except that the word</p>

"IFRS" is changed to "HKFRS". In a small number of cases, standards have been added to deal with Hong Kong specific issues not covered by the international standards.

The HKICPA is the Hong Kong body with statutory responsibility for setting HKFRS. Whenever International Accounting Standards Board (IASB) issues an exposure draft for public comment, the HKICPA issues the same exposure draft in Hong Kong to seek public comments. The HKICPA then submits comment letters to the IASB reflecting the comments received. Where a standard is issued by the IASB, the HKICPA adopts the same standard.

#### *Use of other international standards*

SEHK also accepts Australian GAAP, Canadian GAAP, Japanese GAAP, Singapore Financial Reporting Standards and UK GAAP for dual-primary and secondary listed companies provided that the overseas listing applicant includes a reconciliation statement in its accountants' report and all subsequent financial statements to show the financial effect of the material differences (if any) from either HKFRS or IFRS in a form that would facilitate investors' understanding of the applicants' financial performance.

Rules 19.39 and Note 2.4 to Paragraph 2 of Appendix 16 to the Main Board Listing Rules, and Rules 7.13 to 7.15, and 18.05 and 18.06 of the GEM Listing Rules allow the use of US GAAP or other accounting standards where the listed company is also listed on NYSE and NASDAQ.

Where SEHK allows reports to be drawn up using other accounting standards, SEHK may, having regard to the exchange on which the overseas issuer has its primary listing, require the report to contain a statement of the financial effect of the material differences (if any) from either of HKFRS or IFRS.

#### **Oversight, interpretation and independence**

HKICPA is a professional industry body which has statutory functions under the Professional Accountants Ordinance (PAO). It exercises no discretion in the adoption of IFRS standards for the purpose of Hong Kong.

Interpretation issues are dealt through the IFRS Interpretations Committee (IFRIC), the interpretative body of the IASB.

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

Review of the financial statements of listed issuers is carried out through separate programs run by each of the HKICPA, the FRC and SEHK. Plans for financial statement reviews are coordinated between the three organizations to ensure there is no overlap. SEHK carries out 120 reviews each year, HKICPA around 80 and the FRC 75. Given the work done by all three bodies, just under 20 percent of the population of listed issuers is reviewed each year.

Risk based criteria are used to select financial reports for review, with each organization using different risk criteria.

The FRC uses two external reviewers for each review. These reviewers are drawn from the large

	<p>accounting firms, some mid-tier firms and some academic accountants. HKICPA also engages external reviewers to conduct the review while the HKEx does its reviews in-house.</p> <p>Each year, the three oversight bodies host a joint reporting forum at which they provide feedback to issuers on areas of concern revealed by the reviews. HKEx and HKICPA also publish a report on their Financial Statements Review Program annually.</p> <p>If a financial report reveals material non-compliance or irregularities, the HKEx and HKICPA refer it to the FRC. The FRC is responsible for investigating non compliance and irregularities in accounting and auditing. The FRC in turn refers investigated cases that indicate concern about the professional conduct of the auditor to the HKICPA for disciplinary action. More rarely, the FRC may report a problem to the SFC.</p> <p>Material deficiencies in information available to the market are acted on by the SFC under the Part XIVA of the SFO or the HKEx under the Listing Rules.</p>
Assessment	Fully Implemented
Comments	<p>The assessors note that under the current framework issuers are permitted to use the Mainland accounting standards, without the need for a reconciliation statement (as is the case for other accounting standards). The assessors did not conduct a separate assessment on whether the Chinese accounting standards can be considered “of high international quality”. However they took note of the World Bank assessment of Mainland accounting and the IOSCO assessment that formed part of the 2011 FSAP. Both assessments concluded that CASBE has substantially converged with IFRS. Further the assessors were told that Mainland standards are stricter in some aspects. As the IOSCO Principles do not prescribe IFRS as the only standards that can be used by issuers, and in light of the comments received, this issue has not been taken into consideration for the grade.</p> <p>A separate issue is whether arrangements in place to monitor and enforce compliance with the relevant accounting standards are effective. In this regard, the assessors note that current arrangements are fragmented (as they are split into various agencies); however they also acknowledge that the three authorities have taken steps to ensure coordination of their efforts, thus this issue has not been taken into consideration for the grade. Nevertheless, ideally both the supervision and enforcement components should be vested in one single authority. In many jurisdictions such authority is the securities regulator, in coordination with the criminal authorities (when the severity of the deficiencies warrants criminal actions). In such jurisdictions, this allocation of responsibilities has not been affected by the establishment of a separate oversight body for the auditing profession.</p> <p>Finally the assessors note the challenges to effective enforcement brought by the current market structure, as explained under Principle 16. Addressing such challenges requires effective cooperation. The assessors encourage the authorities to continue working with the Mainland authorities to further strengthen cooperation arrangements.</p>

<b>Principles for Auditors, Credit Ratings Agencies, and Other Information Service Providers</b>	
<b>Principle 19.</b>	Auditors should be subject to adequate levels of oversight.
Description	<p><b>Background</b></p> <p>Under the listing requirements domestic companies listed in the exchange must be audited by an auditor registered in HK.</p> <p>Pursuant to a special arrangement with the Mainland of 2010 Mainland incorporated companies listed in HKSAR may choose to prepare their financial statements using Mainland accounting standards and engage Mainland audit firms approved for the purposes of auditing financial statements. On the basis of the qualification requirement under the special arrangement, 11 Mainland audit firms are allowed to audit the financial statements of Mainland incorporated companies. The relevant regulatory authorities of the two sides have set up cooperation mechanisms of conducting post-approval regulation/investigation of the endorsed audit firms. According to the Exchange, 42 Mainland companies listed in HKSAR were audited by those Mainland audit firms.</p> <p>For other overseas companies, the exchange may be prepared to accept non HKSAR audit firms on a case by case basis if the firm (i) has an international name and reputation, (ii) is 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 MMoU. As of the time of the assessment 18 non HKSAR firms from countries different from Mainland had been accepted by the Exchange.</p> <p><b>Domestic Framework</b></p> <p>The current framework for the oversight of auditors who audit listed companies is laid down in the PAO and the FRCO. Under the PAO, the HKICPA is responsible for setting up accounting and auditing standards, the admission requirements for auditors as well as ethical standards, and for auditors' oversight including the imposition of disciplinary actions, in relation to auditors registered in HK.</p> <p>Under the FRCO the investigation of non-compliance with accounting standards committed by listed companies, as well as of irregularities with auditing standards committed by their auditors (including overseas auditors) has been entrusted to the FRC.</p> <p>The current arrangements are the result of an evolution towards greater independence of the oversight framework for the accounting and auditing profession and additional reforms are planned. The end objective is to become member of the International Forum of Independent Audit regulators. To this end the Government is benchmarking current arrangements against practices of other countries. Overall the thrust of the reforms is to introduce independent oversight by the FRC of the regulation of auditors with listed clients, including the setting of auditing and ethical standards. The Government is currently developing detailed proposals. It expects to engage with relevant stakeholders this year, followed by a full scale public consultation, with the objective of having the legislative reforms passed within the period of this legislature (2016).</p> <p><b>HKICPA</b></p> <p>The main body of the HKICPA is its Council. Pursuant to the PAO, the Council of the Institute is</p>

composed of 18 accountants (including two government representatives as ex officio members) and four lay members appointed by the Government. These four independent members were added as part of the reforms to strengthen the body's independence. The PAO specifies that at least six Council members must not be full-time accounting practitioners; as a result at least 12 out of the 22 members are non practitioners (i.e. a majority).

HKICPA's revenue mainly comes from member subscription, student fees, firm registration fees and fees for practicing certificates.

#### *Registration function*

Pursuant to the PAO, the HKICPA is in charge of setting admission criteria for auditors that audit domestic companies. If requirements are met, then the auditor is included in the registry.

To become a certified public accountant, a person has to hold an accountancy degree or equivalent qualification accredited or recognized by the Institute, pass the Institute's qualification programme and gain relevant practical experience. All certified public accountants have to comply with HKICPA Statement 1.500 Continuing Professional Development (CPD) which sets out CPD requirements that must be complied with for annual membership renewal in accordance with Section 28(2)(c) of the PAO. Statement 1.500 conforms with the International Education Standard for Professional Accountants 7.

Auditors in HK are required to hold a practising certificate (PC). To obtain a PC, a person must be a certified public accountant, and may be required to pass examinations in local law and taxation (and where applicable auditing), and fulfil relevant accounting experience requirements.

There are currently about 36,000 members of the Institute, out of which about 4,190 hold a PC.

Overall the big four audit firms audit listed companies that make up 98 percent of HKEx market capitalization. By number of companies, there is a second tier of audit firms that audit an important number of medium and small listed issuers. In total, about 64 audit firms currently conduct audits of listed companies.

#### *Oversight function*

The HKICPA is in charge of the oversight of domestic audit firms, including those that conduct audits on companies listed in the exchange. The HKICPA exercises this function via its practice review committee.

#### *Disciplinary function*

As part of the reforms to strengthen independence, the disciplinary function is entrusted to the Disciplinary Committee. Reports from the compliance department of HKICPA on complaints received are considered by the Professional Conduct Committee (PCC).

Recommendations of PCC and independent investigation committees where referral to a disciplinary committee is considered appropriate are made to the Council. The Council at its discretion can decide to refer a case to a Disciplinary Committee which has specific powers set out in the PAO. Where the Council decides not to refer a case to a Disciplinary Committee, the complainant can compel the Council to appoint a Disciplinary Committee unless the Council

thinks the case is frivolous. For every case to be heard a disciplinary committee is convened by a lay person appointed by the Government. The convener selects the members from two panels: panel A which consists of lay persons appointed by the Government and panel B which consists of accountants appointed by the Institute. Each Disciplinary Committee consists of three members from panel A (including the chairman) and two from panel B, thus the majority, including the chairman, are lay persons appointed by the Government.

If a Disciplinary Committee is satisfied that a complaint is substantiated, the Disciplinary Committee has power under the PAO to make any one or more of the following orders: (i) removal from the register; (ii) reprimand; (iii) penalty not exceeding HK\$500,000; (iv) cost order; (v) cancellation of the practising certificate; and (vi) denial of the issuance of a practising certificate permanently or for a specified period. HKICPA explained that under the current framework the Committee cannot impose conditions on a license.

All hearings of the Disciplinary Committee are open to the public and the disciplinary decisions are to be made public by way of HKICPA press release. The compliance department of HKICPA publishes reports with general statistics on the number of reviews and enforcement actions, with no names.

### **FRC**

The FRC was established in 2006 with the objective of strengthening the independence of the investigative function. As indicated above, under the present regime the FRC is in charge of the investigation of non-compliance with accounting and auditing standards pertaining to the financial statements of listed issuers. To carry out this function it has full investigative powers, including the power to request information from both auditors and listed companies. This power extends to overseas auditors appointed to audit HK listed entities.

The FRC does not have enforcement powers; thus if after an investigation it has grounds to believe that an irregularity has been committed by an audit firm the case is referred to the HKICPA so that it can exercise disciplinary powers via the Disciplinary Committee.

All members of the FRC are appointed by the Government, including three members who are appointed on an *ad personam* basis on the nomination of HKICPA, HKEx and SFC respectively, and two ex-officio members, namely the Registrar of Companies and the Chief Executive Officer of FRC. The FRCO (Cap. 588) stipulates that the majority of members must be lay members.

FRC is funded on an equal cost sharing basis by the HKSAR Government (through the Companies Registry), HKICPA, HKEx and SFC. There is also a general reserve fund of HK\$20 million for FRC to deploy to meet any inadequacies of the recurrent funding and other exigencies of circumstances

### **Auditors' Oversight**

#### *The HKICPA practice review program*

The HKICPA has developed a process for conducting practice reviews (auditor inspections) in Hong Kong. The process was reengineered in 2007. The authorities stated that the process meets all requirements under International Federation of Accountants Statements of Membership Obligations 1 ("IFAC SMO 1").

The practice review committee is responsible for the review program. It develops an annual plan. Overall, auditors of listed issuers are reviewed on a separate cycle, and are inspected at least every 3 years, with the following breakdown:

- The big four are inspected annually;
- Firms with portfolios of 20 or more engagements have one “full” inspection and one interim inspection (follow up or thematic) in the three year period (around 10 more firms); and
- The remaining firms with engagements with listed issuers are reviewed every 3 years (around 50 more firms).

The review team consists of 12 fully qualified accountants. All of them are full time employees of the HKICPA, mainly with experience from the big four firms, who are kept up to date via training. There are rotation requirements: leaders of the teams that audit the big four are rotated after three years. Last year a first full rotation took place. At the end of last year the HKICPA had completed two three year cycles.

Each inspection encompasses a review of the environment of control, policies, procedures, and reviews of specific audit engagement files. The sample consists of six to eight files for big four firms. The size of the team allocated for each inspection varies; for a large firm HKICPA allocates four or five staff, and the on-site component lasts three weeks. Market participants interviewed provided positive feedback on the quality of the teams and the thoroughness of their reviews.

All inspection reports are delivered to the practice review committee and include recommendations by the inspection team for appropriate follow up action. The committee can make recommendations of action for firms to address the application of professional standards, order a follow up inspection to verify that the audit firm has implemented appropriate follow up action or in cases where material deficiencies are found make a complaint to the Disciplinary Committee. All recommendations are followed up by inspection or desk-top review.

Senior management of the HKICPA indicated that reviews rarely result in disciplinary actions. In this regard, enforcement actions have been taken in three or four cases, and only one suspension has taken place. Furthermore, because the HKICPA does not have powers to request information from listed companies, if deficiencies in relation to the audits of listed companies are found they would be shared with the FRC (which has full investigative powers), and disciplinary actions at the HKICPA would be kept on hold. Other stakeholders also questioned the structure of the disciplinary panels, since in their view they did not foster the development of expertise nor of precedents. This in turn can have an effect on enforcement as a whole.

*The HKICPA, HKEx and FRC program of review of financial statements*

In addition to the practice review program, and as indicated in Principle 18, the HKICPA, the FRC and the HKEx conduct a program of review of financial statements. All three review programs have the objective of improving financial reporting. If the review of financial statements reveals that there are auditing irregularities, FRC would initiate an investigation. HKICPA would consider if any follow-up actions are warranted if the auditing irregularities are

	<p>substantiated.</p> <p>Jointly the three organizations cover less than 18 percent of the financial statements of listed issuers in a year. The HKEx has the most extensive program—it reviews 120 financial statements a year. The FRC review 75 financial statements per year. The HKICPA review around 80. To avoid overlap they send each other the lists of companies whose statements would be reviewed.</p> <p>The HKEx conducts these reviews through in-house staff. The FRC uses professional staff from large and mid-tier accounting firms and academics who do it pro-bono and on an anonymous basis. Each statement is usually sent to two reviewers for their comments. HKICPA also engages external reviewers to conduct the reviews.</p> <p>Each organization follows a risk based approach to determine the statements that will be reviewed. In addition, all three parties include a theme per year (for example mining companies one year, etc).</p> <p>Each year, the three oversight bodies host a joint reporting forum at which they provide feedback on areas of concern revealed by the reviews.</p> <p>The FRC emphasized that in their reviews they have not found major failures, that is cases where the misapplication of standards left the market misinformed.</p> <p>Complaints The FRC indicated that complaints against listed companies are not frequent. When related to corporate misconduct, they are sent to the SFC or DPP. Complaints related to misapplication of accounting and auditing standards are dealt with by the FRC.</p>
Assessment	Partly Implemented
Comments	<p>The main reason for the grade relates to the governance structure of the HKICPA in connection with question 3 of the methodology; and the enforcement framework vis-à-vis question 7 of the Methodology.</p> <p>The assessors acknowledge the progress that has been made to strengthen the framework for auditors' oversight. However in practice the HKICPA is still perceived to be a self-regulatory body, given the presence of practitioners in its board, as well as on the disciplinary panels. Further while the panels have added some level of independence, the current arrangements do not seem to foster the development of expertise and precedents. In addition, the range of enforcement actions appears limited, in particular due to the limitations on the amount of fines. Finally the HKICPA does not have jurisdiction to review auditors not registered in HK but who audit foreign companies listed in HK.</p> <p>The assessors note that for Mainland auditors there is a special arrangement between the authorities. Other non HK auditors have been accepted but a requirement has been that they be subject to independent oversight by a body of a jurisdiction which is signatory of the IOSCO MMoU. This provides some tools to the SFC to require information.</p> <p>As indicated in the description the authorities are aware of many of these challenges and are</p>

	committed to make additional improvements to the system.
<b>Principle 20.</b>	Auditors should be independent of the issuing entity that they audit
Description	<p><b>Independence requirements</b></p> <p>Pursuant to the PAO, the HKICPA is responsible for issuing auditing and ethical standards for auditors registered in HKSAR. Standards for the independence of external auditors are set out in HKICPA's Code of Ethics for professional accountants, which is substantially the same as the International Code of Ethics promulgated by the International Ethics Standards Board for Accountants. Accordingly it deals with all aspects required by this Principle.</p> <p>Section 290 of the HKICPA Code of Ethics deals explicitly with independence obligations. Independence obligations apply to the firm and its network. Independence is defined as comprising (i) independence of mind, and (ii) independence of appearance. The Code then lays out a conceptual framework to deal with independence that must be applied by professional accountants to:</p> <p>(a) Identify threats to independence;</p> <p>(b) Evaluate the significance of the threats identified; and</p> <p>(c) Apply safeguards, when necessary, to eliminate the threats or reduce them to an acceptable level.</p> <p>When the audit firm determines that appropriate safeguards are not available or cannot be applied to eliminate the threats or reduce them to an acceptable level, the firm is required to eliminate the circumstance or relationship creating the threats or decline or terminate the audit engagement. An audit firm must use professional judgment in applying the conceptual framework.</p> <p>Paragraphs 290.102 to 290.231 of Section 290 describe specific circumstances and relationships that create or may create threats to independence (practical application of the conceptual framework). The paragraphs deal with issues such as the significance of (i) financial interests, (ii) loan or guarantees, (iii) business relationships, (iv) family and personal relationships: (v) recent services provided to an audit client.</p> <p>The paragraphs describe the potential threats and the types of safeguards that may be appropriate to eliminate the threats or reduce them to an acceptable level and identify certain situations where no safeguards could reduce the threats to an acceptable level. The paragraphs do not describe all of the circumstances and relationships that create or may create a threat to independence. The firm and the members of the audit team must evaluate the implications of similar, but different, circumstances and relationships and determine whether safeguards can be applied when necessary to eliminate the threats to independence or reduce them to an acceptable level.</p> <p>The Code also has explicit provisions on long association of senior personnel (including partner rotation) with an audit client. Paragraphs 290.150 ss require rotation of the key partner after seven years and a cool off period of two years. Threats related to long association of other partners must also be evaluated and depending on the circumstance rotation or regular independent quality reviews must be performed. The Code also has explicit provisions of non assurance services to clients, including a list of services that should not be provided.</p>

Non HK reporting accountants and auditors must be independent of both overseas company and any other company concerned to the same extent required of an auditor under the CO and in accordance with the HKICPA Guidance on Independence or the Statements on Independence issued by the IFA.

### **Compliance with independence requirements**

There are several mechanisms that seek to ensure auditor's independence

#### *Review by the own firm*

The HK Standard on Quality Control 1 requires an audit firm to establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel and, where applicable, others subject to independence requirements (including experts contracted by the firm and network firm personnel), maintain independence as required by the Code.

Such policies and procedures should enable the firm to:

- Communicate its independence requirements to its personnel and where applicable, others subject to them; and
- Identify and evaluate circumstances and relationships that create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the engagement.

Such policies and procedures should require:

- Engagement partners to provide the firm with relevant information about client engagements, including the scope of services, to enable the firm to evaluate the overall impact, if any, on independence requirements;
- Personnel to promptly notify the firm of circumstances and relationships that create a threat to independence so that appropriate action can be taken; and
- The accumulation and communication of relevant information to appropriate personnel so that:
  - The firm and its personnel can readily determine whether they satisfy independence requirements;
  - The firm can maintain and update its records relating to independence; and
  - The firm can take appropriate action regarding identified threats to independence. Appropriate action by the firm and the relevant engagement partner includes applying appropriate safeguards to eliminate the threats to independence or to reduce them to an acceptable level, or withdrawing from the engagement. In addition, the firm provides independence education to personnel who are required to be independent.

At least annually, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent by the Code.

#### *Audit Committee*

Under the Main Board Listing Rule 3.21 and GEM Listing Rule 5.28 of HKEx every listed issuer must establish an audit committee made up only of non-executive directors. HKICPA's "A Guide for Effective Audit Committees" sets out guidance on the establishment of an audit

	<p>committee, in which paragraph 51 states that members of the Committee may have useful experience in assessing the quality of the service and the reasonableness of the fees charged by the external auditors and they should make recommendations to the board on the appointment of the external auditors, the audit fee, and any questions of resignation or dismissal. Pursuant to Rule 3.21 Listed issuers may adopt the terms of reference set out in that guide, or they may adopt any other comparable terms of reference for the establishment of an audit committee. Rule 3.22 requires the board of directors of the listed issuer to approve and provide written terms of reference for the audit committee which clearly establish the committee's authority and duties.</p> <p>In addition, there are specific provisions in the Code of Corporate Governance Practices in Appendix 14 of the Main Board Listing Rule and Appendix 15 of the GEM Listing Rule of HKEx which state, inter alia, that the audit committee's terms of reference should include at least a duty to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process in accordance with applicable standards.</p> <p>Market participants indicated that the role of audit committees have improved over time; although in practice how proactive they are varies considerably from company to company. Some participants commented that this variation is not necessarily correlated with the size of the company. They also indicated that they expect this role to continue to strengthen as recent reforms to the CO have strengthened provisions concerning fiduciary duties of directors</p> <p><b>Resignation</b></p> <p>Under the Main Board Listing Rule 13.51(4) and the GEM Listing Rule 17.50(4) of HKEx an issuer must publish an announcement as soon as practicable in regard to any change in its auditors, the reason(s) for the change and any other matters that need to be brought to the attention of holders of securities of the issuer.</p> <p>In general, many market participants commented that under the current market structure, audits on companies from the Mainland seem to pose greater challenges that auditors need to manage adequately, starting with the sheer size of the country which can affect their ability to get a good understanding of the company's business. Problems with the quality of financial reporting were mentioned also as an issue mainly in connection with the smaller non-state-owned enterprises listed in Hong Kong. Problems with secrecy provisions relating to listed entities that are state-owned enterprises were also mentioned, and there is currently a court case involving an auditing firm in this regard.</p> <p>Anecdotal evidence suggests that at least the large auditors are being cautious in taking these engagements, as suggested by the resignations that have taken place during the pre-filing period.</p>
Assessment	Broadly implemented
Comments	<p>The grade stems from the current enforcement framework in connection with question 7 of the methodology.</p> <p>Current independence requirements are robust, and there are mechanisms in place to oversee auditors' compliance with them. However, as indicated in Principle 19 the current disciplinary framework does not appear to be strong enough. The assessors also note that the quality of</p>

	engagement of the audit committees varies, however there is consensus that there is a positive evolution.
<b>Principle 21.</b>	<b>Audit standards should be of a high and internationally acceptable quality</b>
Description	<p><b>Standards required</b></p> <p>The CO and the Main Board Listing Rules require that financial statements included in public offering and listing particulars documents and publicly available annual reports shall be audited in accordance with the auditing standards in Hong Kong. Such standards are converged with the International Standards on Auditing.</p> <p>Under the special arrangement described in Principle 19, companies from Mainland that have a dual listing can choose to use the Mainland accounting standards as well as to use a Mainland incorporated auditing firm which would use the Chinese Standards on Auditing</p> <p>For overseas companies the Listing Rules requires auditors to conduct their audits based on a standard comparable to that required by the HKICPA or the IAASB of the IFA. To date the Exchange has accepted the following standards: (i) Australian Auditing Standards, (ii) Canadian GAAP, (iii) Professional auditing standards applicable in France, (iv) Italian Auditing Standards, (v) Singapore Standards on Auditing, (vi) the Standards for Investment Reporting Issued by the Auditing Practice Board of the UK and the (vii) US Public Company Accounting Oversight Board auditing standards.</p> <p><b>Standard setting</b></p> <p>As stated in Principle 19, the HKICPA is the standard setting body. The process of standard setting is open and transparent. The practice of the HKICPA has been to open the consultation process for exposure drafts of the IASSB at the same time than the IASSB does its own consultation. Different stakeholders are consulted, including members and member practices of HKICPA, companies in Hong Kong, HKEx, regulatory and legal authorities, academics and other interested individuals and organizations. Comments are sent to the IASSB. Upon approval of the standards by the IASSB, the HKICPA approves them also for Hong Kong.</p> <p>HK Standards on Auditing can be found in the HKICPA website. Minutes of all meetings of the relevant HKICPA committee as well as the Institute's submission to IASSB on its consultation papers and exposure drafts are also available at HKICPA's website.</p> <p><b>Mechanisms to ensure compliance with auditing standards</b></p> <p><i>Own firm</i></p> <p>The HKSQC1 requires audit firms to establish a System of Quality Control that includes policies and procedures that address each of the following elements:</p> <ul style="list-style-type: none"> <li>• Leadership responsibilities for quality within the firm.</li> <li>• Relevant ethical requirements.</li> <li>• Acceptance and continuance of client relationships and specific engagements.</li> <li>• Human resources.</li> <li>• Engagement performance.</li> <li>• Monitoring.</li> </ul> <p>The firm must document its policies and procedures and communicate them to the firm's personnel. Compliance with this obligation is reviewed during the HKICPA reviews.</p>

	<p><i>HKICPA review program</i> As explained in Principle 19 under the current regulatory structure the HKICPA has in place a program of reviews of audit firms.</p> <p><i>HKICPA and FRC financial statements review program</i> As explained under Principle 19, the HKICPA and FRC also have programs of reviews of financial statements of listed issuers aimed at detecting auditing irregularities and non-compliances with accounting standards.</p>
Assessment	Broadly Implemented
Comments	<p>The grade stems from the current enforcement framework vis-à-vis question 4 of the methodology.</p> <p>Auditing standards in place are of high international quality, and the HKICPA has instituted a program that reviews auditors' compliance with them that is in line with programs established in other jurisdictions. However, as stated under Principle 19, the enforcement framework has limitations.</p> <p>The assessors note that Mainland companies with dual listing can use the Chinese Standards on Auditing. The assessors did not conduct an independent assessment of such standards. However they note that the WB ROSC mentioned in Principle 20 concluded that such standards were largely comparable to IAASB-issued ISA.</p>
<b>Principle 22.</b>	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.
Description	<p><b>Requirement for a license</b></p> <p>Effective June 1 2011, a firm that wants to provide credit rating services in Hong Kong must be licensed for Type 10 regulated activity under the SFO (Chapter 571). In addition, the individual analysts are subject to licensing as representatives.</p> <p>Both the provision of credit rating services and credit ratings are defined terms under Part 2 of Schedule 5 to the SFO.</p> <p>The obligation to obtain a license stems from carrying on a business in the regulated activity (provision of credit rating services) in Hong Kong; regardless of whether such ratings are going to be used for regulatory purposes or not.</p> <p>Ratings are used in Hong Kong for regulatory purposes but only in limited cases: mainly for purposes of determining capital requirements for banks and securities firms. Only the ratings of the global CRAs (Fitch, Standard &amp; Poor's and Moody's) can be used for regulatory purposes. The reference predates the regulation of CRAs, and that is why the names of these CRAs are "hardwired" into the legal framework.</p> <p><b>Regulatory framework applicable to CRAs</b></p> <p>The provision of credit rating services is regulated in the SFO under the general framework for securities intermediaries. Accordingly, all the obligations and requirements imposed on</p>

securities intermediaries are applicable to CRAs, both at the moment of licensing and on an ongoing basis. By the same token, all the powers that the SFC has in connection with securities intermediaries are applicable to CRAs, including the powers to refuse a license, to request information, to conduct investigations and inspections and to impose disciplinary actions.

In addition, the SFC has developed a Code of Conduct for CRAs which sets out the specific obligations and requirements that the SFC expects the CRAs to meet. The CRA Code is fully aligned with the IOSCO's Code of Conduct Fundamentals for Credit Rating Agencies. It is divided in four sections:

- Obligations related to the quality and integrity of the rating process including requirements that a CRA should (i) adopt, implement, and enforce written procedures, (ii) use ratings that are rigorous, systematic and where possible, which result in ratings that can be subject to some form of objective validation, (iii) keep records, (iv) use representatives who individually and collectively have appropriate knowledge and experience, (v) ensure that it has sufficient resources, (vi) establish a review function;
- Independence and avoidance of conflicts of interest: A CRA should (i) refrain from carrying on businesses which can reasonably be considered to give the rise to conflicts of interest; (ii) refrain from entering into any contingent fee arrangement, (iii) adopt policies and mechanisms to identify, eliminate or manage conflicts of interest, (iv) disclose actual or potential conflicts in a complete manner, (v) disclose compensation arrangements, (vi) ensure that reporting lines and compensation for representatives are designed to eliminate conflicts.
- Responsibilities to the investing public and rated entities: A CRA should (i) publicly disclose all ratings and updates of such ratings in a timely manner; (ii) disclose policies for distributing of ratings and updates, (iii) ensure that clear and easily comprehensible information on its procedures, methodologies and assumptions is publicly available, (iv) where sufficient historical data exists, publish information about the historical default rates of rating categories and about ratings transition frequency, and whether the default rates of rating categories has changed over time, (v) disclose any material modification to its methodologies; (vi) adopt procedures and mechanisms to protect confidential information, (vii) use confidential information only for purposes related to its rating activities, (viii) ensure that its representatives and employees do not selectively disclose any non public information about ratings
- Disclosure of a CRA's own code of conduct and communication with market participants: A CRA should have its own code of conduct and should disclose it to the public.

### **Practice**

#### *Registration*

Since the implementation of the CRA regulatory regime, seven CRAs have been granted licenses. The major global CRAs are present in Hong Kong; in addition there are 2 CRAs with Mainland background, both of which are in a start-up stage, and a very small domestic CRA, also in the start-up stage.

The formal application process lasted roughly three months; however SFC staff commented

	<p>that the CRAs approached the SFC informally before the applications were submitted, and sought their views in specific aspects so as to ensure that at the time of the application their governance, policies and procedures complied with the expectations of the SFC.</p> <p>The review conducted by staff focused on five core areas: (i) business, (ii) internal controls and compliance, (iii) substantial shareholders, (iv) management team/ROs, and (v) vetting of individual applicants.</p> <p>The review of files did indicate that the licensing process was thorough; further SFC staff made substantive inquiries relates to policies and procedures, as well as the fitness and properness of the ROs.</p> <p><i>On-going supervision</i></p> <p>Ongoing supervision of CRAs is performed by the Intermediaries Supervision Department. While there is no separate unit in charge of the supervision of CRAs, the SFC has included persons with relevant background on its teams; in addition, staff assigned to CRA supervision has had relevant training.</p> <p>The off-site monitoring focuses on three areas: business model, conduct supervision and industry developments.</p> <p>The Intermediaries Supervision Department follows a risk based approach; which in practice means that the bulk of their work has focused on the three global CRAs. Initially the Intermediaries Supervision Department collected a significant amount of data on these firms, to develop a baseline of their business profile and their rating population, which was followed by a stratification of their rating portfolio.</p> <p>A key input for conduct supervision (and for purposes of inspection planning) is the annual report of the internal control environment and methodology that CRAs are required to provide. As of the time of this assessment, the SFC had received reports for two years. SFC staff commented that after the first cycle, they informed some of the CRAs that these reports were expected to be of a better quality. The second year's reports were better</p> <p>The SFC also monitors actions of major regulators, in particular their annual reports as well as any public disciplinary action.</p> <p>In terms of industry developments, the SFC sampled rating publications, such as new issue rating announcements and sector reports. In addition to the work mentioned above, the SFC conducts analysis of past performance, focused on structured products as this is the area perceived to be more problematic. In this regard they look at the rating population, look at downgrades and the rating transition, and compare the Asia Pacific region against global structure finance.</p> <p>Since the implementation of the CRA licensing regime, the SFC has inspected two of the big three CRAs. The inspection covered all major areas. In both cases, letters of deficiencies were sent to the CRAs.</p>
Assessment	Fully implemented
Comments	

<b>Principle 23.</b>	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.
Description	<p><b>Analysts</b></p> <p>Under the current framework, the issuance of analysis or reports on securities and futures contracts falls under the definitions of Type 4 regulated activity (advising on securities) and Type 5 regulated activity (advising on futures contracts) and therefore is subject to the licensing requirements. The analysts themselves are subject to individual licensing as representatives.</p> <p>As with any other regulated activity, the firm must demonstrate that it is fit and proper to be licensed or registered having regard to the criteria set out in section 129 of the SFO, including demonstrating that it is financially sound, competent, honest, reputable and reliable and in compliance with all relevant laws, codes and guidelines promulgated by the SFC and other regulators (where applicable). A similar fit and proper test applies to the analysts.</p> <p>Intermediaries that provide advisory services are expected to ensure that they have in place processes and procedures to address conflicts of interest. The general expectations and the competence required are set out in the SFC's Fit and Proper Guidelines and the Guidelines on Competence. In addition, a set of specific guidelines for analysts was developed and implemented in 2005 based on the IOSCO's Statement of Principles for Addressing Sellside Analyst Conflicts of Interest. They are included in the Code of Conduct</p> <p>The above guidelines apply to (i) an analyst, (ii) a firm that employs any analyst and (iii) a firm that issues any investment research. The Code of Conduct applies to (i) investment research on securities traded in HK, and (ii) investment research on securities that are issued or to be issued by a new listing applicant which are to be traded in HK and investment research that has an influence on such securities. SFC staff indicated that these guidelines were reviewed and strengthened in 2011 to extend the Code of Conduct to pre-deal research published by connected analysis and REITS, as a result of concerns in connection with the independence of such research.</p> <p>The Code of Conduct contains general principles, which are then disaggregated into more specific obligations, fully aligned with the key issues included in Principle 23.</p> <ul style="list-style-type: none"> <li>• Analysts trading and financial interest: The firm is required to (i) establish trading policies, (ii) place limitations on dealing by analysts, and (iii) impose obligations to disclose relevant relationships and relevant financial interest.</li> <li>• Firm financial interest and business relationships: The firm is required to (i) disclose its financial interest; relevant market making activities; relevant relationships; and relevant business relationships in the research report, (ii) not deal or trade ahead of the issuer, (iii) not provide assurances to issuers of favourable reviews, and (iv) not issue research within certain specific periods of an offering.</li> <li>• Analysts reporting lines and compensation: The firm should ensure that (i) reporting lines and compensation of analysts are not linked to the investment banking function, (ii) there is no preapproval of research by the investment banking function; and (iii) analysts do not participate in the business activities designed to solicit investment</li> </ul>

	<p>banking business.</p> <ul style="list-style-type: none"> <li>• Firm compliance systems: A firm must maintain (i) policies and control procedures to eliminate, avoid or manage actual and potential conflicts of interest, and (ii) procedures to ensure that analysts are not provided with material information that is not reasonably expected to be included in the prospectus or publicly available.</li> <li>• Outside influence: A firm must disclose whether the issuer or a third party has provided or agreed to provide any compensation or other benefits in connection with investment research.</li> <li>• Clarity, specificity and prominence of disclosure: The disclosure should be clear, concise, specific, given adequate prominence and released in a timely and fair manner.</li> <li>• Integrity and ethical behavior: An analyst should have reasonable basis for his analysis and recommendations, and should define the terms used in its research.</li> </ul> <p><b>Supervision</b></p> <p>Conflicts of interest is one of the stated focus areas covered in SFC ongoing supervision of intermediaries. Provision of research is one activity that could give rise to conflicts and thus is looked at in the context of the general framework for risk based supervision.</p> <p>In practice, research in HK is mainly provided by the larger intermediaries; and there are few independent research houses. SFC staff look at compliance with the obligations through their on-site inspections, as well as through their review of the news. As part of the on-site inspections they look at whether policies and procedures are being complied with, in particular the relationship with the investment banking function (reporting lines and compensation).</p> <p>There have been a few cases of enforcement action taken against an analyst. The most recent one was triggered by a complaint and involved conflicts of interest.</p> <p><b>Other evaluative services</b></p> <p>Under the current framework IPO sponsors are required to hold a licence for Type 6 regulated activity (advising on corporate finance). Through its ongoing supervisory program, SFC staff detected weaknesses with the role that they were expected to play in connection with the listing process. As a result, the SFC launched a consultation in May 2012 on proposals to enhance the regulatory regime for IPO sponsors. The conclusions were published in December 2012. The new requirements aim to ensure that sponsors conduct thorough due diligence on any company aspiring to access Hong Kong's securities market before making a listing application. The requirements apply to listing applications submitted from 1 October 2013 onwards. The reforms emphasize early, comprehensive due diligence and a properly drafted prospectus to accompany the application, and encourage sponsors to take a responsible, proactive and constructive role when leading IPOs. Additionally, the SFC recommended that the CO be amended to clarify that the existing civil and criminal prospectus liability provisions apply to IPO sponsors. The SFC is working with the Government on the proposed legislative amendments.</p> <p>SFC staff informed that no other evaluative service has prompted adjustments to the perimeter of regulation.</p>
Assessment	Fully implemented

Comments	
<b>Principles for Collective Investment Schemes</b>	
<b>Principle 24.</b>	The regulatory system should set standards for the eligibility, governance, organization and operational conduct of those who wish to market or operate a CIS.
Description	<p><b>Background</b></p> <p><i>Industry</i></p> <p>At 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. For internal administrative and monitoring purposes, these management firms are classified into 101 fund management groups, including SFC-licensed management firms and overseas management firms.</p> <p>A total of 1,847 funds were authorized by the SFC for public offering in the Hong Kong market, of which 305 (17 percent) were Hong Kong domiciled funds. Out of the 305 SFC authorized funds domiciled in HK, there were 50 SFC licensed firms managing them. Of the remainder, 1,045 (57 percent) were funds domiciled in Luxembourg; 277 (15 percent) were domiciled in Ireland; 151 (8 percent) were domiciled in the Cayman Islands; and 53 (3 percent) were domiciled in the UK.</p> <p>At end of 2012, total assets under management was US \$1,237 billion, of which 120 (9.7 percent) billion was attributable to Hong Kong investors.</p> <p>As at 31 July 2013, there were a total of 10 SFC-authorized REITs listed on SEHK, with a total market capitalization of approximately HK\$176 billion. This represented about 0.8 percent of the total market capitalization of all listed securities on SEHK.</p> <p>Funds management is shared between bank and non-bank groups, but the selling of funds is heavily dominated by banks.</p> <p><i>Regulatory framework</i></p> <p>The authorization, marketing and operation of CIS are governed by the SFO and its subsidiary legislation. While some provisions in the SFO are specific to CIS, CIS activity is also regulated through provisions applying to securities and financial products generally (Schedule 1 of the SFO defines "securities" to include CIS and "financial product" to include – among other things – CIS), or applying to regulated activities generally (CIS operators and marketers are subject to licensing requirements as intermediaries and the provisions that apply to intermediaries apply to them).</p> <p>Codes made by the SFC under s. 399 of the SFO play an important part in the regulation of CIS:</p> <ol style="list-style-type: none"> <li>a. Section II of the SFC Handbook for Unit Trusts and Mutual Funds, ILAS and Unlisted Structured Investment Products (the Products Handbook) sets out a comprehensive UTC. It establishes guidelines for the authorization of scheme in the nature of mutual fund corporations or unit trusts and sets out, amongst others, eligibility requirements for scheme operators (management companies and their delegates, trustees and</li> </ol>

- custodians) who wish to operate a publicly offered scheme. ; and
- b. The FMCC provides guidance on minimum standards of conduct specifically for fund managers licensed by or registered with the SFC.

Non-Hong Kong managers offering products into the Hong Kong market must be from a jurisdiction with an acceptable inspection regime (AIR) (see further below). Products can only be marketed in Hong Kong through a firm licensed by or registered with the SFC in Hong Kong. Unless an exemption under the SFO applies, CIS products offered to the public in Hong Kong must be authorized by the SFC in Hong Kong, including products offered by a CIS operator not domiciled in Hong Kong.

### **Regulatory framework - authorization**

#### *Marketing a CIS*

A person carrying on a business in regulated activities as defined under Schedule 5 to the SFO in Hong Kong, including the marketing of securities such as CIS, is required to be licensed by or registered with the SFC.

#### *Operating a CIS*

Section 103 of the SFO makes it a criminal offence for any scheme to be offered to the public in Hong Kong without SFC's prior authorization. A scheme that is or is intended to be sold only to professional investors (as defined in the SFO, covering broadly financial sector entities and individuals with wealth above the prescribed minimum portfolio threshold requirement) is exempted. The criteria for authorization are set out in the UTC, including the standards for eligibility of the management company who wish to manage a publicly offered scheme.

CIS operators domiciled in Hong Kong are required to be licensed by or registered with the SFC. They hold a licence or registration for Type 9 regulated activity (asset management).

Operators who do not carry on any businesses in regulated activities in Hong Kong, such as fund managers based in overseas jurisdiction, are not required to be licensed by or registered with the SFC, but they are required to have each scheme (fund) that is offered to the public in HKSAR authorized by the SFC. Under UTC 5.1, every scheme for which authorization is requested must appoint a management company acceptable to the SFC. A non-Hong Kong domiciled management company, or investment adviser to which the investment management function is delegated, must be based in a jurisdiction with an AIR (see below).

### **Eligibility criteria**

Chapter 5 of the UTC sets out requirements for management companies of CIS.

UTC 5.2 requires a management company to:

- a. be engaged primarily in the business of fund management;
- b. have sufficient financial resources at its disposal to enable it to conduct its business effectively and meet its liabilities. In particular, it must have a minimum issued and paid-up capital and capital reserves of HK\$1 million or its equivalent in foreign

- currency;
- c. not lend to a material extent; and
- d. maintain at all times a positive net asset position.

A scheme operator who intends to carry on a business in regulated activities in Hong Kong must satisfy the same minimum entry requirements that apply to other market intermediaries to be licensed by or registered with the SFC – for details see under Principle 29.

The UTC provides detailed criteria about competence and experience, and internal controls and risk management systems for specialist funds, including 8.4A futures and options funds (UTC 8.4A), guaranteed funds (UTC 8.5), index funds (UTC 8.6), HFs including funds of HFs (UTC 8.7), structured funds (UTC 8.8) and funds that invest extensively in financial derivative instruments (UTC 8.9).

#### *Integrity and competence*

As well as the general criteria applying to all licensees, specific provisions of the UTC apply.

UTC 5.4 requires the directors of the management company to be of good repute and in the opinion of the SFC possess the necessary experience for the performance of their duties.

UTC 5.5 sets out the requirements on the key personnel of the management company of a scheme. They are expected to be dedicated full-time staff with at least 5 years investment relevant experience managing public funds with reputable institutions. Sufficient human and technical resources must be at the disposal of the management company without relying solely on a single individual's expertise. The SFC must also be satisfied with the overall integrity of the management company including reasonable assurance in respect of the adequacy of internal controls and existence of written procedures.

In addition, there must be ongoing supervision and monitoring of the competence of the delegates of the management companies to ensure that the management company's accountability to investors is not diminished.

For a description of SFC practices (and where relevant those of the HKMA) in confirming compliance with integrity and competence criteria, see under Principle 29.

#### *Financial capacity*

An applicant licensed by or registered with the SFC is required to comply with the financial resources requirements as specified in the Securities and Futures Rules (Financial Resources) Rules (FRR) or other relevant regulatory requirements – see above and under Principle 30.

#### *Internal management procedures*

The Guidelines on Competence apply to all licensees (and RIs) concerning requirements in relation to their human resources, risk management and internal control systems, etc – see further under Principle 29.

In addition:

- a. paragraph 1.2(c) of the FMCC provides that a licensed fund manager should maintain satisfactory internal controls and written compliance procedures which address all applicable regulatory requirements; and
- b. there must be reasonable assurance about the adequacy of internal controls and the existence of written procedures, which should be regularly monitored by its senior management to ensure they are up-to-date and are complied with. Conflicts of interests must be properly addressed to safeguard investors' interests. (UTC 5.5(d).)

#### *Trustees*

UTC 4.1 and UTC 4.7 require every scheme to appoint a trustee/custodian that is independent of the management company. A trustee/custodian must be:

- a. a bank licensed under section 16 of the BO;
- b. a trust company which is a subsidiary of such a bank;
- c. a trust company registered under Part VIII of the Trustee Ordinance; or
- d. a banking institution or trust company incorporated outside Hong Kong acceptable to the SFC.

In limited circumstances, the trustee/custodian and the management company can be bodies corporate having the same ultimate holding company, whether incorporated in Hong Kong or outside Hong Kong (UTC 4.8). See further under Principle 25.

UTC 4.5 sets out general obligations of trustee/custodian, which include safekeeping of assets and taking reasonable care to ensure that the scheme is managed in accordance with the provisions of the constitutive documents. UTC 4.5 (f) requires the trustee/custodian to issue a report to the holders to be included in the annual report of the scheme on:

- a. whether, in the trustee/custodian's opinion, the management has in all material respects managed the scheme in accordance with the provisions of the scheme's constitutive documents; and
- b. if the management company has not done so, the respects in which it has not done so and the steps which the trustee/custodian has taken.

In practice, trustees/custodians of SFC authorized CIS in most cases are banks licensed in HK, subject to the supervision of HKMA, or overseas banks, subject to the supervision of overseas regulators acceptable to the SFC, or subsidiaries of such banks.

### **International cooperation**

#### *Fund managers*

The manager of a scheme authorized for offering to the public in Hong Kong may be situated outside Hong Kong provided that it is based in an AIR. The SFC in determining the acceptability of an overseas supervisory authority as an AIR looks to whether:

- a. the overseas regulatory authority or its delegate carries out inspections of investment management firms within its jurisdiction in a manner generally consistent with the SFC; and
- b. the SFC and the overseas regulatory authority have satisfactory procedures for the

	<p>timely exchange of information regarding investment management firms.</p> <p>SFC conducts a due diligence process before signing an MOU with a jurisdiction. It normally verifies with the home regulator the registration and compliance status of an applicant before authorization of the applicant's application and maintains an on-going dialogue regarding the scheme as long as it continues to be authorized by the SFC.</p> <p>For details of MOUs and co-operation arrangements, see under Principle 13 and 14.</p> <p><i>Trustees</i></p> <p>UTC 4.1 requires every scheme for which authorization is requested to appoint a trustee/custodian acceptable to the SFC. An acceptable trustee/custodian generally should, on an ongoing basis, be subject to regulatory supervision. In accordance with UTC 4.2, a trustee/custodian which is incorporated outside Hong Kong must be a banking institution or trust company which is acceptable to the SFC.</p> <p>Under item 2 of Appendix G of the UTC, in determining the acceptability of an overseas supervisory authority, SFC must be satisfied that either the overseas regulatory authority or its delegate carries out regular inspection of trustees/custodians within its jurisdiction or the latter is subject to regular review in a manner generally consistent with the SFC requirement.</p> <p><b>Sanctions for non-compliance</b></p> <p>Under section 103 of the SFO, a person commits an offence if they engage in unlicensed funds management or offer an unauthorized CIS in Hong Kong, and they are liable to a fine of up to HK\$500,000 or 3 years imprisonment.</p> <p>Overarching Principle (OP) 1.6 provides that failure to comply with any applicable provision of the Products Handbook may, among other things, cause SFC to consider whether such failure adversely reflects on whether the scheme and /or the offering document should remain authorized; and may cause the SFC to impose additional authorization condition(s), which may include restricting the further offering of the scheme to the public.</p> <p>SFC monitors the market to detect unauthorized offerings of CIS, including by reviewing advertisements on randomly selected days of the month.</p> <p>The sanction powers described under Principle 11 are available for breaches by fund managers of their obligations. These include administrative action and in serious cases, criminal sanctions.</p> <p><b>Supervision and ongoing monitoring</b></p> <p><i>Responsibility and powers of regulator</i></p> <p>The SFC has sole responsibility for regulation of CIS activity in Hong Kong, other than the role that the HKMA plays in the supervision of the securities activities of licensed banks and deposit taking institutions (see further under Principle 29).</p>
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The SFC has comprehensive powers with respect to the establishment and operation of CIS (see detail of its supervision and investigation powers under Principles 10 and 11). For CIS, its powers include the power to:

- a. authorize schemes to be offered to the public in Hong Kong (section 104(1) of the SFO);
- b. seek information from and conduct on-site inspections of CIS operators licensed by the SFC (section 180 of the SFO);
- c. conduct investigations (sections 182-183);
- d. withdraw authorization of schemes (section 106); and
- e. take remedial, disciplinary and other form of action for breaches of obligations (Parts IX and X of the SFO).

#### *Authorization*

The process for licensing or registering of CIS operators is the same as that for other licensed or registered intermediaries. For detail, see under Principle 29. As part of the licensing process, applicants are required to provide the SFC evidence that, if licensed, they can and will comply with the provisions of the UTC. For fund managers from an AIR seeking authorization of funds in Hong Kong, the SFC checks with the home jurisdiction regulator as part of the authorization process.

The process used by the SFC is set out in written procedures and the assessors' review of licensing files indicates that it involves a thorough review of all aspects of an applicant's proposed operations, its owners, directors and senior management.

The approval of new products (funds) involves review of disclosure documents (including the Product Key Facts Statements, KFS) and proposed advertising. Staff members of SFC's Investment Products Division review all disclosure documents and commonly ask questions where they have concerns about the quality of disclosure. If disclosure problems are not rectified, the Division writes to the applicant 9 months after the take up of the application indicating that it is minded to reject the application. These "mindedness" letters result either in rectification of the documents, or withdrawal of the application.

This process is followed for all funds, even if the regulator in a fund's home jurisdiction has already approved the disclosure documents.

#### *Ongoing monitoring*

SFC (and HKMA for institutions for which it is the supervisor) uses the same overall approach to ongoing supervision of CIS operators as they do for other licensees. This involves a combination of off-site monitoring and on-site inspections. The SFC uses a formal risk and impact assessment process for all licensees to select targets for inspection (see under Principle 31). For fund management, the nature of the asset classes involved and the track record of the fund manager are an important input in the risk and impact assessment process.

In their ongoing monitoring of funds, SFC staff members pay particular attention to, among other things, the trustees/custodians report and auditor's report. This monitoring applies

equally to all funds authorized in HK, even if their managers do not perform activities in HK. For example, all HK authorized funds are required to comply with specific provisions regarding pricing errors. If an error results in an incorrect price of 0.5 percent or more of the NAV per unit/share in addition to notification to the trustee/custodian and the SFC, investors must be compensated. During the period of January 2008 to July 2013 a total of 321 pricing errors were reported to the SFC, of which 285 pricing errors were related to SFC authorized funds constituted abroad. All of these pricing errors were processed by the SFC and completed in accordance with the requirements under the Code on Unit Trust and Mutual Funds.

For inspections of fund managers, staff members from the Investment Products Division may also participate as members of the Intermediaries Supervision team doing the inspection.

#### **On site inspections of fund managers (that operate in HK)**

<b>Type of Fund Manager</b>	<b>2008-2009</b>	<b>2009-2010</b>	<b>2010-2011</b>	<b>2011-2012</b>	<b>2012-2013</b>
Hedge fund	4	28	16	23	18
Other	16	46	60	38	54
<b>Total inspections</b>	<b>20</b>	<b>74</b>	<b>76</b>	<b>61</b>	<b>72</b>

The concept of AIR helps the SFC maintains regulatory oversight of overseas fund managers managing SFC authorized funds. As indicated above the SFC has entered into MoUs with the regulators of AIR jurisdictions and maintains regular dialogue with home regulators in connection with the SFC authorized funds that are regulated by the overseas regulator. For example, the SFC will inform the overseas regulator of any breaches of the UTC that comes to their attention that may be relevant to the overseas regulator's review, examination or determination regarding the registration, authorization or licensing status of managers or funds regulated by them. The same is expected of the overseas regulator. In terms of enforcement actions the SFC can commence market misconduct proceedings and civil remedial actions against overseas managers who are suspected to have contravened market misconduct provisions of the SFO. The table of enforcement sanctions on fund managers below includes all fund managers, local and overseas for the years 2008 to 2013:

#### **Sanctions imposed on fund managers – by type of breach**

<b>Type of Misconduct</b>	<b>2008/09</b>	<b>2009/10</b>	<b>2010/11</b>	<b>2011/12</b>	<b>2012/13</b>
Insider dealing	0	5	1	1	2
Market manipulation	0	2	0	2	0
Issuing unauthorized advertisement	2	2	3	4	2

Providing misleading information to SFC	0	1	1	0	2
Unlicensed activities	0	1	0	2	0
Other misconduct	3	3	5	0	4
<b>Total</b>	<b>5</b>	<b>14</b>	<b>10</b>	<b>9</b>	<b>10</b>

*Source: SFC*

Two examples of successful actions against fund managers located outside of HK are (i) Tiger Asia Management LLC, and (ii) George Stairs, both US based assets managers, against which the SFC obtained orders in relation to insider dealing.

### **Reporting and record keeping requirements**

#### *Record keeping*

Section 3(1)(a) and section 1 of the Schedule to the Securities and Futures (Keeping of Records) Rules (KRR) require licensed or registered scheme operators to maintain accounting, trading and other records as are sufficient to explain and reflect the financial position and operation of businesses which constitute any regulated activities.

Section 130(3) of the SFO provides for SFC's prior approval of premises to be used for keeping records and documents.

Paragraph 5.1 of the FMCC requires a licensed or registered fund manager to keep its accounts and records properly and in line with all applicable statutory requirements, and specifies the standard to be used

UTC 5.10 makes the management company responsible for maintaining the books and records of a scheme and preparing the scheme's accounts and reports.

For a Non-Hong Kong based schemes, UTC 9.1 provides that a scheme will be required to appoint a representative in Hong Kong if its management company is not incorporated and does not have a place of business in Hong Kong. UTC 9.3 sets out the functions of the representative which include delivering to the SFC, on request, all accounts and records relating to the sale and redemption of units/shares of the scheme in Hong Kong.

#### *Reporting*

UTC 11.6 requires at least two reports to be published for each financial year:

- a. annual reports and accounts containing the information provided in the UTC Appendix E must be published and distributed to holders within four months of the end of the scheme's financial year; and
- b. interim (6 monthly) reports, which must be published and distributed to holders within two months of the end of the period they cover.

	<p>Sections 3 and 4 of the Securities and Futures (Accounts and Audit) Rules (Cap. 571P of the Laws of Hong Kong) require licensed corporations including SFC-licensed fund managers to prepare audited financial statements on an annual basis</p> <p>UTC 11.8 requires that financial reports produced by or for the scheme, its management company and trustee/custodian must be filed with the SFC within the time frame specified in UTC 11.6.</p> <p>Additional reporting requirements apply to:</p> <ol style="list-style-type: none"> <li>a. money market funds - UTC 8.2(d) requires funds to file with the SFC within 7 days from the last working day of each month details of the total subscriptions to the fund that month, and details of the total funds under management at the end of that month;</li> <li>b. HFs - UTC 8.7(w) requires funds required to issue regular reports to holders of the scheme activities at least on a quarterly basis. These reports must be prepared and distributed in accordance with the UTC Appendix H – Guidelines on HFs Reporting Requirements. The reports must also be filed with the SFC.</li> </ol> <p>UTC 4.1 and UTC Appendix G require the trustee/custodian to file a copy of the auditor's report and the trustee/custodian report relating to the internal controls and systems of the trustee/custodian prepared pursuant to the requirements under the UTC Appendix G with the SFC within four months from the end of the period under review.</p> <p><i>Changes in management and operations</i></p> <p>Scheme operators licensed by or registered with the SFC are subject to the same on-going obligations that apply to other market intermediaries.</p> <p>Specified changes to intermediaries' management or organization are subject to the prior approval or notification requirements set out in the SFO and the Securities and Futures (Licensing and Registration) (Information) Rules (the Information Rules). In particular, a licensed scheme operator has to:</p> <ol style="list-style-type: none"> <li>a. seek prior approval of the SFC for any appointment of ROs;</li> <li>b. notify the SFC of any cessation of ROs within 7 business days after the cessation takes effect;</li> <li>c. notify the SFC any change in their board of directors within 7 business days after the change takes place;</li> <li>d. notify the SFC significant changes in the nature of the business carried on by it and type of services provided by it within 7 business days after the change takes place; and</li> <li>e. notify the SFC significant changes in its business plan covering internal controls, organization structure, contingency plan and related matters within 7 business days after the change takes place.</li> </ol> <p>UTC 11.1 sets out the proposed changes to a scheme which must be submitted to the SFC for prior approval – see under Principle 25</p>
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**Conduct of business**

Licensed or registered scheme operators are required to comply with the Code of Conduct, FMCC and ICG. They have conduct obligations as licensed or registered persons (see under Principle 31 for these obligations).

As issuers, they also have obligations as product providers under the Products Code. The OPs of the Products Code apply to them, including:

- a. OP 3.3 which requires product providers to act honestly, fairly and professionally;
- b. OP 4.1 of the Products Handbook requires operators of schemes, among other things, to:
  - i. inform the SFC promptly should there be any material breach of the Products Handbook; and
  - ii. use its best endeavours to take appropriate remedial action to rectify any breach of the Products Handbook promptly.
- a. OP3.6, OP5.3 and OP5.4 provide that the product providers must exercise reasonable care and diligence in selecting counterparties and service provider (including distributors) in respect of the product who are in turn obliged to avoid conflicts of interest which may undermine the interests of investors in a particular product.

The FMCC contains conduct rules in relation to funds management, including provisions dealing with staff dealing, receipt of benefits, order execution, allocation of trades; churning etc.

*Best execution*

Paragraph 3.2 of the FMCC says a licensed or registered fund manager should execute client orders on the best available terms, taking into account the relevant market at the time for transactions of the kind and size concerned.

*Allocation of trades*

Paragraph 3.4 of the FMCC requires a licensed or registered fund manager to ensure that all client orders are allocated fairly and that an executed transaction is allocated promptly in accordance with the stated intention, except where the revised allocation does not disadvantage a client and the reasons for the re-allocation are clearly documented.

*Churning*

Paragraph 3.5 of the FMCC says a licensed or registered fund manager should not trade excessively on behalf of the client portfolio, taking into account the portfolio's stated objectives.

*Due diligence in investments*

General Principle 2 of the Code of Conduct provides that in conducting its business activities, a licensed or registered person should act with due skill and diligence, in the best interests of

	<p>its clients and the integrity of the market.</p> <p>OP 3.8 of the Products Handbook provides that product providers must discharge their functions with due skill, care and diligence.</p> <p><b>Conflicts of interest</b></p> <p>Licensed or registered scheme operators are subject to the conflicts of interest provisions that apply to licensed or registered persons generally (see General Principle 6 and paragraph 10.1 of the Code of Conduct and see further under Principle 31).</p> <p>OP 4.2 of the Products Handbook requires product providers to avoid situations where conflicts of interest may arise including any actual or potential conflicts that may arise between different parties in respect of a product. Where such a conflict cannot be avoided, and provided that investors' interests can be sufficiently protected, the conflict must be managed and minimized by appropriate safeguards, measures and product structure and these measures and safeguards shall be properly disclosed to investors. OP 3.6 provides that the product providers, counterparties and service providers must avoid being placed in a conflict of interest position that may undermine the interests of the investors of the scheme.</p> <p>Specific provisions relating to CIS are also contained in:</p> <ol style="list-style-type: none"> <li>a. paragraph 2.2 of the FMCC which prohibits inducements in connection with the affairs or business of a client which is likely to significantly conflict with duties owed to clients and requires licensed or registered fund managers to have written guidelines, including monetary limits, about the acceptance by staff members of gifts, rebates or other benefits received from clients or business contacts and to keep a register of benefits received above specified limits;</li> <li>b. various provisions of the UTC including provisions: <ol style="list-style-type: none"> <li>i. providing for class meetings where there is a possibility of conflict of interest between different classes of holders (UTC 6.15(e));</li> <li>ii. prohibiting directors of the scheme, the management company, the trustee, investment advisers and connected persons from voting their beneficially owned shares at general meeting of holders at which they have a material interest in the business to be contracted (UTC 6.15(h));</li> <li>iii. relating to potential conflicts in relation to funds of HFs (UTC 8.7(k)(ii) to (v)) and structured funds (UTC 8.8).</li> </ol> </li> </ol> <p>UTC 10.9 to 10.13 set out requirements in relation to a variety of conflicts arising from transactions with connected persons, including:</p> <ol style="list-style-type: none"> <li>a. transactions involving underwriting and sub-underwriting (prior consent of the trustee/custodian unless all commissions and fees payable to the management company under such contracts for part of scheme assets);</li> <li>b. scheme transactions of other kinds (trustee approval required and must be at arms' length and disclosed in the annual report);</li> <li>c. cash or rebates - including soft dollar commissions - from broker-dealers (various requirements including disclosure in offer documents and annual reports);</li> <li>d. transactions with connected broker-dealers (various requirements including best execution, market rates and disclosure in annual report).</li> </ol>
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Paragraph 13.3 of the Code of Conduct states that a licensed or registered person that acts for a client in the exercise of investment discretion must ensure and be able to demonstrate that any transactions undertaken or services acquired in relation to a client's account that involve payment from client assets directly or indirectly to a person connected with the licensed or registered person are undertaken at arm's length terms and in the best interests of the client. This requires that such terms not be less favourable than those generally available in the market.

D12 of Appendix D to the UTC sets out the information about transactions with connected parties that must be contained in a scheme's constitutive documents and Appendix E sets out the information about transactions that must be in schemes' financial reports.

### **Delegation**

Where the investment management functions are delegated to third parties, there must be on-going supervision and regular monitoring of the competence of the delegates by the management company to ensure that the management company's accountability to investors is not diminished. Although the investment management role of the management company may be sub-contracted to third parties, the responsibilities and obligations of the management company may not be delegated. (UTC 5.5(e)).

A scheme operator that completely delegates all of its core functions to another entity will not be regarded as carrying on a business in the regulated activity concerned in Hong Kong. Accordingly, it will not be granted or be permitted to continue to hold a licence for that activity.

By UTC 11.1(b), proposed changes of the key operators of the scheme, including the management company and its delegates, must be submitted to the SFC for prior approval and one month's prior notice is normally required to be given to holders before the changes are to take effect.

The SFC permits delegates based in jurisdictions that are not on SFC's list of jurisdictions with an AIR, provided they meet detailed criteria for acceptability set out in and SFC circular (Circular to Fund Management Companies of SFC-Authorized Funds dated 18 October 2007).

Investment advisers being delegated the investment management function are subject to the same acceptability criteria as management companies, set out in Chapter 5 of the UTC.

### *Responsibility*

UTC 5.5 (e) provides that where the investment management functions are delegated to third parties, the management company must carry out on-going supervision and regular monitoring of the competence of the delegates to ensure that the management company's accountability to investors is not diminished. The responsibilities and obligations of the management company may not be delegated. See also FMCC paragraph 1.8.

UTC 4.5 (a) (iii) provides that the trustee/custodian must be liable for the acts and omissions

	<p>of its nominees and agents in relation to assets forming part of scheme property.</p> <p><i>Termination</i></p> <p>Any change in delegation arrangements amounts to a significant change in the operator's business plan, and the operator is required to notify the SFC of the related change within 7 business days after the change takes place by section 4 of the Information Rule.</p> <p><i>Disclosure and reporting</i></p> <p>Paragraph 6.1(a) of the FMCC provides that a licensed or registered fund manager must provide clients with adequate information about the corporation including its business address, relevant conditions or restrictions under which its business is conducted, and the identity and status of persons acting on its behalf with whom the client may have contact.</p> <p>Delegation arrangement must be disclosed in the offering document including the KFS (UTC Appendix C3).</p> <p><i>Regulator's access to information</i></p> <p>If delegated functions are conducted by licensed or registered managers/advisors, the power to access data related to the licensed or registered managers/advisors is provided under section 180 of SFO. SFC can access information about delegated functions carried out by non-licensees through the scheme operator.</p> <p>The responsibilities and obligations of the management company, including its record keeping obligations, may not be delegated. All records required under the KRR must be kept in a form which is readily accessible.</p>
Assessment	Fully Implemented
Comments	<p>The majority of CIS offered in HKSAR are based in other jurisdictions and the fund manager, if it does not have a presence in HKSAR, is not required to be licensed by or registered with the SFC, although it must distribute its products through licensed/ registered intermediaries. Due diligence is done on fund managers based in offshore jurisdictions before they are permitted to offer funds in Hong Kong, including checks with the home jurisdiction regulator.</p> <p>For fund managers based or having a presence in HKSAR, the SFC's licensing process is rigorous and effective, as is the RIs' registration process administered by the HKMA and SFC.</p> <p>Ongoing supervision of licensed fund managers is carried out as part of the SFC's and the HKMA's supervision programs for licensees and RIs. It involves a combination of off-site monitoring, on-site inspections and thematic reviews.</p> <p>For banks, which are the main distribution channels for CIS products, the monitoring and on-site inspection program used by the HKMA is intensive, and focuses heavily on the selling and distribution process. Although the HKMA is dealing with a backlog of cases arising from the Lehman's minibond crisis, it refers cases to SFC where enforcement action is required against the firm.</p>

	SFC's supervision program uses a well-developed risk-based system which is used to plan both off-site and on-site supervision work. Off-site monitoring of fund managers is thorough and continuous.
<b>Principle 25.</b>	The regulatory system should provide for rules governing the legal form and structure of CIS and the segregation and protection of client assets.
Description	<p><b>Legal form and investors' rights</b></p> <p>The definition of CIS in Schedule 1 of the SFO is functionally based and does not make reference to legal form. The UTC envisages that CIS are mutual funds (whether they are based on contract, companies with variable capital or otherwise) or unit trusts (see definition of CIS in UTC 3.2).</p> <p>In practice, Hong Kong domiciled funds are established as unit trusts. These local unit trusts are governed by the provisions of the trust deeds under which they are constituted. Non Hong Kong based funds are mostly either unit trusts or mutual funds.</p> <p>All authorized schemes, regardless of their legal form, must comply with the general principles in the OP Section of the Products Handbook and the requirements of the UTC relating to, among other things:</p> <ol style="list-style-type: none"> <li>a. key operating parties;</li> <li>b. operational features;</li> <li>c. investment restrictions;</li> <li>d. disclosure in offering documents; and</li> <li>e. post-authorization obligations.</li> </ol> <p>The SFO empowers the SFC to authorize schemes offered to the public in Hong Kong pursuant to section 104 of the SFO.</p> <p>UTC 6.6 requires the constitutive documents of a scheme to contain the information listed in UTC Appendix D. The content required by Appendix D reflects rules set out in the UTC and includes provisions relating to:</p> <ol style="list-style-type: none"> <li>a. participating parties, representative, trustee/custodian, and investment adviser (if any)</li> <li>b. obligations of the management company;</li> <li>c. investment and borrowing restrictions;</li> <li>d. valuation of property and pricing;</li> <li>e. suspension and deferral of dealing;</li> <li>f. fees and charges;</li> <li>g. meetings;</li> <li>h. transactions with connected persons;</li> <li>i. distribution policy and date;</li> <li>j. annual accounting period;</li> <li>k. base currency;</li> <li>l. modification of the constitutive documents; and</li> <li>m. termination of scheme.</li> </ol> <p>UTC 6.6 also provides that nothing in the constitutive documents may provide that the</p>

	<p>trustee/custodian, management company or directors of the scheme can be exempted from any liability to holders imposed under Hong Kong law or the law of the scheme's place of domicile or breaches of trust through fraud or negligence, nor may they be indemnified against such liability by holders or at holders' expense.</p> <p><i>Disclosure</i></p> <p>Details about a CIS and its organization must be set out in offering documents that comply with UTC Appendix C (see discussion under Principle 26). UTC 6.1 provides that a scheme must issue an up-to-date offering document, which should contain the information necessary for investors to be able to make an informed judgement of the investment proposed to them.</p> <p><b>Responsibility for monitoring compliance with form and structure requirements</b></p> <p>A scheme requires prior authorization from the SFC before it can be offered to the public in Hong Kong (section 103 of the SFO). Offering documents are also subject to prior approval by the SFC (section 105).</p> <p>Among the duties of the trustee or custodian of a CIS is the obligation to take reasonable care to ensure that the scheme is managed in accordance with the provisions of the constitutive documents (UTC 4.5).</p> <p>As part of its ongoing supervision of funds and their management companies, the SFC monitors compliance with form and structure requirements.</p> <p><i>Investment and borrowing restrictions</i></p> <p>UTC Chapters 7 (Core Requirements) and 8 (specialized schemes) set out the investment and borrowing restrictions that apply to schemes generally and to different types of schemes. UTC Appendix D requires the scheme's constitutive documents to include a statement to list the restrictions on the investment of the deposited property and the maximum borrowing limit of the scheme.</p> <p>UTC 7.23 provides that, if the investment limits are breached, the management company must take all steps as are necessary within a reasonable period of time to remedy the situation, taking due account of the interests of the holders.</p> <p><b>Changes to investor rights</b></p> <p><i>Approval of holders</i></p> <p>UTC 6.15(f) provides that an extraordinary general meeting must be called:</p> <ol style="list-style-type: none"> <li>a. to modify, alter or add to the constitutive documents, except as provided in UTC 6.7 (see below);</li> <li>b. to terminate the scheme (unless the means of termination of the scheme are set out in the constitutive documents, in which case termination must be effected as required);</li> <li>c. to increase the maximum fees paid to the management company, trustee/custodian</li> </ol>
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- or directors of the scheme; or
- d. to impose other types of fees

Under UTC 6.7, the constitutive documents of a scheme may be altered by the management company and the trustee/ custodian, without consulting holders, provided that the trustee/ custodian certifies in writing that in its opinion the proposed alteration:

- a. is necessary to make possible compliance with fiscal or other statutory or official requirements;
- b. does not materially prejudice holders' interests, does not to any material extent release the trustee/ custodian, management company or any other person from any liability to holders and does not increase the costs and charges payable from the scheme property; or
- c. is necessary to correct a manifest error.

#### *SFC approval*

UTC 11.1 provides that prior approval of the SFC is required for proposed changes to a scheme. They include changes to:

- a. constitutive documents;
- b. key operators (including the trustee/ custodian, management company and its delegates and Hong Kong representative) and their regulatory status and controlling shareholder;
- c. investment objectives, policies and restrictions
- d. fee structure;
- e. dealing and pricing arrangements; and
- f. any other changes that may materially prejudice holders' rights or interests.

UTC 11.1A provides that for changes to a scheme that require the SFCs prior approval, the SFC determines whether holders should be notified and the period of notice (if any) that should be applied before the changes are to take effect. In practice, the SFC requires prior notification to be given to the investors before the changes take effect. Normally, the SFC expects one month's prior written notice, or a longer period if required under applicable laws or the provisions of the offering or constitutive documents. The SFC may permit a shorter period of notice if the change is not significant or may require a longer period of notice (up to three months) in exceptional circumstances.

UTC 11.1B requires the management company to inform holders as soon as reasonably practicable of any material adverse change in the financial condition or business of the key counterparties to a scheme that it is aware of. UTC 11.2A provides that notices to holders must be filed with the SFC within one week from the date of its issuance.

SFC approval is also required if a scheme intends not to maintain its authorization (UTC 11.4) and for mergers or termination of schemes (UTC 11.5). Three months' notice must be given to holders in the first case and in the second case, notice period is as determined by the SFC.

#### **Separation of assets/safekeeping**

Every CIS for which authorization is requested must appoint a trustee/custodian acceptable to

the SFC (UTC 4.1). CIS in the form of unit trusts must appoint a trustee to hold scheme assets; mutual funds must appoint a custodian. Criteria for appointment are set out in Chapter 4 of the UTC and in practice require the trustee/custodian to be a bank.

UTC 4.5(a)(i) and 4.5(a)(ii) require the trustee/custodian to take into its custody or under its control all the property of the scheme and hold it in trust for the holders (in case of a unit trust) or the scheme (in case of a mutual fund corporation) in accordance with the provisions of the constitutive documents, and to register cash and registrable assets in the name of or to the order of the trustee/custodian.

The assets of the scheme therefore should be segregated and not commingled with the assets of the management company and will not form part of the liquidation assets of the management company.

#### *Related party trustee-custodian*

UTC 4.8 permits the appointment of a trustee/custodian that is connected to the management company UTC in defined circumstances. If the trustee/custodian and the management company are both bodies corporate having the same ultimate holding company, whether incorporated in Hong Kong or outside Hong Kong, the trustee/custodian and the management company are deemed to be independent of each other if:-

- a.
  - i. they are both subsidiaries of a substantial financial institution; The SFC has interpreted this requirement to mean a bank.
  - ii. neither the trustee/custodian nor the management company is a subsidiary of the other;
  - iii. no person is a director of both the trustee/custodian and the management company; and
  - iv. both the trustee/custodian and the management company sign an undertaking that they will act independently of each other in their dealings with the scheme; or
- b. the scheme is established in a jurisdiction where the trustee/custodian and the management company are required by law to act independently of one another.

Most SFC-authorized funds have a non-related trustee/custodian. At 31 July, 2013, 78 percent of the SFC-authorized funds had an unrelated and independent trustee/custodian and management company arrangement. As at 31 July 2013, a total of 50 entities act as the trustees/custodians for the 1,854 SFC-authorized funds. 11 of these trustees/custodians are domiciled in Hong Kong. Among them, there were 4 banking groups with trustees/custodians acting as the trustees/custodians of approximately 60 percent of the SFC-authorized funds.

#### **Winding up**

Appendix C24 and Appendix D17 of the UTC require that a summary of the circumstances in which the scheme can be terminated be disclosed in the offering document and constitutive documents respectively. To terminate the scheme in circumstances not specified in the constitutive documents, UTC 6.15(f) requires an extraordinary general meeting to be called.

If a scheme is to be terminated, UTC 11.5 requires that, in addition to following any

	<p>procedures set out in the scheme’s constitutive documents or governing law, notice must be given to investors as determined by the SFC. This notice must be submitted to the SFC for prior approval and contain the reasons for the termination, the relevant provisions under the constitutive documents that enable such termination, the consequences of the termination and their effects on existing investors, the alternatives available to investors (including, if possible, a right to switch without charge into another authorized schemes), the estimated costs of the termination and who is expected to bear them.</p> <p>The SFC can use its power under section 213(2)(d) of the SFO to apply to the court for an order to appoint an administrator over the property of a person if any person commits any of the wrongdoings specified in section 213(1)(a) or it appears to the SFC that any such matter has occurred, is occurring or may occur (section 213(1)(b)). Section 213(2)(d) applies to mutual fund corporations and trustees of unit trusts. The SFC can also present a petition to wind up a CIS that is in corporate form (for example, a mutual fund corporation) where it is just and equitable provided that the corporation is of a class of corporations which the Court of First Instance has jurisdiction to wind up under the CO (section 212(1)).</p> <p>The SFC has no power to appoint an administrator or a manager directly without going through the court process.</p>
Assessment	Fully implemented
Comments	<p>Best practice for CIS requires that all CIS have fully independent trustees/custodians. However, the IOSCO Principles do not prohibit custody by a related party; but they do require that additional safeguards be in place. As explained in the description the assessors believe that such safeguards are in place in HK as (i) custodian can only be regulated entities (and substantial financial institutions – in practice banks), and therefore subject itself to supervision by a financial regulator (ii) and additional rules are in place to foster independence including the prohibition that the custodian be a subsidiary of the management company and that they are not permitted to have common directors.</p>
<b>Principle 26.</b>	<p>Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a CIS for a particular investor and the value of the investor’s interest in the scheme.</p>
Description	<p><b>Disclosure to investors</b></p> <p>Detailed requirements for initial and ongoing disclosure are set out in the UTC.</p> <p><i>Offering documents</i></p> <p>UTC 6.1 provides that a scheme must issue an up-to-date offering document, which should contain the information necessary for investors to be able to make an informed judgement of the investment proposed to them, and, in particular, should contain information listed in UTC Appendix C.</p> <p>UTC Appendix C requires that an offering document must set out, among other things, the investment objectives and risks, restrictions or investment and borrowing, fees and charges, procedures for application and redemption, frequency of valuation and dealing (including dealing days) and proper warning statements. Offering documents must disclose the rights of</p>

	<p>investors and the method of valuation of property and assets, and pricing of scheme units.</p> <p>Appendix C2 provides that if the nature of the investment policy so dictates, the offering document should include a warning that investment in the scheme is subject to abnormal risks, a description of the risks involved, and where appropriate, the risk management policy in place. This applies, for example, to extensive use of financial derivative instruments for investment purposes and to specialized schemes such as HFs, index funds, guaranteed funds, etc. under Chapter 8 of the UTC).</p> <p>Offering documents must be authorized by the SFC before they may be issued to the public (section 105 of the SFO). At least two staff members are involved in the review process for the disclosure documents.</p> <p>UTC 6.6 provides that constitutive documents of a scheme should contain the information listed in UTC Appendix D. UTC Appendix D (D8) requires the constitutive documents to contain the rules on valuation of property and pricing. By UTC 10.1, a scheme must be valued and priced in accordance with the provisions of its offering and constitutive documents and the provisions of Chapter 6 of the UTC. UTC Appendix C requires offering document to disclose a list of constitutive documents and an address in Hong Kong where the constitutive documents can be inspected free of charge or purchased at a reasonable price.</p> <p>OPs 3.4 and 6.1 of the Products Handbook provide that disclosure must be complete, accurate and fair, and be written and presented in a clear, concise and effective manner as to be readily understood by the investing public.</p> <p>UTC 6.2A provides that a scheme must issue a KFS which is deemed to form part of the offering document and must contain information that enables investors to comprehend the key features and risks of the scheme. OP 6.7 also provides that KFS must highlight key information to investors in a clear, concise and effective manner and be prepared in a format that facilitates comparison with other products. In particular, illustrative templates for KFS (which are published on the SFC's website) require a scheme to disclose the frequency of calculating and publishing a scheme's NAV.</p> <p>UTC 6.3 requires the offering document to be accompanied by the schemes' most recent audited annual report and accounts together with its semi-annual report if published after the annual report.</p> <p><i>Periodic reports</i></p> <p>UTC 5.17 and 11.6 requires a scheme to publish at least two reports each financial year – an annual report and a half yearly report. The annual report must be audited by the auditor for the scheme. The minimum requirements of financial reports are set out in the UTC Appendix E. They include disclosure requirements in areas such as the financial statements, connected persons transactions and the investment portfolios held by the scheme. UTC Appendix E contains provisions requiring standard formats in periodic reports in order to facilitate comparison</p> <p>UTC 8.7(w) requires authorized HFs to publish quarterly reports for holders. By UTC Appendix</p>
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H, these quarterly reports should be filed to the SFC and distributed to holders within one month of the end of the relevant period, except for authorized fund of HFs (FoHFs) where the timeframe for filing and distribution to holders is within six weeks of the end of the relevant period.

UTC 11.6 provides that a scheme must publish its interim reports within two months of the end of the period, and its annual reports within four months after year-end.

#### *Material event reporting*

Holders of interests in CIS must be notified of material changes affecting the scheme. As well as in relation to major changes to scheme arrangements that require the approval of the SFC (see under Principle 25), the management company must inform holders as soon as reasonably practicable of any material adverse change in the financial conditions or business of the key counterparties to a scheme that it is aware of. 'Key counterparties' include the management company, guarantor (where relevant), trustee/custodian and swap counterparty of the fund (UTC 11.1(b)).

#### **Regulator's powers**

Section 103 of the SFO requires a scheme offered to the public in Hong Kong to obtain SFC's prior authorization, unless an exemption applies.

If the SFC finds that the documentation contains misleading information, the SFC can require the scheme and the scheme operator to stop distributing the documentation and to amend the documentation as appropriate.

Section 106(1)(a) of the SFO gives the SFC power to withdraw an authorization of the scheme if it decides that any information provided to the SFC in respect of application for authorization of fund was at the time it was provided false or misleading in a material particular.

Documentation that is inaccurate, misleading or false may have civil and criminal consequences under the SFO (for example, under sections 107, 277, 298, 383 or 384), and may call into question the issuer's fitness to hold a license (sections 194 and 196).

Under section 108 of the SFO investors have a private right of action to recover losses resulting from reliance on fraudulent, reckless or negligent misrepresentation.

Many of the SFC powers of discipline and intervention (described under Principle 11) can also be used in response to misleading or inaccurate disclosure.

#### **Advertising**

UTC 11.11 provides that advertisements and other invitations to invest in a scheme must comply with the Advertising Guidelines Applicable to CIS Authorized under the Product Codes (Advertising Guidelines). All advertisements must be submitted to the SFC for authorization prior to their issue or publication in Hong Kong pursuant to section 105 of the SFO, unless

<p>exempted under section 103 of the SFO. Offers exclusively to professional investors are one of the exemptions.</p> <p>When the SFC grants authorization to any scheme, it can and routinely does impose an authorization condition that the fund and/or its management company should cease and/or use their best endeavours to procure their agents to cease issuing any advertisements of the scheme upon the request of the SFC.</p> <p>OPs 6.9 and 6.10 and General Principle 1 of the Advertising Guidelines provides that all advertisements for a product shall:</p> <ol style="list-style-type: none"> <li>a. not be false, biased, misleading or deceptive;</li> <li>b. be clear, fair and present a balanced picture of the product with adequate and prominent risk disclosures; and</li> <li>c. contain information that is timely and consistent with its offering document</li> </ol> <p>Advertisements may also breach the prohibition on fraudulently or recklessly inducing others to invest money under section 107 of the SFO.</p> <p>The SFC conducts regular checks on advertisements by choosing a date in a month and reviewing all fund-related advertisements on that date.</p> <p><b>Accounting standards</b></p> <p>Financial reports for SFC-authorized funds domiciled in Hong Kong are required to be prepared in accordance with the applicable requirements under Hong Kong Accounting Standards and HKFRS. Reports for funds domiciled in recognized jurisdictions must be prepared in accordance with the applicable laws, regulations and accounting standards acceptable in their home jurisdictions (e.g. UK GAAP). In practice this means that financial reports are prepared in accordance with IFRS standards.</p> <p>UTC Appendix E sets out detailed requirements for the content of financial reports.</p> <p><b>Power to ensure compliance with investment policies</b></p> <p>UTC 5.10 provides that the management company must manage the scheme in accordance with the scheme's constitutive documents in the best interest of the holders. UTC 4.5(d) provides that the trustee/custodian must carry out instructions of the management company in respect of investments unless they are in conflict with the provisions of the offering or constitutive documents or the UTC.</p> <p>UTC 4.5(f) provides that the trustee/custodian must issue a report to the holders to be included in the annual report on whether in the trustee/custodian's opinion:</p> <ol style="list-style-type: none"> <li>a. the management company has in all material respects managed the scheme in accordance with the provisions of the constitutive documents; and</li> <li>b. if the management company has not done so, the respects in which it has not done so and the steps which the trustee/custodian has taken.</li> </ol> <p>If any licensed or registered person fails to comply with the requirements set out in the UTC or</p>
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	the Products Handbook, it is open to the SFC to conclude that they are no longer a fit and proper person for licensing purposes. This gives the SFC power to conduct an investigation under section 182 of the SFO and to impose sanctions under sections 194 and 196 of the SFO, such as revocation or suspension of the intermediary's licence or registration, as well as fine (maximum of \$10 million) and public reprimand the intermediary.
Assessment	Fully implemented
Comments	
<b>Principle 27.</b> Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a CIS.	
Description	<p><b>Asset valuation</b></p> <p><i>Principles for valuation</i></p> <p>FMCC 5.3 provides that all assets held by a scheme operator on behalf of clients should be valued on a regular basis and the basis of valuation disclosed to the clients. Unless otherwise agreed with a client or specified in a scheme's constitutive documents, valuation should be made in accordance with the following general principles:</p> <ol style="list-style-type: none"> <li>a. listed securities should be consistently valued at a price representative of either the daily opening, mid, closing or average price for that security at the stock exchange or market on which that security is listed or traded as indicated by an automatic price feed or other independent pricing source; (In practice, listed securities are usually valued by last traded price or bid/ask price instead of average price.);</li> <li>b. unlisted or unquoted securities should be valued at cost price subject to adjustment by reference to: <ol style="list-style-type: none"> <li>i. comparable third party transactions in the same investments, taking into consideration the cost of the investments;</li> <li>ii. any appraisals of the relevant investments or issuer of the investments undertaken by qualified accountants, appraisers or a CRA. Where necessary the fund manager should seek independent confirmation of the valuation from a suitably qualified person; and</li> <li>iii. any information generally about the relevant investments or issuer of the investments that is or becomes known to the fund manager from independent sources;</li> </ol> </li> <li>c. units or shares in schemes should be consistently valued by reference to the latest quoted price;</li> <li>d. any listed securities which are not actively traded or have been suspended from trading should be identified and the price at which that security is valued should be monitored. In this case, a fund manager should maintain procedures to: <ol style="list-style-type: none"> <li>i. demonstrate that it will actively seek independent confirmation of the appropriate price for the security from suitable brokers or market makers;</li> <li>ii. identify when such a security will be written down or written off in the valuation of a client account; or</li> <li>iii. ascertain whether it will, in appropriate situations, transfer the security to its own account and if so, at what price the client account will be compensated for the transfer.</li> </ol> </li> </ol>

	<p><i>Where market prices not available</i></p> <p>UTC 6.12 requires the value of investments not listed or quoted on a recognized market to be determined on a regular basis by a professional person approved by the trustee/custodian as qualified to value such investments. This person may, with the approval of the trustee/custodian, be the management company.</p> <p>The accounting standards adopted in Hong Kong replicate IFRS. They require an entity to establish fair value by using a valuation technique if the equity instruments do not have a quoted market price in an active market. Hong Kong Accounting Standards 39 – Financial Instruments: Recognition and Measurement and HKFRS 13 – Fair Value Measurement sets out valuation techniques that an entity may apply.</p> <p><i>Timing</i></p> <p>UTC 6.13 requires all schemes to have at least one regular (issue and redemption) dealing day per month. In practice, most funds are priced daily. The offer price quoted or published must be the maximum price payable on purchase, and the redemption price must be the net price receivable on redemption.</p> <p>UTC 8.7(o) requires that the investments of HFs authorized by the SFC for offering to the public must be independently and fairly valued on a regular basis.</p> <p><i>Independent audit</i></p> <p>Information in the scheme's annual report on the valuation of the scheme assets and calculation of NAV must be audited by an independent auditor (UTC 5.17 and Appendix E).</p> <p><b>Pricing and redemption of interests</b></p> <p><i>Requirement</i></p> <p>UTC 6.11 provides that offer and redemption prices should be calculated on the basis of the scheme's NAV divided by the number of units/shares outstanding. These prices may be adjusted by fees and charges, provided the amount or method of calculating such fees and charges is clearly disclosed in the offering document.</p> <p>UTC 4.5(c) provides that the trustee/custodian must take reasonable care to ensure that the methods adopted by the management company in calculating the value of units/shares are adequate to ensure that sale, issue, repurchase, redemption and cancellation prices are calculated in accordance with the provisions of the constitutive documents.</p> <p><i>Disclosure</i></p> <p>UTC Appendix D8(b) provides that the constitutive documents must contain the method of calculating the issue and redemption prices. UTC Appendix C9 requires offering documents to disclose the procedure for subscribing for and redeeming units or shares. UTC Appendix C10 requires the offering documents disclose the maximum interval between the request for</p>
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redemption and the sending of redemption proceeds.

UTC 11.7 provides that a scheme has to publish its latest available offer and redemption prices or NAV at least once a month in at least one leading Hong Kong English language and one Chinese language daily newspaper. UTC 10.7 provides that, if dealing in units ceases or is suspended, the management company or the Hong Kong representative of the scheme must publish that fact immediately following the decision and at least once a month during the period of suspension. This information is to be published in the newspaper(s) in which the scheme's prices are normally published.

#### *Pricing errors*

All schemes are required to comply with UTC 10.2 regarding pricing errors. If an error is made in the pricing of units/shares, the error should be corrected as soon as possible and any necessary action should be taken to avoid further error. If the error results in an incorrect price of 0.5 percent or more of scheme's NAV per unit/share, the trustee/custodian and the SFC must be informed immediately. In this case, individual investors should be compensated for all losses over HK\$100, unless determined otherwise by the trustee/custodian with justification to the SFC.

SFC's experience is that pricing errors are detected early and dealt with effectively. No major problems have occurred.

#### *Suspension/deferral of valuations and redemptions*

UTC 10.6 states that suspension of dealings may be provided for only in exceptional circumstances, having regard to the interests of holders. The SFC generally expects that suspension of dealings should only be considered where there are difficulties in the valuation of the assets of a scheme. The SFC would generally not consider that concern about massive redemption is a valid reason for suspension of dealings. The SFC's approach is published in a circular.

UTC 10.8 states that where redemption requests on any one dealing day exceed 10 percent of the total number of units or shares in issue, requests in excess of the 10 percent may be deferred to the next dealing day.

UTC 10.7 states that the management company or the Hong Kong representative of the scheme must immediately notify the SFC if dealing in units or shares ceases or is suspended. Investors must be notified on a timely basis.

#### **Regulatory authority to monitor compliance**

The SFC has authority to monitor compliance with rules relating to asset valuation and unit pricing, and may use all its powers to obtain information and conduct investigations.

Breaches of asset valuation and unit pricing rules may result in licensing action, withdrawal of a scheme's authorization or the authorization of a particular product, and sanctions under sections 194 and 196 of the SFO.

	In its supervision of compliance with valuation rules, SFC relies in the first instance on the obligation of trustees/custodians to ensure that the management company complies with its obligations under a scheme's constitutive documents, and on the obligation to report pricing errors, which it polices strongly. It reviews in detail the annual auditor's report which includes a review of the valuation methodologies used in calculating NAV and unit values. It carries out some thematic reviews where external events create potential pressure on the valuing of assets, such as the European debt crisis, or QE tapering.
Assessment	Fully implemented
Comments	
<b>Principle 28.</b>	Regulation should ensure that HFs and/or HFs managers/advisers are subject to appropriate oversight.
Description	<p><b>General approach</b></p> <p>HF managers and advisers are required to hold a license for Type 4 regulated activity (advising on securities) and/or Type 9 regulated activities (asset management), whether or not the funds managed or advised by them are offered to the public in Hong Kong. The HFs themselves are not subject to authorization, except if they are offered to the public.</p> <p><b>Licensing of HF managers</b></p> <p>HF management is covered under the general regulatory framework for asset management, which is a type of regulated activity, as explained under Principle 24 and 29. Thus as any other intermediary a firm that wishes to manage HFs must prove that it is fit and proper.</p> <p>For such purpose the applicant must provide the information required, which includes (i) information on the applicant, (ii) a business plan detailing the nature of business carried on or to be carried on and types of services provided or to be provided by the applicant, (iii) information relating to the human and technical resources, operational procedures and organizational structures of the applicant showing that it is capable of carrying on its regulated activities, and its proposed regulated activities, competently; (iv) the business history (if any) of the applicant; (v) internal controls, risk management, contingency plans and related matters, and (vi) the capital and shareholding structure of the applicant and basic information in respect of any person in accordance with whose directions or instructions it is, or its directors are, accustomed or obliged to act. In addition, the SFC has also issued the Guidelines on Competence, which are made under the SFO, setting out the matters that the SFC will normally consider in assessing whether a person is competent to carry on any regulated activity.</p> <p>The FMCC is also applicable to HF managers. As indicated in Principle 24, such Code contains specific obligations applicable to fund managers on (i) organization and management structure, (ii) fund management, and (iii) dealing with clients.</p> <p><b>Authorization of Retail HFs</b></p> <p>HFs that are offered to the public in Hong Kong are subject to authorization by the SFC as any other CIS, as explained under Principle 26. Pursuant to the UTC, HFs are generally regarded as non-traditional funds that possess different characteristics and use different investment strategies from traditional funds. In reviewing an application for authorization of a HF the SFC</p>

will consider (i) the choice of assets classes, and (ii) the use of alternative investment strategies such as long/short exposures, leverage and/or hedging, and arbitrage techniques.

Pursuant to the UTC due to the wide array of schemes that fall under this category, the SFC will exercise its discretion in imposing additional appropriate conditions on each scheme on a case by case basis.

The UTC imposes certain specific requirements for the management company of a HF that is offered to the public, as well as for the fund itself as summarized below:

- The management must have the requisite competence, expertise and appropriate risk management and internal controls;
- The key investment personnel of the management company and the investment adviser must have experience in managing HFs;
- The management company must have internal controls system that are suitable to the risk profile of the operations;
- A minimum amount of assets under management (at least US\$100 million) that follow HF strategies;
- A minimum subscription by each investor of not less than US\$ 50,000 except on FoHFs, where the minimum is US\$10,000;
- The liability of holders must be limited to their investment in the scheme;
- The scheme must have clearly defined investment and borrowing parameters in its constitutive and offering documents;
- Dealing: there must be at least one regular dealing day per month;
- Valuation: the investment of the scheme must be independently and fairly valued on a regular basis. Generally accepted accounting principles (GAAP) and industry's best practices should be applied on a consistent basis;
- Disclosure requirements. This would include, but not be limited to, the HFs' risks incurred, limitations on redemptions, gating provisions, side letter arrangements with existing and potential investors, and the fund's strategy/performance. UTC 8.7 also requires that the offering document of retail HFs must give lucid explanations of the investment strategy and the risks inherent in the HFs (e.g. the risk and reward characteristics of the strategy, the circumstances hostile to the performance of the scheme, etc.); The management company must issue periodic financial reports to holders and at least on a quarterly basis;
- The investment management operations must be based in a jurisdiction with an inspection regime acceptable to the SFC; and
- There are also specific requirements for the prime brokers

At the time of this assessment there were only four HFs authorized by the SFC for public offering.

#### **Powers of the SFC**

All the obligations and requirements imposed on securities intermediaries are applicable to HF managers, both at the moment of licensing and on an ongoing basis. By the same token, all the powers that the SFC has in connection with securities intermediaries are applicable to HF managers, including the powers to refuse a licence application, to request information

including non-public information on exposures as required by the principles, to conduct investigations and inspections and to impose disciplinary actions such as revoking or suspending a license.

### **Supervision of HF managers**

Management companies and advisors of HFs are part of the general supervisory regime developed for licensees. As such they are subject to ongoing off-site monitoring, for which they are required to submit periodic reports.

They are also subject to on-site inspections, on a risk based approach.

	<b>2012/ 2013</b>	<b>2011/ 2012</b>	<b>2010/ 2011</b>	<b>2009/ 2010</b>	<b>2008/ 2009</b>
<b>Inspections of Hedge Fund Management Companies</b>	18	23	16	28	4

The SFC also conducts monitoring of the HFs themselves, via surveys, first on their own (2006 and 2009) and currently under the umbrella of the IOSCO HF Survey process (2010 and 2012). The surveys allowed the SFC to obtain information on the larger HFs exceeding a specified Net Asset Value threshold, irrespective of the location of each HF, including Net Asset Value, predominant strategy/regional focus and performance, leverage and risk (including concentration risk), assets and liability information, counterparty risk, product exposure, identification of investment activity known to represent a significant proportion in important markets or products. SFC staff expect that these surveys will become a regular part of their monitoring arrangements.

### **Cooperation with other regulators**

Section 378 of the SFO allows the SFC to share information collected with other regulators, subject to some confidentiality conditions. In addition, section 378 also allows the SFC to disclose information in the form of a summary compiled from any information in the possession of the SFC which summary is so compiled as to prevent particulars relating to the business or identity, or the trading particulars, of any person from being ascertained from it.

In this regard SFC staff informed that it has shared the results of the 2010 and 2012 HF Surveys on an aggregate basis with IOSCO.

Assessment Fully implemented

Comments

<b>Principles for Market Intermediaries</b>																									
<b>Principle 29.</b>	Regulation should provide for minimum entry standards for market intermediaries.																								
Description	<p><b>Industry and regulatory background</b></p> <p><i>Industry</i></p> <p>Securities intermediaries in Hong Kong include both banks<sup>3</sup> and non-bank intermediaries. At March 2013, 117 banks were registered with the SFC to carry on securities business. For the non-bank sector, the position is as follows:</p> <p><b>Number of corporations licensed under the SFO – by ownership</b></p> <table border="1"> <thead> <tr> <th></th> <th>At end-March 2013</th> <th>At end-March 2012</th> <th>At end-March 2011</th> </tr> </thead> <tbody> <tr> <td><b>Total no. of licensed corporations (other than banks)</b></td> <td><b>1,905</b></td> <td><b>1,840</b></td> <td><b>1,752</b></td> </tr> <tr> <td>Affiliates of banks</td> <td>10%</td> <td>11%</td> <td>12%</td> </tr> <tr> <td>Affiliates of insurance companies</td> <td>2%</td> <td>3%</td> <td>3%</td> </tr> <tr> <td>Affiliates of other financial institutions</td> <td>36%</td> <td>35%</td> <td>35%</td> </tr> <tr> <td>Others</td> <td>52%</td> <td>51%</td> <td>50%</td> </tr> </tbody> </table> <p><i>Percentage figures rounded to the nearest whole number.</i></p> <p><i>Source: SFC</i></p> <p>There are a large number of small intermediaries in the SFC licensed sector. A small number of banks and major securities houses (including subsidiaries of international investment banks) have a major share of securities intermediation business. Banks are not permitted to be participants directly in HKEx so the related trade execution activities are conducted through their securities subsidiaries licensed by the SFC or other licensed execution brokers.</p> <p>At March 2013, around 37,000 individuals were licensed by SFC as representatives of licensed intermediaries (other than banks).</p> <p><i>Regulatory framework</i></p> <p>The regulatory framework for intermediaries largely is set out in the SFO, its subsidiary legislation, and a number of codes and guidelines issued by the SFC. There are also provisions in the BO that are related to EOs who are responsible for directly supervising the conduct of each regulated activity and to "ReIs" who are individuals carrying out any regulated function in one or more regulated activity.</p> <p>AIs which want to carry on one or more regulated activities are required to register with the SFC.</p>		At end-March 2013	At end-March 2012	At end-March 2011	<b>Total no. of licensed corporations (other than banks)</b>	<b>1,905</b>	<b>1,840</b>	<b>1,752</b>	Affiliates of banks	10%	11%	12%	Affiliates of insurance companies	2%	3%	3%	Affiliates of other financial institutions	36%	35%	35%	Others	52%	51%	50%
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<sup>3</sup> In this context, "banks" includes some non-bank deposit taking institutions regulated by HKMA.

**Licensing of intermediaries***Basic requirement*

Part V of the SFO provides that a person who carries on business in a regulated activity (as defined in section 1 of Part 1 of Schedule 1 and Part 2 of Schedule 5 of the SFO) in Hong Kong is required to be licensed by or registered with the SFC.

Schedule 5 stipulates ten types of regulated activity:

- Type 1: Dealing in securities
- Type 2: Dealing in futures contracts
- Type 3: Leveraged foreign exchange trading
- Type 4: Advising on securities
- Type 5: Advising on futures contracts
- Type 6: Advising on corporate finance
- Type 7: Providing ATS
- Type 8: Securities margin financing
- Type 9: Asset management
- Type 10: Providing credit rating services

Specifically, section 114(1) and (2) of the SFO requires that no person shall carry on a business in a regulated activity or hold himself out as carrying on a business in a regulated activity unless that person is:

- a. a corporation licensed under section 116 or 117 of the SFO for the regulated activity (an LC);
- b. a licensed bank, restricted licensed bank or a deposit taking company authorized under the BO (an AI) that is registered with the SFC under section 119 of the SFO for the regulated activity. For SFO purposes this is an RI); or
- c. a person authorized under section 95(2) of the SFO as an ATS operator.

A breach of section 114(1) constitutes a criminal offence.

Individuals performing regulated activities for LCs (called representatives) must also be licensed under section 120 of the SFO as licensed representatives. This is a full licensing process analogous to that applying to LCs.

Section 125 of the SFO provides that every LC must have at least two individuals (at least one of whom is an executive director of the LC) who are approved by the SFC as the LC's ROs in relation to each of the regulated activity for which the LC is licensed.

The appointment of an EO to an RI requires the consent of HKMA. That consent can only be given if the person is a fit and proper person to be an EO of the RI concerned; and has sufficient authority within the institution to be such EO. (Section 71C(2) of the BO). Section 71D of the BO requires an RI to appoint at least two EOs for each regulated activity the RI carries on.

ReIs (individuals performing regulated activities on behalf of RIs) are required to be registered with HKMA. It is a statutory condition of registration for a RI to ensure that its ReIs are fit and

proper to be so engaged. The HKMA conducts background checks on the ReIs with the SFC and, if necessary, other relevant agencies.

### *Integrity*

All market intermediaries (including LCs and RIs) are required to demonstrate that they are “fit and proper” for the purposes of being licensed by or registered with the SFC. Criteria set out in the SFO and the SFC’s Fit and Proper Guidelines and the Guidelines on Competence apply both to LCs and RIs.

Section 129(1) of the SFO provides that in considering whether a person is fit and proper for the purposes of licensing or registration, the SFC or the HKMA must have regard to various matters including:

- a. financial status or solvency;
- b. educational or other qualifications or experience having regard to the nature of the functions which, if the application is allowed, the person will perform;
- c. the ability to carry on the regulated activity competently, honestly and fairly; and
- d. the reputation, character, reliability and financial integrity, of the ReI or corporation. For corporations, this includes the officers of the corporations and for AIs it includes any director, chief executive, manager (as defined in section 2(1) of the BO) and EO.

Section 129(2) permits the SFC or the HKMA (as relevant) to take into account decisions made in relation to a person by other regulators, including the insurance and pension fund regulators.

Section 119 of the SFO gives SFC power to register or refuse to register an AI to carry on business in regulated activities in Hong Kong. In making such a decision, section 119(4) of the SFO requires that the SFC shall have regard to any advice given to it by the HKMA. The SFC may rely wholly or partly on that advice in making its decision. In practice, the vetting of an application for registration as an RI is done by the HKMA and the SFC relies largely on its assessment.

Under section 132 of the SFO, a person is required to obtain the SFC’s approval before they can become or continue to be a “substantial shareholder” (defined in Schedule 1 to the SFO to mean holders of 10 percent or more of voting shares) of a LC. The SFC is obliged to refuse to approve an application under section 132 of the SFO unless the applicant satisfies the SFC that the LC concerned will remain fit and proper to be licensed. Analogous provisions apply to “controllers” of AIs under section 70 of the BO.

### *Capital requirement*

LCs are subject to the capital requirements stipulated in the FRR on an on-going basis. RIs are subject to the capital requirements applicable to AIs/RIs under the BO on an on-going basis. See under Principle 30.

### *Competence*

The Guidelines on Competence published by the SFC set out the matters that both the SFC

	<p>and the HKMA consider in assessing whether a person is competent to carry on any regulated activity. These requirements are applicable to all LCs, licensed representatives (including ROs) accredited to LCs, as well as RIs, their EOs and ReIs.</p> <p>Competence requirements for individuals under Part 5 of the Guidelines on Competence include a combination of education and experience qualifications, management experience and regulatory knowledge.</p> <p>Part 4 of the Guidelines on Competence establishes criteria for the assessment of the competence of corporations. In determining whether a corporation is competent to carry on any regulated activity, the corporation's organizational structure and the combined competence of its personnel are considered. A corporation must also have proper business structure, good internal systems and qualified personnel to enable it to properly manage the risks it will encounter in carrying on its business as detailed in its business plan.</p> <p><i>Internal controls</i></p> <p>In considering whether a corporation is fit and proper to be licensed/registered, the SFC and the HKMA take into account whether the applicant has established effective internal control procedures and risk management systems to ensure compliance with all applicable regulatory requirements under any of the relevant provisions (see Section 129(2)(c) of the SFO).</p> <p>As AIs, RIs are required to comply with the authorization criteria specified in the Seventh Schedule of the BO on an on-going basis. These include requirements for the institution to maintain adequate accounting systems and systems of control to: ensure the prudent and efficient running of the institution's business; safeguard its assets; minimize the risk of fraud; monitor the risks to which the institution is exposed; and comply with legislative and regulatory requirements. In addition, RIs are generally required to comply with the provisions of the SFO in the same way as LCs in respect of their regulated activities.</p> <p><b>Authority of Regulator</b></p> <p><i>Assessment of applications for license and registration</i></p> <p>SFC handles a relatively large number of corporate license applications each year (about 150 in 2012). The HKMA deals with fewer than 10 RI applications each year, and in 2012 the number was below 5.</p> <p>Both the SFC and the HKMA have internal processes for handling applications for license /registration. The SFC's licensing processes are subject to regular review by the independent PRP. Both regulators have designated resources to handle license/registration applications. The SFC's Licensing Department has approximately 80 staff and IT systems allow applications to be made electronically. The HKMA has 20 licensing staff who deal with all registration applications, including for authorization as AIs.</p> <p>The SFC process focuses on 4 main aspects:</p> <ol style="list-style-type: none"> <li>a. ensuring it has a good understanding of the applicant's proposed business activities (including the impact of these activities on the applicant's clients and on the markets</li> </ol>
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- it operates in);
- b. the firm's infrastructure – its organizational structure, internal controls and risk management and systems;
- c. financial requirements and the firm's internal controls and ability to comply with requirements;
- d. the senior management team – the ROs' integrity and competence.

The SFC conducts regulatory checks on the fitness and properness of an applicant's ROs, the applicant company, all directors, and substantial shareholders. Applicants and their ROs are required to demonstrate their fitness and properness including integrity but the SFC carries out selective police checks on applicants and their officers.

The HKMA process focuses on assessing the fitness and properness of an EO of an AI which applies for the registration as a RI.

The HKMA will exercise the power under section 119(3) of the SFO to assess the merits of an application by an AI to become a RI.

Staff follow a procedures manual for the registration of RIs. They use the HKMA's internal database in their assessment of proposed EOs and routinely ask SFC for information about them. The HKMA will advise the SFC whether it is satisfied that the applicant is fit and proper to be registered and may make recommendations in respect of any proposed condition(s) deemed necessary.

To assess an applicant's fitness and properness for the purposes of licensing/registration, the SFC and the HKMA routinely conduct external checks with other regulators, both domestic and foreign, on the past conduct of the applicant and the individuals concerned.

The assessors' review of files showed that these processes are applied on a consistent basis.

#### *Refusal of application*

The SFC is obliged to refuse a license/registration application if the applicant fails to satisfy the SFC that it is a fit and proper person to be licensed or registered under the SFO pursuant to sections 116 (LC), 117 (temporary LC), 119 (RIs), 120 (licensed representatives), 121 (temporary licensed representatives) or 126 (ROs).

Under section 16 of the BO, the HKMA must refuse an application for authorization as an AI to carry on banking business or the business of taking deposits as a deposit taking company or as a restricted licence bank if the applicant does not meet the minimum criteria for authorization set out in the Seventh Schedule to the BO, and it has power to refuse applications in other cases.

Under section 71C(2)(a) of the BO, the HKMA is obliged to refuse to give consent if an EO applicant fails to satisfy the HKMA that he is a fit and proper person to be an EO of the RI and he has sufficient authority within the RI concerned.

	<p><i>Licensing conditions</i></p> <p>Under sections 116, 117, 119, 120, 121 and 126 of the SFO, any licence/registration granted by the SFC can be made subject to such reasonable conditions as the SFC may impose. The SFC may at any time, by notice in writing served on the RI, LC or licensed individual concerned, amend or revoke any such condition or impose new conditions as may be reasonable in the circumstances. Some standard conditions are used, for example a condition prohibiting investment advisers from holding client assets.</p> <p>The HKMA has power under section 71C(9) of the BO to impose conditions on its consent for a person to become an EO.</p> <p><i>Revocation/suspension of license/registration</i></p> <p>Under sections 194 and 196 of the SFO, the SFC can take disciplinary action against a regulated person (any person licensed by or registered with the SFC) if that person is found to be guilty of misconduct or not fit and proper to be or to remain a regulated person. Subject to procedural fairness processes specified in section 198 of the SFO, the SFC may among other things:</p> <ol style="list-style-type: none"> <li>a. revoke or suspend a license or a registration;</li> <li>b. revoke or suspend part of a license or registration in relation to any of the regulated activities for which a regulated person is licensed or registered;</li> <li>c. revoke or suspend the approval granted to a RO; or</li> <li>d. prohibit a regulated person from applying to be licensed or registered or to be approved as an RO, etc.</li> </ol> <p>Sections 195 and 197 of the SFO also permit the SFC to revoke or suspend a person's licence or registration upon the occurrence of various stipulated events, including the entering into of a voluntary arrangement with creditors, bankruptcy, failing to satisfy a levy of execution, liquidation or winding up, conviction for a criminal offence which impugns fitness and properness, etc.</p> <p>In relation to RIs, it is a statutory condition of registration under section 119(8) of the SFO for a RI to ensure that the ReIs engaged for any regulated activity are fit and proper. In addition, a RI is required under section 125(2) of the SFO to comply with section 71D and 71C of the BO by having at least two EOs who have received prior written consent from the HKMA.</p> <p>Where an EO is, or was at any time, guilty of misconduct, or the HKMA has ceased to be satisfied that an EO is a fit and proper person or has sufficient authority within the RI concerned to be such officer, the HKMA may, after consultation with the SFC, withdraw or suspend his consent (section 71C of the BO). The HKMA also has power to remove a ReI from the register maintained under section 20(1)(ea) of the BO if the ReI ceases to be a fit and proper person (section 58A).</p> <p>The HKMA may, under sections 71C and 58A of the BO, make recommendations to the SFC about the exercise of the SFC's disciplinary powers against EOs and ReIs under section 196 or 197 of the SFO.</p>
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**Ongoing requirements**

Section 135 of the SFO sets out the events for which notification by LCs, licensed representatives and RIs is required. In addition to notifying any intended cessation of business, LCs, licensed representatives and RIs are required to notify the SFC of certain changes in the information that they have provided to the SFC in their initial applications. In the case of RIs, the notification must be made to both the SFC and the HKMA. Changes requiring notification are specified in the Information Rules (see also sections 20(4) and 72A of the BO for notification requirements about changes in EOs and ReIs).

Paragraph 12.5 of the Code of Conduct requires that a licensed or registered firm should report to the SFC immediately certain specified incidents, such as any material breach or suspected material breach by itself or one of its representatives of any law, rules, regulations or code, or any material failure, error or defect of its operational systems.

Under section 138(4) of the SFO, all LCs and licensed representatives are required to submit annual returns to the SFC within one month after each anniversary date of the granting of their licences. All LCs are also required to submit annual audited accounts. The content of these audit reports is set out in the Securities and Futures (Accounts and Audit) Rules.

LCs are obliged to submit to the SFC a business and risk management questionnaire annually, which contains information about the LC's business operations and risk management, including controls and procedures to ensure compliance with the regulatory requirements applicable to the LC (section 156(1)(a) of the SFO and section 3(1) of the Securities and Futures (Accounts and Audit) Rules).

**Public disclosure of licensed intermediaries**

Section 136 of the SFO requires the SFC to maintain a register of licensed persons (including LCs and licensed representatives) and RIs containing details about all persons licensed by or registered with the SFC. This enables any member of public to ascertain whether he is dealing with a licensed person or a RI and the particulars of the license or registration.

Section 20 of the BO requires the HKMA to maintain a register which contains the name and business address of every ReI; the capacity in which every ReI is engaged in relation to a regulated function in a regulated activity; the date on which every ReI was first so engaged; and such other particulars as the HKMA thinks fit.

Registers are available on the relevant regulator's website.

**Investment Advisers**

A person who carries on an investment advisory business in Hong Kong is required to be licensed or registered for Type 4 regulated activity (advising on securities) and/or Type 5 regulated activity (advising on futures contracts) and is regulated under the SFO in the same manner as other licensed or registered persons.

If an investment adviser (who is licensed/registered for Type 4 and/or Type 5 regulated

	<p>activity) deals in securities and/or futures contracts on behalf of clients, they must also be licensed/registered for Type 1 (dealing in securities) and/or Type 2 (dealing in futures contracts) regulated activity and to comply with all relevant regulatory requirements applicable to dealers, such as higher capital requirements under the FRR (applicable to LCs) and operational controls requirements.</p> <p>As a matter of general practice, the SFC imposes a condition on an investment adviser's licence prohibiting it from holding client assets. Accordingly, investment advisers holding Type 4 and/or Type 5 licences only are not permitted to have custody of any client assets.</p>
Assessment	Fully implemented
Comments	The assessment by the SFC of applications for licenses is rigorous, and includes, for applicants regulated in offshore jurisdictions, detailed due diligence with the home jurisdiction regulators.
<b>Principle 30.</b>	There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.
Description	<p>Both RIs and LCs are subject to capital and prudential requirements.</p> <p>Capital and prudential requirements for RIs are dealt with in the BCP Assessment; and thus have not been assessed separately under this assessment. However, the BCP Assessment concluded that 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. Additional information on the capital adequacy for banks can be found in the BCP Assessment.</p> <p>Equally the assessment concluded that 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. Equally, when new returns are required (such as the new return with respect to exposures to Mainland considerable care is taken in identifying comprehensive and granular data points to be reported in order to facilitate thorough analysis. The practice of commissioning annual 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.</p> <p><b>Capital requirement - LCs</b></p> <p>LCs must to meet minimum capital requirements stipulated by the FRR at all times while licensed by the SFC. The minimum capital requirements include a liquid capital requirement and a paid-up share capital requirement. The FRR rules are a form of a net capital rule.</p> <p>LCs that are subsidiaries of banks are subject to the FRR on a solo basis.</p> <p><i>Minimum paid up capital</i></p>

Most LCs are subject to a requirement to maintain a minimum paid up share capital (section 5 of the FRR). However, section 5 FRR exempts a number of types of licenses:

- a. an approved introducing agent (as defined in 58(4) of the FRR) who is not a LC licensed for Type 3 regulated activity (leveraged foreign exchange trading);
- b. a trader (a licensee that is a securities or futures dealer who deals only for its own account and does not hold client assets or handle client order - section 2 of the FRR);
- c. a futures non-clearing dealer (an exchange participant of a recognized futures market but not a clearing participant of a recognized clearing house – section 2 of the FRR);
- d. a LC licensed for Type 4 (advising on securities), Type 5 (advising on futures contracts), Type 9 (asset management) or Type 10 (providing credit rating services) regulated activity that is subject to a condition that they do not hold client assets;
- e. a LC licensed for Type 6 (advising on corporate finance) that is subject to conditions that they do not hold client assets and they do not act as a sponsor for a listed corporation.

LCs are subject to minimum paid up share capital requirements that vary according to activity or activities for which they are licensed. If an LC is licensed for more than one activity, the minimum amount is the higher or highest amount applying to an activity for which it is licensed.

The minimum amounts are set out in Table 1 of Schedule 1 of the FRR:

**Table 1 in Schedule 1 to the FRR (paid-up share capital requirements)**

<b>Regulated activity</b>	<b>Minimum amount of paid-up share capital (HK\$)</b>
Type 1 (Dealing in securities) -	
(a) where the licensed corporation in question provides securities margin financing	\$10,000,000
(b) in any other case	\$5,000,000
Type 2 (Dealing in futures contracts)	\$5,000,000
Type 3 (Leveraged foreign exchange trading) -	
(a) where the licensed corporation in question is an approved introducing agent	\$5,000,000
(b) in any other case	\$30,000,000
Type 4 (Advising on securities)	\$5,000,000
Type 5 (Advising on futures contracts)	\$5,000,000
Type 6 (Advising on corporate finance) -	
(a) where the LC in question is not subject to the no sponsor work licensing condition	\$10,000,000
(b) in any other case	\$5,000,000
Type 7 (Providing ATS)	\$5,000,000
Type 8 (Securities margin financing)	\$10,000,000
Type 9 (Asset management)	\$5,000,000
Type 10 (Providing credit rating services)	\$5,000,000

AIs are also subject to minimum capital requirements. For banks, the minimum paid up share capital and share premium account is HK\$300 million; lesser amounts are prescribed for restricted license banks and deposit taking companies.

*Liquid capital requirements*

Section 6(1) of the FRR requires all LCs to maintain liquid capital which is not less than its required liquid capital. Its required liquid capital is the higher of:

- a. the required liquid capital requirements specified for each category of regulated activity in Table 2 in Schedule 1 of the FRR. If an LC is licensed for more than one activity, the minimum amount is the higher or highest amount applying to an activity for which it is licensed; and
- b. its variable required liquid capital.

By section 2 of the FRR:

- a. "liquid capital" means the amount by which liquid assets exceed ranking liabilities;
- b. "liquid assets" in relation to a LC, means the aggregate of the amounts required to be included in liquid assets under the provisions of Division 3 of Part 4 of the FRR;
- c. "ranking liabilities" means the aggregate of the amounts required to be included in its ranking liabilities under the provisions of Division 4 of Part 4 of the FRR. These are all balance sheet liabilities, in some cases subject to add-ons (for example, 200 percent of the market value of written put options, section 40(12)).

LCs are required to calculate their liquid assets and ranking liabilities according to the detailed provisions of the FRR.

**Table 2 in Schedule 1 to the FRR (Required liquid capital requirements)**

<b>Regulated activity</b>	<b>Minimum amount of required liquid capital – floor amount (HK\$)</b>
Type 1(Dealing in securities)	
(a) where the LC in question is an approved introducing agent or trader	\$500,000
(b) in any other case	\$3,000,000
Type 2 (Dealing in futures contracts)	
(a) where the LC in question is an approved introducing agent, futures non-clearing dealer or trader	\$500,000
(b) in any other case	\$3,000,000
Type 3 (Leveraged foreign exchange trading)	
(a) where the LC in question is an approved introducing agent	\$3,000,000
(b) in any other case	\$15,000,000
Type 4 (Advising on securities)-	
(a) where the LC in question is subject to the specified licensing condition (no holding of client	\$100,000

assets)	
(b) in any other case	\$3,000,000
Type 5 (Advising on futures contracts)	
(a) where the LC in question is subject to the specified licensing condition	\$100,000
(b) in any other case	\$3,000,000
Type 6 (Advising on corporate finance)	
(a) where the LC in question is subject to the specified licensing condition	\$100,000
(b) in any other case	\$3,000,000
Type 7 (Providing ATS)	\$3,000,000
Type 8 (Securities margin financing)	\$3,000,000
Type 9 (Asset management)	
(a) where the LC in question is subject to the specified licensing condition	\$100,000
(b) in any other case	\$3,000,000
Type 10 (Providing credit rating services)	
(a) in the case where the LC in question is subject to the specified licensing condition	\$100,000
(b) in any other case	\$3,000,000

The variable required liquid capital (VRLC) of an LC is equal to 5 percent of the aggregate of:

- adjusted liabilities (liabilities less client monies held in segregated accounts and approved subordinated loans);
- the aggregate of the initial margin requirements in respect of outstanding futures contracts and outstanding options contracts held on behalf of clients; and
- the aggregate of the amounts of margin required to be deposited in respect of outstanding futures contracts and outstanding options contracts held on behalf of clients, to the extent that such contracts are not subject to payment of initial margin requirements.

For an LC licensed for Type 3 regulated activity (leveraged foreign exchange trading) an additional amount of 1.5 percent of its aggregate gross foreign currency position must be held.

#### **LCs - risk-sensitivity of capital requirements**

The liquid capital requirement aims to address liquidity and solvency risks of LCs by requiring them to maintain adequate liquid assets to meet all liabilities with a safety buffer. The FRR imposes capital charges to address market risk, credit risk, liquidity risk and concentration risk. In addition, the FRR require LCs to maintain a capital buffer (i.e. the required liquid capital) to cover any other risks including operational risks. The required liquid capital (through the calculation of VRLC) of a LC increases with its business size and the LC must maintain more capital as its business expands.

#### *Market risk*

Capital charges for market risk are generally imposed by way of haircuts on trading positions

	<p>held by LCs, for example, investments in shares listed on SEHK are subject to haircuts ranging from 15 percent to 30 percent of the investment's market value.</p> <p><i>Credit risk</i></p> <p>In the calculation of liquid capital, credit risk is generally addressed by requiring deductions to be made on long outstanding, unsecured or under-secured credit exposures for potential default risks. For example, a LC must not include in its liquid assets any amount receivable from client which has been outstanding for one month or more after the settlement date. (See section 21(1) of the FRR.)</p> <p><i>Liquidity risk</i></p> <p>Liquidity risk of LCs is addressed by requiring them to maintain adequate liquid assets to meet all liabilities with a buffer to ensure their solvency. Illiquid assets such as fixed assets, illiquid bonds, time deposits with maturity of more than 6 months, assets denominated in a foreign currency which is subject to exchange control etc. are excluded from liquid assets. (Division 3 Part 4 of the FRR).</p> <p><i>Concentration risk</i></p> <p>Concentrated securities margin loans and concentrated proprietary positions are subject to additional capital charges under the FRR.</p> <p>When the amount receivable from a margin client or total amount receivable from a group of related margin clients exceeds 10 percent of the aggregate of amounts receivable from all margin clients, the LC is subject to a capital charge to cover the concentration risk. The concentration risk charge equals the amount by which the margin loan due from the margin client (or total margin loan due from the group of related margin clients) exceeds 10 percent of the aggregate margin loans due from all margin clients.(See section 42(1) of the FRR.)</p> <p>A concentration risk charge is imposed on proprietary positions if the net market value of proprietary positions in any line of securities or investments specified in FRR equals 25 percent or more of an LC's required liquid capital. The concentration risk charge is 5 percent of the net market value of the concentrated proprietary positions concerned if the net market value is 25 percent or more of the LC's required liquid capital. This increases to 10 percent if the concentration is 51 percent or more of the LC's required liquid capital. (See section 44 of the FRR).</p> <p><b>Record keeping and reporting</b></p> <p><i>Record keeping</i></p> <p>An intermediary must keep such accounting, trading and other records in relation to its regulated activities as are sufficient to explain, and reflect the financial position and operation of, the firm's businesses and enable profit and loss accounts and balance sheets that give a true and fair view of its financial affairs to be prepared from time to time (section 3(1)(a) of the KRR )</p>
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Specifically, section 146(4) of the SFO and section 3(1)(a)(vii) of the KRR requires LCs to keep such records as are sufficient to enable them to readily establish whether they have complied with the FRR.

#### *Reporting*

LCs are subject to regular reporting requirements as well as ad hoc reporting requirements to report to or notify the SFC in respect of their capital positions.

Pursuant to section 56 of the FRR, LCs must submit financial returns containing a balance sheet, a computation of liquid capital and other financial data to the SFC on a monthly basis within 3 weeks from the end of the reporting period. LCs that do not hold client assets need only report on a six monthly basis. The format of the financial returns is specified by the SFC under section 402 of the SFO. LCs are required to report any required liquid capital deficit in the return.

An LC is required to notify the SFC in writing if its liquid capital falls below 120 percent of its required liquid capital (section 55(1)(a) of the FRR). LCs usually maintain a liquid capital above this reporting threshold in order to avoid triggering the notification requirement.

If a LC becomes aware of its inability to maintain, or to ascertain whether it maintains, financial resources as required by the FRR, it is required, to give written notice, as soon as reasonably practicable, to the SFC (section 146(1) of the SFO.) It must also notify the SFC of its inability to comply with, or to ascertain whether it complies with, any other requirements of the FRR (see section 146(3)).

#### **Independent audit**

LCs are required to submit annual audited accounts together with a computation of liquid capital and an auditor's report on these documents to the SFC (section 156 of the SFO and section 4 of the Securities and Futures (Accounts and Audit) Rules). Section 4(1)(g) of the Account and Audit Rules requires the auditor to express an opinion on compliance with the FRR rules. The SFC follows up any issue raised or qualified opinion expressed by the external auditor of a LC.

#### **Monitoring by regulator**

The SFC analyses all financial returns submitted by LCs with the assistance of computerized tools. The computer system performs various analyses to help identify any significant deterioration in liquid capital of LCs. These include monthly analyses to identify significant changes in an LC's liquid capital, and to monitor the profitability of the LC.

The SFC also performs stress testing periodically based on the information reported by LCs. Risky LCs identified will be subject to close monitoring and may be subject to more stringent reporting requirements, such as to submit regular updates of its financial positions.

	<p><b>Regulator's powers of intervention</b></p> <p>By section 57 of the FRR, an LC must comply with any request by the SFC to provide it within information, including any record or document that the SFC specifies relating to the financial resources or trading activities of the LC.</p> <p>If the SFC becomes aware (whether by notice from an LC or otherwise) that an LC cannot comply with FRR requirements, the SFC can permit the LC to continue operating but subject to conditions specified by the SFC (section 146(2) of the SFO and section 146(5)(b)). It can also, under sections 204 to 206 of the SFO, restrict an LC's business or require property to be dealt with in a specified fashion if the preconditions under section 207 are met (these include that any property connected with the business which constitutes a regulated activity for which it is licensed, might be dissipated, transferred or otherwise dealt with in a manner prejudicial to the interest of any of its clients or creditors). The SFC has used these powers to deal with failures to comply with FRR requirements.</p> <p><b>Risks from outside the regulated entity</b></p> <p>All non-trade related receivables from affiliated companies are excluded from liquid assets of the LC. This is equivalent to a 100 percent deduction from the LC's liquid capital. All liabilities due to affiliated companies are included in the LC's ranking liabilities. In this way, the LCs are required to provide capital against all non-trade related exposures to affiliates. Assets and liabilities arising from business transactions with affiliated companies which fall within the regulated activities conducted by the LC are treated in the same way as transactions with third party customers and counterparties.</p> <p>The FRR applies to LCs on a solo basis only. However, an LC must include in its ranking liabilities any amount by which the total liabilities of a subsidiary exceed the assets of that subsidiary (section 52(1)(b) of the FRR).</p>
Assessment	Fully implemented
Comments	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.
<b>Principle 31.</b>	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.
Description	<p><b>Management and supervision</b></p> <p>SFC's Code of Conduct, ICG and other guidance provide a detailed framework for systems of internal controls and risk management for LCs supervised by the SFC and RIs supervised by the HKMA.</p> <p>Part I of the ICG deals with management and supervision. It requires that an effective</p>

management and organisational structure which ensures that the operations of the business are conducted in a sound, efficient and effective manner be established, documented and maintained. These provisions require:

- a. management to take full responsibility for the firm's operations including the development, implementation and on-going effectiveness of the firm's internal controls and compliance with them by its directors and employees;
- b. regular and effective communication so that management is fully aware of the firm's operations, financial position, risks and compliance with regulatory requirements ;
- c. reporting lines to be clearly identified with supervisory and reporting responsibilities assigned to appropriate staff member(s);
- d. detailed policies and procedures established relating to authorizations and approvals, including that the authority of key positions are clearly defined and communicated to and followed by staff.
- e. management to ensure that management and supervisory functions are performed by qualified and experienced individuals.

In the context of the ICG "management" is used as a generic collective term that may include a firm and its board of directors, chief executive officer, managing director and/or other senior operating management personnel. Therefore according to the ICG, while the management structure and personnel to whom the internal audit and compliance functions (described below) should report vary from firm to firm depending on the firm's particular structure, business operation and needs, the reporting line should be in such a way as to ensure independence, objectiveness and effectiveness of the internal audit and compliance function.

#### *Internal controls*

The Code of Conduct requires an intermediary to have internal control procedures and financial and operational capabilities that can be reasonably expected to protect its operations, its clients and other licensed or registered persons from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions (Paragraph 4.3). It requires senior management to properly manage the risks associated with the business of the intermediary, including by performing periodic evaluation of risk management processes (Paragraph 14.1).

The ICG prescribes detailed control guidelines for:

- a. management and supervision (Part I);
- b. segregation of duties and functions (Part II);
- c. personnel and training (Part III);
- d. information management (Part IV);
- e. compliance (Part V);
- f. audit (Part VI);
- g. operational controls (Part VII); and
- h. risk management (Part VIII).

#### *Management information*

Part IV of the ICG requires an intermediary to establish policies and procedures to ensure the integrity, security, availability, reliability and thoroughness of all information, including

<p>documentation and electronically stored data, relevant to the firm's business operations. It specifies in some detail the content of these policies and procedures.</p> <p><i>Evaluation of internal controls and risk management</i></p> <p>Part VI of the ICG requires an audit policy and related review function to be established and maintained which objectively examines, evaluates and reports on the adequacy, effectiveness and efficiency of the firm's management, operations and internal controls. Where practicable, management should establish an independent and objective internal audit function which is free of operating responsibilities. This function should have a direct line of communication to management or audit committee as applicable.</p> <p>Paragraph 22 of the Appendix to the ICG on risk management requires that a firm's risk policies and measurements and reporting methodologies be subject to regular review, particularly prior to the commencement of the firm's provision of new services or products, or when there are significant changes to the products, services, or relevant legislation, rules or regulations that might impact the firm's risk exposure.</p> <p><b>Organizational requirements</b></p> <p><i>Compliance function</i></p> <p>Part V of the ICG requires policies and procedures to be established and maintained to ensure the firm's compliance with all applicable legal and regulatory requirements as well as with the firm's own internal policies and procedures. It requires management to establish and maintain an appropriate and effective compliance function within the firm which, subject to constraint of size, is independent of all operational and business functions, and which reports directly to management. It provides detailed requirements for the function, including that compliance staff promptly report to management all occurrences of material non-compliance by the firm or its staff with legal and regulatory requirements, as well as the firm's own policies and procedures.</p> <p><i>Systems of client protection, risk management and internal and operational controls</i></p> <p>Paragraph VII of the ICG requires an intermediary to establish, maintain and comply with effective policies and operational procedures and controls in relation to the firm's day-to-day business operations. The effectiveness of these is to be evaluated in the light of whether they serve to ensure, among other things, the integrity of the firm's dealing practices, including the treatment of all clients in a fair, honest and professional manner.</p> <p>Paragraph 4.3 of the Code of Conduct requires intermediaries to have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operations, its clients and other licensed or registered persons from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions.</p> <p><i>Segregation of duties</i></p> <p>Part II of the ICG on segregation of duties and functions requires key duties and functions to</p>
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be appropriately segregated, particularly those duties and functions which when performed by the same individual may result in undetected errors or may be susceptible to abuses which may expose the firm or its clients to inappropriate risks.

### **Senior management responsibility**

General Principle 9 and paragraph 14.1 of the Code of Conduct require senior management of an intermediary:

- a. to take primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by the firm; and
- b. to understand the nature of the business of the intermediary, its internal control procedures and its policies on the assumption of risk. They should clearly understand the extent of their own authority and responsibilities.

### **Direct Electronic Access**

The Appendix to the ICG contains a number of provisions that, although of general application to intermediaries, apply especially to an intermediary providing Direct Electronic Access. These include:

- a. a requirement that firms establish and maintain an effective credit rating system to evaluate client and counterparty creditworthiness (paragraph 23); and
- b. a requirement, prior to executing a client order, that a detailed check is made by designated staff on information relating to the client, including on account limits, the sufficiency of available funds or available credit in the relevant account; the availability of securities to meet settlement obligations; and the authority and applicable limitations of the person placing the order (paragraph 7(b)).

A licensed person engaged in leveraged foreign exchange trading is required by the Code of Conduct to set limits on the size of the positions which each client may establish in the light of the financial position, investment objectives, and strategy of the client (paragraph 50 of Schedule 6 to the Code of Conduct).

The SFC has recently consulted on proposed amendments to the Code of Conduct relating to electronic trading. With respect to supervisory controls for direct market access services, it was concluded that in providing direct market access services, an intermediary must ensure that all client orders are transmitted to the infrastructure used by the intermediary and are subject to appropriate automated pre-trade risk management controls reasonably designed to prevent the entry of any orders that would result in exceeding appropriate trading and credit thresholds prescribed for each client or proprietary account. This requirement will come into effect on 1 January 2014.

### **Protection of clients**

The Code of Conduct has a range of provisions dealing with the way clients of intermediaries are to be treated. These include:

- a. accurate representations to clients (paragraph 2.1 of the Code of Conduct);
- b. prompt execution of client orders (paragraph 3.1);
- c. execution of client orders on the best available terms (paragraph 3.2);

- d. prompt and fair allocation of trades to client accounts (paragraph 3.3);
- e. advice provided to clients should be done diligently and carefully, and suitable for the client in all the circumstances (paragraphs 3.4 and 5.2);
- f. various information to be provided to clients to ensure fair dealing including risk disclosure statements, timely and accurate reporting such as prompt confirmation of executed trades, etc (See paragraphs 6.2 and 8.1 to 8.5);
- g. priority for client orders in respect to order handling, recording and allocation (paragraphs 9.1 and 9.2);
- h. conflicts of interest disclosure and fair treatment (paragraph 10.1);
- i. acting honestly, fairly and with due skill, care and diligence when conducting business activities, in the best interests of clients and the integrity of the market (paragraphs 2.1 to 2.4 and 3.1 to 3.10).

*Client funds and assets*

All intermediaries are required to ensure that client assets and positions are promptly and properly accounted for and adequately safeguarded (see General Principle 8 and paragraph 11.1 of the Code of Conduct). Appropriate and effective procedures must be established and followed when handling movements of the intermediary's and clients' assets to protect the intermediary's and its clients' assets from theft, fraud and other acts of misappropriation (paragraph 9 in Part VII and paragraph 13 of Appendix to ICG).

The Client Securities Rules require segregation of client securities received or held in Hong Kong from the intermediaries' own assets. The Client Money Rules require segregation of client money received or held in Hong Kong from the LCs' money.

Client securities must be registered in the name of the client or deposited in safe custody in a segregated account with an AI, another institution approved by the SFC (presently the HKSCC), or another intermediary licensed for dealing in securities (section 5 of the Client Securities Rules).

For client monies, a LC must establish and maintain with an AI one or more segregated accounts designated as a trust account or client account into which it shall pay:

- a. all amounts that are received from or on behalf of its clients (less brokerage and other proper charges and other amounts as specified in section 4(3) of the Client Money Rules) in Hong Kong within one business day after receipt of the amounts; and
- b. all interest derived from the retention of client money in a segregated account.

(See sections 4 and 6 of the Client Money Rules).

The segregation of client funds required under these provisions for both securities and futures dealings does not require that each client's funds be held separately in an individual segregated account (such as an individual trust account). Segregated client funds can be held in an omnibus client account, while the ledgers of the intermediary would have the information at an individual client level.

Section 148(3) of the SFO further provides that client securities and collateral held by an intermediary are not liable to be taken in execution against the intermediary or its associated entity under the order or process of a court. Similarly, section 149(3) of the SFO provides that

client money of a LC is not liable to be taken in execution against the LC or its associated entity under the order or process of a court.

Under section 12 of Client Securities Rules and section 11 of Client Money Rules, an LC is required to notify the SFC in writing within one business day upon becoming aware that it does not comply with specified provisions in the Client Securities Rules and/or Client Money Rules.

#### *Investor complaints*

Paragraph 12.3 of the Code of Conduct requires an intermediary to ensure that:

- a. complaints from clients relating to its business are handled in a timely and appropriate manner;
- b. steps are taken to investigate and respond promptly to the complaints;
- c. where a complaint is not remedied promptly, the client is advised of any further steps which may be available to the client under the regulatory system including the right to refer a dispute to the FDRC; and
- d. where a complaint has been received, the subject matter of the complaint is properly reviewed. If the subject matter of the complaint relates to other clients, or raises issues of broader concern, an intermediary should take steps to investigate and remedy such issues, notwithstanding that the other clients may not have filed complaints with the intermediary and/or the FDRC.

The FDRC administers an independent and impartial Financial Dispute Resolution Scheme (FDRS). The Scheme assists individual customers and financial institutions to resolve monetary disputes with a maximum claimable amount of HK\$500,000 by way of “mediation first, arbitration next”. The FDRC is funded by the Hong Kong Government, SFC and HKMA for its set-up costs and operating costs in the first three years (from 2012 to 2014), and will be funded by the financial industry and to a lesser extent by the claimants from the fourth year (i.e. 2015) onwards. It has representatives from SFC, HKMA, FSTB and the banking and securities industries on its board. All financial institutions authorized by the HKMA and /or licensed by the SFC, except those which provide credit rating services only, are members of FDRS.

### **Client information, know your client and suitability rules**

#### *Client identity*

An intermediary is required to take all reasonable steps to establish the true and full identity of each of its clients, and of each client’s financial situation, investment experience, and investment objectives (paragraph 5.1 of the Code of Conduct). The ICG requires an intermediary to establish and maintain processes to obtain and confirm information regarding every client in relation to establishing the true identity of the client; the beneficial owner(s) and person(s) authorized to give instructions; and the client’s financial position, and investment experience and objectives prior to the establishment of an account (paragraph 1 under Part VII of the ICG).

The SFC’s Guideline on Anti-Money Laundering and Counter-Terrorist Financing sets out the

detailed customer due diligence measures the SFC expects from licensed persons for identification of customers as part of their anti-money laundering program.

*Know your customer*

General Principle 4, paragraphs 5.1 and 5.2 of the Code of Conduct require an intermediary to establish each client's financial situation, investment experience, and investment objectives in order to provide suitable recommendations or solicitations for that client in all the circumstances.

Part VII of the ICG requires an intermediary to establish the client's financial position, investment experience and investment objectives prior to the establishment of an account, and to adopt measures and procedures to ensure that investment recommendations or advice are based on thorough analysis, taking into account available alternatives and that such recommendations and advice are appropriate for the relevant client. The intermediary is obliged to document and retain the reasons for the recommendations and advice given.

The SFC has published a Q&A on suitability obligations. This clarifies the requirements in paragraph 5.2 of the Code of Conduct and states that investment advisers should collect from each client information that includes their investment knowledge, investment horizon, risk tolerance (including risk of loss of capital) and capacity to make regular contributions and meet extra collateral requirements, where appropriate. Each client's information should be fully documented and where appropriate, updated on a continuous basis.

*Records*

Section 3 of the KRR requires an intermediary to keep such accounting, trading and other records as are sufficient to, among other things:

- a. account for all clients assets that it receives or holds;
- b. enable all movements of such client assets to be traced through its accounting and stock holding systems; and
- c. records that show particulars of all orders or instructions concerning securities, futures contracts or leveraged foreign exchange contracts that it receives or initiates, including particulars of each transaction to implement any such order or instruction, identifying with whom or for whose account it has entered into such transaction.

Section 10 of the KRR requires such records to be kept for a period of not less than 7 years except for order and instruction records which are to be kept for not less than 2 years.

*Disclosure to clients*

Intermediaries are obliged to make adequate disclosure of relevant material information in their dealings with their clients (General Principle 5 of the Code of Conduct). Where complex products are involved, intermediaries must provide risk disclosure information in addition to the minimum content requirements set out in the Code of Conduct.

Where an intermediary distributes an investment product to a client, it must deliver the following information to the client prior to or at the point of sale:

- a. the capacity (principal or agent) in which an intermediary is acting;
- b. affiliation of the intermediary with the product issuer;
- c. disclosure of monetary and non-monetary benefits; and
- d. the generic terms and conditions under which client may receive a discount of fees and charges from an intermediary. (See 8.3A of the Code of Conduct.)

The Q&A on suitability obligations provides additional guidance on assisting clients to make informed investment decisions. It includes requirements that an adviser give clients: relevant product disclosure documents; proper explanations of why recommended investment products are suitable for them; and the nature and extent of risks the investment products bear. Investment advisers must always present balanced views and use simple and plain language.

Paragraph 6.2 of the Code of Conduct provides that, when opening an account for conducting certain types of transactions or dealing for the first time in those transactions, intermediaries must provide the relevant risk disclosure statements to the client. Risk disclosure statements that comply with Schedule 1 of the Code of Conduct should be given to clients in respect of the following products and services:

- a. Securities trading;
- b. Trading futures and options;
- c. Trading GEM stocks;
- d. Providing an authority to lend or deposit clients' securities with third parties;
- e. Providing an authority to hold mail or to direct mail to third parties;
- f. Margin trading; and
- g. Trading NASDAQ-AMEX securities on SEHK

#### *Reports to clients*

An intermediary must provide a monthly statement of account to clients who have money, securities, collateral or open positions with the intermediary, or who have been provided with a contract note during the relevant month (section 11 of the Contract Note Rules). The intermediary must also provide a statement if a client requests it (section 12).

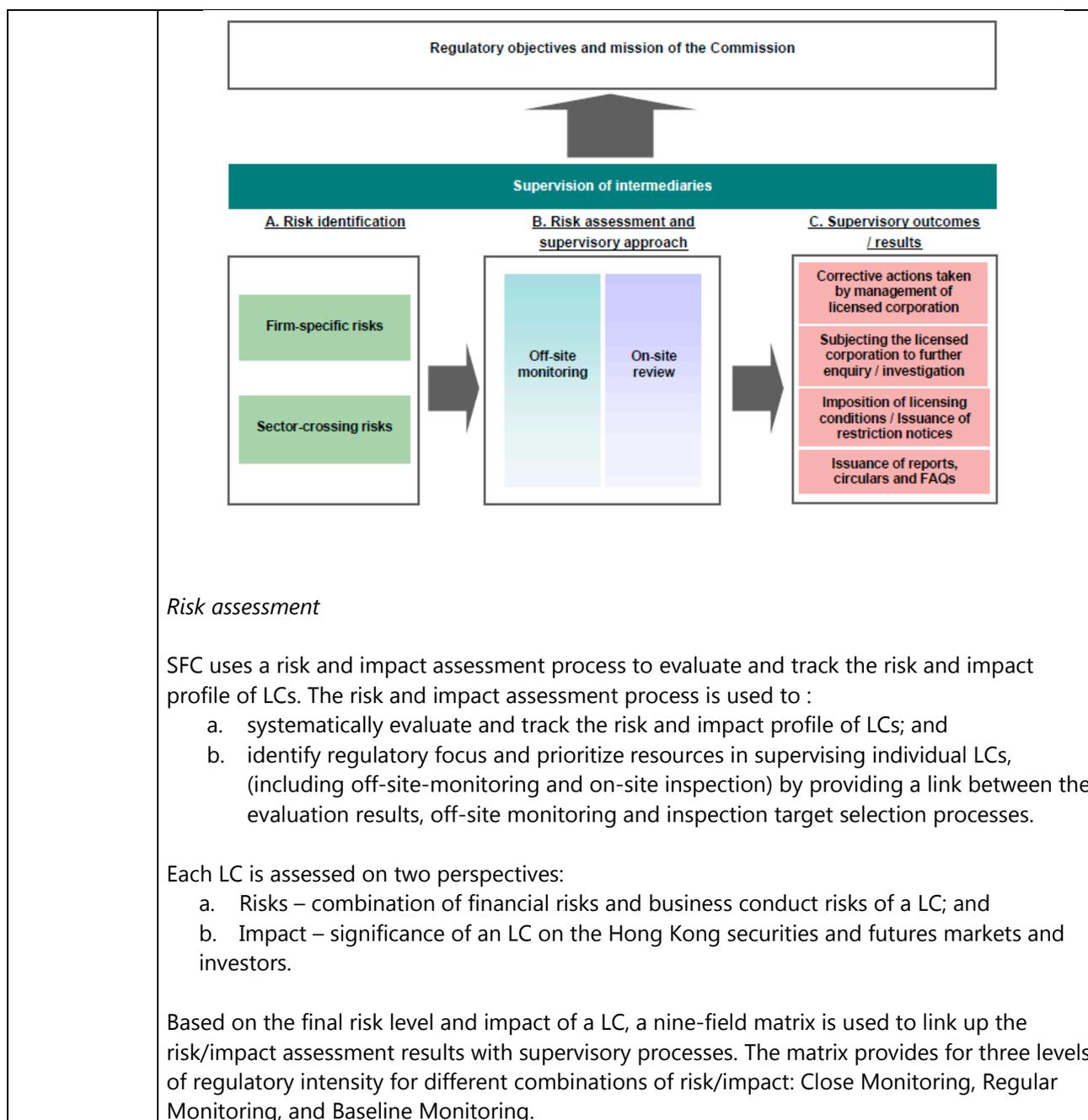
#### **Customer access to terms and conditions of services**

All intermediaries must enter into a written agreement with each client before services are provided (paragraph 6.1 of Code of Conduct). The minimum required content of the client agreement is detailed in paragraph 6.2 of the Code of Conduct. The client agreement should not operate to remove, exclude or restrict any rights of a client or obligations of the intermediary under the law, and should properly reflect the services to be provided. (paragraphs 6.3 and 6.4 of the Code of Conduct).

#### *Information about remuneration*

The client agreement must contain a description of any remuneration (and the basis for payment) that is to be paid by the client to the intermediary, such as commission, brokerage, and any other fees and charges (paragraph 6.2 of the Code of Conduct).

	<p>Paragraph 8.3 of the Code of Conduct further details the requirement for an intermediary to make pre-sale disclosure of both monetary and non-monetary benefits that are receivable by it under specified circumstances.</p> <p><b>Conflicts of interests</b></p> <p><i>Conflicts of interest</i></p> <p>The general requirements for dealing with conflicts of interest are set out in General Principle 6 and paragraph 10.1 of the Code of Conduct. They require an intermediary to try to avoid conflicts of interest and when they cannot be avoided, must ensure that its clients are fairly treated, and requires an intermediary not to advise, or deal in relation to a transaction which gives rise to an actual or potential conflict of interest unless the intermediary has disclosed that conflict to the client and has taken all reasonable steps to ensure fair treatment of the client.</p> <p>Paragraph 4 of Part VII of the ICG requires intermediaries to have specific policies and procedures to minimize the potential for the existence of conflicts of interest between the firm or its staff and clients, and ensure that, where actual or apparent conflict of interest cannot reasonably be avoided, clients are fully informed of the nature and possible ramifications of such conflicts and are treated fairly. The ICG also contains other provisions, for example, a requirement for adequate information barriers (“Chinese walls” – see paragraph 8 of Appendix).</p> <p>The Code of Conduct (paragraphs 9.1 and 9.2) also sets out detailed requirements about the handling and execution of client orders, including a requirement to give client orders priority over proprietary orders.</p> <p>The Code also contains specific conflicts of interest requirements relating to analyst’s activities (paragraph 16(3)(a)). Other conflicts of interest requirements are set out in the FMCC, and the Corporate Finance Adviser Code of Conduct .</p> <p><b>Supervision - SFC</b></p> <p>SFC’s general approach to supervision of intermediaries is set out in the SFC’s publicly available Approach to Supervision. It comprises both prudential supervision (compliance with FRR requirements) and conduct supervision. The Intermediaries Supervision Department, which at 31 August 2013 had a total of 128 staff, is responsible for supervision of LCs. Staff numbers have increased by 70 percent over the last 5 years.</p> <p>The overall approach is summarized in the following diagram:</p>
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Regulatory Intensity		Final Risk Level		
		Significant	Intermediate	Low
Impact	High	Close Monitoring	Regular Monitoring	
	Medium			
	Low	Baseline Monitoring	Baseline Monitoring	

The risk and impact assessment is updated in an internal database on an ongoing basis as soon as practicable after the SFC receives new information and conducts assessment/review of such information. It is updated continuously, for example on receipt of monthly returns on compliance with FRR requirements, or new information coming from supervision activities or externally.

*Off-site monitoring*

About half of the Intermediaries Supervision department of 128 staff do off-site monitoring work. Some members are specialists in particular types of intermediaries (such as CRAs, or investment banks). There is an active policy of “reaching out” by maintaining a dialogue with individual firms and the industry. Off-site supervision staff review information SFC receives about firms, such as regulatory filings, annual audited accounts, the annual business and risk management questionnaire, and breach notifications by LCs. Each LC has an SFC staff member “owner” and all reviews by case owners are subject to another layer of review by their supervisors.

The financial soundness of LCs is assessed mainly through analysis of monthly financial returns and annual accounts. Monthly returns are analyzed by computer system against 51 key indicators and the system produces red flags indicating the need to follow up with the LC. Sensitivity and stress testing are done regularly to identify financially vulnerable firms.

Off-site monitoring work is stepped up for LCs that pose higher risks or have significant impact on the market. For example, their financials may be subject to more intensive review if such firms are financially vulnerable and close dialogue with management may be maintained. At the same time, they may be subject to more frequent on-site inspections and the breadth and depth of the on-site inspection scope may be adjusted, depending on the risk assessment of these firms.

SFC monitors industry risk profile and business model changes through regular interaction with market participants and industry and trade associations, surveys of LCs, and gathers market intelligence from various channels. For instance, the SFC carried out a mystery shopping exercise in 2010 to look into the selling practices of LCs. A total of 150 samples were

conducted on 10 LCs which comprised investment advisory firms as well as brokerage firms that sell unlisted securities and futures investment products to retail customers.

In practice, off-site monitoring is likely to trigger inquiries from and meetings with the SFC when issues of concern arise.

*On-site inspections and prudential visits*

SFC prepares an annual plan for its on-site inspection work. The identification of inspection priorities and themes, and the selection of LCs for inspection, follows a mixed top-down (industry-wide and linked to SFC's overall priorities) and bottom-up (firm specific, linked to the risk impact assessment framework for all LCs described above) approach which determines whether routine, special or thematic inspections should be conducted, and the targets of those inspections.

Under the on-site inspection program, all firms are inspected at least every 7 years. Firms of higher risk or impact are subject to more frequent inspections, so that the interval between on-site inspections can be 3-4 years for the highest risk/impact firms.

On-site inspections fall broadly into three types:

- a. *Routine inspections* are general checks on LCs' internal controls and risk management processes, as well as their compliance with relevant rules and regulations, in the area(s) of relative importance. Typically, before the inspection is due to commence, the inspection team will identify the key potential risk areas and formulate an inspection plan. Different inspection checklists and programs have been developed to cover the different types of business activities conducted by LCs. These are used as guidance, although the scope and depth of each review is tailored to suit the specific circumstances of each firm.
- b. *Thematic inspections* are performed to assess the scale and nature of a particular sector-crossing risk. These may be triggered by the SFC identifying trends, emerging risks and compliance lapses that require prompt regulatory response through the top-down and bottom-up approach. A sample of LCs is selected for review in each round of thematic inspection covering firms of different size and that are more exposed to the particular risk. The review steps are normally tailor-made. Examples include a number of reviews on the selling practices of LCs; a thematic review of the role of sponsors in the IPO process; and a review of risk controls used by brokers active in trading derivative warrants and callable bull-bear contracts.
- c. *Special inspections* are usually cause-driven and are performed on LCs that are suspected to be financially vulnerable or otherwise pose imminent risks to the market or to their customers in light of the intelligence received or referrals made by off-site monitoring teams or external sources. The scope of the inspection and review steps are tailored to cater for the specific circumstances of each case.

**Risk-based on-site inspections by major business types**

Firm Type	2012/2013	2011/2012	2010/2011	2009/2010	2008/2009
<b>Brokers</b>	148	145	82	76	116
<b>Hedge Fund Management Companies (HFMCs)</b>	18	23	16	28	4
<b>Asset Management Companies (excluding HFMCs)</b>	54	38	60	46	16
<b>Investment Advisors</b>	20	34	36	28	13
<b>Others</b>	31	12	41	22	11
<b>Total No. of Inspections</b>	271	252	235	200	160

Source: SFC

**Breakdown of risk-based on-site inspections by inspection types**

	2012/2013	2011/2012	2010/2011	2009/2010	2008/2009
<b>Routine inspections</b>	248	152	189	171	80
<b>Thematic inspections</b>	16	85	35	26	70
<b>Special inspections</b>	7	15	11	3	10

Source: SFC

In addition, on-site supervisory contact with individual LCs includes prudential visits to licensed firms. Prudential visits last between half a day and a day and are designed to make a general assessment of controls of the firm based on management representations.

**Number of LCs subject to prudential visits**

	2012/2013	2011/2012	2010/2011	2009/2010	2008/2009
<b>On-site prudential visits</b>	66	74	82	74	69

*Regulatory response to problems identified*

As well as requiring LCs to remedy problems identified in off-site monitoring and on-site inspections, staff in Intermediaries Supervision also refer cases to SFC's Enforcement Division. The recommendation to refer a case to the Enforcement Division is based on criteria used by SFC in its supervision and enforcement activities. (See the discussion in Principles 11 and 12)

**Referrals to Enforcement Division as a result of on-site inspections and off-site monitoring  
(for investigation and/or disciplinary inquiry)**

	2012/20	2011/201	2010/201	2009/20	2008/2
	<b>13</b>	<b>2</b>	<b>1</b>	<b>10</b>	<b>009</b>
<b>Referrals</b>	29	22	27	34	19

**Supervision - HKMA**

Supervision of RIs is done by HKMA's Banking Conduct Department. The Department conducts both off-site monitoring and on-site inspections of the 118 RIs as of 30 June 2013.

Three teams of HKMA staff are involved in off-site supervision and cases are referred to them on an ad hoc basis. Specialist teams do reports analysis and review the quarterly surveys of securities activity that HKMA requires RIs to complete.

HKMA does not have a formal risk scoring system, but its approach takes into account the risks posed by individual firms, as well as risks from particular types of activity. Inputs into the risk assessment process include:

- supervisory experience of the RI such as the results of previous on-site examinations and off-site reviews, or referrals from the banking supervision area of HKMA;
- the development of the securities business of the RI, particularly if a new regulated activity or new business under a particular regulated activity has been undertaken recently;
- whether the RI has been actively selling investment products to retail customers;
- the number of complaints received against the RI;
- the information reported in the Return of Securities Related Activities submitted by the RI concerned on a semi-annual basis;
- self-reporting of breaches by an RI;
- input from the SFC, if any;
- adverse media reports of the RI; and
- compelling issues as identified in the banking industry of disciplinary cases.

*Off-site monitoring*

Off-site monitoring involves maintaining an open dialogue with RIs and reviewing:

- Self-assessment reports, thematic on-site examination reports, and RIs' reports on independent reviews conducted by internal/external auditors;
- quarterly surveys of RIs with a retail customer base, containing details of products and activities that relate to retail clients;

- c. half-yearly Return of Securities Related Activities submitted by RIs;
- d. the results of mystery shopping exercises undertaken by RIs and those instituted by HKMA with respect to RIs' selling of investment and insurance products;
- e. incident and exception reports from RIs that relate to their securities activities.

A specialist team prepares and circulates reports on their analysis of information obtained from the quarterly surveys and half-yearly returns. HKMA's off-site monitoring is supported by a computerized system which records and makes available to all off-site review team members "incident summaries" which are records of breaches or issues identified in each case, areas of concern, follow-up actions taken, RI's remedial actions, conclusion and recommendations. This system allows the staff, for example, to identify breaches that have occurred across a range of RIs, and all breaches committed by an RI. The system also ensures consistency in the handling of breaches or other incidents.

In practice, these sources of information trigger different types of intervention, from inquiries to meetings, as confirmed by conversation with market participants. On-site inspections could also follow on an exceptional basis.

Prudential supervision is the responsibility of HKMA's Banking Supervision Department.

#### *On-site inspections*

HKMA carries out both routine inspections and thematically focused inspection work.

In setting an inspection cycle, HKMA distinguishes between RIs' with a retail client base and those who offer securities services only to institutional or high net worth clients. The target cycle used is:

- a. for the 21 RIs with a retail client base, the examination cycle is 1-2 years;
- b. the top 10 non-retail RIs are subject to a 3-4 year cycle; and
- c. other non-retail RIs are subject to a cycle that takes into account the length of time since the last inspection, known areas of concern etc.

HKMA prepares an annual inspection plan. The process involves deciding on themes and priorities and, using the risk approach described above, deciding on the inspection targets for that year. Routine surveillance – checking on compliance with organizational requirements and processes - is generally combined with the year's thematic priorities as the basis of individual inspection plans.

In 2012, HKMA staff conducted 27 on-site examinations of RIs covering areas including the sale of Qualified Foreign Institutional Investors funds; accumulators and decumulators; the selling process; product due diligence; and training regarding investment products regulated under the SFO.

In its inspection work in recent years, HKMA has been placing emphasis on the selling of products to retail clients, particularly products bearing significant risk for unsophisticated investors such as ETFs, ILAS and high yield bonds.

	<p><i>Regulatory response to problems identified</i></p> <p>As well as requiring RIs to remedy problems identified in offsite monitoring and on-site inspections, staff in the Banking Conduct Department also refer cases to HKMA's Enforcement Department. The selection of cases to refer is based on meeting internal criteria used by HKMA in all its supervisory activities. These criteria identify a number of "triggering events" which result in a referral to Enforcement. Key factors include the length of time non-compliance has been occurring, its potential impact on clients, the number of complaints received, whether the conduct in questions (even if isolated), reflects on the fitness and properness of the relevant person, etc.</p> <p>17 cases were referred in 2011, 18 in 2012 and 21 cases in the first half of 2013.</p> <p>In addition, HKMA refers cases to the SFC where disciplinary action under the SFO, or possible administrative, civil or criminal action may result.</p> <p><b>HKMA referrals to SFC</b></p> <table border="1" data-bbox="477 827 1351 970"> <thead> <tr> <th></th> <th><b>2013 (Jan-Aug)</b></th> <th><b>2012</b></th> <th><b>2011</b></th> <th><b>2010</b></th> </tr> </thead> <tbody> <tr> <td><b>Referrals</b></td> <td>12</td> <td>22</td> <td>7</td> <td>691*</td> </tr> </tbody> </table> <p>* 2010 cases were almost all cases concerning the sale of Lehman minibonds.</p>		<b>2013 (Jan-Aug)</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>	<b>Referrals</b>	12	22	7	691*
	<b>2013 (Jan-Aug)</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>							
<b>Referrals</b>	12	22	7	691*							
Assessment	Fully Implemented										
Comments	<p>The conversations with both the regulatory authorities and market participants led the assessors to conclude that the Lehman minibonds experience triggered significant improvements in conduct supervision. On the regulatory side, the SFC strengthened its code of conduct for intermediaries in connection with distribution of products in 2010, and a number of additional requirements have been imposed on banks by the HKMA via circulars since 2009. On the supervisory front, the HKMA created a separate department for conduct supervision. Finally the SFC has pursued enforcement actions aimed at achieving compensation of investors. These are all welcome developments that led the assessors to conclude that conduct supervision is a priority for both regulatory authorities.</p> <p>The role of supervision is to allow the regulator to identify risk and potential poor practices early on so that risks do not build up and misconduct is dealt with swiftly and in a manner that sends clear signals to the market about conduct that will not be tolerated.</p> <p>HKMA uses a combination of offsite and on-site work.</p> <p>HKMA relies for its offsite supervision work on much more than financial reporting, as explained in the description.</p> <p>As can be concluded from the description, HKMA makes more extensive use of on-site supervision than many securities regulators would do for the intermediaries they supervise. Banking supervisors traditionally make intensive use of on-site inspections, but focus on prudential rather than conduct issues. The HKMA is unusual in the emphasis it places on</p>										

	<p>conduct issues.</p> <p>A review of the files and conversations with market participants indicate that inspections are thorough and focus heavily on conduct issues (especially mis-selling) and they have been active in referring cases to the SFC as a result of these inspections. This intense intervention of HKMA is critical given the role banks play in the distribution of investment products in HKSAR.</p> <p>Similar to HKMA, SFC uses a combination of both offsite and on-site work.</p> <p>Its approach to offsite work is similar to that used by HKMA and relies on a combination of inputs. These inputs trigger different types of intervention, from inquiries to meetings and potentially inspections.</p> <p>As explained in the description, for on-site work, like other regulators, SFC uses a risk based approach. However, all firms are inspected at least every 7 years, and higher risk/impact firms are inspected on a shorter cycle. Based on the information provided, it can be concluded that the SFC makes greater use of the on-site tool than in many jurisdictions. More importantly, through refined use of calibration, it addresses a key drawback of many pure risk based approaches. SFC's risk based approach covers not only firms that would have a large impact because of their size but also smaller firms when common problems are identified in them that could lead to clusters of risk that, though on an individual firm basis would be small, taken together pose important risk. It addresses this drawback through the thematic work that in some cases is off-site but involves examining all the information that would be requested in an on-site inspection and in others is conducted on-site. A good example of the use of this calibration has been the intense supervision that the SFC has on the segment of small vulnerable brokers.</p> <p>Review of files and conversations with market participants confirm that the SFC's inspections are thorough and focus on both conduct and prudential issues, and referrals to Enforcement Division take place,</p> <p>In conclusion, review of the files and conversations with market participants confirm the picture of regulators that have an active presence in the market.</p> <p>However, because of limitations in the regulatory framework for enforcement, the SFC is confronted with difficult trade-offs between client compensation and disciplinary sanctions. These are challenges in enforcement rather than the supervision, so this issue has been taken into account for the grade in Principles 11 and 12.</p>
<b>Principle 32.</b>	There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.
Description	<p><b>Plans for dealing with failure of regulated firm</b></p> <p>The SFC has a Market Contingency Plan (MCP) providing guidance on the measures and procedures to deal with emergency scenarios and their impact on the financial market and other market participants. It includes a specific section dealing with the failure of an intermediary and specifies procedures to be followed in that circumstance.</p>

The MCP has detailed procedures for the SFC to contact other relevant financial market regulators during crisis situations that may have cross-market or systemic implications. Updated contact information for the key contact persons (from senior to working levels) of other financial market regulators are set out in the appendix to the MCP.

SFC has a contingency plan (contained in Appendix 3 of the MCP) which sets out:

- a. The roles of designated staff in Intermediaries Supervision Department under the contingency plan; and
- b. Core actions in case of the following major risk scenarios:
  - i. Substantial market decline;
  - ii. LCs with material systematic operational failure;
  - iii. LCs with material systematic financial failure;
  - iv. Sizable listed company failure or share price plummet; and
  - v. Bank crisis.

The FSTB conducts a market-wide contingency rehearsal for the financial services sector every two years. The SFC, HKEx and all other financial market regulators participate in the rehearsal to test how they coordinate with each other to deal with various contingency scenarios that may have cross-market or systemic implications. The rehearsals test communication among financial market regulators during the crises. The last market-wide contingency rehearsal was conducted on 15 December 2012.

The core actions in the contingency plan include identification of affected LCs and assessment of the impact, communication and information exchange with SEHK and other regulators, and consideration of the need for supervisory and/or ring-fencing or restrictive actions and public announcement.

#### **Early warning systems**

LCs are required to notify or report to the SFC of deterioration in financial positions in addition to regular reporting. In particular, a LC is required under section 55(1) of the FRR to notify the SFC in writing within one business day whenever it becomes aware of, among other matters:

- a. its liquid capital falls below 120 percent of its required liquid capital;
- b. its liquid capital falls below 50 percent of the liquid capital stated in its latest return submitted to the SFC under section 56(1) or (3) of the FRR; and
- c. any information contained in any of its previous returns submitted to the SFC pursuant to the FRR has become false or misleading in a material particular.

The notice must contain full details of the matter and what steps the LC has taken or plans to take to prevent its liquid capital falling below the required minimum, or to improve liquidity.

Sections 146(1) and 146(3) of the SFO also provide for LCs to notify the SFC of their inability to meet capital requirements or to ascertain whether they are meeting them.

#### **Regulator's powers to intervene**

If it receives a notice from a LC under section 146(1) of the SFO, the SFC may permit the LC to

carry on any regulated activity for which it is licensed, subject to such conditions as may be imposed by the SFC by notice given to it (section 146(2) of the SFO).

If the SFC reasonably believes that a LC is unable to maintain, or to ascertain whether it maintains, financial resources in accordance with the FRR requirements, the SFC may, whether or not notice has been given under section 146 (1)(a) of the SFO:

- a. suspend the LC's license, wholly or in part, for a specified period or until the occurrence of an event specified by SFC; or
- b. permit the LC to carry on any regulated activity for which it is licensed, subject to conditions specified by SFC.

(Section 146(5) of the SFO).

The SFC can also take a number of other measures under the SFO. These include:

- a. impose licensing conditions under section 116(6); and
- b. impose a prohibition or a requirement under sections 204 (restriction on business), 205 (restriction on dealing in property) or 206 (maintain assets in Hong Kong, or a place specified by the SFC). Exercise of these powers requires the threshold requirements in section 207 to be met.

HKEx, the front-line regulator of clearing house participants, has the following powers in respect of defaulting clearing participants:

- a. to close out any unsettled contracts (Rule 3702(i) of General Rules of CCASS); and
- b. to transfer any open futures/options contracts and margin collateral to other non-default clearing participants (Rule 510(f) of HKCC Rules and Rule 703(5) of SEOCH Clearing Rules).

An administrator/liquidator appointed by the court for a LC is usually authorized to allocate and distribute securities and cash back to the clients of the LC. This has occurred in a number of cases in Hong Kong. For example, in the case of MF Global Hong Kong Limited, an SFC restriction notice was varied to enable the liquidator to close out or transfer to other brokers client positions held on local and overseas exchanges.

#### *Appointment of administrator*

A court, on the application of the SFC, can appoint a person to administer the property of an LC, if the LC has contravened a relevant provision, or may do so (section 213(2)(d) of the SFO).

#### *Use of these powers*

The SFC has used the powers described above in a number of cases. This includes the use of restriction notices under sections 204-206 of the SFO and the appointment of administrators.

#### **The Investor Compensation Fund**

In the event of the default of an intermediary/authorized financial institution, the SFC will work together with the Investor Compensation Company Limited, a wholly owned subsidiary of the SFC, to handle the compensation claims made by the clients of the defaulting intermediary/authorized financial institution against the Investor Compensation Fund (the

	<p>Fund). The Fund was set up in 2003 under the SFO to replace the two previous investor compensation funds, namely, Unified Exchange Compensation Fund and Commodity Exchange Compensation Fund. It is funded by an Investor Compensation Levy on exchange-traded product transactions and with an automatic levy suspension/reinstatement triggering mechanism. Currently the levy has been suspended because the fund size has exceeded the maximum level required to be maintained.</p> <p>The Fund was established to pay compensation to investors of any nationality who are “qualifying clients” and suffer pecuniary losses as a result of default of an intermediary licensed or registered for dealing in securities or dealing in futures contracts, an intermediary licensed for securities margin financing or an authorized financial institution which provides securities margin financing, in relation to exchange-traded products in Hong Kong. A qualifying client means a person for whom the intermediary/authorized financial institution provides a service but does not include certain categories of institutions and persons (including licensed corporations and authorized financial service providers).</p> <p>The Claims Rules of the Fund cap the compensation payable to each person in relation to securities and futures respectively at HK \$150,000. According to SFC’s compensation history, for about 70 percent of the clients who applied for compensation, this amount was sufficient to cover all their losses.</p>
Assessment	Fully Implemented
Comments	
<b>Principles for the Secondary Markets</b>	
<b>Principle 33.</b>	The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.
Description	<p>Background</p> <p>Under the current legal framework, section 19 of the SFO granted the SEHK a monopoly for the establishment of a securities exchange (i.e. trading of domestically listed securities). The only exception to this monopoly relates to trades conducted by exchange participants in their offices (such as trade crossing platforms operated by exchange participants).</p> <p>The monopoly does not extend to futures exchanges. Pursuant to the SFO the establishment of such type of exchange is subject to recognition by the SFC, after consultation with the FS. Currently the only futures exchange recognized by the SFC is the HKFE, which is part of the HKEx group.</p> <p>HKEx is the holding company and controller of the following recognized exchanges and clearing houses: SEHK; HKFE; HKSCC; SEOCH; and HKCC. HKEx also owns London Metal Exchange in the UK.</p> <p>In addition, HKEx has established OTC Clear, together with 12 founding members (which are commercial banks and investment banks). OTC Clear was granted recognition as a recognized clearing house under section 37 of the SFO on 25 October 2014 and operations were launched on 25 November. OTC Clear will clear OTC derivatives contracts on interest rate swaps and non-deliverable forwards at the initial stage.</p> <p>Pursuant to the SFO, ATS can be established; however what it is permitted as an ATS is</p>

affected by the monopoly granted to the SEHK in respect of the trading of securities listed in HK, as only exchange participants could have Part V ATS that trade securities listed in the SEHK (in light of the exception granted to them).

The SFO contains two different frameworks for the regulation of ATS:

- ATS licensed under Part V of the SFO, as a Type 7 licence: these are ATS established by firms that already hold a Type 1 or Type 2 licence. In other words, the ATS is provided incidentally to the agency brokerage business offered by the firms. These ATS can trade securities listed on the SEHK as well as other types of securities and derivatives because they are operated by exchange participants. As of March 2013, there were 25 ATS operators licensed or registered under Part V --Type 7 regulated activity, with 13 of them providing ATS in the form of dark pools to trade securities listed on the SEHK. The Type 7 ATS operated by the remaining intermediaries are primarily for trading pre-IPO stocks, equity-linked notes and/or fixed income securities. Only a couple of them (including one lit operator and one odd lot stock trading platform operator) operated Type 7 ATS which are primarily involved in SEHK listed shares.
- ATS authorized under Part III of the SFO: these ATS are operated by firms in the form of an exchange or exchange-like operation. In practice, this regime has been used by foreign exchanges and foreign ATS operators to set up platforms that give access to foreign products. As of May 2013, there were 21 overseas exchanges and electronic facilities authorized under Part III, including major exchanges such as the Australia Securities Exchange, the Tokyo Exchange Eurex Deutschland and CME Group exchanges.

Historically there has not been overlap between the products traded by the HKEx group and the Part III authorized ATS, given the business model of the HKEx (which has largely focused on equity related products). As the HKEx moves into new products (as foreseen in its strategy) the probabilities of overlap would increase. In this regard the CEO of the HKEx summarized the HKEx strategy as "across asset classes, across continents, and across borders."

### **Recognition of Exchanges**

Sections 19, 37 and 50 of the SFO empowers the SFC to recognize an exchange when it is satisfied that it is (i) in the interest of the investing public or in the public interest and (ii) for the proper regulation of markets in securities and contracts. The recognition is subject to consultation with the FS.

Apart from the two conditions detailed above there are no additional criteria in the SFO for the recognition of an exchange. SFC staff highlighted that should a company seek recognition as an exchange company (other than a stock exchange), the SFC will have regard to the regulatory objectives of the SFC under Section 4 of the SFO; the functions of the SFC under Section 5 of the SFO; and the matters the SFC shall have regard to under Section 6(2) of the SFO in pursuing its regulatory objectives and performing its functions and impose prudential and capital requirements. In addition, the SFC will review if the company would have the capability to carry out the statutory duties specified in the SFO. The SFC will also review the various trading or clearing systems to ensure the readiness and integrity of the systems.

Further the SFO imposes specific duties on REC: ensure an orderly, informed and fair market in securities, and ensure that risks associated with its business and operations are managed prudently (Section 21). In discharging these duties, the REC has to (a) act in the interest of the public, having particular regard to the interest of the investing public; and (b) ensure that the interest of the public prevails where it conflicts with the interest of the REC. In addition, the REC has the duty to operate its facilities in accordance with the rules made under Section 23 and approved by the SFC under Section 24; and formulate and implement appropriate procedures for ensuring that its exchange participants comply with the rules. At all times, it has to provide and maintain (a) adequate and properly equipped premises; (b) competent personnel; and (c) automated systems with adequate capacity, facilities to meet contingencies or emergencies, security arrangements and technical support, for the conduct of its business. In reviewing the application, the SFC would assess the capability of the applicant company to fulfil these duties.

Pursuant to the SFO, the SFC can attach conditions to a recognition order. The SFC can also give orders and withdraw the licence of an exchange, in both cases prior consultation with the FS is required.

The authorities highlighted that no applications to be recognized as a REC have been submitted as of the time of this assessment. If such applications were to be received, the internal policies and procedures that the SFC had to develop for purposes of the application of OTC Clear will be adapted accordingly.

#### *HKEx*

Pursuant to Section 5 of the SFO the SFC is in charge of the supervision of all exchanges, including the recognized exchanges controlled by the HKEx. The SFO does not contain a detailed list of issues that the SFC must assess as part of its ongoing supervision of exchanges; however SFC staff highlighted that the duties imposed on exchanges provide a framework for such supervision.

Specifically in what relates to the HKEx, current rules deal with a number of the aspects expected to be in place for a recognized exchange mentioned in Principle 33, as detailed below.

**Products:** The listing rules specify the types of products that can be listed and the listing requirements. Overall as explained under Principle 16 the HK regime has features of a merit system, whereby in addition to the disclosure requirements there is an overall assessment of the suitability of a particular company to be in the exchange.

**Intermediaries:** The rules specify the type of intermediaries that can be participants of the exchange. Only type 1 licensees for the cash market and type 2 licensees for the derivatives markets are eligible to be participants of the SEHK and the HKFE respectively. The rules for admission are based on objective criteria. The decisions that the exchange takes in connection to participants are final and conclusive.

**Order execution procedures:** The rules specify order execution procedures, trade matching and execution algorithms. Both the securities and futures/options contracts traded are executed based on price/priority as stated in the rules.

**Connection:** The rules of the exchanges (Rules 364B and 365 of the SEHK Rules and Rule 1201 of the HKFE Rules) stipulate that all participants may use the software provided by the exchanges, by vendors or developed in-house. Participants are free to choose trading devices which suit their business requirements and nature to access the trading systems. In practice, the current network (SDNET) allows a difference in access depending on where the participant is located, but according to senior HKEx officials the difference is very small. Nevertheless, SEHK started its new co-location services for the cash market in November of 2012 and for derivatives in June 2013. As of the time of the assessment 25 percent of the volume of the cash markets and 45 percent of the derivatives markets was coming through co-location. The HKEx is also developing a new central gateway service to be implemented in mid-2014. These new services will provide participants quicker access to the trading systems. All participants have equal opportunity to subscribe to these two services. Among those participants who have trading systems at the co-location centre, the system access time and latency are equal. As the central gateway is optional initially and will become mandatory later, all participants using central gateway for trading would ultimately enjoy the same system access time or execution response time.

**Operational information:** Rules are available to participants and the public via the HKEx website. All participants connected to the trading systems of SEHK and HKFE have equal access to pre-trade information and information on completed trades. The trading information is disseminated directly to the participants by SEHK and HKFE. Trade data captured by the system can be used to reconstruct trading activity.

**Risk management:** SEHK's trading system only allows trades to be executed at prices within the range of the lowest of twenty-four spreads below the previous closing price, the lowest bid and the lowest ask price up to the time of the transaction on the day and the highest of twenty-four spreads above the previous closing price, the highest bid and the highest ask price up to the time of the transaction on the day (Rule 501F(3) of SEHK Rules). HKFE's trading system only allows input of prices within a price range set by HKFE. The price range (different products have different price ranges) is subject to change in accordance with market circumstances. HKFE informs participants of the price range (or change of price range) via circulars. HKEx senior officials informed that the exchange is strengthening its current protections to include new features such as "cancel on disconnection" and "drop copy" (i.e. real-time data feed of details of trades and orders entered by a participant).

**Direct market access:** Current rules do not allow for direct access to non-exchange participants; thus direct access is "intermediated" through the system of the participants. The trading systems of SEHK and HKFE have functions which allow their users to modify certain system settings to help them prevent the occurrence of erroneous trades. Effective in January 2014, more stringent obligations are required from participants in connection with the establishment of pre-trade controls. HKEx is enhancing its pre-trade controls measures to assist participants in complying with these new risk management obligations.

Senior officials from the HKEx indicated that high frequency trading (HFT) is rare in the cash markets due to the stamp duty that applies to every trade. There is more HFT in derivatives markets as some products are exempted from the stamp duty (i.e. options), but it is often conducted by market makers for structured products and warrants that add liquidity and are

lowering spreads. They do not have make or take models.

### **Regulation of ATS**

The ATS Guidelines set out the Principles and Standards of Practice pursuant to which the SFC review ATS applications. The principles are modelled on the objectives, functions and duties of the SFC as provided in the SFO (Sections 4, 5, 6 of the SFO). In addition the SFC has identified core standards of practice for the regulation of ATS that set out the expectations of the SFC as to the authorization requirements. The standards themselves are disaggregated into more specific obligations. The standards are summarized below.

- Financial resources and risk management: An ATS should comply with appropriate prudential and operational standards.
- Operational integrity: An ATS provider should maintain electronic facilities with adequate security, capacity and contingency arrangements.
- Fitness: An ATS should be fit and proper as established in HK or in its home country.
- Record keeping; An ATS should keep full records of its ATS operations, including audit trails of ATS activity
- Transparency: An ATS should provide appropriate transparency in relation to ATS operations, traded products, including when relevant order processing arrangements, transaction execution, settlement arrangements and operational requirements or rules.
- Surveillance: Surveillance of ATS activity should be performed by the ATS provider, a regulatory authority or another competent person, and such surveillance should be consistent with relevant market regulation in HK.
- Reporting: An ATS provider should keep the SFC informed of its operations and traded products, and any material changes to those operations.

The ATS Guidelines establish that the SFC takes a pragmatic approach to the regulation of ATS, as ATS operators are diverse and likely to grow. The regulatory approach is flexible and applies on a case by case basis. In general the level of regulation of an ATS would be commensurate with the function it performs and the risks it poses. In addition, a fair and level playing field will be sought so that similar regulation is applied to similar functions.

The ATS Guidelines also indicates that the SFC's considerations will include: the nature and extent of each ATS activity; the market participants that might be affected by the ATS; whether retail investors may be involved; and whether any systemic risk might arise. Generally, the greater the extent of the activity and its potential effect on market participants, and especially if systemic risks might arise, the more that will be expected from an ATS. Where the ATS activity is similar in all circumstances to that of an exchange company or clearing house a level playing field will be sought.

The ATS Guidelines further explains that for ATS authorized under Part III the SFC generally would rely on the regulation and supervision of the home regulator as these are typically foreign operators already recognized and regulated in another jurisdiction.

### *Application process for ATS*

Either authorized under Part III or licensed under Part V, the SFC is empowered by the SFO to require all the information that it deems necessary in order to process an application. In the

	<p>context of an ATS application, the applicant will need to submit all the information necessary to demonstrate that it is compliant with the ATS Guidelines.</p> <p>For applicants for a Part III authorization that are foreign exchanges and ATS already recognized by a foreign regulator, the SFC requires that a MoU between the SFC and the corresponding jurisdiction be in place. If this requirement is met, then staff proceeds to review the rules of the home country, and then review whether the applicant is fit and proper. On the latter, the SFC conducts its own due diligence, including inquiries to the home regulator, rather than relying fully on the home regulator. The conversations and file reviewed attested to that effect.</p> <p>In the case of applicants for a licence under Part V, it is customary that staff from the Intermediaries Supervision and Licensing Departments and the SOM visit the applicant to have a demonstration of how the systems work. If there is any problem with the systems the SFC would ask for additional information. SFC staff indicated that if the problem is severe it would ask for an external certification of the systems (and they indicated that in the past they have actually done so).</p> <p>Important policy decisions regarding issues such as transparency and the type of users that would have access to a platform have been dealt with on a case by case basis, via the licensing conditions. For example, licensing conditions have limited Part V ATS that are dark pools to trading with/for institutional investors.</p> <p>Market participants commented that the licensing conditions imposed on dark pool operators under Part V (and thus the policy positions of the SFC) have evolved over time. The last six operators have been subject to the same licensing conditions. Dark pool operators licensed at an earlier time (some were grandfathered) are currently subject to varying, and generally less onerous, conditions, resulting in an unlevel playing field. In February 2014, the SFC issued a consultation paper proposing that standardized regulatory obligations and requirements, which will be incorporated into the Code of Conduct, be imposed on all dark pool operators in Hong Kong.</p> <p>Periodic reporting obligations have also been dealt with via Part III authorization conditions or Part V licensing conditions, and vary from quarterly to monthly reporting of volumes.</p> <p>ATS have also been subject to notification obligations via authorization or licensing conditions. Such notification obligations include:</p> <ul style="list-style-type: none"> <li>• Any material change to the operations of the ATS. These changes must be notified along with an explanation of the reasons for the change prior to their implementation. The notification gives the SFC an opportunity to make inquiries and determine whether the change is in line with its expectations. This obligation extends to areas such as: (i) corporate structure and governance arrangements; (ii) business plans or operations; (iii) the trading rules, trading sessions and operating hours, the system operator, hardware, software, and other technology and all system interfaces, (iv) the ATS provider's contractual responsibilities in relation to the users, (v) criteria for approval or disapproval of the users; and (vi) the business continuity and disaster recovery plans;</li> <li>• A breach of conditions or the ATS Guidelines, which must be notified forthwith upon</li> </ul>
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	<p>its occurrence.; and</p> <ul style="list-style-type: none"> <li>• Any incidents of material service breakdown or disruption to the operations which must also be notified upon their occurrence.</li> </ul> <p><b>The choice between an exchange and a Part III ATS</b></p> <p>Currently there is no explicit stated policy to guide applicants that wish to establish a trading platform to decide between applying for exchange recognition (in those cases where that is not prohibited by the monopoly) or a Part III ATS authorization.</p> <p>The SFC was confronted with this issue in connection with a local applicant which applied to operate a futures market in Hong Kong. At the time the SFC conducted an analysis of the legal differences between the two frameworks and the potential reasons to apply for one framework versus the other and developed an internal policy to guide future decisions. This policy has not yet been publicly articulated in a formal policy document, but senior staff from the SFC highlighted that the SFC plans to issue a consultation on these issues with a view to articulating the regulatory considerations for choosing between a recognized exchange and Part III ATS in the ATS Guidelines.</p>
Assessment	Partly implemented
Comments	<p>The grade stems from the lack of a clear and specific policy that would guide applicants in determining the appropriate regulatory framework for trading platforms – including recognized exchanges, Part III ATS and Part V ATS – and the conditions that apply to them. This relates to questions 2 and 3 of the methodology.</p> <p>There are two aspects to this. First, the conditions that apply to Part V ATS operators are not uniform. As stated in the description, critical aspects related to the operation of Part V ATS, including the type of users that could have access to the platform and transparency requirements have been left to licensing conditions. This approach could have been reasonable at an initial stage; however the market has evolved and this approach of setting up policy by license conditions has led to an inconsistent treatment of participants and an unlevel playing field as the initial Part V ATS were grandfathered and have not been subject to the same conditions as the recently authorized Part V ATS.</p> <p>Secondly, there is currently no publicly articulated policy to guide applicants in deciding whether to apply for a recognition as an exchange or an authorization as an “exchange like” platform via a Part III ATS authorization. Even within the current framework which grants a monopoly to the SEHK there could be platforms trading in products not covered by the monopoly and that therefore could either be set up as an exchange or as a Part III ATS. Currently, an applicant would not have sufficient information to make an informed decision as to which framework to apply for, nor as to the obligations that could be imposed based on the choice made. This renders the current framework opaque.</p> <p>The assessors note that the SFC is aware of these challenges and intend to issue consultation papers with the objective of formalizing its policy positions on these two topics.</p>

<b>Principle 34.</b>	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.
Description	<p><b>Exchanges</b></p> <p>Section 5 of the SFO provides for the SFC to supervise, monitor and regulate the activities of the recognized exchange companies, recognized clearing houses, and persons carrying out activities regulated by the SFC. An MoU of 2001 on Matters related to SFC Oversight, Supervision of Exchange Participants and Market Surveillance, provides a framework for the conduct of market oversight and the division of responsibilities between the SFC and the HKEx.</p> <ul style="list-style-type: none"> <li>• Under the current arrangements, the HKEx is the front line supervisor for purposes of ensuring fair, transparent and orderly markets. Surveillance for purposes of detecting unfair trading practices (market manipulation, insider dealing, etc) is a responsibility of the SFC. On the latter the HKEx has a complementary role, whereby if during its own surveillance it detects evidence of unfair practices it must make a referral to the SFC.</li> <li>• The HKEx also has responsibilities in connection with the authorization of prospectuses (in certain cases) and the listing of products, as explained under Principle 16.</li> <li>• The HKEx can establish its own trading, and clearing rules and qualifications for participation, and it is responsible for monitoring compliance with them. HKEx must put in place systems to promote such compliance and take the necessary actions against participants for breaches to such rules, where necessary exercising its power to suspend, restrict or otherwise vary the trading or clearing or settlement rights of participants. One of the eligibility criteria established by the HKEx is that persons should be corporations licensed by the SFC, and thus subject to SFC oversight. In this regard prudential and conduct supervision of rules under the SFO is a responsibility of the SFC. However, under the SFO the exchange has a duty to immediately notify the SFC (i) if any of its participants is unable to comply with any exchange rules or any financial resources rule, or (ii) a financial irregularity or other matter which in its opinion may indicate that the financial standing or integrity of the exchange participant is in question, or that the participant may not be able to meet his legal obligations. Under the MoU signed in 2001 the HKEx will also refer to the SFC any suspected violation of ordinances or codes, rules and regulations made by the SFC.</li> </ul> <p>The SFC exercises ongoing supervision of the HKEx through several arrangements.</p> <p><i>Market surveillance conducted by the HKEx</i></p> <p>The HKEx has two dedicated teams to enforce rules related to fair and orderly trading:</p> <ul style="list-style-type: none"> <li>- Counterparty surveillance: it monitors participants vis-a-vis their compliance with financial requirements, as well as positions limits. Currently this team has 7 staff.</li> <li>- Market surveillance: it monitors trading activities in real time to detect unusual trades. To this end the HKEx has automated systems, with parameters embedded that generate alerts. The team follows up on these alerts, and where there is evidence of misconduct they refer the case to the SFC. The team holds regular contacts with the SFC on investigations. This team has 6 staff.</li> </ul>

	<p><i>Market oversight by the SFC</i></p> <p><i>On going powers</i></p> <ul style="list-style-type: none"> <li>• Pursuant to Section 23 of the SFO, the SFC may direct the exchange company to make or amend any rules which an exchange company is permitted under that provision to make. Before directing the exchange company to do so, the SFC must consult the FS and the recognized exchange company to which the request relates.</li> <li>• Procedures for ordering an exchange/exchange controller to take particular actions are set out in Sections 28 and 29 of the SFO.</li> <li>• Pursuant to Section 28, the SFC may, after consultation with the FS, withdraw the recognition.</li> <li>• In addition, the SFC may exercise its emergency powers under section 29 of the SFO. Section 29 empowers the SFC to direct the exchange to cease to provide or operate such facilities or services as may be specified. This is a more effective tool in emergency cases where more immediate action is needed because there is no obligation to give the exchange 14 days' prior notice. However, there are limitations to this power: (i) it can only be exercised in limited cases (e.g. natural disaster, economic or financial crisis, circumstances likely to prejudice orderly transaction of business on the exchange), and (ii) any such direction can only stay in place for a maximum of 10 business days.</li> </ul> <p><i>On going monitoring</i></p> <p>The SFC engages on a regular basis with the HKEx to review and discuss major strategic and policy initiatives of HKEx that have an impact on the trading, clearing and settlement operations, market surveillance, regulation, and risk management functions of HKEx and its exchange companies and clearing houses. Discussions also cover developments that could impact orderly market functioning, as well as international market and regulatory developments that have implications for HKEx or Hong Kong's role as an international financial center.</p> <p>Senior management of HKEx and the SFC meet on a monthly or bi-monthly basis: RMC (monthly); FSTB/SFC/HKEx Meeting (bi-monthly); and SFC/HKEx Liaison Meeting (bi-monthly). Also a meeting between the Supervision of Markets (SOM) Division and HKEx IT Team is held each quarter. These meetings provide a forum for continuing engagement to provide updates on market and regulatory developments so that emerging trends and issues of potential concern happening both locally and internationally can be addressed in a timely manner.</p> <p>Specific arrangements for the oversight of regulatory and surveillance functions are also in place, as detailed below.</p> <p>Market function:</p> <p>The SFC has real time access to the pre-trade information on trades conducted on SEHK and HKFE. The SFC also receives post trade data from SEHK and HKFE on a daily basis.</p> <p>Extensive reports are provided:</p> <ul style="list-style-type: none"> <li>○ daily reports on the cash market from HKSCC regarding settlement</li> </ul>
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	<p>compliance, margin requirement, and reports on Sensitivity Analysis (used for the purpose of determining the sufficiency of the Guarantee Fund), Liquidity Requirement of individual clearing participants and the Guarantee Fund (contributions made by individual clearing participants);</p> <ul style="list-style-type: none"> <li>○ daily reports on Margin, Reserve Fund and Delta Positions (held by clearing participants), and on Large Open Positions;</li> <li>○ daily reports on cross-market risks in respect of “high-risk” brokers reported under Consolidated Accounts Reporting;</li> <li>○ weekly reports on operational statistics on the trading and clearing of the cash and derivatives markets; and</li> <li>○ monthly reports on CCASS trade, settlement and depository statistics.</li> </ul> <p>The reports are supplemented with notifications of significant events:</p> <ul style="list-style-type: none"> <li>○ The HKEx is required to give notice to the SFC as soon as practicable of matters designated as serious as set out in Appendix I of the MoU, such as defaults by participants, forced liquidation of open positions of participants, suspension/revocation of, or imposition/revision of restrictions on, a participant’s trading or clearing rights;</li> <li>○ The HKEx is also required to give notice of potential breaches by participants</li> </ul> <p>Through the analysis of these reports, notices and other information received from HKEx, the SFC supervises and monitors the activities of these entities on an on-going basis to detect any unusual market activities; ensure that they operate an orderly, informed and fair market; that risks associated with its business and operations are managed prudently; and to safeguard the stability of the financial market.</p> <p>Further, the SFC conducts the daily monitoring which entails:</p> <ul style="list-style-type: none"> <li>• Macro monitoring (local and overseas markets) and analysis of the latest market developments, including performance, volatility, trading activities in both the cash and derivatives markets; and</li> <li>• Risk monitoring reports of various market segments to detect irregularities such as concentration and building up of positions, and identify trends and significant or sudden changes, which may have systemic impact on the stock and derivatives markets. The activities of major financial institutions in various segments of the Hong Kong markets are also monitored.</li> </ul> <p>As of the time of the assessment, on-site inspections had not been used for ongoing supervision of the market function of the HKEx. However SFC staff indicated that there is an inspection planned for 2014. SFC staff noted that the use of on-site inspections to complement the off-site monitoring has been triggered mainly by the recent evolution of the business model of the exchange, including the acquisition of the London Metal Exchange, but more generally its desire to become a more global exchange.</p>
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	<p><b>Market reliability</b></p> <p>The HKEx is required to give notice of incident events. SFC staff indicated that overall there have not been major problems (glitches) with IT.</p> <p>More generally, as indicated in Principle 9, the SFC is member of the RMC which provides recommendations to the board of HKEx on risk management issues.</p> <p><b>Listing/Product function</b></p> <p>The supervision of the product function has been conducted through two channels:</p> <ul style="list-style-type: none"> <li>• The approval of listing rules which includes the SFC's power to object to decisions of the HKEx in connection with specific products to be listed; and</li> <li>• From a process perspective, via on-site examinations of the listing function. These examinations are performed on an annual basis, and the results are made public.</li> </ul> <p><b>ATS</b></p> <p>Either through Part III or through Part V of the SFO, the SFC has the power to request the ATS to provide any information necessary for the SFC to be satisfied that an ATS is meeting its authorization or licensing obligations. In practice the SFC uses the authorization or licensing process to establish the minimum periodic reporting obligations on ATS.</p> <p>While the SFO does not require an ATS which is regulated by its home regulator to send the ATS' rules for formal approval to the SFC, the conditions set up notification requirements. In practice when the SFC receives a notification, it makes inquiries, and the operator cannot implement changes unless the SFC has been satisfied with its inquiries.</p> <p>The SFC can withdraw the authorization (for Part III) or revoke the licence (for Part V) given to an ATS.</p> <p><i>Ongoing monitoring</i></p> <p>For ATS that have a Type 7 licence under Part V, ongoing monitoring is conducted as part of the general program for supervision of intermediaries since the ATS is provided incidentally to the operator's agency brokerage business. Therefore, these firms are supervised by the Intermediaries Supervision Department. SFC staff indicated that there is close contact with the SOM, when there are incidents of material service breakdown or disruption of the operation of the ATS.</p> <p>A first line of monitoring would come from the reporting obligations that ATS are subject to, including in particular a report on trading volumes of the ATS. This report is provided quarterly or monthly depending on the nature and extent of the services provided. (See Principle 33.) This approach allows the level of supervision to reflect the potential impact of the particular ATS.</p> <p>When planning the inspection of an LC, the SFC would consider the types of activities that it is licensed to conduct and the risks involved in each one (based on the considerations described under Principle 31), to determine the scope of the inspection. SFC staff indicated that in a</p>
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	<p>number of cases, they selected the ATS as a key part of the inspection of an LC.</p> <p>For Part III ATS providers ongoing supervision is facilitated by the regulatory conditions imposed on the authorization. In essence, Part III ATS are required to notify the SFC of any material change to the matters set out in the application after obtaining the authorization, and prior to the changes taking effect. Such matters include corporate structure, business plan, systems, business continuity plan, disaster recovery program, contractual documentation and admission criteria for its participants. The SFC may follow up with the authorized ATS provider after receiving notification and where appropriate may take action such as to allow or disallow the implementation of the changes in HK. The authorized ATS are also required to provide periodic reporting to the SFC on the activities conducted in HK, including the identity of its HK participants and their trading statistics. As foreign exchanges and ATS are regulated and supervised by their home regulator if the situation warrants the SFC will contact the home regulator to discuss specific matter under the IOSCO MMoU or the bilateral MoU.</p>
<b>Assessment</b>	Broadly implemented
<b>Comments</b>	<p>This grade stems from the lack of on-site inspections in connection with question 2b of the methodology. The assessors note that the SFC keeps a close monitoring of the market function of the HKEx via its access to the HKEx systems, reporting obligations (including notification of break downs) and regular contact. However, on-site inspections play a key role on supervision as they allow the regulatory authorities to review aspects that cannot be easily monitored via reporting, such as internal controls and risk management, reliability of IT systems and the quality of reporting itself. Thus the recent decision of the SFC to conduct an on-site inspection on the market functions of the HKEx is a welcome development that addresses current concerns about the completeness of the supervisory program. The assessors also encourage the SFC to consider whether other mechanisms to oversee the market function should also be strengthened, including for example whether decisions made by the HKEx on participants should have recourse to the SFC. More generally the assessors recommend an overhaul of the RMC as it does not foster a sufficiently arms' length relationship between the SFC and HKEx as a regulated entity.</p> <p>The assessors also note that under the current arrangements the supervision of ATS operators licensed under Part V of the SFO is conducted within the Intermediaries Division, and thus as one more activity of the intermediary (although engagement with the SOM takes place when needed). This approach is reasonable given the limited size of these platforms. However if they were to grow the SFC should change its supervisory approach and integrate it into the market supervision program.</p>
<b>Principle 35.</b>	Regulation should promote transparency of trading.
<b>Description</b>	<p><b>Exchanges</b></p> <p>There is no explicit statutory requirement for the provision of pre-trade and post-trade information to market participants for exchanges in general, and in particular for the HKEx. However, the trading rules of the HKEx do provide adequate levels of pre trade transparency. The pre-trade information includes best bid and ask quotations and market depth. Orders include the broker ID.</p> <p>A similar situation occurs with post-trade transparency. The post-trade information includes last traded price, day high, day low, closing price and trading volume.</p>

Further post trade transparency obligations apply also to trades executed off exchange by exchange members. Exchange members are not required to conduct all trades on the exchange; but they are subject to best execution vis-a-vis their clients. Off-exchange trades however must be reported to the SEHK and HKFE within the time stipulated in their rules. Currently, under SEHK rules, direct business transactions have to be reported within 15 minutes after the conclusion of the transactions and in any event before the close of trading for transactions transacted on that closing day. SFC staff informed that the percentage of off-market transactions is around 4 percent.

Market participants can access the pre and post trade information directly via the market data systems of the exchanges or indirectly through information vendors on a timely basis. Some information vendors are providing basic real time market information free of charge, which includes real time nominal prices, day high, day low, closing prices of exchange products, and market turnover information.

*Exemptions to pre-trade transparency*

Under the current trading rules iceberg orders are not permitted, and block orders are only permitted in the futures markets.

In the latter case, the exchange has established clear parameters (volume thresholds) by products. In practice, block trades are allowed for the most active 100 products, provided that the participant can meet the margin requirements. Under HKFE rules, a block trade must be negotiated during the trading hours of the Block Trade Contract concerned and be executed immediately on the Hong Kong Futures Automated Trading System, HKATS, via the Block Trade Facility (Chapter VIII Trading Arrangements – Practices and Systems). The time difference between the input of one side of a Block Trade and the input of the other side of the Block Trade must be within 5 minutes or at such other time period as notified by the Exchange to Exchange Participants. Any block trade order entered but not matched within the prescribed time period will be cancelled automatically (HKATS User's Guide).

**ATS**

There is no statutory obligation concerning pre and post trade transparency for ATS. The ATS Guidelines contain a principle on transparency which is applicable to all ATS (Part III or V), whereby in assessing an application the SFC will consider transparency of trading information. The requirements will depend on the type of ATS involved. The ATS Guidelines establish that the SFC will consider this aspect on a case by case basis with reference to the type of ATS and relevant international best practices. Thus, as a general reference in most equity and derivatives trading systems global market practice is generally to provide for transparency of bid/ask prices, related quantities and details of completed transactions. Different level of pre trade transparency generally exists internationally for OTC markets and fixed income markets.

SFC staff informed that within the current market structure almost all ATS authorized under Part III are foreign exchanges and foreign-based ATS, initially recognized/authorized by another regulator. In reviewing whether such markets should be authorized in HK, the SFC will review them vis-à-vis its regulatory principles and policies and the global practices stated above.

About half the ATS licensed under Part V are mainly internal crossing facilities in the form of dark pools operated by brokers and investment banks for client order flows in the trading of

	<p>stocks listed on the SEHK. These crossing systems generally match client order flows internally but some may execute the client order flows against the brokers' proprietary orders. None of these ATS currently provide pre-trade transparency since they are operated as dark pools. The recent licensing conditions limit access to these platforms to institutional investors and require that investors are informed of the way their orders are handled. Vis-à-vis the client, the obligation to provide best execution exists. Market participants commented that in practice dark trades offer a tighter/better price to their clients than the price range of the exchange.</p> <p>In regard to post-trade transparency, pursuant to the trading rule of the HKEx (which apply to these ATS as they are all exchange members) there is a requirement that all trades from the ATS be reported to the HKEx within 1 minute after execution. This allows the HKEx (and vendors) to provide consolidated post-trade information.</p> <p>Pursuant to their licensing requirements these ATS have to provide their clients with sufficient information about the operation of its dark pool so that clients are able to understand the manner in which their orders are handled and executed.</p> <p>At March 2013, there were 13 licensed dark pools and they together account for about 2.5 percent of the turnover of SEHK. To enhance the monitoring of dark pool activities in Hong Kong, starting from 1 February 2011, trades concluded in dark pools were voluntarily flagged as "ALP" (Alternative Liquidity Pool) in the brokers' reporting to SEHK. The flagging is now mandatory under the Rules of the SEHK since October 2012.</p> <p>As indicated in Principle 33 the remaining ATS licensed under Part V as a Type 7 were primarily for trading pre-IPO stocks, equity-linked notes and/or fixed income securities. Only a couple of them (including one lit operator and one odd lot stock trading operator) operated Type 7 ATS which primarily involved trading in SEHK listed shares, and their volumes are not significant.</p> <p><b>Access of the SFC to information</b></p> <p>Pursuant to the MoU with HKEx, the SFC has real time access to the trading data of the exchanges, which would also include data on executed trades in the ATS authorized under Part V.</p> <p>All ATS (including those authorized under Part III) are required to provide the SFC with periodic reports on trading volumes.</p>
Assessment	Fully implemented
Comments	In light of the current limited size of ATS, their current treatment vis-à-vis pre-trade transparency does not pose concerns for the overall transparency of the market in SEHK securities. However from a policy perspective it is important that the decision not to require any form of pre-trade transparency from ATS that operate dark pools be kept under review.
<b>Principle 36.</b>	Regulation should be designed to detect and deter manipulation and other unfair trading practices.
Description	<p><b>Prohibited misconduct</b></p> <p>The SFO prohibits the following conduct:</p> <ul style="list-style-type: none"> <li>• Market or price manipulation: It is prohibited under sections 274, 275, 278, 295, 296, 299</li> </ul>

	<p>and 300 of the SFO.</p> <ul style="list-style-type: none"> <li>• Misleading information: under sections 277 and 298 of the SFO, disclosure of false or misleading information to induce transactions in either securities or futures contracts is prohibited.</li> <li>• Insider trading: under sections 270 and sections 291 of the SFO, insider dealing is prohibited. The definition of insider dealing covers both the tipper and the tippee, and includes both listed securities and related derivatives.</li> <li>• Front running: is a breach of the Code of Conduct for intermediaries.</li> <li>• Unfair practices: under section 300(1) of the SFO, a person shall not, directly or indirectly, in a transaction involving securities, futures contracts or leveraged foreign exchange trading-       <ul style="list-style-type: none"> <li>○ employ any device, scheme or artifice with intent to defraud or deceive; or</li> <li>○ engage in any act, practice or course of business which is fraudulent or deceptive, or would operate as a fraud or deception.</li> </ul> </li> </ul> <p><b>Available remedies</b></p> <p>With the exception of front running, if the SFC found evidence of the commission of any of this misconduct, it may either bring criminal prosecution before the court or initiate proceedings in the MMT under sections 283 and 307 of the SFO.</p> <ul style="list-style-type: none"> <li>• Under the criminal route, a person who is convicted of insider trading is liable to a maximum fine of \$10 million and imprisonment for up to 10 years (section 303 of SFO).</li> <li>• The MMT has the power to make various prohibition and cease and desist orders on the person identified as having engaged in insider trading (section 257 of SFO).</li> </ul> <p>Where a licensed or registered intermediary is found to have conducted any of these unfair practices, the intermediary will also face disciplinary actions by the SFC. Under sections 194 and 196 of the SFO, the SFC has the power to suspend or revoke the intermediary's licence or registration, to fine or to reprimand the intermediary. However, for serious misconduct, the SFC is likely to revoke or impose a lengthy suspension of the intermediary's registration or licence, and or impose a fine (up to the maximum of HK\$10 million) or 3 times of the profit gained/loss avoided, whichever is higher. Disciplinary action is not mutually exclusive with MMT or criminal proceedings.</p> <p>If the SFC identifies that any materially false, incomplete or misleading information has been included in announcements issued by or on behalf of any listed company, the SFC may, by notice to HKEx, direct HKEx to suspend trading in that security under Rule 8 of SMLR.</p> <p>Section 213 of the SFO also empowers the SFC to apply for injunctive and remedial orders for any contravention of provisions in the SFO.</p> <p>In the case of front running, the remedies available are those explained above for the commission of a misconduct by an intermediary; that is, the SFC can suspend or revoke the license, fine or reprimand the intermediary.</p> <p><b>Arrangements to detect market manipulation</b></p> <p>As indicated under Principle 34, the SFC is the authority responsible for market surveillance</p>
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for the purposes of detecting unfair trading practices. To this end the MoU between the SFC and the HKEx requires the latter to provide the SFC with (i) real time access to the SMARTS system, and with the daily MSS data containing such trading and other information as agreed between HKEx and the SFC; and (ii) in relation to index futures and options contracts, real time electronic access to the CIBOIS terminal and a daily data feed in an agreed manner.

The SFC deploys dedicated systems, where specified parameters can be entered to detect unusual orders and transactions. There is a specialized team of staff within the SFC who closely monitors and follow-up the exception reports generated from the systems. In addition, pursuant to their MoU, the SFC receives referrals from the HKEx. The following table shows the number of referrals/suspicious transactions reports received from the HKEx over the last five years:

Type of referral	2008-09 <sup>1</sup>	2009-10	2010-11	2011-12	2012-13	Total
Suspected insider dealing	0	1	2	1	1	5
Suspected market manipulation	5	2	1	3	0	11
Irregularities in derivatives trading	6	4	0	1	0	11
Complaints	1	4	6	3	8	22
Suspected breach of DI requirements	37	30	19	23	14	123
Others	7	5	9	4	7	32
<b>Total</b>	<b>56</b>	<b>46</b>	<b>37</b>	<b>35</b>	<b>30</b>	<b>204</b>
<sup>1</sup> Data is for the financial year from April 1 to March 31.						

When staff members consider that it is necessary to make further enquiries, the staff member will prepare a recommendation. This recommendation will be considered by the head of the team who may approve the commencement of an enquiry under section 181 of the SFO. Under section 181 of the SFO, the SFC is empowered to obtain the identity details of the person who placed the order, the ultimate beneficial owner of the trade and other particulars of the order. The SFC may also ask the market intermediaries to provide the background information on the clients involved.

If, after section 181 enquiry, it is considered that there is suspicion of market or price manipulation, the RO of the surveillance team will prepare a case assessment report setting out the suspicions and recommending referring the matter to the investigation team. The case assessment report will then be considered and discussed by the ESC, which is comprised of senior executives from the investigation, surveillance and disciplinary teams in SFC's Enforcement Division. Once approved by the ESC, the investigation can be commenced under

	<p>section 182 of the SFO. Further details on investigation and enforcement procedures have been included under Principle 12.</p> <p>Market manipulation may also be the subject of a complaint to the SFC or a referral from another law enforcement or regulatory body or a referral from another division within the SFC (e.g. where it is detected in a routine inspection).</p> <p><b>Coordination with the DoJ</b></p> <p>As indicated under Principle 11, under the current legal framework the authorities can only pursue one avenue in connection with the six types of market misconduct included in the SFO; that is they must choose either to prosecute a person criminally or take him/her to the MMT under sections 283 and 307 of the SFO.</p> <p>The stated policy of the SFC and the DoJ is to seek criminal actions as opposed to MMT actions if there is sufficient evidence to do so, and it is in the public interest in accordance with the DoJ Prosecution policy. As explained in Principle 12, in 2007 the SFC reached an agreement with the DoJ concerning the handling of criminal cases. The first prosecutions under the SFO following this agreement took place in the period of 2008-2010. However, after those initial indictments no more new cases have been taken by way of indictment. These issues have been further explained in Principle 12.</p> <p><b>Cross-border cooperation</b></p> <p>As indicated under Principle 16, currently roughly 56 percent of the companies listed in the HKEx and 60 percent of the trading volume are companies whose main operations are in the Mainland (although many of them are incorporated in other jurisdictions such as the Cayman Islands and Bermuda). Overall, market participants expressed general concern about the enforcement challenges faced by the SFC in light of this market structure, which makes it significantly more difficult to gather evidence and impose enforcement actions on the companies or their directors.</p> <p>SFC staff concurred that they are heavily dependent on the assistance from the China Securities Regulatory Commission (CSRC). An MoU among the SFC, HKEx, CSRC, Shanghai Stock Exchange and Shenzhen Stock Exchange has been put in place to facilitate cooperation. SFC staff acknowledges that there are challenges for effective cooperation, which stem from practical aspects (for example, the sheer size of China) rather than from legal impediments or lack of will. There is evidence of co-operation in practice. For example, there have been recent cases where injunctive actions were sought in the HK courts, which required the assistance from the Chinese authorities. The assistance was received, allowing for the freezing of assets and eventually to compensation for investors.</p> <p><b>Commodities markets</b></p> <p>Market participants are required to report to HKFE their large open positions of commodity futures contracts traded on recognized futures exchanges and certain authorized ATS. The SFC has access to this information. Based on the information, the SFC is able to identify concentrations of positions and the overall composition of the commodity futures markets.</p>
Assessment	Fully implemented
Comments	The assessors note the challenges faced by the SFC in connection with enforcement, in light of the cross-border nature of the bulk of the companies listed in the SEHK. They also note that the SFC has proactively sought to establish good cooperation arrangements with the

	<p>relevant authorities.</p> <p>The assessors also note the challenges for criminal enforcement.</p> <p>Both issues have been taken into consideration for the grade of Principle 12.</p>
<b>Principle 37.</b>	Regulation should aim to ensure the proper management of large exposures, default risk and market disruption
Description	<p><b>Large exposures</b></p> <p>The authorities responsible for the front-line monitoring of large exposures of exchange trades are HKEx and its subsidiary exchanges and clearing houses including SEHK, HKFE, HKSCC, SEOCH and HKCC.</p> <p>Reporting and positions limits are specified both under legislation (Securities and Futures Rules) and under the relevant Exchange rules, and monitoring is done on a continuous basis by both HKEx and the SFC. The statutory position limits, which mirror the limits in the Exchange rules, were initially introduced after the Asian financial crisis, in order to deter the accumulation of large open positions by speculators. They apply both to cash as well as derivatives products. The limits are quantitative and different levels are specified for different types of contracts. The reports of large open positions are generated by HKEx and its subsidiaries and submitted daily to the SFC.</p> <p>In addition, HKEx produces a 'consolidated accounts report' which shows consolidated information on open positions of participants of the stock and futures exchanges and the clearing houses when certain positions are reached. The report is generated automatically when the trigger conditions occur. Thus this monitoring is not necessarily done on a daily basis, although in practice reports are produced daily. These trigger levels are set based on quantitative criteria.</p> <p><b>Access to information on beneficial owner</b></p> <p>The Securities and Futures Rules require any person holding a specified position in relation to stock options and futures contracts to submit a report to the respective exchange. In addition, exchange participants who hold such positions or whose clients hold such positions are required to submit reports on their positions and their clients' positions separately to the respective exchange.</p> <p>Under the rules of the respective exchanges, exchange participants are required to provide additional information in their reports to the exchange when they or their clients hold specified positions.</p> <p>The reports to the exchanges include the position which is held and the time when the position was acquired. Where reports are submitted in respect of client positions, the client's identity, nature of its business (e.g. whether a HF) and the type of account (e.g. an omnibus account) are also provided.</p> <p>These reports are submitted to the respective exchanges on the trading day following the day on which the specified position is acquired (i.e., on T+1). The exchanges pass this information on to the SFC on the same day.</p> <p>Therefore, the regulator and the respective exchanges have direct and routine access to the large open positions held by exchange participants and their clients (whether individuals or</p>

aggregated positions) through the above-described reporting system. As the legislation also requires any person who holds a specified position to submit reports to the exchange, persons (including individuals or entities) which are not exchange participants are also required to submit reports of their holdings if they hold the specified positions. These reports are also passed by the respective exchanges to the SFC.

In addition, if the SFC wishes to obtain further information in relation to the position (including the identity of a holder of a position), it may require such further information from persons licensed by or registered with the SFC pursuant to Section 181 of the SFO. All persons licensed by or registered with the SFC are expected to comply with the Client Identity Rules in the Code of Conduct which stipulates that licensed or registered persons must ascertain the identity of the ultimate beneficiary of transactions executed by the broker.

Failure to comply with these reporting requirements is a criminal offence subject on conviction on indictment, to a fine at level 6 and imprisonment for 2 years; and or on summary conviction, to a fine at level 3 and imprisonment for 6 months.

Moreover, an exchange participant who fails to file large open position reports as required would be in breach of the exchange rules and may be subject to the exchange's disciplinary proceedings. Penalties which may be imposed include censure, fines, limitations on trading, liquidation of positions, higher margin requirements, revocation of trading privileges, suspension from trading, etc.

Persons licensed or registered with the SFC who fail to comply with the duty to file large open position reports may also be subject to the SFC's disciplinary procedures.

Where the SFC requests additional information in relation to a large open position under its statutory powers (e.g., Section 181 of the SFO), a failure to provide the information is a criminal offence.

#### **Power to take action**

The exchanges and clearing houses have powers under their rules to require their participants to reduce exposures if the permitted limits for holding stock options or futures contracts are exceeded. The respective exchanges and clearing houses are empowered under their rules to:

- at any time, increase, reduce or remove prescribed limits (Rules 624, 625 of Options Clearing Rules, Rule 502 of HKCC Rules, Rule 629 of HKFE Rules);
- if the prescribed limits are exceeded, require the exchange participant to close out or effect a transfer in accordance with the rules of the clearing house. If the exchange participant does not comply with such order, the exchange is empowered to close out or effect the transfer on its behalf. (Rule 508 HKCC Rules, Rule 631 HKFE Rules, Rules 625 and 628 of Options Clearing Rules); and
- where the exchange is of the opinion that the accumulated positions may be detrimental to the market or markets, prescribe the number of contracts or value (long or short positions) in respect of any market an exchange participant is permitted to buy or sell or do so on behalf of any person. (Rule 630 HKFE Rules).

Participants are required to calculate and monitor margin in respect of all open positions and delivery obligations of its clients and to demand payment of such (or any additional) margin from the client as the participant sees fit. (Rules 424 and 425 of the Options Trading Rules). This would also be applicable where the clients hold large open positions.

<p>Clearing house margin is calculated and collected from participants in respect of the open positions they hold. (Rule 402 of HKCC Rules, Rule 603 of Options Clearing Rules, Rule 3601 and 3602 of HKSCC Rules).</p> <p><b>Exchange of information</b></p> <p>Information on large exposure of market participants is shared between the HKEx and the SFC under the <i>MoU on Matters relating to SFC Oversight, Supervision of Exchange Participants and Market Surveillance</i>. Such information may also be provided to other local regulators or authorities (such as the HKMA) on request under the information sharing arrangement set out in the SFO.</p> <p><b>Exchange with other regulators</b></p> <p>If there is request from an overseas regulator involving disclosure of non-public information which is in the possession of SFC, the SFC will provide such information under the relevant MoU (including the IOSCO MMoU). (See the discussion under Principles 14 and 15.)</p> <p><b>Default procedures</b></p> <p>Current risk management arrangements at the CCPs seek to minimize the potential for default. Such arrangements include:</p> <ul style="list-style-type: none"> <li>- Additional financial requirements above those prescribed by the SFO for clearing members;</li> <li>- The requirement to post margins on a daily basis, which are also reassessed intraday; and</li> <li>- Contribution to a default fund: there is a basic contribution and a dynamic contribution</li> </ul> <p>Pursuant to Section 40 of the SFO, recognized clearing houses are required to have rules providing for default proceedings.</p> <p>For exchanges and clearing houses, events of default where action may be taken are set out in the respective rules of the exchanges or clearing houses. (Rule 701 of Options Clearing Rules, Rule 509 of HKCC Rules, Rule 3701 of HKSCC Rules, Rule 568 of SEHK Rules). These rules are freely accessible on the website of the HKEx.</p> <p>The default handling procedures are set out in the rules of the exchanges and clearing houses. In general, the rules provide the Chairman with the power to take a wide range of actions, including suspension of trading of a defaulting participant, close out of the positions registered in the defaulting participant's name, transfer of the positions to other non-defaulting participant and compulsory settlement of a defaulting participant's position.</p> <p><i>Minimising market impact</i> – In the event of a default by a broker-clearing participant, the clearing house is able to step in and close out the clearing participant's trades/positions. Additionally, the law includes insolvency override provisions whereby the default proceedings and procedures of a clearing house take precedence over general insolvency law. These safeguards serve to minimise impact on other clearing participants, and consequently limit any market disruption as well.</p> <p><i>Control of client assets</i> – In such cases, the SFC will also, typically, have issued a restriction notice on the clearing participant pursuant to its powers under Part X of the SFO. Restriction notices essentially prohibit the clearing participant from handling its own or its clients' property. The SFC will then apply to the Court to appoint an Administrator, and the</p>
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Administrator will then return assets/monies to clients in accordance with the Court's order.

*Segregation of client assets* –Pursuant to the Client Money Rules and Client Securities Rules, client monies and assets are required to be segregated from a broker's own monies and assets. Participants manage two accounts with the CCP, one for its own positions and the other for clients' positions. Thus in the event of default the client account and related assets should not be affected. In practice the use of omnibus accounts for clients usually means that the CCP would close out rather than transfer client positions in order to manage volatility.

HKEx senior officials noted that the lessons from the Lehman crisis led to improvements in risk management. For example, standard margins were established for the cash markets; the size of the default fund was enlarged to cover the default of the first and fifth largest intermediaries; and the stress testing methodology was strengthened.

Further improvements must be made to comply with the PFMI. The HKEx has provided the SFC with its preliminary analysis of the aspects that may need to be strengthened to align the CCPs with the PFMI, such as phasing out bank guarantees, assessing the liquidity arrangements, possible changes for segregation to address portability requirements in the cash markets; the analysis requires closer study. Currently the cash market settles everything from one account; current arrangements for derivatives already provide investors the choice of individual accounts although as stated above they are not commonly used.

### **Short selling**

Pursuant to section 170 of the SFO, naked short selling is generally prohibited; that is, a short seller is required to borrow shares or have a written assurance that he has a presently exercisable and unconditional right to vest the securities in the purchaser before a short selling order can be submitted to the SEHK for execution. Further, short selling orders must be "marked" so that short selling transactions are traceable by the SFC (section 172 of the SFO). Finally, the SEHK has an uptick requirement to prevent short sales at successively lower prices and has established eligibility criteria such that only the more liquid securities are allowed for short selling.

With effect from 18 June 2012, market participants are required to make weekly reports of outstanding short positions of specified stocks to the SFC under the Securities and Futures (Short Position Reporting) Rules. The reportable short position is specified in Rule 3 of the Short Position Reporting Rules. Under normal market conditions, any person who has reportable short position on the last trading day of the week must report to the SFC within the following two business days. The SFC has the power under the Short Position Reporting Rules to require daily reporting of reportable short positions under stressed market situations.

The SFC publishes the aggregated short positions of the specified stocks within three business days upon the receipt of the short position reports.

Market makers and liquidity providers in exchange traded markets (both stock and futures markets) are exempted from certain short-selling restrictions (e.g. there is an exemption from observing the up-tick rule) when they use the stock market to hedge their positions.

### **Settlement failures**

The HKEx has the statutory duty to maintain an orderly, informed and fair market and to manage the risks associated with its operations. The control measures imposed by the exchange are specified in its rules and the rules of its clearing house.

	<p>In Hong Kong, equity transactions are settled on T+2. For failed trades, SEHK will conduct a compulsory buy-in on T+3 to purchase the equity from the market for settlement purpose and collect a compulsory buy-in fee of 0.5 percent from the exchange participant who failed to settle the trade.</p> <p>The SFC receives information on settlement failures from HKEx on a daily basis.</p> <p>SFC staff informed that settlement failures are rare. Currently the efficiency rate is 99.7-99.8 percent. Staff attributed this efficiency rate to the stringent rules on short-selling, and the compulsory buy-in.</p>
Assessment	Fully implemented
Comments	