2014 IOSCO Annual Conference Workshop
– Market Intermediaries Risk Based Supervision

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Outline

I. SFC’s regulatory framework and philosophy on market intermediaries supervision

II. SFC’s approach and focus on risk based supervision of market intermediaries
   – Off-site monitoring
   – On-site inspection
I. SFC’s regulatory framework and philosophy on market intermediaries supervision
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IOSCO Principles for Market intermediaries

- Regulation should provide for minimum entry standards for market intermediaries. (*Principle 29*)
- There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake. (*Principle 30*)
- 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. (*Principle 31*)
- 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. (*Principle 32*)

IOSCO Principles for Enforcement of Securities Regulation

- The Regulator should have comprehensive inspection, investigation and surveillance powers. (*Principle 10*)
- The Regulator should have comprehensive enforcement powers. (*Principle 11*)
- The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program. (*Principle 12*)
I. SFC’s regulatory framework and philosophy on market intermediaries supervision

- Balanced and principles / risk-based regulation
- Fair and consistent regulatory processes
- Benchmarking with international standards
- Responsibility of intermediaries
- Collaborative approach – Partnership with the industry and fellow regulators
I. SFC’s regulatory framework and philosophy on market intermediaries supervision

- **Balanced and principles / risk-based regulation**
  - The SFC constantly aims to achieve a proper balance in regulation
    - Ensure appropriate safeguards for investors, with adequate regulation to ensure as far as possible sound business practices and market confidence
    - Provide a regulatory environment that allow enough impetus for market development without stifling innovation and competition
  - The regulatory framework builds in an important element of transparency in policy making
    - The SFC is required to consult the public regarding its proposals to make rules
I. SFC’s regulatory framework and philosophy on market intermediaries supervision

- **Balanced and principles / risk-based regulation (continued)**
  - Principles-based regulation that focuses on a higher level articulation, notwithstanding prescriptive rules setting minimum standards for critical areas such as segregation of client assets to ensure adequate levels of consistency, certainty and investor protection
  - Risk-based approach adopted by directing more regulatory attention to areas perceived to be the highest risk or have the greatest impact to the SFC’s regulatory objectives
  - Examples of codes and guidelines issued by the SFC:
    - Code of Conduct
    - Fit and Proper Guidelines

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![Code of Conduct](image1.png)

![Fit and Proper Guidelines](image2.png)
I. SFC’s regulatory framework and philosophy on market intermediaries supervision

- Fair and consistent regulatory processes
  - Clear and objective internal procedures and guidelines for staff performing their day-to-day regulatory activities to ensure that regulatory processes are fairly and consistently applied
  - The SFC is subject to a system of checks and balances, both internal and external, on its procedures and decision-making so as to ensure fairness and consistency
  - The SFC is obliged to observe:
    - Principles of procedural fairness in the exercise of regulatory functions over firms
    - Principles of procedural fairness and natural justice when taking disciplinary actions
I. SFC’s regulatory framework and philosophy on market intermediaries supervision

- **Benchmarking with international standards**
  - With growing internationalisation of markets, more and more firms are developing and pursuing global strategies, operating through affiliates in many countries that press for global regulatory standards. The SFC works extensively with a number of multilateral organisations and forums such as FSB, IOSCO and G20, and contributes to their international regulatory agenda and initiatives.
  - The SFC strives to maintain high regulatory standards in line with those in other major jurisdictions.

- **Responsibility of intermediaries**
  - A firm is primary responsible for its own activities and for ensuring that its business complies with the relevant legislative and regulatory requirements and its senior management bears primary responsibility for ensuring proper management of risks associated with the firm’s business.
  - The SFC helps to reinforce this tenet through delivering effective supervision of firms, including monitoring compliance with relevant laws and regulatory standards and promoting a good compliance culture.
I. SFC’s regulatory framework and philosophy on market intermediaries supervision

- Collaborative approach – Partnership with the industry and fellow regulators

  - The SFC seeks to maintain ongoing communication and two-way dialogue with firms individually and the industry on all relevant policy and regulatory matters
  - This may be by way of circulars to firms and FAQs posted on the SFC’s website, as well as meetings, seminars and training
II. SFC’s approach and focus on risk based supervision of market intermediaries
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Regulatory objectives and mission of the SFC

Supervision of market intermediaries

A. Risk identification
- Firm-specific risks
- Sector-crossing risks

B. Risk assessment and supervisory approach
- Off-site monitoring
- On-site inspection

C. Supervisory outcomes/results
- Corrective actions taken by management of firm
- Subjecting firm to further enquiry/investigation
- Imposition of licensing conditions/Issuance of restriction notices
- Issuance of reports, circulars and FAQs
II. SFC’s approach and focus on risk based supervision of market intermediaries

Firm-specific risks

Financial risks
- Normally associated with firms that have inadequate liquidity, ineffective credit management systems, unsustainable business models or high leverage
- Typically includes credit risk, liquidity risk and market risk where firms may be exposed to losses caused by default by clients/counterparties, inadequate liquid funds and adverse market movements

Conduct risks
- Generally covers the risk of loss to the firm, its clients and/or counterparties stemming from inappropriate or undesirable business conduct or violation of applicable laws and regulation by a firm
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Sector-crossing risks

Economic and market performance
- Monitor risks arising from major changes in the economic/market environment that would have significant impact on the business operation of firms through market survey, industry data analysis, etc.

Market evolution
- Mindful of the dynamism present in today’s financial markets and provide additional guidance to the industry such as issuance of FAQs, etc.

Regulatory
- Conduct surveys and special reviews on areas of particular regulatory importance from time to time, e.g. anti-money laundering is a regulatory area that is kept under constant review
II. SFC’s approach and focus on risk based supervision of market intermediaries – Off-site monitoring

Off-site monitoring

- Analyse the business profile and risks of firms
- Perform risk and impact assessment on firms
- Follow up on complaints and self-reported breaches
II. SFC’s approach and focus on risk based supervision of market intermediaries – Off-site monitoring

Analyse the business profile and risks of firms

- Maintain regular interactions with firms in order to understand their business models, latest plans and aspiration and the risks inherent in such activities

- Taps intelligence from different sources such as:
  - Market news or media reports
  - Actions taken by other divisions of the SFC
  - Sharing with or referrals from fellow regulators
  - Frequent dialogue with market practitioners/industry and trade associations
  - Industry surveys results

- Collect other information about firms’ risks from time to time through their filings with the SFC, e.g. annual audited accounts, compliance reports, business and risk management questionnaires, etc.
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Perform risk and impact assessment on firms

- Assess financial soundness of firms, mainly through analysis of regular financial returns submitted by firms
- Identify any firms that may potentially be in financial difficulties

Use of system-aided risk indicators (including trend analyses and peer comparisons)
- Financial Analysis System
- Compliance History Database
- Client Asset Custody System

Performance of sensitivity and Stress Testing
II. SFC’s approach and focus on risk based supervision of market intermediaries – Off-site monitoring

Financial Analysis System

- A database maintains monthly / semi-annual financial returns submitted by all firms

- A tool to help to:
  - Alert firm requiring immediate attention on its liquid capital position and screen preliminary unreasonable/erroneous information reported in the financial returns ~ **Message alerts**
  - Collate, analyse financial and quantitative information of firms to enable comparison and identification of high risk firms for regulatory actions ~ **Risk Indicators**
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Message alerts on financial returns

- Send messages through emails to alert case owners
- Highlight exceptions to facilitate review of financial returns
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Risk Indicators

- Analysis of key financial data in financial returns
- Analytical techniques employed include:
  - Ratio analysis, Trend analysis, Peer groups comparison, etc.

<table>
<thead>
<tr>
<th>Description on risk indicators (NP)</th>
<th>CRITICAL (C)</th>
<th>MEDIUM (M)</th>
<th>NORMAL (N)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Objectives</strong></td>
<td>Specification</td>
<td>Risk Indicator Ref No</td>
<td></td>
</tr>
<tr>
<td>1. To highlight any deficiency in Liquid Capital (LC)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. To highlight if LC falls below the warning level at 120% of the RLC when the minimum liquid capital requirement has been met</td>
<td></td>
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</tr>
<tr>
<td>3. To highlight if LC falls below 65% of the previous month LC (i.e., if notifiable event under the PPA)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. To highlight if ELC fails below 8% of liquid capital</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>5. To highlight if ELC fails below 5% of the previous month ELC (i.e., if notifiable event under the PPA)</td>
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</tr>
<tr>
<td>6. To highlight if ELC fails below 10% of the previous month ELC (i.e., if notifiable event under the PPA)</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>7. To highlight if ELC falls below 6% of the previous month ELC (i.e., if notifiable event under the PPA)</td>
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</tr>
<tr>
<td>8. To highlight if ELC falls below 5% of the previous month ELC (i.e., if notifiable event under the PPA)</td>
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<tr>
<td>9. To highlight if ELC falls below 10% of the previous month ELC (i.e., if notifiable event under the PPA)</td>
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<tr>
<td>10. To highlight if ELC falls below 6% of the previous month ELC (i.e., if notifiable event under the PPA)</td>
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<td></td>
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</tr>
<tr>
<td>11. To highlight if ELC falls below 5% of the previous month ELC (i.e., if notifiable event under the PPA)</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>12. To highlight if ELC falls below 10% of the previous month ELC (i.e., if notifiable event under the PPA)</td>
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<th>MEDIUM (M)</th>
<th>NORMAL (N)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Type 1: Dealing in securities</strong></td>
<td>Specification</td>
<td>Risk Indicator Ref No</td>
<td></td>
</tr>
<tr>
<td>(a) and does not provide securities margin financing</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(b) and provides securities margin financing</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(c) acts as a trader</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(d) acts as an introducing agent</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(e) and in a futures non-clearing dealer</td>
<td></td>
<td></td>
<td></td>
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</table>

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<th>MEDIUM (M)</th>
<th>NORMAL (N)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Type 2: Dealing in futures</strong></td>
<td>Specification</td>
<td>Risk Indicator Ref No</td>
<td></td>
</tr>
<tr>
<td>(a) and does not provide securities margin financing</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(b) and provides securities margin financing</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>(c) acts as a trader</td>
<td></td>
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<td>(d) acts as an introducing agent</td>
<td></td>
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<td></td>
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</tbody>
</table>
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Risk Indicators (continued)

- Samples of analysis
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Risk Indicators (continued)

- Highlight any parameters with significant deviation from a pre-set amount or percentage for follow-up

- Risk indicators are classified into:
  - critical risk indicators
  - non-critical risk indicators

  to distinguish their degree of importance

- Financial aspects covered by the risk indicators:
  - Liquid capital positions
  - Shareholders’ funds
  - Profit & loss statements
  - Risk management and credit control
  - Liquidity position
  - Clients’ securities and monies held

- Generate risk indicators summary reports
  - Individual company summary
  - Key financial information of all firms
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Compliance History Database

- A risk rating system which evaluates compliance risks with an uniform methodology across all firms

- Information of firms include:
  - Financial returns
  - Auditor’s reports
  - Business Risk Management Questionnaire
  - Inquiries and referrals from local and overseas regulators
  - Investors’ complaints
  - Inspection findings
  - Disciplinary actions
  - Market news

- A tool to rate the risk of firms to enable comparison and identification of high risk firms for regulatory actions
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Types of information

- **Management and company profile**
  - General background information of a firm, such as capital structure, licence type, licensing condition, business activities, etc.
  - Assess management and company quality

- **Compliance history**
  - Disciplinary records
  - Inspection findings
  - Audit findings

- **Business quality**

- **Market intelligence**
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Client Asset Custody System

- A system to identify exceptions on stockholding by brokers at clearing house
  - To identify significant drop in stockholding level
  - To identify significant concentration in, and hence risk exposure to any particular stock

- Indicators include:
  - Change in stockholding by value
  - Change in stockholding by quantity in respect of constituent stocks of major indices
  - Holding of individual stock against total stockholding

- Stockholding data and exception reports to be accessed through web-based system
  - Email alert to case officers and supervisors of exception firms
  - System accessible by all supervision staff, by username and password

- Functionality
  - Cater for different exception thresholds
  - View the trend of stockholding of individual broker over a period of time
  - Access the stockholding by stock by broker
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### System report samples

#### Change in total stock value of a broker between the reporting date and the reference date

<table>
<thead>
<tr>
<th>Date (Reporting)</th>
<th>Date (Reference)</th>
<th>Participant Id</th>
<th>Participant Name</th>
<th>Total Stock Value At Reporting Date ($)</th>
<th>Total Stock Value At Ref Date ($)</th>
<th>Change In Total Stock Value ($)</th>
<th>Change In Total Stock Value (%)</th>
<th>Total Stock Value As At Reporting Date (adjusted For Hsci Movement)</th>
<th>Total Stock Value As At Ref Date (adjusted For Hsci Movement)</th>
<th>Change In Total Stock Value (adjusted For Hsci Movement) ($)</th>
<th>Change In Total Stock Value (adjusted For Hsci Movement) (%)</th>
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</thead>
<tbody>
<tr>
<td>22SEP2009</td>
<td>21AUG2009</td>
<td>L....</td>
<td>L....</td>
<td>182,991,879</td>
<td>349,243,745</td>
<td>-166,251,866</td>
<td>-46.23</td>
<td>192,843,710</td>
<td>192,843,710</td>
<td>-855,036</td>
<td>-0.45</td>
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<td>22SEP2009</td>
<td>21AUG2009</td>
<td>T....</td>
<td>T....</td>
<td>37,311,026</td>
<td>58,477,022</td>
<td>-21,166,026</td>
<td>-36.41</td>
<td>36,719,279</td>
<td>36,719,279</td>
<td>-866,043</td>
<td>-2.2</td>
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<tr>
<td>22SEP2009</td>
<td>21AUG2009</td>
<td>P....</td>
<td>P....</td>
<td>203,413,467</td>
<td>272,503,345</td>
<td>-69,089,878</td>
<td>-25.35</td>
<td>210,868,212</td>
<td>210,868,212</td>
<td>-56,635,032</td>
<td>-20.1</td>
</tr>
</tbody>
</table>

#### Stock Concentration Report

**Applied Filters:** Total stock value ($) greater than 0 AND Individual stock value to total stock value ratio (%) greater than or equal to 20 AND (Indtype contains ALL)

<table>
<thead>
<tr>
<th>Ccass Date</th>
<th>Participant ID</th>
<th>Participant name</th>
<th>Stock code</th>
<th>Stock name</th>
<th>Stock Type</th>
<th>Stock value ($)</th>
<th>Total stock value ($)</th>
<th>Individual stock value to total stock value ratio (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>22/06/06</td>
<td>0803</td>
<td>HON KIWWO LAND</td>
<td>60203</td>
<td>DENNAY MOTORS</td>
<td>STOCK</td>
<td>1,964</td>
<td>1,964</td>
<td>100</td>
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<tr>
<td>22/06/06</td>
<td>0803</td>
<td>CHINA RESOURCES</td>
<td>06103</td>
<td>HON KIWWO LAND</td>
<td>STOCK</td>
<td>200</td>
<td>200</td>
<td>100</td>
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<tr>
<td>22/06/06</td>
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<td>PEACE MARK</td>
<td>07690</td>
<td>HSBC HOLDINGS</td>
<td>STOCK</td>
<td>281,610</td>
<td>284,785</td>
<td>99</td>
</tr>
<tr>
<td>22/06/06</td>
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<td>CHINA RESOURCES</td>
<td>06103</td>
<td>HON KIWWO LAND</td>
<td>STOCK</td>
<td>78</td>
<td>78</td>
<td>100</td>
</tr>
<tr>
<td>22/06/06</td>
<td>0803</td>
<td>CHINA TRAVEL HK</td>
<td>06103</td>
<td>HON KIWWO LAND</td>
<td>STOCK</td>
<td>78</td>
<td>78</td>
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</tr>
<tr>
<td>22/06/06</td>
<td>0803</td>
<td>NAM FONG INTL</td>
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<td>HON KIWWO LAND</td>
<td>STOCK</td>
<td>99</td>
<td>99</td>
<td>100</td>
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<td>22/06/06</td>
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<td>SHY LAND</td>
<td>06103</td>
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<td>STOCK</td>
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<td>99</td>
<td>100</td>
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<td>22/06/06</td>
<td>0803</td>
<td>BU ENT WATER</td>
<td>06103</td>
<td>HON KIWWO LAND</td>
<td>STOCK</td>
<td>99</td>
<td>99</td>
<td>100</td>
</tr>
<tr>
<td>22/06/06</td>
<td>0803</td>
<td>YUE YUEN LTD</td>
<td>06103</td>
<td>HON KIWWO LAND</td>
<td>STOCK</td>
<td>99</td>
<td>99</td>
<td>100</td>
</tr>
<tr>
<td>22/06/06</td>
<td>0803</td>
<td>KERRY FPT</td>
<td>06103</td>
<td>HON KIWWO LAND</td>
<td>STOCK</td>
<td>99</td>
<td>99</td>
<td>100</td>
</tr>
<tr>
<td>22/06/06</td>
<td>0803</td>
<td>CHINA MER HOLD</td>
<td>06103</td>
<td>HON KIWWO LAND</td>
<td>STOCK</td>
<td>181,822,079</td>
<td>791,299,011</td>
<td>23</td>
</tr>
<tr>
<td>22/06/06</td>
<td>06103</td>
<td>GST HOLDINGS</td>
<td>06103</td>
<td>HON KIWWO LAND</td>
<td>STOCK</td>
<td>223,819,600</td>
<td>791,299,011</td>
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<tr>
<td>22/06/06</td>
<td>06103</td>
<td>OTIC PACIFIC</td>
<td>06103</td>
<td>HON KIWWO LAND</td>
<td>STOCK</td>
<td>2,483,777,652</td>
<td>5,323,889,230</td>
<td>47</td>
</tr>
</tbody>
</table>

List of individual stocks held by a broker with value exceeding a preset % of the broker’s total stock value

% of individual stock value out of the broker’s total stock value
II. SFC’s approach and focus on risk based supervision of market intermediaries – Off-site monitoring

Stress Testing

- Assume a certain % drop of price of stock collateral to simulate the impact of a market crash on the broker
- Set a single price drop percentage (e.g. 30% or 50%) for every stock

Stress test helps to:

- **Simulate impact on excess liquid capital level of a firm**
  - Apply haircut % on the projected market value of each stock under market stress scenarios
  - Detailed review of latest positions should be performed on firms with projected liquid capital deficit

- **Assess impact on solvency of a firm**
  - Calculate “projected shortfall” for any projected “underwater” margin loans
  - Assess capability to absorb potential loss (but not a reflection of liquidity or ability to remain a going concern)

- **Identify firms’ concentration risk in specified stock collateral(s) and impact of suspension**
  - Check impact of suspension of specified stock / basket of stocks
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**On-site inspection**

- A key supervisory tool to understand a firm’s business operation, risk management and internal controls and gauge the level of compliance with relevant laws and regulatory requirements
- Scope and depth of each review is tailor-made to suit specific circumstances of each case
- Types of on-site inspection:
  - Routine Inspection
  - Special Inspection
  - Thematic Inspection
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Objectives of Inspection

- An on-site inspection is a key supervisory tool that helps to evaluate a firm’s business operation, risk management and internal controls, and gauge the level of compliance with relevant laws and regulatory requirements.
- This enables regulators to assess whether, and to what extent, a firm acts with due skill, care and diligence and adopt proper business conduct, procedures and practices.
- An effective deterrent to encourage all firms to maintain and raise their standards.
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Types of Inspection

3 types of inspection

Special    Thematic    Routine
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Routine inspection

- All firms are subject to routine inspection periodically
- General checks on firms’ systems and controls as well as compliance with applicable laws and regulations
- Different inspection checklists and programs developed for different business activities, to be used as guidance only
- Generally adopting a balanced top-down and bottom-up approach
  - First to gain a high-level understanding of the business operation, management supervision, role played by compliance / internal audit / middle office
  - Then to take examination steps to review selected areas by performing walk-through tests and reviewing record samples
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Special inspection

- Performed on firms suspected to pose imminent risks to the market or to their customers, e.g. when there is reason to suspect misappropriation of client assets or acute financial or cashflow problems

- Inspection checklist or program; usually involves detailed substantive testing and forensic reviews

- Time is critical for confirming the suspicion and deciding if escalation to the Commission’s level will be needed
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Thematic inspection

- Being the primary tool used to spot trends or emerging risks and to assess the scale and nature of a particular sector-crossing risk to determine if such will warrant regulatory response

- The actual approach may differ from inspection to inspection, with different scoping and criteria for selecting targets
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Inspection Target Selection – Top down approach

- The top-down approach comprises identification of overall inspection priorities taking into consideration of the trends and emerging risks in the market.

- For instance, market volatility increased the financial risks of brokers, the risk of insolvency and proprietary trading will be one prime inspection focus area on brokers.
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Inspection Target Selection – Bottom up approach

- Referral made by monitoring teams based on their off-site monitoring work
- Inspection requests by other divisions/departments of the Commission, overseas regulator, whistle-blower
- Other inspection targets, taking into account various factors such as:
  a. Risk and impact assessment results of firms
  b. Risk factors pertaining to the different business activities involved
  c. The likely risk of a firm failing
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Field inspection procedures

(1) Planning
(2) Opening meeting
(3) Fieldwork
(4) Review by team heads
(5) Follow up and reporting
(6) Other follow up actions
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Field inspection procedure - Planning

- Financial Return
- Risk Management Questionnaire
- Auditors’ Report
- Compliance database
- Correspondence File
- Licensing Records
- Investor complaint
- Previous Inspection Results
- Disciplinary records

Market News
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Field inspection procedure – Pre-inspection work

- Advance notice to the firm
- Fax notification and documents request list to the firm, including information such as:
  - Group / organization structure and updated business activities
  - Client information
  - Handling of client assets
  - Supportings for financial position
  - General operating and risk management procedures
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Field inspection procedure – Fieldwork

- Fieldwork by at least 2 inspection staff
- Standard inspection checklist available for routine inspections
- Tailored checklists normally used for special and thematic inspections
- Checklists are to guide rather than dictate what and how to check
- Decide key risk areas for review in advance
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Field inspection procedure – Review by Team Head

- Fieldwork exit meeting
- Fieldwork exit letter
- Document findings in working papers
- Prepare letter of deficiencies
- Review of working papers by team head
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Field inspection procedure – Follow-up & reporting

- Firms are normally given 2 weeks to respond to the letter of deficiencies

- Firms are required to take rectification measures (including expected timeframe for rectification) so as to reduce the risk to its clients and the market

- Follow up on the rectification measures taken by the firm

- Refer serious cases for further enforcement actions, and where appropriate, disciplinary actions, including reprimands, revocation or suspension of licences and monetary fines
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Disciplinary / Corrective actions

- May require the firm to take action e.g. raising additional capital to address financial concerns or appoint an external consultant to carry out detailed review on certain systems and procedures
- Investigate serious misconduct further
- Where investors’ interests are at imminent risk, may impose restrictive actions to preserve assets of the firm and clients to contain the damage