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

SFC 證監會

2014 IOSCO Annual Conference Workshop – Market Intermediaries Risk Based Supervision

30 September 2014

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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

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

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

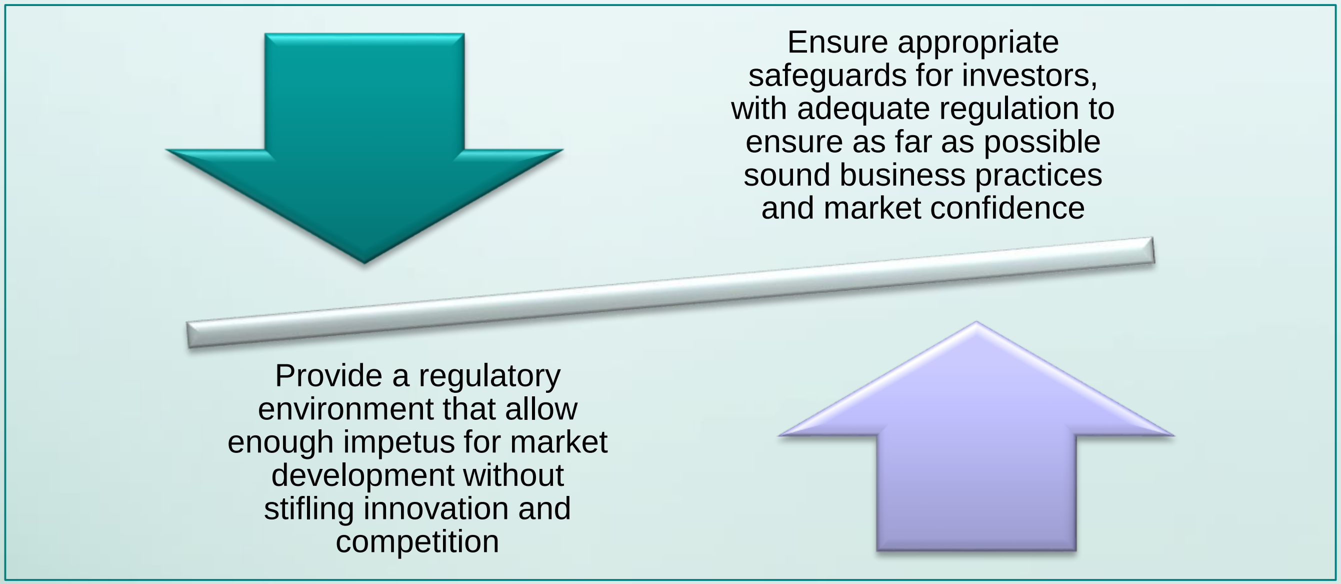
- The Regulator should have comprehensive inspection, investigation and surveillance powers. (*Principle 10*)
- The Regulator should have comprehensive enforcement powers. (*Principle 11*)
- The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and 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



  - 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

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

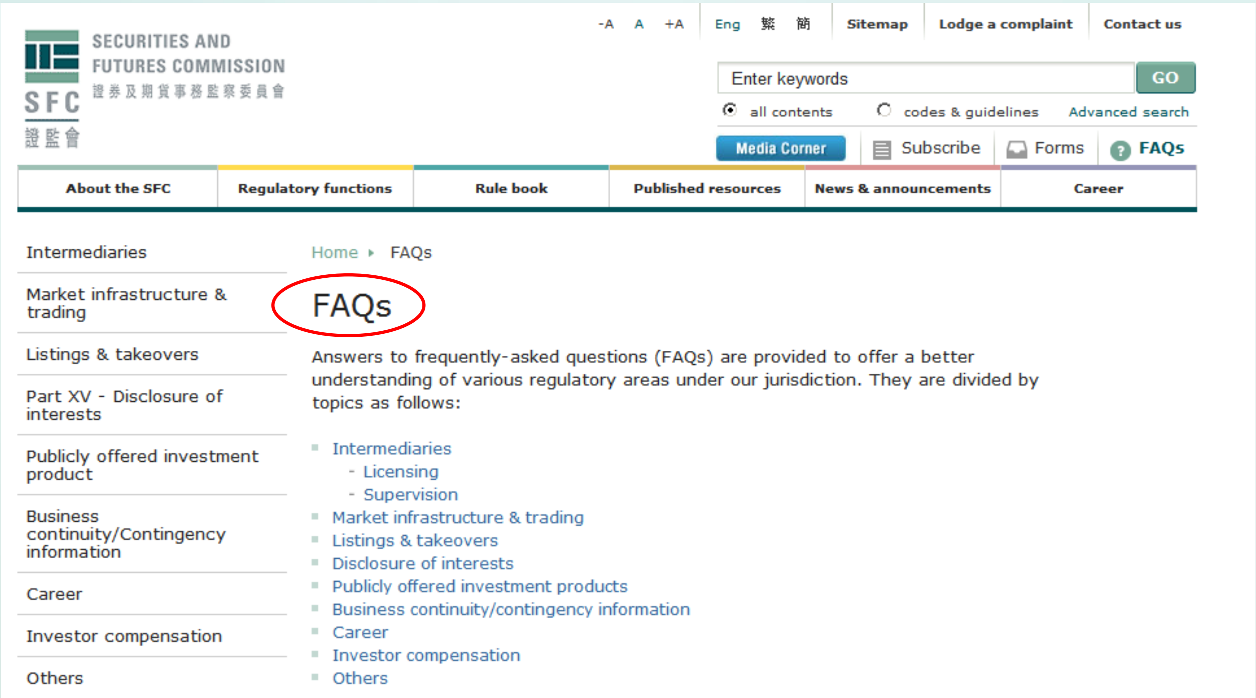
- **Fair and consistent regulatory processes**
  - Clear and objective internal procedures and guidelines for staff performing their day-to-day regulatory activities to ensure that regulatory processes are fairly and consistently applied
  - The SFC is subject to a system of checks and balances, both 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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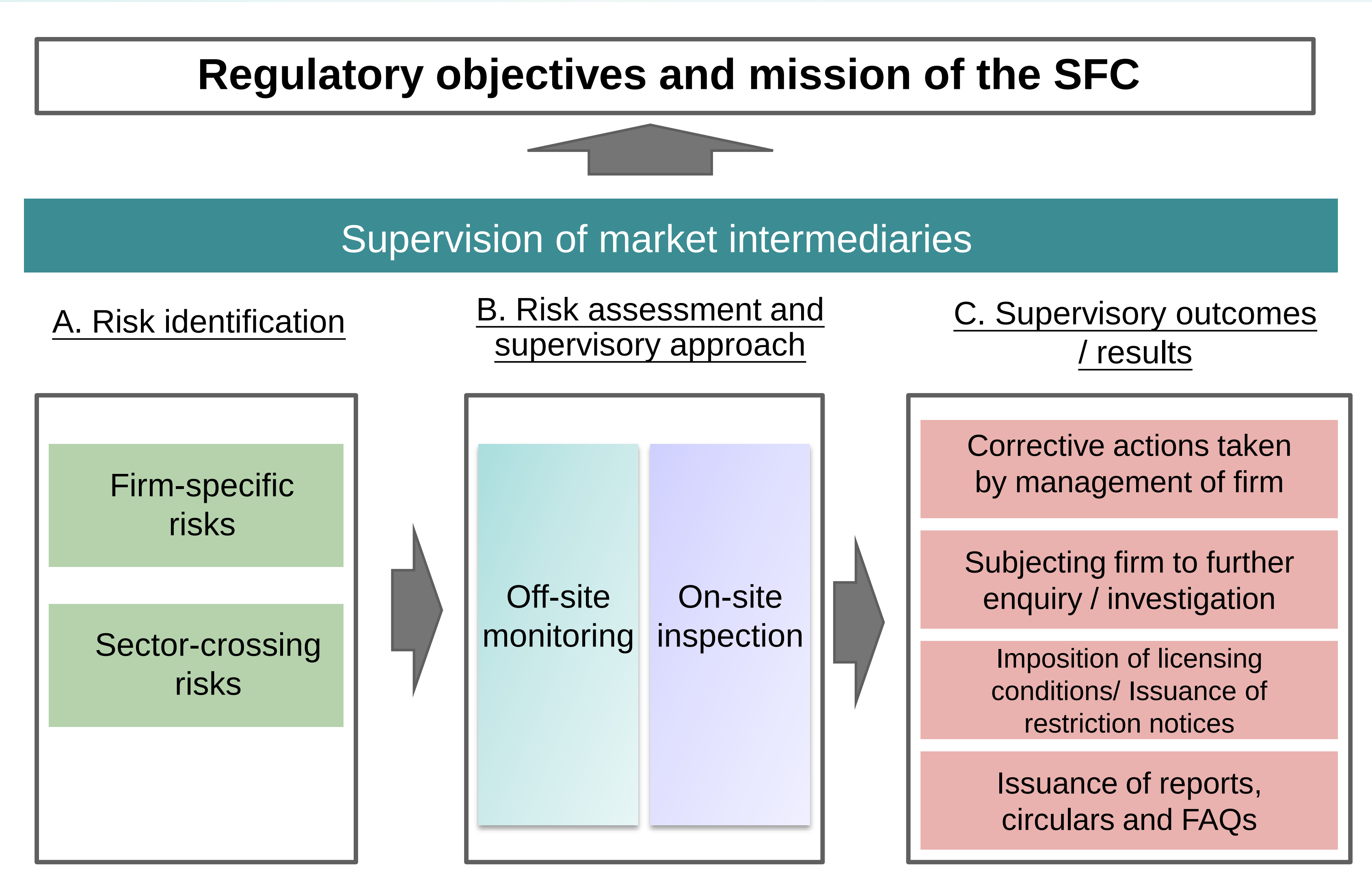

II. SFC's approach and focus on risk based supervision of market intermediaries

Firm-specific risks

Firm-specific risks

Sector-crossing 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

II. SFC's approach and focus on risk based supervision of market intermediaries

Sector-crossing risks

Firm-specific risks

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

On-site inspection

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.**

II. SFC's approach and focus on risk based supervision of market intermediaries – Off-site monitoring

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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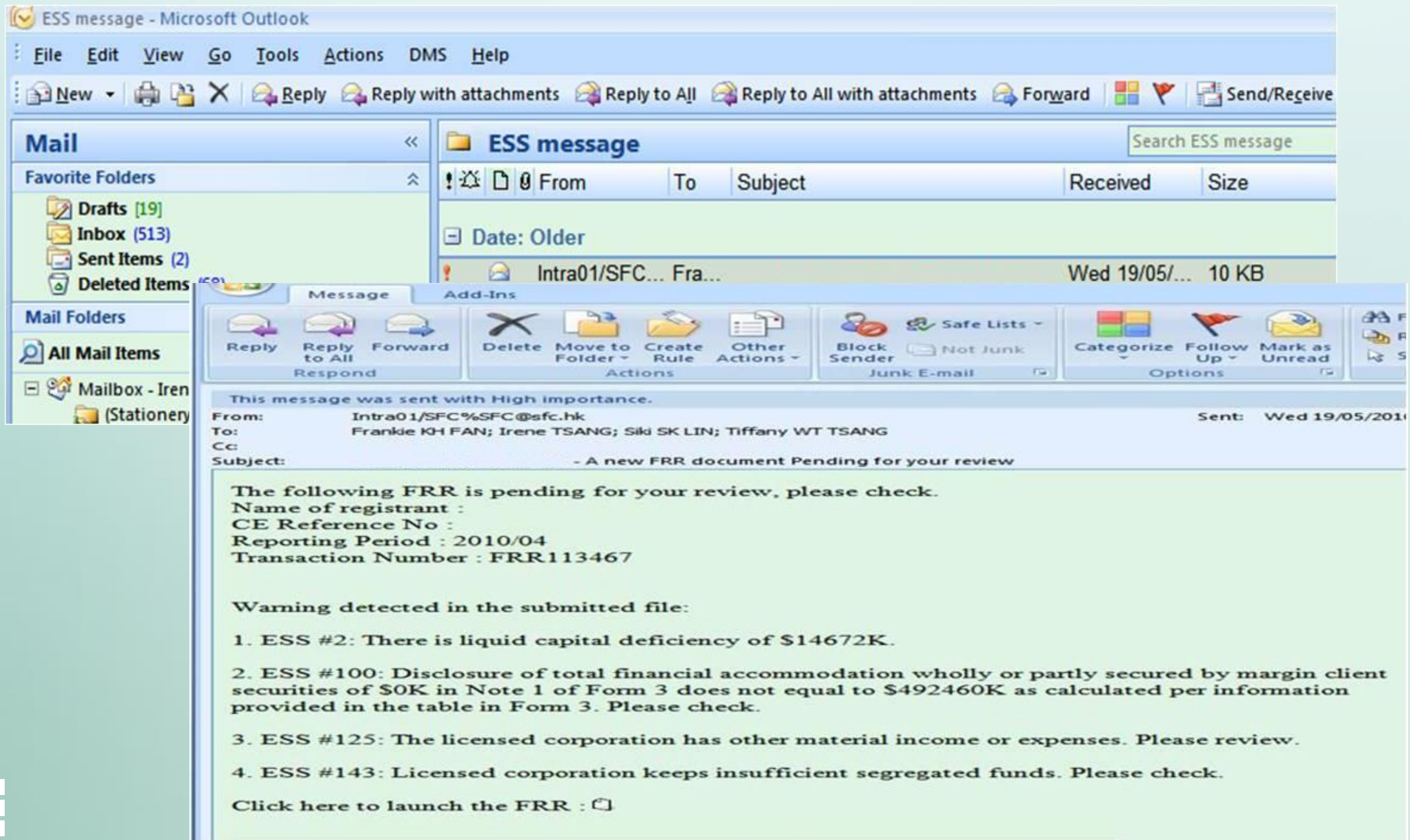
Message alerts on financial returns

- **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.

Description on risk indicators ("RI")

RI Ref No	Critical ("C") / Non-critical ("N")	Objectives	Specification	Risk Indicator Ref No	Type 1: Dealing in securities (a) and does not provide securities margin financing	Type 1: (b) and provides securities margin financing	Type 1: (c) solely as a trader	Type 1: (d) solely as an approved introducing agent	Type 2: Dealing in futu (a) dealing in futures contracts	Type 2: (b) and is a futures non-clearing dealer
LC POSITION				LC POSITION						
1	C	To highlight any deficiency in Liquid Capital ("LC").	If LC < Required Liquid Capital ("RLC")	1	√	√	√	√	√	√
2	C	To highlight if LC falls below the warning level at 120% of the RLC when the minimum liquid capital requirement has been met.	If LC < 120% but >= 100% of RLC	2	√	√	√	√	√	√
3	C	To highlight if LC falls below 50% of the previous month LC (i.e. a notifiable event under the FRR).	If the current month LC < 50% of the previous month LC ON THE CONDITION THAT LCs of both current month and previous month > 0	3	√	√	√	√	√	√
4	C	To highlight loss-making company which ELC may not be able to sustain continuous losses for 6 months.	If ELC / Curr mth operating loss OR 12-month average operating loss < 6 months	4	√	√	√	√	√	√
5	C	To highlight if the projected ELC fall below zero upon overall market drop by 20%	If projected ELC < 0 in the sensitivity analysis for overall market drop by 20% ON THE CONDITION THAT ELC > 0	5	√	√	√	√	√	√
6	C	To highlight loss-making company which projected ELC upon overall market drop of 20% may not be able to sustain continuous losses for 6 months	If projected ELC upon overall market drop of 20% /current month operating loss or 12-month average operating loss < 6 months	6	√	√	√	√	√	√
7	N	To highlight if a company persistently maintains thin Excess Liquid Capital ("ELC") (i.e. LC - RLC).	If the current month LC is at or below 130% of the RLC AND that there are more than 6 times in the 12-month period that the LC stays at or below 130% of the RLC	7	√	√	√	√	√	√
8	N	To highlight if there are any large swings in the ELC in the latest 6-month period.	If the ELCs in the latest 6-month period fluctuates over or below the mean ELC (i.e. 6-month average ELC) by more than (120- 100)% and such fluctuation displays a down-up-down trend or up-down-up	8	√	√	√	√	√	√
9	N	To highlight if the ELCs show a significant decreasing trend over the 6-month period and/or 12-month period	If the current month ELC is < 80% of the 6-month and/or 12-month Average ELC on the condition that RI#4 is triggered	9	√	√	√	√	√	√

list of exceptional messages

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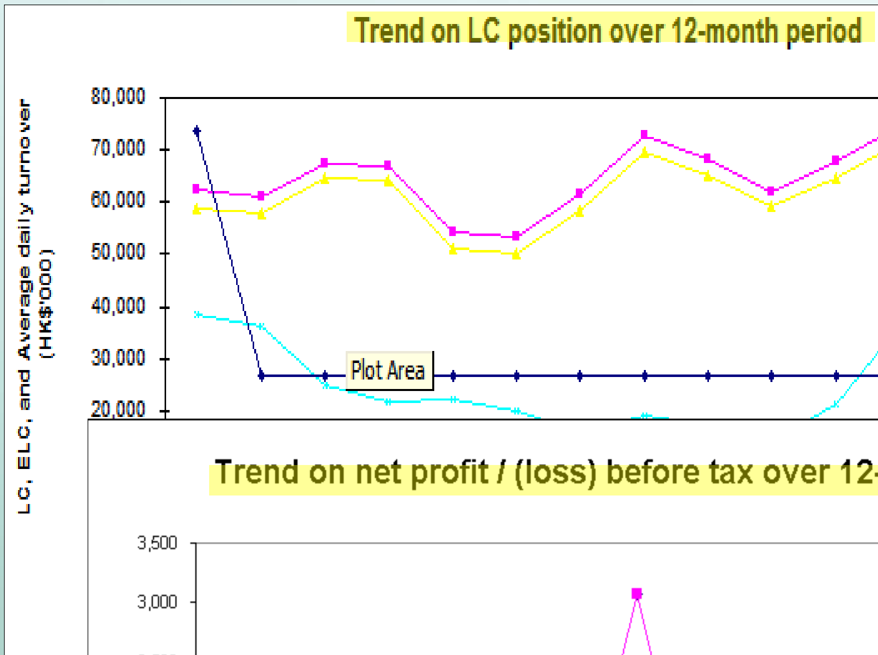
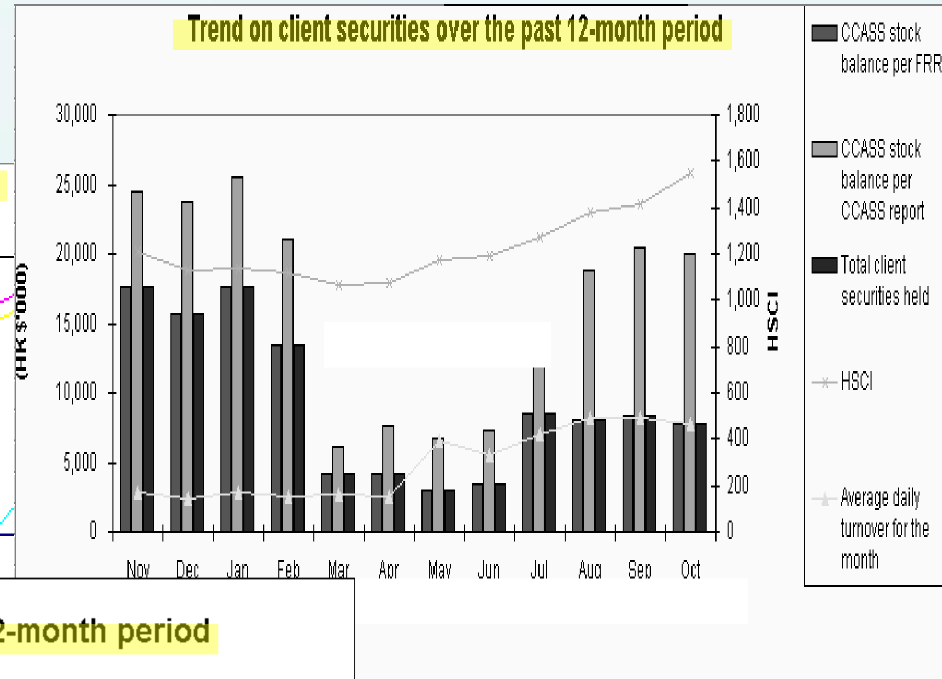
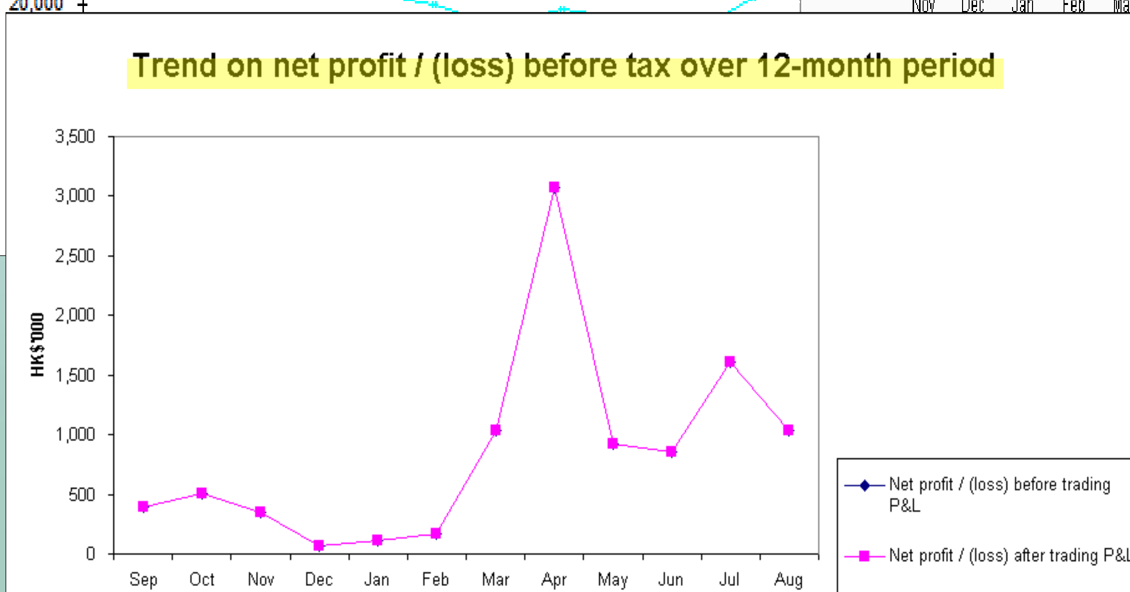
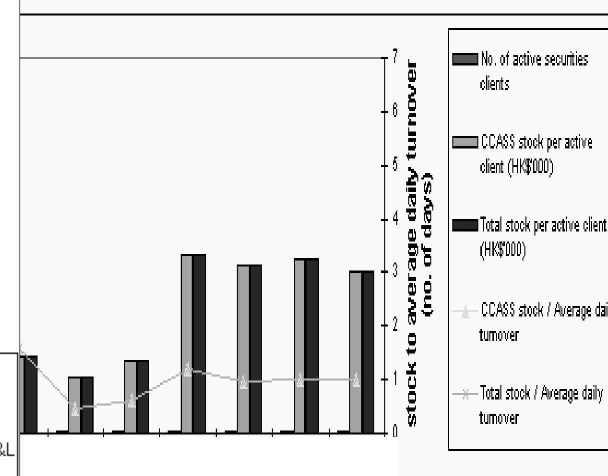
Risk Indicators (continued)

- **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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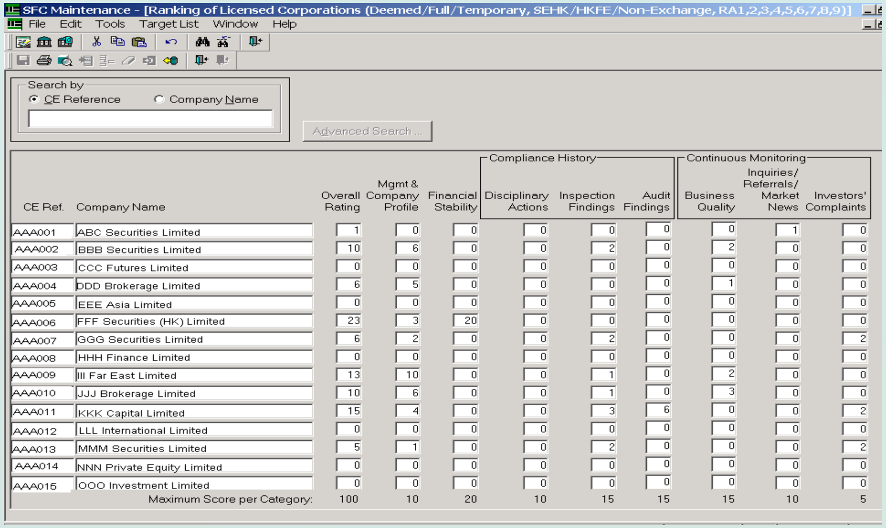
Compliance History Database

- **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**



CE Ref.	Company Name	Overall Rating	Mgmt & Company Profile	Financial Stability	Compliance History: Disciplinary Actions	Compliance History: Inspection Findings	Compliance History: Audit Findings	Continuous Monitoring: Business Quality	Continuous Monitoring: Inquiries/ Referrals/ Market News	Continuous Monitoring: Investors' Complaints
AAA001	ABC Securities Limited	1	0	0	0	0	0	0	1	0
AAA002	BBB Securities Limited	10	6	0	0	2	0	2	0	0
AAA003	CCC Futures Limited	0	0	0	0	0	0	0	0	0
AAA004	DDD Brokerage Limited	6	5	0	0	0	0	1	0	0
AAA005	EEE Asia Limited	0	0	0	0	0	0	0	0	0
AAA006	FFF Securities (HK) Limited	23	3	20	0	0	0	0	0	0
AAA007	GGG Securities Limited	6	2	0	0	2	0	0	0	2
AAA008	HHH Finance Limited	0	0	0	0	0	0	0	0	0
AAA009	III Far East Limited	13	10	0	0	1	0	2	0	0
AAA010	JJJ Brokerage Limited	10	6	0	0	1	0	3	0	0
AAA011	KKK Capital Limited	15	4	0	0	3	6	0	0	2
AAA012	LLL International Limited	0	0	0	0	0	0	0	0	0
AAA013	MMM Securities Limited	5	1	0	0	2	0	0	0	2
AAA014	NNN Private Equity Limited	0	0	0	0	0	0	0	0	0
AAA015	OOO Investment Limited	0	0	0	0	0	0	0	0	0
	Maximum Score per Category:	100	10	20	10	15	15	15	10	5

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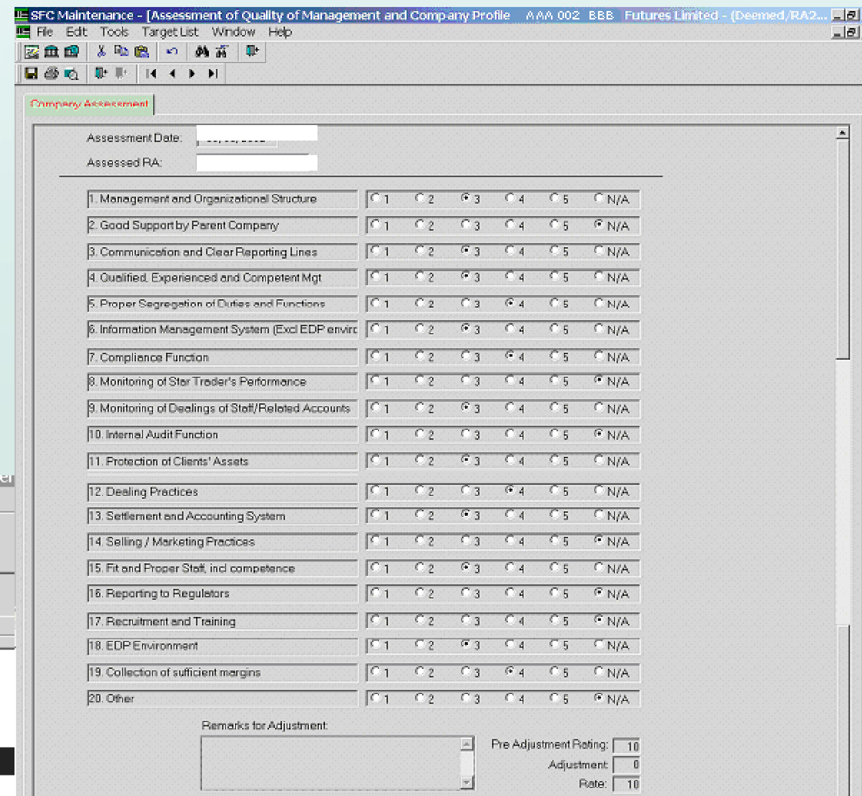
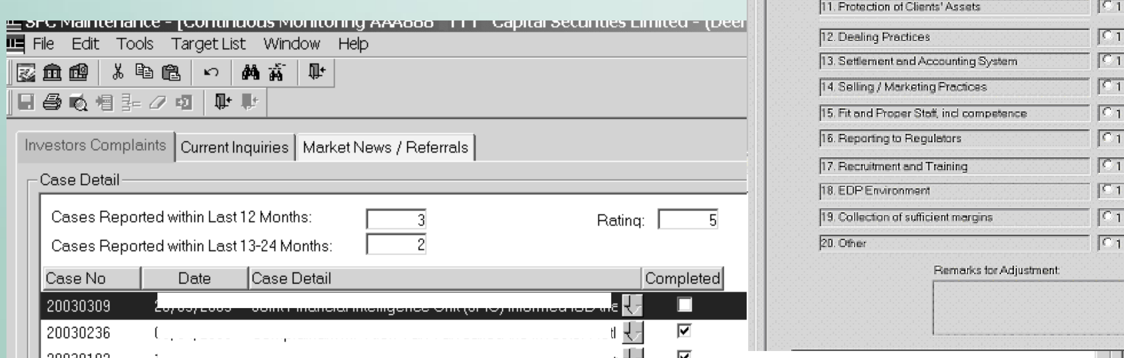
Types of information

- **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

II. SFC's approach and focus on risk based supervision of market intermediaries – Off-site monitoring

- **System report samples**

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

Report on change in total value of CCASS stockholdings

HSCI as at reporting date: 2,634.220
HSCI as at reference date: 2,808.460

Date (Reporting)	Date (Reference)	Participant Id	Participant Name	Total Stock Value As At Reporting Date ($)	Total Stock Value As At Ref Date ($)	Change In Total Stock Value ($)	Change In Total Stock Value (%)	Total Stock Value As At Reporting Date (adjusted For Hsci Movement)	Change In Total Stock Value (adjusted For Hsci Movement) ($)	Change In Total Stock Value (adjusted For Hsci Movement) (%)
22SEP2008	21AUG2008			180,691,879	349,243,745	-168,551,866	-48.26	192,643,710	-156,600,035	-45
22SEP2008	21AUG2008			37,311,328	58,677,622	-21,366,294	-36.41	39,779,279	-18,898,343	-32
22SEP2008	21AUG2008			203,413,467	272,503,845	-69,090,378	-25.35	216,868,213	-55,635,632	-20

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 (Indextype contains ALL)

Ccass Date	Participant ID	Participant name	Stock code	Stock name	Stock Type	Stock value ($)	Total stock value ($)	Individual stock value to total stock value ratio (%)
22/09/08			00203	DENWAY MOTORS	STOCK	1,984	1,984	100
22/09/08			00160	HON KWOK LAND	STOCK	200	278	72
22/09/08			04	PEACE MARK	STOCK	78	278	28
22/09/08			05	HSBC HOLDINGS	STOCK	281,610	284,705	99
22/09/08			91	CHINA RESOURCES	STOCK			41
22/09/08			08	CHINA TRAVEL HK	STOCK			59
22/09/08			78	NAM FONG INT'L	STOCK			86
22/09/08			83	SINO LAND	STOCK			99
22/09/08			71	BJ ENT WATER	STOCK			89
22/09/08			51	YUE YUEN IND	STOCK			64
22/09/08			83	KERRY PPT	STOCK			20
22/09/08			44	CHINA MER HOLD	STOCK	181,832,079	791,929,011	23
22/09/08			00416	GST HOLDINGS	STOCK	223,616,800	791,929,011	28
22/09/08			00267	CITIC PACIFIC	STOCK	2,493,777,553	5,323,368,380	47

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

II. SFC's approach and focus on risk based supervision of market intermediaries – On-site inspection

Off-site monitoring

On-site inspection

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

II. SFC’s approach and focus on risk based supervision of market intermediaries – On-site inspection

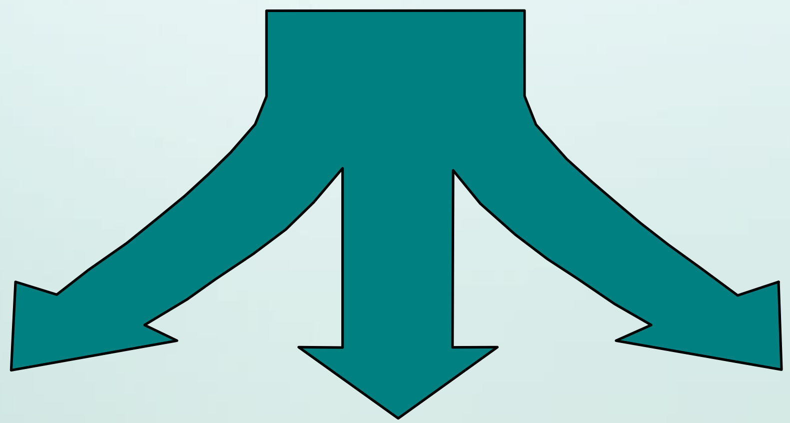
Objectives of Inspection

- 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

II. SFC’s approach and focus on risk based supervision of market intermediaries – On-site inspection

Types of Inspection

3 types of inspection



Special Thematic Routine

II. SFC’s approach and focus on risk based supervision of market intermediaries – On-site inspection

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

II. SFC’s approach and focus on risk based supervision of market intermediaries – On-site inspection

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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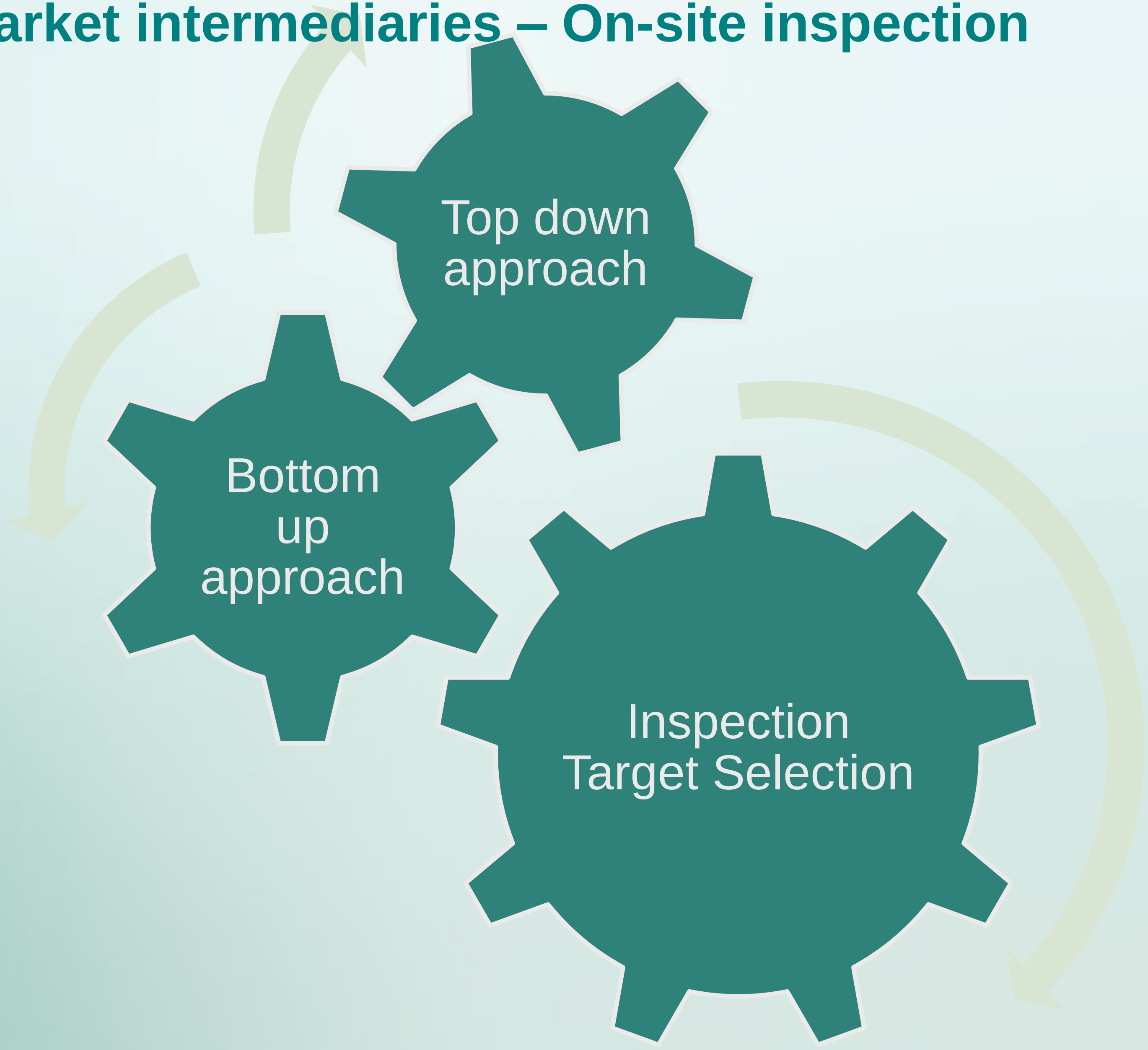


II. SFC’s approach and focus on risk based supervision of market intermediaries – On-site inspection

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

II. SFC’s approach and focus on risk based supervision of market intermediaries – On-site inspection

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

II. SFC's approach and focus on risk based supervision of market intermediaries – On-site inspection

Field inspection procedures

(1) Planning

(2) Opening meeting

(3) Fieldwork

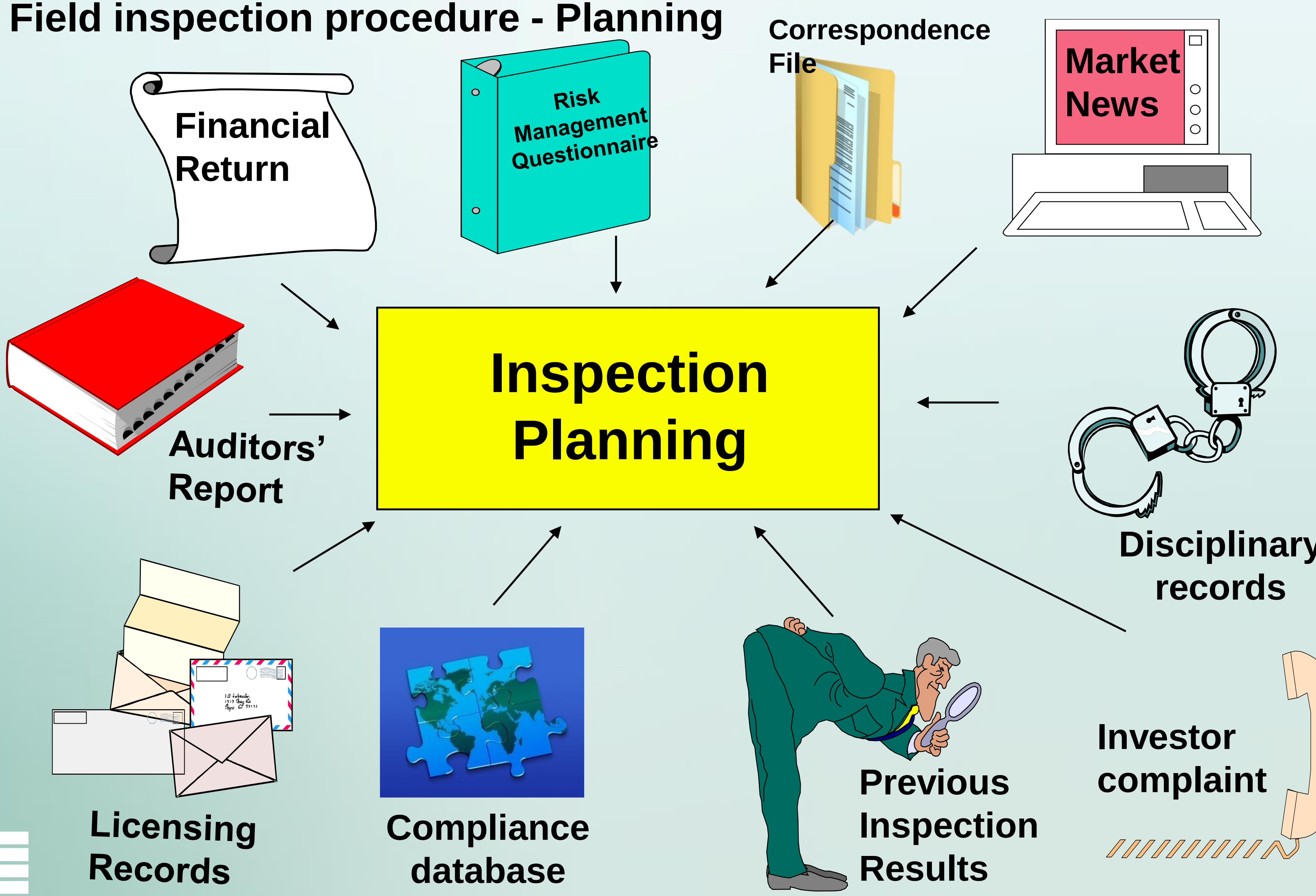
(4) Review by team heads

(5) Follow up and reporting

(6) Other follow up actions

II. SFC's approach and focus on risk based supervision of market intermediaries – On-site inspection

Field inspection procedure - Planning



II. SFC's approach and focus on risk based supervision of market intermediaries – On-site inspection

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

II. SFC's approach and focus on risk based supervision of market intermediaries – On-site inspection

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

II. SFC’s approach and focus on risk based supervision of market intermediaries – On-site inspection

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

II. SFC's approach and focus on risk based supervision of market intermediaries – On-site inspection

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

II. SFC's approach and focus on risk based supervision of market intermediaries – On-site inspection

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