

Process Review Panel
for the
Securities and Futures
Commission

Annual Report
for 2015-16

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Message from the Chairman

This is the fourth message for the Annual Report that I wrote as the Chairman of the Process Review Panel for the Securities and Futures Commission ("PRP"). PRP is tasked to ensure fairness and consistency in the operation of the Securities and Futures Commission ("SFC"). In so doing it seeks to enhance public confidence in its regulatory work. As the Chairman, I am pleased to report that PRP has been performing effectively.

During the year, PRP had examined the checks and balances and how they worked in the different divisions. PRP reviewed cases handled by the divisions and provided recommendations on how to improve upon the system. Noting market participants' concerns, PRP conducted a thematic review on the issuance of statutory notices as part of the investigation procedure undertaken by the SFC enforcement team. PRP held discussions with the SFC and noted areas for improvements. Some noteworthy findings on the thematic review can be found in Chapter 3 of this annual report.

On completing this year's work satisfactorily, I must thank all fellow Members in selflessly devoting their precious time to study the cases and the operational manuals and to hold discussion with officers of the SFC despite their own hectic schedules. In particular, I have to pay tribute to four Members who retired during the year after working with us for many years; for their wise counsel during meetings, and more specifically to Ms. Chow Yuen Yee for her expertise in market rules and practices; to Professor Richard Ho for leading us in all the enforcement studies; to Dr. Cynthia Lam for her limitless positive energy in all the tiring reviewing sessions; and to Mr Alfred Mak for his dedication and thoughtful recommendations. I am indeed most grateful to you all.

Message from the Chairman (*continued*)

I would also bid a warm welcome to Ms Lena Chan and Dr Billy Mak as they are joining as our new Members. Taking this opportunity, I would like to thank the Secretary for the Financial Services and the Treasury and his staff for the tremendous support given to PRP.

Together with all fellow Members and the secretariat, I shall continue to carry out PRP's functions earnestly, independently and impartially. In close collaboration with the SFC, we will forge towards the common goal of an ever improving and effective regulatory regime for the financial market of Hong Kong.

May I take this opportunity to wish everyone a good and successful year ahead!

Moses Cheng Mo-chi, GBM, GBS, JP
Chairman

Executive Summary

In 2015-16, PRP reviewed 59 cases selected from monthly closed case lists submitted by the SFC. PRP also conducted a thematic case review of the investigation procedures in Enforcement.

2. PRP conducted in-depth deliberation on each case. PRP aimed to suggest practical recommendations for the SFC to consider in enhancing its procedural work. The recommendations include -

Enforcement

- ✧ The system of checks and balances on issue of statutory notices to brokers should be enhanced. A holistic review by senior management on work prioritisation, internal communication and seeking legal advice from external counsel would help improving upon the timeliness of investigation

3. PRP reviewed 20 cases relating to the work of the Enforcement Division (“ENF”). The processing time ranged from one month to five years 11 months. PRP noted that in most of the lengthy cases the SFC had spent substantial time in obtaining legal advice and collecting evidence from suspects and witnesses residing out of Hong Kong. For some cases under review, the time taken to obtain legal advice contributed to 60% of the total processing time.

Provision of Legal Advice

4. The ENF should put in place an effective system to monitor progress of obtaining legal advice from outside counsel. PRP commented that it was not uncommon that the ENF would receive different (if not conflicting) legal advice from different legal advisers on the same case. The SFC should consider designating an officer at an appropriate level to take forward the case based on the legal advice.

5. The SFC agreed that cases should be pursued as quickly and effectively as possible to ensure fairness to the suspects and in order not to prejudice the investigation due to the long lapse of time. The ENF should follow up closely with the Legal Services Division (“LSD”) on the progress of legal advice sought. The LSD should critically manage its workload to ensure that legal advice was provided in a timely manner particularly on high priority cases. Where external counsel was engaged, it should keep track of the progress to ensure that external counsel’s advice was obtained within a reasonable timeframe. The ENF should also review its policy on engagement of external counsel in suitable cases.

6. PRP was assured that senior management of the SFC would take a holistic review on work prioritisation in the ENF to improve upon the timeliness of investigations.

Liaison with Regulators

7. PRP reviewed a number of potential market misconduct cases with suspected traders or witnesses residing overseas or in the Mainland. The investigation was most challenging as the SFC did not have investigation power for persons residing outside Hong Kong. PRP recommended that the SFC should enhance its cooperation with the China Securities Regulatory Commission and other overseas regulators to handle suspected trading by people residing outside Hong Kong. In this connection, the ENF advised that it would consider all possible and legal means to obtain evidence both locally and overseas. The ENF would train its teams regularly on how to investigate cases involving overseas suspects and how to get international cooperation.

Work Prioritisation

8. The ENF prioritised its cases according to different categories, worked out an investigation plan with an expected timeframe and submitted the plan to the Enforcement Steering Committee of the ENF for endorsement. PRP considered that prioritisation of cases had an impact on processing time. PRP recommended the ENF to review how different categories of case were handled by case officers and monitored by senior

management of the SFC. PRP was concerned whether subject officers had been provided with adequate guidelines so that processing of cases would not be procrastinated unnecessarily.

9. The ENF explained that cases with higher priority would be assigned to a more senior staff as a “Case Manager” and be given more resources and supervision. The ENF also explained that arising from a substantial increase in cases for investigation in 2014-15, there had been some prolonged investigations.

10. The ENF had commenced a comprehensive strategic review of its enforcement priorities and processes, which included case selection, case prioritisation, resources allocation and timeliness of enforcement action.

Internal Communication

11. PRP questioned why irregularities in intermediaries had remained undetected for years during regular inspection. PRP felt that had the Intermediaries Supervision Department (“ISD”) of Intermediaries Division detected irregularities earlier, the ENF might have commenced the investigation and disciplinary action more efficiently. The SFC explained that all licensed firms were subject to routine inspections which involved an assessment of the firms’ systems and controls, and compliance with relevant rules and regulations. The SFC further explained that the ISD adopted a risk-based inspection approach. No inspection could be a full “audit” or review of a licensed firm.

12. PRP recommended that the SFC should enhance internal communication, promote cooperation and make effective deployment of resources among divisions so as to enhance efficiency of regulatory work. SFC senior management assured PRP that the SFC would continue to develop greater internal communication and cross-divisional cooperation, both at an operational and at developing regulatory policy.

Investigation Procedures on the issue of Section 182 Directions and Section 183 Notices

13. PRP carried out an in-depth study of the issue of Section 182 Directions and Section 183 Notices. PRP not only focused on the procedures taken, but also questioned the system of the checks and balances over the issue of the Notices. In this regard, PRP noted that-

- (a) Senior Director of the ENF had authorised a pool of Investigators (more than 30 SFC staff members) for a case and provided only general description of the case in the Section 182 Direction. There was no detail on the scope of investigation; and
- (b) the ENF had imposed a different level of checks and balances on the issue of Section 183 Notices to banks and to brokers.

14. The ENF explained that the purpose of authorising a pool of Investigators was to deploy resources flexibly and to facilitate substitution of a staff working on a particular investigation to properly manage resources. The description of the case in the Section 182 Direction should provide flexibility for the subsequent investigation. As part of the comprehensive strategic review of the enforcement priorities and processes, the ENF would review whether there was a need to change the monitoring and control over the issue of Section 183 Notices from an accountability and efficiency standpoint.

15. PRP considered that the checks and balances on the issue of statutory notices to brokers should be enhanced. The current procedures allowed all staff named as Investigators by the SFC to issue Section 183 Notices to brokers without prior endorsement by supervisors. This posed a risk that Investigators might ask for more than absolutely necessary information under the Notices, causing undue pressure on brokers. The SFC should improve its checking mechanism.

Intermediaries Supervision

- ✧ The ISD should take a holistic review on inspection process and ensure timely conclusion of an inspection and effective follow up on the deficiencies identified

16. PRP reviewed six inspections and two prudential visits conducted by the Intermediaries Supervision Department (“ISD”). The time taken to conclude an inspection ranged from four to ten months.

17. PRP enquired why an inspection would take nine months to conclude. The case officer responded by pointing out that the inspection was completed upon the issuance of the letter of deficiencies. That was issued within four months from the commencement of the inspection. PRP reminded that the importance of concluding an inspection and rectifying deficiencies of an intermediary at the soonest possible time need not be further emphasised. PRP deferred this to the senior management of the SFC to take effective measures for timely conclusion of an inspection, follow-up on deficiencies identified and monitoring of remedial action taken by the various teams in the ISD.

18. PRP recommended the ISD to review the appropriate time when a case should be closed when follow-up action was still pending and subject to the ISD’s monitoring. The ISD should provide its staff with adequate guidelines in this regard.

19. The ISD explained that there were procedures and mechanisms in place to monitor follow-up action after letters of deficiencies were issued and when an inspection should be closed.

20. PRP noted from the ENF case studies that serious deficiencies of internal control of some intermediaries remained undiscovered for a prolonged period. PRP queried why such internal deficiencies could have escaped detection.

21. The ISD reported that a designated director would set inspection priorities and prepare a list of inspection targets based on a risk-based approach. Licensed Corporations (“LC”) with higher risk would be inspected in a shorter timeframe, say with a four- to five-year inspection cycle. The ISD developed different inspection checklists to cover different business activities. The ISD explained that given that it had adopted a risk-based inspection approach, inspections could not be equivalent to a “full” audit of LCs.

22. PRP invited the ISD to examine the inspection process of the specified cases as reviewed by PRP. The ISD was recommended to consider why it had not been able to detect basic internal deficiencies of intermediaries in these cases with a view to improving the effectiveness of supervision of intermediaries in future. PRP would monitor the effectiveness of the measures adopted in the inspection approach in future case reviews.

Licensing

- ✧ Provide more public education reminding substantial shareholders of LC of the statutory requirements

23. PRP reviewed eight licensing applications. The processing time ranged from 28 days to one year and one month.

24. PRP recommended the LIC to provide more public education, say publishing frequently-asked questions (“FAQ”), to remind market participants of the statutory requirements that substantial shareholders of LC needed to provide the LIC with updated information of change of their particulars of contact details within 14 days of change.

25. The LIC would revise the application form stating the statutory obligations that substantial shareholders were required to provide updated information of its directors when they applied for approval to become substantial shareholders of another LC.

Authorisation of Investment Products

- ✧ On 9 May 2016, the revamped fund authorisation process was formally adopted and the six-month application lapse policy was formally extended to Mandatory Provident Fund products and pooled retirement funds

26. PRP reviewed eight completed authorisation cases handled by the Investment Products Division (“IPD”). The processing time ranged from five to 11 months.

27. PRP was glad to acknowledge the noticeable improvements in processing time after the introduction of the six-month application lapse policy.

28. The six-month application lapse policy was formally extended to Mandatory Provident Fund products and pooled retirement funds on 9 May 2016. PRP reminded that there might be some overlapping on the vetting of fund applications between the SFC and the Mandatory Provident Fund Schemes Authority (“MPFA”) on disclosure requirements. PRP looks forward to the IPD’s further review in achieving a more streamlined and efficient authorisation process.

29. The revamped fund authorisation process was formally adopted on 9 May 2016.

Corporate Finance

- ✧ Set up case monitoring system for effective supervision

30. PRP reviewed seven cases on processing of applications handled by the CFD. The processing time ranged from one year to more than four years.

31. PRP recommended that the Corporate Finance Division (“CFD”) should set up a case monitoring system for effective supervision.

Complaints Handling

- ✧ Consider imposing measures to monitor progress of complaint handling by operational divisions

32. PRP reviewed eight cases related to complaints against intermediaries and market and studied the mode of operation of the Complaints Control Committee (“CCC”).

33. PRP recommended that the SFC should consider putting in place measures, for example, to assign CCC to monitor the progress of handling of complaints by operational divisions. This would ensure that different divisions in the SFC had handled complaints effectively.

Chapter 1 General Information

Background

1.1 PRP for the SFC is an independent panel established by the Chief Executive in November 2000. It is tasked to conduct reviews of operational procedures of the SFC and to determine whether the SFC has followed its internal procedures and operational guidelines to ensure consistency and fairness.

Functions

1.2 PRP reviews completed or discontinued cases handled by the SFC and advises the SFC on the adequacy of the SFC's internal procedures and operational guidelines governing the actions taken and operational decisions made by the SFC in the performance of its regulatory functions. These areas include authorisation of investment products, licensing of intermediaries, inspection of intermediaries, enforcement, corporate finance including processing of listing applications, and complaints handling.

1.3 PRP does not judge the merits of the SFC's decisions and actions. It focuses on the process.

1.4 The Terms of Reference of PRP are -

- (a) To review and advise the Commission upon the adequacy of the Commission's internal procedures and operational guidelines governing the actions taken and operational decisions made by the Commission and its staff in the performance of the Commission's regulatory functions in relation to the following areas -
- (i) receipt and handling of complaints;
 - (ii) licensing of intermediaries and associated matters;
 - (iii) inspection of licensed intermediaries;
 - (iv) taking of disciplinary action;
 - (v) authorisation of unit trusts and mutual funds and advertisements relating to investment arrangements and agreements;

- (vi) exercise of statutory powers of investigation, inquiry and prosecution;
 - (vii) suspension of dealings in listed securities;
 - (viii) administration of the Codes on Takeovers and Mergers and Shares Buy-back (formerly known as the Codes on Takeovers and Mergers and Share Repurchases);
 - (ix) administration of non-statutory listing rules;
 - (x) authorisation of prospectuses for registration and associated matters; and
 - (xi) granting of exemption from statutory disclosure requirements in respect of interests in listed securities.
- (b) To receive and consider periodic reports from the Commission on all completed or discontinued cases in the above-mentioned areas, including reports on the results of prosecutions of offences within the Commission's jurisdiction and of any subsequent appeals.
- (c) To receive and consider periodic reports from the Commission in respect of the manner in which complaints against the Commission or its staff have been considered and dealt with.
- (d) To call for and review the Commission's files relating to any case or complaint referred to in the periodic reports mentioned in paragraphs (b) and (c) above for the purpose of verifying that the actions taken and decisions made in relation to that case or complaint adhered to and are consistent with the relevant internal procedures and operational guidelines and to advise the Commission accordingly.
- (e) To receive and consider periodic reports from the Commission on all investigations and inquiries lasting more than one year.
- (f) To advise the Commission on such other matters as the Commission may refer to the Panel or on which the Panel may wish to advise.
- (g) To submit annual reports and, if appropriate, special reports (including reports on problems encountered by the Panel) to the Financial Secretary which, subject to applicable statutory secrecy provisions and other confidentiality requirements, should be published.
- (h) The above terms of reference do not apply to committees, panels or other bodies set up under the Commission the majority of which members are independent of the Commission.

1.5 PRP submits its annual reports to the Financial Secretary who may cause them to be published as far as permitted under the law.

1.6 The establishment of PRP demonstrates the Government's resolve to enhance the transparency of SFC's operations, and the SFC's determination to boost public confidence and trust. PRP's work contributes to ensuring that the SFC exercises its regulatory powers in a fair and consistent manner.

Modus operandi

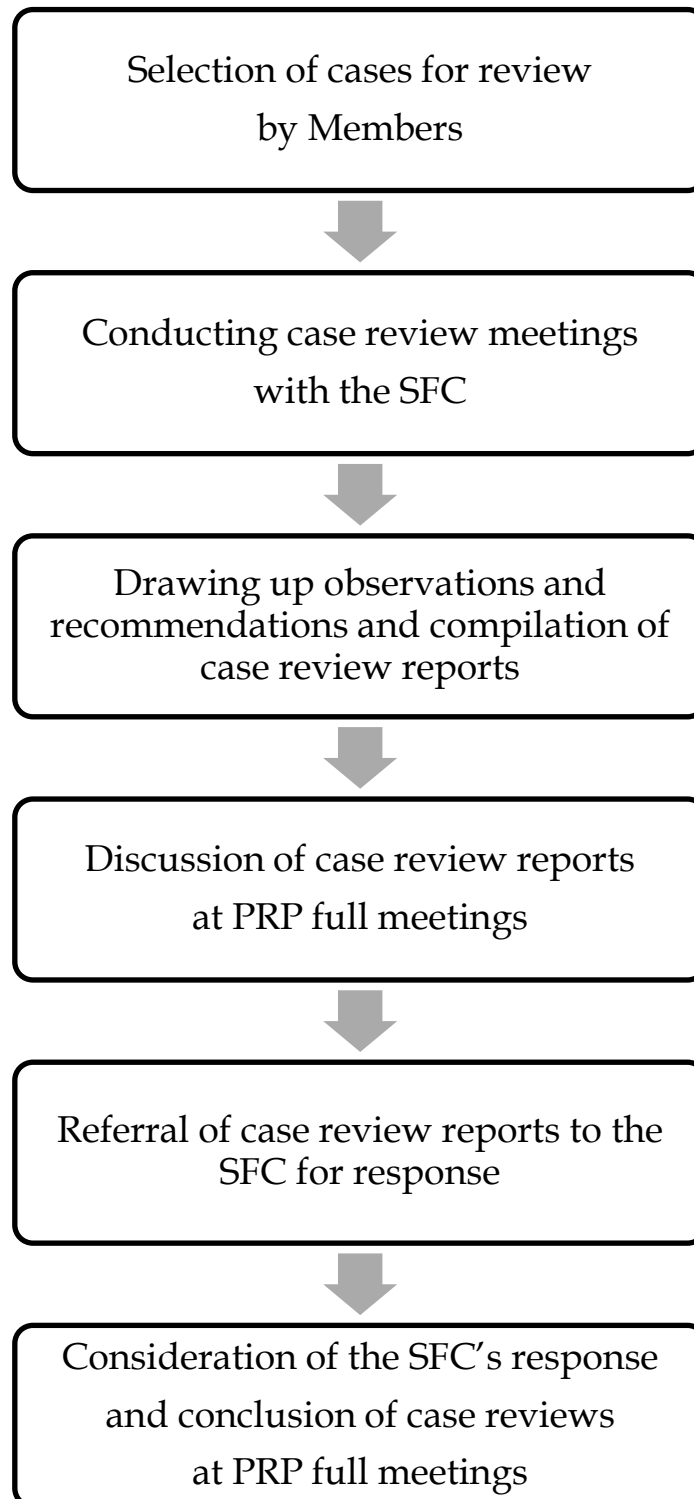
1.7 The SFC provides PRP with monthly lists of completed and discontinued cases. Members of PRP select cases from these lists for review. Members pay due regard to factors including processing time of completed cases, procedural steps taken by the SFC in arriving at its decisions and relevant checks and balances.

1.8 The SFC also provides PRP with monthly lists of on-going investigation and inquiry cases that have lasted for more than one year for PRP to take note and consider for review upon completion or closure of the case.

1.9 PRP members are obliged to keep confidential the information furnished to them in the course of PRP's work. To maintain independence and impartiality of PRP, all PRP members are required to make declaration of interest upon commencement of their terms of appointment and declare their interest in the relevant matters before conducting/discussing each case review, as appropriate.

Case review workflow

1.10 The workflow of PRP case reviews is set out below -



Membership

1.11 Dr. Cheng Mo-chi, Moses is the Chairman of PRP.

1.12 PRP comprises members from the financial sector, academia, and the legal and accountancy professions. In addition, there are two ex-officio members, including the Chairman of the SFC and the representative of the Secretary for Justice.

1.13 The membership of PRP in 2015-16 is as follows -

Chairman:

Dr. CHENG Mo-chi, Moses, GBM, GBS, JP since 1 November 2012

Members:

Mr. CHAN Kam-wing, Clement since 1 November 2012

Ms. Lena CHAN since 1 June 2016

Ms. CHOW Yuen-yee since 1 November 2010

Ms. DING Chen since 1 November 2014

Prof. HO Yan-ki, Richard, JP since 1 November 2010

Dr. HU Zhanghong since 1 November 2012

Dr. LAM Kit-lan, Cynthia since 1 November 2010

Ms. LEE Pui-shan, Rosita since 1 November 2012

Mr. LEE Wai-wang, Robert since 1 November 2012

Mr. MAK Chi-ming, Alfred since 1 November 2012

Dr. Billy MAK Sui-choi since 1 June 2016

Ms. YUEN Shuk-kam, Nicole since 1 November 2014

Ex officio Members:

Chairman, the Securities and Futures Commission Mr. Carlson TONG, SBS, JP since 20 October 2012

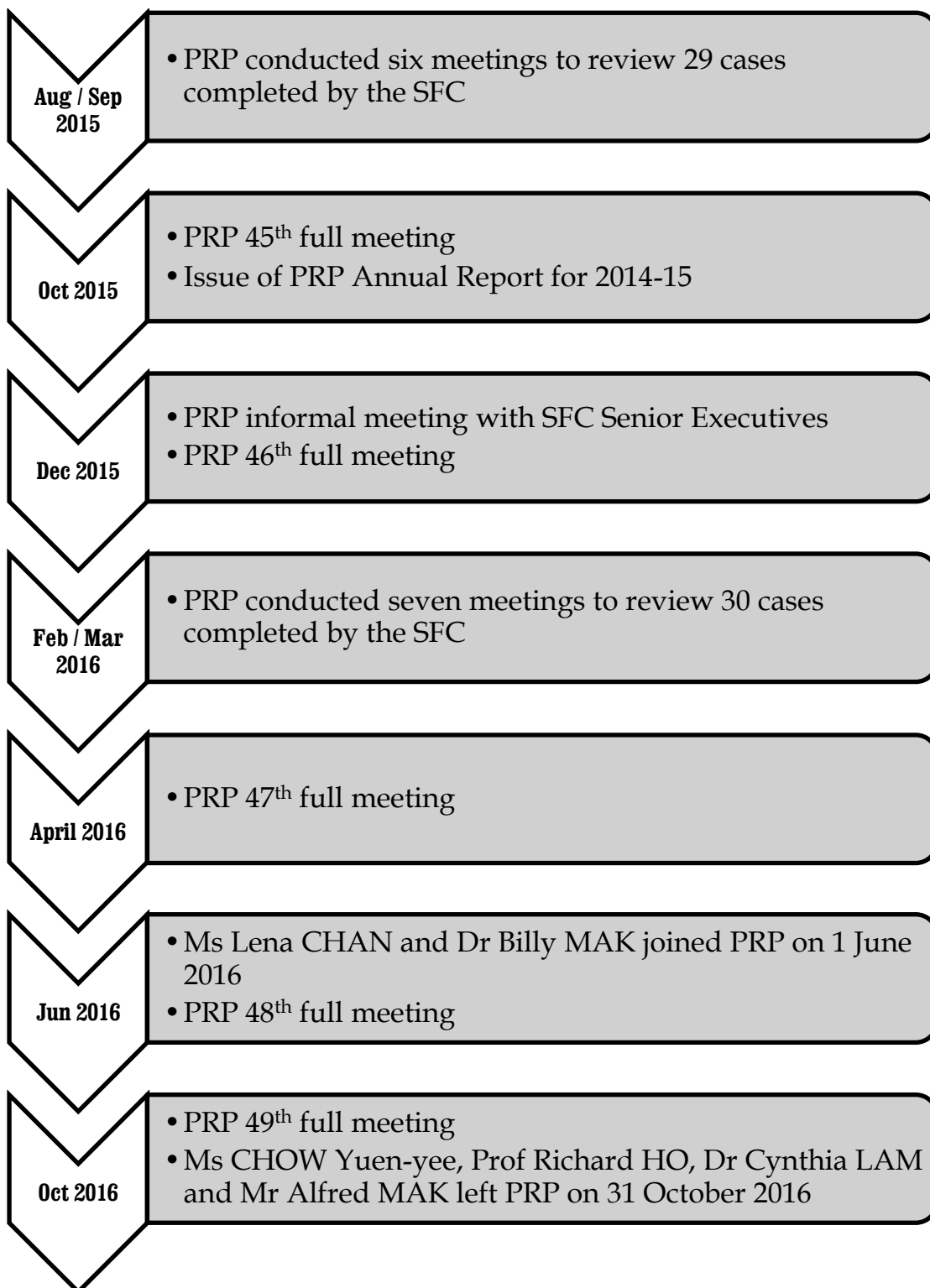
Representative of the Secretary for Justice Ms. CHEUNG Kam-wai, Christina, JP since 26 February 2015

Secretariat:

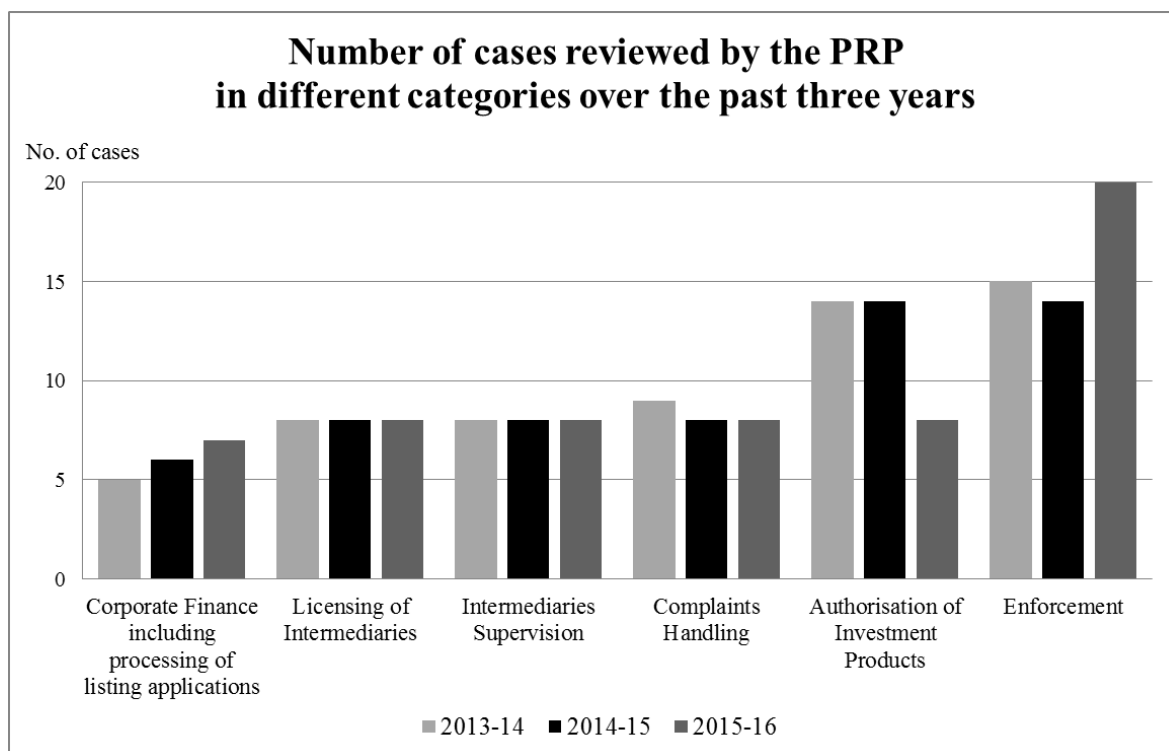
The Financial Services Branch of the Financial
Services and the Treasury Bureau

Chapter 2 Highlights of the work of PRP

2.1 Major events in 2015-16 are set out below –



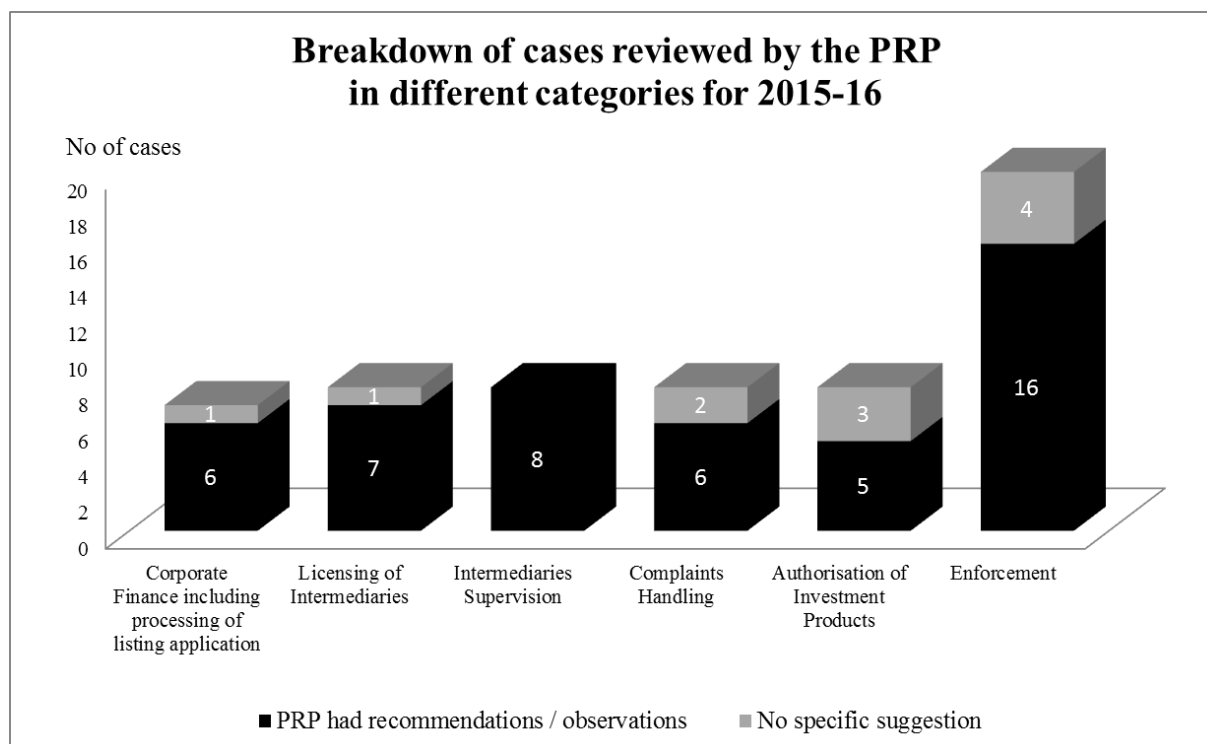
2.2 Distribution of the cases which PRP has reviewed in the past years –



2.3 Distribution of the 59 cases which PRP has reviewed in 2015-16 -

	No. of Cases
Corporate Finance including processing of listing applications	7
Licensing of Intermediaries	8
Intermediaries Supervision	8
Complaints Handling	8
Authorisation of Investment Products	8
Enforcement	20
Total	59

2.4 Among these 59 cases reviewed, PRP had made recommendations or observations on 48 cases representing 81% of the cases under review.



2.5 A thematic case review of the investigation procedures in the Enforcement Division has also been conducted, with findings set out in Chapter 3.

2.6 Highlight of PRP's observations and recommendations for other case reviews are set out in Chapter 4. Follow-up actions taken by the SFC in response to PRP's recommendations in the Annual Report for 2014-15 are set out in Chapter 5.

Chapter 3 Thematic Case Reviews of the Investigation Procedures in Enforcement

3. Enforcement

3.1 PRP reviewed 20 cases relating to the work of the ENF. The cases were concluded by the ENF during the period from December 2014 to November 2015. Majority of the cases selected for review involved relatively long processing time. PRP took an in-depth study of the investigation procedures taken for each case.

3.2 PRP requested the SFC to provide a set of investigation procedures taken in the issue of Section 182 Directions and Section 183 Notices for review. Noting market participants' comments on the issue of Section 182 Directions and Section 183 Notices by the SFC, PRP studied the consideration and basis for the issue of Section 182 Directions and Section 183 Notices, the checks and balances imposed and the measures taken by management of the SFC to monitor its staff in exercising investigation power. Details of the findings are set out at paragraph 3.49 to 3.69.



(a) *Long Processing Time*

3.3 For the 20 cases under review, the processing time ranged from one month to five years 11 months. PRP discussed with ENF colleagues the procedure taken in case investigation. While PRP appreciated efforts made in an investigation, it reminded the SFC that an unduly long processing time was undesirable to both the SFC and targets under investigation.

3.4 PRP noted that in most of the lengthy cases the SFC had spent substantial time in the following procedures -

- (a) obtaining legal advice from SFC's in-house counsel, external counsel and the Department of Justice ("DoJ");

and

- (b) collecting evidence from suspects and witnesses residing out of Hong Kong.

For some cases under review, the time taken to obtain legal advice contributed to 60% of the total processing time.

Provision of Legal Advice

3.5 For a case under review, PRP noted that the ENF completed its fact finding within 14 months but spent a period of three years and six months to seek advice successively from SFC's in-house counsel, external counsel and the DoJ. PRP observed that the investigation process had taken an unreasonably long period of time which was due to delays at various stages of the process as a result of staff departure, heavy workload, change in counsel, decisions to obtain external legal advice etc. PRP also observed that the SFC should at the outset devise a clearly laid down strategy with regard to seeking legal advice so as to shorten the overall process of investigation.

3.6 For another case under review, PRP noted that over a period of approximately three years the ENF sought successive rounds of advice from SFC's in-house counsel and external counsel. PRP commented that it was highly undesirable as the party affected might allege that it was being prejudiced if ultimately legal action was to be taken after an undue long lapse of time.

§ PRP's recommendations

3.7 PRP enquired about the communication between the ENF with different groups of legal experts in seeking advice.

3.8 PRP recommended that the ENF should carefully identify suitable cases and issues before seeking legal advice. When seeking legal advice in-house, the ENF should put in place an expected timeframe with SFC's Legal Services Division ("LSD"). When an external counsel was

engaged, the ENF should put in place an effective system to monitor the progress of outside counsel's advice. The ENF should monitor the overall progress including to keep in view the advice given to avoid any duplication of efforts between the in-house team and external counsel.

3.9 PRP recommended that the ENF should provide more internal guidelines to its subject officers on how to handle legal advice from different parties. PRP commented that it was not uncommon that the ENF would receive different (if not conflicting) legal advice from different legal advisers on the same case. Subject officers should be provided with suitable guidance on how to follow-up such efficiently. The SFC should consider designating an officer at an appropriate level to take forward the case based on such legal advice.

3.10 PRP also recommended that the ENF should consider issuing interim replies or providing regular updates to those involved in the investigation. This was particularly important for cases involving long investigation period.

§ *SFC's responses*

3.11 The SFC agreed that cases should be pursued as quickly and effectively as possible to ensure fairness to the suspects and in order not to prejudice the investigation. To this end, the SFC implemented and would continue with the following measures –

- (a) The MoU entered between the SFC and the DoJ on 4 March 2016 set out the way in which the SFC would provide the findings and evidence of its investigation to the DoJ for the DoJ to furnish its advice within a reasonable time frame;
- (b) The ENF would follow-up closely with the LSD in obtaining its legal advice including prioritising cases. The LSD would critically manage its workload with a view to providing advice in a timely manner particularly

on high priority cases;

- (c) The ENF would review its policy on engagement of external counsel in suitable cases; and
- (d) Where external counsel was engaged, the LSD would keep track of the progress to ensure that external counsel's advice was obtained within a reasonable timeframe.

3.12 The ENF explained that multiple rounds of legal advice might be inevitable as very often after having considered the first piece of legal advice, additional investigation was required and further legal advice would need to be sought. The ENF and the LSD did work closely to coordinate the issues to be addressed to external counsel.

3.13 While acknowledging that it was possible that different legal advisers would provide different legal opinion, senior management of the ENF and the LSD would decide how best to resolve conflicting legal opinion basing on their experience and by conducting thorough discussions about the issues. As legal opinion was usually case specific, the ENF did not think that providing guidelines to subject officers would be of assistance.

3.14 The ENF and the LSD were exploring ways to obtain legal advice more efficiently. For example, whether the LSD should be asked to give advice at an earlier stage on whether further investigation was required and the feasibility of briefing out cases to external counsel at an earlier stage if it appeared that there were no internal resources to handle the matter within a reasonable timeframe.

3.15 The ENF did not consider it was appropriate to issue periodic updates to investigation suspects owing to secrecy obligations.

§ PRP's further comments to the SFC's responses

3.16 PRP was assured that senior management of the SFC would take a holistic review on work prioritisation in the ENF to improve upon the timeliness of investigation. PRP looks forward to the SFC's report on the comprehensive review.

Liaison with Regulators

3.17 PRP reviewed a number of potential market misconduct cases with suspected traders or witnesses residing overseas or in the Mainland. The investigation was most challenging as the SFC did not have investigation power over persons residing outside Hong Kong. PRP commented that the ENF should take more effective steps to deal with the risks and challenges associated with such cases, the number of which had been increasing.

§ PRP's recommendations

3.18 PRP recommended the SFC to enhance its cooperation with the China Securities Regulatory Commission ("CSRC") and other overseas regulators to handle suspected trading by people residing outside Hong Kong.

3.19 The ENF should provide more guidelines to subject officers on how to conduct investigation of potential market misconduct cases involving suspected traders residing outside Hong Kong.

§ SFC's responses

3.20 The ENF was very aware of the difficulties and challenges when investigating suspects or seeking evidence outside Hong Kong.

3.21 To this end, the ENF was regularly reviewing its means of investigation. It was worth-mentioning that the SFC had-

- (a) participated actively in the International Organization of Securities Commissions (“IOSCO”) which sought to improve regulatory standards in enforcement and cooperation with overseas and Mainland authorities;
- (b) entered into an Enforcement MoU with the CSRC in October 2014 to enable the provision of timely and effective investigatory assistance to each other regarding matters on Shanghai-Hong Kong Stock Connect; and
- (c) had regular meetings with the Enforcement Bureau of the CSRC, both at top and working level, to discuss how surveillance information exchange could be further enhanced.

3.22 The ENF would continue to consider all possible and legal means to obtain evidence both locally and overseas.

3.23 The ENF assured that it would train its teams regularly on how to investigate cases involving suspects not residing in Hong Kong and how to obtain international cooperation.

§ *PRP’s further comments to the SFC’s responses*

3.24 PRP invited the SFC to further report the effectiveness of its actions.



(b) *Work Prioritisation*

3.25 The ENF prioritised cases according to different categories, worked out an investigation plan with an expected timeframe and submitted the plan to the Enforcement Steering Committee (“ESC”) of the

ENF for endorsement. The ESC comprises Executive Director (Enforcement), Senior Director (Investigation), Senior Director (Surveillance), Senior Director (Discipline), Director (Policy and International) and Deputy Chief Counsel. PRP considered that prioritisation of cases had an impact on processing time.

§ *PRP's recommendations*

3.26 PRP enquired how the ENF prioritised its cases and how senior management monitored progress of cases under different priorities. PRP was concerned whether subject officers had been provided with adequate guidelines on how to prioritise work so that processing of cases would not be procrastinated unnecessarily.

3.27 PRP recommended that the ENF should review the prioritisation of cases, in particular, how different categories of case should be handled by case officers and monitored by senior management of the SFC.

§ *SFC's responses*

3.28 The ENF explained that the key factors for considering prioritisation of a case included complexity, sensitivity, novelty and amount of resources needed for its investigation. Cases with higher priority would be assigned to a more senior staff as a "Case Manager" and be given more resources and supervision. Irrespective of priority of cases, all cases would be regularly reviewed by the ESC or Mini-ESC. Cases with urgency or specific difficulties would also be reviewed by a Senior Director or above, as and when required.

3.29 The ENF advised that it had issued guidance notes to staff on work prioritisation. That said, the ENF acknowledged that it was difficult to set down all possible scenarios in a written guideline as it was common that the ENF needed to reprioritise work to tackle other urgent cases.

3.30 The ENF further explained that arising from substantial increase in cases for investigation in 2014-15, there had been some prolonged investigations.

3.31 In view of the recommendations by PRP, the ENF had commenced a comprehensive strategic review of its enforcement priorities and processes, which included case selection, case prioritisation, resources allocation and timeliness of enforcement action.

§ *PRP's further comments to the SFC's responses*

3.32 PRP looks forward to the SFC's report on the comprehensive review.



(c) *Communication with other Divisions for early detection and investigation of cases*

3.33 PRP questioned why irregularities in intermediaries had remained undetected for years during regular inspection. PRP considered that the effective supervision of intermediaries and listed companies was critical in upholding market quality. Early detection and timely action to handle any potential disciplinary and market misconduct cases was critical.

§ *PRP's observations*

3.34 PRP noted that the ENF received a potential market misconduct case on a listed company only when the company had suspended its trading for over one year due to financial issues. When the ENF took up the investigation, the Chief Financial Officer of the company had resigned. The evidence and documents had been destroyed.

3.35 In three other cases under review, PRP noted that the intermediaries under investigation had not complied with the SFC regulated requirements for a number of years. PRP questioned why the irregularities had remained undetected during routine inspection. PRP felt that had the ISD detected the irregularities earlier, the ENF might have commenced the investigation and disciplinary action more efficiently. PRP commented that an effective inspection and supervision of intermediaries was important for the protection of investors.

§ *SFC's responses*

3.36 For listed company, the SFC explained that since the establishment of the Corporate Regulation Team in the Corporate Finance Division in 2013, it had been able to detect suspected misconduct of listed companies in a more proactive and timely manner. The Corporate Regulation Team reviewed company announcements, conducted reviews of listed companies and referred suspected misconduct to the ESC. Moreover, the SFC had regular liaison meetings with Hong Kong Exchange and Clearing Limited ("HKEX"), the frontline listing regulator in Hong Kong, to discuss among others, the status of suspended listed companies under investigation. The SFC added that there could be many reasons why listed companies were suspended, and not all suspensions would trigger SFC's enforcement action.

3.37 As regards intermediaries' supervision, the SFC reported that all licensed firms were subject to routine inspections which involved an assessment of the firms' systems and controls, and compliance with relevant rules and regulations. The SFC added that the ISD adopted a risk-based inspection approach. No inspection could be a full "audit" or review of a licensed firm and therefore could not in practice identify all possible breaches and deficiencies.

§ *PRP's further comments to the SFC's responses*

3.38 PRP commented that there was room for improvement in communication among the different divisions in the SFC despite each had its area of functional focus and responsibility. The SFC should enhance internal communication, promote cooperation and make effective deployment of resources among divisions so as to enhance efficiency of regulatory work.

3.39 The SFC senior management assured PRP that the SFC would continue to develop greater internal communication and cross-divisional cooperation, both at an operational level and when developing regulatory policy. The ENF was studying the feasibility of inviting colleagues from other divisions to provide specialized advice to the investigation teams so that cases could be progressed more efficiently. The ENF would also determine its priorities and focus its resources accordingly.

3.40 PRP looks forward to the improvement.



(d) Communication with intermediaries under investigation

3.41 PRP reviewed a disciplinary case involving failure of an intermediary to act fairly and in the interest of the clients when it provided dark pool trading services to its clients. The intermediary had failed to comply with requirements of the regulated activities for a number of years.

3.42 The ENF took three years and five months to investigate the case. During the period, the ENF issued 15 rounds of Section 183 Notices to the intermediary asking for information. The intermediary subsequently reported that it would cease its dark pool business and the investigation ended.

3.43 The ENF explained that the main difficulties in the investigation rested with the provision of inconsistent and incorrect information by the intermediary under investigation.

§ *PRP's recommendations*

3.44 PRP recommended that the ENF should write to responding intermediaries to remind them of the expected quality and timeliness of response if the intermediaries had repeatedly failed to provide acceptable response.

3.45 PRP also shared with the SFC that some professional bodies did not allow their members to resign during the course of investigation. This would ensure that the licensed party could not evade its responsibilities simply by ceasing operation.

3.46 Noting the seriousness of the misconduct of the intermediary in the case under review, PRP recommended that the SFC should provide more guidelines to its case officers on appropriate follow-up actions to supervise intermediaries in the longer term. The SFC should conduct more inspections of intermediaries and pay attention to corporate governance of intermediaries.

§ *SFC's responses*

3.47 The SFC explained that while there were no statutory provisions prohibiting any suspect from resigning, it had the disciplinary jurisdiction over people who had left the industry but had committed misconduct while licensed.

3.48 The SFC reported that the ISD adopted a risk-based approach in the regulation of LC, and LCs identified as higher risk firms would be subject to a shorter inspection cycle. The ISD would also pay attention to corporate governance of LC, as appropriate.



(e) *Investigation Procedures on the issue of Section 182 Directions and Section 183 Notices*

3.49 PRP carried out an in-depth study on the issue of Section 182 Directions and Section 183 Notices under each case review. PRP not only focused on the procedures taken, but also looked into the system of checks and balances over the issue of the statutory notices.

3.50 The ESC of the ENF would decide whether to open a case for investigation. Only when the ESC had given an approval would the ENF start an investigation.

3.51 The ENF would first issue a Section 182 Direction. The Section 182 Direction served as a formal proof of authority to investigate and define the investigation scope. SFC employees were named in the Section 182 Direction as “Investigators”.

3.52 The ENF would issue Section 183 Notices to conduct the investigation. Section 183 Notices gave Investigators the power to require a suspect or a person whom the Investigators had reasonable cause to believe that he/she was in possession of information relevant to the investigation under the Section 182 Direction to (a) produce documents and explain them; (b) attend an interview with the Investigators; and (c) give any other reasonable assistance to the Investigators, including responding to any written question raised by the Investigators.

Section 182 Direction

3.53 PRP noted that in a case review, a Senior Director of the ENF had authorised some 30 SFC staff members as Investigators. PRP enquired why the ENF needed to authorise such a large pool of staff members as Investigators for an individual case.

3.54 PRP also noted that Section 182 Direction provided only general description of the case. There was no detail on the scope of investigation.

3.55 In another case, PRP noted that the ENF issued a Section 182 Direction and started an investigation before seeking an endorsement from the ESC. PRP was told that such exceptional arrangement was made in view of urgency to conduct the investigation. PRP questioned on the checks and balances imposed for investigating urgent cases.

§ PRP's recommendations

3.56 PRP invited the ENF to elaborate on the criteria and consideration to commence investigation prior to seeking an endorsement from the ESC.

3.57 PRP also recommended that the ENF should review the need to authorise such a large pool of staff as "Investigators" in a Section 182 Direction.

§ SFC's responses

3.58 The ENF provided the following explanations -

- (a) The ENF investigation team might issue a Section 182 Direction before it was endorsed by the ESC after taking into account various factors including, whether (i) there was immediate risk or jeopardy to client assets, (ii) there was a likelihood that any illegal proceeds would soon be transferred out of Hong Kong, and (iii) whether the wrongdoer would soon abscond from Hong Kong. The investigation team would decide the action on a case by case basis. As a matter of practice, the issue of such direction must be approved by the Senior Director or Executive Director of ENF; and

- (b) the description of the case in the Section 182 Direction should provide flexibility for the subsequent investigation.

3.59 As regards the need to authorise a pool of Investigators, the ENF explained the arrangement was to deploy resources flexibly and to facilitate substitution of staff working on a particular investigation to properly manage resources. The ENF informed PRP that in practice, a much smaller number of staff worked on the investigation.

3.60 The ENF did not see any unwarranted risk in authorising a large pool of Investigators.

Section 183 Notice

3.61 PRP noted that it was common for the ENF to issue a number of Section 183 Notices in each case investigation. The Section 183 Notices were signed by the SFC staff who were named as “Investigators” in the Section 182 Direction. There was no post title or ranking level of the Investigators printed on the Section 183 Notice.

3.62 PRP commented that some questions which the ENF asked the intermediaries by the Section 183 Notices were only general market knowledge. PRP questioned if the ENF had assigned any suitable officer to review the questions and information as requested in the Section 183 Notices.

System of Checks and Balances on issue of Section 183 Notices

3.63 PRP noted that the ENF imposed a different level of checks and balances on the issue of Section 183 Notices to banks and to brokers.

3.64 For Section 183 Notices issued to banks seeking customer's information, a prior written certification from director level or above was required to confirm that the disclosure of information or production of documents sought was necessary for the investigation. However, no such requirement was required for issuing Section 183 Notice to brokers. PRP requested the ENF to elaborate on the rationale behind the different arrangements.

§ PRP's recommendations

3.65 PRP recommended the ENF to –

- (a) consider to put in place more checks and balances over the issue of Section 183 Notices to brokers;
- (b) impose effective measures to guard against the possibility that the extent of information which brokers were asked to provide under Section 183 Notices could be more than necessary; and
- (c) designate officers of an appropriate rank as an Investigator to sign Section 183 Notices. The Investigator should include his ranking level and post title in the Notice.

3.66 PRP further recommended the ENF to explore the feasibility of a maker-checker system. For example, a Section 183 Notice initiated by an Investigator was to be reviewed and signed by another Investigator whose seniority was higher than the originating Investigator before the issue of Section 183 Notices to brokers.

§ SFC's responses

3.67 The ENF would review whether there was a need to change the monitoring and control over the issue of Section 183 Notices from an accountability and efficiency standpoint.

§ PRP's further comments to the SFC's responses

3.68 PRP considered that the current checks and balances over the issue of Notices to brokers should be enhanced.

3.69 The current procedure allowed all staff named as "Investigators" by the SFC to issue Section 183 Notices to brokers without prior endorsement by supervisors. This posed a risk that Investigators might ask for more than absolutely necessary information under the Notices, causing undue pressure on brokers. The SFC should improve its checking mechanism.



§ Concluding Remarks

3.70 The checks and balances over the issue of statutory notices to brokers should be enhanced. There was room for improvement in work prioritisation, internal communication, and seeking legal advice from external counsel.

3.71 PRP looks forward to the review and report by the senior management on the enhancement of these areas which would improve timeliness in case handling as a whole.

3.72 PRP also recorded its appreciation to the ENF in facilitating the thematic case review. In some case studies, PRP noted passion, patience and professionalism exhibited by individual case officers in the case investigations. PRP believed that senior management's review would not only improve the procedures, but also help prepare case officers for new challenges ahead.

Chapter 4 Observations and Recommendations of Case Reviews

4.1 Intermediaries Supervision

4.1.1 PRP reviewed six inspections and two prudential visits conducted by the ISD. The completion time ranged from four to ten months.



(a) *Conclusion of Inspection*

4.1.2 PRP reminded the ISD of the importance to conclude an inspection case with reasonable aptness.

4.1.3 As stated in PRP Annual Report for 2014-15, the ISD should instil a good sense in its case handling. Any deficiency detected in the inspection of intermediaries should be rectified as soon as possible. This is important as SFC's regulatory work aims to protect investors, among others. Intermediaries also expect that inspections be concluded within a reasonable timeframe. Any unnecessary holding up of inspections would result in undue pressure on intermediaries.

4.1.4 In response to PRP's recommendations to strengthen the monitoring mechanism in 2014-15, the ISD reported that it had implemented an enhanced case monitoring system from early 2014. The enhanced system provides alerts to senior officers for monitoring. Outstanding cases, which were defined as "long-dated" matters by the SFC, would be tabled at the weekly Divisional Steering Committee chaired by the Executive Director (Intermediaries). With the enhancement, the ISD advised that it would not adopt PRP's recommendation on the setting up of performance pledges for completion of inspection process. The SFC advised that it was not feasible to set any rigid timeframe or performance pledges for issuing a letter of deficiencies and completing the whole inspection process as the number and complexity of issues arising from an

inspection varied widely between firms.

4.1.5 For 2015-16, PRP reviewed three routine inspection cases. For one case under review, PRP noted that it took nine months to conclude. For the other two cases, PRP noted that it took some four months to conclude.

§ PRP's observations

4.1.6 PRP enquired why a routine inspection would take nine months to conclude. The case officer responded by pointing out that the inspection was completed upon the issuance of the letter of deficiencies. That was issued within four months from the commencement of the inspection.

§ SFC's explanation on inspection process

4.1.7 Inspection was an important tool to maintain market integrity and to protect investors. During onsite inspection, the ISD would examine selected books and records of the LC.

4.1.8 The ISD would issue a letter of deficiencies within "four months" starting from the commencement of the inspection. In cases where the inspection was likely to remain outstanding after four months, the ISD would issue an interim letter of deficiencies to ensure that the inspected firm was informed of interim findings. A final letter of deficiencies was always sent to the inspected firm upon completion of the inspection. The inspection team had been following this internal guideline for many years. For 2015-16, 84% of inspection cases had had letter of deficiencies issued from 3.5 to four months after the commencement of the inspection.

4.1.9 There was no set timeframe on subsequent follow-up work in response to deficiencies identified in a letter of deficiencies and hence the conclusion of an inspection. The inspection team could only issue a

closure letter to the firm to conclude the inspection after reviewing the firm's rectification plans and where necessary, making follow-up enquiries, and the responsible Senior Manager/Associate Director was satisfied that the firm's rectification steps should properly rectify major breaches and address significant systematic risks identified during the inspection.

§ *PRP's further comments to the SFC's explanations*

4.1.10 PRP reminded that the importance of concluding an inspection and rectifying deficiencies of an intermediary at the soonest possible time need not be further emphasized. PRP deferred this to the senior management of the SFC to take effective measures for timely conclusion of an inspection, follow up on deficiencies identified and monitoring of remedial action taken by various teams in the ISD.



(b) The ISD Case Monitoring System

4.1.11 PRP noted that an ISD case officer had not properly used the case monitoring system to manage an outstanding case, resulting in closure of a prudential visit without the issue of a closure letter.

4.1.12 The prudential visit which consisted of a one-day courtesy visit was closed without the issuance of a closure letter in the case monitoring system. The case officer explained that although he received system alerts of the outstanding action required in the case, he was not familiar with the operation of the case monitoring system and therefore failed to act on the system reminders.

4.1.13 For another inspection case involving sponsor inspection, PRP noted that while the ISD was expecting a progress report from an intermediary, it had marked case conclusion right after it had issued an closure letter and the system ceased generating alerts on the follow-up action. PRP enquired if it would be a better course to keep the case open until the ISD had received confirmation.

§ PRP's recommendations

4.1.14 PRP made the following recommendations-

- (a) the ISD should provide more training to staff members on the operation of the case monitoring system and how the system could help officers to effectively manage their cases; and
- (b) the ISD should review the appropriate time when a case should be closed when follow-up action was still pending and subject to ISD's monitoring. The ISD should provide its staff with adequate guidelines in this regard.

§ SFC's responses

4.1.15 The ISD held induction training periodically, which included but not limited to, explaining the various functionalities of the case monitoring system. The ISD elaborated that in the training sessions held in 2015, it had specifically discussed with its staff when key alerts to outstanding cases would be generated.

4.1.16 Apart from training, the ISD also rolled out new alerts and other enhancements to the case monitoring system to enhance the control over monitoring of prudential visits. Staff were kept posted by an email circulated to all ISD staff in March 2015.

4.1.17 For the sponsor inspection case, the sponsor team supplemented that it had a manual system of bringing up follow-up work to the Manager in-charge. The team reported that the case under review was the only case that required follow-up action and hence considered the manual bringing-up system sufficient.

§ PRP's further comments to the SFC's responses

4.1.18 Marking the case "Closed" when follow-up action was still expected could lead to possible oversight when a case should still be monitored. PRP recommended the ISD to review the appropriate time when its staff should close a case in the ISD case monitoring system having considered that in some cases follow-up action were still pending. The ISD assured that there were procedures and mechanisms in place to monitor follow-up action after letters of deficiencies were issued and when an inspection should be closed. The SFC should also provide staff with adequate guidelines.



(c) *Investor Education*

4.1.19 The ISD noted that an intermediary was operating an unauthorised fund that was not subject to SFC's regulation. The ISD was concerned that the Responsible Officers and the directors of the intermediary might have caused other investors of the unauthorised fund to be treated unfairly and referred the case to the ENF for investigation.

4.1.20 In another special inspection on provision of pre-Initial Public Offering ("pre-IPO") trading service to clients, PRP noted that the ISD took cautious steps checking on the compliance of the intermediary in the pre-IPO activities.

§ PRP's recommendations

4.1.21 PRP noted that the ISD had generally followed its operational guidelines and procedures in processing the cases.

4.1.22 PRP recommended that the SFC should provide more investor education on risks associated with investment in unauthorised fund and pre-IPO trading.

§ SFC's responses

4.1.23 The SFC accepted PRP's suggestions.

4.1.24 The Investor Education Centre ("IEC") provided education covering topics about potential risks of investing in unauthorised funds on "The Chin Family" website and its Facebook, and contributed newspaper columns in June 2016.

4.1.25 The IEC would also liaise with the SFC with a view to enhancing investor education on operation and risks of pre-IPO trading.



(d) *Effectiveness of Inspection*

4.1.26 Based on PRP's review of the ENF cases, serious deficiencies of internal control of a number of intermediaries were noted to have remained undiscovered for a prolonged period. PRP queried why such internal deficiencies could have escaped detection. PRP questioned the effectiveness of inspection to identify material non-compliance and serious deficiencies of internal control.

4.1.27 Specifically, PRP asked if the ISD staff were provided with –

- (a) an inspection checklist so that they knew what to check; and
- (b) sufficient guidelines so that they knew how to check regulatory compliance in a consistent manner.

4.1.28 PRP was concerned why substantial deficiencies of internal control had not been detected in the ISD inspections. In one case under review, PRP noted that a licensed intermediary with a 24-year history was reported to have no operational manual, staff handbook or written guideline governing procedures for handling requests for transfer of funds to third party accounts.

§ PRP's recommendations

4.1.29 PRP enquired about the work of the inspection planning team, and the inspection frequency for LCs that were not classified as "high risk".

4.1.30 PRP asked to be provided with the inspection checklist and recommended the ISD to review the adequacy of the guidelines provided to the inspection team on checking compliance of an intermediary.

§ SFC's responses

4.1.31 The ISD reported that the inspection planning process was handled by a designated Director in the inspection team. Adopting a risk-based approach, the director would identify inspection priorities and prepare a list of inspection targets. Other SFC divisions/departments would also be invited to comment annually on risk factors for the identification of possible inspection priorities. The list of inspection targets would be approved by the Executive Director (Intermediaries) and then discussed and reviewed by the SFC Executive Committee.

4.1.32 LCs with higher risk would generally be inspected in a shorter timeframe, say with a four- to five-year inspection cycle. A LC might also be subject to an even shorter inspection cycle where circumstances warranted.

4.1.33 The ISD explained that different inspection checklists had been developed to cover different business activities and the checklists were subject to ongoing review.

4.1.34 In 2015, the inspection team conducted 294 on-site inspections. The ISD explained that it adopted a risk-based inspection approach and hence the inspection could not be equivalent to a full "audit" of a LC.

4.1.35 The ISD further explained that it had adopted various measures to ensure the effectiveness of the inspection approach. The ISD would take into account PRP's comments when reviewing the adequacy and effectiveness of the measures and would continuously strengthen its supervisory approach by continuously identifying prevalent issues.

§ *PRP's further comments to the SFC's responses*

4.1.36 PRP invited the senior management to examine the inspection process of the specific cases reviewed by PRP. The ISD was recommended to consider why it had not been able to detect basic internal deficiencies of the intermediaries in these cases with a view to improving effectiveness of supervision of intermediaries in future. PRP would monitor the effectiveness of the measures adopted in the inspection approach in future case reviews.



§ *Concluding Remarks*

4.1.37 PRP noted practices that warranted improvement: staff were not familiar with the case monitoring system which assisted them to manage cases with outstanding action, and staff marked the case "Closed" when rectification from the intermediary was still pending. The ISD should take steps to guard against oversight of follow-up action.

4.1.38 The ISD had internal guideline stipulating that staff should issue a letter of deficiencies to an intermediary within four months after the commencement of an inspection. PRP pointed out repeatedly that the ISD should not hold up the issue of the letter until the expiry of the four-month period. PRP would defer this observation to SFC senior management.

4.1.39 PRP recommended that the ISD should examine the inspection process of the specific cases reviewed by PRP with a view to improving effectiveness of supervision of intermediaries in future. PRP would monitor the effectiveness of the measures adopted in the inspection approach in future case reviews.

4.2 Licensing of Intermediaries

4.2.1 PRP reviewed eight licensing applications, including two on approval as substantial shareholders and one on provisional representative licence.

4.2.2 The processing time ranged from 28 days to one year and one month.



(a) *Application for approval as substantial shareholders*

4.2.3 PRP reviewed two applications for approval as substantial shareholders. One application involved a new shareholder while another one involved an approved substantial shareholder applying for approval for becoming a substantial shareholder of another LC.

4.2.4 In accordance with Section 132 of the SFO, the SFC may approve an applicant to become or to continue to be a substantial shareholder of a licensed corporation. The ordinance states that the SFC shall refuse the application unless the applicant satisfies the SFC that the corporation will remain a fit and proper person to be licensed if the application is approved.

4.2.5 The SFO also provides that it shall be a condition of an approval that the substantial shareholder shall at all times keep the SFC informed of the particulars of contact details and inform the SFC of any change in the particulars within 14 days of the change.

§ *PRP's recommendations*

4.2.6 PRP commented that market participants might not be aware of the statutory requirements that they need to provide the LIC with updated information of change of their particulars within 14 days of

change. Market participants might not have a good understanding on the requirements of a substantial shareholder of LC.

4.2.7 PRP recommended the LIC to provide more public education, say publishing frequently-asked questions (“FAQ”), to remind market participants of the statutory requirements.

§ *SFC’s responses*

4.2.8 To facilitate understanding by substantial shareholders of their statutory obligations, the LIC would revise the application form stating that substantial shareholders were required to provide updated information of their directors when they applied for approval to become substantial shareholders of another LC.



(b) Application for a provisional representative licence

4.2.9 PRP reviewed a case in which an applicant submitted an application for a provisional representative licence and an application as a Responsible Officer to carry on Type 1, 4 and 9 regulated activities of a firm.

§ *PRP’s recommendations*

4.2.10 PRP enquired how provisional licences were being monitored.

4.2.11 PRP noted that no expiry date was specified on a provisional licence. A provisional licence would expire when a full licence was granted. As a provisional licence empowered the holder to carry on the same scope of regulated activities as a normal licence, PRP recommended that there should be an effective system to monitor and review provisional licences issued.

§ SFC's responses

4.2.12 Under section 120 of the SFO, an individual holding a provisional licence under section 120(2) must also have applied for a representative licence under section 120(1). The LIC reported that in line with this statutory requirement, it had developed its internal system with a feature that every licensee holding a provisional licence must have a pending application for a corresponding licence. The duration of a provisional licence should correspond to the aging period of the related normal licence application.

4.2.13 The applications for the normal licence would be monitored by the LIC's senior management. The LIC case system generated aging reports once every two weeks and long outstanding applications would be escalated to LIC senior management for the purpose of effective monitoring.



(c) *Application for authorised financial institutions*

4.2.14 PRP reviewed an application from a bank to carry on Types 1 and 4 regulated activities. The applicant also applied to the Hong Kong Monetary Authority ("HKMA") for the approval of the proposed appointment of its Executive Officers. In order to become a registered institution under the SFO, the bank has to be firstly approved by the HKMA as an authorised financial institution with a banking licence.

4.2.15 The case took more than one year to complete. The LIC explained that significant amount of time was spent by the HKMA on-

- (a) vetting of the proposed Executive Officers;
- (b) waiting for the Independent Assessment Report ("IAR") from the bank; and
- (c) assessing the IAR.

4.2.16 The LIC and the HKMA jointly approved the application two weeks after the HKMA was satisfied that the proposed Executive Officers were fit and proper to be licensed for the regulated activities.

§ *PRP's recommendations*

4.2.17 PRP noted that the LIC had generally followed its operational guidelines and procedures in processing the case.

4.2.18 PRP recommended that the LIC should liaise with the HKMA with a view to providing an estimated timeframe for the vetting of the Executive Officers. The LIC could better manage timing of the application.

§ *SFC's responses*

4.2.19 The LIC considered that its current coordination with the HKMA was effective.

4.2.20 The LIC was working closely with the HKMA on applications for registration as a registered institution, including requesting the HKMA to provide the LIC with monthly reports on progress of applications, holding meetings and maintaining close communication with the HKMA to discuss issues of mutual concern on the applications. The current arrangements enabled it to process applications with a reasonable estimate of timeframe.

§ *PRP's further comments to the SFC's responses*

4.2.21 PRP noted that the LIC considered its monitoring mechanism effective. In this aspect, PRP would continue to monitor the effectiveness of the mechanism and put forth recommendations to expedite process in future case reviews.



§ Concluding Remarks

4.2.22 PRP would monitor the effectiveness of the follow-up actions taken by the LIC and the cross-party coordination between the LIC and the HKMA; and provide further recommendations to the LIC to enhance its procedure in future case reviews.

4.3 Authorisation of Investment Products

4.3.1 PRP reviewed eight completed authorisation cases handled by the IPD, five of which were subject to the six-month application lapse policy introduced on 1 January 2014. The processing time of all eight applications ranged from five to 11 months.

4.3.2 Among the cases, five applications involved vetting from more than one regulator.



(a) *Six-month application lapse policy*

4.3.3 PRP was glad to acknowledge the noticeable improvements in processing time after the introduction of the six-month application lapse policy. The authorisation time in 2014 was reduced by about 38% to less than four and a half months on average.

4.3.4 PRP invited the SFC to liaise with other regulators on extending the six-month application lapse policy to co-regulated investment products. On 9 October 2015, the SFC announced the extension of the six-month application lapse policy to Mandatory Provident Fund ("MPF") products and pooled retirement funds ("PRF") for a six-month pilot scheme effective on 9 November 2015. On 22 April 2016, the SFC announced the formal adoption of the six-month application lapse policy for MPF products and the PRF effective on 9 May 2016.

4.3.5 With the introduction of the Mainland-Hong Kong Mutual Recognition of Funds Scheme ("MRF") on 1 July 2015, there should be more overseas fund houses applying for authorisation in Hong Kong. As at 31 August 2016, the SFC authorised 44 Mainland funds and the CSRC approved six Hong Kong funds under the MRF arrangement.

4.3.6 PRP also recommended various improvement measures for the SFC's consideration. The measures were set out in the ensuing

paragraphs. PRP was glad to note that the IPD had adopted most of the recommendations in the revamped fund authorisation process.



(b) Application for new mandatory provident fund requiring the SFC's authorisation and the MPFA's approval

4.3.7 PRP reviewed three applications which comprised constituent funds of an MPF scheme and approved pooled investment funds. An approval from the Mandatory Provident Fund Schemes Authority ("MPFA") was required. The processing time ranged from five months to 11 months.

4.3.8 PRP noted that in one application involving two sub-funds, the IPD closely followed up with the applicant on the outstanding comments and the case progress with the MPFA. The subject officer explained that the applicant made numerous partial responses in addressing the disclosure requirements of the funds.

4.3.9 Subject officer also explained that the application involved special features and risks of target date funds. As a result, a significant amount of time was spent on making multiple rounds of submission and comments.

§ PRP's recommendations

4.3.10 PRP recommended that the IPD should provide more guidelines to the industry on the application concerning target date funds.

4.3.11 PRP also looks forward to a more streamlined and efficient authorisation process after the extension of the six-month application lapse policy to MPF products.

§ SFC's responses

4.3.12 The IPD accepted the recommendation and published guidance to the industry regarding the disclosure requirements of target date funds in March 2015 under the FAQs section of SFC's website. Such guidance was subsequently incorporated into the "Guide on Practices and Procedures for Application for Authorisation of Unit Trust and Mutual Funds" ("the Guide") issued by the IPD under the revamped fund authorisation process.

4.3.13 The IPD also advised that the IEC had adopted PRP's recommendation by providing information on the key features and risks of target date funds at its website.

4.3.14 The IPD explained that with the extension of the six-month application lapse policy to MPF products on 9 May 2016, the applicant must first submit its application to the MPFA for approval-in-principle. The IPD would only take up the application after the MPFA had given its approval-in-principle. The IPD would count the six-month application time with effect from its formal take-up date.

§ PRP's further comments to the SFC's responses

4.3.15 It was crucial to have a lead approval authority for efficient authorisation process involving more than one regulator. The arrangement of obtaining the MPFA's approval-in-principle to MPF fund applications would help speed up the whole process.

4.3.16 PRP reminded that there might be some overlapping on vetting of fund applications between the SFC and the MPFA on disclosure requirements. The IPD should consider further streamlining the procedure.

4.3.17 PRP looks forward to SFC's report on effectiveness of the new policy after its formal adoption on 9 May 2016.



(c) *Providing checklist on the disclosure of the PRC tax related information*

4.3.18 PRP reviewed an application involving a sub-fund invested in China A shares through the Renminbi Qualified Foreign Institutional Investor ("RQFII") quota. The case took six months to complete.

4.3.19 The IPD explained that despite its reminder email and various rounds of comments provided to the applicant, the applicant took a significant amount of time to respond and only until after the IPD issued a letter of mindedness, the applicant fully and properly addressed IPD's comments.

4.3.20 The IPD explained that the long outstanding comments included, among others, the disclosure of PRC tax related information.

§ *PRP's recommendations*

4.3.21 PRP recommended that the IPD should provide a checklist or a template for applicants to provide PRC tax related information.

4.3.22 PRP noticed that since the implementation of the Shanghai-Hong Kong Stock Connect, it had been a standard requirement to disclose tax information and the procedures involved were relatively routine. Provision of the checklist or the template would facilitate applicants' understanding on IPD's requirement for a timely and quality submission.

§ *SFC's responses*

4.3.23 The IPD accepted the recommendation.

4.3.24 As part and parcel of the revamped fund authorisation process,

to facilitate applicants' preparation of their new fund applications including the submission of quality advance drafts of the funds' offering documents with proper disclosure, the IPD published a new Guide. The Guide included a number of minimum disclosure requirements covering investment strategy and key risks for funds' offering documents.

4.3.25 The Guide contained PRC taxation related minimum disclosure for RQFII/QFII funds, such as warning and confirmatory statements and PRC tax related minimum risk disclosure templates.



(d) Imposing deadline for Applicants' response

4.3.26 PRP reviewed a relatively routine application involving three sub-funds. The application took six months to complete.

4.3.27 The IPD subject officers explained that the long processing time was mainly attributable to the applicant taking prolonged response time, submitting only partial responses to the IPD's requisitions and providing inconsistent information. The IPD had issued several rounds of comments, made telephone calls with the overseas applicant, and issued a letter of mindedness.

§ PRP's recommendations

4.3.28 PRP recommended that the IPD should impose a deadline for applicants to provide a proper and substantive response to the IPD.

§ SFC's responses

4.3.29 The IPD accepted the recommendation.

4.3.30 The IPD reported that under the revamped fund authorisation

process, with a view to shortening turnaround time of applicants, the IPD would require applicants to provide a proper, complete and substantive response to the IPD's requisitions within a prescribed time limit ("response time limits"), failing which the application might be refused subject to SFC's right to grant an extension.

4.3.31 The IPD would remind applicants of the response time limits in its first requisition and subsequent requisitions issued to the applicants.



(e) *Revamped Fund Authorisation Process*

4.3.32 SFC's revamped process was first launched on 9 November 2015 under a six-month pilot arrangement. On 22 April 2016, the IPD announced that it would formally adopt the enhanced revamped process on 9 May 2016. The process would also be extended to application of Mainland funds seeking authorisation under the MRF arrangement.

4.3.33 Under the revamped process, fund applications were classified into "standard" and "non-standard" types. Standard applications, if authorised, were aimed to be completed on average between one to two months while non-standard applications, if authorised, were targeted to be completed on average within two to three months from the date of taking up the applications.

4.3.34 PRP discussed with SFC's senior executives about the revamped fund authorisation process at its informal meeting held in December 2015. Discussions included classification of applications, updating of SFC's guidelines, general feedbacks from the fund industry and PRP's observations on fund application process.

4.3.35 PRP invited SFC's senior executives to elaborate on the following areas -

- (a) communication with the industry on the revamped fund authorisation process;
- (b) classification of fund applications and applicants' response to the classification;
- (c) timing on issue of a letter of mindedness; and
- (d) number of lapsed applications after the implementation of the six-month application lapse policy on 1 January 2014.

Communication with the Industry

4.3.36 PRP was told that in formulating the revamped fund authorisation process, the IPD set up a technical working group comprising representatives from asset management companies, industry associations, and legal professionals to finalize the revamped procedures, the minimum disclosure requirements for offering documents and the new information checklist for applications. After the launch of the revamped fund authorisation process, the IPD conducted industry briefings and would continue organising workshops and updating FAQ for market participants, where necessary.

Classification of the Fund Application

4.3.37 As regards the classification of fund applications, the IPD explained that standard applications generally included the following-

- (a) funds under application were sub-funds under an existing SFC-authorized umbrella fund;
- (b) new sub-funds which did not use financial derivative instruments extensively for investment purposes; and
- (c) new sub-funds with existing approved trustee/custodian and management company with good regulatory records.

The IPD aimed to have the standard applications authorised, if granted, on average between one to two months from date of taking up applications.

4.3.38 Applicants were informed of the classification of fund applications at the start of process in SFC's first requisition. Since the launching of the pilot arrangement on 9 November 2015, the IPD had not received any objection from applicants on IPD's classification of applications.

Issuing Letter of Mindedness

4.3.39 Under the revamped fund authorisation process, the IPD would issue letters of mindedness when it identified any substantial problem in the applications. The letter served to remind applicants to rectify the problem timely; otherwise the SFC might reject the applications. To ensure applicants would provide substantive and quality response in a timely manner, the IPD would also specify a deadline in each requisition and request applicants to provide substantive response to properly address SFC's question, failing which the applications might be refused. Under the revamped process, deterrent effect of issuing a letter of mindedness was more flexibly applied.

Number of lapsed application under the six-month application lapse policy

4.3.40 The IPD advised that no application had lapsed since the implementation of the six-month application lapse policy.



§ Concluding Remarks

4.3.41 PRP appreciates the efforts made by the IPD in improving the fund application process. PRP looks forward to SFC's further report on the effectiveness of the new measures.

4.4 Corporate Finance

4.4.1 PRP reviewed seven cases on processing of applications or providing confirmation as required under the Codes on Takeovers and Mergers and Shares Buy-back handled by the CFD. The processing time¹ ranged from one year to more than four years.

4.4.2 Apart from timeliness, PRP invited the CFD to review the transparency of its work. PRP noted that there was no performance pledge promulgated by the CFD on the completion of an application. In this regard, PRP invited the CFD to elaborate on its measures taken in case monitoring.



(a) *Application under the Codes on Takeovers and Mergers and Shares Buy-back*

4.4.3 Members reviewed different types of applications, including Rule 8.2 application (Offer Document Time Limit), Rule 25 application (Special deals with favourable conditions) and Rule 3.5 announcement. The processing time ranged from one year to four years nine months.

4.4.4 Among the cases involving relatively long processing time, PRP noted that the CFD had got an application approved within 8.5 months. However, the CFD had taken another 12 months to complete internal documentation before closing the case. The overall completion time was much longer although no outside party was prejudiced by the time taken to complete internal procedures for closing a case.

4.4.5 Upon enquiry, the CFD explained that a 8.5-month processing time was quite common given the complexity of the application. The CFD further elaborated that it was facing a stringent staffing position

¹ The CFD has explained that the processing time referred to the life span of the case on the electronic workflow system.

coupled with a drastic upsurge of applications between 2013 and 2015. As a result, there was a delay in filing internal correspondences to close the case.

Performance Pledges

4.4.6 PRP invited the CFD to reconsider setting up performance pledges as suggested in earlier Annual Report, and asked if there were sufficient internal guidelines provided to staff on timely processing of applications.

4.4.7 Subject officers explained that there were internal guidelines stipulating that they had to respond to applicants within five-business day for each round of enquiry. Normally, the CFD staff could comply with the guidelines.

§ PRP's recommendations

4.4.8 PRP recommended that the CFD should formulate performance pledges for different types of applications. Apart from enhancing the timeliness of completing an application, the performance pledges would provide applicants with an expected timeframe to get a decision from the CFD.

4.4.9 PRP considered the only internal guideline of five-business day response time for handling enquiries for different types of applications was inadequate. In this connection, PRP invited the CFD to provide some readily available statistics on processing time of different types of applications so that PRP could offer more practical recommendations for the CFD's consideration to draw up performance pledges.

4.4.10 PRP also recommended that the CFD should enhance transparency of its work.

§ *SFC's responses*

4.4.11 The CFD explained that the time taken for the CFD to process a case depended very much on the nature and complexity of the case and the time spent by applicants to respond to CFD's requisitions. For example, a case involving complex concerted party issues would take much longer to process than a more straightforward ruling. A transaction that was conditional on overseas regulatory consents would often span many months.

4.4.12 Therefore, there was a concern that publishing performance pledges for the Takeovers Team might not be meaningful as the performance pledges could only be broadly drafted to cater for the diverse nature of the work of the CFD.

§ *PRP's further comments to the SFC's responses*

4.4.13 The present arrangement of having only a five-business day response time internal guideline was undesirable. PRP would invite the CFD to seriously reconsider drawing up performance pledges and would monitor the timeliness of the applications in future case reviews.



(b) *Checks and Balances in Monitoring the case progress*

4.4.14 PRP invited the CFD to explain the measures taken by senior management to monitor case progress. In this connection, PRP was told that –

- (a) each application was handled by at least two officers to ensure efficient case management;
- (b) there was a weekly active case report system;
- (c) since July 2015, a designated staff had been engaged to

provide case officers monthly reminders to close cases;
and

- (d) the CFD staff attended regular team meetings, normally held weekly.

4.4.15 The CFD added that staff had regularly been reminded at meetings and by email that cases should be closed as soon as possible. The CFD staff would actively contact applicants who had not responded to a requisition for over a month to check the latest position. Cases remained outstanding for some months would be closed.

§ *PRP's recommendations*

4.4.16 PRP invited the CFD to elaborate on the effectiveness of actively chasing unresponsive applicants. PRP would particularly like to know how many cases had been closed due to inaction of the applicants for over a month and how senior management had supervised progress of outstanding cases.

4.4.17 PRP recommended that the CFD should seriously consider formulating performance pledges for different types of applications. This would improve upon timeliness on case completion and enhance transparency.

§ *SFC's responses*

4.4.18 The CFD reported that it had started a monitoring mechanism by way of a monthly reminder from February 2014. For all the relevant completed Exempt Fund Manager/Exempt Principal Trader applications (except the case under review by PRP and one active case), responses by the CFD and the applicants were prompt. The longest response time by applicants was only six weeks. Therefore, it was not necessary to invoke the mechanism and no case was closed due to applicants' inaction. As for other Code applications, a small number of cases were closed due to applicants' inaction.

4.4.19 In general, a case officer would regularly discuss outstanding cases with the director in charge who would also receive copies of incoming and outgoing correspondences.

§ *PRP's further comments to the SFC's responses*

4.4.20 It was crucial to have an effective case monitoring system for senior management to monitor the progress of cases. It was equally important to have an expected completion time for different types of applications for the sake of supervision and work transparency. In this connection, the CFD had assured PRP that it would take its internal guideline very seriously. PRP would follow up with CFD on the case monitoring system in future case reviews.



§ *Concluding Remarks*

4.4.21 PRP recommended the CFD to set up a case monitoring system for effective supervision.

4.5 Complaints Handling

4.5.1 PRP reviewed eight cases related to complaints against intermediaries and market.

4.5.2 PRP also studied the mode of operation of the Complaints Control Committee (“CCC”) which played a coordinating role in complaint handling.



(a) *Complaints Control Committee*

4.5.3 PRP noted that the External Relations Department (“ER”) of the SFC would coordinate all complaint cases received by the SFC for the CCC’s review.

4.5.4 The CCC was made up of representatives from various divisions. Chaired by a senior executive appointed by Chief Executive Officer of the SFC, the CCC met weekly to consider each complaint received, to decide whether further action was required and to assign the complaint to an operational division for follow-up. The ER was also responsible for notifying complainant of the CCC’s decision. The CCC was also tasked to establish and to modify the procedures for handling complaints in a consistent, transparent and accountable manner.

4.5.5 A complaint case, prior to being considered by the CCC, would be handled by the ER, which would prepare complaint summary reports, conduct preliminary fact finding, and clarify matters with the complainants. After being assessed by the CCC, cases involving no further action would be handled by the ER or operational divisions for reply to the complainants. Cases requiring further action would be passed to operational divisions.

4.5.6 The SFC advised that operational divisions would be responsible for handling complaint cases, including providing periodic

update to the complainants, informing the complainants of outcome of investigation and documenting reasons why no further action would be taken. The CCC would not ask operational divisions to report back the cases.

§ *PRP's recommendations*

4.5.7 PRP, having enquired about the terms of reference, composition and mode of operation of the CCC, recommended the SFC to enhance monitoring procedure of the CCC. PRP recommended that the CCC should also monitor progress of investigation taken by operational divisions.

§ *SFC's responses*

4.5.8 The CCC was given the mandate to allocate complaints that were within SFC's jurisdiction to operational divisions for further assessment, but not to monitor progress of complaint handling by the operational divisions. The operational divisions were responsible for monitoring progress of complaint handling after case allocation. Each operational division had its own internal procedure to handle and monitor the progress of complaints referred to it by the CCC.

§ *PRP's further comments to the SFC's responses*

4.5.9 PRP recommended that the SFC should consider putting in place measures, for example, to assign CCC to monitor the progress of handling complaints by operational divisions. This would help ensure that the different divisions in the SFC had handled complaints effectively.



§ *Concluding Remarks*

4.5.10 The SFC should consider putting in place measures, for example, to assign the CCC to monitor the progress of handling complaints by operational divisions to ensure all complaints being assigned to and handled by the different divisions could be completed effectively.

Chapter 5 **Follow-up action by the SFC on PRP's Recommendations in 2014-15**

5.1 Responding to the Annual Report of PRP for 2014-15, the SFC committed to report progress in the following areas –

- (a) the result of the SFC Fund Process Revamp;
- (b) the extension of the six-month application lapse policy for the authorisation of funds requiring approval by the SFC and the MPFA; and
- (c) the new working protocol with the DoJ.

5.2 The SFC also agreed to put in place a policy to inform targets of complaints who had been contacted by the SFC during enquiry process on a "without prejudice" basis when the SFC concluded that no further action would be taken.



(a) Result of the SFC Fund Process Revamp

5.3 The SFC Fund Process Revamp ("Revamped Process") was introduced on 9 November 2015 for a six-month pilot period.

5.4 During the pilot period, the Revamped Process received support from the industry. Quality of new fund applications had generally improved. Applicants provided more timely responses. The overall processing time was shortened.

5.5 The Revamped Process was formally adopted on 9 May 2016. The Revamped Process was extended to applications of Mainland funds seeking authorisation under the Mainland-Hong Kong Mutual Recognition of Funds Scheme to align their processing with other new fund applications.



(b) *Extension of six-month application lapse policy for the authorisation of funds requiring approval by the SFC and the MPFA*

5.6 The six-month application lapse policy for MPF products and PRFs was introduced on 9 November 2015 for a six-month pilot period.

5.7 During the pilot period, there was an overall enhancement on the authorisation process. New product applications were processed smoothly.

5.8 The six-month application lapse policy for MPF products and PRFs was formally adopted on 9 May 2016.



(c) *New working protocol with the DoJ*

5.9 On 4 March 2016, the SFC and the DoJ entered into a MoU to formalise and strengthen cooperation in handling criminal prosecutions.

5.10 The MoU reaffirmed SFC's firm commitment to work closely with the DoJ to ensure that all relevant corporate and financial services misconduct cases were dealt with in a timely and effective manner for protection of the Hong Kong securities and futures markets and the investing public.

5.11 The MoU stated that the DoJ would ensure timely advice was provided to the SFC. It also set out the way in which the SFC would provide the findings and evidence of its investigation to the DoJ for the DoJ to furnish its advice.

5.12 The MoU set out the areas for guidance by the DoJ and collaboration and cooperation between the SFC and the DoJ. The MoU stipulated that the SFC would refer five types of cases to the DoJ for advice on whether criminal prosecutions should be instituted, namely (i) market misconduct offences and other offences to fraudulently or recklessly induce others to invest money, (ii) offences involved element of intent to defraud, (iii) offences under the Companies (Winding Up and Miscellaneous Provisions) Ordinance, Company Ordinance and Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance, (iv) indictable offences with the maximum term of imprisonment exceeding two years, and (v) any other cases where the SFC considered it necessary to seek advice from the DoJ.

5.13 The MoU stated clearly that the exercise of SFC's power to commence and conduct prosecutions would not derogate from the powers of the Secretary for Justice in the prosecution of criminal offences.

5.14 The SFC uploaded the MOU on its website. The relevant links were as follows-

http://www.sfc.hk/web/EN/files/ER/PDF/MOU/MOU_DOJ_4Mar2016.pdf

http://www.sfc.hk/web/TC/files/ER/PDF/MOU/MOU_DOJ_4Mar2016C.pdf



(d) *Informing targets of complaints upon case conclusion*

5.15 On 24 June 2015, the SFC implemented the practice of issuing “no prejudice” letters to inform complaint targets of the outcome of complaints in which no further action would be taken.



Chapter 6 Way forward

6.1 In the year ahead, PRP would continue its work with a view to ensuring that the SFC adheres to its internal procedures for consistency and fairness.

6.2 PRP welcomes and attaches great importance to the views from market practitioners. Comments on the work under PRP's terms of reference can be referred to PRP through the following channels²-

By post to: The Secretariat of the Process Review Panel
 for the Securities and Futures Commission
 24th Floor, Central Government Offices
 2 Tim Mei Avenue
 Tamar
 Hong Kong

By email to: prp@fstb.gov.hk

² For enquiries or complaints relating to non-procedural matters, they could be directed to the SFC by the following channels –

By post to	:The Securities and Futures Commission, 35th Floor, Cheung Kong Center, 2 Queen's Road Central, Hong Kong
By telephone to	: (852) 2231 1222
By fax to	: (852) 2521 7836
By email to	: enquiry@sfc.hk (for general enquiries, comments and suggestions, etc.) : complaint@sfc.hk (for public complaints)

Chapter 7 Acknowledgement

7.1 PRP would like to express its gratitude to the support and corporation of the SFC in the review work. Special thanks must go to the Commission Secretary Mr Paul YEUNG and his team, for their assistance in facilitating the review work and in coordinating the responses from different divisions in the SFC.

**Process Review Panel
for the Securities and Futures Commission
October 2016**