

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

**Annual Report**  
**for 2013-14**

# Table of Contents

Chapter		Paragraph(s)
1	General Information	
	• Background	1.1
	• Functions	1.2 – 1.5
	• Membership	1.6 – 1.8
2	Work of the PRP in 2013-14	
	• Modus operandi	2.1 – 2.5
	• Case review workflow	2.6
	• Highlights of work	2.7 – 2.8
3	Executive Summary – Case Reviews	3.1 – 3.10
4	Observations and Recommendations - Case Reviews	
	• Licensing of intermediaries	4.1 – 4.35
	• Inspection of intermediaries	4.36 – 4.73
	• Handling of complaints	4.74 – 4.107
	• Corporate finance including processing of listing applications	4.108 – 4.114
	• Investigation and disciplinary action	4.115 – 4.133
	• Authorisation of investment products	4.134 – 4.154
5	Follow-up action by the SFC on the PRP's Recommendations in 2012-13	5.1 – 5.15
6	Way Forward	6.1 – 6.2
7	Acknowledgement	7.1 – 7.3

## Chapter 1      General Information

### Background

1.1            The Process Review Panel (“PRP”) for the Securities and Futures Commission (“SFC”) is an independent panel established by the Chief Executive (“CE”) 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            The PRP will review completed or discontinued cases handled by the SFC and advise 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 licensing of intermediaries, inspection of intermediaries, handling of complaints, corporate finance including processing of listing applications, investigation and disciplinary action and authorization of investment products. The PRP does not judge the merits of the SFC’s decisions and actions. It focuses on the process.

1.3            The terms of reference of the 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 Share Buy-backs (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.

1.4 The PRP will submit its annual reports to the Financial Secretary who may cause them to be published as far as permitted under the law.

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

## Membership

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

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

1.8 The membership of the PRP in 2013-14 is as follows:

### Chairman:

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

### Members:

Mr CHAN Kam-wing, Clement	since 1 November 2012
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
Dr the Honourable LEUNG Mei-fun, Priscilla, JP	from 1 February 2009 to 31 October 2014

Mr MAK Chi-ming, Alfred	since 1 November 2012
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 from 4 May 2006

Mr LAI Ying-sie, Benedict, SBS, JP to 25 February 2015

Representative of the Secretary for Justice since 26 February 2015

Ms Cheung Kam-Wai, Christina

**Secretariat:**

Financial Services Branch of Financial Services  
and The Treasury Bureau

## Chapter 2 Work of the PRP in 2013-14

### Modus operandi

2.1 The SFC provides the PRP with monthly lists of completed and discontinued cases. Members of the PRP select individual cases from these lists for review with a view to examining cases encompassing different areas of the SFC's work. Members pay due regard to factors including processing time of the completed cases, procedural steps taken by the SFC in arriving at their decisions.

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

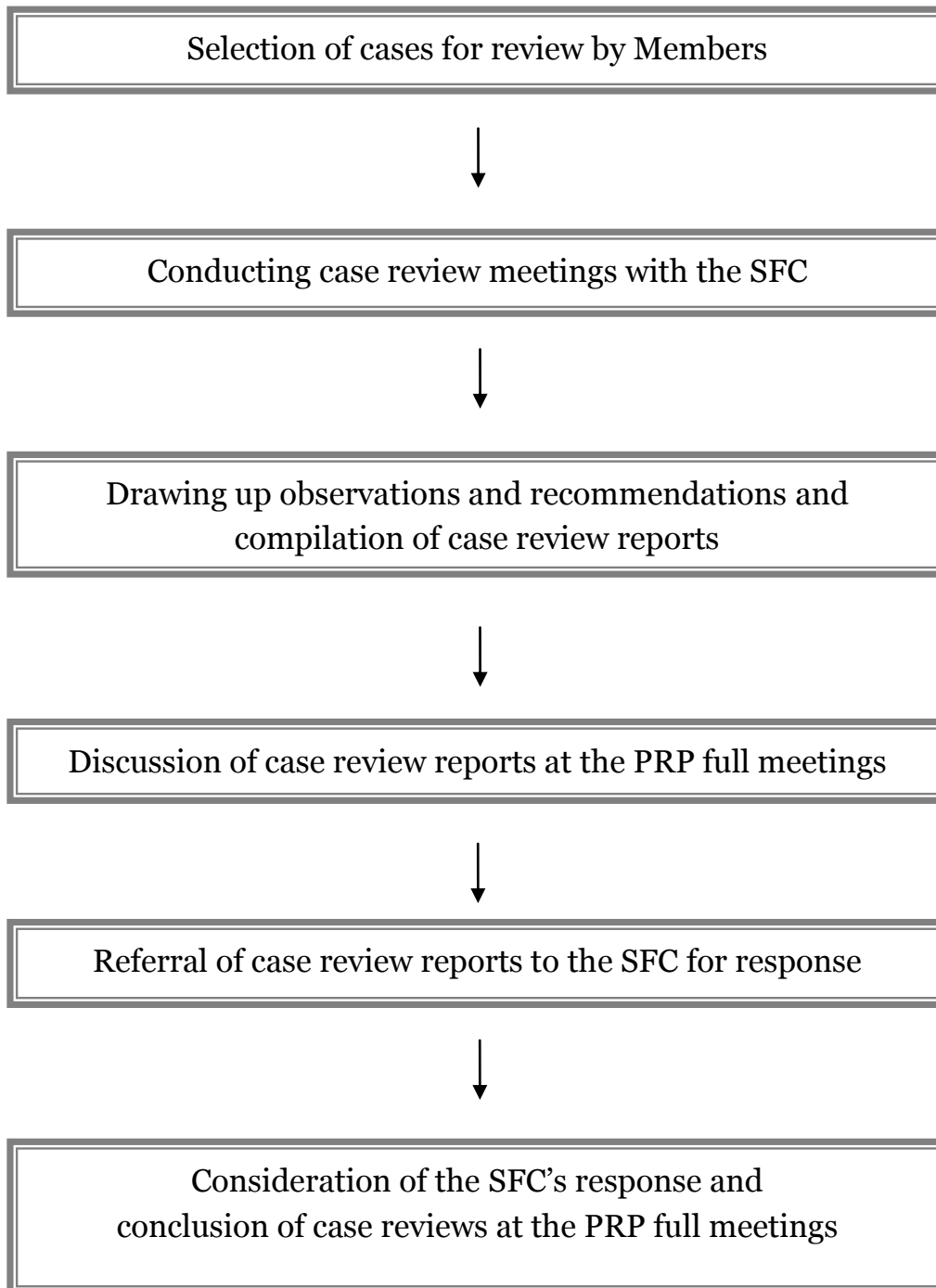
2.3 The PRP attaches importance to the views of the trade industry towards the SFC's work. On 17 April 2014, the PRP met fund industry associations, the Hong Kong Investment Funds Association and the Chinese Asset Management Association of Hong Kong, to gauge their views towards the SFC's work in the fund authorization process. Their views were conducive to the work of PRP.

2.4 The PRP maintains direct dialogue with the top executives of the SFC on the PRP's observations in various areas of the SFC's work under review. On 19 June 2014, the PRP invited Mr Ashley Alder, CEO/SFC and his three Executive Directors ("ED") Mrs Alexa Lam, Deputy CEO and ED (Investment Products, International and China), Mr James Shipton, ED (Intermediaries) and Mr Mark Steward, ED (Enforcement) for an informal meeting. The SFC gave an overview of its operational policies and practices, and updated the PRP on follow-up actions taken to the recommendations made in last year PRP Annual Report. The PRP also discussed with the SFC's top executives on various recurrent procedural matters which the PRP had noted in case reviews over the past two years.

2.5 The PRP members are obliged to preserve secrecy in relation to information furnished to them in the course of the PRP's work, and to refrain from disclosing such information to other persons. To maintain the independence and impartiality of the PRP, all the PRP members are required to declare their interests upon commencement of their terms of appointment and before conducting/discussing each case review, as appropriate.

## Case review workflow

2.6 The workflow of the PRP case reviews is set out below –





## Highlights of work

2.7 During the year, the PRP conducted a total of 11 meetings with the SFC's case officers on 59 selected cases that were completed or discontinued by the SFC. The PRP met four times in the year to discuss its observations and recommendations of cases reviewed. The distribution of the 59 cases reviewed in 2013-14 is summarised below -

	No. of Cases
Licensing of intermediaries	8
Inspection of intermediaries	8
Handling of complaints	9
Corporate Finance including processing of listing applications	5
Investigation and disciplinary action	15
Authorisation of investment products	14
<b>Total</b>	<b>59</b>

2.8 An executive summary of the PRP's recommendations is provided in Chapter 3. Highlights of the PRP's observations and recommendations and the SFC's responses are set out in Chapter 4. Follow-up actions taken by the SFC in response to the PRP's recommendations in the Annual Report for 2012-13 are set out in Chapter 5.

## Chapter 3 Executive Summary – Case reviews

3.1 In 2013-14, the PRP reviewed 59 cases selected from the monthly case lists submitted by the SFC. The PRP focused on two major areas: how to expedite the processing of applications and product authorisations; and how to enhance the communication of the SFC with different parties, be that with intermediaries, complainants or different enforcement parties. The PRP emphasized that there should be more communication within the SFC, and between regulators, licensees, applicants and the SFC.

3.2 The PRP was delighted to note that the SFC had made a good start; in particular, the product authorization team had arranged more meetings with applicants and imposed a new application time lapse policy with effect from 1 January 2014 which was a recommendation made by the PRP in 2012-13. In 2013-14, the PRP provided other recommendations for the SFC's consideration. The SFC's responses to the recommendations were extracted in Chapter 4.

3.3 The PRP hoped that with the continual efforts of the SFC and through the publishing of the annual report, it would help the market participants better understand the process involved in the work of the SFC.

### **Licensing of intermediaries**

3.4 Licensing has been the gatekeeper for individuals and corporations seeking to enter the securities and futures markets of Hong Kong. In 2013-14, the SFC had some 39,000 licensees and received more than 6,500 applications for the SFC licence. The PRP fully recognized the role of the Licensing Department ("LIC") of the SFC and the prudence required to carry out its function. That said, it was equally important to ensure that the processing time in the licensing applications was reasonable. For the case review in 2013-14, the PRP noted that the processing time ranged from eight months to four years and five months. The PRP further noted an exceptionally lengthy migration application case that took eight years to complete. The PRP looked into the explanation provided by the SFC in each lengthy application and discussed with the top executives of the SFC at the informal meeting on 19 June 2014 how the SFC could improve its handling and monitoring mechanism on outstanding licensing applications.

## **Inspection of intermediaries**

3.5 The SFC outsourced special inspections to an audit firm to conduct circularization exercise for checking client asset records and internal controls of broker firms. The PRP reviewed these special inspections and noted that the cases took 10 to 11 months to complete. The PRP questioned why the inspections lasted for so long, which might cause undue pressure on both the broker firms being inspected and its clients being checked. The PRP also asked the SFC if there was penalty imposed on the outsourced agent if it failed to follow the timeframe imposed on the engagement contract between the agent and the SFC. The PRP further suggested the SFC to review its supervision of the outsourced agent and to consider inviting small-medium sized audit firms in its outsourcing exercise. The PRP invited the SFC to review the de-freezing procedures for non-responding clients, and suggested the SFC to promulgate the lessons learnt in the circularization exercise for all intermediaries' information. The SFC responded positively to each of the observations and recommendations.

## **Handling of complaints**

3.6 The PRP reviewed complaint cases against the staff of the SFC and the SFC's decision. The PRP noted that the SFC had not informed a licensed corporation being complained of the SFC's finding or assessment result. The PRP also observed that the definition of "public complaints" in the performance pledges published by the SFC was not clear. The SFC was also invited to review the complaint handling procedure of individual divisions.

## **Corporate Finance**

3.7 The PRP recommended the SFC to devise performance pledges or internal guidelines for applications under the Takeovers Team of the Corporate Finance Division ("CFD").

## **Investigation and disciplinary action**

3.8 The PRP reviewed 15 enforcement cases and made enquiries on the process and procedure. The SFC revealed that there was an Enforcement Steering Committee (“ESC”) which met weekly to keep track of the investigation process and provided strategic guidance in investigation.

## **Authorisation of investment products**

3.9 The SFC accepted the PRP’s recommendation in 2012-13 to enhance its policy on lapse of application. The PRP welcomed the SFC’s positive response. At the PRP’s meeting with the SFC’s top executives on 19 June 2014, the SFC reported that for applications received from 1 January to mid-June 2014, the average processing time of completed cases was 3.5 months. The PRP would continue monitoring the effectiveness of the new application time lapse policy.

3.10 For 2013-14, the PRP reviewed 14 product authorization cases. The PRP observed that in some cases, the long processing time of the applications was due to the sub-standard applications submitted by the applicants. The PRP recommended the SFC to enhance the transparency of the authorization process. The PRP also recommended the SFC to consider extending the six-month application lapse policy to products involving vetting by other regulators.

## Chapter 4      Observations and Recommendations in Case Reviews

### Licensing of intermediaries

4.1      The PRP studied the licensing applications for different types of regulated activities with emphasis on the processing time spent. The PRP picked up for review cases involving long processing time with the view of identifying possible suggestion for improvement. For a migration application, the PRP observed that the SFC had taken exceptionally long processing time to complete. For the other applications under review, the processing time ranged from 8 months to 4 years 5 months.

The PRP further reviewed an application submitted by insurance agents for Type 1 licence in 2009 and studied an application involving disclosure of conviction records of the applicant. The PRP made recommendations on the handling process for the cases.

#### *(a) § Migration Application*

The PRP reviewed a migration application which took eight years and six months to complete. The PRP enquired (i) the total number of applications; (ii) the standard processing time; and (iii) guidelines; and recommended the SFC to keep proper documents to monitor the inactive applications.

The SFC replied that (i) there were 16,452 migration applications and all migration applications had been completed by March 2013; (ii) there was no standard processing time for migration applications; and (iii) it approved migration applications according to section 116 or 120 of the SFO. The SFC monitored the process of all outstanding migration applications through its IT system which generated reports twice every month.

### The PRP's review

4.2 The PRP reviewed an application from a firm for migrating its deemed licence to the new licence regime under the Securities and Futures Ordinance (Chapter 571) ("SFO") to carry on Type 1 regulated activity. The firm was first registered as a dealer under the repealed Securities Ordinance in 1992. When the SFO came into force on 1 April 2003, the firm was deemed licensed to carry on regulated activities pending the completion of the migration application.

4.3 The PRP noted that the migration application took eight years and six months to complete. In this context, the PRP asked for :

- the total number of migration applications received and completed by the SFC;
- standard processing time for migration applications; and
- guidelines for handling migration applications.

4.4 When reviewing the application, the PRP also noted that the SFC took no action for a period of 15 months. The SFC was invited to explain. The PRP also recommended that the SFC should have properly documented in the file why a case had remained inactive.

### The SFC's response

4.5 According to the transitional arrangements which were stipulated in Schedule 10 of the SFO, corporations and individuals that were registered with or licensed by the SFC immediately before the SFO coming into force (i.e. 1 April 2003) were deemed to have been licensed under sections 116 and 120 of the SFO respectively to carry on certain types of regulated activities for which licences were required under the SFO. Thereafter, they had two years up to 31 March 2005 to apply to be formally licensed under the SFO.

4.6 As long as the deemed licensees lodged their migration applications during the two-year transitional period, they were allowed to continue operating their business on their deemed licences until the SFC's decisions to approve or refuse their applications were made. These deemed licensees had all the rights, and had to observe all the obligations applicable to licensed entities under the SFO.

4.7 In determining whether to approve a migration application, the SFC had to be satisfied on the basis of the information before it that the corporate or individual applicant concerned was fit and proper to be licensed under section 116 or 120 of the SFO. If there were unresolved allegations against the applicant which might, if established, lead the SFC not to be satisfied as to the applicant's fitness and properness to be so licensed, it would likely have been inappropriate for the SFC to have granted the applicant a licence under section 116 or 120 until the resolution of the issues in question.

4.8 Having considered the above and given the huge volume of migration applications, the SFC had to prioritize its resources in handling the new applications made under the SFO by unlicensed applicants and the migration applications.

4.9 The SFC also explained that there was no standard processing time for migration applications. The SFC staff worked on the outstanding migration applications when resources permitted.

#### *Monitoring*

4.10 The IT system of the Licensing Department ("LIC") generated reports twice every month on all outstanding migration applications. In addition, each portfolio team received a report listing all of the migration applications being handled. The LIC also maintained an internal log of outstanding migration applications involving applicants whose applications gave rise to concerns.

#### *Documentation on the reasons for inaction*

4.11 The SFC reiterated that the LIC had maintained reports on the status of cases that were complex or contentious. The reports had been updated by the case officers regularly and reviewed by the management of the Department.

#### *Number of migration applications*

4.12 There were a total of 16,452 migration applications received by the end of the transitional period.

#### *All applications were completed in March 2013*

4.13 By March 2013, all of these migration applications were completed. They were either approved, refused or withdrawn.

(b) § *Communication with Market Participants when lodging new initiatives*

In reviewing a Type 1 licence application submitted by an insurance agent, the PRP noted that the market might have misunderstanding about the need for Type 1 licence for selling ILAS products. The PRP recommended that the SFC should enhance communication with other regulators and market participants when launching a new kind of activity.

The SFC responded that once it became aware of the issue, it had already taken immediate action to handle the situation.

*The PRP's review*

4.14 The PRP reviewed a Type 1 licence application which was submitted by one of numerous insurance agents in May 2009. At the material time, there was misunderstanding from the market that Type 1 licence was required for them to sell Investment-linked Assurance Scheme ("ILAS") products.

4.15 During the review, the PRP noted that the SFC issued a circular clarifying the licensing requirements for handling the ILAS products on 13 August 2009. After clarification by the SFC, the number of applications dropped drastically.

4.16 With hindsight, the PRP considered that the SFC could have clarified the misunderstanding with market participants earlier, stating clearly the SFC's role in respect of the ILAS products.

4.17 The PRP recommended that when launching a new kind of activity, in particular those involving jurisdiction of different regulators, the SFC should -

- clarify with other regulators the division of responsibilities; and



- enhance the communication with market participants, clarify any misunderstanding and explain responsibilities of the SFC in the new initiatives.

### The SFC's response

4.18 The SFC explained that there were a large number of insurance intermediaries that were automatically entitled to deemed licences under the “grandfathering” provisions of the SFO when the SFO came into force in 2003. These deemed licensees had two years to apply to the SFC to be formally licensed under the SFO. There were some 20,000 applications. The SFC explained that SFC’s assessment of the applications was relatively primary and had substantially relied on applicants familiarizing themselves with the new licensing obligations under the SFO and applying for the correct type of licence. Insurance intermediaries who represented to the SFC that they were conducting the business of distributing or advising on funds (i.e. securities) were invariably formally licensed under the SFO.

4.19 It was only in 2007, when the strain of dealing with the applications of 20,000 deemed licensees began to subside, the SFC realized that some of these insurance intermediaries were only conducting insurance business and were not conducting funds business. The SFC began adopting a policy of very closely scrutinizing all licence applications submitted by the insurance intermediaries and refusing applications where the applicants were only involved in the insurance business. The SFC made known to the management of insurance companies that the SFC would not license the applicants and that the SFC would revoke the licences of all insurance intermediaries who held licences under the SFO to which they were not legally entitled.

4.20 The SFC summarized its action as follows:

- As soon as the SFC became aware of the licensing issue in 2007, it acted immediately by closely scrutinizing and rigorously processing all applications submitted by insurance intermediaries and refusing to grant licences in appropriate cases.
- The SFC also immediately discussed the issue with the Office of the Commissioner of Insurance, who undertook to actively address the issue with the insurance industry.

- Although the SFC's 2009 Circular possibly played a role in the reduction of the number of applications made to the SFC by insurance intermediaries, it was more likely that the reduction was the result of the SFC's active engagement with the insurance industry from 2007 onwards, the SFC's rigorous assessment of applications by insurance intermediaries & its frequent refusal to grant licences to the group, and the SFC's subsequent concerted efforts to revoke the licenses of insurance intermediaries who were not entitled to be licensed under the SFO.

(c) § *Communication with Regulators*

The PRP reviewed an application which required co-handling by the SFC and the HKMA. The PRP recommended the SFC to (i) conduct an initial vetting of applications; (ii) meet the HKMA regularly to discuss case progress; and (iii) impose lapse policy for applications co-regulated with other regulators.

The SFC responded that (i) it had procedures to screen applications; (ii) it held regular meetings with the HKMA and the HKMA had provided monthly updates on the applications to the SFC; and (iii) it had mechanism to monitor the progress of applications and thus imposing a rigid time lapse policy was not appropriate.

The PRP's review

4.21 The PRP noted that the SFC took one year and 11 months to process an application for Types 1 and 4 regulated activities by an authorized financial institution ("AFI"). The application required co-handling between the Hong Kong Monetary Authority ("HKMA") and the SFC.

4.22 Under the SFO, the SFC might, upon application by an AFI, register the applicant to be a registered institution to carry on regulated activities. According to the Memorandum of Understanding between the SFC and the HKMA ("MoU"), the SFC would conduct the first screening

upon receiving an application for registration by an AFI and would pass it to the HKMA for processing after the screening.

4.23 The SFC explained that the application was delayed because there were changes in the proposed executive officers of the AFI; and the HKMA, after reviewing the information on internal controls that was provided in support of the application, had asked for further information in the area.

4.24 The PRP recommended the SFC to:

- conduct an initial vetting on accuracy and completeness upon receiving the application materials;
- invite the HKMA to hold regular meetings at three to four weeks intervals to discuss case progress co-handled by the two regulators; and
- consider imposing lapse policy for the applications co-regulated by the SFC and other financial regulators.

### The SFC's response

#### *Conduct Initial Vetting*

4.25 The SFC had prevailing procedure to screen out sub-standard applications before accepting them for processing. The initial screening would usually be completed within a few days. Applications that failed to pass through the screening process would be returned to the applicants with reasons.

*Could initial vetting be expanded to cover greater depth of accuracy and completeness of the application?*

4.26 The SFC explained that if the scope of the initial screening was expanded to cover a greater depth of accuracy and completeness of the application materials, the screening process would take longer. It would ultimately result in greater duplication of effort and it would result in applications taking longer to be processed.

*Regular meetings with HKMA*

4.27 The SFC reported that pursuant to the existing MoU between the SFC and the HKMA, the SFC held periodic meetings and maintained close communications with the HKMA to discuss issues of mutual concern including application-related issues. Based on the PRP's previous suggestion, the HKMA provided the SFC with monthly updates on licensing applications by registered institutions.

*Time lapse policy*

4.28 The SFC did not feel it appropriate to impose a rigid time lapse policy in relation to the processing of licence applications. If an applicant failed to respond to the SFC's requisitions fully or in a timely manner, the SFC might refuse the application on the basis that the applicant had failed to satisfy the SFC that it was fit and proper to be licensed. The SFC opined that it was essential for the SFC to have flexibility to determine when to conclude the SFC's processing of a licence application on a case by case basis.

**(d) § Guidelines for Applicants for Disclosing Conviction Records**

The PRP reviewed an application in which the applicant had failed to disclose his conviction record due to a misunderstanding that the conviction had been expunged. The PRP recommended the SFC to review the adequacy of its guidelines for applicants in this area.

The SFC responded that it had reminded applicants of so in the application form. Besides, applicants could separately report the matters of spent, dismissed or expunged investigations, charges or convictions to the SFC.

*The PRP's review*

4.29 The PRP noted that an application had taken unnecessarily long processing time as the applicant had failed to disclose his conviction record committed years ago due to a misunderstanding that the conviction had been expunged.

4.30 Upon the PRP's enquiry, it was noted that the protection under the Rehabilitation of Offenders Ordinance<sup>1</sup> Chapter 297) ("ROO") did not apply to an application of an SFC licence. To protect the applicant's privacy from disclosing to his/her firms, the SFC allowed the applicant to provide details of the conviction record in a separate submission which needed no countersigning by his/her firms.

4.31 Noting the SFC's arrangement, the PRP requested the SFC to review if it had provided adequate guidelines for applicants on the arrangement.

#### The SFC's response

4.32 The SFC agreed with the PRP that it was beneficial to assist applicants in understanding their obligations of disclosure.

4.33 The SFC indicated that it had already in place guidance to applicants by way of three footnotes ("Footnotes") to its Form 3 (Application for Licence - Representative). The Footnotes reminded applicants that the protection under the ROO did not apply to proceedings relating to a person's suitability to be granted a licence, and that investigation, charges and convictions must be reported to the SFC.

4.34 Noting that if the applicant disclosed a conviction in Form 3 that had been spent, dismissed or expunged, the licensed corporation would become aware of it, the SFC indicated that it had therefore formulated a workable solution by permitting an individual applicant not to disclose investigations, charges and convictions in Form 3, but to require him to separately report the matters directly to the SFC within two business days of the date when his application was submitted.

---

<sup>1</sup> In accordance with ROO, a conviction record should have been spent after 3 years.

## Concluding Remarks

4.35 The PRP noted the SFC's responses in the above cases and had discussed with the top executives of the SFC at its informal meeting on 19 June 2014 how the SFC could improve its handling and monitoring mechanism on outstanding licensing applications. The PRP would continue keeping an eye on the SFC's efforts in handling the applications.

## Inspection of intermediaries

4.36 The PRP reviewed one prudential visit and seven inspection cases, involving routine inspections and special inspections. For the special inspection “circularization exercise”, the SFC engaged an outsourced agent to conduct the inspection to the firms on the proper handling of client assets. For various inspection cases, the PRP made recommendations for the SFC’s considerations, including how to effectively supervise the performance of outsourced agents.

### (a) § *Circularization exercise*

The PRP reviewed special inspections (circularization exercise) which were assigned to an outsourced agent. The processing time was relatively long due to late submission of reports by the agent. The PRP recommended the SFC to (i) provide detailed conditions in engagement contracts with the outsourced agent including expected completion time; (ii) impose penalty clause in engagement contracts; (iii) inform clients of inspected brokers of expected completion time; (iv) devise a proper monitoring mechanism on outsourced agent; (v) develop a database template so that more audit firms in particular small and medium sized firms could be invited for tendering; (vi) review its follow-up action on de-freezing of client accounts; and (vii) publish the lesson learnt from the exercise.

The SFC responded that (i) the engagement contract had set out the deliverables and indicative timeframe; (ii) it was not practicable to fix an absolute deadline or penalty in advance; (iii) it was not possible to inform clients of an inspected broker about the expected timeframe of the inspection due to secrecy provisions under the SFO; (iv) the current monitoring mechanism was adequate to ensure the exercise was properly supervised; (v) it would explore the feasibility of requiring outsourced agents to adopt a standard database template; (vi) it was not practical to require non-responding clients to confirm their account balances with the outsourced agent or the SFC before defreezing their accounts; and (vii) it had already provided guidance on compliance matters in its circulars issued.

#### The PRP's review

4.37 The SFC engaged an outsourced agent to conduct special inspections, namely, circularization exercises, to test whether brokers had properly accounted for client assets. The SFC started the circularization exercises in October / November 2012 and selected ten broker firms on a risk basis. The PRP reviewed three inspection cases in this context.

4.38 For the cases under review, the PRP noted that the SFC took ten to 11 months to conclude the inspections. The SFC explained that the long processing time was due to the delay in submission of final reports by the outsourced agent. There was resources constraint at the senior manager level of the outsourced agent which resulted in the late submission of the reports to the SFC.

4.39 The PRP recommended the SFC to :

- provide detailed and specific conditions in engagement contracts for appointment of outsourced agents, including the expected completion time of the inspection. This was to ensure that the agent would provide sufficient manpower resources to complete the inspection without delay;



- consider imposing penalty to the outsourced agent in case it failed to meet the target completion time. This should be stipulated in the engagement contracts; and
- devise a proper internal monitoring mechanism to monitor the work of the outsourced agent.

4.40 The PRP further noted that the SFC had only invited big audit firms to tender for the outsourced inspection and had appointed only one audit firm to perform inspection for all ten broker firms. The SFC explained that engaging only one audit firm was to ensure consistency in the assessment.

4.41 In this regard, the PRP recommended the SFC :

- to consider developing a database template for the exercise;
- with the database template, the SFC could assign more audit firms to conduct the inspections; and
- to invite more audit firms, in particular those small and medium sized audit firms, to tender for the outsourcing. It would allow more firms to gain exposure to the SFC's jobs.

4.42 The PRP also studied the follow up action taken by the SFC after the outsourced agent had submitted its inspection reports. In this aspect, the PRP recommended the SFC to review its follow up action on the de-freezing of clients' accounts when the outsourced agent could not confirm the clients' account in its checking process.

4.43 At the case review meeting, the PRP was told that broker firms themselves could defreeze the clients' accounts that could not be confirmed by the outsourced agent during the circularization exercise. There was no need for the SFC to countercheck the clients' information before de-freezing.

4.44 The PRP recommended that the SFC should look into the procedure and impose necessary checks and balances in the de-freezing process. Otherwise, it would defeat the objective of engaging an outsourced agent to conduct independent checking to the clients' accounts. The PRP also enquired if the SFC had performed audit steps to the de-freezing process for the cases under review.

4.45 The PRP suggested that the SFC should publish the lesson learnt from the circularization exercise. This would help educating other broker firms on internal controls.

#### The SFC's response

##### *Engagement of outsourced agent*

4.46 The SFC explained that it had asked the outsourced agent to ensure that it would provide sufficient manpower to handle the exercise before the appointment was granted, and the engagement contract had set out the deliverables and indicative timeframe for the whole exercise.

4.47 The engagement contract also provided that the fees would only be payable after the interim/final reports had been issued. Moreover, the engagement contract set out the outsourced agent's responsibilities and professional liabilities as a result of any breach of contract, tort or otherwise by the outsourced agent.

##### *Fixed timeframe and penalty*

4.48 The SFC fully agreed that completing circularization exercise as soon as reasonably practicable was in the best interests of clients, but it was of utmost importance that sufficient time was allowed for clients to respond. The SFC remarked that any irregular client responses and other findings of the exercise should be properly followed up to ensure the interests of clients were protected.

4.49 Regarding the imposition of a penalty for failing to meet deadlines, the SFC explained that it was hard to budget accurately for how much time and resources would be required for the completion of the exercise when the contract terms were agreed. The SFC also expressed concern that a service provider might compromise the standard of work in order to meet the deadline. Accordingly, the SFC was of the view that "hardwired" timetables run the risk of defeating the purpose of the exercise and resulting in bad investigation outcomes.

4.50 The SFC would explore with outsourced agents bidding for future exercises whether the agent could commit to provide reasonable additional manpower as and when the circumstances required. The SFC would also continue to work with the Legal Service Division to ensure appropriate protections and expectations were included in the contractual documents.

*Communication with inspected firms and its clients*

4.51 The SFC had informed the broker about the expected duration of the site visit to facilitate the broker to make the logistic arrangements. The SFC also kept the broker informed about the progress of the inspection after the inspection staff had completed work at the broker's premises.

4.52 However, the SFC explained that it was not possible to inform clients of an inspected broker about the expected timeframe to complete the inspection due to secrecy provisions under the Securities and Futures Ordinance that restricted the SFC to disclose to third parties, including clients of its regulatory actions. This was because it was the broker, not the clients, who was subject to the inspection. The clients' role was to voluntarily assist in the inspection by responding to requests for confirmation about their account balances. Any further disclosure to clients might arouse unnecessary speculation on a broker's operations, which might unfairly prejudice firms.

*SFC internal monitoring mechanism*

4.53 The SFC considered that current monitoring mechanism appropriate and adequate to ensure that the progress of the exercise was properly reviewed and supervised. The SFC explained that for the client circularization exercise, the relevant SFC case officers had liaised closely with the outsourced agent staff that inspected the brokers.

4.54 The SFC had assigned a designated team to coordinate with the outsourced agent on detailed work plans and reporting, and to monitor the overall progress of the exercise.

*Inviting more small-medium sized audit firms in outsourcing exercise*

4.55 The SFC explained that regarding candidates to be invited to submit project proposals, a number of factors had to be considered, including track record and/or expertise, manpower and independence. For a large scale circularization exercise, which involved simultaneous review and circularization of a few thousand client accounts for over a number of brokerage firms, it was of paramount importance that the candidate must have sufficient manpower and backup resources to handle the job.

4.56 The SFC would explore the feasibility of requiring outsourced agents to adopt a standard database template developed by the SFC in future exercises.

*Alternative audit step and procedures in de-freezing non-responding clients*

4.57 For one of the cases under review, the SFC also noted that the broker firm had undertaken to arrange independent staff to follow up with the non-responding clients, and to establish contact and confirm with the clients their account balances and stock holdings before de-freezing the account. The SFC had asked the broker to inform the SFC immediately should any of the clients report any discrepancy in the account balances and/or stock holdings or any other irregularities when they subsequently contacted the broker.

4.58 The SFC explained that unless management fraud or integrity issue was suspected, it was appropriate to rely on the management of the firm, which was charged with governance and supervision of the firm's activities and internal controls, to follow up with non-responding clients.

*Promulgation of lessons learnt after the special inspection exercise*

4.59 The SFC explained that in its circular issued in September 2012 and February 2013, it had highlighted the importance of guarding against email scams and misappropriation risk and putting in place comprehensive controls. In February 2013, the SFC held a joint seminar with the Hong Kong Institute of Certified Public Accountants to discuss fraud risk and financial risk. In April 2013, the SFC held a meeting with broker associations to explain the major control deficiencies which might facilitate misappropriation of client assets by unscrupulous employees and the need to put in place comprehensive internal control systems and exercise close management supervision.

(b) § *Prudential visits*

The PRP reviewed a prudential visit which was aimed to understand a firm's new business. However, it was revealed during the visit that the firm's business had not commenced. The PRP enquired (i) how the SFC devised a schedule for prudential visits; (ii) its procedures for referring cases to Enforcement Division; and recommended that (iii) a prudential visit be arranged after a firm's new business had been implemented.

The SFC replied that (i) a prudential visit to a firm was generally conducted when there were (a) major change in business or in management; (b) new products launched; (c) the firm had not been inspected for a long period; and (d) significant event affecting the firm; (ii) if serious breaches or misconduct were identified during the visit, the case would be considered for referral to the Enforcement Division.

*The PRP's review*

4.60 The PRP studied a case of a prudential visit. The licensed corporation was approved to expand its business scope in September 2011. The ISD conducted a prudential visit to the corporation in April 2012 (seven months later) with a view to understanding the firm's new business and its internal control. However, it was only found in the visit that the firm had not yet commenced its new business. The ISD issued a closure letter to the firm in July 2012.

4.61 The PRP enquired how the SFC had devised its schedule for prudential visits. For effective deployment of resources, the PRP recommended the SFC to arrange a prudential visit to a new business licensed corporation only after its licensed business had been implemented.

4.62 The PRP also enquired how the ISD referred the case to the Enforcement Division when it had identified problems at the prudential visit.

## The SFC's response

### *Prudential Visits and Formal Inspections*

4.63 As part of its ongoing supervision of licensed corporations, the ISD conducted:

- Targeted and formal inspections under the exercise of the SFC's statutory power under section 180 of the SFO ("formal inspections"); and
- General visits, known as "prudential visits" that were not an exercise of section 180 powers and served different regulatory purposes than a formal inspection.

4.64 A formal inspection conducted under section 180 of the SFO was a highly formal procedure for the licensed corporation and was conducted mostly by the ISD's Compliance team. It typically involved a detailed on-site examination of a licensed corporation's records and making inquiries of the firm for assessment of its compliance status and key controls. The firm was obligated to provide the records and to answer the questions.

4.65 A prudential visit was not founded in section 180 of the SFO. It was not conducted by the ISD Compliance team. Prudential visits normally took the form of a one-time meeting with senior management of licensed corporations for the purpose of receiving updates on general corporate information and market intelligence. Generally, it did not involve any review of books or records and would be concluded by the issue of a courtesy letter thanking the licensed corporation for its cooperation, i.e. "closure letter".

4.66 The main objectives of the prudential visits were to :

- obtain information and the licensed corporation's views on the recent firm-specific event or market/industry trend and ascertain their impacts on the licensed corporation and where appropriate, the industry as a whole;
- gain a high level understanding of the licensed corporation's current business situation, business outlook and future

viability, and how they managed the risks / challenge; and

- build a communication channel with the licensed corporation and provide the opportunity for them to share their views on the market and regulatory environment and for the staff of the SFC to discuss any regulatory issues / concerns with them.

#### *Arranging prudential visits*

4.67 In general, a licensed corporation meeting one or more criteria as below would more likely to be selected :

- there had been or would be a major change in business arrangement / structure of the firm;
- new products had been or would be launched by the firm;
- there had been or would be a major change in management, compliance personnel or internal control procedures of the firm;
- the firm had not been inspected or visited for a long period of time; or
- the firm was or might be significantly affected by other firm-specific event or a market / industry trend or event.

4.68 In light of these objectives, prudential visits were planned according to the circumstances of the situation and were generally triggered by current and specific events. It might not always be feasible to arrange prudential visit regularly at fixed time intervals.

4.69 For a new business licensed corporation, a prudential visit might be arranged if one or more of the abovementioned objectives were met.

4.70 For the case under review, the prudential visit was arranged to better understand the firm's internal controls and its readiness to implement the new licensed business.

*Referral of case to the Enforcement division*

4.71 The SFC explained that if serious breaches or misconduct were identified on a licensed corporation during the course of a prudential visit, the responsible senior manager and director would consider whether the matters warranted a referral to Enforcement Division for investigation or disciplinary inquiry.

4.72 In gauging the seriousness of a case, consideration would be given to whether the suspected breaches or misconduct would (a) have a material adverse implication on the licensed corporation's fitness and properness to remain licensed with the SFC; (b) have a material adverse impact on client interest or the licensed corporation's financial position; and/or (c) pose a systematic risk to the market.

## Concluding Remarks

4.73 The PRP noted the SFC's responses, including its elaboration on the objectives of the prudential visit and its undertaking to explore the feasibility of requiring outsourced agent to adopt standard database template so that more small-medium size audit firms might be considered to be invited for the outsourcing exercise.



## Handling of complaints

4.74 The PRP recommended clarification of the performance pledges on handling of “public complaints” on the SFC website. The PRP also emphasized that the SFC should not only inform complainants of its investigation as far as the statutory secrecy provision permitted, but it was equally important for the SFC to keep the subject of a complaint informed of the results when fact-finding and/or investigation procedures were completed.

### (a) § *Performance Pledge*

The PRP reviewed a staff complaint and enquired (i) whether the complaint against staff was considered as “public complaint”; (ii) whether a reply pledged within the two-week time was an acknowledgement of receipt; and (iii) whether there was any pledge for follow-up and substantive replies.

The SFC replied that (i) ‘complaints’ mentioned on the SFC’s website on performance pledges referred only to “public complaints against intermediaries and market activities” but not complaints against the SFC or its staff; (ii) for the public complaints against intermediaries and market activities, it had aimed at providing a substantive reply within two weeks, but if the complaint was complicated, the two-week reply could be an acknowledgement or a letter seeking additional information; and (iii) there was no other public pledges for complaints against intermediaries and market activities. In response to the PRP’s enquiry, the SFC had updated the SFC’s website to clarify the type of complaints covered in the SFC’s performance pledges.

### The PRP's review

4.75 When reviewing a complaint against staff, the PRP studied the SFC's performance pledge on issue of a preliminary response for "public complaints". The PRP enquired if a complaint against staff was categorized as "public complaint" and invited the SFC to state it clearly on the website.

4.76 For "public complaint", it was published on the website that the SFC would provide a preliminary response to verbal and written complaints within two weeks. In this regard, the PRP enquired:

- whether the "two-week" performance pledge for a preliminary response was an acknowledgment of receipt of the complaint or it was an interim response; and
- what were the pledges for the follow-up and substantive replies.

4.77 The PRP was given to understand that for complaints against the SFC's staff, the SFC would write to the complainant to acknowledge receipt of the complaint within seven working days. The pledge time was different from that promulgated on the website for "public complaint".

### The SFC's response

#### *Public complaint*

4.78 The SFC explained that 'Complaints' mentioned on the platform of 'Performance Pledges' page on the SFC's website referred only to public complaints against intermediaries and market activities. The SFC had already updated the SFC's website to clarify the type of complaints covered in the SFC's performance pledges.

4.79 For complaints against intermediaries and market activities, the SFC had aimed to provide a substantive response to a complainant within two weeks. Where a complaint was complicated or contained insufficient information, the two-week response could be in the form of an acknowledgement of receipt, or a letter seeking additional information from the complainant.

4.80 For complaints against intermediaries and market activities, apart from the two-week performance pledge, the SFC did not have other public pledges for complaints as the time required to review a complaint had depended on the nature and complexity of each case. The SFC would however provide periodic updates to a complainant until completion of the SFC's review of the complaint.

*Complaint against the SFC and SFC's staff*

4.81 For complaints against the SFC and its staff under the separate procedure, the Commission Secretary would write to the complainant to acknowledge receipt within seven working days and notify the complainant whether the complaint was one which could be dealt with under the relevant procedures.

4.82 For complaints against the SFC and its staff, the SFC's website also set out an indicative timeline within which the SFC aimed to provide a substantive response. The SFC could not commit to a definite timeline as the actual time required to process a complaint depended on various factors.

**(b) § Keeping subject being complained informed**

In reviewing an anonymous complaint which the Licensing Department concluded insufficient evidence, the PRP recommended that the SFC should inform the subject of a complaint of the SFC's findings.

The SFC responded that in the absence of a formal investigation, it was not the SFC's usual practice to issue a letter to the subject of a complaint advising of any "progress/result". Otherwise, this would give the impression that a formal investigation had been commenced.

### The PRP's review

4.83 In a complaint case which the Licensing Department had concluded there was insufficient evidence to support an allegation against a licensed representative, the PRP noted that the SFC had not informed the subject of a complaint (i.e. the licensed representative) of the SFC's findings.

4.84 The PRP considered that the SFC had a duty to inform the subject of the complaint. The PRP recommended that the SFC should improve its complaint handling procedures, including to inform the subject under complaint, either by phone or by letters/emails, once the complaint finding/assessment was completed.

### The SFC's response

4.85 The SFC explained that in reviewing a complaint, it was the SFC's usual practice to seek an initial explanation from the subject of the complaint in order to assist the SFC in determining whether further action by the SFC was warranted. This did not mean that the subject was being investigated. Rather, the preliminary enquiry helped the SFC to assess if a complaint had any substance and should be taken further.

4.86 In the absence of a formal investigation, it was not the SFC's usual practice to issue a letter to the subject of a complaint advising of any "progress/result".

4.87 The SFC explained that there was a real risk that if the SFC, after seeking an initial explanation, did adopt a formal process to inform the subject of a complaint of the "progress/result", this would give the impression that a formal investigation had been commenced when it had not.

4.88 In addition, the initial screening enquiry did not mean that a definitive answer could be given in all cases lest subsequent information might come to the SFC's attention which changed the position.

(c) § *Complaint handling procedures for Corporate Finance Division*

The PRP reviewed a complaint case handled by the Takeovers Team of the CFD. Due to procedural oversight, there was a delay in the issue of the final reply to the complainant. The PRP noted that the CFD had taken immediate action to improve its processes and procedures in handling complaints.

The SFC replied that the case was an isolated incident. The CFD introduced new initiatives and measures to improve its processes and procedures to avoid similar incident in future.

*The PRP's review*

4.89 The Takeovers Team of the CFD (“the Team”) received a case about a conditional voluntary share buy-back offer involving a whitewash waiver in January 2012. The complainant suggested that the SFC and the Stock Exchange of Hong Kong (“SEHK”) should critically review the relevant rules. The complainant also suggested that the transaction should have been approved by a special resolution instead of an ordinary resolution and that pre-vetting of the offer document did not serve any purpose given that the whitewash waiver was subject to independent shareholders’ approval.

4.90 The Team immediately reviewed the relevant documentation and noted in particular that (i) the relevant resolutions had already been approved by an overwhelming majority of independent shareholders (99.5%), and (ii) the parties had complied with the relevant disclosure requirements under the Codes on Takeovers and Mergers and Share Buy-backs (formerly known as the Codes on Takeovers and Mergers and Share Repurchases) (“the Codes”). The Team considered that the Codes had been complied with. The standard interim replies were sent to the complainant and the final reply was sent to the complainant on 18 January 2013.

4.91 During the review, the Team admitted that there had been a procedural oversight which led to the delay in the final reply to the complainant.

4.92 The PRP noted that the Team had taken immediate action to improve its process and procedures in handling complaints once the team discovered its belated action. New measures were introduced five days after the conclusion of the case, as follows:

- team members had set a reminder in the Corporate Finance e-workflow to remind the case team, the Senior Director, all Directors and the policy representative about the progress of complaint cases;
- all outstanding complaint cases and their details were to be included on the agenda for the Team's weekly meeting; and
- the Team commenced reviewing the PRP manual with a view to updating the complaints handling procedures.

4.93 The PRP appreciated the initiatives taken and remedial measures made by the SFC to improve the process and procedure.

4.94 As a side issue, the PRP agreed that there was insufficient manpower in the CFD at the material time. The CFD team members accorded priority to other urgent tasks instead of replying to the complainant. The PRP recommended that the SFC should evaluate the manpower position in the CFD so that complaints could be handled in a timely manner.

#### The SFC's response

4.95 The CFD believed that the new initiatives and measures put in place would not only improve its complaint handling processes, but it would also help make responses to complainants less resource intensive.

4.96 The CFD appreciated that it was important to handle complaints as well as active cases in a timely and efficient manner and should prioritize the tasks accordingly.

4.97 The CFD emphasized that the case being reviewed was an isolated incident. Generally speaking, under the Commission's current complaints handling procedures, there were procedures in place to ensure that periodic replies would be provided to complainant. The CFD put new initiatives and measures in place to improve its processes and procedures with a view to handling complaints in a timely and efficient manner and preventing future delays.

*(d) § Complaint handling procedures for Investment Products Division*

The PRP reviewed a complaint case handled by the IPD and noted that there was no segregation of duties between the product authorization work and the complaint investigation work for the same investment product.

The SFC replied that for case specific complaints, the case officer who was responsible to handle the matter was subject to a second level review as checks and balances.

*The PRP's review*

4.98 In reviewing a complaint case handled by the Investment Products Division ("IPD"), the PRP noted there was no segregation of duties between the product authorization work and the complaint investigation work for the same investment product.

4.99 The team responsible for approving the product was also assigned to investigate any subsequent complaint relating to that product. The PRP was concerned if it would pose a potential conflict of interests and remarked that a proper segregation of responsibilities would ensure impartiality of the complaint investigation.

4.100 The PRP also noted that other than the existing complaint handling procedures (IPD PRP Manual issued in May 2013), the IPD did not have a separate internal complaint handling procedure which defined clearly the responsibilities of the External Relations Department and the IPD for replying complainants. Similar procedural guidelines were found in the complaint handling procedures of the Licensing Department.

4.101 The PRP recommended the IPD of the SFC to:

- formulate internal complaint handling procedures, similar to the Licensing Department, to ensure a better coordination / cooperation with the External Relations Department;
- review the current work arrangement of assigning the same product approval team to handle subsequent complaint investigation; and
- educate and train its staff when the revised procedures was promulgated.

### The SFC's response

#### *Ensure impartiality of the complaint investigation*

4.102 The SFC noted the PRP's concern. Currently, for any complaint against a SFC staff member, there were separate Commission-wide procedures in place whereby the case would be reviewed by a decision maker who was not involved in the complaint matter and, where practicable, had had no previous dealings with that staff member.

4.103 The SFC explained that for other case-specific complaints, the current practice was for the case officer(s) to review and handle the matter, subject to a second level of review (i.e. a Director for IPD-related cases) so as to ensure checks and balances in the process.

#### *IPD's complaint handling procedures*

4.104 The IPD had reviewed the procedures of the Licensing Department and observed, in particular, that there were certain procedures specified in the manual for the Licensing Department which, although not explicitly stated in the IPD Manual, had in fact already been fully implemented into the IPD's existing complaint-handling practices.



*4.105* The SFC welcomed the PRP's suggestion to assess how such procedures could be incorporated more specifically into the IPD Manual. The IPD revised the complaint handling procedures in the IPD PRP Manual with appropriate update in May 2014.

*4.106* Furthermore, the IPD provided appropriate training to staff members after the revised IPD PRP manual was introduced.

### **Concluding Remarks**

*4.107* The PRP noted the SFC's explanations and its actions taken, including the updating its website to clarify the types of complaints covered in the performance pledges and the updating of the IPD complaint handling procedures.

## Corporate Finance including processing of listing applications

4.108 The PRP reviewed five cases on corporate finance. The PRP recommended the SFC to consider setting up a performance pledge on completion of applications handled by the Takeovers Team.

### § *Performance pledges*

In reviewing an application for a ruling under the Codes for a waiver of the general offer obligation, the PRP recommended the SFC to (i) devise a performance pledge or internal guideline, and (ii) introduce an automatic application lapse policy for this kind of application.

The SFC responded that (i) there were several internal performance pledges including (a) to issue a decision on a waiver application within five days of receipt of all information; and (b) to respond to the applicant within five days of receipt of the subsequent submission from the applicant; and (ii) the CFD would actively follow up with applicants who did not respond to the SFC's requisitions.

### *The PRP review*

4.109 When reviewing an application for a ruling under the Codes on Takeovers and Mergers and Share Buy-backs ("the Codes") (formerly known as the Codes on Takeovers and Mergers and Share Repurchases) for a waiver of the general offer obligation, the PRP noted that the SFC had not formulated any performance pledge or internal guideline for applications of this kind.

4.110 The PRP recommended the SFC to consider devising a performance pledge or internal guideline. The PRP advised that the CFD might encounter applicants who did not provide response timely. The CFD might consider introducing an automatic application lapse policy to protect the interests of the SFC.

### The SFC's response

#### *Performance pledges or internal guidelines*

4.111 The Takeovers Team of the CFD was subject to certain internal performance pledges. These included a pledge to issue a decision on a waiver application within five days of receipt of all information required to process the application. Where additional information or clarification from the applicant was needed, the team would respond to the applicant within five days of receipt of the application or any subsequent submission from the applicant. This performance pledge applied to the case under review.

#### *Follow up with inactive case within a month*

4.112 The SFC explained that due to the nature of takeovers transactions, the CFD did not have an automatic application lapse policy. Notwithstanding that, the CFD routinely followed up with applicants if a response to its requisitions was not received within a reasonable period of time. What was considered as "reasonable" would depend on the facts and circumstances of the case.

4.113 Given the PRP's recommendation, in future, the CFD would follow up with applicants who did not respond to the SFC's requisitions within one month. Depending on the circumstances of the case, the CFD would then decide whether the case should be closed or more time should be provided for the response.

## Concluding Remarks

*4.114* The PRP was pleased to note the SFC's agreement to take active follow up with applicants who did not respond to the SFC's requisitions within a month. Depending on the circumstances of the case, the CFD would consider whether the case should be closed or more time be given for the response.

## Investigation and disciplinary action

4.115 The PRP studied 15 completed cases in the Enforcement Division and enquired into the decision making process of the cases. The PRP also reviewed a case relating to the selling of Lehman Brothers related structured products.

(a) § *Action taken against complaint on selling of Lehman Brothers Related structured products*

The PRP reviewed the SFC's follow-up action in handling a complaint on selling of Lehman Brothers related structured products and noted that the SFC had asked the firm to engage an independent audit firm to review its internal control system and account opening procedures. Apparently, the SFC had not conducted further follow-up action with the firm. The PRP recommended the SFC to arrange a follow-up inspection to ensure that the firm had improved its internal control.

The SFC responded that the firm was subject to on-site inspections conducted by the Intermediaries Supervision Department from time to time. The SFC would assess the specific circumstances of each case carefully to determine whether a further follow-up review was appropriate.

### The PRP's review

4.116 The PRP reviewed a case related to a complaint on the selling of Lehman Brothers related structured products.

4.117 The PRP noted that the SFC had asked the firm to engage an independent audit firm to review its internal control system and account opening procedures. The SFC fully relied on the report produced by the audit firm. The SFC had not followed up with the firm direct.

4.118 The PRP recommended the SFC to consider arranging a follow-up inspection. This was important to ensure that the firm had complied with the revised procedures and had implemented the enhanced internal control.

4.119 The PRP commented that the SFC should have:

- asked the firm to engage an independent audit firm to conduct a follow-up inspection. The requirement should have been imposed in the SFC's agreement with the firm; or
- assigned an outside agent to confirm the firm's compliance with the enhanced internal control procedures; or
- referred the case to its intermediaries' inspection team for a special follow-up inspection.

4.120 The PRP remarked that under no circumstances should the SFC wait for the next round of routine scheduled inspection to check the compliance of the firm on the enhanced internal control procedures.

#### The SFC's response

4.121 The SFC explained that the requirement to engage an independent audit firm to conduct an internal control review was part of the section 201 agreement that the SFC had agreed with the firm with a view to resolving the SFC's concerns.

4.122 The agreement had not provided for a follow-up review to be conducted. Like all other licensed intermediaries, the firm was subject to on-site inspections conducted by the ISD of the SFC from time to time.

4.123 The SFC further supplemented that the independent audit firm had produced a report setting out details of the review and its recommendations as to how the firm's internal controls and systems might be enhanced. In response to the report, the management of the firm had agreed to implement the reviewer's recommendations. If the firm did not implement the recommendations, it risked annulment of the section 201 agreement and severe enforcement action from the SFC.

4.124 The SFC viewed that the likelihood of this happening was remote in most cases.

4.125 The SFC would assess the specific circumstances of each case carefully to determine whether a further follow-up review was appropriate.

**(b) § Enforcement Steering Committee**

The PRP reviewed a possible insider dealing case and noted that after the Surveillance Department had completed its findings, it would put up its recommendations to the Enforcement Steering Committee ("ESC"). The PRP enquired about the relevant procedures, mechanism and mode of operation of the ESC.

The SFC replied that the ESC was chaired by the Executive Director of Enforcement and comprised the Senior Director (Investigation), Senior Director (Discipline), Senior Director (Surveillance), Director (International & Policy) and a Deputy Chief Counsel. The ESC met weekly to supervise and to manage the case initiation, progress and conclusion; and to ensure that investigations were disciplined and met the SFC's regulatory objectives.

### The PRP's review

4.126 In reviewing a possible insider dealing case, the PRP noted the internal guidelines in the Surveillance Department of the SFC. The surveillance work was required to be completed within six weeks and the maximum processing time should be two months. The PRP appreciated the efficiency of the Surveillance Department in monitoring improper cases.

4.127 Upon enquiry, the PRP also noted that after the Surveillance Department had completed its findings, it would put up its recommendations on the action to be taken to the ESC of the SFC for consideration.

4.128 The PRP then enquired about the relevant procedures, mechanism and mode of operation of the ESC.

### The SFC's response

4.129 The ESC of the SFC was chaired by the Executive Director of Enforcement and comprised the Senior Director ("SD") (Investigation), SD (Discipline), SD (Surveillance), Director (International & Policy) and a Deputy Chief Counsel in Legal Services Division. It was an integral part of the case management process to ensure that senior management stayed informed about the progress of active investigations and provided strategic guidance to the case manager in conducting an investigation.

4.130 The ESC met weekly to supervise and to manage the case initiation, progress and conclusion; and to ensure that investigations were disciplined and met the SFC's regulatory objectives. The ESC did not manage the day-to-day case activities.

4.131 At the ESC meetings, case managers updated the ESC on the latest development of the case. Once a case had been discussed, the ESC might decide on the allocation of resources required for carrying out the case; and provide guidance to the case manager where necessary.



4.132 The ESC also provided a communication channel for case managers to discuss problems and issues they had faced with senior management directly.

### **Concluding Remarks**

4.133 The PRP noted the SFC's assurance that it would assess the specific circumstance of the case carefully before determining if follow up review by the SFC was required. The SFC's explanations on the mode of operation of the ESC would enhance the transparency of the SFC enforcement work. The PRP was pleased to note.

## Authorisation of investment products

4.134 The PRP reviewed 14 product authorization cases which were processed by the SFC from July 2012 to November 2013. The processing time ranged from eight months to one year & three months. Noting that the SFC implemented a new six-month application lapse policy on 1 January 2014, the effect on the new policy on processing time had to be seen. The PRP also questioned how the SFC clocked the six-month processing time.

The PRP made suggestions to enhance the transparency of the approval process. The PRP reviewed several applications requiring approvals from the SFC and other regulators, and recommended the SFC to enhance its communication with regulators.

### (a) § *Measures taken to expedite authorization*

The PRP recommended the SFC to (i) take proactive action to follow up with applicants; and (ii) consider effective measures to improve the quality of application materials.

The SFC responded that (i) since 17 June 2014, the SFC had implemented an expedited closing procedure under which, if the applicant did not respond or provide any substantive response within one month, the SFC would issue a reminder to the applicant informing it that the SFC intended to issue a letter of mindedness to refuse authorization, unless the applicant satisfactorily addressed all the SFC's requisitions in a month's time; and (ii) the SFC had provided regular guidance to market participants through issuing circulars, FAQs and hosting briefing sessions/workshops to improve the quality of applicant's submission.

The PRP's review

4.135 The PRP focused on processing time spent in each case review. The PRP found that the SFC had often reported that the lengthy processing time was due to the applicant.

4.136 The SFC subject officers explained that the six-month application time lapse policy did not apply to the product application involving vetting from the Mandatory Provident Fund Schemes Authority ("MPFA"). The SFC subject officers also explained that the application process of those products had hinged on vetting performed by other regulators, instead of the SFC.

4.137 The PRP's observations and recommendations were summarized as follows:

- Nine months was taken to complete a relatively straight forward application. The SFC explained that the problem rested with the applicant who took long time to respond. The PRP recommended the SFC to take proactive action to follow up with applicants;
- The SFC was invited to consider formulating performance pledges for cases involving vetting by other regulators. The current performance pledges included only timeframes for taking up applications and issuing first requisition letters<sup>2</sup>;
- The SFC was invited to consider effective measures to improve the quality of application materials submitted by applicants; and
- The SFC was requested to keep the application lapse policy under regular reviews; and consider imposing stringent timeframe as when necessary.

---

<sup>2</sup> At present, the SFC's performance pledges for authorization of investment products are (a) taking-up of applications within 2 business days and (b) a preliminary response to applications after the take-up within 7/14 business days.

4.138 Regarding the six-month application lapse policy, the PRP learnt from the SFC's subject officers that :

- The SFC would clock the progress only when it formally took up the application, i.e. when the SFC received a complete application (i) without obvious omission and (ii) with a fully-paid application fee; and
- If the applicant had invited the SFC for a briefing/discussion prior to the formal submission of application, the SFC would not count the briefing/discussion towards the six-month application lapse period.

#### The SFC's response

##### *Processing time*

4.139 The SFC remarked that it had been conscious of time when processing each application. It had maintained regular dialogue with applicants to discuss and deal with the issues involved.

4.140 The long processing time of the application was mainly attributable to the prolonged response time taken up by the applicant which spent significant time in dealing with another regulator's comments and in obtaining its approval.

##### *Measures to improve quality of applications*

4.141 To improve the quality of applicant's submission, the SFC had provided regular guidance to market participants through issuing circulars, frequently asked questions ("FAQs") and hosting briefing sessions/workshops to elucidate the SFC's regulatory requirements and to answer questions; especially when important new policies or types of investment products were introduced.

*Reminders to applicants if inactive for a month*

4.142 With a view to shortening the response time of the applicant, the SFC had been monitoring the progress of every application closely.

4.143 For cases where applicants had not responded to requisitions or provided incomplete responses, the SFC would issue chasing letters/emails to remind applicants of the outstanding requisitions as well as to seek clarification on the applicants' intention to proceed with the applications.

4.144 Since 17 June 2014, the SFC had implemented an expedited closing procedure under which, if the applicant did not respond or provide any substantive response within one month of the SFC's requisitions, the SFC might issue a reminder to the applicant informing it that the SFC intended to issue a letter of mindedness to refuse authorization unless the applicant properly and satisfactorily addressed all the SFC's requisitions to the SFC's satisfaction within a further month.

**(b) § *Enhancing transparency of application time***

The PRP reviewed an application for new mandatory provident fund scheme and suggested the SFC to (i) consider not allowing the applicants to submit the application within a certain period if the application did not include sufficient documents; and (ii) provide a breakdown of time spent by the SFC, the applicant and the other regulators in the authorization letter to enhance transparency of the authorization process.

The SFC responded that (i) the SFC might refuse taking up any application in which the materials submitted were not in good order; and (ii) providing a detailed breakdown of the processing time in the authorization letter might not serve the purpose to enhance transparency. The SFC was considering other approaches for communicating the messages to the public that could help the industry as a whole.

The PRP's review

4.145 The PRP reviewed an application for a new mandatory provident fund scheme with ten new constituent funds. The application took one year to complete.

4.146 The PRP was told that the relatively long processing time of the application was attributed to the fact that :

- the applicant took approximately five months to address the MPFA's comments;
- the applicant took significant time to seek authorization of a new underlying pooled investment fund; and
- the applicant changed the business plan during the application process which resulted in substantial revisions to draft offering documents.

4.147 The SFC reported that the applicant's response time had taken up 84% of the total processing time.

4.148 The PRP suggested that the SFC should:

- consider adopting the practice of the SEHK: if there were insufficient documents submitted in applications of Initial Public Offering, the applicants could not resubmit the application again within six weeks; and
- provide a detailed breakdown of time spent by (i) the SFC, (ii) the applicant and (iii) the other regulators in its authorisation letter to the applicant so as to enhance transparency of the authorization process.

*The SFC's response*

4.149 The SFC explained that it might refuse taking up any application where the materials submitted were not in good order or otherwise not suitable for clearance.

4.150 The SFC also explained that it had rolled out the revised application lapse policy from 12 to six months. The SFC was of the view that the new policy should be allowed to run its course and to deliver the intended effects for a reasonable time.

*Stipulating the processing time in authorization letter*

4.151 The SFC opined that providing a detailed breakdown of the processing time in authorization letter might not serve the purpose of communicating with market and the industry as a whole. This was because authorization letter was issued by the SFC as a private document to the applicant only.

4.152 The SFC was considering other approaches for communicating important messages to the public that could help the industry as a whole.

4.153 The SFC held a briefing to the industry on 21 May 2014 to share with market participants common pitfalls which had caused delay in the application process. The materials had been posted on the SFC's website for market participants' reference and the materials would also be updated from time to time.

## Concluding Remarks

4.154 The PRP noted the new measures introduced by the SFC since 17 June 2014 and its undertaking to consider other approaches for communicating important messages to the public so as to help the industry as a whole. The PRP would appreciate the SFC's continued efforts in expediting the authorization process.



---

## Chapter 5      Follow-up action by the SFC on the PRP's Recommendations in 2012-13

5.1            In the PRP Annual Report for 2012-13, the SFC committed to explore the following areas –

- (a) Application lapse policy for the authorization of investment products;
- (b) Time spent to obtain in-house legal advice in investigation of enforcement cases; and
- (c) Reply to complainants.

### **(a) Application lapse policy for the authorization of investment products**

5.2            In the PRP Annual Report 2012-13 (*para 3.17*), it was stated that the SFC would introduce a six-month application lapse policy.

#### Action taken

5.3            The SFC issued the circular on the new application lapse policy on 29 November 2013. The policy took effect on 1 January 2014.

#### Progress reported

5.4            The SFC reported that for applications received from 1 January 2014 to mid-June 2014, the average processing time for the completed application was 3.5 months.

#### PRP's remarks

5.5            The situation was encouraging. The SFC was requested to closely monitor the situation and to explore every mean to further speed up the application process.

5.6            The PRP would invite the SFC to report further progress in due course.

## **(b) Time spent to obtain in-house legal advice**

5.7 In the PRP Annual Report 2012-13 (*para. 3.89-3.93*), it was stated that in a suspected market manipulation case which took more than two years' time to complete the investigation, nine months were spent waiting for legal advice from the SFC in-house legal advisor and an external counsel. The SFC pointed out that the delay was a resources issue in the Legal Services Division ("LSD") of the SFC.

### Action taken

5.8 Eight new headcounts were added to the LSD in 2014-15. This represented a 22% increase in approved establishment of the LSD for 2014-15 as compared to 2013-14.

5.9 The SFC explained in its 2014-15 budget book that the additional headcounts were required to establish a new litigation team to take on a mix of civil and criminal litigation work.

### PRP's remarks

5.10 The effect of the SFC's improved resources in the LSD on the provision of in-house legal advice would be closely monitored in future case reviews.

## **(c) Reply to Complainants**

5.11 In the PRP Annual Report 2012-13 (*para 3.130-3.135*), it was stated that the SFC should enhance transparency in its replies to the complainants.

---

Progress reported

5.12 The SFC reported in early 2015 that the SFC had updated the Procedure for Handling Complaints effective from July 2014. The complaint review process of the Complaints Control Committee had been enhanced and template responses to the complainants had been provided to the operational divisions to ensure that the communication between the SFC and the complainants were simpler and clearer. The External Relations Department had also organized briefing and sharing sessions on the enhanced process to all the staff members who were involved in complaint handling.

5.13 The SFC explained that it had been working on the balance between secrecy, privacy and outcome. However, when a complaint resulted in non-public sanctions, the SFC was clearly not in a position to inform the complainant of the results. The SFC's policy had not and would not change in this regard.

PRP's remarks

5.14 The PRP emphasized that the overarching principles were that –

- complainants should be made aware of complaint progress and result in a timely manner without undue delay; and
- communication with complainants should be made in simple, clear and precise language, citing provisions of the SFO if applicable.

5.15 The PRP will follow up with the SFC's report as stated in the above and look forward to the SFC's comprehensive review report on the complaint handling procedure.

## Chapter 6      Way forward

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

6.2            The PRP welcomes and attaches great importance to the views from market practitioners. Comments on the work under the PRP's terms of reference could be referred to the PRP through the following channels<sup>3</sup> –

By post to: 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](mailto:prp@fstb.gov.hk)

---

<sup>3</sup> 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	: <a href="mailto:enquiry@sfc.hk">enquiry@sfc.hk</a> (for general enquiries, comments and suggestions, etc.) : <a href="mailto:complaint@sfc.hk">complaint@sfc.hk</a> (for public complaints)

## Chapter 7      Acknowledgement

7.1            The PRP would like to express its gratitude to the SFC and its staff, in particular 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. The PRP is also grateful for the opportunity to meet the top management of the SFC in June 2014.

7.2            The PRP would also like to express its gratitude to members of the Hong Kong Investment Funds Association and the Chinese Asset Management Association of Hong Kong for the time and efforts made in collating views from the industry and reflecting them to the PRP with a view to improving the current practices for the benefit of the market as a whole. The PRP is glad to be involved in the culmination of the shortening of the application lapse period for the SFC authorised investment products from 12 months to six months. The PRP would continue to play its role to review the operational procedures of the SFC to ensure consistency and fairness.

7.3            Last but not the least, the PRP would like to place on record its appreciation to the dedication and valuable contribution made by the representative of the Secretary for Justice, Mr LAI Ying-sie, towards the work of PRP in the past nine years. Mr LAI retires from the civil service in February 2015. We warmly wish him a happy retirement.

**Process Review Panel  
for the Securities and Futures Commission  
March 2015**