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Introduction

- 1. The Commission has set out in its paper entitled its role and approach in regulating intermediaries through: (i) initial gate keeping or licensing; (ii) ongoing supervision; and (iii) enforcement actions to combat misconduct.
- 2. This paper focuses more particularly on the supervisory function of the Commission in respect of regulated activities¹ carried out by licensed corporations. This function is primarily undertaken by



and places more emphasis on dealing with regulatory issues that may significantly affect investors and/or the market at large.

7. When no regulatory regime can ensure zero-failure, our overall supervisory framework has been designed with a view to minimising any adverse impact on the investors and the market when a licensed corporation goes out of business.



by clients / counterparties, inadequate liquid funds and adverse market movements.

Business conduct risk

This generally covers the risk of loss to the licensed corporation, its clients and/or counterparties stemming from inappropriate or undesirable business conduct or violation of applicable laws and regulations by a licensed corporation.

(b) Sector-crossing risks

10. The term "sector-crossing risks" refers to risks that may affect the whole securities industry or a significant segment of the industry instead of isolated licensed corporations. These are normally associated with the following three areas:

Economic and market performance

The Commission strives to monitor risks arising from major changes in the economic / market environment that would have significant impact on the business operation of licensed corporations. For example, when the stock market was booming in 2007, a detailed analysis was carried out on the margin financing business of major firms to assess their risk management control and compliance with related regulation.

The Commission also conducts market surveys and analyses consolidated industry data so as to identify trends and emerging risks / issues that require regulatory response.

Market evolution

The Commission is mindful of the dynamism present in today's financial markets. For some time, the Commission has been reviewing the selling practices of licensed corporations and notably in 2007, issued the *Questions and Answers on Suitability Obligations of Licensed and Registered Persons who are engaged in Financial Planning and Wealth Management Business Activities*, in order to provide additional guidance to the industry.



upon application by licensed corporations. Through consolidating information gathered



- performing sample compliance tests; and
- o Interviewing relevant staff to assess the control environment of the firm.

Special inspection

- 26. Special inspections are performed on licensed corporations suspected to pose imminent risks to the market or to their customers, for example, where there is reason to suspect misappropriation of client assets. In this case, inspection steps are tailor-made to cater for the specific circumstances of each case. Normally, a special inspection involves carrying out detailed substantive testing and forensic reviews to assist in gauging any potential losses to investors.
- 27. Special inspections are also performed on licensed corporation where its financial position is considered vulnerable. In this case, an on-site inspection will be arranged as soon as practicable to assess its latest financial and liquidity positions, as well as determine if client interests may be at risk, so that the Commission can move to ring fence the licensed corporation if necessary.

Thematic inspection

28. Thematic inspection is the primary tool used to assess the scale and nature of a particular sector-crossing risk, which may be triggered upon the Commission identifying trends, emerging risks and compliance lapses that require prompt regulatory response. A sample of licensed corporations will be selected for review in each round of thematic inspection. The review steps are[()] 65 36dthe



ring fence risky firms t