1. Purpose of inspections carried out by the Securities and Futures Commission (SFC)

1.1 The Securities and Futures Ordinance (SFO) vests the SFC with multiple roles. One of the functions performed by the SFC is to supervise, monitor and regulate the activities carried on by licensed corporations (LCs)[1].

1.2 As a gatekeeper of standards for individuals and corporations seeking to enter the securities and futures markets of Hong Kong to carry on regulated activities[2], the SFC grants licences to those who are appropriately qualified and can demonstrate their fitness and properness to be licensed under the SFO.

1.3 After obtaining its licence, an LC must at all times fulfil its statutory and regulatory obligations, including compliance with all applicable provisions of the SFO and its subsidiary legislation, as well as the SFC's codes and guidelines.

1.4 Inspections carried out under section 180 of the SFO are one of the SFC's tools to ascertain LCs' compliance with these obligations and their continued fitness and properness to remain licensed. In exercising its powers under section 180 of the SFO, the SFC may require an LC to produce records or documents and respond to inquiries concerning the LC's business or transactions[3]. The SFC may exercise these powers independently or in conjunction with its power to enter the LC's premises[4].

2. Unsatisfactory practices and behaviours during inspections

2.1 Below is a non-exhaustive list of examples of unsatisfactory practices and behaviours observed among some LCs[5] during the SFC's inspections:

(a) Attempting to postpone, delay, or reject, the SFC's notices to conduct inspections or interviews with relevant staff;

(b) Challenging the SFC's inspection scope, review areas or selected samples, or the necessity of inspection inquiries, without a valid legal basis;

(c) Delay in providing responses or providing evasive, misleading, intentionally incomplete or partial responses to inspection inquiries;

(d) Withholding information from the SFC, or submitting documents, information or responses which were ambiguous, illegible, inaccurate, incomplete, inconsistent, false, misleading or even forged;

(e) Arranging affairs or manipulating circumstances to delay, disrupt or obstruct the SFC's inspection efforts; and

1 Section 5(1)(b) of the SFO.
2 As defined in Schedule 5 to the SFO.
3 Sections 180(1)(b) and (c), (3) and (4) of the SFO.
4 Sections180(1)(a) of the SFO.
5 For the purposes of this circular, this includes any third party engaged and authorised by an LC to represent it in matters concerning inspections carried out under section 180 of the SFO.

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(f) Engaging in unprofessional, uncooperative or antagonistic conduct towards an authorised person[6], or treating inspection inquiries as an inconvenience.

3. Statutory obligations and expected standards

3.1 <u>Giving access to information and answers to related inquiries</u>

(a) Section 180 of the SFO requires an LC to give an authorised person access to any record or document relating to its business, any transaction, etc. as part of the SFC's inspection, and produce, within the time and at the place specified, the record or document, and answer any question regarding the record or document or its transaction or activity[7].

(b) LCs are reminded that it is a criminal offence under section 180 of the SFO if a person:

(i) fails to comply with a requirement imposed on the person under section 180 of the SFO without reasonable excuse[8];

(ii) produces any record or document or gives an answer which is false or misleading in a material particular, and knows that, or is reckless as to whether, the record or document or the answer is false or misleading in a material particular in purported compliance with a requirement imposed on the person under section 180 of the SFO[9]; or

(iii) with intent to defraud, fails to comply with a requirement imposed on the person under section 180 of the SFO, or in purported compliance with such a requirement, produces any record or document or gives an answer which is false or misleading in a material particular[10].

(c) The SFC has encountered instances where LCs declined to provide specific records and documents, citing confidentiality or privacy concerns as reasons. In this regard, LCs should take note of the following:

(i) The information requested during the SFC's inspections is used for discharging functions of a financial regulator and authorised by law, and is therefore exempt from the relevant requirements under the Personal Data (Privacy) Ordinance (Cap. 486) (PDPO)[11];

(ii) In general, a duty of confidentiality owed to a client or counterparty does not excuse non-compliance with the statutory obligations under section 180 of the SFO; and

(iii) The conduct of an inspection, and any correspondence, record and document associated with an inspection, are confidential. Specifically, section 378 of the

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6 Means a person authorised under section 180(11) of the SFO.
7 Sections 180(3) and 180(4) of the SFO.
8 Section 180(14) of the SFO.
9 Section 180(15) of the SFO.
10 Section 180(16) of the SFO.
11 Sections 58(2) and (3) and 60B of the PDPO.

SFO imposes an obligation upon specified persons[12], including staff of the SFC conducting the inspection, to maintain secrecy and confidentiality in relation to these matters.

3.2 Maintenance and retrieval of records

(a) LCs have ongoing obligations to maintain proper business records. Accordingly, any information and records related to the carrying out of an LC's regulated activities should be readily available at all times. The SFC expects LCs to be able to retrieve these records upon inspection inquiries being made without undue delay, irrespective of any changes in circumstances, including organisational changes and staff departure.

(b) In particular:

(i) The Keeping of Records Rules[13] require an LC to keep accounting, trading and other records related to the businesses of its regulated activities, in a manner which enables convenient and proper auditing, and ensures these records are readily accessible and convertible into written form.

(ii) The Internal Control Guidelines[14] require LC's management to establish and maintain effective record retention policies which ensure that all relevant statutory and regulatory requirements are complied with, and which enable the LC, its auditors and other interested parties, eg, the SFC, exchanges and clearing houses, to carry out routine and ad hoc comprehensive reviews or investigations.

(c) In this regard, LCs are reminded that it is an offence[15] if an LC, without reasonable excuse or with intent to defraud, contravenes the relevant provision(s) of the Keeping of Records Rules.

3.3 Availability of responsible officers (ROs) at all times

(a) As the senior management of an LC, ROs are responsible for ensuring the LC's compliance with all statutory and regulatory requirements applicable to the conduct of its business activities.

(b) During an inspection, the SFC may request to speak with the ROs to discuss the LC's compliance with these requirements and the SFC expects the ROs to be available to participate in the inspection process.

[12] Means the SFC, any person who is or was a member, an employee or a consultant, agent or adviser, of the SFC, or any person who is or was, among others, a person assisting in the performance of a function under or carrying into effect any relevant provisions as defined in the SFO.
[13] Sections 3 and 9 of the Securities and Futures (Keeping of Records) Rules (Keeping of Records Rules).
[14] Paragraph IV.6 of the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission (Internal Control Guidelines).
[15] Section 12 of the Keeping of Records Rules.

(c) Specifically, the SFO provides that an LC shall not carry on any regulated activity for which it is licensed unless it has two ROs, at least one of whom shall be an executive director of the LC, in relation to the regulated activity[16].

(d) Furthermore, it is a statutory licensing condition that all LCs[17] must have at least one RO available at all times to supervise their business of carrying on of a regulated activity. If all ROs are travelling away from Hong Kong or are otherwise absent from work, the LC should ensure that the ROs can be contacted (preferably by telephone) whenever necessary and that proper internal controls are in place to ensure effective supervision of that LC's regulated activities during their absence. However, this measure should be temporary only and the out-of-town period or absence of the ROs should not adversely affect the proper discharge of their duties.

(e) The SFC wishes to emphasise that when the SFC issues a formal notification to an LC about its intention to carry out an inspection under section 180 of the SFO, such notification serves as an official notice to the LC, rather than an appointment scheduling. While the SFC will maintain a practical approach and ongoing communication with the LC during the inspection, the asserted unavailability of any RO or staff is generally not considered a reasonable excuse for failing to comply with a requirement under section 180 of the SFO. Regardless of such unavailability, the SFC will proceed with the inspection.

3.4 <u>Fitness and properness of LCs</u>

(a) LCs must comply with all applicable statutory and regulatory requirements, and are expected to be cooperative in their dealings with the SFC during an inspection.

(b) In this regard, the SFC wishes to remind LCs of the following:

(i) General Principles 1, 2 and 3 of the Code of Conduct[18] stipulate that a licensed person should act honestly, fairly, with due skill, care and diligence, and in the best interests of its clients and the integrity of the market, and have and employ effectively the resources and procedures for the proper performance of its business activities; and

(ii) General Principles 7 and 9 of the Code of Conduct stipulate that a licensed person should comply with all applicable regulatory requirements to promote the best interests of clients and the integrity of the market, and the senior management of a licensed person should bear primary responsibility for ensuring the maintenance of appropriate standards of conduct and proper procedures.

(c) LCs are expected to adhere to these principles in responding to the SFC's inspection notices under section 180 of the SFO throughout the inspections. Failure to comply with section 180 of the SFO and/or other requirements under the

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16 Section 125(1) of the SFO.
17 Section 118(1)(a)(ii) of the SFO.
18 Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct).

SFC's codes or guidelines will constitute misconduct and may affect adversely an LC's fitness and properness to remain licensed[19].

3.5 Engagement of external representatives

(a) When an LC engages and authorises a third party, such as external consultants or legal representatives, to act on its behalf in matters concerning inspections carried out under section 180 of the SFO (eg, preparing responses to the inspection inquiries), the LC remains fully responsible and accountable to the SFC for the conduct of its authorised representatives, and the information and representations provided to the SFC by these parties.

4. Legal liabilities of senior management[20]

4.1 Senior management of an LC bears primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by the firm. Under Part IX of the SFO, the SFC may exercise its disciplinary powers to sanction regulated persons (including a person involved in the management of the business of an LC), if the person is, or was at any time, guilty of misconduct or is considered not fit and proper to be or to remain the same type of regulated person[21].

4.2 All senior management members of an LC (even if they are not licensed) are regulated persons because of their involvement in the management of the LC's business.

4.3 Where an LC is (or was) guilty of misconduct as a result of the commission of any conduct occurring with the consent or connivance of, or attributable to any neglect on the part of, an RO or a person involved in the management of the business of the LC, then that person is also guilty of misconduct[22].

4.4 Furthermore, in determining whether a regulated person, including a person involved in managing an LC, is a fit and proper person when considering potential disciplinary action, the SFC may take into account the past or present conduct of the person[23]. For instance, if a Manager-In-Charge of Core Function(s) (MIC) fails to ensure an LC's compliance with the SFC's codes or guidelines, this may call into question the MIC's fitness and properness.

4.5 To this end, the SFC will call on the MIC of the Overall Management Oversight function at an LC, supported by the MIC of the Compliance function, to exercise robust oversight and proactive leadership in ensuring the LC's full cooperation and compliance throughout the SFC's inspection process.

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[19] Under section 129 of the SFO, in considering whether a person is a fit and proper person, the SFC shall, in addition to any other matter that the SFC may consider relevant, have regard to the person's (i) ability to carry on the regulated activity competently, honestly, and fairly; and (ii) reputation, character, reliability and financial integrity.

[20] This is also outlined in section E of the Circular to Licensed Corporations Regarding Measures for Augmenting the Accountability of Senior Management, issued by the SFC on 16 December 2016 (MIC regime).

[21] Under section 194(7) of the SFO, the term "regulated person" means a person who is or at the relevant time was any of the following types of person:
(a) A licensed person (ie, an LC or a licensed representative);
(b) An RO of an LC; or
(c) A person involved in the management of the business of an LC (regardless of whether he or she is licensed).

[22] Section 193(2) of the SFO.

[23] Sections 194(3) and 129 of the SFO.