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REGULATION AND SUPERVISION OF SECONDARY
MARKETS

Prepared By
**Monetary and Capital Markets
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This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program in Hong Kong Special Administrative Region, led by Ananthakrishnan Prasad. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at <http://www.imf.org/external/np/fsap/fssa.aspx>

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Glossary

ALP	Alternative Liquidity Pool
ATS	Automated Trading Services
CE	Chief Executive of Hong Kong SAR
CSRC	China Securities Regulatory Commission
DMA	Direct Market Access
FS	Financial Secretary
FSAP	Financial Sector Assessment Program
FSTB	Financial Services and the Treasury Bureau
HKEX	Hong Kong Exchanges and Clearing Limited
HKFE	Hong Kong Futures Exchange Limited
IOSCO	International Organization of Securities Commissions
MoUs	Memoranda of Understanding
Listing MoU	Memorandum of Understanding Governing Listing Matters between the SEHK and the SFC dated 28 January 2003
MMoU	Multilateral Memorandum of Understanding
MPF	Mandatory Provident Fund
MPFA	Mandatory Provident Fund Schemes Authority
SEHK	The Stock Exchange of Hong Kong Limited
SFC	Securities and Futures Commission
SFO	Securities and Futures Ordinance
SOM	Supervision of Markets Division
SSE	Shanghai Stock Exchange
Supervision MoU	2001 MoU on Matters relating to SFC Oversight, Supervision of Exchange Participants and Market Surveillance
SZSE	Shenzhen Stock Exchange

EXECUTIVE SUMMARY¹

Hong Kong SAR has, over the recent years, become an equity trading hub catering to domestic and foreign investors, including increasingly to investors from Mainland China. Most trading is conducted on markets operated by recognized exchange companies, with limited domestic trading happening via automated trading services (ATS) providers in the form of alternative liquidity pools. The introduction of Stock Connect in 2014 enabled investors from Hong Kong (including domestic and foreign) to directly invest in the Shanghai and later Shenzhen markets and investors from the Mainland to directly access the Hong Kong market. Trading via Stock Connect has seen a steady rise over the last few years, increasing the linkages between Hong Kong SAR and the Mainland. Mainland companies currently account for over 60 per cent of market capitalization of the equities traded on the Stock Exchange of Hong Kong (SEHK).

The Securities and Futures Commission (SFC) has improved its regulatory and supervisory framework for ATS since the previous FSAP in 2014. Regulation of intermediaries providing ATS has been revamped with the introduction of guidelines and specific sections in the intermediaries' code of conduct to consolidate regulatory requirements that previously were mostly imposed via licensing conditions. As a consequence, the framework is clearer and more consistent and provides a more level-playing field for different service providers. At the same time, supervision of ATS providers has become more risk-based and granular, with the SFC engaging in more comprehensive data analysis as part of their on-site inspections and getting a better understanding of firms' practices via thematic reviews.

Supervision of the operations of recognized exchange companies has also been significantly enhanced. The SFC has conducted several on-site inspections of the recognized exchange companies and clearing houses since 2015, focusing on their respective trading and clearing functions and leading to visible improvement in their oversight of members and rules. The supervision of the listing function of the securities exchange has also seen major improvements through a number of angles: (i) an enhancement of SFC's ongoing oversight of the listing function and periodic reviews, with more in-depth reviews and a more risk-based selection of audit themes; (ii) a more proactive approach by the SFC on vetting listing applicants and monitoring major transactions and corporate actions by listed issuers, intervening earlier and focusing on the most serious conducts; and (iii) a more intrusive approach to the supervision of the due diligence role of sponsors of listing applicants. Such enhancements have enabled the SFC to more effectively control previously on-the-rise misconduct like the misuse of backdoor listing and shell companies.

The SFC has also dedicated great efforts to creating a closer work relationship with the China Securities Regulatory Commission (CSRC). As the connections between both markets continue to grow, the SFC and the CSRC have stepped up cooperation by entering into a number of agreements on market oversight, supervision and enforcement, as well as by significantly increasing the frequency of their formal and informal exchanges of information, meetings and other joint events.

¹ This technical note was prepared by Cristina Cuervo (IMF/MCM). The FSAP mission took place in September 2019.

Regular and deepened cooperation between the SFC and CSRC has improved their understanding of each other's markets and contributed to greater efficiency in tackling misconduct.

Overall, the current regulatory and supervisory framework for trading systems has been strengthened towards a more solid one that better contributes to financial stability. Efficient, fair and transparent markets are key to financial stability. Strong investor protection standards, transparency, risk monitoring and strong enforcement are all important elements enabling the regulator to mitigate the systemic risk that might result from an erosion of market trust. In this context, the improvement of supervision of the listing function contributes to a more transparent market and better formation of prices, together with a reduction of fraud and better protection of investors. A more risk-based supervision of the exchanges and ATS providers, together with a more targeted enforcement approach, contribute to ensuring that markets remain fair and efficient. Finally, robust international cooperation with relevant counterparts is key to ensuring both a better monitoring of risks and a more efficient prosecution of misconduct.

The SFC is encouraged to continue enhancing its regulatory and supervisory framework for secondary market trading. This technical note points to a few areas where the system could be improved further, like expanding SFC's enforcement powers in relation to recognized exchange companies and certain ATS providers, fine-tuning its market surveillance function to ensure it has access to a more comprehensive range of trading data and considering consolidating requirements for recognized exchange companies into the regulatory framework. The SFC should also ensure it continues to strengthen its cooperation with the Mainland as the ties between the two markets are likely to continue intensifying.

Table 1. Hong Kong SAR: Main Recommendations

Recommendation	Priority
1. Consider consolidating requirements for recognized exchange companies into the regulatory framework	Medium term
2. Enhance transparency and accountability of the FS consultation framework in relation to approval/withdrawal of recognition of exchanges/clearing houses.	Medium term
3. Continue enhancing the surveillance function, particularly through (i) finalizing the Southbound Investor ID regime in cooperation with Mainland authorities, and (ii) continuing SFC's ongoing work on OTC trading to enable the monitoring of those trades, or otherwise address the issue based on overall risks and safeguards (see recommendation 7 below).	(i) Short term (ii) Medium term
4. The SFC to ensure that HKEX's program to monitor members' compliance with its rules continues to be adequate going forward or otherwise needs further improvements.	Medium term
5. Expand enforcement powers over recognized exchange companies and clearing houses, and Part III ATS providers.	Medium term
6. Continue to deepen cooperation with the CSRC in line with increasing interlinkages with the Mainland.	Medium/Long term
7. As part of its work on OTC trading, the SFC is encouraged to consider the potential risks for market integrity of this type of trading and whether there are compelling reasons and sufficient safeguards in place for it to continue to be allowed.	Medium term

INTRODUCTION²

A. Scope and Approach of this Note

1. **This technical note (TN) reviews the effectiveness of the regulation, supervision and systemic risk monitoring of secondary markets in Hong Kong.** The focus of the TN is on equity trading activities conducted on exchanges and other regulated trading systems. While over-the-counter (OTC) equity trading exists in Hong Kong, it is not covered in this note. Particular emphasis has been placed on regulatory and supervisory issues with most direct relevance for financial stability. It makes reference to the relevant International Organization of Securities Commissions (IOSCO) documents³ and points out areas where enhancements are recommended to be made.
2. **The TN is structured in two main sections and is based on documentation provided by the authorities as well as a number of on-site meetings with the authorities and industry.** The first section provides some background on the regulatory structure in Hong Kong, and more specifically on the powers of the SFC with respect to secondary markets. For the purposes of producing this TN, the mission reviewed the authorities' response to a questionnaire on the regulation and supervision of secondary markets as well as other documentation made available by the authorities. This included laws, regulation and guidelines, reports on specific topics as well as supervisory and enforcement files where available.
3. **The author is grateful to the authorities and private sector participants for their cooperation.** The author benefitted greatly from the valuable inputs and insightful views from meetings with regulators, supervisors, the Hong Kong Exchanges and Clearing Limited (HKEX) and market intermediaries.

BACKGROUND

4. **Under the current legal framework, the SFC is the main authority responsible for the regulation and supervision of securities markets.** The SFC's mandate stems from the Securities and Futures Ordinance (SFO) which entrusts it with the development and regulation of the securities and futures markets and the reduction in systemic risk in those markets. The SFC is a non-governmental statutory authority, with a board of directors appointed by the Chief Executive of Hong Kong SAR or by the Financial Secretary (FS) under delegated authority.

² The main author of this note is Cristina Cuervo, Senior Financial Sector Expert from the Monetary and Capital Markets Department of the IMF. The on-site work supporting the findings and conclusions was conducted during September 2019. The information in this note is current as of January 2020.

³ Relevant IOSCO work includes Principles 33-35 of the IOSCO Principles and the following Standards: Principles for Dark Liquidity, May 2011, Regulatory Issues Raised by the Impact of Technological Changes in Market Integrity and Efficiency, October 2011; and Regulatory Issues Raised by Changes in Market Structure, December 2013.

5. The SFC's responsibilities, powers and authority are set out in the SFO. Section 4 of the SFO sets out the regulatory objectives of the SFC, which include maintaining the integrity of markets, investor protection, the prevention of financial crime and the reduction of systemic risk. Sections 5 and 6 detail the general functions and powers of the SFC, which include: supervising, monitoring and regulating the activities carried out by (i) recognized exchange companies, recognized clearing houses, recognized exchange controllers or recognized investor compensation companies, (ii) registered institutions and (iii) persons carrying on activities⁴ regulated by the SFC under any of the relevant provisions⁵ other than registered institutions. Further, specific powers and duties are set out in the SFO.

6. HKEX has important regulatory responsibilities, mainly in connection with the authorization of prospectuses/listing. As discussed in the next section, the HKEX operates the only recognized securities exchange in the jurisdiction through its wholly-owned subsidiary, the Stock Exchange of Hong Kong Limited (SEHK). The HKEX also operates the only futures exchange in the jurisdiction through its other wholly-owned subsidiary, the Hong Kong Futures Exchange Limited. Two memoranda of understanding (MoUs) provide a framework for the discharge of regulatory functions by the HKEX and for its oversight by the SFC: the 2001 MoU on Matters relating to SFC Oversight, Supervision of Exchange Participants and Market Surveillance (Supervision MoU) and the Memorandum of Understanding Governing Listing Matters between the SEHK and the SFC dated 28 January 2003⁶ (Listing MoU). The Stock Exchange of Hong Kong Limited (SEHK) is the regulator administering the rules governing the listing of securities (Listing Rules⁷). SEHK is responsible for admitting companies and products for listing and monitoring and enforcing the requirements of the Listing Rules. The SFC can intervene directly in serious listing matters in initial public offerings (IPO) and post-IPO transactions by raising objections to the listing applications or directing the suspensions of trading in listed companies' shares⁸.

7. In recent years, the SFC has undergone a significant shift in its approach to overseeing the markets. Stemming from concern about the need to increase the intensity of oversight of listing matters and to better balance enforcement, licensing and supervisory functions, the SFC started a gradual change in the manner it used its powers. With the aim of better utilizing all regulatory and

⁴ The following are the regulated activities for which the SFC can grant licenses: dealing in securities (Type 1), dealing in futures contracts (Type 2), leveraged foreign exchange trading (Type 3), advising on securities (Type 4), advising on futures contracts (Type 5), advising on corporate finance (Type 6), providing automated trading services (Type 7), securities margin financing (Type 8), asset management (Type 9), and providing credit rating services (Type 10). The regulated activities of dealing in or advising on OTC derivative products (Type 11) and providing client clearing services for OTC derivative transactions (Type 12) are not yet in operation.

⁵ "Relevant provisions" is defined in section 1 of Part 1 of Schedule 1 to the SFO. It includes the SFO and certain parts of the Companies (Winding Up and Miscellaneous Provisions) Ordinance, the Companies Ordinance, and the Anti-Money Laundering and Counter-Terrorist Financing Ordinance.

⁶ As supplemented by the First Addendum to the Listing MoU dated 9 March 2018.

⁷ The Listing Rules refer to both the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (Main Board Listing Rules), or the Rules Governing the Listing of Securities on GEM of The Stock Exchange of Hong Kong Limited (GEM Listing Rules).

⁸ Please refer to paragraph 8 for more detail on SFC's intervention on serious listing issues.

supervisory tools available to the SFC to achieve a more effective oversight of matters under its mandate, the SFC has adopted what it calls a “front-loaded” regulatory approach (see Box 1 for more details). A multi-angle strategy, front-loaded regulation has positively impacted the SFC’s effectiveness, resulting in a more balanced use of resources, as well as a reduction of the level of misconduct in some particularly problematic sectors.

8. As part of this new approach, the SFC repositioned itself as the statutory regulator for listing matters. Contrary to previous practice, the SFC now directly intervenes in more serious cases of misconduct by listing applicants and listed issuers. The SFC obtains any necessary clarifications in relation to the transaction in question by issuing letters to the company whenever an initial review shows any red flags for potential fraud or other serious matters. Overlap of review between the SFC and SEHK of prospectus and listing documents in IPO vetting has been reduced. Under the new approach, whether in vetting listing applications or in evaluating proposed transactions or actions by listed issuers, SEHK will focus on general Listing Rules compliance while the SFC targets serious concerns of misconduct and public interest concerns (e.g. backdoor listing, use of shell companies to circumvent listing requirements, etc.). Changes to supervisory practices regarding listing matters were made subsequent to a 2016 public joint consultation on the matter by the SFC and HKEX that assisted the SFC in rethinking its approach. Improvements to coordination between both authorities have also been made, further smoothing the process and avoiding unnecessary overlap.

Box 1. Hong Kong SAR: Breaking Down Silos Through “Front-loaded” Regulation

In recent years, the SFC has been refining its approach to the supervision and enforcement of matters under its mandate.

Traditionally characterized as an enforcement agency with a strong focus on prosecuting misconduct, the SFC was underutilizing a number of regulatory and supervisory tools provided for in the regulatory framework that could be used outside of the enforcement context. A significant rise in misconduct and fraud in the GEM board (small and mid-cap companies) of the SEHK led to an overburden of the SFC's enforcement function and a sense of non-efficient use of the SFC's powers and resources. This prompted the SFC to initiate a shift in its approach that is commonly known as the “front-loaded” approach.

Through the front-loaded regulatory approach, gradually implemented from a number of angles, the SFC has fundamentally changed the way it operates.

- The SFC identified a number of tools that were available in the regulatory framework to tackle specific problems in a more efficient manner and without the need to resort to enforcement action. It started to apply tools that were traditionally only used in the context of enforcement proceedings (e.g. requests for books and records under Section 179 of the SFO) for regular supervisory purposes. It made use of the power to impose conditions on corporations not only during licensing, but also for the purposes of requesting swift correction of issues detected through supervision. A significant change in approach was also implemented in relation to supervision of listing matters, where the SFC repositioned itself as the statutory regulator by intervening directly and at an earlier stage to ensure better gatekeeping of IPO activities and post-IPO corporate actions. This was articulated by using SFC's powers in already existing subsidiary legislation more proactively.
- It developed a practice of prioritizing a few major themes to ensure a more effective enforcement program. As more issues were being rectified through ongoing licensing and supervisory activities, valuable enforcement resources were freed to deal with the most serious offences. Regular collaboration among licensing, supervision and enforcement functions of the SFC has enabled a better selection of issues on which to focus enforcement efforts.
- It openly communicated all of these changes to the market via circulars, supervisory reports or speeches, to ensure awareness of the SFC's change in profile and its expectations towards the industry and the markets.

To be able to implement this approach, significant efforts were placed on breaking down silos across the SFC. No structural internal changes were made, rather initial collaboration in specific joint policy projects developed into regular cooperation on day-to-day matters.

The SFC has seen a clear improvement in its effectiveness (e.g. the excessive weighing of the market towards the small and mid-cap segment with its corresponding share of misconduct was corrected) and has also received feedback from the public that now perceives the SFC as a more operational authority.

SECONDARY MARKETS

A. Market Structure

9. Most of the securities trading in Hong Kong takes place through recognized exchange companies. The SEHK is the only recognized securities exchange company in Hong Kong⁹ and is wholly owned by the HKEX. The HKEX is also controller of the Hong Kong Futures Exchange Limited (HKFE). As discussed in the next section, legislation also permits trading through ATS providers, most of which are brokers operating internal crossing systems in the form of alternative liquidity pools (ALPs). Trading through ALPs is limited, and as of April 2019 the transactions executed by ALPs accounted for about one per cent of the total turnover of the securities market. There is another category of ATS, which has in practice been used by overseas exchanges and overseas ATS providers for allowing direct access to their trading platforms for trading foreign products. There are currently 43 overseas exchanges and electronic trading facilities authorized by the SFC, including many of the world's leading exchanges (e.g. Australia Securities Exchange Group, Chicago Mercantile Exchange Group, ICE Futures, etc.)¹⁰

10. SEHK's market is dominated by issuers based in the Mainland. Mainland companies accounted for 50 per cent of listings, 68 per cent of total market capitalization and 59 per cent of market turnover in 2018. Out of the US\$36.5 billion equity funds raised through IPOs in Hong Kong in 2018, 95 per cent were raised for Mainland companies.

Table 2. Hong Kong SAR: Mainland Issuers in the SEHK		
Mainland component in the SEHK	Total	% share
Number of listed companies (end-2018)		
Total (Main Board + GEM)	2,315	100%
<i>Mainland companies</i>	<i>1,146</i>	<i>50%</i>
Market capitalisation (end-2018, HK\$ bn)		
Total (Main Board + GEM)	29,909	100%
<i>Mainland companies</i>	<i>20,193</i>	<i>68%</i>
Market turnover in 2018 (HK\$ bn)		
Total (Main Board + GEM)	26,423	100%
<i>Mainland companies</i>	<i>15,480</i>	<i>59%</i>
Source: SFC.		

⁹ There were four stock exchanges in Hong Kong prior to the establishment of SEHK in 1986. To address the issues of market fragmentation and market efficiency, the Government consolidated the four stock exchanges into SEHK and provided that SEHK is the only stock market operator in Hong Kong. This was written into Section 19 of the SFO at the time of its enactment in April 2003.¹⁰ Although trading via ATS providers is limited, this note covers regulation and supervision of all trading systems (recognized exchanges, Part V and Part III ATS) for comprehensiveness and to understand how regulatory and supervisory arrangements may vary for different trading systems.

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11. SEHK has a relatively large number of members that range from global players to very small domestic firms. There are 594 licensed intermediaries who are members of SEHK, although trading is concentrated in a smaller number of firms, with the top 14 brokers accounting for 55 per cent of the total volume of trades. About 65 members account for more than 90 per cent of the trading volume.

12. The Stock Connect establishes mutual stock market access arrangements between the Mainland and Hong Kong. Under Shanghai-Hong Kong Stock Connect, launched in 2014, the SEHK and the Shanghai Stock Exchange (SSE) established mutual order-router connectivity and related technical infrastructure to enable investors of their respective markets to trade shares listed on each other's market. In a similar fashion, Shenzhen-Hong Kong Stock Connect, which was launched in 2016, establishes mutual access between the SEHK and the Shenzhen Stock Exchange (SZSE). Northbound trading (Hong Kong to the Mainland) is conducted through SEHK's subsidiaries in both Shanghai and Shenzhen that receive orders to trade in SSE and SZSE; similarly, southbound trading is conducted through SSE and SZSE's subsidiaries in Hong Kong. In 2018, southbound trading reached about 6 per cent of total trading in Hong Kong, while northbound trading was about 3 per cent of total trading in the Mainland.

Stock Connect average daily turnover (RMB bn)	2018	2017	2016	2015	2014
Northbound	20.4	9.6	3.3	6.4	5.6
Southbound	10.8	8.6	3.2	2.7	0.8

Source: SFC.

B. Regulation

Regulation of Authorized Trading Systems

13. The SFO regulates two types of trading systems: recognized exchange companies and ATS providers.

- a. Sections 19 and 59 of the SFO empower the SFC to recognize a company as an exchange company and an exchange controller, respectively.
- b. As for the second category of trading systems, the SFO regulates two types of ATS:
 - i. those which operate more like an exchange or a clearing house are authorized under Part III of the SFO (Part III ATS); and
 - ii. those where the provision of ATS services is incidental to the performance of a dealing function are licensed or registered under Part V of the SFO (Part V ATS).

14. The provision of ATS requires authorization, registration or licensing under the SFO.

Any person providing services in Hong Kong by means of electronic facilities (not being facilities provided by a recognized exchange company or a recognized clearing house) to trade in or clear securities or futures contracts will require authorization, registration or licensing as an ATS provider. Recognizing that ATS operations can vary significantly, two types of licenses are envisaged by the SFO under Part III and Part V of the SFO, depending on whether provision of ATS is a core function, resembling those of an exchange or clearing house, or whether provision of ATS is incidental to the performance of a dealing function.

15. The principles, standards and procedures for ATS provision have been set out in the Guidelines for the Regulation of Automated Trading Services (ATS Guidelines).

The latest version of the ATS Guidelines was published in 2016¹¹. While they do not have the force of law, they are enforceable in that failure to follow their spirit may reflect adversely on the fitness and properness of persons to be, or to continue to be, authorized, registered or licensed to provide ATS. The Guidelines set forth core standards of practice for the provision of ATS and describe the SFC's approach to ATS regulation, which is a pragmatic one where regulation can be appropriately adapted and applied on a case-by-case basis, taking into account all relevant facts and circumstances.¹² Having in mind that ATS are diverse, it aims to tailor the regulation of these services in a manner that is commensurate with their functions and risks, provide a level-playing field and have regard for international standards and practices. The SFC, therefore, has discretion in setting the intensity of regulation of ATS providers depending on the type and risks of such services. The Guidelines specifically point out that in appropriate cases, the level of regulation of an ATS provider can be similar to that of a recognized exchange company. As regards Part III ATS providers, the SFC allows regulatory deference, once it has assessed the appropriateness/equivalence of the relevant overseas regulatory regime at the time of authorization.¹³

16. Part V ATS providers are also bound by the rules for licensed intermediaries.

Part V ATS providers are intermediaries that are licensed or registered to provide ATS (Type 7) regulated activities under Part V of the SFO. In addition, the SFC can impose more specific conditions to applicants at licensing. As licensed intermediaries, they are required to comply with the Code of Conduct for Persons Licensed or Registered with the SFC (Code of Conduct)¹⁴. As specifically stated in the ATS Guidelines, where a person is licensed or registered under Part V, all of the provisions of

¹¹ The SFC regularly reviews the legislative requirements, the SFC rules, codes and guidelines to ensure that the regulatory requirements remain appropriate and in line with market developments.

¹² Reference will be made to, among other things, the nature and scope of the ATS, the market participants that might be affected by the provision of such ATS and whether any systemic risks may arise.

¹³ When not specifically addressed in this note, it should be understood that there are no specific regulatory requirements for Part III ATS providers on any relevant topic, and that the SFC relies on the home jurisdiction regulatory regime.

¹⁴ Paragraph 18 and Schedule 7 of the Code of Conduct stipulate the general principles and specific requirements that apply to licensed or registered persons conducting electronic trading of securities or futures. Paragraph 19 and Schedule 8 of the Code of Conduct stipulate the general principles and specific requirements that apply to licensed or registered persons operating an alternative liquidity pool or routing client orders to an ALP.

the SFO (including subsidiary legislation under the SFO) relating to intermediaries will normally apply. These include, for example, provisions and requirements relating to the licensing of representatives, the maintenance of financial resources, the protection of client assets and compliance with relevant codes for business conduct. Prior to 2015, requirements were imposed on Part V ATS providers via licensing conditions, which gave rise to an inconsistent approach to their regulation and supervision; this issue was pointed out during the previous FSAP in 2014. In order to standardize the regulation of ATS, a uniform set of requirements for ALP operators and persons conducting electronic trading was codified in paragraphs 18 and 19 and Schedules 7 and 8 to the Code of Conduct.

17. The ability to impose licensing conditions still gives the SFC discretion to tailor requirements as needed, but there is a process in place to provide transparency and aim towards a level-playing field. Licensing conditions are displayed on the public register of the SFC's website. Generally, when imposing licensing conditions on an ATS provider licensed under Part V of the SFO, the SFC will consider particular facts and circumstances of each case including the proposed scope of the applicant's intended business and will make reference to licensing conditions imposed on existing licensed ATS providers which conduct similar businesses. If there is a need to vary certain conditions because of particular circumstances of an ATS provider, the reasoning and justification for the variation is documented in an internal memo for record and future reference. Before granting the license, the SFC also seeks comments from applicants and provides sufficient time for them to respond before imposing the licensing conditions.

Figure 1. Hong Kong SAR: Regulation of Trading Systems in Hong Kong		
Type	Regulation	Authorized/Licensed trading systems service providers
Recognized exchange companies	SFO	The Stock Exchange of Hong Kong Limited (SEHK) Hong Kong Futures Exchange Limited (HKFE)
Part III ATS providers	SFO ATS Guidelines	43 overseas exchanges and electronic trading facilities.
Part V ATS providers¹	SFO ATS Guidelines Code of Conduct: -Para 18 and Schedule 7 (electronic trading, including internet trading and direct market access (DMA) specific provisions) - Para 19 and Schedule 8 (ALP)	15 Alternative Liquidity Pool (ALP) operators. 3 pre-IPO trading platforms 6 platform operators for fixed income products and inactive ATS firms
¹ The SFO does not detail the types of ATS providers that may be set up, but the ATS Guidelines and Code of Conduct contain specific provisions applicable to some business models in existence in Hong Kong SAR, namely: electronic trading -including internet trading and direct market access; and alternative liquidity pool operators (ALP)		

Financial Resources

18. The SFO does not detail specific financial resources requirements for recognized exchange companies and leaves discretion to the SFC when granting recognition. If a company seeks recognition as an exchange company, the SFC will determine prudential and capital requirements as it deems appropriate. It will also review if the company would have the capability to carry out the statutory duties specified in the SFO and provide and maintain the various trading or clearing systems. In particular, Section 21(1) (b) of the SFO stipulates that recognized exchange companies have to manage the risks associated with its business and operations prudently. While the SFO does not specify further, the SFC in 2015 determined that it was appropriate to impose specific capital requirements, and further requested that both SEHK and HKFE maintain at all times net current assets funded by equity sufficient to cover their projected total operating expenses for at least the following six months. Additionally, each needs to hold net current assets funded by equity or long-term loans from HKEX that are sufficient to cover their projected total operating expenses

for at least the following 12 months¹⁵. Similar requirements were imposed for the four recognized clearing houses under HKEX. In determining the level of financial resources to be required, the SFC analyzed the regime of a number of jurisdictions. For the clearing houses in particular, the SFC, ensured that the level of financial resources to be required met the Principles for Financial Market Infrastructures and added more stringent capital requirements on top of those.

19. For Part V ATS providers, minimum financial resources requirements are set in the Securities and Futures (Financial Resources) Rules (the Financial Resources Rules). Section 129 of the SFO stipulates that in determining whether a person is fit and proper, the SFC shall have regard to its financial resources and solvency. The ATS Guidelines require that the ATS provider should have sufficient financial resources for the proper performance of its operations, functions and obligations. When applying licenses, ATS providers should demonstrate that their resources are sufficient to provide services on an on-going and continuous basis, such as to minimize the probability of its failure and any consequential adverse impact on market participants and investors. After being licensed, they have to maintain at all times financial resources in the amounts required under the Financial Resources Rules. Specifically, Part V ATS providers with only a Type 7 license have to maintain minimum paid-up share capital and liquid capital of HK\$5,000,000 and HK\$3,000,000 respectively. For those with more than one license apart from Type 7, the minimum paid-up share capital and liquid capital shall be the highest amount required amongst those licenses.

20. As regards Part III ATS, the SFC would generally expect them to comply with the financial resources requirement set by their home regulator. Part III ATS providers also need to report material changes of regulatory requirements (including financial resources requirement) in their home jurisdiction, as well as any material change in their Hong Kong operations.

Market Monitoring and Surveillance

21. The HKEX is required to carry out specific market monitoring and surveillance activities. Pursuant to the SFO, a recognized exchange company has the duty to ensure an orderly, informed and fair market for securities or futures that are traded on the market that it operates or through the facilities of that company. The Supervision MoU sets out more specific obligations for HKEX, including to (i) monitor and control the risks on any market operated by the HKEX or a recognized exchange company; (ii) oversee the activities of participants in the trading and clearing systems of the securities and futures markets operated by it, the recognized exchange companies or clearing houses; (iii) promote market transparency by monitoring price and turnover movements on a real-time basis and by requiring prompt disclosure of price-sensitive information to the public; (iv) conduct cross-market surveillance in connection with the markets operated by HKEX or any recognized exchange company by putting in place an appropriate system to implement appropriate risk management measures and monitor compliance with its rules; (v) notify the SFC of serious matters, such as defaults by participants, forced liquidation of open positions of participants,

¹⁵ According to HKEX's 2018 Annual Report, SEHK holds approximately HK\$ 1,362 million in net current assets and approximately HK\$ 2,725 million in net current assets funded by equity or long-term loans from HKEX.

suspension of trading, etc.; and (vi) notify the SFC of any detected trading malpractices in the markets operated by the HKEX or a recognized exchange company.

22. The level of surveillance expected from ATS providers is determined by the SFC and will vary depending on the nature of the ATS involved. The ATS Guidelines generally require that surveillance should be consistent with relevant market regulation practices in Hong Kong and internationally and that proper surveillance of the activities conducted via an ATS should be performed by the ATS provider, a regulatory authority (including potentially the SFC) or another competent person. The Guidelines include some specific examples of cases where the SFC would expect particular surveillance activities to be carried out (e.g. ATS suspending trading in co-ordination with the primary market or having in place mechanisms to detect unusual activity that may create a disorderly or unfair operating environment). In practice, the SFC expects all ATS providers to carry out proper surveillance of their trading activities and can set specific surveillance requirements via licensing conditions, which can vary depending on the type of ATS provided.

23. The Code of Conduct sets out specific monitoring requirements for electronic trading and ALP operators. ALP operators are expected to have controls that are reasonably designed to monitor and prevent crossing of orders that are erroneous or illegal or otherwise interfere with the operation of a fair and orderly market; they should also regularly conduct post-trade reviews of transactions conducted in their ALP to identify suspicious market manipulative or abusive activities, market event or system deficiencies or other market misconduct. Detailed requirements on pre-trade controls and risk management are also specified for entities providing internet trading and DMA, as well as for algorithmic traders.

Member Access and Supervision

24. The HKEX is expected to have objective and transparent member admission criteria as well as ongoing requirements that enable open and fair access by market participants. The requirements and application procedures of the SEHK and the HKFE regarding membership and access must be stipulated in their rules. All rules and rule amendments of the SEHK and the HKFE, including those on market access and membership, are subject to the review and approval of the SFC. Further, the Supervision MoU states that the HKEX must administer its rules fairly. SFC expects SEHK and HKFE to have a comprehensive rule enforcement program to oversee its members and how they comply with the rules of SEHK and HKFE.

25. ATS providers are expected to have objective, risk-based and transparent criteria for participation, permitting fair and open access. The ATS Guidelines also specify that the criteria and requirements should be monitored and enforced on an on-going basis. It is considered particularly relevant where continued access to the ATS by non-qualified users may adversely affect other market participants, and consequently, affect the efficiency and integrity of the ATS. As regards ALPs, only qualified investors are permitted to be users of these services and ALP operators are expected to have measures in place to ensure this requirement is met. They also need to ensure that they will be able to comply with the requirements of the SFC regarding client identity (including identity, address and contact details of the users of its ALP).

Dealing with Disorderly Trading Conditions

26. A recognized exchange controller must ensure orderly, informed and fair markets in securities or futures contracts. A recognized exchange controller which is a controller of a recognized clearing house must also ensure orderly, fair and expeditious clearing and settlement arrangements for any transactions in securities, futures contracts or OTC derivative products cleared or settled through the facilities of the recognized clearing house. Pursuant to the SFO, they have the duty to ensure that risks associated with their business and operations are managed prudently. In discharging this duty, they have to (a) act in the interest of the public, having particular regard to the interest of the investing public, and (b) ensure that the interest of the public prevails where it conflicts with the interest of the recognized exchange controller. The Supervision MoU also requires the HKEX to maintain an orderly and fair market by putting in place an appropriate system to implement the sound functioning and development of its trading, settlement and operational systems so as to minimize interruption or systemic impact on the markets operated by the HKEX or a recognized exchange company in the event of any trading, settlement and operational systems failure.

27. ATS providers are expected to set up and maintain electronic facilities to achieve a high degree of reliability, availability and security in respect of their systems, data and networks, as well as provide transparency on their rules and processes. They should also incorporate adequate capacity and contingency arrangements. The ATS Guidelines specify that appropriate policies, procedures and controls should be in place to ensure that a high degree of reliability, availability and security is assured and maintained at all times. Proper documentation and change management of the system software, hardware and network configuration are expected, as well as sufficient backup and recovery facilities to ensure the rapid recovery and resumption of business in the event of a major system disruption. An ATS provider is also expected to make available to its members/users information concerning how the ATS operates, including systems for order processing and execution; list of products that may be traded or cleared through the ATS; rules or other operating requirements; clearing and settlement arrangements; margin or collateral requirements; and all fees and charges.

28. The Code of Conduct contains more detailed provisions on system adequacy and risk management for electronic trading and ALP operators. In particular, it stipulates specific requirements regarding system controls, reliability, security, capacity and contingency plans.

- a. It also specifically requires that those persons providing internet trading or Direct Market Access (DMA) services ensure that all client orders are transmitted to the infrastructure used by the licensed or registered person and are subject to appropriate automated pre-trade risk management controls, as well as regular post-trade monitoring.
- b. ALP operators are expected to have controls reasonably designed to monitor and prevent crossing of orders in its ALP which may be erroneous or illegal or otherwise interfere with the operation of a fair and orderly market; they should also regularly

conduct post-trade reviews of transactions conducted in its ALP to identify suspicious market manipulative or abusive activities, market events, system deficiencies or any other market misconduct.

- c. Algorithmic trading system operators should have controls reasonably designed to ensure the integrity of its algorithmic trading system and that it operates in the interest of the integrity of the market.

Pre-Trade Transparency

29. The SFC requires the exchanges to provide appropriate levels of transparency in relation to pre-trade information on a timely and equitable basis. This includes real time best bid and ask quotations and market depth. Market participants can access the pre-trade information directly via the market data systems of exchanges or indirectly through information vendors. No pre-trade transparency derogations are made available to recognized exchanges.

30. There are no pre-trade transparency requirements for Part V ATS providers. The Guidelines generally state that ATS providers are expected to make available trading and clearing information in appropriate cases depending on the nature of the ATS. They also recognize that in most equity and derivatives trading systems, the international best practice is to provide some level of pre and post-trade transparency, including bid/ask prices, related quantities and details of completed transactions. However, for Part V ATS, the Code of Conduct does not include any pre-trade transparency requirement for electronic trading services¹⁶. The SFC closely monitors the level of dark pool trading (currently at 1% compared to the highest peak in recent years registered at 2.7% in 2013) and would consider imposing pre-trade transparency requirements should the volume of trading rise to a level where market integrity could be compromised.

Post-Trade Transparency

31. The SFC requires the exchanges to provide appropriate levels of transparency in relation to information on completed transactions on a timely and equitable basis. The post-trade information includes last traded price, day high, day low, closing price and trading volume. No delay is allowed for post-trade transparency of transactions executed on the HKFE/SEHK. For trades executed off-exchange, exchange participants are required to report the trades to the SEHK and HKFE within the time stipulated in the rules of the exchanges:

- a. Pursuant to SEHK rules: direct business transactions have to be reported within 15 minutes after the conclusion of the transaction and in any event before the close of trading for transactions conducted on that day. For transactions conducted outside of trading hours, they shall be reported within the first 15 minutes of the

¹⁶ According to paragraph 19.2(b) of the Code of Conduct, alternative liquidity pool (ALP), under Part V ATS, means an electronic system operated by a licensed or registered person through which the crossing/matching of orders involving listed or exchange traded securities is conducted with no pre-trade transparency. ALPs by definition have no pre-trade transparency.

commencement of trading on the next trading session. For ATS transactions via ALPs, exchange participants are required to report immediately, and in any case within one minute after the conclusion of the transaction.

- b. Under the HKFE rules: a block trade must be negotiated during the trading hours of the block trade contract concerned and be executed immediately on the Hong Kong Futures Automatic Trading System (HKATS) via the block trade facility. The time difference between the input of one side of the trade and the input of the other side of the trade must be within five minutes. Any block trade order entered but not matched within the prescribed time period will be cancelled automatically.

32. Part V ATS providers are required to report trades on instruments traded on the SEHK immediately. As explained above, SEHK rules prescribe that trades executed through ATS providers must be immediately reported to SEHK and in any case within one minute after the conclusion of the transaction. ALP operators are also required to have appropriate arrangements to ensure that (i) transactions conducted in its ALP that are required to be reported to the SEHK or to any exchange or regulator outside of Hong Kong are properly reported in the manner and within the time limit required; (ii) regular transaction reports are made available to the users of its ALP concerning the transactions that are conducted on their behalf in the ALP; and (iii) it provides the SFC with a report recording the volume of trades conducted by each of the 10 largest users of its ALP on a monthly basis within 10 business days after the end of each calendar month or as otherwise requested by the SFC.

Conclusions and Recommendations

33. The regulation of ATS providers has been significantly improved via the ATS Guidelines and Code of Conduct. Almost exclusively regulated through licensing conditions at the time of the previous FSAP, Part V ATS providers now have more consistent principles and requirements set out both in the ATS Guidelines and the Code of Conduct. This has not only clarified expectations for intermediaries providing ATS but has also added transparency and improved the level-playing field for the provision of these services. As for Part III ATS, the ATS Guidelines now refer specifically to the requirements that overseas exchanges or clearing houses have to meet to obtain an authorization to provide their services in Hong Kong, and also clarify the different regulatory implications for ATS providers and recognized exchange companies.

34. While mostly principles-based, the regulatory framework for trading systems in Hong Kong is comprehensive and presents no significant enforceability challenges. The SFO contains a high-level set of requirements for recognized exchange companies, with needed details provided mostly through regulatory conditions or supervisory actions (e.g. setting of financial resources) and MoUs. Similarly, for ATS providers, detailed guidance is provided via non-legally binding instruments, like the ATS Guidelines and the Code of Conduct. The SFC's ability to enforce these requirements is underpinned by the general powers it has under the SFO and the SFC is confident that the regulatory framework allows it to discharge its supervisory duties as needed.

- a. The ATS regulatory package provides the SFC with the needed flexibility to ensure adequate supervision of ATS providers in a manner that is commensurate with their risks. The SFC should continue to ensure the ATS Guidelines are reviewed and updated on a regular basis to ensure they remain appropriate and that individual licensing conditions are in line with the baseline set by the Guidelines.
- b. The principles-based approach does not hamper the adequate supervision of the HKEX, at least in the current context where there is only one securities exchange and one futures exchange in Hong Kong. However, supervision of multiple trading systems under this regime may prove to be more challenging and the SFC should consider whether it would be appropriate to move towards a more prescriptive approach in the future, should there be any discussions about expanding the market to include more players. In that case, new guidelines or code of conduct similar to the ones applicable to ATS may be useful.

C. Licensing and Authorization

35. The SFC may recognize a company as an exchange company if it is satisfied that doing so is in the interest of the investing public and for the proper regulation of markets. If a company seeks recognition as an exchange company, the SFC will have regard to the regulatory objectives and general duties of the SFC for the purposes of considering granting the relevant recognition after consultation with the FS. It will also consider whether the company would have the capability to carry out the statutory duties imposed by the SFO and review the various trading or clearing systems to ensure the readiness and integrity of the systems. Pursuant to the SFO, the SFC can attach conditions to the written notice to the exchange company and can withdraw the recognition of an exchange company, after consultation with the FS. The consultation process is not detailed by law in the sense that there is no prescribed procedure that must be followed. Generally, for any consultation with the FS, the SFC would submit a letter setting out the proposals and asking for comments. Meetings are also arranged if particular issues need to be discussed in the course of the consultation.

36. The authorization or licensing conditions are important in the SFC's approach to regulating ATS. Due to the principles-based and pragmatic approach to regulating ATS taken by the SFC, there is a certain degree of discretion to be exercised at the authorization or licensing or registration phase, by imposing regulatory conditions.

37. For persons wishing to operate trading systems similar to an exchange or a clearing house, the SFC may grant a Part III ATS authorization subject to such conditions as it considers appropriate. As explained, in practice, this regime has been used by foreign exchanges and foreign ATS providers to set up platforms that give access to foreign products. When considering those applications, the SFC will assess whether the ATS provider is subject to proper regulation in its home jurisdiction and whether it is comparable to the regulatory regime in Hong Kong and consistent with international standards. Normally the SFC will also require that there be a

supervisory MoU between the SFC and the home regulator of the applicant. The ATS Guidelines contemplate the possibility of persons wishing to operate an exchange-like platform, in which case they could apply to become a recognized exchange company or a Part III ATS Provider. As explained, pursuant to the flexible approach to ATS regulation, the SFC will determine the level of regulation of the applicant taking into account the nature and scope of the ATS, the market participants that may be affected by the provision of the services and whether any systemic risks may arise. The ATS Guidelines incorporate a section outlining the main regulatory differences between the recognized exchange company and the Part III ATS regimes to guide potential applicants in determining the suitable approach. In practice, it is expected that any applicant would engage in early discussions with the SFC to determine the applicable type of regime.

38. Intermediaries can submit an application for a license to provide ATS services (Type 7 regulated activity) as part of their Part V license. ATS providers applying for a license or registration under Part V of the SFO are required to demonstrate that they are fit and proper for the purposes of being licensed by or registered with the SFC. These criteria are established by the SFO, the Fit and Proper Guidelines and the Guidelines on Competence issued by the SFC. For the specific purposes of obtaining a license or registration to provide ATS services as a Type 7 regulated activity, the ATS Guidelines serve as reference for applicants as the SFC would expect them to meet the core standards and principles contained in the Guidelines. Since these are high-level principles, the SFC can determine more specific requirements for applicants via licensing conditions on a case-by-case basis when it considers appropriate. For the purposes of determining the need for particular conditions (e.g. additional reporting or risk management requirements), the Intermediaries Division of the SFC consults the Supervision of Markets (SOM) Division of the SFC, as appropriate.

Conclusions and Recommendations

39. Although prescribed in the SFO, the need to consult with FS for the recognition of a company as an exchange company, as well as for the withdrawal of its recognition, may raise potential independence issues. While the SFC appears to have sufficient operational independence in its day-to-day business, the requirement for consultation with the FS on key decisions concerning recognition of exchanges may give rise to concerns regarding the independence of the regulator. It is noted that some level of government involvement is not unusual globally, since exchanges and financial market infrastructures can have a strategic role for the jurisdiction. However, in absence of full independence, it would be helpful if a detailed framework specifying the procedures that the SFC would take to process the applications, including how it would take into consideration the FS' views, was articulated internally.

D. Supervision

Organization and Resources

40. The SFC has different supervisory arrangements for recognized exchange companies and ATS providers.

- a. The SOM Division of the SFC is responsible for supervising the HKEX's operations and functions other than listing. That includes the two recognized exchange companies and four recognized clearing houses. The SOM Division has about 50 staff and dedicated teams are formed to oversee trading, clearing and settlement, infrastructure and risk management functions of the HKEX. Additionally, the Corporate Finance Division of the SFC is responsible for supervising the SEHK in the performance of its listing functions and conducting periodic review of the SEHK's performance in this regard. There is a team of about 36 staff responsible for the day-to-day supervision of the SEHK and a team of around 8 staff is assigned to carry out periodic reviews of the SEHK.
- b. The SOM Division is also responsible for supervising Part III ATS providers. Typically, 3 to 4 executives would form a team to review an application of an ATS authorization. The team would usually continue to supervise the same ATS providers after the authorization is granted. Currently, this ATS supervisory team of the SOM Division has 8 core members.
- c. Staff resources of the Intermediaries Division have been allocated to conduct on-site review and off-site monitoring of the operations of licensed ATS providers, to assess their compliance with relevant regulatory requirements and to monitor industry and regulatory developments on these subject matters. They engage with SOM Division as needed and can perform joint inspections.

Rule Approval

41. All rules and amendments of rules of the recognized exchange companies must be approved by the SFC before taking effect. The HKEX will engage the SFC at an early stage to discuss any proposed initiatives that may include introduction of new market infrastructure, new products, system upgrades and admission of new category of members or changes to admission criteria. Depending on the nature and impact of the proposal the SFC will require the HKEX to provide a detailed assessment of the proposal and collect views of relevant stakeholders and market participants where relevant. The SFC works closely with the HKEX to ensure that any initiative is implemented smoothly and to monitor post-implementation developments. For material system changes, the SFC will also expect market readiness testing and market rehearsals to take place before launching major initiatives. The HKEX is also required to put in place adequate technical support and a fallback plan during the initial launch of major system changes. Staff of the SFC regularly meets with the HKEX to discuss potential rule amendments.

42. Additionally, the SFC reviews any amendments to the Listing Rules. The SEHK is required to submit to the SFC any amendments to the Listing Rules, together with explanations of their purposes and the likely effect, including their effect on the investing public, in sufficient detail to enable the SFC to decide whether to approve them or not. Staff of the SFC regularly meets with the SEHK to discuss any amendments to the Listing Rules.

43. Part III ATS providers must notify the SFC of any material changes to their activities and operations in Hong Kong before the changes can take effect. This obligation is imposed on Part III ATS providers via regulatory conditions imposed upon authorization and it includes notifying the SFC of the launch of any new products and the admission of any Hong Kong participants as members.

Reporting

44. The SFC receives both periodic and ad-hoc reports from the HKEX. On a daily basis, the SFC monitors the orderly functioning of the trading and clearing operations of the recognized exchange companies and recognized clearing houses. The SFC also obtains daily and weekly reports on operational statistics relating to the trading and clearing of the cash and derivatives markets, as well as monthly reports on trading systems performance statistics. For the launch of new initiatives, the SFC may require the HKEX to provide ad hoc reports to facilitate its monitoring of the rollout and identify potential regulatory issues at an early stage. SFC staff have access to live trading data via the HKEX's NASDAQ SMART system to monitor market operations. The HKEX also submits to the SFC an end-of-day report including issues (if any) that have affected market operations.

45. Reporting requirements for Part III ATS providers are imposed through authorization conditions. Part III ATS providers are generally required to provide periodic reports on trading and participant statistics, in particular those relating to Hong Kong participants. The relevant case officers review the reports received and the ATS supervisory team in the SOM Division would analyze the data and share observations at their regular team meeting. For ad hoc incident reports filed by ATS providers, the relevant case officer will follow up with the concerned ATS provider as appropriate.

46. For Part V ATS providers, specific reporting requirements are set out for electronic traders and ALPs. Electronic traders should promptly report to the SFC any material service interruption or other significant issues related to the electronic trading system provided to clients for use. ALP operators are required to provide the SFC with: (i) a report recording the volume of trades conducted by each of the 10 largest ALP users on a monthly basis; (ii) notification of any proposed change that may affect the operation of its ALP or its users prior to implementation; (iii) notification of any breach of any regulatory obligations (by both the ALP and its participants) or the ALP Guidelines upon its occurrence; (iv) notification of the causes or possible causes of material delay or failure to the operation of its ALP affecting the users of its ALP upon its occurrence; and (v) any updated review report (e.g. internal audits) concerning its ALP as soon as it becomes available.

Supervisory Activities

HKEX

47. The first on-site inspection of the HKEX by the SFC took place in 2015, and inspections have been carried out regularly after that. The first inspection focused on the cash market trading operation, the second one in 2016-2017 was on the cash market clearing operation and in mid-2018

the SFC started the third on-site inspection of the HKEX on the trading, clearing and risk management of its derivatives market. Prior to the on-site inspection, the SFC liaises with the HKEX on the scope and review period to be covered and the HKEX conducts a self-assessment and submits a report. The reviews are usually a combination of on-site and off-site activities including interviews of both management and working-level staff as well as visits to HKEX's premises. Preliminary findings are shared with HKEX's executives and will incorporate their feedback where appropriate. The SFC follows up with the HKEX regarding the findings and recommendations in the inspection report. Implementation of SFC's recommendations by the HKEX has been generally swift and in line with SFC's expectations.

48. As a direct consequence of the on-site inspection findings, the HKEX has implemented a number of improvements. For example, enhancement was introduced to enable a more adequate monitoring of members' compliance with HKEX's rules. This was a recommendation of the first on-site inspection of the HKEX, which found that there was not a comprehensive program in place to ensure that the HKEX members were in compliance with its rules. The Rule Enforcement Team of the HKEX annually requests members to fill in a self-declaration that is reviewed by the Team, and also conducts on-site inspections of its members as needed.

49. The SFC holds regular meetings with HKEX's different operating divisions. The objective of these is for the SFC to stay apprised of HKEX new initiatives and projects as well as any relevant issues regarding its trading, clearing and risk management operations. The meetings enable the SFC to identify potential issues and ask HKEX to resolve them at the early stage.

50. Supervisory activities in relation to listing matters of SEHK are set out in the Listing MoU. Under the Listing MoU, it was agreed that the SFC would conduct periodic reviews of SEHK's performance in its regulation of listing-related matters. As part of the efforts to enhance the supervision of SEHK's listing function, the Listing MoU was amended in March 2018 to update the focus of periodic reviews and provide details of SFC's approach to ongoing supervision of listing matters as follows:

a. Periodic reviews.

- i. Pursuant to the First Addendum to the Listing MoU, the SFC would focus on a number of issues when carrying out periodic reviews, including: (a) whether SEHK is discharging its duties under the SFO (including assessing its work in developing, administering and implementing the Listing Rules as well as the monitoring and enforcement of compliance with those rules); (b) the adequacy of the SEHK's systems, processes, procedures and resources for performing its listing function; and (c) the effective management of conflicts of interest within the SEHK as a regulator and as part of a for-profit organization, including the supervisory functions performed by the Listing Committee of the SEHK.

- ii. Further to this enhanced approach to supervision, the SFC carries out a general audit of the systems, processes and procedures of SEHK's operational activities, as well as a detailed review of SEHK's approach and practices in certain selected areas. These areas are selected as they are related to certain market behavior or trends noted by the SFC in the course of its monitoring of listed companies' disclosure and issues that arise as part of SFC's ongoing supervision¹⁷. For these detailed reviews, the SFC conducts a review of written policies and procedures, file records of a significant number of selected cases and interviews of relevant management and personnel. All periodic audit reports are published on the SFC's website.
- b. **Ongoing supervision.** Further to the Listing MoU, as supplemented by the First Addendum in 2018, the SEHK and the SFC agreed that the SEHK would submit to the SFC (i) a report relating to its responsibilities in listing-related matters on a monthly basis and (ii) any information or report that the SFC may reasonably require within 14 days after the SFC gives written notice. The SFC and the SEHK will hold monthly meetings to discuss any matters arising from the reports submitted, any matters relating to SEHK's regulation of listed companies or the SFC's oversight of the SEHK in listing-related matters, as well as any policy or matters relating to any of the SEHK's functions and responsibilities.

51. The SFC regularly performs market surveillance of trading activity in the HKEX. This function is operated by the Enforcement Division and in regular collaboration with the SOM Division. The market surveillance function reviews daily live trading data from the exchanges, reported through SMARTS¹⁸, as well as a number of suspicious transaction reports from intermediaries. As discussed above, any trade carried out by an exchange member needs to be promptly reported to the HKEX. However, there is a potentially sizeable volume of trades¹⁹ that happen over the counter by intermediaries that are not exchange members and are therefore not reported and with no visibility for the market surveillance function²⁰. As discussed in Box 2 below, all Southbound trades from the Mainland into Stock Connect are reported under the respective broker ID of the SSE and SZSE subsidiaries, also making effective market surveillance difficult.

Part III ATS

¹⁷ For example, four areas were selected for the 2018 periodic audit of the SEHK's listing function: (a) vetting of IPO applications and suitability for listing, (b) SEHK's work in regulating reverse takeovers, (c) SEHK's work in handling disclaimer audit opinions, and (d) SEHK's policy on listing enforcement.

¹⁸ Nasdaq's trade surveillance technology solution.

¹⁹ The volume of non-reported trades is estimated to be around ten per cent of the SEHK trading volume, noting that the estimate is based on the amount of stamp duty collected on the transfer of shares. This estimate includes share transfers as a result of settlement of derivatives products, private placement and gifts. Therefore, the estimate may be overstated.

²⁰ The SFC is aware of this issue and currently considering a process for gathering market feedback in relation to the most appropriate route for obtaining these data.

52. Overseas ATS providers authorized under Part III of the SFO are subject to supervision by their home regulator. The Part III ATS regime is premised on the fact that an authorized ATS provider is regulated primarily in its home jurisdiction by an authority whose regulatory standards are comparable to those of the SFC. At the time of authorization, the SFC generally requires that there is an MOU entered into between the SFC and the ATS provider's home regulator permitting the exchange of supervisory information. The SOM Division reviews ongoing reporting material submitted by Part III ATS providers and maintains regular contact with them to follow up on any conditions imposed upon authorization.

Part V ATS

53. Supervision of the provision of ATS by intermediaries licensed or registered under Part V to perform Type 7 regulated activity is carried out as part of routine on-site inspection of the firms and has recently become more data-driven. The SFC considers that the traditional approach of reviewing policies and procedures and conducting limited sample testing may no longer be adequate for reviewing business conduct standards of firms in the new era of rapid growth of technology-enabled business, like DMA and algorithmic trading. In view of this, the SFC has, over the last three years, performed data analysis on a trial basis when conducting routine on-site inspections of brokerage firms engaged in algorithmic trading and dark pool operation. This involves analyzing trading behavior and patterns on these firms through restructuring and interrogating large volumes of their trading-related data, covering different angles such as (i) review of order cycles to spot change of order capacity (e.g. from agency to principal); (ii) dark pool execution price compared to prevailing bid and ask in the lit market; and (iii) timing of transactions compared to issue of research reports and staff dealings. This new approach has enabled the SFC to identify irregularities and find systemic control deficiencies and instances of non-compliance that would otherwise go undetected. The SFC is working with the industry to ensure that production of data by the firms is adequate for this new approach, enabling the SFC to better analyze the whole order cycle.

54. The SFC has also conducted a number of thematic reviews on Part V ATS providers in recent years. Thematic reviews have proven to be a helpful tool for the SFC to better understand the operations of licensed corporations and determine potential areas for improvement. These thematic reviews have also been positively received by the industry. The themes that have been examined are described below:

- a. **Review of algorithmic trading in 2015-2016.** One of the main focus was to review the risk management processes and controls of algorithmic trading for a sample of firms and included a review of relevant policies and procedures for risk management, as well as of pre-trade and post-trade controls in place and the limits set for those controls. The review found insufficient pre-trade controls for preventing the generation of algorithmic orders that may adversely affect market integrity. The SFC highlighted this, together with other observations and good practices, in a circular to all licensed entities. It subsequently followed up with relevant entities to ensure appropriate changes were put in place.

- b. **Review of ALPs in 2016-2017.** Some of the key areas of concern identified by the review were (i) the fact that orders were being routed to third party ALPs without appropriately disclosing this to the clients, and (ii) simultaneous orders were being posted to both the ALP and the exchange, a practice that prevented ALP operators in some instances from compliance with the requirement to ensure that non-proprietary orders have priority over proprietary orders. These and other relevant findings and a number of best practices identified through the review were disclosed to the industry in a report and a circular to licensed entities. The SFC subsequently followed up with relevant entities to ensure appropriate changes were put in place.

Conclusions and Recommendations

55. The SFC has significantly enhanced its approach to supervision of the HKEX since the previous FSAP. The SFC started carrying out on-site inspections of the HKEX in 2015 and is expected to continue doing so on a regular basis. This has allowed the SFC to better understand the HKEX's operations and identify areas for improvement. This, together with regular meetings for discussion of matters relating to trading, clearing and listing operations, has enhanced the relationship between the two institutions. The supervision of the listing function of the SEHK has also been significantly revamped, with the SFC exercising more control in the process for approving new listings, as well as with more detailed reporting requirements and a programmatic approach to periodic reviews.

56. Supervision of Part V ATS providers has become a more granular and risk-oriented function. The thematic reviews of ALPs and electronic trading have provided the SFC with better insight on the operation of Part V ATS providers and also identified a number of common areas for improvement across the industry. Open communication of the main findings has signaled SFC's supervisory priorities and has been positively received by the industry. The introduction of data analytics in the periodic reviews of intermediaries has also improved the quality of supervision of ATS providers, enabling the SFC to identify specific misconduct that would have otherwise gone undetected.

57. The SFC is encouraged to continue improving the market surveillance function to ensure it has access to comprehensive and adequate trading data. The introduction of the Southbound trading investor ID will enhance the surveillance of trading via Stock Connect from the Mainland in the Hong Kong market and the SFC should continue engaging with the CSRC to ensure prompt implementation (please refer to Box 2 for more details). In addition, for a complete picture of trading in the Hong Kong market, the SFC is encouraged to prioritize their work on non-reported OTC trading and explore avenues to, at a minimum, collect trading information on OTC trades executed by non-exchange members, which are currently not reported for market surveillance purposes (please also refer to recommendation in paragraph 74 below).

58. Additionally, the SFC should ensure it continues to follow up on HKEX's implementation of improvements coming out of its inspections. In particular, given the large number of members of the HKEX, the SFC should continue its close watch on HKEX's monitoring of

members' compliance with its rules and make sure its rule enforcement program is sufficient for the task or otherwise further improvements are required (e.g. increasing member inspections).

E. Enforcement

HKEX

59. The SFC can amend or revoke a recognized exchange company's recognition conditions or withdraw its recognition but it does not have the power to impose monetary sanctions. The recognition of exchange companies is subject to such conditions as the SFC considers appropriate and the SFC may, by notice in writing, amend or revoke any condition or impose new conditions where it is in the interest of the investing public or for the proper regulation of markets in securities and futures contracts. The SFO also provides for the withdrawal of recognition of an exchange by the SFC where it fails to comply with any requirement of the SFC or with a condition of recognition, amongst other reasons as stated in section 28(4) of the SFO. Any service of such notice of withdrawal can only be done after consultation with the FS.

60. The SFC addresses any relevant issues through regular supervisory activities. The SFC monitors the HKEX closely and has a wide range of powers that can be exercised in its supervision. A number of those have been described throughout this note, like the power to approve rules or to impose financial resource requirements. Others include making a suspension order on the functions of the board of directors, a governing body, a director or the CEO, or serving restriction notices to amend, supplement, withdraw or revoke a provision of its rules or other instruments. Importantly, it can amend, revoke or withdraw its recognition, as discussed above. No regulatory non-compliance relating to the HKEX or recognized exchange companies was noted in the past three years, while a number of recommendations were made to improve the operations of the HKEX as a result of the on-site inspections, including the setting up of a Regulatory Compliance Team and a Rule Enforcement Team. The SFC has generally been satisfied with the adequacy and speed of implementation of recommendations by the HKEX.

Part III ATS

61. If Part III ATS providers fail to comply with authorization conditions the SFC can impose new or additional conditions or withdraw the authorization. The SFC monitors the authorized providers of Part III ATS on an on-going basis to assess whether they are in compliance with authorization conditions. If they fail to comply, pursuant to Part III of the SFO the SFC has the power to impose new or additional conditions or, in the worst-case scenario, withdraw the authorization. The SFC does not have the ability to impose monetary penalties against Part III ATS providers or their executives. No major breaches of conditions by Part III ATS were noted in the past three years.

Part V ATS

62. Where a Part V ATS provider is found to have breached any regulatory requirements related to the provision of ATS, the SFC takes disciplinary actions against the intermediary.

The SFC is empowered to impose a wide range of disciplinary sanctions by the SFO, including partial or full suspension or revocation of license or registration, fines, reprimands and prohibitions of applications for license (to become a licensed corporation or licensed representative) or registration (to become a registered institution) or to become responsible officers, executive officers or relevant individuals. For serious misconduct, the SFC may suspend or revoke the intermediary's registration or license for a prescribed period and/or impose a fine of up to HK\$10 million or 3 times the profit gained, or loss avoided, whichever is higher. The SFO allows the SFC to enter into agreements with subjects of a disciplinary procedure for certain conducts. This allows the SFC to seek undertakings from regulated entities and/or their management to achieve intended remedial actions (e.g. payment of compensation to affected investors for their losses, commissioning independent reviews, etc.).

63. A number of breaches and control issues have been identified in recent years leading to investigations and disciplinary actions involving Part V ATS providers.

As described, the deployment of data analytics for on-site inspection brought fruitful results leading to investigation of misconduct by Part V ATS providers. Examples of misconduct discovered include the executed price of crossed trades in one ALP falling beyond the best bid and ask at the prevailing lit market; opaque trading patterns were identified that led to the discovery of client mis-representation incidents in the equity sales trading business of a licensed firm, and retail client orders were found to have been executed by an ALP provider in violation of the ALP regime. In the past three years, the SFC conducted three investigations into the provision of ATS (in the form of ALPs), two of which resulted in disciplinary actions, including reprimands and serious monetary penalties. In all three investigations it was found that the misconduct had ceased, and the ATS providers were taking remedial actions to address the concerns at the time of commencement of the investigation.

International Cooperation

64. Increased connectivity with overseas markets and the Mainland requires strong international cooperation arrangements. As discussed in previous sections, Hong Kong markets have strong international connections and are an important gateway between international investors and the Mainland. Increasingly, investors from the Mainland are accessing the Hong Kong stock market via Stock Connect, while at the same time, a significant number of Chinese companies continue to list on the SEHK. To be able to adequately supervise markets and enforce its rules, the SFC must have effective cooperation arrangements with its foreign and Mainland counterparts.

65. The SFC is a signatory to the IOSCO Multilateral Memorandum of Understanding (MMoU) and has a number of bilateral MoUs with foreign regulators. The SFC signed the IOSCO MMoU in 2003 and the Enhanced IOSCO MMoU in 2018, through which it channels most of its enforcement cooperation requests and maintains close liaison with securities regulators worldwide. Moreover, the SFC has entered into more than 50 bilateral MoUs and other cooperation arrangements with securities regulators around the world. The SFC is an active authority, both in terms of submitting and responding to requests from foreign regulators.

66. The SFC maintains an active exchange of information with regulators in the Mainland.

Cross-boundary market manipulation and corporate fraud are on top of the SFC's enforcement priorities because of the significant potential for investor losses and reputational damage. The SFC and CSRC, its Mainland counterpart, have formed a close partnership in tackling cross-boundary corporate fraud and market manipulation. For the purposes of handling most enforcement requests, the SFC and the CSRC actively use the IOSCO MMoU. The SFC has also entered into a tri-party MoU with the CSRC and the Chinese Ministry of Finance for the purposes of exchanging audit records of Chinese companies in the context of enforcement investigations. The SFC and the CSRC have a number of agreements for market surveillance and enforcement purposes in relation to Stock Connect (see Box 2). Additionally, both authorities carry out a number of regular events and activities to continue to understand each other's markets and deepening their relationship, including seminars and both high level and working-level meetings.

Conclusions and Recommendations**67. While enforcement powers over Part V ATS providers are appropriate, the SFC should consider expanding its enforcement powers over Part III ATS providers and the exchanges.**

For a more extensive enforcement reach, it would be advisable that the SFC had not only supervisory, but also adequate enforcement powers over recognized exchange companies and clearing houses and Part III ATS providers.²¹ While the SFC appears to have been able to rectify any relevant matter of concern with the HKEX and has a wide range of supervisory tools, the ability to impose penalties on the recognized exchange companies would further assist in achieving credible deterrence in the Hong Kong market. Monetary penalties are a particularly effective tool to sanction a for-profit exchange, rather than the threat of withdrawal of its recognition which is in practice unlikely to be implemented.

68. The SFC has a sound enforcement program and takes prompt action on matters of material concerns.

The SFC has enhanced its enforcement program by specializing in a number of matters that are considered more serious or where the SFC determines that a stronger signal needs to be sent to the market. This has been made possible through better cooperation amongst its functional departments and, in particular, more seamless coordination between the SOM Division and the Intermediaries Division. In recent years, the SFC has undertaken investigations and has taken enforcement action, where appropriate, against intermediaries in relation to their sponsor activities, which has provided an additional layer of control in relation to listing activities and aided in sending a clear message to the market about SFC's expectations. It has also imposed relevant sanctions against intermediaries in relation to their provision of ATS. Cooperation with the CSRC has been very important in relation to cross-border market abuse investigations and has enabled the SFC to take disciplinary measures against wrongdoers.

²¹ Any initiative to extend enforcement powers to these entities should be paired with a review of the appropriateness of the levels of fines contained in the SFO, to ensure that they provide sufficient flexibility and are commensurate with the gravity of the potential misconduct.

69. As connections with the Mainland are likely to remain growing, the SFC should continue its active dialogue and cooperation with the CSRC. Close partnership with the CSRC will be key to enable the SFC to carry out adequate market surveillance and prosecute fraud and misconduct. Both authorities have significantly increased their interactions and cooperation arrangements, through formal and informal channels and they are encouraged to continue deepening their relationship.

Box 2. Hong Kong SAR: Stock Connect and Cooperation with the Mainland

Stock Connect has enabled investors from both Hong Kong SAR and the Mainland to access each other's markets. It has consequently increased the need for the SFC and the CSRC to ensure they have the necessary arrangements in place to exchange the information needed for supervision and enforcement. Both authorities have therefore put in place various arrangements to assist each other in market monitoring and surveillance, and detecting and prosecuting cross-boundary market misconducts under Stock Connect.

In terms of market monitoring and surveillance, the SFC signed an MoU with the CSRC in 2014 on exchange of information under Stock Connect. Pursuant to this MoU, the SFC may send requests to the CSRC, in the course of market monitoring and surveillance and on a case-by-case basis, seeking detailed information on a particular trade, the relevant investor and the relevant broker.

- This MoU was updated in December 2018 with the introduction of the Northbound Investor ID regime. Under this regime, the CSRC regularly obtains information on Hong Kong intermediaries placing each particular Northbound order/trade and their immediate client in connection with that trade.
- The updated MoU also provides that the SFC will be able to receive securities account number and corresponding unique identification numbers of Mainland investors in their Southbound orders/trades regularly to facilitate market surveillance in a more effective manner. Without the Southbound Investor ID, all Southbound trades are reported under the respective broker ID of the SSE and SZSE subsidiaries, which makes market surveillance challenging. SFC currently uses a market surveillance agreement (i.e. the Agreement on the Provision of Information under Mutual Access between the Mainland and Hong Kong Stock Markets) to obtain the information it requires for market surveillance purposes. This is not ideal, and a swifter mechanism like the Investor ID regime would improve the SFC's market surveillance function.

Additionally, the SFC and the CSRC signed a communication agreement in emergency situations and major events for the Stock Connect in 2014 to facilitate prompt communication in specified situations. Among other communications, both authorities will provide each other with market situation reports in times of high volatility, with analysis of market situation, factors leading to the market decline and assessment of outlook.

The SFC and the CSRC also entered into an enforcement cooperation agreement under Stock Connect. Further to this arrangement, both authorities will notify each other of any investigation with a cross-boundary element, provide each other with investigation assistance and commence joint investigations to combat market misconduct where needed.

F. Market Risk Monitoring

70. The SFC monitors market activities and developments to identify any major changes in market structure that may call for regulatory response. The SFC covers this from a three-angle perspective: market-wide, by segments and by individual entities. It also monitors news, events, economic situation and developments of major overseas markets and benchmarks Hong Kong markets based on the indications against major overseas markets, historical trends and crisis situations.

- a. In its market-wide monitoring, the SFC looks at areas and risks that are specific to the Hong Kong market as well as potential contagion effects from the Mainland and overseas markets. These include size, level and changes in, among other indicators, performance and volatility, trading, valuation, leverage, capital flow, short selling and short positions, changes in sentiment and currencies, interest rates and commodity prices.
- b. The SFC also covers various exchange-traded market segments such as futures, options, ETFs, derivative warrants and callable bull/bear contracts, as well as OTC equity derivatives on Hong Kong underlyings.
- c. The SFC monitors the activities of market participants, mainly by looking at sizes and changes in positions, as well as concentration.

71. The SFC keeps close coordination with the HKEX for the analysis of market information, as well as the monitoring of trading systems. The SFC monitors market information, trends and developments, analyses it and compares it with previous data and discusses any observations with the HKEX. Examples of key information under monitoring is order-to-trade ratio (e.g. to detect high frequency trading or changes in market structure) or system response time. The SFC and the HKEX also maintain close dialogue in relation to the monitoring of recognized clearing house operations and potential risks arising from those activities. HKEX provides a number of regular reports to the SFC on clearing house exposures, collateral balances, liquidity requirements and resources, as well as updates on financial status. Based on this information, the SFC is able to identify changes in market structure and potential accumulation of risk.

72. Domestic cooperation across financial sectors is overseen by the FS and the Financial Services and the Treasury Bureau (FSTB), underpinned by a number of standing cross-sectoral committees. The SFC also communicates with the FSTB and the FS on a regular basis, including through the provision of various reports on market situation. Apart from regular meetings of the committees mentioned below, the HKMA and the SFC also meet on a bilateral basis to discuss issues that are more relevant to the two regulatory authorities. The following formal cross-sectoral committees are currently operating:

- a. The Financial Stability Committee was established in 2000 and consists of representatives from FSTB, the HKMA, the SFC and the Insurance Authority (IA). It

monitors the functioning of the financial markets in Hong Kong (including money, foreign exchange and securities) and deliberate on issues with possible cross-market and systemic implications.

- b. The Council of Financial Regulators was also established in 2000 and consists of the FS and representatives of the HKMA, the IA, the Mandatory Provident Fund Schemes Authority (MPFA), the SFC and the FSTB. It enables coordination in the regulation and supervision of financial institutions.
- c. The Financial Leaders Forum comprises financial leaders in Hong Kong (including the Chairman and the Chief Executive Officer of the SFC) and discusses and provides policy steers on strategic and forward-looking proposals to further develop or strengthen Hong Kong's position as an international financial center, having regard to maintaining monetary stability, financial safety and market quality.
- d. The MPF Intermediaries Regulation Co-ordinating Committee discusses potential risk issues and coordinates enforcement action of the four regulators in respect of MPF intermediaries to ensure regulatory consistency.

73. The SFC has a market contingency plan providing specific guidance on measures and procedures to deal with emergency scenarios. The plan also specifies the detailed procedures for the SFC to contact/consult the FSTB and other relevant financial market regulators during crisis situations that may have cross-market or systemic implications. The exercise of certain statutory tools in the plan requires consultation with the FS. As such, the plan critically assesses the pros and cons of the various options, the scope of application and the likely impact in order to provide an informed basis for the consultation. Going beyond market-related issues, the SFC recently conducted an internal exercise to review its available tools for potential extreme market scenarios and their application. This review and the implications of the deployment of any of the relevant tools was also discussed with other relevant domestic authorities to enhance the common understanding of the SFC's toolkit and the pros and cons of potentially using any of the measures under the toolkit.

Conclusions and Recommendations

74. The SFC has mechanisms in place to monitor risks and these mechanisms are generally adequate for the complexity of the Hong Kong market. The procedures and arrangements for the monitoring and sharing of information and data are observed to be appropriate and working efficiently, both in relation to the market and with official counterparts and peer supervisors. In line with the recommendation in paragraph 57, to ensure a comprehensive picture of trading activity in Hong Kong the SFC should also consider the risks for market integrity of the OTC trading carried out by non-exchange members. Going beyond market surveillance concerns, and given the estimated size of OTC trading, it could raise investor protection and price transparency concerns that would also be relevant for market integrity. As part of its ongoing work on OTC trading, the SFC is therefore encouraged to consider the potential risks for market integrity of this type of trading and

whether there are compelling reasons and sufficient safeguards in place for it to continue to be allowed.

75. Continued cooperation with foreign and Mainland counterparts, especially the CSRC, will also be key for the monitoring of risks going forward. The SFC is an active member of the international securities regulatory community and has engaged with a number of regulators through IOSCO and bilateral channels. Increased cooperation with the Mainland in market supervisory affairs should provide an enhanced avenue for the identification of any potential build-up of risk and the SFC is encouraged to continue deepening its cooperation with its counterpart in the Mainland as the interconnectedness between the two markets is likely to continue growing.