

TOPIC 1 - OVERVIEW

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1. FINANCIAL PRODUCTS AND SERVICES, AND THEIR REGULATION

1.1 Introduction

- **Hong Kong is an international financial centre**, providing a wide range of financial products and services for the investment industry, including an avenue for price discovery and investment liquidity

- **Products and services** include:

Products

- Futures and options
- FX products
- Mutual funds
- Unit and investment trusts
- Certificates of deposit
- Money market products
- Gold market products
- Company shares
- Debentures
- Warrants
- Convertible securities

Services

- Securities dealing
- Futures trading
- FX trading
- Financial advising
- Corporate finance
- Underwriting
- Mergers and acquisitions
- Venture capital
- Investment/portfolio management
- Investment banking
- Commercial banking
- Credit rating services
- Money lending
- Gold trading
- Insurance/insurance broking

- **The need for efficient, well-organized markets**, overseen by independent professional regulators, has resulted from:

- Growth and sophistication of financial products and services
- Flows of large amounts of wealth
- Proliferation of malpractices

- **In addition to regulation**, financial regulators also:

- Encourage development of new products and services
- Help improve the quality and skills of financial market professionals
- Help educate the investing public

The Hong Kong Securities Institute (HKSI) provides educational and examination facilities

1.2 Objectives of Hong Kong's Regulatory Framework

- **The common objectives of Hong Kong's financial regulators** are:
 - To maintain Hong Kong's position as a leading financial centre by ensuring regulations enable proper supervision of financial markets
 - To operate financial regulations of an acceptable international standard
 - To be market-friendly, open, approachable, fair and effective
 - To ensure that the legal framework of financial regulation is certain, adequate and fairly enforced
 - To encourage a sound technical infrastructure so that the Hong Kong financial markets interlink with global settlement and clearing systems
 - To promote confidence in the financial markets, internationally and locally

1.3 Philosophy and Systems of Regulation

- Share offers and listing matters can be referred to as *merit-based* or *disclosure-based*.

Merit-based Regulation

- Objective is to screen out undesirable players and undesirable offerings
- Ensure a fair balance between promoters and investors
- Provides the investing public with a fair balance between risks and returns
- It has been claimed that the HK Listing Rules are merit-based, although they are primarily a system of disclosure

Disclosure-based Regulation

- the focus is on maximizing disclosure and provision of information regarding public offerings
- UK and US are disclosure-based
- HK New Companies Ordinance (NCO) is disclosure-based and has legal force
- the idea is that maximum disclosure is required to enable investors to make their own investment decisions

Risk-based Approach

- regulation is weighted towards the areas that pose the greatest risk to the markets and participants

1.4 Relevance and Impact of Past Regulatory Problems

1891

- First stock exchange in Hong Kong formed

1973

- Five Hong Kong stock exchanges, including futures exchange
- Exchanges virtually unregulated
- Stock Exchange Control Ordinance enacted banning any further exchanges
- Market crash led to the Securities Ordinance and Protection of Investors Ordinance

1987

- Market crash led to a review of the regulatory framework
- Ian Hay Davison appointed as Chairman of the Securities Review Committee

Broad Points Stated by Davison Committee

The need for:

- Systemic stability
 - An orderly and smooth-functioning market which is fair and free from manipulation and deception
 - Adequate investor protection
 - Practitioner-based regulation – operated by professionals with an industry or regulatory background
 - Checks and balances on the system, with the exchanges being supervised by a commission that was independent of government
 - Market participants to be represented on exchanges and clearing houses
-
- The structure recommended by the Davison Committee has functioned since 1989 and remains basically unchanged
 - The SFO is largely a consolidation of ten diverse ordinances regulating the securities, futures and leveraged foreign exchange industries

2. REGULATORY AUTHORITIES

2.1 Roles of the Government Hierarchy

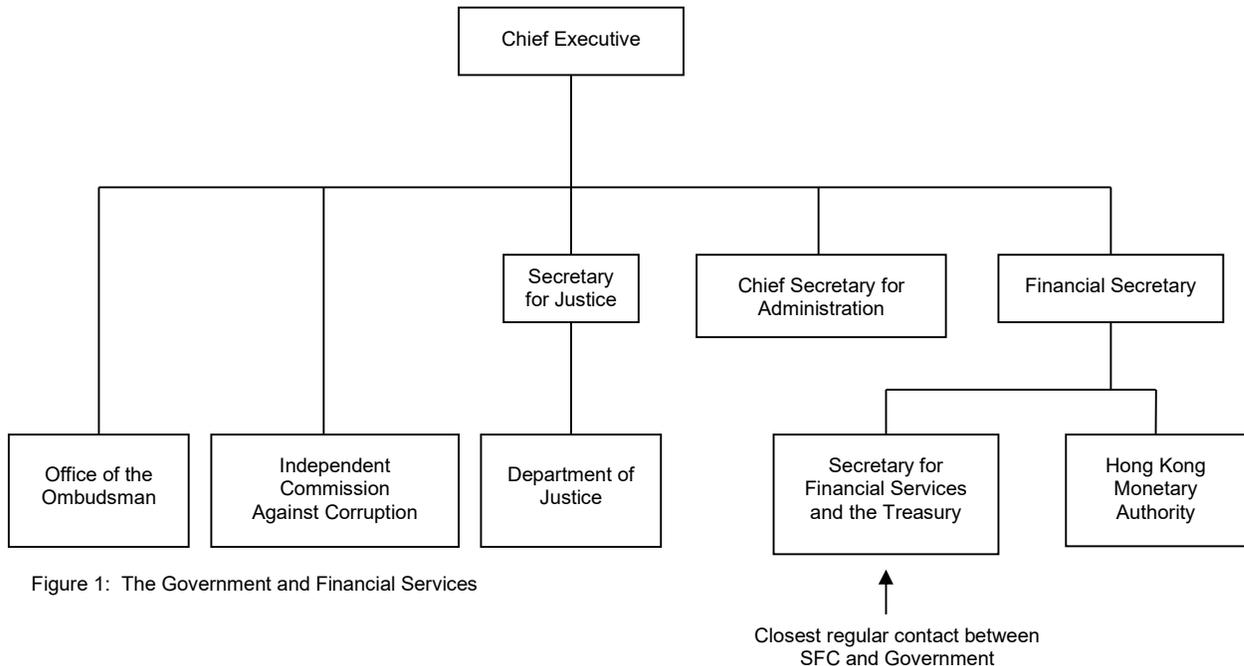


Figure 1: The Government and Financial Services

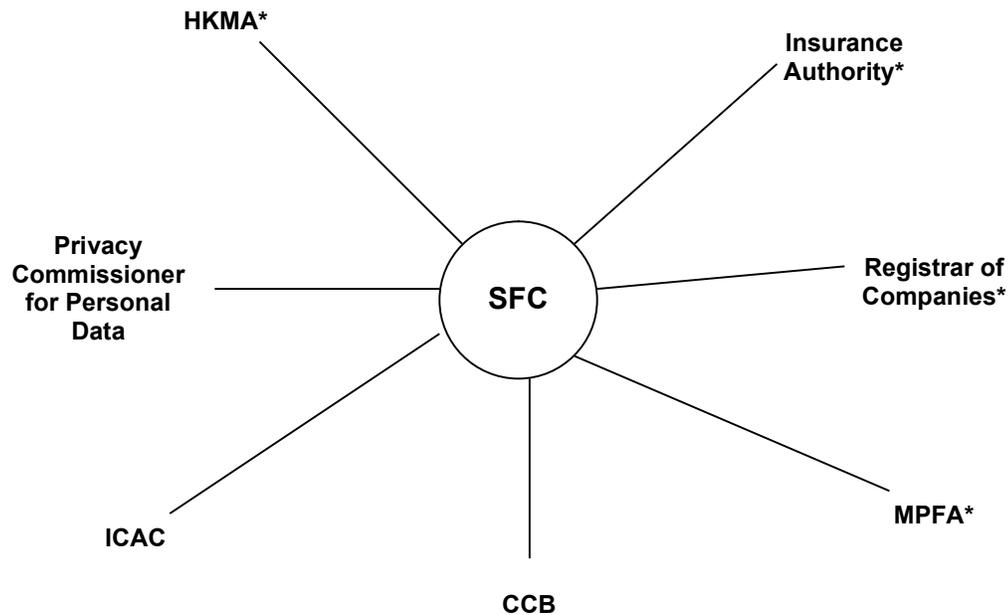
The Chief Executive

- Appoints the SFC Chairman, Deputy Chairman (optional), CEO, executive directors and non-executive directors
- Determines SFC officers' terms and conditions
- May give written directions to SFC on how it should meet its objectives and perform its functions
- SFC submits budget to Chief Executive for approval

The Financial Secretary

- Primary duty is to oversee policy formulation and implementation in financial, monetary, economic and employment matters
- Chairman of the Exchange Fund Advisory Committee (governing body of the HKMA)
- Has effective overall authority over SFC
- Can require the SFC to provide him with information on its principles, practices and policy
- SFC submits annual report and financial statements to Financial Secretary
- May appoint inspectors and investigators to look into problematic companies

2.2 Financial Regulators in Hong Kong



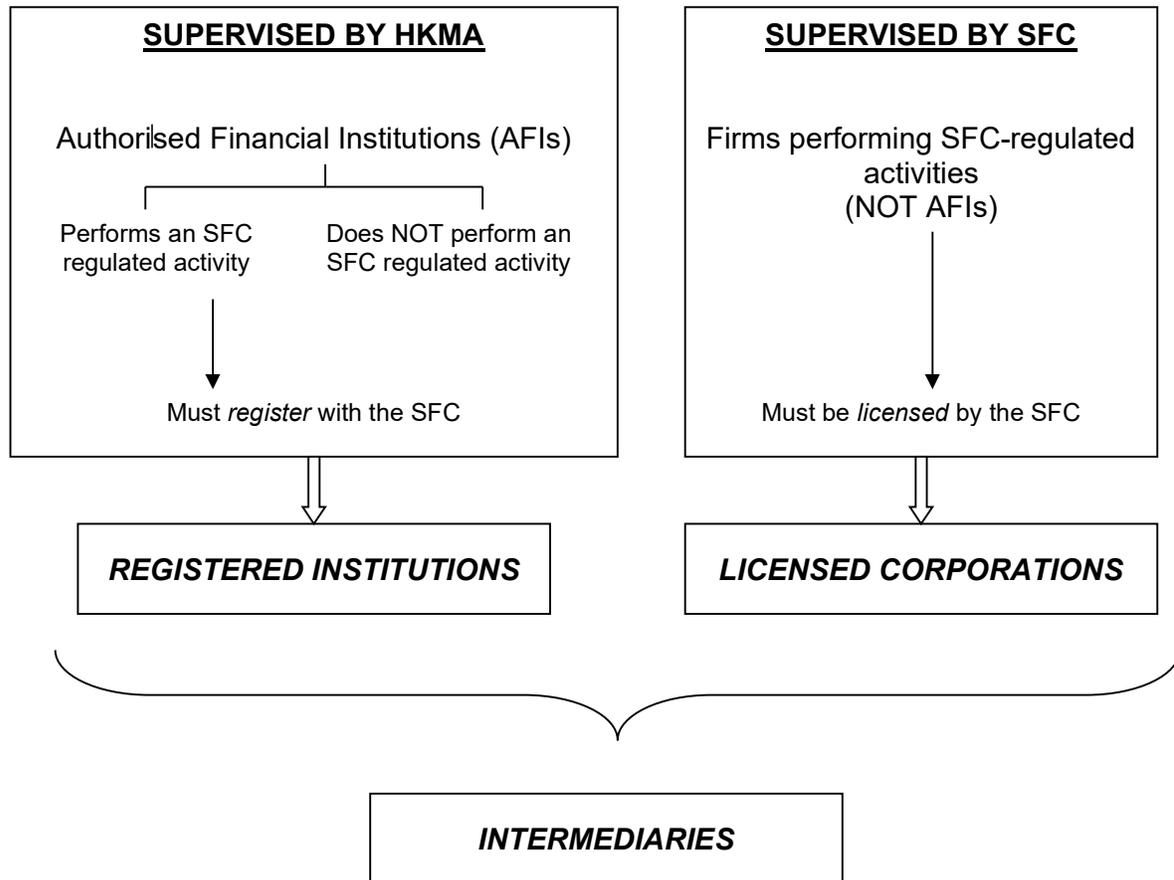
* covered in this section

Figure 2: The SFC and its regulatory counterparts (including some enforcement agencies)

2.2.1 Hong Kong Monetary Authority (HKMA)

- Headed by a Chief Executive with several deputies
- Manages the Exchange Fund
- Manages Hong Kong's monetary policy
- Required to maintain currency stability
- Ensures the safety and stability of the banking system
- Promotes the efficiency, integrity and development of the financial system
- Supervises the banking system
- Under the SFO and the Banking Ordinance, **Authorized Financial Institutions (AFI's)**, which are regulated by the HKMA and include banks, have to be registered with SFC as **registered institutions** if they wish to carry out an **SFC-regulated activity**
- HKMA is frontline regulator of AFIs and takes the leading role in vetting applications for registration with the SFC and in supervising their SFC-regulated activities, including on-site inspection
- HKMA applies all SFC criteria in supervising AFIs registered with the SFC

Supervision of Intermediaries – Registered or Licensed?



The HKMA:

- May refer cases of suspected malpractice to the SFC
- May remove the names of AFI employees from the register maintained under the Banking Ordinance

The SFC:

- May suspend or revoke registrations of AFI's reported by the HKMA, as well as issue public or private reprimands and impose fines

A Memorandum of Understanding has been signed between the HKMA and the SFC clarifying their roles and responsibilities to minimize any overlaps

Figure 3: Analysis of HKMA and SFC supervision of Intermediaries

The Ten SFC-regulated Activities

1. Dealing in securities
2. Dealing in futures contracts
3. Leveraged foreign exchange trading
4. Advising on securities
5. Advising on futures contracts
6. Advising on corporate finance
7. Providing automated trading services
8. Securities margin financing
9. Asset management
10. Providing credit rating services

2.2.2 Insurance Authority

- **Principal functions** are to regulate and supervise the insurance industry in Hong Kong
- **Major duties and powers** include:
 - Issues licenses for insurance intermediaries, including insurance brokers and agents
 - Conducting supervisions and investigations
 - Commencing prosecutions under the Insurance Ordinance

2.2.3 Mandatory Provident Fund Schemes Authority (MPFA)

- **The MPFA has responsibility for:**
 - Registering MPF schemes and approving pooled investment funds
 - Overseeing and making rules/guidelines for the administration and management of the above
 - Ongoing monitoring of compliance by MPF products with the MPFSO
 - Investigating alleged breaches of the MPFSO
 - Approving trustees and regulating their affairs and activities
 - Dealing with complaints about MPF products and approved trustees, referring them to the SFC and other regulators, where necessary

- **Certain responsibilities of the MPFA interlink with those of the SFC.** The relevant SFC responsibilities are:
 - Vetting and authorizing MPF products and related marketing materials in accordance with the SFC Code on MPF Products and relevant ordinances
 - Registering and approving investment managers and continued monitoring of their conduct
 - Supervising activities of investment advisors and securities dealers providing services relating to MPF products
 - Investigating alleged breaches of the SFC Code on MPF Products and taking enforcement action
 - Dealing with complaints referred by the MPFA

- **The MPFA and SFC have an MOU** coordinating their respective responsibilities

2.2.4 The Chinese Gold and Silver Exchange Society

- Runs a market now focused on bullion trading in tael gold and kilo gold
- The Society is NOT directly regulated
- Promotes paper gold schemes, which are classified as Collective Investment Schemes, which are, in turn, regulated by the SFC

2.2.5 Registrar of Companies

- Administers and enforces certain aspects of the: New Companies Ordinance, Companies (Winding Up and Miscellaneous Provisions) Ordinance; Limited Partnerships Ordinance, Trustee Ordinance, Registered Trustees Incorporation Ordinance and Money Lenders Ordinance
- Maintains and makes available for public inspection financial and other returns made by companies
- May strike off companies for failure to make returns or for not carrying on business
- Does not directly regulate companies, but takes an active interest in corporate governance issues and may make recommendations
- No direct link between SFC and Companies Registry

3. SECURITIES AND FUTURES COMMISSION (SFC)

3.1 Regulatory Functions and Structure

- **SFC was created by law** under the Securities and Futures Commission Ordinance (part of the SFO)
- **The SFC is independent** (not part of the Government machinery of the Civil Service or the ministerial system)
- It reports to, and is accountable to, the Hong Kong Government.

3.1.1 Regulatory Objectives of the SFC

- As stated in the SFO, **the objectives of the SFC**, in relation to the securities and futures industry, are:
 - Maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the industry
 - Promote understanding by the public of financial services including the operation and functioning of the industry
 - Provide protection to the investing public
 - Minimize crime and misconduct in the industry
 - Reduce systemic risks in the industry
 - Assist the financial secretary in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the industry

3.1.2 Functions and Powers of the SFC

- The functions and powers of the SFC are wide and set out in the SFO. The **principal functions** are to:
 - Take such steps as it considers appropriate to meet the first objective above
 - Supervise, monitor and regulate the activities of:
 - (i) recognised exchange clearing houses, exchange controllers and investor compensation companies or persons carrying on regulated activities; and
 - (ii) the activities of registered institutions that are regulated or to be regulated by the SFC under any relevant provisions
 - Promote, encourage and enforce the proper conduct, competence and integrity of persons carrying on regulated activities
 - Maintain and promote confidence in the industry
 - Cooperate with and provide assistance to other regulators
 - Secure appropriate degree of protection for the investing public

- Promote, encourage and enforce internal control and risk management systems by persons carrying on regulated activities, including registered institutions in the case of any regulated activities they conduct
- Suppress illegal, dishonourable and improper practices in the industry
- **Other functions of the SFC** include promoting:
 - Investor education
 - Investors' understanding of investment products
 - Investors' understanding of the importance of making informed investment decisions
 - Investors' appreciation of the benefits of purchasing different types of financial services including investing in financial products through regulated persons
- **General duties of the SFC** are to:
 - Help maintain Hong Kong's position as an international financial centre
 - Facilitate innovation in financial products
 - Avoid restrictions on competition
 - Act in a transparent manner
 - Use its resources efficiently

3.2 Directors, Committees, Tribunals and Panels

3.2.1 Directors of the SFC

- Directors of the SFC include the Chairman, CEO, and at least 5 other directors
- **The majority of SFC directors must be non-executive** who are prominent persons from the industry or the professions
- **Each of five executive directors supervise an operational division** from the following:
 - Corporate Finance
 - Enforcement
 - Investment Products
 - Supervision of Markets
 - Intermediaries
- Two support units are:
 - Legal Services Division
 - Corporate Affairs Division

SFC Organization Chart

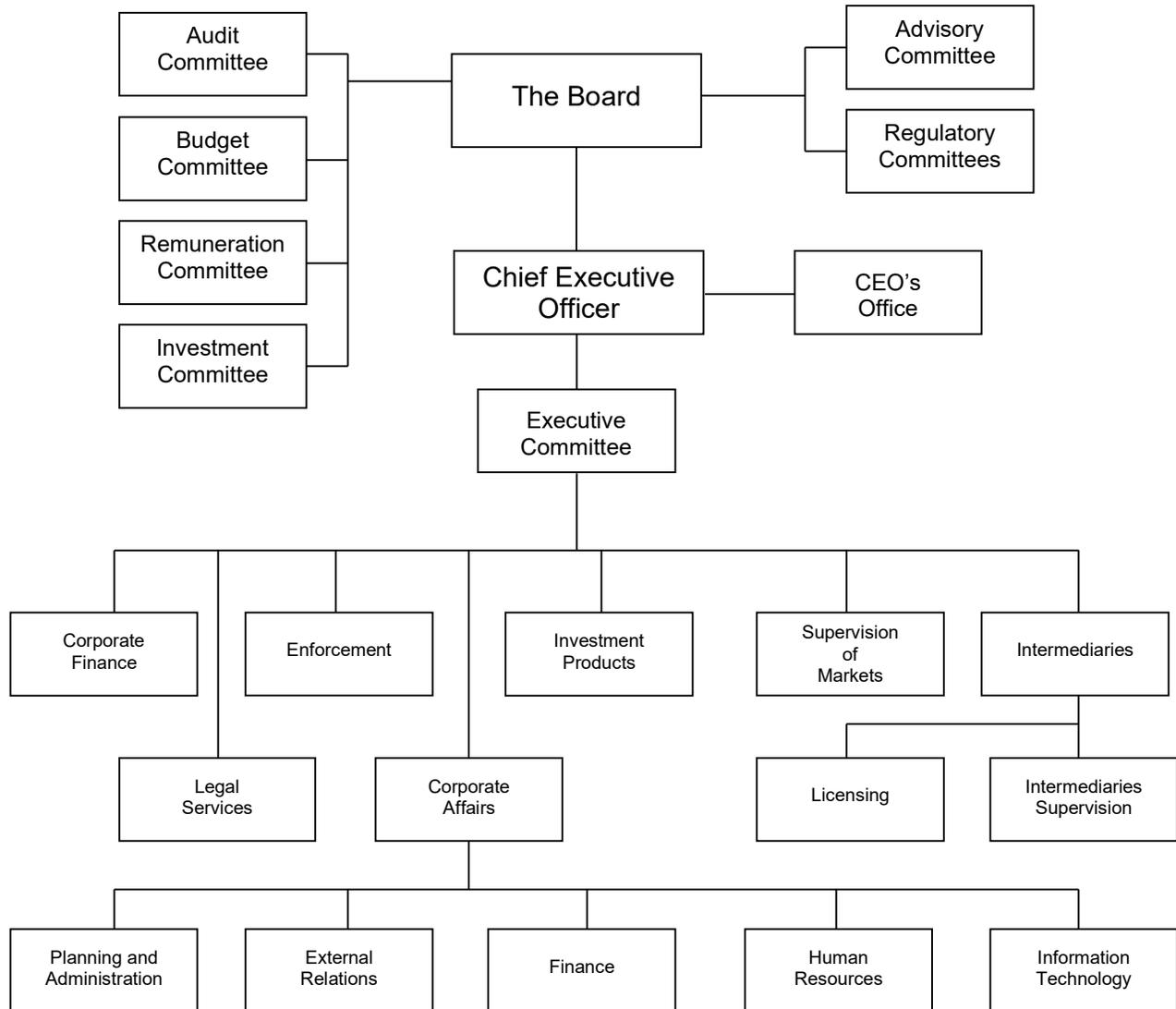


Figure 4: SFC Organization Chart as at October 2018. Source: www.sfc.hk

3.2.2 Advisory Committee

- Advises the SFC on policy matters concerning regulatory objectives and functions
- No executive powers and does not police the SFC
- Chaired by the SFC Chairman

3.2.3 Committees, Tribunals and Panels

- **Examples of regulatory committees** established by the SFC, to which it has delegated some of its functions, are:
 - **Takeovers and Mergers Panel**
 - **Takeovers Appeal Committee**
 - **Products Advisory Committee**
 - **Investor Compensation Fund Committee**
 - **Academic and Accreditation Advisory Committee**
 - **Share Registrars' Disciplinary Committee**

- **The following tribunals and panels are independent** of the SFC:
 - **Securities and Futures Appeals Tribunal** – statutory body with full-time members headed by a judge appointed by the Chief Executive to hear appeals against decisions made by the SFC
 - **Leveraged Foreign Exchange Trading Arbitration Panel** – hears disputes relating to leveraged foreign exchange trading
 - **Process Review Panel** – reviews and monitors the operational processes of the SFC, reporting suggested improvements to the Financial Secretary
 - **Market Misconduct Tribunal** – see Topic 9

3.3 Functions of the SFC's Operational Units

Five divisions, two departments. Here they are.

- **Corporate Finance Division:**
 - Administers the Codes on Takeovers and Mergers and Share Buy-backs and regulates takeovers, mergers and share buy-backs
 - Supervises listing-related activities of Stock Exchange (SE administers listing process)
 - Reviews and recommends changes to Listing Rules
 - Reviews/authorises prospectuses and marketing materials for unlisted shares/debentures
 - Administers dual filing regime under the SFO

- **Enforcement Division:**
 - Enforces the SFO
 - Monitors markets to detect market misconduct
 - Investigates market misconduct and disciplines/prosecutes those responsible, including those that may be unlicensed
 - Inspects books and records of listed companies where impropriety is suspected which may involve directors, officers or substantial shareholders

- Reports suspected market misconduct to Financial Secretary
- Cooperates with domestic/overseas regulatory bodies in investigations
- **Investment Products Division:**
 - Develops regulatory platforms, including those for authorization applications of investment products, so as to facilitate market growth and product innovation
 - Regulates and approves investment products that are offered to the public and subject to the SFO
 - Monitors disclosures and ongoing compliance of authorized investment products
 - Registers and regulates open-ended fund companies (OFCs)
- **Supervision of Markets Division:**
 - Supervises conduct, operation and internal systems of the exchanges and clearing houses
 - Strengthens market infrastructure
 - Authorizes automated trading service providers
 - Regulates approved share registrars
 - Supervises and monitors activities of the Investor Compensation Company
 - Conducts market-related research to help formulate policies
- **Intermediaries Division:**
 - Licensing department
 - Intermediaries Supervision Department
- **Licensing Department:**
 - Licenses corporations and individuals to enable them to carry out SFC-regulated activities
 - Issues codes and guidelines concerning the competence and suitability of corporations and individuals to remain licensed
 - Maintains a public register of licensed persons/registered institutions
 - Reviews continuing suitability of licensed corporations and individuals to be licensed
- **Intermediaries Supervision Department:**
 - Supervises the business conduct of licensed corporations and individual licensees on an ongoing basis by conducting on-site inspection and off-site monitoring
 - Monitors financial integrity of licensed corporations
 - Communicates with intermediaries and industry on policy and regulatory issues

3.4 Disciplinary Powers, Actions, Proceedings and Penalties

3.4.1 Disciplinary Powers of the SFC

- **The SFC may investigate suspected breaches of the SFO, subsidiary legislation, codes and guidelines:**
 - **Breaches of SFO and subsidiary legislation are legal offences.** Serious cases may be referred to law enforcement agencies such as the Commercial Crime Bureau (CCB - part of the police force), or the Independent Commission Against Corruption (ICAC)
 - **SFC can apply to the courts for an injunction** to stop someone dealing with his assets or from carrying on his business, if it can be shown to be in the public interest
 - **Codes and guidelines do not have the force of law** and are not legally enforceable. Breaching the codes and guidelines may result in a licensed or registered person not being considered 'fit and proper' to remain licensed or registered
 - **The SFC has the power to:**
 - Reprimand (privately or publicly)
 - Fine
 - Suspend or revoke a license or registration

3.4.2 Disciplinary Powers of Hong Kong Exchanges

- The exchanges and clearing houses have disciplinary powers over participants, however they are more limited in scope than those of the SFC
- Disciplinary powers relate mainly to trading, clearing and settlement infractions and listing matters

3.5 Interaction with Local and Overseas Regulators and the International Organization of Securities Commissions

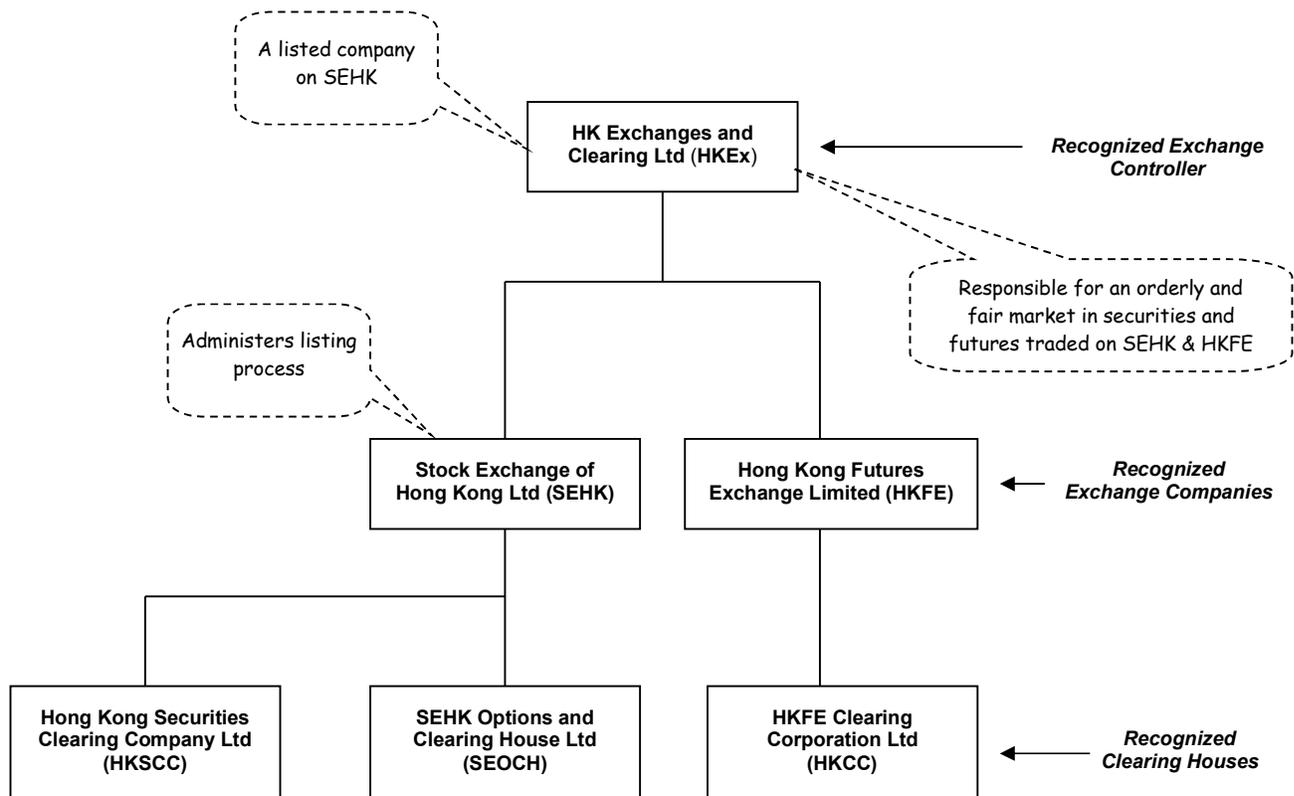
3.5.1 Disclosure of Information by the SFC

- The SFC is empowered to disclose confidential information to a number of persons and organizations, if it is in the public interest, or where it will help the recipient perform his functions and it is not against the public interest
- The SFC may also provide information to an overseas authority or regulator who is subject to adequate secrecy provisions
- The SFC has entered into a number of MOUs with local, Mainland and overseas regulators covering the provision of mutual assistance

3.5.2 IOSCO

- **The International Organization of Securities Commissions is a global group of securities regulators** that promotes cooperation and high standards of regulation to maintain fair, efficient and sound markets
- **The SFC is an active member of IOSCO** and is one of the small group of members of the influential Technical Committee
- As of January 2019, IOSCO had over 220 members

4. HONG KONG EXCHANGES AND CLEARING LIMITED



- The board of HKEx is a mix of directors appointed by the Government (the majority) and those elected by shareholders
- The SFC supervises and monitors the activities of all HKEx companies
- All exchange companies and clearing houses are 100% owned subsidiaries of HKEx
- Except in relation to the enforcement of their own listing, trading, clearing and settlement rules, the above entities are not responsible for front-line regulation of market participants, which is carried out by the SFC

5. PARTICIPANTS AND INTERMEDIARIES IN THE HONG KONG FINANCIAL MARKET

Retail Investors

- Individuals, or small businesses and companies who invest in relatively small amounts of money for themselves rather than on behalf of anyone else
- These investors need the most protection under the regulatory regime, as they are less sophisticated

High Net Worth Individuals (HNWIs)

- Usually serviced by private banks, which set a minimum asset level for such clients
- HNWIs vary as to their level of investment experience – some may be recognized by the SFC as professional investors (see Topic 5 for more detail)

Institutional Investors

- Entities that make investments on behalf of others, such as pension funds, unit trusts and mutual funds, insurance companies, AFIs, private banks and fund managers

Professional Investors (PIs)

- Persons who are highly experienced in making investments and investment decisions. Under SFC regulations, PIs are not automatically provided the same level of regulatory protection as retail investors. Covered in more detail in Topic 5

Intermediaries

- Intermediaries provide products and services to principals and investors. They include dealers, advisers, securities margin financiers and asset managers

Principals

- Principals act for themselves, are not agents, and include banks, insurance companies and market makers. However, such entities can act as agents for clients

Providers of Professional Support

- This group includes lawyers, accountants, auditors, valuers, financial analysts and other experts in finance-related matters