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1. FINANCIAL PRODUCTS, SERVICES AND SERVICE PROVIDERS

1.1 Introduction

- The Securities and Futures Commission (SFC) is the principal regulator of the securities industry in Hong Kong
- The SFC assumes responsibility for front-line regulation and discipline of stock exchange trading participants and also other securities intermediaries
- Regulatory approach is risk-based supervision

1.2 Products and Services

- Security-related products traded in Hong Kong market and services covered include:

Products

- Equities
- Warrants
- Mutual funds
- Bonds and other debt instruments

- Unit trusts/mutual funds
- Exchange traded funds
- Equity linked instruments
- Options on securities

Services

- Buying and selling securities for customers (clients) retail, institutional or professional
- Securities margin financing
- Acting as a securities introducing agent
- Securities lending and borrowing
- Holding of client assets
- Distributing securities issues
- Operating automated trading services (ATS)
- Advising about securities (issuing analyses, reports or advice)

1.3 Service Providers

- Principal service providers in securities investment and advising include (list not examined):
 - Intermediaries who are SEHK participants
 - Underwriters
 - Approved introducing agents
 - Corporate finance advisors
 - Financial planners for collective investment schemes
 - Trust companies
 - Support service providers: lawyers, accountants, auditors and valuers
 - Financial journalists and radio broadcasters
 - Exchanges from outside HK
 - Nominee companies holding assets of intermediaries
 - Intermediaries who act for foreign securities companies
 - Fund and portfolio managers
 - Advisors to retail investors
 - Securities analysts
 - Licensed banks
 - Securities margin financiers
 - Listed companies
 - Market operators (HKEx, SEHK and HKSCC)
 - ATS providers
 - Share registrars
 - Investor compensation companies

- The SFC is responsible to ensure proper discharge of the functions of many of these service providers

2. SECURITIES AND FUTURES ORDINANCE AND RELEVANT REGULATIONS

2.1 Securities and Futures Ordinance

- Securities and Futures Ordinance (SFO) is the principal legislation governing the securities market in Hong Kong with 17 parts and 10 schedules

2.2 Subsidiary Legislation

- SFO empowers SFC to make rules and to issue guidelines
- SFC-issued regulations apply to the day-to-day running of intermediaries
- Major relevant rules are:
 - Securities and Futures (Licensing and Registration) (Information) Rules
 - Securities and Futures (Associated Entities – Notice) Rules
 - Securities and Futures (Insurance) Rules
 - Securities and Futures (Financial Resources) Rules
 - Securities and Futures (Client Securities) Rules

- Securities and Futures (Client Money) Rules
- Securities and Futures (Keeping of Record) Rules
- Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules
- Securities and Futures (Accounts and Audit) Rules
- Securities and Futures (Short Selling and Securities Borrowing and Lending (Miscellaneous)) Rules
- Securities and Futures (Professional Investor) Rules
- Securities and Futures (Short Position Reporting) Rules
- Securities and Futures (Contract Limits and Reportable Positions) Rules
- Securities and Futures (Investor Compensation - Levy) Rules
- Securities and Futures (Investor Compensation – Compensation Limits) Rules
- Securities and Futures (Investor Compensation - Claims) Rules
- Securities and Futures (Disclosure of Interests – Securities Borrowing and Lending) Rules
- Securities and Futures (Levy) Order
- Securities and Futures (Miscellaneous) Rules

2.3 Codes, Guidelines and Guidance Notes

- The SFC issues codes, guidelines and guidance notes
- These do not have the force of law but failure to follow them may reflect on a licensed person's fitness and propriety
- Major relevant codes are:
 - Licensing Information Booklet – requirements and procedures for licensing
 - Fit and Proper Guidelines – lists matters SFC considers in considering if person is fit and proper to be licensed
 - Guidelines on Competence
 - Guidelines on Continuous Professional Training (CPT)
 - Code of Conduct for Persons Licensed by or Registered with the SFC
 - Guidance Note on Short Position Reporting
 - Guidance on the Regulation of ATS
 - Guideline on Anti-Money Laundering and Counter-Terrorist Financing
 - Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC – minimum best practice for management controls and procedures

3. OTHER RELEVANT LAWS

3.1 New Companies Ordinance (NCO) and Related Matters

- The NCO came into force on 3 March 2014. The prospectus regime and winding-up and insolvency provisions, which were in the old Companies Ordinance are now contained in the Companies (Winding Up and Miscellaneous Provisions) Ordinance (CO)
- Licensed person must be a company or a body corporate
- Company can be formed by one or more persons
- One member constitutes a quorum for a meeting of a company with only one member

3.1.1 Private, Public and Guarantee Companies

There are 3 distinct types of company.

Private company

- Restricts the right to transfer its shares
- May not have more than 50 members (excluding present and past employees who are members)
- May not offer shares (or debentures) to the public
- Is not limited by guarantee

Public company

- Does not restrict the right to transfer its shares
- May have more than 50 members
- Is not a private company, nor a guarantee company

Guarantee company

- Does not have share capital
- Liability of members is limited to an amount stipulated in the Articles in the event of a winding up

Listed company

- Satisfies the listing requirements of an exchange
- Its shares or debentures are traded on the exchange

3.1.2 Articles of Association

- Considered to be constitution of a company, forming an agreement between the company and its members
- Covers regulations for the internal management and operations of the company
- Companies often adopt Model Articles consisting of four broad parts including matters relating to:
 - Capital, such as share capital, and rights and dealing with shares and dividends
 - Members, including meetings and voting procedures
 - Officers, including powers, duties, appointments and disqualifications of directors, appointments and removal of company secretaries
 - Miscellaneous provisions such as communications to and by the company

3.1.3 Meetings and Procedures

- Company meetings provide the only opportunity for shareholders to exercise control over affairs of company and take part in its operations
- Companies can dispense with the requirement to hold annual general meetings by passing a written resolution
- **Annual general meeting (AGM)** of shareholders:
 - Public companies must hold an AGM within **six months** after the end of their accounting reference period (financial year-end). The time frame for private/guarantee companies is **nine months**
 - Other AGMs should be held within 15-monthly of each other
 - Business of an AGM includes:
 - Presentation of accounts
 - Declaration of dividend
 - Election of directors to replace those retiring
 - Appointment of auditors
 - Questioning of directors and auditors by members

3.1.4 Resolutions

- Resolutions may be passed by circularization and signing by all members **except** for two cases where the matter must be put to members at a general meeting as an ordinary resolution:
 - Removal of auditors before expiration of term of office, and
 - Removal of a director before his term of office

- **Special resolution** required with at least 75% of members at a general meeting with 21 days notice of intention, to pass resolution for:
 - Reduction of share capital
 - Winding up of the company voluntarily or by the court
 - Alteration of objects, articles or conditions in memorandum that could have been included in the articles, and
 - A printed copy of a special resolution must be lodged with the Registrar of Companies within 15 days of passing
- An **ordinary resolution** is not defined and generally is a resolution passed by a simple majority of those present and voting at a meeting of members. Notice of the resolution and meeting must have been given

3.1.5 Powers of shareholders

Powers Exercisable by Members in a General Meeting

- Changes to articles of association and company name
- Matters relating to buybacks
- Issue of shares at a discount
- Alteration of capital, including reduction
- Variation of class rights
- Corporate arrangements and reconstructions
- Appointment and removal of auditors
- Removal of directors
- Disposal of company assets
- Approval of payments for loss of office
- Winding-up petitions under court order and voluntary winding-up

Protection of Members and Minority Shareholders

- A company may vary the rights of the holders of a class of shares – **the holders of at least 10%** of the nominal value of the shares of that class may petition the court to have the variation cancelled, if against their interests
- **An individual member** may petition the court if the affairs of the company are being conducted in a manner prejudicial to the interests of the members generally

Protection of the Interests of Minority Shareholders

(in relation to internal procedures)

- Members with 5% of paid-up capital carrying voting rights, may ask the directors to call a meeting; if the directors refuse, the members may do so
- 100 members or 10% of the holders of issued shares may ask the Financial Secretary to appoint an investigator to look into the company's affairs

Judicial Protection of the Minority

- In addition to statutory safeguards, a court may intervene to allow an individual member, or members, to bring an action:
 - To enforce some personal right (personal action)
 - To enforce a right of a group of members (joint action)
 - On behalf of the company, where misconduct has been committed against the company; eg by a director (derivative action)

3.1.6 Directors and Officers

Directors

- A director includes any person who occupies the position of director, by whatever name he is called
- A non-private company must have at least 2 directors
- A private company must have at least 1 director who is a natural person

Shadow Directors

- Persons in accordance with whose directions or instructions the directors, or a majority of the directors, of a company are accustomed to act
- A person providing advice in a professional capacity which the directors act on will not be considered a shadow director

Officer

- Per NCO, includes a director, manager or company secretary

3.1.7 Qualifications, Powers, Duties and Liabilities of Directors

Qualifications of Directors

- Must be at least 18 years old
- Must hold any shareholding stipulated in the articles
- Must not be an undischarged bankrupt
- Must not be disqualified by court order. Four principal grounds are:
 - Conviction of fraud or dishonesty
 - Persistent default of performance as CO or liquidator or receiver
 - Fraud relating to company or fraudulent trading
 - Found to be unfit during directorship if insolvent company

Powers of Directors

- General powers to manage the business of a company are vested in the directors
- Directors can exercise all the powers of the company except those otherwise required by the NCO, the Articles, and any directions given by special resolution
- Members in general meeting may only intervene in management if directors are:
 - Unwilling to act
 - Seeking approval to act beyond their powers
 - Acting in breach of their fiduciary duties
- Under common law, directors should have board meetings with a proper quorum, passing resolutions that must be minuted

Duties of Directors

- Directors have a **fiduciary relationship with the company**. They must act with the utmost good faith towards the company, act for the benefit of the company, exercise their powers for the proper purpose and not allow conflicts of interest to prevail
- Directors **must exercise skill, care and diligence**, as reasonably expected of persons carrying out a director's functions (objective test) and reflecting their own experience and knowledge (subjective test)

Liabilities of Directors

- In relation to specific offences, directors may incur liabilities due to:
 - Authorizing the issue of a prospectus containing an untrue statement (fine and/or imprisonment)
 - Failing to prepare financial statements when required to do so
- If a director breaches his duties, the company:
 - May obtain an injunction to stop the action
 - May cancel a company contract if the director did not declare a personal interest in the contract
 - May force directors to account for profits wrongfully earned by dealing with the company's property
 - The court may give relief to a director if, in causing the breach, the director is shown to have acted honestly and reasonably

Financial Arrangements with Directors

- Directors with a direct or indirect interest in a contract with the company, must disclose the interest as soon as reasonably practicable for an existing transaction or before the company enters into a transaction – the contract must be significant for disclosure to be necessary
- Directors' fees should be determined by the company in general meeting
- A company cannot, directly or indirectly, without the approval of its members
 - Make a loan to a director of the company or holding company
 - Enter into a guarantee or provide security for such a loan
 - Make a loan or guarantee to a company in which a director has a controlling interest

3.1.8 Audits and Investigations

- Investigations may be ordered by the Financial Secretary or the company may itself carry out a private investigation

Appointment of Inspectors by Financial Secretary

- The Financial Secretary is required to appoint inspectors to investigate the affairs of a company if the court declares that an investigation should be carried out
- The Financial Secretary may also order an investigation if he suspects fraud or misconduct

Duty to Assist the Inspector

- All present and past officers and agents of the company, including bankers, solicitors and auditors, are required to assist an appointed investigator
- Exceptions are solicitors, who cannot be forced to provide privileged client information, and bankers, who do not have to provide information other than that relating to the company under inspection

3.1.9 Liquidation of Companies

Compulsory Liquidation

- A compulsory winding-up by the court
- The liquidator is appointed and controlled by the court
- A company may be wound up by the court if:
 - It has resolved to be wound up by special resolution
 - It does not commence business within a year of incorporation or has suspended business for a whole year
 - It has no members
 - It is unable to pay its debts
 - The Memorandum stipulates liquidation on the occurrence of particular events
 - The court believes it would be just and equitable to wind up the company
- Petitioners for a compulsory winding up may be:
 - The company
 - A creditor
 - Financial Secretary
 - Registrar of Companies, if company has breached CO or is breaking the law
 - Official Receiver, where there is already a voluntary winding up
 - SFC, if it is in the public interest

Voluntary Liquidation

- A voluntary winding up may be started by members or creditors
- Fewer formalities than a compulsory winding up and therefore more popular

Members' Voluntary Winding Up

- If the directors are able to declare that the company can meet its debts within 12 months from the start of the winding up, a members' voluntary winding up can proceed
- This declaration must be made 5 weeks before the resolution to wind up the company

Creditors' Voluntary Winding Up

- If the conditions for a members' compulsory winding up cannot be met, a creditors' winding up will proceed
- The company will arrange a meeting of creditors to take it forward

3.2 Contract Law

- The elements of a legally binding contract are:
 - An intention to create legal obligations
 - The existence of an offer and acceptance, where acceptance may be implied by conduct
 - Valuable consideration, which can include an agreement not to sue. (A contract under deed does not need consideration)
 - The parties must have legal capacity (for example, over 18)
 - Unenforceable if it contains an illegal element
 - Parties gave consent to contract without any form of pressure
- The terms of the contract can be:
 - Expressly agreed or implied
 - Conditions or warranties
 - Conditions precedent or subsequent
- Examples of contracts are:
 - Purchase or sale of security/futures contract
 - Acceptance by an investor of an IPO
 - Undertaking to manage a mutual fund
 - Purchase of a leveraged foreign exchange contract

3.3 Law of Agency

- Agency is a fiduciary relationship, created by express or implied contract, where the agent may act on behalf of the principal
- Agent binds principal by words and actions
- Stockbroker can be agent of client; account executive may be considered agent of employer
- A principal is liable for the acts of the agent, who is a fiduciary
- A fiduciary is a person who owes another person duties of good faith, trust, confidence, honesty and care
- The agent has a duty to act for the benefit of the principal

3.4 Law of Tort

- In situations where no contract exists, a wrong or tort can occur when one party suffers a loss or damage from the actions of another
- Financial advisers who are negligent in giving advice may be exposed to actions in tort

3.5 Employment Law

- Under common law, an employer must provide an employee with:
 - Remuneration
 - Indemnity for expenses, losses and liabilities
 - A safe working environment
- Under common law, an employee must demonstrate skills and competence, faithful service, obedience and confidentiality

3.6 Personal Data (Privacy) Ordinance

- The PDPO protects the privacy of individuals in relation to personal data
- The Privacy Commissioner for Personal Data is an independent public officer appointed to enforce and promote compliance with the PDPO
- Personal data is data that can identify a living individual
- Any person who alone or jointly controls the collection, holding processing or use of the data is covered
- Data users must comply with six data protection principles

Principle 1 - Purpose and manner of collection of personal data

- Data shall only be collected for a lawful and relevant purpose
- The purpose of collecting the data should be disclosed

Principle 2 - Accuracy and duration of retention of personal data

- Personal data should be accurate, up to date and kept no longer than necessary and should be rectified if incorrect

Principle 3 - Use of personal data

- Without the consent of the subject, the data should not be used for any purpose other than for which it was collected

Principle 4 - Security of personal data

- All measures should be taken to ensure that personal data are protected against unauthorized access, processing, erasure, etc

Principle 5 - Information to be generally available

- A data user's policies and practices relating to the data should be available

Principle 6 - Access to personal data

- A data subject should be able to get access (at a reasonable fee) to the data held and request corrections to it

4. SECURITIES AND FUTURES COMMISSION (SFC)

4.1 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.

4.1.1 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

4.1.2 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

4.1.3 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
 - Corporate Affairs

SFC Organization Chart

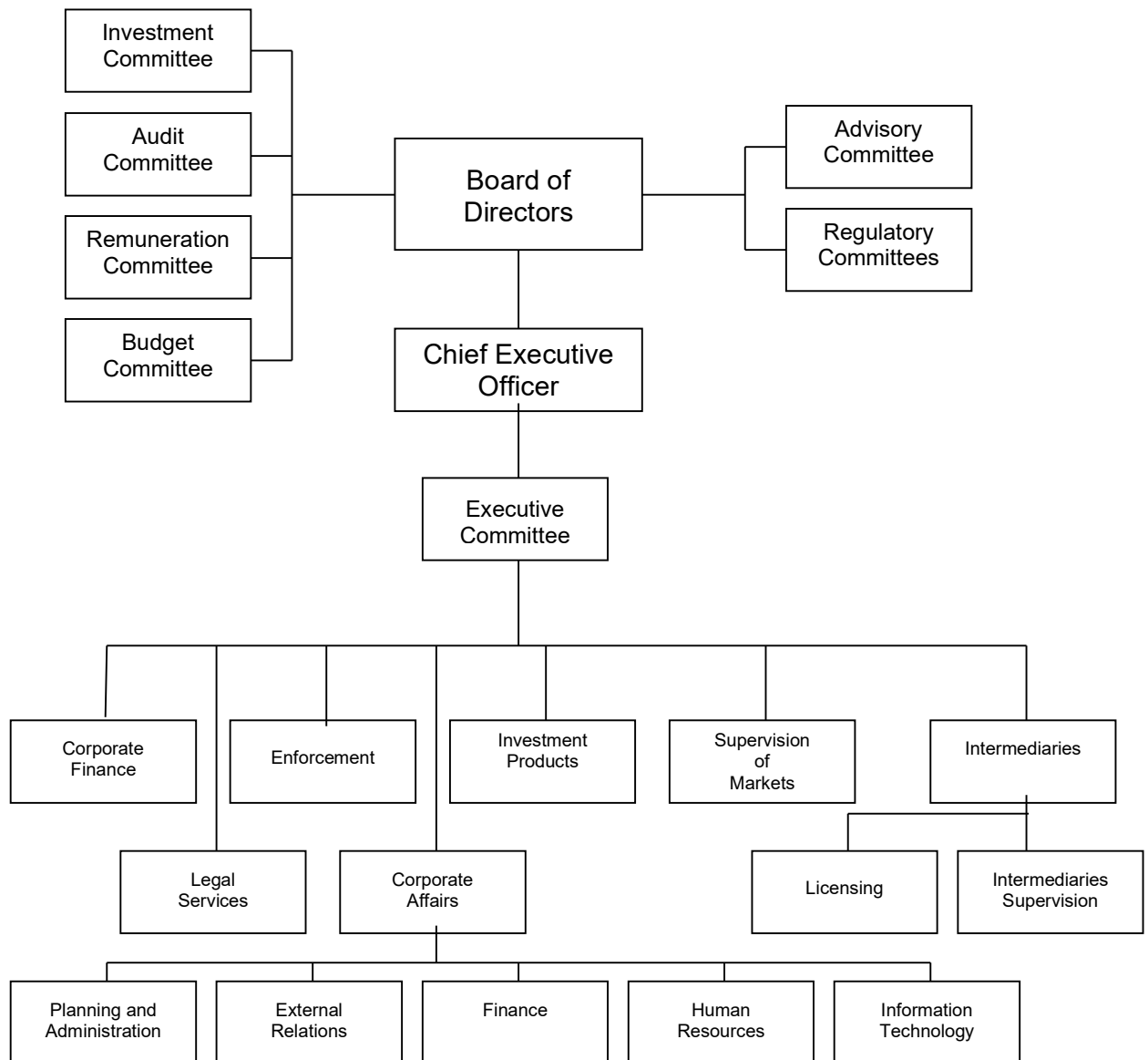


Figure: SFC Organization Chart at July 2014. Source: www.sfc.hk

4.1.4 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

4.1.5 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
 - **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 7

4.2 Functions of the SFC's Operational Divisions

Five divisions, two departments. Here they are.

- **Corporate Finance Division:**
 - Regulates takeovers, mergers and share repurchases
 - Administers securities legislation applicable to listed and unlisted companies
 - Supervises listing-related activities of Stock Exchange (SE administers listing process)
 - Reviews and recommends changes to Listing Rules
- **Enforcement Division:**
 - Monitors markets to detect market misconduct
 - Investigates market misconduct and has the power to discipline/prosecute 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 the Financial secretary
 - Co-operates with domestic and overseas regulatory bodies

- **Investment Products Division:**
 - Develops and implements codes/guidelines for authorisation and registration of investment products
 - 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
 - Formulates policies for the regulation of asset management

- **Supervision of Markets Division:**
 - Supervises conduct, operation and internal systems of the exchanges and clearing houses
 - Strengthens market infrastructure
 - Supervises and monitors activities of the Investor Compensation Company
 - Ensures that markets are operated efficiently and that risk is minimized for market participants and for the image of Hong Kong as a financial centre
 - Helps participation in the Hong Kong markets by liaising with local/overseas participants
 - Conducts market-related research to help formulate policies

- **Intermediaries Division:**
 - Comprises Licensing and Intermediaries Supervision Departments

- **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
 - Reviews continuing suitability of licensed corporations and individuals to be licensed
 - Maintains public register of licensed persons/registered institutions
 - Initiates licensing policies

- **Intermediaries Supervision Department:**
 - Supervises the business conduct of licensed corporations and individual licensees on an ongoing basis, including on-site inspections
 - Monitors financial integrity of licensed corporations
 - Communicates with intermediaries/industry on policy and regulatory issues

5. OTHER REGULATORY AUTHORITIES

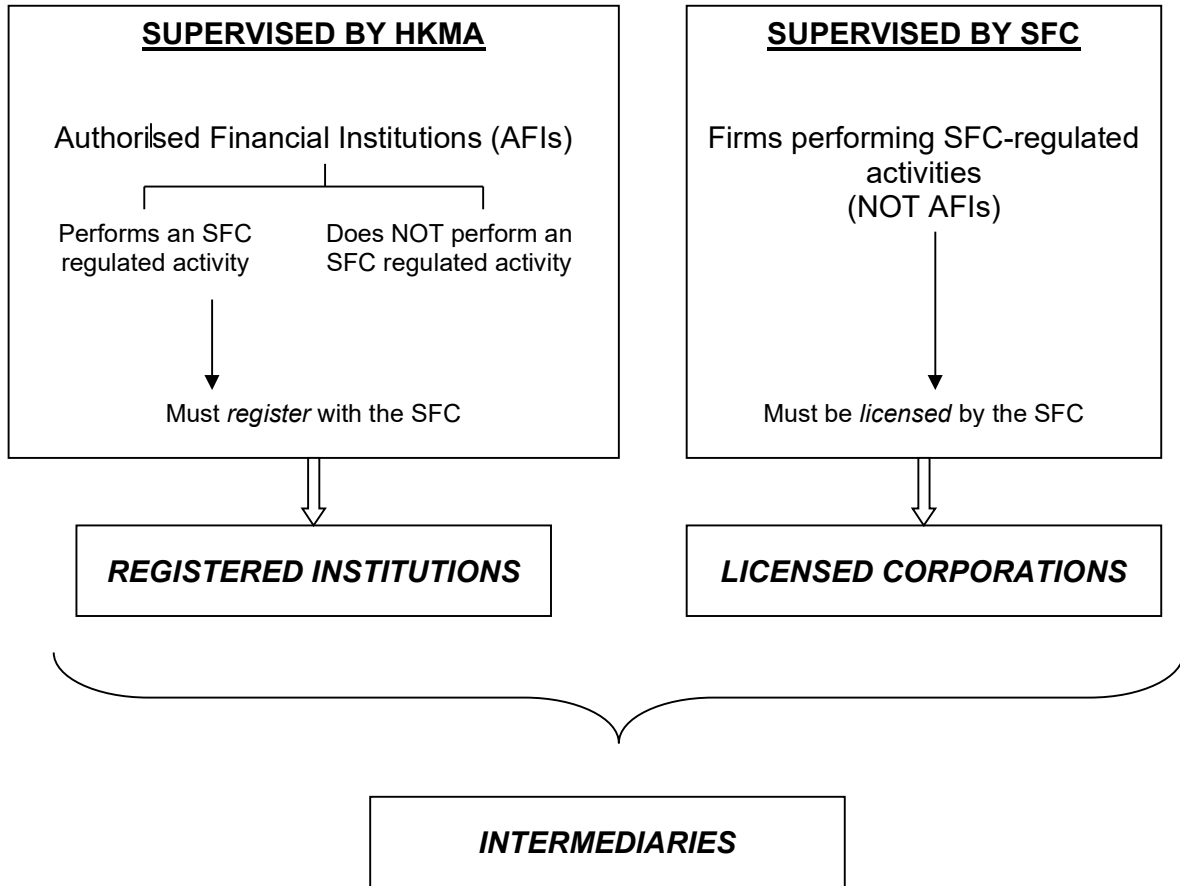
5.1 The Hong Kong Monetary Authority (HKMA)

- 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

5.2 Registrar of Companies

- Administers and enforces certain aspects of the: New Companies Ordinance, Companies Ordinance, Limited Partnerships Ordinance, Trustee Ordinance, Registered Trustees Incorporation Ordinance and Money Lenders Ordinance and Miscellaneous Incorporation Ordinances
- 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

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

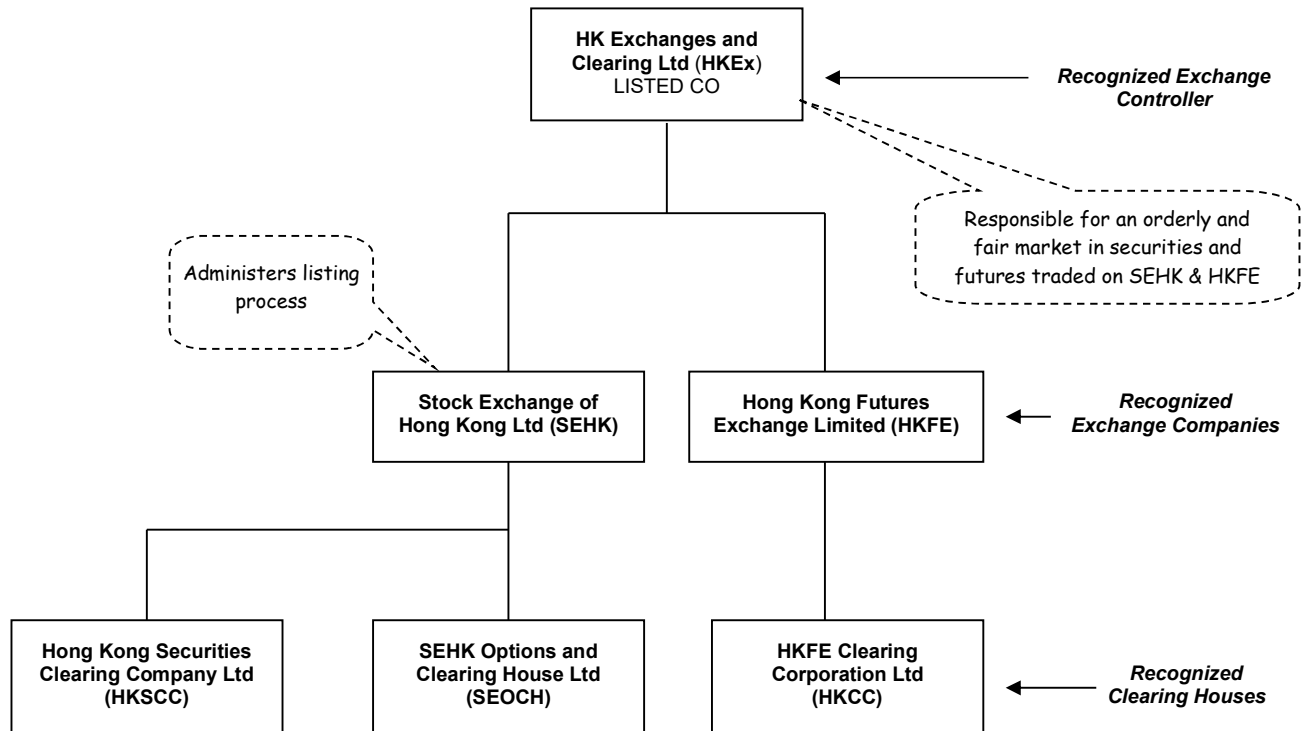
5.3 Insurance Authority (IA)

- IA is a statutory body, financially and operationally independent of the government, established under the **Insurance Ordinance**
- **Major powers** include:
 - **Issuing licenses** for insurance intermediaries, including licensed insurance brokers and licensed insurance agents
 - **Conducting supervisions** and investigations
 - **Applying disciplinary sanctions** and commencing prosecutions under the Insurance Ordinance

5.4 The 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

5.5 The 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
- HKEx group is responsible for:
 - Conduct of market participants trading on exchanges
 - Management of business risk
 - Enforcement of own trading and clearing rules
 - Disputes, complaints and enquiries related to trading, clearing and settlement matters in markets operated by group

6. OVERALL LICENSING REGIME

6.1 Key Features

- A single licensing system to cover all regulated activities
- Each license endorsed to show which of regulated activities are permitted and any conditions attached to license
- Two types of licenses: licensed corporations and licensed representatives (individuals)
- Fit and proper criteria are set for issuing licenses
- Registration of Authorised Financial Institutions (AFIs) carrying out any of regulated activities
- Registered institutions must ensure persons carrying out regulated activities are fit and proper
- Approval of responsible officials of licensed corporation or executive officers of a registered AFI
- Excluded activities from licensing for certain classes of persons

6.2 Regulated Activities

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

6.3 Licensed Corporation

- Regulated activities may only be carried out by a corporation
- Individuals, sole proprietorships and partnerships cannot be licensed for this purpose

6.4 Registered Institutions

- AFIs (including banks) will need to register with SFC if conduct regulated activities
- These AFIs will be jointly regulated by SFC and HKMA
- HKMA is front-line regulator

6.5 Licensed Individual

- Individuals conducting regulated activities within licensed corporation need to be individually licensed with SFC as licensed representative
- Individuals may act for more than one licensed corporation, within the same group of companies
- If a licensed representative ceases to be employed by the licensed corporation, the corporation must notify the SFC within seven business days of cessation. If the license is not transferred to another licensed corporation within 180 days, the license is deemed to have been revoked

6.6 Responsible Officer

- A responsible officer is a licensed representative who:
 - Actively participates in or supervises a regulated activity;
 - Is nominated by the licensed corporation; and
 - Is approved by the SFC
- Although the SFO does not provide a definition of responsible officer, the SFC has stated:
 - **Every executive director*** of a licensed corporation is required to obtain the approval of the SFC as a responsible officer; and
 - Every licensed corporation must have, for each regulated activity for which it is licensed, **at least two responsible officers** approved by the SFC – at least one of them must be an executive director and at least one must be based in Hong Kong
- * *A director who actively participates in, or is responsible for directly supervising, the business of a regulated activity for which the corporation is licensed (s113, SFO)*
- For **registered institutions**: the Banking Ordinance requires at least **two executive officers** to be responsible for supervising regulated activities – at least one to be available at all times

6.7 Substantial Shareholder

- Substantial shareholders have a special relevance in the licensing regime
- All substantial shareholders of licensed corporations must be approved by the SFC
- Under this legislation, a substantial shareholder is a person who, alone or together with his associates:
 - Has an interest of more than 10% of the nominal value of the issued share capital
 - Directly or indirectly has more than 10% of the voting power of the company at a general meeting
 - Is able to exercise 35% or more of the voting power of another company at a general meeting which in turn has more than 10% of the voting power of the company at a general meeting
- A substantial shareholder must keep the SFC informed of his contact details and notify the SFC of any changes within 14 days
- Someone who becomes a substantial shareholder, **without being aware**, must apply for approval when he discovers the fact. Time limit for approval is “as soon as reasonably practicable” or within three business days from becoming aware)

6.8 Exclusions from Regulated Activities

A number of parties are not required to be licensed for certain activities, including:

- **Professional accountants, solicitors, and counsel** conducting Types 4, 5, 6 and 9 regulated activities that are wholly incidental to their profession
- **Trust companies** conducting Types 4, 5, 6 and 9 regulated activities, wholly incidental to the discharge of their trustee duties
- **Persons licensed or registered to conduct Type 9** regulated activity who carry out Types 1, 2, 4 and 5 regulated activities solely for the purposes of their Type 9 regulated activity
- Corporations carrying out Types 4, 5, 6 and 9 regulated activities solely for their **wholly owned subsidiaries**, holding companies holding all their issued shares or other wholly owned subsidiaries of the holding company

6.9 Temporary and Provisional Licenses

6.9.1 Temporary Licenses

- The SFC may grant a temporary license to a **corporation**, for not more than 3 months:
 - Which principally carries on its business overseas
 - For specified SFC regulated activities, other than Types 3, 7, 8 and 9
- The SFC may grant a temporary license to **representatives** of a licensed or a temporary licensed corporation, for not more than 3 months
- The total period for which temporary licenses can be held by the same person may not exceed 6 months over a 24-month period

6.9.2 Provisional Licenses

- On application for a representative license, a person may be given a provisional license to cover the period before a decision is made on the licensing application

7. TYPES OF REGULATED ACTIVITIES

- The regulated activities covered by Paper 2 are:
 - Type 1 – Dealing in Securities
 - Type 4 – Advising on Securities*
 - Type 7 – Providing Automated Trading Systems*
 - Type 8 – Securities Margin Financing*
- * covered in Topic 5

7.1 Dealing in Securities (Type 1)

7.1.1 Definitions: Securities and Derivatives

- Securities are defined in the SFO as covering a wide range of instruments, including:
 - shares, stocks, debentures
 - rights, options or interests in the above instruments
 - certificates of interest or participation in, or warrants to subscribe for or purchase, the above instruments
 - interests in Collective Investment Schemes (CIS)
 - interests, rights or property, whether in the form of instruments or otherwise, commonly known as securities
 - other interests, rights or property which are prescribed by the Financial Secretary as securities
 - structured products not covered above
- Note that the above definition specifically includes derivatives such as options (and implicitly warrants)
- Warrants and options are traded on the SEHK; options on futures are traded on the HKFE

7.1.2 Definition: Dealing in Securities

- A person deals in securities if he makes or offers to make an agreement, or induces or attempts to induce another person to enter into an agreement:
 - for acquiring, disposing of, subscribing for or underwriting securities; or
 - for the purpose of making profits from securities
- Excepted from the above definition are:
 - recognized exchanges, clearing houses and authorized ATS;
 - persons engaging in dealing in securities as defined above through a licensed securities dealer or registered institution (no exception, if for remuneration);
 - persons acting as principals with a professional investor, or in the acquisition, disposal, subscription or underwriting of securities;
 - the issuing of prospectuses and forms of application for shares with prospectuses;
 - the issuing of an advertisement or invitation authorized by the SFC;
 - trust companies registered under the Trustee Ordinance acting for a CIS; and
 - certain types of Type 4, 6, and 9 activities

- Categories of persons conducting Type 1 activity would include:
 - SEHK participants, whether they engage in activities on the SEHK or outside it
 - another securities dealers carrying out dealing in securities in Hong Kong
 - licensed representatives of the above
 - AFI's registered with the SFC for this activity, and their staff who deal with the public and are on a register maintained by the HKMA
 - any portfolio managers who are licensed (as security dealers) for Type 1 regulated activity
 - a securities introducing agent* (see below)

Summary: *Dealing in securities, for the purposes of the SFC licensing regime, will include dealing in securities traded on the SEHK and other securities, where the activity is conducted in Hong Kong*

***Approved Introducing Agent**

- Approved introducing agents introduce securities or futures business to other securities/futures dealers. Not defined in the SFO, but **created under the FRR**
- The SFC may approve a licensed corporation as an approved introducing agent if it can satisfy the SFC that it
 - Only receives offers for dealings in securities and **passes them on** to an exchange participant or another licensed dealer; or
 - Only **introduces a client** who wishes to trade to an exchange participant or another licensed dealer; and
 - **Does not handle client assets and incurs no legal liability** in respect of the introduced business
- The SFC allows approved introducing agents to maintain a **lower level of liquid capital** and is not required to maintain paid-up capital

7.1.3 Structure of Large Entities

- Larger intermediaries can include the following:
 - A securities dealing company (Type 1 license)
 - A SEHK participant that deals for the first company (Type 1 license)
 - An SMF company that lends money directly to investors (Type 8 license)
 - A finance company engaging in treasury functions for group companies
 - A group holding company

8. FIT AND PROPER REQUIREMENTS FOR LICENSING

- Corporate and individual applicants for licensing and registration must satisfy fitness and properness requirements as stated in the **Fitness and Properness Guidelines**. These relate to:
 - Financial status or solvency
 - Educational or other qualifications/experience
 - Ability to carry on the regulated activity competently, honestly and fairly
 - Reputation, character, reliability and financial integrity

8.1 Fit and Proper Criteria for Individuals

Financial Status or Solvency

- An individual applicant should **not**, in Hong Kong or elsewhere:
 - Be an undischarged bankrupt
 - Be a recently discharged bankrupt
 - Be involved in bankruptcy or similar proceedings
 - Have failed to meet any judgment debt

Competence and Capability

- An individual applicant should:
 - Be 18 years or older
 - Satisfy the competence tests involving experience and educational qualifications

Character and Integrity

- An individual applicant should satisfy the SFC (or HKMA) that he:
 - Is of **good character**
 - Has **not breached** any SFC codes or guidelines
 - Has not been subject to **disciplinary action** by professional associations
 - Has not been disqualified by the court from **acting as a director**
 - Has not been a director/substantial shareholder/management of an **insolvent corporation**
- Individuals who are granted a license must continue to meet the above requirements on an ongoing basis

8.2 Fit and Proper Criteria for Corporate Applicants and Intermediaries

Financial Status or Solvency

- An intermediary:
 - Should be able to comply with capital requirements: Financial Resources Rules (FRR) for licensed corporations; HKMA's capital adequacy requirements for registered institutions
 - Should not be subject to insolvency proceedings
 - Should not have failed to meet a judgment debt

Competence and Capability

- An intermediary should demonstrate it is competent in accordance with Guidelines on Competence.
- Competence includes:
 - Proper business structures
 - Sound internal controls and risk management procedures
 - Competent personnel
- SFC will not expect smaller entities to install full set up
- Guidelines indicate areas SFC will consider:
 - Proper organization structure based on good corporate governance principles, taking account of nature of business and with effective lines of authority and reporting
 - Risk management policies, controls and procedures as an independent function under competent risk manager reporting to senior management
 - Effective internal control systems, and internal audit and compliance functions with direct reporting lines and qualified and experienced personnel
 - Effective information technology supported headed by experienced manager
 - Appropriately qualified employees to perform task with supervisory staff have at least three years experience and relevant qualifications
 - Training policies and programmes for new and existing staff based on SFC guidelines

Character and Integrity

- A corporate applicant must be reliable and have a good reputation and financial integrity:

8.3 Continuous Professional Training

- Continuous professional training (CPT) is a requirement and seeks to:
 - Ensure that professional and technical knowledge of licensees is up to date
 - Provide investors with comfort that licensed persons have necessary skills
 - Maintain international recognition of Hong Kong professionals
- SFC expects:
 - Corporations to conduct or arrange CPT programmes for staff
 - Individuals to meet CPT criteria
- Every individual licensee is expected to undertake a minimum of **5 CPT hours** every calendar year for **each** regulated activity **competence group** (eg Types 1 and 4 are in the same Group; Types 1 and 9 are in different Groups)
- Activities **allowed as CPT**:
 - Attending courses, workshops, lectures and seminars
 - Distance learning
 - Self-study with submission of assignments to recognized institutions
 - Research
 - Publications
 - Speeches
- Activities that **do not qualify as CPT**:
 - Reading financial journals, newspapers and other technical publications
 - Normal work
 - Activities which do not involve interaction with other individuals
- Corporations and individuals should keep training materials and attendance records for a minimum of **three years**

8.4 Licensing Handbook

- Gives full details of how to apply for a license and the various requirements
- Summarizes licensing matters covered in the SFO and subsidiary legislation

8.5 Securities and Futures (Licensing and Registration) (Information) Rules

- Rules prescribe information to be included in:
 - Applications
 - Notification of changes
 - Annual returns
 - Particulars for entry in Public Register maintained by SFC

9. CORPORATE GOVERNANCE AND REGULATORY SUPERVISION

9.1 Introduction

- Intermediaries should ensure that they operate within a properly regulated environment, within which they can achieve their business objectives
- Regulated persons should ensure a good compliance philosophy among all directors and employees where they:
 - fully understanding its practical applications; and
 - conduct themselves at all times at the highest standards expected by clients, the market, the regulators and Government

9.2 Role of Senior Management

- Senior management must provide leadership and drive to promote, encourage and enforce good compliance practices
- Senior management must ensure
 - Good line and reporting structures
 - Clearly defined functions and responsibilities
 - Effective communications
 - Appropriate transparency and disclosure practices
 - Well defined policies, practices and procedures set out in writing
 - Distinctions between supervisory and review functions and operational and line functions
 - Good relationship with external agencies, such as regulators and auditors
 - Open access for complaints which should be promptly and satisfactorily dealt with
 - Good corporate governance practices

9.3 Corporate Governance

- A key objective of good governance in any corporate business is to avoid management taking improper advantage of its position to benefit itself in preference to the legitimate interests of the company
- OECD has developed a set of core principles of corporate governance practices which include fairness, transparency, accountability and responsibility
- Possible mechanisms are to:
 - Install checks and balances such as:
 - Separation of Chairman and CEO
 - Non-executive directors
 - Audit Committees
 - Independent and strong audit function
 - Remuneration Committees
 - Increase transparency and disclosure to shareholders, stakeholders and public
 - Adopt international accounting and auditing standards
 - Install strong protective structures for minority shareholders, creditors and other lenders
 - Identify and penalize corporate wrongdoings
- Deficiencies in corporate governance can result in:
 - Insider dealing
 - Fraud, misfeasance and misconduct by directors and managers to their own benefit
 - Connected transactions which are undervalued, often to detriment of minority shareholders

9.4 Regulatory Supervision by the SFC

- The SFC has several mechanisms to exercise its regulatory mandate:
 - Licensing so that only fit and proper persons can engage in regulated activities
 - Supervision and monitoring
 - Marketing standards for investment products via the authorization of CIS
 - Disciplinary measures
- To further these aims, the SFC conducts regular inspections of licensed corporations. Regulators in different jurisdictions increasingly share information.

10. PROVISION OF INFORMATION TO THE SFC

- Code of Conduct of Licensed or Registered Persons requires voluntary reporting of compliance breaches
- Management must promptly notify SFC of:
 - Material failure or error in operation of trading, accounting, clearing or settlement systems
 - Non-compliance with regulatory requirements
 - Suspected material breach of regulations or rules
 - Winding up or bankruptcy of it or substantial shareholders or directors
 - Any disciplinary actions
- SFC can conduct inspections to determine if intermediary has complied with SFO requirements and license conditions
- SFC, with consent of Financial Secretary, may investigate if there are suspicions of malpractice or situations where the public may be exposed to risk of loss
- Person under investigation must:
 - Provide all documents and explanations
 - Answer questions in writing
 - Give investigator all reasonable assistance
 - Support evidence by a statutory declaration
 - Or make a statutory declaration on reasons why required evidence cannot be provided
- It is an offense if person fails to comply or provides false or misleading responses
- Investigator may apply to court for a warrant to enter premises within 7 days and:
 - Require any person on premises to produce any document
 - Prohibit any person erasing or altering or removing any document
 - Seize and remove any document
 - Retain such documents for a period of six months, which may be extended
- Any person who destroys, falsifies, conceals or otherwise disposes of any documents is guilty of an offence