

## TOPIC 4 - OVERVIEW

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## 1. LICENSING AND REGISTRATION REQUIREMENTS UNDER THE SFO

- Part V of the SFO provides for the implementation of the licensing regime
- Details of the regime now follow

### 1.1 Board Responsibility

- Ultimately, an intermediary's board is responsible for conduct, operations and financial soundness of the intermediary
- Many decision-making powers are delegated by the board to senior management, including managers-in-charge of core functions, however the board remains responsible for the oversight of those powers
- An effective management and organisational structure should be established and maintained by an intermediary, having been approved by the board
- An intermediary's board should be involved in any SFC license application, providing details on the managers-in-charge, including an organizational chart showing the relevant reporting lines

### 1.2 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

*\* 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)*
- The SFC generally expects two types of MIC to be licensed and approved as responsible officers:
  - Any person who undertakes the overall management oversight function
  - Any person who undertakes a key business line function
- 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

### 1.3 Executive Officer

- An executive officer is defined as being:
  - A **responsible officer** of a licensed corporation
  - An **executive officer** of a registered institution
  - A **director of an associated entity** who is directly responsible for supervising the receiving or holding client assets by the associated entity

### 1.4 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 total number of the issued shares of the corporation
  - 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

### 1.5 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
- **Persons licensed or registered to conduct Type 1** regulated activity conducting Types 4, 6 or 9 regulated activities, wholly incidental to Type 1
- **Persons licensed or registered to conduct Type 2** regulated activity conducting Types 5 or 9 regulated activities, wholly incidental to Type 2

## 1.6 Temporary and Provisional Licenses

### 1.6.1 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

### 1.6.2 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

## 1.7 Fitness and Properness

- 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

### 1.7.1 Fit and Proper Guidelines 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

## 1.7.2 Fit and Proper Guidelines for Intermediaries

### Financial Status or Solvency

- An intermediary should:
  - Be able to comply with capital requirements: FRR for licensed corporations; and HKMA's capital adequacy requirements for registered institutions
  - Not be subject to insolvency proceedings

### Competence and Capability

- An intermediary is expected to demonstrate that it is competent and conducts its regulated activities efficiently and effectively
- Competence includes proper business structures, sound internal control and risk management systems and competent personnel – covered in **Topic 6**

### Character and Integrity

- A corporate applicant must:
  - Be reliable
  - Have a good reputation
  - Have financial integrity

## 1.7.3 Additional Fit and Proper Guidelines for Sponsors and Compliance Advisers (Sponsor Guidelines)

- A **sponsor** is a Type 6 licensee/registrant permitted to act as a sponsor for the listing of securities on a recognized stock market under the Listing Rules

- A **compliance adviser** is a Type 6 licensee/registrant permitted to undertake work as a sponsor appointed to act as a compliance adviser under the Listing Rules
- In addition to the fit and proper requirements above, sponsors and compliance advisers must:
  - Have sufficient expertise and resources
  - Ensure that management supervise sponsor work in line with laws and regulations
  - Have at least **two Principals** to supervise the transaction team at all times. A principal must be a responsible officer (LCs) or an executive officer (RIs) of the sponsor firm and satisfy one of the three eligibility options under the Sponsor Guidelines
  - Have effective systems and controls
  - Have minimum paid-up share capital of HK\$10 million at all times
  - Meet additional CPT requirements

## 1.8 Guidelines on Continuous Professional Training

- 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 **not allowed as CPT**:
  - Reading financial journals, newspapers and other technical publications
  - Normal work
  - Activities which do not involve interaction with other individuals



### Applicability of SFC Rules

	Licensed Corporations	Registered Institutions	Associated Entities
Financial Resources Rules	YES	NO (HKMA)	NO (Not an issue)
Client Securities Rules	YES	YES	YES
Client Money Rules	YES	NO (HKMA)	YES (if not an AFI)
Keeping of Records Rules	YES	YES	YES
Contract Notes Rules	YES	YES	YES
Accounts and Audit Rules	YES	NO (HKMA)	YES (If not an AFI)
Insurance Rules	YES (Those holding client assets)	NO	NO

## 2. CAPITAL REQUIREMENTS

### 2.1 The Need for Capital Requirements in the Licensing Regime

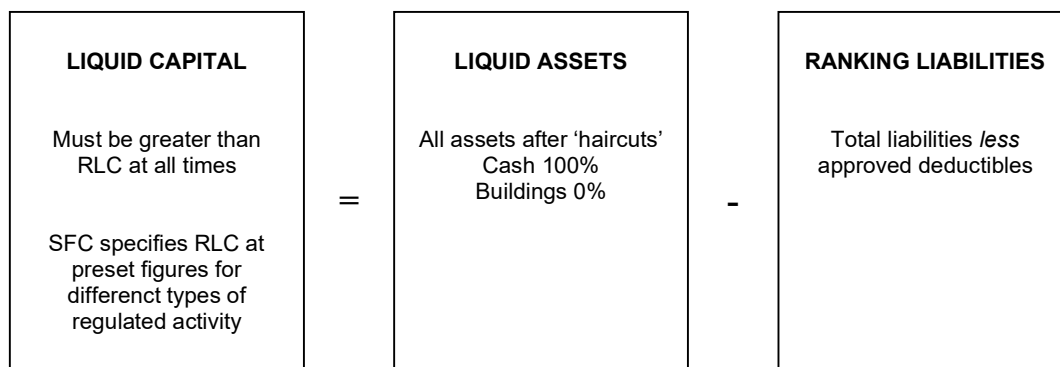
- When looking at the **fitness and properness** of a licensed corporation, the first criterion is **financial status**. The regulator must be satisfied that a licensed corporation has enough capital to:
  - Support the level of business activities
  - Be able to pay debts as they fall due
  - Provide a financial buffer in times of sudden market volatility
- Minimum capital levels required by **registered institutions** are set by the **HKMA**, not the SFC, and are therefore not examinable
- Minimum capital levels required by **licensed corporations** are set by the **SFC** through the **Securities and Futures (Financial Resources) Rules**

### 2.2 Securities and Futures (Financial Resources) Rules (FRR)

#### 2.2.1 Liquidity Reported on the Balance Sheet

- A licensed corporation must have an **adequate amount of liquid assets to meet its liabilities**. To extract the relevant liquidity information, the regulator requires **balance sheets to be prepared or adjusted on specified bases**:
  - In accordance with generally accepted accounting principles
  - Substance of transactions to be reported
  - Items to be calculated on trade dates, not settlement dates
  - Liabilities not on the balance sheet to be included

#### 2.2.2 Liquid Capital (LC) and Required Liquid Capital (RLC)



### 2.2.3 Paid-up Share Capital Requirements

- Licensed corporations are **required to maintain, at all times, paid-up share capital ranging from HK\$5m to HK\$30m** depending on their regulated activity
  - Approved introducing agents, securities advisers, corporate finance advisers, asset managers and credit rating agencies, which do not hold client assets, **do not have paid-up capital requirements**

### 2.2.4 Notifications to the SFC

- A licensed corporation, unable to comply with capital requirements (RLC and paid-up capital) must:
  - Notify the SFC in writing asap
  - Cease conducting the regulated activity immediately, unless permitted by SFC to continue
- A licensed corporation must also notify the SFC in writing if:
  - LC falls below 120% of RLC
  - LC falls below 50% of last LC reported
  - Information submitted in an earlier return becomes materially false or misleading

### 2.2.5 Returns to the SFC

- Licensed corporations **holding client assets** are required to make **monthly** returns to the SFC of liquid capital and RLC with supporting information
- Licensed corporations involved in regulated activities which **do not involve the holding of client assets**, need only make a return **half-yearly** containing financial statements with less details than the others

### 2.2.6 Approvals by the SFC

- The SFC may approve the following for specified periods:
  - Certain licensed corporations as **approved introducing agents**, who only introduce business, do not hold client assets and incur no legal liabilities (different RLC levels)
  - Modification or waiver of liquid capital calculation of FRR
  - Adoption of a non-GAAP accounting principle

### 3. CLIENT SECURITIES REQUIREMENTS

#### 3.1 General – Client Securities and Money

- Intermediaries are called upon to handle client assets, including money, in a fiduciary capacity. The **SFC protects the assets of investors** by making rules regarding:
  - The holding of and dealing with client assets and securities collateral
  - The holding of and dealing with client money
  
- No person may receive or hold client assets of an intermediary in Hong Kong, unless the person is:
  - The intermediary
  - An associated entity of the intermediary
  - An excluded person
    - Any AFI
    - Another intermediary holding securities collateral
    - Any company approved by the SFC

#### 3.2 Securities and Futures (Client Securities) Rules

##### 3.2.1 Part 1 - Preliminary

###### The Assets

- The Client Securities Rules apply to client securities or securities collateral of an intermediary that are:
  - Listed on a recognized stock market (ie SEHK);
  - Interests in an SFC authorized CIS; and
  - Received or held in Hong Kong by an **intermediary (or its associated entity)** in the course of conducting a regulated activity
  
- The Client Securities Rules **do not apply** to securities held by an intermediary **in an account in a client's name**, set up by that client with persons other than the intermediary or its associated entity:

*[Rules only apply to Hong Kong stocks held in Hong Kong received by an intermediary or associated entity in the course of conducting regulated activities]*

### Standing Authority

- A written notice authorizing the intermediary/associated entity to deal with client assets in specified ways
- It specifies the way in which it may be revoked
- Effective for a period not more than 12 months (no time limit for PIs)
- May be renewed on the written request of the client for a period not more than 12 months
- May be **deemed to be renewed** by the intermediary/associated entity giving written notice at least 14 days prior to expiry reminding client of impending expiry. Deemed to be renewed on date of expiry, unless client objects
- Intermediary/associated entity must provide written confirmation of deemed renewal to client within a week of expiry date

## 3.2.2 Part 2 – Treatment of Client Securities and Securities Collateral (keeping assets safe)

### Depositing or Registration of Client Assets

- The intermediary shall, *as soon as reasonably practicable* after receiving client securities/securities collateral, deal with them as follows
  - If a deposit is to be made, it must be with
    - An AFI
    - An approved custodian
    - Another intermediary licensed for dealing in securities
  - Any deposits
    - Must be in separate segregated accounts for each category, designated as trust or client accounts
    - Which are securities collateral, may be deposited in an account in the name of the intermediary/associated entity
  - If registered, it must be in the name of:
    - The client
    - The associated entity of the intermediary
    - For securities collateral only, the intermediary itself

### Dealings with Client Securities and Securities Collateral

- There are 3 basic authorities under which the intermediary/associated entity may deal with client securities/securities collateral:
  - An oral or written direction to sell or settle a sale order
  - A written direction
  - A standing authority

- The **standing authority** cannot be used by the intermediary/associated entity to:
  - Transfer client securities/securities collateral to an account of the intermediary, its associated entity or any entity which has a controlling entity relationship with the intermediary
  - Make any such transfer to any officer or employee of these entities
  - Deal with client securities/securities collateral in an unconscionable manner  
(*Unconscionable = contrary to a sense of justice, decency or reasonableness*)
- Generally, the Rules, with the **written** agreement of the client, allow for:
  - Withdrawal of client securities to sell or settle a sale order
  - Disposal of client securities/securities collateral in settlement of a liability of the client to the intermediary/associated entity

### Permitted Transactions

- If it has a standing authority to do so, a Type 1 intermediary or its associated entity may:
  - Use client securities/securities collateral for a stock borrowing and lending transaction
  - Re-pledge securities collateral\* with an AFI to borrow money
  - Deposit the securities collateral with a recognized clearing house or another Type 1 intermediary as collateral for settlement obligations
- \* In relation to the re-pledging of securities collateral, Type 1 and Type 8 intermediaries must establish the aggregate market value of the re-pledged securities by reference to closing prices on that business day. If the aggregate value exceeds 140% of the intermediary's aggregate margin loans on the same business day, the intermediary must by the close of the next business day, reduce the aggregate value of re-pledged securities collateral so that it does not exceed 140% of aggregate margin loans

### 3.2.3 Part 3 - Miscellaneous

- Non-compliance with certain provisions of the Client Securities Rules must be reported to the SFC within one business day after discovery

## 4. SECURITIES AND FUTURES (CLIENT MONEY) RULES

- The Client Money Rules prescribe how **licensed corporations and their associated entities** should deal with client money received or held in **Hong Kong**

### 4.1 Application

- The Rules do **not** apply to client money that:
  - Is received or held **outside** Hong Kong
  - Is moved outside Hong Kong
  - Is held in a bank account by the client in his own name

### 4.2 Sources of Client Money

- Client money to be safeguarded includes all amounts received by the licensed corporation or its associated entity, from or on behalf of clients, less amounts due from the clients and any proper charges due

### 4.3 Treatment of Client Money on Receipt

- The licensed corporation/associated entity holding client money should have **one or more segregated accounts** (designated as a trust or a client account) **maintained with an AFI** or another SFC-approved person (ie open a separate bank account)
- **Within one business day** of receiving client money, the licensed corporation/associated entity should **pay the money**:
  - Into a segregated account
  - To the client directly
  - In accordance with a written direction
  - In accordance with a standing authority
- **Money should be held in the segregated account** until payment has to be made
  - To the client
  - In accordance with a written direction
  - In accordance with a standing authority
  - To meet settlement or margin requirements
  - To meet amounts due from the client to the licensed corporation/associated entity
- Interest received on client money is due to the client unless otherwise agreed in writing
- Money held in a segregated account, which is discovered not to be client money, must be moved out of the account within one business day of discovery

## 5. SECURITIES AND FUTURES (KEEPING OF RECORDS) RULES

- The Keeping of Records Rules apply to intermediaries and their associated entities

### 5.1 General Requirements

- Sufficient accounting, trading and other records should be kept:
  - To explain and reflect the financial position and operations of regulated businesses
  - To enable financial statements to be prepared
  - To show all client assets handled and their movements
  - To make monthly reconciliations with external parties
  - To demonstrate compliance with the FRR, Client Securities Rules and Client Money Rules
  - To enable audits to be conveniently and properly carried out
  - In accordance with GAAP

### 5.2 Form of Records

- Records should be kept in Chinese **or** English, in writing or in any other form that may be convertible into writing

### 5.3 Retention Time

- The general rule is that all records should be kept for at least **7 years**, except for:
  - Daily statements of account – 2 years
  - Records documenting orders – 2 years
  - Copies of contract notes – 2 years

### 5.4 Offences

- A breach of the Rules without a reasonable excuse will attract penalties, including a fine
- If breach is committed with **intent to defraud**, imprisonment can result



## 6. SECURITIES AND FUTURES (CONTRACT NOTES, STATEMENTS OF ACCOUNT AND RECEIPTS) RULES

- The Contract Notes Rules relating to the provision of contract notes, statements of account and receipts to clients **do not apply to PIs**:
  - If PIs are **Category 1** (see Topic 5), the intermediary has informed them in writing and the clients do not object
  - If PIs are **Category 2** (see Topic 5), and the clients have agreed in writing not to receive these documents

### 6.1 Contract Notes

- Contract notes are issued for:
  - Dealings in securities, including securities borrowing and lending transactions
  - Dealings in futures contracts
  - LFET
- Usually prepared for a single transaction, but several contracts on the same day for the same client may be included in a single contract note or consolidated into the daily statement of account
- Must be issued no later than **second business day** after contract entered into
- A contract note **must contain**:
  - Client's name and account number
  - Intermediary's trade name
  - Full particulars of the contract
  - Notification if intermediary is acting as principal
  - Whether the account is a margin account

### 6.2 Daily Statements of Account

- A daily statement must be prepared:
  - By intermediaries providing securities margin finance and their associated entities when client assets are deposited or withdrawn
  - By intermediaries conducting margined transactions, both when the margined transaction is entered into, and when it is closed
- A daily statement must be issued to the client no later than the end of the second business day after the specified event
- Contents of a daily statement of account are the same as contract notes (see above)

### 6.2.1 Statements Relating to Securities Margin Finance

- The following should be included:
  - Opening and closing balances and all movements in the balance during the day
  - Quantity, market price and value of each description of client securities and collateral
  - Margin ratio and margin value at the end of the day
  - Details of all movements of client securities and collateral during the day

### 6.2.2 Statements Relating to Margined Transactions\*

- The following should be included:
  - Opening and closing balances and all movements in the balance during the day
  - Quantity, market price and value of each description of security provided by or on behalf of the client
  - Details of each margined transaction that is closed during the day
  - All floating profits and floating losses in respect of open positions
  - Net equity in the account at the end of the day
  - A list of all open positions held, their minimum margin requirement and the margin excess/shortfall at the end of the day

### 6.3 Monthly Statements of Account

- A monthly statement must be prepared by an intermediary for **all** clients
- Monthly statements must contain the same information as outlined above for contract notes
- Information should also include:
  - All contracts entered into for the client during the month
  - Outstanding balances at the beginning and end of the month
  - All open positions held at the end of the month
- Monthly statements must be issued within **7 business days** of the end of each monthly accounting period (**10 business days** for portfolio asset managers)
- No statement needed when no activity during the month and no balances at the end of the month
- An asset manager does not need to prepare monthly statements for authorized CISs that it manages

### 6.4 Receipts

- Receipts must be issued by an intermediary or an associated entity on receiving client assets/security **by the end of the second business day** after receipt
- No receipts are required to be given in some cases where the client has received satisfactory confirmation in other ways

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\* A margined transaction involves a client paying a margin to the intermediary or providing security

## 7. SECURITIES AND FUTURES (ACCOUNTS AND AUDIT) RULES

### 7.1 Financial Statements

- Licensed corporations and associated entities of intermediaries (not AFIs) are required to prepare accounts for each financial year consisting of:
  - Profit & loss account
  - Balance sheet
  - Notes to the accounts
- Supplementary financial information should also be supplied covering:
  - Liquid capital calculations
  - Business and risk management questionnaire
  - Analyses of borrowings and client accounts

### 7.2 Auditor's Report

- The normal 'true and fair' opinion is required of the auditor
- In addition, the auditor is required to report on:
  - Accuracy of returns made under the FRR
  - Compliance with the FRR, Keeping of Records Rules, Client Securities Rules and Client Money Rules
- The audit report can be submitted in 2 parts: one containing the normal 'true and fair' opinion and another referring to other compliance matters

## 8. REGULATED ACTIVITIES UNDER THE SFO

- This section addresses requirements of the 10 SFO-regulated activities

### 8.1 Dealing in Securities (Type 1)

#### 8.1.1 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
  - interests, rights or property which are prescribed by the Financial Secretary as securities
  - structured products not covered above that are subject to an authorized offer to the public
- 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

#### 8.1.2 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 dealer 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 with 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

## **8.2 Dealing in Futures Contracts (Type 2)**

### **8.2.1 Definitions: Futures Contract and Futures Market**

- A **futures contract** is defined in the SFO to mean:
  - A contract or an option on a contract made under the rules or conventions of a futures market
  - Interests, rights or property prescribed by the Financial Secretary as futures contracts
- A **futures market** is defined in the SFO to mean a place where facilities are provided for persons to buy and sell:
  - Contracts where one party agrees to deliver to another party at an agreed future time an agreed property, or an agreed quantity of a property, at an agreed price; or
  - Options on such contracts

### 8.2.2 Definition: Dealing in Futures Contracts

- The SFO definition is that a person deals in futures contracts if he:
  - makes or offers to make an agreement with another person to enter into, acquire or dispose of, a futures contract; and
  - induces or attempts to induce another person to enter into, acquire or dispose of a futures contract
- **Excepted** from the definition are:
  - Recognized clearing houses
  - Persons engaging in the above acts through a Type 2 licensed/registered person (no exception if for remuneration)
  - Persons acting as principal with a professional investor in dealing in futures contracts
  - Persons engaged in the above acts on markets referred to in the Commodity Exchanges (Prohibition) Ordinance
  - Type 9 licensees who engage in the above solely for the purposes of the type 9 activity; and
  - Persons entering into market contracts

### 8.3 Leveraged Foreign Exchange Trading (Type 3)

- LFET is a subset of foreign exchange trading relating only to trading in LFE contracts
- **A LFE contract is** a contract/arrangement where one party undertakes to:
  - Make an adjustment between himself and another person according to whether a currency is worth more or less than another currency
  - Pay an amount of money or to deliver a quantity of any commodity determined by reference to the change in the value of a currency
  - Deliver to another person at an agreed future time an agreed amount of currency at an agreed consideration
- The contract is **not** executed on an exchange
- **LFET is** the act of trading in LFE contracts or providing finance to do so
- AFIs do **not** need to be registered to conduct Type 3 activities
- **Approved introducing agents** involved in LFET are required to hold Type 3 licenses
- If a client requires a dispute between himself and a licensed LFE trader to be **settled by arbitration**, the licensed trader is obliged to have it so settled

## 8.4 Advising on Securities and Futures Contracts (Types 4 & 5)

- Advising on securities or futures contracts is defined in the SFO as:
  - The giving of advice
  - The issuing of analyses or reports to allow recipients to make decisions on the buying or selling of securities/futures contracts
- Persons exempted from requiring a Type 4/5 license are:
  - **Solicitors, counsel, professional accountants, trust companies and Type 9 licenses** who give advice wholly incidental to their professions
  - **Financial journalists and broadcasters** who give investment advice or issue analyses/reports on investments to the public on subscription or otherwise
  - Corporations giving advice/issuing analyses and reports to **wholly owned subsidiaries**/holding companies/fellow wholly owned subsidiaries
  - **Type 1/2 licensees** giving advice wholly incidental to their dealing activities

## 8.5 Advising on Corporate Finance (Type 6)

- Per the SFO, advising on corporate finance **means giving advice**:
  - On compliance with the listing rules and SFC codes on takeovers, mergers and share buy-backs
  - Concerning offers to dispose of securities to, or acquire them from, the public
  - To the holders of securities concerning the acceptance of such offers
  - To a listed corporation or public company regarding corporate restructuring in respect of securities
- The **regulatory aspects** of corporate finance advising are covered by:
  - Securities and Futures Ordinance
  - New Companies Ordinance
  - Companies (Winding Up and Miscellaneous Provisions) Ordinance
  - Listing Rules
  - Code on Takeovers and Mergers
  - Code on Share Buy-backs

## 8.6 Providing Automated Trading Services (ATS) (Type 7)

- ATS describes any automated system that provides, by means of electronic facilities, a trading mechanism for securities and futures contracts, other than the operations of recognized exchange company or clearing house
- The services provided include:
  - Trade confirmation and matching systems provided by brokers \*
  - Full trading and settlement systems for non-local securities #

- ATS are covered in two Parts of the SFO:
  - **#Part III** – a person may be **authorized** to provide ATS similar to the services provided by a recognized exchange or clearing house
  - **\*Part V** – a person may be **licensed/registered** to provide ATS as a regulated activity

## 8.7 Securities Margin Financing (Type 8)

### 8.7.1 Definition of SMF

- **SMF is defined as** the provision of financial accommodation in order to facilitate:
  - The acquisition of securities listed on any stock market, whether in HK or elsewhere
  - Where applicable, the continued holding of such securities
- **Exceptions to the definition** are the provision of finance:
  - For underwriting, sub-underwriting and acquisition under a prospectus
  - By a Type 1 licensee to enable the licensee to engage in SMF for his clients
  - By a CIS to finance investment in the CIS it issues
  - By an AFI to enable its clients to buy/hold securities
  - By an individual to a company in which he holds >10% of its issued shares, to facilitate SMF
  - By an intermediary who introduces a client to a related corporation to enable the corporation to provide SMF to the client

### 8.7.2 Conduct Requirements for SMF

- Standards of business practice expected by the SFC of securities margin financiers are:
  - Vetting the credit-worthiness of clients; setting margin lending limits, lending ratios and margin call policies/procedures
  - Prudent risk management and internal controls
  - Efficient monitoring of client loan balances, details of collateral held, margin ratios and loan balances which are exposed to concentration risk
  - Issuing of contract notes and statements of account
  - Segregation of margin and cash client accounts
- There is a 140% limit on re-pledging client securities collateral



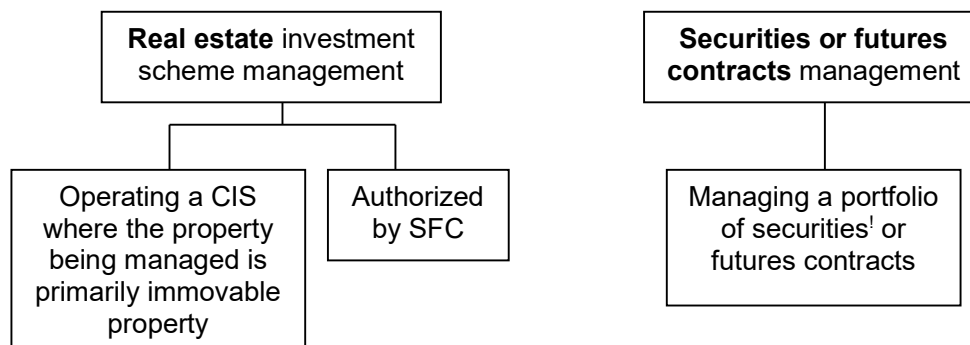
### 8.7.3 Margin Agreements

- A licensed corporation must not start trading on margin for a client before entering into a clear, written margin client agreement with the client. The agreement should cover:
  - How interest on margin loan is calculated
  - When and how the loan must be repaid
  - Usage of collateral permitted by client's authorization
  - Permitted loan limit and lending ratio
  - Margin call procedures
  - What notice, if any, the financier will give the client before selling collateral to cover a margin deficiency

## 8.8 Asset Management (Type 9)

- The principal ordinances applicable to the asset management industry are:
  - **SFO**
  - **MPFSO**
  - Occupational Retirement Schemes Ordinance (**ORSO**)
  - Insurance Ordinance (**IO**)

### 8.8.1 Definition of Asset Management



<sup>1</sup>Securities includes interests in any CIS, but does not include any interest in a CIS that is:

- A registered MPF scheme under the MPFSO
- An occupational retirement scheme under the ORSO
- A contract of insurance under the IO

## 8.8.2 Functions of the SFC for Asset Management

- Authorization of CISs, including unit trusts, managed funds and retirement schemes
- Supervision of CIS marketing
- Licensing and supervision of intermediaries engaged in asset management

## 8.9 Providing Credit Rating Services (Type 10)

### 8.9.1 Definition of Credit Ratings

- 'Credit ratings' is defined in the SFO as **opinions, expressed using a defined ranking system, primarily regarding the creditworthiness of:**
  - A person other than an individual
  - Debt securities
  - Preferred securities
  - An agreement to provide credit

### 8.9.2 Definition of Credit Rating Services

- 'Providing credit rating services' is defined as **preparing credit ratings for:**
  - **Dissemination to the public**, whether in Hong Kong or elsewhere, or with a reasonable expectation that they will be so disseminated
  - **Distribution by subscription**, whether in Hong Kong or elsewhere, or with a reasonable expectation that they will be so distributed
- **Excluded** from the definition are:
  - Credit ratings prepared exclusively for persons, as requested by those persons, without any public dissemination
  - Gathering, collating, disseminating or distributing information concerning the indebtedness or credit history of any person
- Examples of **activities not requiring a license/registration:**
  - A firm that prepares credit ratings for its internal use, such as a bank might do when assessing counterparty risk
  - Consumer credit agencies that prepare opinions regarding creditworthiness of individuals

## 9. REPORTING AND RECORD KEEPING OBLIGATIONS FOR OVER-THE-COUNTER TRANSACTIONS

### 9.1 Background

- There has been an international effort to reduce systemic risks in the **OTC derivatives market** as a result of the global financial crisis of 2008
- There are now requirements for OTC derivative transactions to be **reported to trade repositories** and cleared through a central counterparty (CCP)
- Since 10 July 2015 (phase 1), there has been a Hong Kong requirement for mandatory reporting and record keeping prescribed by the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules (“OTCD Reporting Rules”)
- Phase 2 of the requirement commenced on 1 July 2017, expanding the scope of products subject to the reporting obligation
- This topic considers the requirements for **Licensed Corporations**

### 9.2 Scope of Application

- Reporting and record-keeping obligations arise in respect of OTC derivative transactions that the HKMA has specified as being subject to transaction information reporting requirements

### 9.3 Reporting Obligations

- Unless exempted, all licensed corporations are subject to OTCD Reporting Rules. **The obligations arise when:**
  - A licensed corporation:
    - enters into a transaction in a specified product type as counterparty
    - has conducted a transaction in a specified product type “in Hong Kong” on behalf of a Group company
    - loses its exempt status
- After a reporting obligation arises, **open and subsequent** positions must be reported

### 9.4 Means and Timing of Reporting

- All transaction information must be reported to the HKMA via the **Hong Kong Trade Repository (HKTR)** electronic reporting system operated by the HKMA
- HKTR membership is required to make a report
- Reports must be made **within two business days** of a transaction (T+2)
- Reporting details and timing are subject to a “concession period” and possibly a “grace period”

## 9.5 Information to Report

- Information to be reported includes:
  - Product class and type
  - Dates: transaction; effective and maturity
  - Particulars of counterparties
  - Clearing information
  - References assigned to the transaction
  - Transaction particulars (notional amount, currency rate, interest rate etc)
  - Subsequent events
- The primary reporting obligations rests with the licensed corporation, however if the transaction is conducted on behalf of a Group company, the Group company may make the report. In such a case, the licensed corporation needs written confirmation from the Group company to demonstrate compliance with the reporting requirement

## 9.6 Exemptions

- A licensed corporation is exempt from the reporting requirement if the **notional amount of all outstanding OTC Derivative transactions** within the specified product class **does not exceed US\$30 million**
- The exemption is lost permanently once the notional value exceeds US\$30 million

## 9.7 Record Keeping Obligations

- Transaction records must be kept for at least **five years** after the maturity date
- Records must be sufficient to demonstrate compliance with reporting requirements
- Where a licensed corporation is exempt from reporting, records should still be kept to justify the exemption

## 9.8 Legal Entity Identifiers

- From 1 April 2019, entities that are subject to the reporting obligation must use their Legal Entity Identifiers (LEIs) in the transaction reports to be submitted to the HKTR
- An LEI is an identifier issued under the Global LEI System that enables the clear and unique identification of legal entities participating in financial transactions

## **10. SECURITIES AND FUTURES (OTC DERIVATIVE TRANSACTIONS – CLEARING AND RECORD KEEPING OBLIGATIONS AND DESIGNATION OF CENTRAL COUNTERPARTIES) RULES**

### **10.1 Background**

- Following on from the Rules introduced in Section 9 above, the SFC introduced mandatory clearing through subsidiary legislation (above)
- Mandatory clearing of OTC derivative products is being introduced in phases – the first phase was introduced on 1 September 2016

### **10.2 Mandatory Clearing Obligation**

- Where an OTC derivative clearing obligation exists, the transaction must be cleared through a designated central counterparty (CCP) within one business day of the transaction
- Eligible CCPs are:
  - Recognised clearing houses under the SFO
  - Persons authorized by the SFC to provide automated trading services
- Transactions that cannot be cleared in time will be terminated

### **10.3 Product Subject to the Clearing Obligation**

- In the first phase, the only class of product subject to mandatory clearing is Interest Rate Swaps (IRS), including:
  - Fixed to floating
  - Floating vs. floating
  - Overnight index swaps
- As the regulatory objective is to catch systemic risks posed by larger and more significant participants in the OTC derivatives market, the OTCD Clearing Rules only apply to positions of US\$20 billion or more (the clearing threshold)
- Transactions below the clearing threshold are not subject to the clearing obligation

### **10.4 When Clearing Obligation will not Apply**

- When a transaction has been cleared under the laws of a designated jurisdiction, through a designated CCP, it will not be necessary to clear the transaction in Hong Kong

- There are three further situations where the clearing obligation does not apply:
  - Transaction with a group company member that is an exempt affiliate
  - Transaction is recorded in another jurisdiction that is an exempt jurisdiction
  - Transaction is entered into on a multilateral basis to reduce operational or counterparty credit risk

## 10.5 Record Keeping Obligations

- Records sufficient to demonstrate compliance with the clearing obligations should be kept for at least **5 years** from the termination or maturity date of the transaction

## 10.6 Consequence of Breaches

- SFC can bring licensed corporations that breach the OTCD Clearing Rules before the Court of First Instance
- Maximum penalty is HK\$5 million and possible disciplinary sanctions

## 11. OPEN-ENDED FUND COMPANIES (OFCs)

### 11.1 Background

- An OFC is a type of CIS established in Hong Kong in the form of a limited liability company with variable capital that provides flexibility to meet investor applications and redemptions
- Under the SFO, the SFC has issued the Securities and Futures (Open-ended Fund Companies) Rules (OFC Rules)
- The OFC Rules set out detailed provisions relating to the establishment and operation of OFCs

### 11.2 OFC Registration, Formation and Power

- Prior to incorporating an OFC, an application must be made to the SFC, identifying the directors, the investment manager and custodian
- The incorporation of an OFC will be undertaken by the Registrar of Companies (Registrar), however the relevant fees and documents will need to be provided to the SFC, which will then provide the documents to the Registrar if the SFC agrees to register the OFC
- An OFC may issue more than one class of share capital
- Shareholder rights may include the right to participate in profits from the management of scheme property and to vote at general meetings
- Shares in OFCs are transferrable
- A register of shareholders should be kept open for inspection by any shareholder of the OFC, the investment manager or custodian of the OFC or the SFC

### 11.3 Shareholder Meetings and Proceedings

- Directors have the power to call general meetings
- An OFC's instrument of incorporation will set out matters to be passed by an ordinary resolution and those to be passed by a special resolution
- Transactions below the clearing threshold are not subject to the clearing obligation

### 11.4 Operators of the OFC

#### Directors

- The means of appointing directors depends on whether the instrument of incorporation requires the OFC to hold an annual general meeting; if no such requirement directors have the power to appoint directors
- Directors can be removed at any time by ordinary resolution at general meeting
- An OFC needs to keep a register of directors that is open for inspection to any shareholder
- Where a director has an interest in a significant transaction, the director is required to declare the interest to the other directors

**Custodian**

- The custodian will be identified in the initial documents provided to the SFC
- Directors may appoint a new custodian, subject to the SFC's prior approval

**Investment Manager**

- The investment manager will be identified in the initial documents provided to the SFC
- Directors may appoint a new investment manager, subject to the SFC's prior approval

**Auditor**

- Every OFC must have an auditor, who is appointed by the OFC directors
- An auditor can be removed at any time by ordinary resolution at a general meeting and can also resign, but must make a statement to shareholders or creditors if there is anything that should be brought to their attention

**11.5 Financial Statements and Reports**

- The directors of an OFC must prepare and publish an annual report for each financial year
- The annual report must include the financial statements of the OFC and the auditor's report