

TOPIC 5 - OVERVIEW

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1. APPROVED INTRODUCING AGENT (AIA)

1.1 Definition

- AIA is a licensed corporation recognized under the Financial Resources Rules (FFR) that:
 - Only conducts business of receiving and passing on client trades or introducing client to SEHK participant or other intermediary;
 - Does not handle client assets; and
 - Incurs no legal liability on introduced business

1.2 Capital Requirements

- AIA has lower risks so lower capital requirements:
 - No paid-up share capital
 - Liquid capital requirement is HK\$500,000

1.3 Other Requirements

- AIA is required to comply with all other obligations of licensed corporations **except** does not need to:
 - Comply with rules on handling of client securities and money
 - Issue contracts notes or receipts to client (done by executing intermediary)
 - Contribute to investor compensation fund

2. SECURITIES MARGIN FINANCING (SMF) (TYPE 8)

2.1 Definition

- SMF is the provision of financial accommodation to facilitate:
 - Acquisition of listed securities (in HK or elsewhere)
 - Continued holding of listed securities
- Applies even if securities are pledged to support accommodation
- Type 8 license required for activity except where provision of accommodation is:
 - For underwriting, sub-underwriting and acquisition under a prospectus
 - For a Type 1 licensee providing securities margin finance for own clients
 - To finance investment in collective investment scheme by CIS issuer
 - For AFIs for holdings by its clients
 - By an individual to a company in which he owns more than 10%

- By an intermediary that provides an introduction to a related corporation
- Financial accommodation may be a loan or credit, such as an overdraft or guarantee
- The portion of the purchase cost that the investor deposits is the “margin”
- Security is normally required as collateral for a margin loan facility
- Investors use margin financing to increase their purchasing power and leverage their investments
- A person licensed for Type 8 activities is subject to the sole business requirement. Any advance in excess of the securities collateral is beyond what a Type 8 licensed person is permitted to do

2.2 Financial Resource Requirements

- Paid-up capital: minimum HK\$10 million
- Minimum liquid capital requirement of HK\$3m
- Asset values: stocks held as security must be discounted to allow for price fluctuations
- SMF brokers must report top 20 margin clients with largest outstanding margin loan balances monthly to SFC
- SMF brokers must notify the SFC immediately if:
 - Aggregate amounts on loans drawn exceeds total facility limits
 - Inability to meet calls from a lender for 3 consecutive days
 - A lender has exercised the right to liquidate stock collateral to reduce an outstanding loan

2.3 Conduct Requirements for SMF

- Standards of business practice expected by the SFC (through Code of Conduct) of securities margin financiers, dealers conducting SMF and their representatives, include:
 - Setting prudent lending and margin call policy in writing and communicating it to staff
 - Vetting the credit-worthiness of clients, setting margin lending limits, lending ratios and margin call policies and procedures
 - Utilizing prudent risk management and internal controls, including bank borrowing limits, client and collateral concentration limits, and controls on the use of clients' securities collateral
 - Ensuring efficient control of lending exposures through ongoing management reports
 - Segregation of margin and cash client accounts to avoid commingling
- SMF brokers should ensure that all borrowings secured by securities collateral remains prudent compared to all outstanding margin loans made to margin clients

- SMF brokers that repledge securities collateral should notify the SFC in writing whenever bank borrowings equal or exceed 80% of the total bank credit limit for a period of 2 weeks
- A written margin client agreement is required with proper risk disclosures included
- Clients **MUST** be informed **IN WRITING** of margin lending and margin call policies
- The practice of re-pledging securities collateral should be informed to margin clients

2.4 Internal Control Guidelines

- Risks include credit risk, market risk, liquidity risk and operation risk (as covered in Topic 3)
- Key points to consider:
 - Credit risk exposure to clients (pre-settlement and settlement) should be monitored. Haircuts should be made to market value of securities pledged
 - Margin policy should be established and specify acceptability of different types of margins, rates to be applied, when additional margin can be called and options if margin is not met
 - Prudent margin lending and call policy should be in writing and communicated to all staff and clients and enforced
 - Concentration limits for products, markets and counterparties should be set and enforced
 - Default procedures should be established to alert liquidity management staff to potential problems

2.5 SMF Guidelines

- In addition to the Internal Control Guidelines, the SMF Guidelines provide guidance on **minimum standards of risk management practices** expected of SMF Brokers
- They **do not have the force of law**, but non-compliance may be taken into account when considering fitness and properness
- The **SMF Guidelines cover the following**:
 - Avoidance of excessive leverage
 - Control of concentration risks
 - Setting and enforcement of prudent margin call policies
 - Setting of prudent haircut percentages
 - Conduct of stress testing
 - Notification requirements

2.5.1 Leverage

- **Overarching requirement** is that an SMF Broker's leverage must always be commensurate with its liquidity profile and capital, the risk profile of its margin loan portfolio and prevailing market conditions
- Specifically, the **maximum total margin loans-to-capital multiple** brokers can adopt is five times
- Where the **five-times limit is exceeded**, senior management should prepare a written risk assessment and endorsement and the SFC should be notified
- Margin clients should be subject to prudent credit limits
- Margin policies and limits should be reviewed at least annually

2.5.2 Concentration Risks

- Risks arising as a result of securities being taken as collateral that are concentrated in individual securities or a group of "connected major securities collateral" must be monitored and limited
- Concentration limits, including the methodology to set them, should be properly documented, monitored and strictly enforced
- Concentration limits should be established for individual margin clients and groups of connected margin clients
- SMF Guidelines provide for a maximum concentration risk of 40% of the SMF Broker's shareholder funds

2.5.3 Margin Calls

- An SMF Broker must establish and document prudent triggers for:
 - Margin calls
 - Cessation of further margin advances
 - Cessation of further securities purchases by margin clients
 - Forced liquidation of securities collateral
- SMF Guidelines require reasonable steps to be taken to avoid excessive exposure to outstanding margin calls
- Where margin call exposure exceeds shareholder's funds or margin-calls outstanding for more than 90 days exceeds 25% of shareholder's funds, the SFC must be notified immediately
- A margin call should be made immediately when the outstanding margin loan balance exceeds:
 - The margin value of the securities (market value less haircuts)
 - The client's credit limit
 - Any other trigger amount as specified in the SMF Broker's margin call policy

2.5.4 Haircuts

- “Haircut” refers to the discount factor applying to a security’s market value to determine the amount to be used as collateral
- Haircut methodology should be clearly documented in the SMF Broker’s margin lending policy
- A list of securities that are acceptable as collateral should be maintained, together with applicable haircut rates
- The methodology used to determine haircuts should be reviewed at least annually

2.5.5 Stress Testing

- Stress testing ensures that SMF brokers are properly insulated from unusual risks, for example, a sudden plunge in one or more securities
- Hypothetical stress testing should be conducted to determine effects of price movements on Excess Liquid Capital and liquidity
- Where liquidity is likely to deteriorate, prompt and effective pre-emptive measures should be taken, including preparation of a contingency plan to prevent a liquidity squeeze, insolvency or a breach of the FRR

2.5.3 Notification

- Non-compliance with various quantitative benchmarks, including stress tests, should be reported immediately to the SFC
- Where appropriate, notification should include details of measures taken to prevent a liquidity squeeze, insolvency or non-compliance with FRR

2.6 Subsidiary Legislation

2.6.1 Requirements of Contract Notes Rules

- The SMF Broker should indicate in contract notes and monthly statements that the account is a margin account
- Each statement of account of margin clients should contain details of all financial accommodation provided to the client, the basis of interest calculations and the quantity, market value, margin value and margin ratio of securities held at the end of the day or month

2.6.1 Requirements of Client Securities Rules

- An SMF Broker must obtain a client’s written standing authority before it can pool and repledge the client’s securities collateral
- Standing authority details are covered in Topic 2
- The aggregate value of repledged securities collateral cannot exceed 140% of the SMF Broker’s aggregate margin loans

3. SHORT SELLING

3.1 General Definitions

- **Short selling:** selling securities which you do not own
- **Covered short sale:** a short sale where seller can deliver stock on settlement date (usually through a stock borrowing or repurchase agreement to allow access to stock when needed)
- **Naked short sale:** a short sale where seller does not have a presently exercisable and unconditional right to access securities when needed

3.2 SFO Provisions

- Short selling of securities on a recognized stock market is **prohibited**
- It is not an offence to short sell **off** the SEHK
- However, short selling is **permitted** if it is a **covered short sale**

A person shall not sell securities **through a recognized stock market** unless, at the time he sells them, he or his principal has (or he believes he or his principal has) a **presently exercisable and unconditional right to vest the securities in the buyer**

- Securities charged or pledged to secure a loan may still give a person an unconditional right to vest the securities, depending upon details of the charge/pledge
- The following are permitted short sellers or short sales:
 - A person acting in good faith who believes (and has reasonable grounds to believe) that he or the intermediary has the right to pass on the securities
 - Odd lot brokers
 - A sale of underlying securities relating to an options contract traded on a recognized stock market

3.3 Requirements to Confirm Short Selling Order

- Principal/SEHK participant/agent must not short sell unless a document is available providing evidence that there is a presently exercisable and unconditional right to vest securities
- However, Rules below in 3.5 have relaxed this requirement and oral assurances are now acceptable, as long as recorded, time stamped and kept for 12 months

3.4 Requirements to Disclose Short Sales

- Exchange Participants must indicate short sell orders when inputting the orders to the trading system

3.5 The Securities and Futures (Short Selling and Securities Borrowing and Lending (Miscellaneous)) Rules

- The following are exempted from general prohibition on short sales:
 - Sales by HKMA- appointed market maker of Government securities
 - Sales by securities and futures market makers for hedging
 - Sales by securities and futures market makers where right is acquired to pass on title to purchaser before the end of the next trading day
- The Rules also relax the requirement for a written document as evidence of the right to vest the stock to oral assurances (see 3.3 above)

3.6 Guidance Notes for Short Selling Reporting and Stock Lending Record Keeping Requirements

- Notes clarify that the following are not short sellers:
 - Sale is preceded by purchase but seller has not yet received stock (for example day trades)
 - Seller is given irrevocable instructions to convert options or other convertibles to securities before sale of underlying securities
 - Purchase of HK listed securities on an overseas exchange later sold in HK
- Notes also clarify that the following are covered sellers:
 - Sale is covered by “hold notice” or “blanket assurance” (both confirm lender has sufficient stock to give to seller)
 - Seller holds options or other convertible instruments into securities
 - Seller can recall stock on loan

3.7 Short Selling Regulations of SEHK

- Short selling may only be undertaken in securities designated by SEHK, of which there are a large number
- Only covered short sales are permitted where seller has:
 - Entered into a securities borrowing and lending agreement;
 - A title to another security which is convertible into or exchangeable for the security being sold;
 - An option to acquire the security; or
 - Rights or warrants to subscribe for and receive the security
- SEHK participant must indicate short selling order when passing on or inputting the order
- Exchange participants must make stock borrowing arrangements for settlement before the short sale
- A short sale cannot be made below the best current ask price (the tick rule)

3.8 Short Position Reporting

- The Securities and Futures (Short Position Reporting) Rules requires market participants to report holdings of any reportable short positions in any specified shares at the close of trading on a reporting day where:
 - Net short position value \geq the lower of:
 - HK\$30 million; and
 - 0.02% of the value of the total number of specified shares issued by the company concerned
 - Specified shares are those listed in the Short Position Reporting Rules and include Hang Seng Index and Hang Seng China Enterprises Index constituents
 - Reporting day is usually the last trading day of each week and the report is to be made within two business days, but depending on market conditions, the SFC could require daily reporting within one business day

4. SECURITIES BORROWING AND LENDING (SBL)

4.1 Activities

- A person borrows or lends securities on the condition that the borrower undertakes to return securities of the same description on a future date or pay the equivalent in cash by that date
- Regulated short selling is usually supported by SBL arrangements. Custodian institutions often make securities available to generate profits
- Borrowers may not have received securities or may have short sold
- Borrower normally needs to provide collateral

4.2 Laws, Regulations and Rules

4.2.1 Stamp Duty Ordinance: Exemption from Stamp Duty

- Borrowing/lending of HK stocks is exempted from stamp duty
- Certain details required on contract note to obtain exemption

4.2.2 SEHK Rules

- An Exchange Participant engaged in SBL must:
 - Collect collateral of at least 100% of the value of securities loaned or 105% if the borrowing is for short selling
 - Mark to market all securities borrowings at least daily against previous day's closing price
- A ledger must be kept for all SBL and be available for inspection by the Inland Revenue Department to justify exemption from stamp duty

4.3 Types and Sources of Risk to Securities Lending Counterparts

- **Credit Risk:**
 - Principal risk – loss of full value of securities
 - Replacement cost risk – loss of unrealized gains
- **Liquidity Risk:** obligation not settled on due date
- **Market Risk:** movement in market prices of securities
- **Legal Risk:** loss due to unexpected application of law or regulation or because a contract cannot be enforced
- **Operational Risk:** unexpected loss due to lack of internal control or management information systems
- **Settlement Risk:** when settlement of transaction does not occur

4.4 Practices and Procedures for Managing Risk

- Conduct credit evaluations
- Impose counterparty credit limits
- Draw up approved list of borrowers
- Establish policies and guidelines on type and amount of collateral
- Establish policies and procedures on methodology of setting credit limits and concentration limits
- Separate responsibility for trading, operations, accounting, risk management and compliance
- All securities lending should be managed in one location
- Management information systems should produce daily reports to monitor concentration, mark-to-market exposure and credit limits
- Establish sound collateral policies
- Appropriate systems to process transactions

5. ADVISING ON SECURITIES (TYPE 4)

5.1 Activities

- Advising on securities 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
- Persons exempted from requiring a Type 4 license are:
 - **Solicitors, counsel, professional accountants, trust companies and Type 9** licensees 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
- Corporate finance advisers and asset managers require separate Type 6 and Type 9 licenses

5.2 Conduct Requirements

- Type 4 licensees must ensure that **no reports issued are misleading or deceptive**
- It is an **offence** under the SFO to make any **fraudulent or reckless misrepresentation** to induce a person to buy or sell securities
- The Code of Conduct requires firms to establish mechanisms, including policies and procedures, to ensure that **research analysts are held to high standards of integrity and ethical behaviour** on securities traded or to be issued in Hong Kong
- The following points cover trading, financial and business interests:
 - If an intermediary has a **business relationship with a company** that is the subject of an analyst's report, this must be disclosed prominently in the report
 - If an analyst is a director or officer of a company for which he is publishing a report, this must be **disclosed prominently in the report**, and also when making media appearances
 - **Analysts cannot undertake personal transactions** that are contrary to the published recommendation (eg cannot sell a stock that is being recommended as a buy)
 - **Analysts cannot deal in a stock 30 days before and 3 business days after** the issue of research relating to that stock. If an analyst has dealt in the stock within the 30-day period, the research should be withheld
 - **Assurances should not be made** to a listed company or a new listing applicant regarding the issuing of favourable reports
 - Research reports should not be issued by managers, sponsors or underwriters **during the quiet period** (40 days after IPO pricing and 10 days after secondary offer pricing)
- Compliance procedures should be **established that eliminate, avoid or manage conflicts of interest**, including:
 - Not allowing an investment banking function to pre-approve research
 - Not linking an analyst's remuneration to investment banking transactions
 - Not allowing analysts to solicit investment banking business
 - Prohibiting an analyst, who is working on a new listing applicant, from using information that is not reasonably expected to be in the prospectus or publicly available

6. ON-LINE TRADING AND ADVISING ON SECURITIES

6.1 On-line Trading

- Buying and selling securities and derivatives through Internet or other electronic means (phones, tablets, ATMs, computers)

6.2 On-line Broker Models and Services

Model	Description
Traditional/on-line broker combination	Uses on-line as alternate channel to trade. 2-tier fee structure normally used
Traditional broker with separate on-line broker	Separate on-line brokerage subsidiary or associate
Virtual broker	All products and services offered on-line
Bank with on-line brokerage service	Brokerage services as part of on-line banking business
Alliance among brokers	Centralised or linked platform to trade on-line

- Services include:
 - **Trading services:** execution only, price quotes, market news, research materials, advisory services, discretionary accounts, margin financing, analytical tools
 - **Products:** securities, futures, options, fixed income, foreign exchange, overseas securities, investment funds
 - **Communication channels:** Internet, wireless, handheld devices, proprietary electronic systems, telephone, fax

6.3 SFC Requirements

- Regulatory requirements covered by SFC in:
 - Para 18 and Schedule 7 of the Code of Conduct
 - Guidelines for Electronic Public Offerings
 - Circular on the Provision of Financial Information on the Internet – Licensing Requirements
 - Guidance Note for Persons Advertising or Offering Collective Investment Schemes on the Internet (CIS Internet Guidance Note)

6.4 Conduct Requirements of Electronic Trading in Code of Conduct

- Para 18/Schedule 7 of the Code of Conduct sets out the conduct requirements of electronic trading. **Electronic trading** refers to the trading of securities and futures contracts electronically and includes internet trading, direct market access and algorithmic trading

6.4.1 Responsibility for Orders

- A licensed or registered person is responsible for:
 - Settlement and financial obligations of orders made electronically
 - Supervise orders in compliance with regulatory requirements

Management and Supervision

- Design and operation of an electronic trading system should be effectively managed and adequately supervised, including:
 - Written internal policies and procedures
 - At least one responsible officer or executive officer responsible for overall management and supervision
 - Adequate qualified staff, technology and financial resources

Adequacy of System

- The following controls should be adopted to ensure the reliability, security and capacity of the system:
 - Ability to immediately **prevent the system from generating and sending orders** to the market and cancel any unexecuted orders
 - System should be **tested before deployment** and regularly reviewed
 - Any material **service interruption should be promptly reported** to the SFC
 - **Security controls** should ensure that: reliable authentication or validation techniques are used restricting access as appropriate; confidential information is protected; and security breaches are prevented and detected
- Monitoring of system capacity usage and recording of spare capacity planned
- Stress testing of system capacity and documentation of findings
- Ability to handle client orders beyond system capacity

Record Keeping

- Records should be kept covering:
 - Design and development of electronic trading system
 - Comprehensive documentation of risk management controls of the system (should be kept for 2 years after ceasing to use the system)
 - Audit logs of system delays/failures (to be kept for 2 years)
- Recommendations made should be suitable for the client in light of client's financial situation, investment objectives and experience

6.4.2 Specific Requirements on Internet Trading and Direct Market Access (DMA)

- DMA refers to the access to a market provided to a client through a licensed or registered person's identifier under which the client transmits orders, directly or indirectly, to the market's trade matching system for execution

Risk Management

- A licensed/registered person providing internet trading/DMA must ensure that all client orders are transmitted to its infrastructure.
- Controls should prevent entries that exceed trading or credit limits
- Controls should prevent erroneous order entries
- Regular post-trade monitoring should identify manipulative or abusive order instructions/transactions

Internet Trading Self-assessment

- SFC has produced a self-assessment checklist providing guidance to licensed corporations to help them undertake a regular review of areas that may need improvement to ensure compliance with relevant electronic trading requirements
- SFC may use the self-assessment results to assist it with any reviews of internet trading systems of licensed corporations

Minimum Client Requirements for DMA Services

- Each client should meet requirements before being granted the DMA service. The requirements are that the client:
 - ensures users are proficient and competent in using the system
 - understands and complies with applicable regulatory requirements
 - can monitor orders entered through the system

6.4.3 Algorithmic Trading System and Trading Algorithms

- An **algorithmic trading system** is a system through which algorithmic trading (ie computer generated trading activities created by a predetermined set of rules aimed at delivering specific execution outcomes) is conducted. It includes a system designed and developed in-house or by a third party service provider

Qualification

- Suitably qualified persons should be involved in the design and development of an algorithmic trading system
- Where required, suitable training should be provided

Testing

- There should be adequate testing of any algorithmic trading system and trading algorithms before providing such services to clients
- Testing should be carried out regularly and no less than annually

Risk Management

- There should be controls to ensure
 - Integrity of system and algorithms
 - Erroneous orders are not processed

6.5 Electronic Public Offerings

- An ePO takes place when the internet or other electronic means is used to display or provide access to a prospectus, an application form and/or to collect an application or application instruction from the public during an IPO or a follow-on offering

6.5.1 Issuer-Driven ePO

- The IPO issuer offers an ePO mechanism through intermediaries who are eligible service providers (ESPs). This usually involves the issuer providing the ESP with an electronic prospectus. The electronic collection of application information from the applicants is performed by the ESP who then transmits the information to receiving banks and share registrars
- The issuer prepares the prospectus in electronic form and in a format that cannot be tampered with
- The ESP is responsible for the compliance and system integrity of the ePO's front-end processes, including those concerned with collection and handling of applications and the website electronic interface

6.5.2 Registrant-Driven ePO

- An intermediary may collect applications from its clients electronically or manually and the applications may be delivered to the issuer or the receiving bank, either in traditional paper-based form, or in any other way specified by the issuer
- The issuer has little or no additional role
- The issuer has little or no responsibility towards the intermediary and the need for coordinating the back-end of the ePO does not arise
- The intermediary's responsibilities are largely identical to those in issuer-driven ePOs

6.6 Advertisements on the Internet

- Advertisements or other documents relating to securities, investment arrangements and investing advising services via the Internet need SFC approval unless they are specifically exempt
- Advertisements not targeted at Hong Kong residents do not need to be submitted for SFC approval
- Advertisements offering advisory services or the management of client portfolios, for remuneration, if targeted at Hong Kong residents, will not be allowed unless such advertisements are exempt under Hong Kong legislation. Such advertisements may trigger licensing or registration requirements
- Materials using internet "push" technology targeted at Hong Kong residents will require SFC approval
- Advertisements will not be considered targeted at Hong Kong residents if:
 - The broadcast includes a prominent disclaimer that the products/services are not available to Hong Kong residents
 - Reasonable steps are taken to ensure that the products/services are not provided to Hong Kong residents

7. ALTERNATIVE LIQUIDITY POOLS (ALP)

- ALP means an electronic system operated by a licensed/registered person allowing crossing/matching of orders involving Hong Kong and overseas listed securities
- Code of Conduct applies to ALP operators

7.1 Management and Supervision

- An ALP operator should have written policies and procedures to ensure that:
 - There is at least one responsible/executive officer responsible for overall ALP management and supervision
 - There are controls to manage the risks of ALP operations
 - There is a formal governance process with input from risk and compliance functions
 - There are clearly defined reporting lines
- Regarding access to and operation of ALPs, an ALP operator should:
 - Ensure only qualified investors can become ALP users
 - Ensure client orders have priority over proprietary orders
 - Revise/update as necessary the ALP Guidelines

7.2 Adequacy of Systems

- An ALP system should restrict the visibility of trading information available to staff of the ALP operator, including:
 - Restricting staff access to ALP trading information
 - Keeping the SFC informed of the identities of staff with access to the ALP
 - Maintaining a log with details of staff access to the ALP
 - Ensuring that staff members who originate proprietary orders in the ALP do not have access to ALP trading/transaction information

7.3 Record Keeping

- An ALP operator should keep proper records covering the design, development, deployment and operation of the ALP
- SFC should be kept informed of any changes to ALP operation

8. 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 #
 - Bulleting boards with information on stock and other related matters
- 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 for Hong Kong residents with a less extensive regulatory regime applied
 - ***Part V** – a person may be **licensed/registered if AFI** to provide ATS as a regulated activity with same regulatory regime as other licensed persons
- Regulation is pragmatic, flexible on a case-by-case basis taking account of proportionate risks to business and market
- Nine core standards which ATS service providers should maintain:
 - *Standard 1 – Financial resources*: should be sufficient for the proper performance of operations, functions and obligations
 - *Standard 2 – Risk management*: risks associated with the business and operations should be prudently managed
 - *Standard 3 – System integrity*: electronic facilities should have adequate security, capacity and contingency arrangements
 - *Standard 4 – Governance*: arrangements should be robust, well-defined and transparent
 - *Standard 5 – Access and participation*: there should be objective, risk-based and transparent criteria for participation
 - *Standard 6 – Transparency*: There should be appropriate levels of transparency for operations and traded products, order processing, transaction execution and settlement arrangements, and operational requirements and rules
 - *Standard 7 – Surveillance*: by the provider or a regulatory authority
 - *Standard 8 – Record keeping*: Full records of its ATS operations, including audit trails, should be kept
 - *Standard 9 – Reporting*: Should report to regulatory authority

9. OFFERS OF SECURITIES (TYPE 1 AND TYPE 4)

- Offers of securities (including IPOs) fall within the scope of Type 1 and Type 4 regulated activities. This section deals with the statutory regulatory framework governing:
 - Prospectus requirements of the **CWUMPO** as part of an offer of securities
 - The offer and distribution of shares, units and other interests in CISs and structured products covered under the **SFO**

9.1 Offers of Listed Securities: Requirements of Companies (Winding Up and Miscellaneous Provisions) Ordinance

- Prospectus is any document:
 - Offering shares or debentures in a company to the public
 - Calculated to invite offers by the public to subscribe for or purchase shares or debentures
- Prospectuses must be in **English with Chinese translation or visa versa**. The two versions (English and Chinese), may be distributed separately, provided that both are available at each distribution location
- Certain offers are excluded from the prospectus requirements, including an offer to persons defined as “professional investors” under the SFO

9.1.1 Companies Incorporated in Hong Kong

- Key provisions are:
 - A copy of the prospectus must be registered by the Hong Kong Registrar of Companies before the issue
 - The issue of an application form without a prospectus is prohibited except in certain circumstances
 - Prospectuses to existing shareholders (rights issues) or for same class of shares do not need to follow requirements

9.1.2 Companies Incorporated Outside Hong Kong

- Companies incorporated outside Hong Kong and seeking a listing on the SEHK, will need to be registered under, and be bound by, Part XVI of the New Companies Ordinance
- Such companies are subject to the same prospectus requirements as outlined above

9.1.3 Requirements of Schedule 3 CO

Part I - Contents

- *Paragraph 1* - General description of business and if more than one business that is material to profit/loss, assets employed or other factors relevant to each activity
- *Paragraph 3* - Sufficient information for a reasonably person to form a valid opinion on financial condition and profitability at the time of issue of the prospectus
- *Paragraph 6* - Names, descriptions and addresses of current and proposed directors
- *Paragraph 11* - Number and consideration of shares issued in last two years as fully paid or partly paid up otherwise than in cash
- *Paragraph 20* - For offers of debentures, debenture holders rights, secured or unsecured, guarantee arrangements and name of guarantor
- *Paragraph 27* – Voting rights, capital and dividend rights, where the company's share capital is divided into different classes of share
- *Paragraph 28* – For offer of shares, names, addresses and descriptions of vendors of shares and any directors' interests

Part II – Additional Reports

- *Paragraph 31* – **Auditor's report** on company and its subsidiaries and any guarantor and its subsidiaries with respect to profit/loss, assets/liabilities and dividends for three preceding years ending within three months of issue of prospectus
- *Paragraph 32* – If all or part of proceeds from issue are to purchase a business, an **accountants report** on that business for three financial years preceding issue of prospectus together with assets/liabilities at date of last accounts
- *Paragraph 33* – If all or part of proceeds from issue are to purchase a company which will become a subsidiary, **accountants report** as per Para 32
- *Paragraph 34* – Valuation report for properties and land and buildings if comprise more than 10% of company's assets or HK\$3 million

9.1.4 Civil and Criminal Liability for Misstatements in the Prospectus

- Directors or promoters of an issue, or any person that has authorized the issue of a prospectus that includes untrue statements, will be civilly liable to pay compensation
- Experts are only liable for untrue statements in their own reports, not the entire prospectus
- Any person authorizing the issue of a prospectus will also have criminal liability for misstatements, unless immaterial or reasonable grounds to believe statement was correct

9.2 Offers of Securities, Units and Other Interests in Collective Investment Schemes – SFO Requirements

9.2.1 Definitions

- The key elements of the SFO definition of CISs are:
 - Arrangements in respect of property which are not subject to the day-to-day control of the participants
 - The property is managed as a whole by or for the person operating the arrangement
 - The participants' contributions and accruing profits/income are pooled; and
 - The purpose of the arrangement is to enable the participants to receive profits/income or payments or returns from the property or dealings relating to it
- Exclusions from the definition include:
 - Participants and the arrangement operator belong to the same Group of companies
 - Franchise arrangements; and
 - A solicitor holding money for clients during the course of his work

9.2.2 Authorization of CISs

- There are two circumstances where a CIS may be offered or marketed to the Hong Kong public:
 - structured as a company and listed on the SEHK
 - authorized by the SFC
- The SFC can refuse to authorize a CIS or withdraw the authorization
- An individual must be approved by the SFC to receive notices and decisions served by the SFC relating to an authorized CIS
- CISs not offered to the public may still be subject to the regulation of the SFC via the licensing or registration regime

9.2.3 Advertisements

- Advertisements inviting the public to respond to the following opportunities must be **authorized by the SFC**:
 - To enter into:
 - an agreement to acquire, dispose of, subscribe for or underwrite securities; or
 - a regulated investment agreement
 - To acquire an interest in or participate in a CIS

- **Exemptions** to the requirement to have advertisements authorized by the SFC include:
 - prospectuses complying with the Companies (Winding Up and Miscellaneous Provisions) Ordinance;
 - listing documents in relation to SEHK
 - advertisements, invitations and documents issued by certain licensed corporations (see below);
 - advertisements in relation to interests in CISs only offered to PIs;
 - sellers or publishers of newspapers and other publications containing such advertisements; and
 - conduits or live broadcasters issuing such prohibited material in the ordinary course of their business
- The SFC's authorization requirement no longer applies to Advertisements placed by **Type 1, 4 or 6 licensees** in respect of securities (except for unlisted securities that are structured products and unauthorized CISs)

CIS Internet Guidance Note

- Web page needs SFC authorization if the fund is authorized by SFC for marketing in Hong Kong, the web site is advertised in the Hong Kong media or the web site is operated by someone in Hong Kong
- A hard copy of the web page and the script should be given to the SFC
- Banner ads do not require approval, unless they contain a link to a website which requires SFC authorization
- An electronic prospectus, a paper version of which has been approved by the SFC, should be made available in an online offering of a CIS, in the same way the electronic application form is made available to investors

9.2.4 Misrepresentations

- Civil liability may result from fraudulent, reckless or negligent misrepresentations which induce investor to:
 - Acquire, dispose of, subscribe for or underwrite securities
 - Enter into a regulated investment arrangement
 - Acquire an interest in or participate in a collective investment scheme
- Fraudulent or reckless misrepresentations can be treated as criminal offences

- Different types of misrepresentation are defined in the SFO as follows:
 - A fraudulent misrepresentation is any statement which is known to the person making the misrepresentation, at the time it is made, to be false, misleading or deceptive
 - A reckless misrepresentation is any statement which, at the time it is made, is false, misleading or deceptive, and is made recklessly
 - A negligent misrepresentation is any statement which, at the time it is made, is false, misleading or deceptive, and is made without reasonable care having been taken to ensure its accuracy
 - Each of the above also covers promises, forecasts and material omissions

9.3 Structured Products

- A structured product is defined in Part IV of the SFO as:
 - A regulated investment agreement; and
 - Any instrument under which the return or amount due or the method of settlement is determined by reference to either:
 - Changes in price, value or level of other financial products (including securities, commodities, indices, property, interest rates or currency exchange rates or futures contracts); or
 - The occurrence or non-occurrence of specified events, other than events relating to the issuer or guarantor of the instrument
- The following are excluded from the definition of a structured product:
 - CISs
 - Convertible debentures
 - Subscription warrants
 - Currency linked and interest rate linked instruments issued by AFIs
- A structured product will be considered a security, as defined in the SFO, and subject to the licensing and registration requirements, if it is the subject of an offer to the public which is authorized or required to be authorized under the SFO

9.3.1 Authorization of Structured Products

- A structured product may be offered or marketed to the public in Hong Kong only if it is:
 - Listed on the SEHK
 - Authorized by the SFC
- The SFC's authorization requirements are outlined in the Code on Unlisted Structured Investment Products (SIP Code).
- Structured products are subject to the same SFO requirements for advertisements and misrepresentations that apply to CISs
- The SFO states that the SFC may deny authorization of a structured product if it is in the public interest

10. CROSS-BORDER TRADING

10.1 Mutual Market Access

- Launched in November 2014 (Shanghai-Hong Kong Stock Connect) and in December 2016 (Shenzhen-Hong Kong Stock Connect), the “Stock Connect” allows eligible investors in Mainland China to trade shares listed on the SEHK, known as the **Southbound link**, and investors in Hong Kong to trade eligible securities listed on the Shanghai Stock Exchange(SSE) and the Shenzhen Stock Exchange (SZSE) via the so-called **Northbound trading links**.
- These links are important steps in the internationalization of Mainland China's capital markets and currency.
- **Home market rules apply to all trades.** Orders are placed through local securities firms, however trading and clearing is subject to the rules and procedures of the exchange where the securities are listed.
- Trading and clearing participants are regulated by the rules and laws of the markets where they operate
- The **SFC and the China Securities Regulatory Commission (“CSRC”)** have signed an **MOU** covering cross-border regulatory and enforcement issues. The MOU includes information sharing and joint investigations of suspected improper activities, including insider dealing and market manipulation
- Stock Connect has no effect on existing rules for listed companies and intermediaries. Licensed corporations and registered institutions participating in the Stock connect program remain regulated by the SFC and HKMA respectively
- Stock Connect may be **suspended at any time** by any of the relevant exchanges participating in each trading link in whole or in part to ensure a fair and orderly market. However, any suspension is subject to prior approval by the relevant regulator (SFC/CSRC)

10.2 Eligible Securities

- **All Hong Kong persons and overseas investors** able to trade on the SEHK can participate in the Northbound link.
- Mainland China persons who are able to participate in the Southbound link include institutional investors and individuals with Rmb500,000 in cash and securities
- Only eligible shares may be traded through Stock Connect. Shanghai securities are outlined below – there are also similar Shenzhen securities
- **Northbound eligible shares** are
 - SSE 180 Index constituents
 - SSE 380 Index constituents
 - SSE listed A shares with dual listing of H shares on the SEHK

- **Northbound shares that are excluded:**
 - Shares trading in a currency other than the Rmb
 - Shares listed on the SSE's risk alert board
- **Southbound eligible shares are:**
 - Hang Seng Composite Large Cap Index constituents
 - Hang Seng Composite Mid Cap Index constituents
 - Shares of all companies listed on both the SEHK and the SSE
- **Southbound shares that are excluded:**
 - Shares trading in a currency other than the Hong Kong dollar
 - H shares which have a corresponding listing on any Mainland exchanges besides the SSE; and
 - H share issuers which have a corresponding A share on the SSE's risk alert board
- If a Stock Connect security ceases to be a constituent member of the stock index that made it eligible, only sell orders will be admitted.
- More complicated eligibility rules apply for dual A and H share listed companies, where one is newly admitted to listing or subject to suspension on the relevant exchange

10.3 Trade Quota

- Trading under both the Northbound and Southbound trading links is subject to a daily quota of the maximum amount by value that can be traded each trading day.
- The current **Northbound trading link quota** is:
 - daily quota of Rmb52 billion
- The current **Southbound trading link quota** is:
 - daily quota of Rmb 42 billion
- Daily quotas are calculated on a "net buy" basis
- Sell trades increase the available quota. Investors are always allowed to sell their cross-border securities
- Buy trades are subject to there being available daily quota

10.4 Trading, Clearing and Settlement

- Exchange participants/members of the SEHK, SSE and SZSE and clearing participants/members of the HKSCC and China Securities Depository and Clearing Corporation Limited (ChinaClear) may participate in Stock Connect subject to specific eligibility criteria for information technology, risk management, client documentation and other requirements
- SEHK exchange participants that participate in stock Connect are called **China Connect Exchange Participants** (“CCEPs”). Clearing participants are **China Connect Clearing Participants** (“CCCPs”)
- Trading under both Northbound and Southbound links is through local securities firms who are exchange participants/members or have arrangements with participants to execute orders
- For **Northbound orders received in Hong Kong**:
 - The SEHK exchange participant must be registered as a CCEP to execute via Stock Connect
 - The CCEP must be a CCCP or have at least one clearing arrangement with a CCEP
 - CCCPs may use Stock Connect clearing and exchange facilities to clear the trades
 - HKSCC, through its Mainland subsidiary, acts as a participant of ChinaClear; and
 - Settlement obligations of CCCPs are undertaken by HKSCC
- For **Southbound orders received in Mainland China**:
 - ChinaClear’s Hong Kong based subsidiary acts as a Special Participant of HKSCC and undertakes the same obligations and risk management provisions as other HKSCC participants
 - HKSCC remains the central clearing party
- Investors can only trade through Stock Connect on days when both markets are open and banking services are available on the corresponding settlement days
- Southbound trades are settled on a T+2 basis. **Northbound** trades are settled on the **same day for the securities** and on **T+1 for money settlement**

10.5 Pre-trade Checking for Northbound Trades

10.5.1 Standard Pre-Trade Check

- Northbound trading eligible shares can only be sold via Stock Connect if they have been deposited with a relevant exchange participant by the end of the trading day prior to the intended date of sale
- If shares are held by exchange participants or custodians who are not the intended selling brokers, they must be transferred prior to the date of sale
- Eligible A shares acquired via Stock Connect will be held in HKSCC's omnibus account maintained with ChinaClear

10.5.2 Enhanced Pre-Trade Check

- Optionally, an investor whose shares are held by a Custodian or General Clearing Participant of HKSCC, which is not an exchange participant, can open a special segregated account (SPSA) with CCASS that is given a unique investor ID number
- The investor can place orders by providing this ID number to the selling broker who can make sure that the shares are available
- The shares only need to be transferred to the exchange participant after the sell order is executed

10.6 Additional Restrictions on Northbound Trading

- **Margin trading** is permitted:
 - Only on shares specified by the SSE/SZSE; and
 - Only for CCEPs and EPs who are registered with the SEHK to conduct Northbound trading through CCEPs for the account of their clients
 - SSE/SZSE may suspend margin trading in shares where volume exceeds certain thresholds
- **Stock borrowing and lending** is only permitted:
 - for covered short selling; or
 - for meeting pre-trade checking requirements
- No stock borrowing and lending agreement may be for more than one month. All stock borrowing activities must be reported to the SEHK
- Day trading is not permitted – shares bought cannot be sold before settlement, so cannot be sold on the same trading day
- No single foreign person can own more than 10% of a listed company's shares and total foreign ownership cannot exceed 30% of its total issued shares
- Mainland China has disclosure rules for holdings over 5% that may affect a person's ability to trade during specified periods

10.7 Short Selling via the Northbound Trading Links

Northbound Short Selling

- Covered short selling is permitted on stocks that have been specified by the SSE/SZSE – they are published on the HKEx website – and are subject to:
 - Pre-trade checking to ensure that the borrowed stock is in the participants clearing account with CCASS
 - The stock is not subject to quantity restrictions
 - Reporting requirements to the SEHK
- Number of shares sold short on a given trading day should not exceed 1% of the number of those securities held by all investors through CCASS
- Number of shares sold short should not grow beyond 5% in any period of ten consecutive trading days
- The sell price should not be lower than the most recent execution price or previous closing price
- SSE/SZSE may suspend short selling activities in certain A shares when total open short positions reach 25% of the stocks listed. Short selling may resume when the A share's total open short position drops below 20%
- As with Southbound trading, naked short selling is not permitted
- The exchange participant (EP) will need to inform the buying EP that the transaction is a short sale
- An EP acting for the client should ensure that the client has borrowed sufficient stock to settle the order, if executed

11. VIRTUAL ASSETS

11.1 Introduction

- Since the first Bitcoin was issued in January 2009, **a wide range of different types of digital tokens have been issued**, based on some form of blockchain or distributed ledger technology
- A digital token is **a digitally written entry on a computer code** that is able to be controlled by one or more persons in accordance with the set of functions the computer code provides or permits
- Billions of dollars have been invested in digital tokens, **in primary market capital raisings and in subsequent secondary market activity**, typically in the absence of the usual regulatory oversight mechanisms that are normally in place in traditional markets
- Regulatory agencies globally are considering **how such digital tokens**, and activities related to them, **should be treated under current laws and regulations**
- A key issue is recognizing the **scope of a regulatory agency's authority**, e.g. the SFC has the authority to regulate the securities and futures market - does a digital token fall within the scope of the agency's authority?
- **The SFC has defined digital tokens as "virtual assets"** irrespective of how they are referred to (e.g. a "cryptocurrency", a "crypto- asset", etc)

11.2 Hong Kong Regulatory Regime

- Where a virtual asset in substance amounts to a security or futures contract, as defined in the SFO, the usual laws and regulations will apply
- Conversely, where a virtual asset does not fall within the SFO definitions of securities or futures contracts, the SFO will not apply

11.3 Offering of Virtual Assets

- A significant amount of money has been invested in virtual assets through **initial coin offerings ("ICOs")**, **securities token offerings ("STOs")** and, more recently, **initial exchange offerings ("IEOs")**
- While some offerings are intentionally structured as securities offerings (as in an STO), **tokens offered in an ICO or IEO may be considered securities**, where the token characteristics are as follows:
 - they represent equity or ownership interests in a corporation
 - they represent debt or a liability
 - proceeds are managed on a collective basis for profit, thereby constituting a CIS.
- In March 2018, **the SFC enforced a halt to an ICO** undertaken by Black Cell Technology Limited. The virtual assets being offered were considered to constitute a CIS and accordingly, the ICO would potentially have involved unauthorized promotional activities and unlicensed regulated activities

11.4 Investor Risks

- The SFC has listed the following set of **risks associated with investing in virtual assets**:
 - **Valuation, volatility and liquidity** – tokens are typically not backed by underlying physical assets or government guarantees, and price is frequently affected by short term speculation and small and fragmented liquidity pools
 - **Accounting and auditing** – there are no agreed standards among the accounting profession to ascertain ownership or reasonableness of valuations
 - **Cybersecurity and safe custody of assets** –billions of dollars have been lost through cyber attacks
 - **Market integrity** – markets that have formed around virtual assets are unregulated and subject to abusive practices
 - **Risk of money laundering and terrorist financing** – owing to the typically anonymous basis on which virtual assets are held and traded, there is a risk they may be used in connection with money laundering and terrorist financing
 - **Conflicts of interest** – operators of virtual platforms providing trading venues may act in various capacities that give rise to unregulated conflicts of interest
 - **Fraud** – insufficient due diligence may have been done in relation to disclosures made in relation to a virtual asset, raising the risk of fraudulent behaviour

11.5 Regulated activities

- Although **the SFO does not apply to virtual assets that are not considered to be securities or futures contracts** (as defined in the SFO), there are a few important qualifications that need to be noted, as follows:
 - Where **an investment portfolio is structured as a CIS**, activities in relation to the CIS's shares or units will be subject to the SFO even though the investment portfolio might consist solely of virtual assets that are not securities or futures contracts
 - Following the launch of **futures contracts on cryptocurrencies** (such as Bitcoin and Ethereum) on regulated markets in the United States and the UK, dealing in or advising on such futures contracts will constitute Dealing in Futures (Type 2) and Advising on Futures (Type 5), respectively, irrespective of how the underlying assets would be regarded for the purposes of the SFO
 - Platforms that are sometimes called “cryptocurrency exchanges” or “cryptoexchanges” may trade in a variety of virtual assets. Where any one or more of those assets meet the definition of securities under the SFO, then the platform would need to be licensed or registered under the SFO
- On 1 November 2018 the SFC announced a regulatory sandbox for cryptocurrency exchanges. Under the sandbox, an exchange would need to trade at least one security in order to trigger the SFC's oversight and to meet the basic requirement for applying a licence or registration as an automated trading service provider

- Licensed corporations/registered institutions which intend to **provide trading or asset management services involving virtual assets**, should note that the SFC regards this as a significant change of activities, triggering the notification requirement under the Securities and Futures (Licensing and Registration) (Information) Rules

11.6 Fund management

- Funds that invest in virtual assets, that are not regarded as securities or futures contracts, **will continue to be regarded as CISs**, subject to the provisions of the SFO and any applicable regulations issued by the SFC
- Accordingly, **licensing requirements will continue to apply to persons who distribute shares or units in a CIS** irrespective of what the CIS invests in
- On the other hand, persons who manage investment portfolios will **be engaged in Asset Management only if the portfolio includes securities or futures contracts**. Where they do, and the portfolio includes virtual assets, they will be subject to licensing conditions that include a requirement to notify the SFC of its involvement or planned involvement in investing in virtual assets