

TOPIC 3 - OVERVIEW

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1. BACKGROUND TO THE SECURITIES AND FUTURES ORDINANCE (2003)

1.1 Why Create the SFO?

- It was recognized in the 1990s that **Hong Kong needed a more efficient, modern and flexible financial regulatory regime.**
- The SFO was drafted to meet challenges being faced and **replaced 10 previous ordinances** which had been drafted at various times to meet needs as they arose
- **Reasons for overhauling** Hong Kong's financial legal framework included:
 - Expansion of new financial products and services
 - Entry of new market participants
 - Introduction of new trading methods
 - Enhanced global competition
 - Hong Kong's role as a fund-raising centre for Mainland China
 - Hong Kong's role as a regional financial centre in the Asia-Pacific zone
 - Hong Kong's standing as an international financial market straddling London and New York

1.2 Objectives of the SFO

- To provide a regulatory framework which:
 - Promotes a **fair, orderly and transparent market**
 - Is **flexible enough to cope with new products** and other innovations, and further advances in technological infrastructure
 - Is **administered by a regulator** with sufficient powers and discretion whose operations are transparent and who is accountable to the stakeholders through a system of adequate checks and balances
 - Is **on a par with international standards** and compatible with international practices, but tailored to meet local needs and circumstances

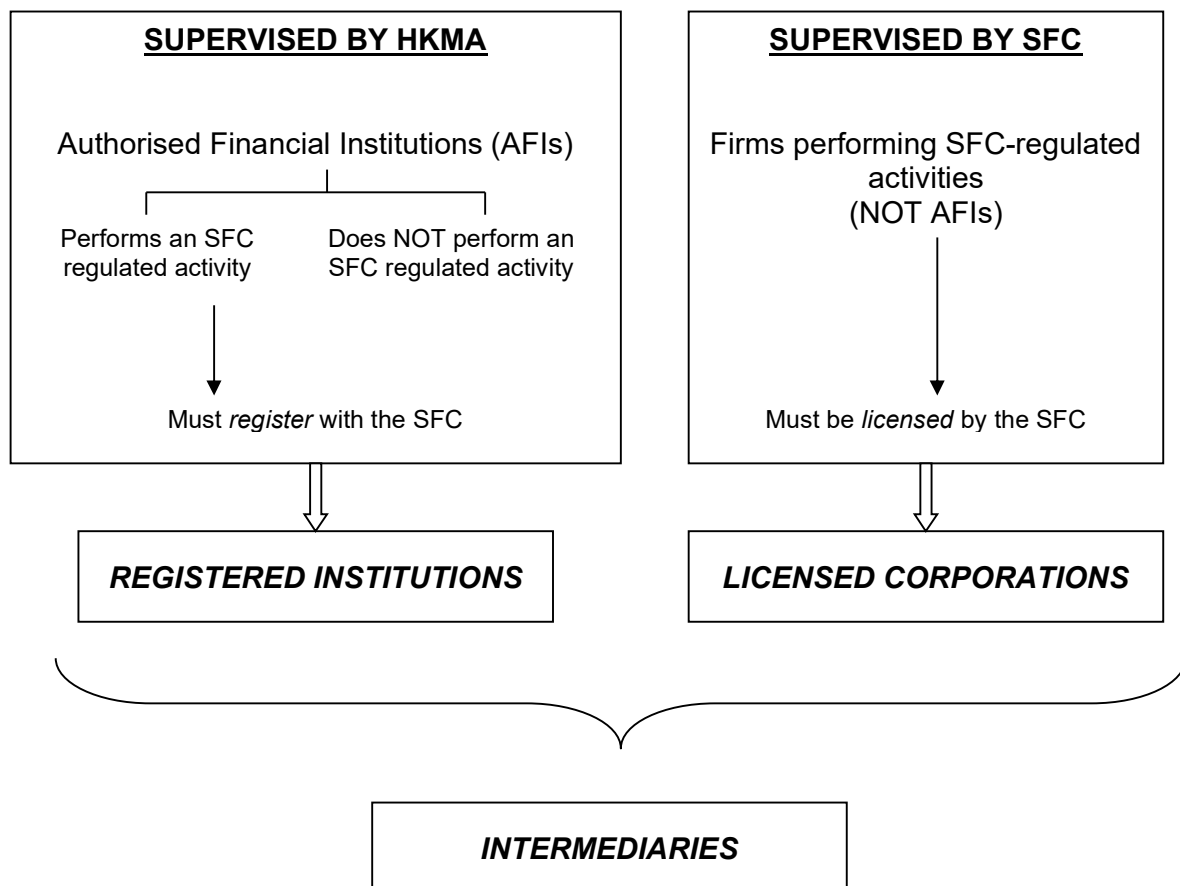
2. STRUCTURE OF THE SFO

Part		Topic
I	Preliminary	1 and 3
II	The SFC – its Constitution, Objectives, Functions, Powers and Duties	1
III	Exchange Companies, Clearing Houses, Exchange Controllers, Investor Compensation Companies and Automated Trading Services	1 and 7
IIIA	Over-the-Counter Derivatives Transactions	4
IV	Offers of Investments	8
IVA	Open-ended fund Companies	3, 4 and 5
V	Licensing and Registration	3 and 4
VI	Capital Requirements, Client Assets, Records and Audit Relating to Intermediaries	3 and 4
VII	Business Conduct of Intermediaries	3 and 5
VIII	Supervision and Investigations	3
IX	Discipline	3, 4, 7 and 8
X	Powers of Intervention and Proceedings	3
XI	Securities and Futures Appeals Tribunal	1 and 3
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XIVA	Disclosure of Inside Information	3
XV	Disclosure of Interests	3
XVI	Miscellaneous	3 and 6
XVII	Repeals and Related Provisions	N/A

2.1 Part I - Preliminary

- The provisions of the SFO have different applications to the following different classes of person:
 - **Licensed corporation** – corporations which are licensed and directly supervised by the SFC
 - **Registered institution** – AFIs directly supervised by the HKMA and registered with the SFC
 - **Intermediary** – collective term for licensed corporations and registered institutions

Revision from Topic 1.....



2.2 Part II – The SFC – its Constitution, Objectives, Functions, Powers and Duties

- Dealt with in Topic 1

2.3 Part III – Exchange Companies, Clearing Houses, Exchange Controllers, Investor Compensation Companies and Automated Trading Services

- The SFC supervises the following operators, as recognized in Part III, to ensure that they perform their regulatory functions and operations in accordance with the SFO:
 - **Exchange controller** – i.e. Hong Kong Exchanges and Clearing Limited
 - **Exchange company** – two are recognised: SEHK and HKFE
 - **Clearing house** – three are recognized: HKSCC; SEOCH; and HKCC
 - **Investor compensation company** – i.e. Investor Compensation Company Limited
 - **Providers of automated trading services**
- **Market operators** (Exchange Controller, Exchange Companies, Clearing Houses and Investor Compensation Company) are **immune from civil liability** under Part III

2.4 Part IIIA – Over-The-Counter Derivative Transactions

- Establishes the framework for the regulation of OTC derivative transactions, setting out requirements for the **reporting, clearing and trading** of specified OTC derivative transactions
- Reportable information should be provided to the **HKMA**, while the **SFC** is empowered to make appropriate rules
- Different parts of Part IIIA will be rolled out when the necessary legal and regulatory infrastructure is in place

2.5 Part IV - Offers of Investments

- SFC is empowered to:
 - Authorize Collective Investment Schemes (CISs) i.e. mutual funds/unit trusts
 - Authorize structured products enabling them to be marketed to the public
 - Authorize the issue of adverts and other documents containing an offer to the public
- Dealt with further in Topic 8

2.6 Part IVA – Open-ended Fund Companies (OFCs)

- Enacted in July 2018, this Part enables investment funds to be established in Hong Kong in a corporate form – **OFCs are a form of CIS**
- **OFCs have limited liability with variable share capital**, providing flexibility to meet investor applications and redemptions – primary purpose is to manage investments for the benefit of investors
- It is **an offence**, punishable by fine/imprisonment, to carry on a business as an OFC without being registered by the SFC
- Topic 4 covers the **Securities and Futures (Open-ended Fund Companies) Rules**
- Topic 5 covers the **SFC Code on Open-ended Fund Companies**

2.7 Part V – Licensing and Registration

- Intermediaries and their representatives must be licensed (or registered) by/with the SFC if they carry out a regulated activity.
 - **Intermediaries** must be incorporated
 - **Representatives** are individuals who engage in regulated activities on behalf of an intermediary
- A **single license** regime operates whereby a person is granted one license/registration which will enable the holder to carry out one or more regulated activities
- Dealt with further in Topic 4

The Ten SFC-regulated Activities

1. Dealing in securities
 2. Dealing in futures contracts
 3. Leveraged foreign exchange trading
 4. Advising on securities
 5. Advising on futures contracts
 6. Advising on corporate finance
 7. Providing automated trading services
 8. Securities margin financing
 9. Asset management
 10. Providing credit rating services
- The Financial Secretary can amend this list by notification in the Gazette

2.8 Part VI – Capital Requirements, Client Assets, Records and Audit Relating to Intermediaries

2.8.1 SFC Empowerment for Making Detailed Rules

- Part VI provides the SFC with powers to regulate certain aspects of intermediary activities:
 - Financial resources – **Financial Resource Rules**
 - Client assets – **Client Securities Rules** and **Client Money Rules**
 - Keeping of accounts and records – **Keeping of Records Rules**, **Contract Notes Rules** and **Accounts and Audit Rules**
- Each set of rules is covered in detail in Topic 4

2.8.2 Associated Entity

- The Client Securities Rules apply to intermediaries and their associated entities.
- An **associated entity** (AE) of an intermediary is defined as a company which:
 - Is in a controlling entity relationship (>20% voting power) with the intermediary; and
 - Receives or holds client assets of the intermediary in Hong Kong
- An AE is required to notify the SFC in writing within 7 business days of becoming or ceasing to be an AE
- An AE cannot conduct any other business unless authorized in writing by the SFC

2.8.3 SFO Audit Provisions

- The audit provisions apply to licensed corporations and their associated entities, but not to registered institutions
- The main requirements relating to audits are in the SFO, although the contents of audited accounts and audit reports are given in the Accounts and Audit Rules
- Audited accounts of a licensed corporation must be submitted to the SFC **not later than 4 months** after the end of the financial year, or the date of cessation of the business
- Licensed corporations and any associated entities must appoint auditors within **one month** of being licensed – the appointment must be notified to the SFC within **7 business days**
- **Removal or resignation of auditors** should be notified to the SFC within **1 business day** from giving notice of the required resolution
- If an auditor becomes aware of a **reportable matter**, a written report must be made to the SFC as soon as practicable (or to HKMA if AE is an AFI). [A reportable matter is a failure to comply with a prescribed requirement and anything that adversely affects a financial position to a material extent or breaches the FRR]

2.8.4 Appointment of Auditors by the SFC

- The SFC may appoint an auditor to examine and audit a licensed corporation or any of its associated entities if:
 - The licensed corporation has failed to comply with the FRR
 - The licensed corporation/associated entity has failed to comply with a prescribed requirement or failed to submit audited accounts
 - An auditor has made a report on a reportable matter
- The SFC may appoint an auditor if it receives a *written* report from a person alleging that a licensed corporation/associated entity:
 - Failed to account to him as a client for any client assets held; or
 - Failed to act in accordance with instructions given by the person as a client
- An auditor appointed by the SFC has extensive powers to:
 - Question on oath officers, employees, agents and auditors of the target entity
 - Require all these plus recognized exchange companies, clearing houses and any persons holding client assets to produce records
- Any person failing to comply with any auditor requirements will be committing an offence. A person also commits an offence by interfering with an audit by:
 - Deleting, destroying, mutilating, falsifying, concealing or making unavailable any records relating to the audit, or helping someone do so
 - Disposing of property relevant to the audit
 - Leaving, or attempting to leave Hong Kong

2.9 Part VII – Business Conduct of Intermediaries

- SFO empowers SFC to make subsidiary legislation (Rules) to **regulate the conduct of intermediaries and their representatives**. SFC has not issued Rules, but has issued a number of **codes of conduct**
- A failure to comply with a code of conduct is **not a legal offence**. However breaches will be taken into account:
 - By the SFC when considering whether an intermediary or its representative is fit and proper to remain licensed or registered
 - By the courts when hearing legal proceedings under the SFO
- It is an offence for an intermediary or its representative to hold out that its/his abilities or qualifications have been endorsed or warranted by the Government or SFC
- Five codes of conduct are covered in detail under Topic 5

2.10 Part VIII – Supervision and Investigations

- There is a big difference between supervision and investigations!
- The SFC has two main powers of investigation:
 - To make enquiries and obtain documents from **listed corporations, intermediaries** and their **associated entities**, and **specific transactions**
 - A general power to investigate possible **breaches of the SFO, misfeasance** and **activities** that are **not in the public interest**

2.10.1 Investigation of Listed Corporations

- The SFC has powers to obtain records and documents, explanations and statements on oath
- Persons who may be subject to an enquiry:
 - Directors and employees (past and present)
 - A related corporation
 - An AFI
 - An auditor
 - Any other person

2.10.2 Supervision of Intermediaries and Associated Entities

- The SFC may conduct supervisory inspections to establish if intermediaries/associated entities are complying with SFO
- The SFC may authorize a person to inspect the premises of a licensed corporation

2.10.3 Investigation of Specific Transactions

- The SFC has the power to require specified persons to disclose information related to transactions in securities, futures contracts and CISs
- The specified persons can be the parties with an interest in the transaction and any intermediary involved
- Failure to comply with requests for information without reasonable excuse constitutes an offence

2.10.4 Investigation of Possible Offences

- A person under investigation is required to:
 - Provide documents and explanations
 - Meet an investigator and answer questions
 - Give the investigator all reasonable assistance
 - Support evidence with a statutory declaration
 - Make a statutory declaration that evidence is unable to be provided for reasons to be stated
- If someone being investigated fails to comply with the requests of an SFC investigator, the SFC may apply to a magistrate for the issue of a warrant:
 - Authorizing specified persons, **a police officer** and others, as necessary, to assist in the execution of the warrant to enter specified premises, if necessary by force, at any time **within 7 days**
 - Requiring persons on the premises to produce any relevant documents
 - Prohibiting any person to erase, alter or remove any relevant documents
 - Authorizing the specified persons to **search for, seize and remove any relevant documents** and to retain such documents for **6 months** (can be extended)

2.11 Part IX – Discipline – Regulated Persons

- The **disciplinary provisions** in this part of the SFO relate to:
 - Licensed corporations, licensed representatives, responsible officers and persons involved in the management of licensed corporations;
 - Any person involved in the management of a licensed corporation, including managers-in-charge of core functions. Such individuals are not necessarily SFC licensed; and
 - Registered institutions, executive officers and persons involved in the management of registered institutions

- If a regulated person (any of the above) is **guilty of misconduct**, or is not a fit and proper person, **the SFC may**:
 - Revoke or suspend the license/registration in respect of all or part of the regulated activity
 - Revoke or suspend approval as a responsible/executive officer
 - Publicly or privately reprimand the regulated person
 - Prohibit the regulated person from applying for a license, registration, approval as a responsible officer, or entry in the HKMA register, or to act as an executive officer
 - Separately, or in addition, order the regulated person to pay a penalty up to the greater of HK\$10million or 3 times any profit gained or loss avoided as a result of his misconduct

- **Misconduct includes** contravention of:
 - Provisions of the SFO and certain parts of the NCO
 - Terms and conditions of any license or registration with the SFC
 - Any act or omission relating to regulated activities which is prejudicial to the public interest

- The **SFC may take disciplinary action** in the event of:
 - A bankruptcy, receivership or arrangements with creditors
 - Failure to satisfy a levy of execution
 - Mental incapacity of individuals or directors
 - Conviction of individuals, corporations or directors for an offence which casts doubts on their fitness and properness

- The **SFC recognises and values intermediaries' cooperation with SFC** investigations and enforcement proceedings. Cooperation may be recognised in the form of reduced sanctions as outlined in the SFC's **Guidance Note on Cooperation with the SFC**

- The SFC may recognise cooperation by **reducing up to 30%** of the disciplinary sanctions imposed

- **Ways of cooperating with the SFC** include:
 - Voluntarily and promptly reporting any breaches or failings to the SFC
 - Providing true and complete information regarding breaches or failings
 - Acceptance of liability, such as taking a proactive and positive approach to bring the disciplinary case to an early conclusion
 - Taking rectification measures, such as taking early and active steps to contain breaches or failings and/or making full and prompt compensation to clients for their losses

2.12 Part X – Powers of Intervention and Proceedings

2.12.1 Intervention with Licensed Corporations

- Part X empowers the SFC to intervene in the way a licensed corporation conducts its business. The powers are designed to:
 - Protect the interests of investors of licensed corporations
 - Look after the interests of the investing public/public in general
 - Be used where the licensed corporation has:
 - Shown it is not fit and proper
 - Contravened provisions of the SFO
 - Had its license suspended or revoked

2.12.2 Intervention Notices Issued by the SFC

- The SFC can intervene with a licensed corporation by:
 - Restricting its business activities
 - Prohibiting it from disposing or dealing with client property
 - Requiring it to maintain property in Hong Kong so that it may meet its liabilities

2.12.3 Winding-up and Bankruptcy Orders

- The SFC may petition/apply to the Court of First Instance for:
 - Winding-up orders for corporations (other than AFIs) under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (see Topic 2: 2.11.1)
 - Bankruptcy orders for licensed representatives under the Bankruptcy Ordinance
 - Injunctions to prevent contravention by any person of any terms and conditions of any license or registration

2.13 Part XI – Securities and Futures Appeals Tribunal

- The SFO established a full-time Securities and Futures Appeals Tribunal chaired by a judge to hear appeal against decisions made by the SFC. The Tribunal is independent of the SFC

2.14 Part XII – Investor Compensation

- SFO empowers SFC to establish and maintain a **single Investor Compensation Fund** to cover losses incurred by clients of intermediaries in general, including non-exchange participants
- The **Investor Compensation Company Limited** has been established to administer, manage and operate the Investor Compensation Fund and process claims made against the fund
- Detailed legislation contained in three sets of rules:
 - **Securities and Futures (Investor Compensation – Levy) Rules:** funded by a levy on buy and sell transactions on the SEHK and HKFE
 - **Securities and Futures (Investor Compensation – Claims) Rules:** prescribe who can make claims from the Fund and how claims may be made and paid
 - **Securities and Futures (Investor Compensation – Compensation Limits) Rules:** prescribe that the maximum amount of compensation that can be paid per person per claim is HK\$500,000

2.15 Part XIII – Market Misconduct Tribunal

- Dealt with in Topic 9

2.16 Part XIV – Offences Relating to Dealings in Securities and Futures Contracts

- Dealt with in Topic 9

2.17 Part XIVA – Disclosure of Inside Information

2.17.1 Duty of Disclosure

- A relatively new development, effective from 1 January 2013
- Gives statutory backing to disclosure obligations imposed by the Listing Rules of the SEHK
- Listed companies have an **obligation to disclose inside information**¹ to the public as soon as reasonably practicable after the information has come to their attention

¹ See Topic 9 for definition of Inside Information

2.17.2 Exception to Disclosure Requirement

- A listed corporation is not required to disclose inside information in the following situations:
 - Disclosure is prohibited by an enactment or a court order
 - Confidentiality of the information is preserved, and
 - Information concerns an incomplete proposal/negotiation
 - Information is a trade secret; or
 - SFC grants a waiver

2.17.3 Breach of Disclosure Requirement

- An officer of a listed corporation, which is in breach of the disclosure requirement, will be liable if:
 - Breach is caused by his intentional, reckless or negligent conduct; or
 - Reasonable measures to prevent the breach have not been taken
- The listed corporation and/or its directors may be subject to a civil liability of a fine up to HK\$8 million and/or other sanctions

2.17.4 Guidelines on Disclosure of Inside Information

- These SFC Guidelines, which give guidance on Part XIVA compliance, do not have the force of law

2.18 Part XV – Disclosure of Interests

2.18.1 Duty of Disclosure

- Reflects modern trend towards greater disclosure and transparency
- **Two basic rules** concerning the duty to disclose interests in the relevant share capital of a listed company:
 - Directors and chief executives are required to disclose all interests
 - Other persons must make disclosures once their interests in the relevant share capital reach 5%
- **'Interest in relevant share capital'** is widely defined to include:
 - Both long and short positions, without any netting
 - Interests in equity derivatives
 - Attributed interests, including trust arrangements, corporate shareholdings and family arrangements
- Persons subject to disclosure requirements are **required to make disclosures when**:
 - Having reached (and reported) the 5% disclosure level, their holdings rise or fall through a whole percentage level
 - The level of interest falls below 5%
 - The nature of their interest changes (eg acquiring shares on the exercise of a call option)
- Disclosure must be made:
 - To the listed company
 - To the exchange on which the company is listed
 - Within 3 business days after the relevant date

2.18.2 Listed Corporation's Powers to Investigate Ownership

- A **listed company may investigate** the interests held in its voting shares, including short positions and equity derivatives
- A listed company **must perform such an investigation** if requested by members holding at least **10%** of the total number of issued voting shares
- When a listed company investigates the ownership of its shares, it must:
 - Submit the information collected **to the relevant exchange** and the **SFC**
 - Submit the information to the HKMA if the listed company or its subsidiary is an AFI
- The **Financial Secretary** may appoint inspectors to investigate the ownership or control of a listed company if he thinks it necessary

2.19 Part XVI – Miscellaneous

- Statutory immunity is provided to **persons performing the SFCs statutory functions** in good faith
- **Auditors** of listed companies reporting suspected fraud and other improper practices are given immunity from civil liability
- A person commits an offence if he knowingly or recklessly provides **false or misleading information** regarding a material matter to the SFC – also applies to filing of public statements and disclosure obligations imposed by the listing rules
- **SFC can intervene in civil proceedings** between third parties which concern matters under the SFO or certain parts of the NCO
- If an offence under the SFO committed by a company is aided or abetted by an officer of the company, **that officer will be guilty of that offence**. “Officer” includes senior management and managers-in-charge
- Powers are given to the **Financial Secretary** to prescribe, by notice in the Gazette, **new financial products, including OTC derivatives**
- SFC is given powers to make **rules, codes and guidelines** (eg Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission)

2.20 Part XVII – Repeals and Related Provisions

- Deals with transition from previous legislation to the SFO – not examinable