

TOPIC 1 - OVERVIEW

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1. DEFINITION OF DERIVATIVES

- **A derivative** is any product where the price is derived in part or whole from another instrument (the underlying instrument)

- **Derivatives** include:

- Contracts for differences
- Convertible bonds
- Covered or uncovered warrants
- Callable bull/bear contracts
- Depository receipts
- Forward contracts
- Futures contracts
- Rights of various kinds
- Options on futures contracts

- Licenses which are required for activities with derivatives:

ACTIVITY	LICENSE
Dealing in securities	Type 1
Dealing in futures contracts	Type 2
Advising on securities	Type 4
Advising on futures contracts	Type 5
Asset Management	Type 9

- Under the Securities and Futures Ordinance, futures contracts are defined to include:

- Contracts for differences (meeting either the futures contract or options on futures contract definitions)
- Forward contracts (but only when they are traded on an exchange)
- Futures contracts and option contracts (options on futures contracts and traded on an exchange)

- Specifically,

STOCK OPTIONS AND WARRANTS	OPTION ON FUTURES CONTRACTS
Traded on SEHK	Traded on HKFE
Dealing requires Type 1 license	Dealing requires Type 2 license
Advising requires Type 4 license	Advising requires Type 5 license
Covered under Paper 2	Covered under Paper 3

- Asset management is covered under Paper 6

2. LEGISLATION AND REGULATION

2.1 Structure

- The SFO came into effect in April 2003 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 meeting changes due to:
 - Globalization
 - Technological innovations
 - Introduction of new products, services and trading methods
- SFO empowers SFC to publish rules, codes of conduct and guidelines, guidance notes and circulars
- **Rules** have status of subsidiary legislation and have the force of law. Breaches of rules can be a criminal offence
- **Codes of conduct and guidelines** set out practices and standards and do not have the force of law. Failure to follow may reflect on fitness and properness of persons licensed or registered and may result in fines or license suspension/revocation
- **Guidance notes and circulars** provide interpretations and SFC's views on particular issues

2.2 SFO, Subsidiary Legislation, Codes and Notes

Securities and Futures Ordinance

Part		Reference
I	Preliminary	
II	The SFC – its Constitution, Objectives, Functions, Powers and Duties	
III	Exchange Companies, Clearing Houses, Exchange Controllers, Investor Compensation Companies and Automated Trading Services	2.2.1 2.2.2
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IX	Discipline	
X	Powers of Intervention and Proceedings	
XI	Securities and Futures Appeals Tribunal	
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2.2.1 Part III – Recognition of Exchange Companies, Clearing Houses, Exchange Controllers, Investor Compensation Companies and Automated Trading Services

- Part III empowers the SFC to recognise and supervise the following operators:
 - **Exchange controller** – i.e. Hong Kong Exchanges and Clearing Limited
 - **Exchange company** – two are recognised: Stock Exchange of Hong Kong Limited (SEHK) and Hong Kong Futures Exchange Limited (HKFE)
 - **Clearing house** – three are recognized: Hong Kong Securities Clearing Company Limited (HKSCC); Stock Exchange of Hong Kong Options and Clearing House Limited (SEOCH); and Hong Kong Clearing Corporation Limited (HKCC)
 - **Investor compensation company** – i.e. Investor Compensation Company Limited
 - **Providers of automated trading services**

Part IIIA – Over-the-Counter Derivative Transactions

- Part IIIA empowers the SFC to regulate OTC derivative transactions
- Sets out requirements concerning the **reporting, clearing and trading** of specified types of OTC derivative transactions
- Requirements are designed to provide for greater transparency allowing regulators to better monitor risks in the financial system
- Reportable information is **provided to the HKMA**
- SFC has made Rules covering reporting, clearing and trading obligations – see Topic 7

2.2.2 Schedule 3 – Default rules for Exchange Companies, Clearing Houses and Exchange Controllers

- Part 5 of Schedule 3 requires that:
 - Clearing houses operate default rules (to ensure that collateral can be set off)
 - Default rules cover events which trigger a default
 - Rules must specify action to be taken on default

2.2.3 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
- An **authorized financial institution (AFI)** that engages in one or more regulated activity must be registered with the SFC as a registered institution (see Section 5 below)

2.2.4 Schedule 5 – Regulated Activities

The Ten SFC-regulated Activities

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

2.2.5 Part VI – Capital Requirements, Client Assets, Records and Audit in Respect of Intermediaries

- SFO contains detailed rules, including:
 - 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**

2.2.6 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
- Relevant codes and guidelines for Type 2 and Type 5 activities are:
 - **Code of Conduct** for Persons Licensed by or Registered with the SFC (Code of Conduct) – principles and general requirements including Client Identity Rule and “know your client”
 - **Management, Supervision and Internal Control Guidelines** for Persons Licensed by or Registered with the Securities Futures Commission
- Naked or uncovered short selling is prohibited – criminal offence to sell securities through stock exchange unless at the time of sale the seller has exercisable and unconditional right to deliver ownership of the securities to the seller

- Rules relating to short selling include:
 - **Securities and Futures (Short Selling and Securities Borrowing and Lending (Miscellaneous)) Rules** – permits short selling by a market maker
 - **Guidance Note on Short Selling Reporting and Stock Lending Record Keeping Requirements**
- Unsolicited calls must not be made to arrange a sale or purchase of securities. More details are covered in Topic 4

2.2.7 Part XII – Investor Compensation

- This Part is intended **to strengthen investor confidence**. It is important that intermediaries advise clients of the existence of investor compensation.
- The Rules under Part XII cover the Investor Compensation Levy (currently suspended); those who can claim against the Fund (retail investor); and compensation limits (HK\$500,000 per claim per person)

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

- Dealt with in Topic 4

2.2.9 Part XV – Disclosure of Interests

- Sets out the requirement for the disclosure of interests in the “relevant share capital”

2.2.10 Part XVI – Miscellaneous

- Standard of proof for an offence under SFO is no more than in a civil court
- However, if offence is prosecuted in criminal court then standard of proof is beyond reasonable doubt (rather than balance of probabilities)
- If an offence which is criminally prosecuted under the SFO is committed by a corporation then a senior officer who aided, abetted, counselled, procured, induced or consented to the offence can also be prosecuted
- Rules include:
 - **Securities and Futures (Miscellaneous) Rules**: documents to be submitted to SFC and display of licence/certificate of registration
 - **Securities and Futures (Professional Investor) Rules**: dispenses of some of investor protection measures for investing public when dealing with professional investors

2.3 Anti-money laundering and counter-terrorist financing

- Dealt with by four Ordinances and SFC Guidelines
- Dealt with in Topic 4

3. SECURITIES AND FUTURES COMMISSION (SFC)

3.1 Regulatory Functions and Structure

- **SFC was created by law** under the Securities and Futures Commission Ordinance (part of the SFO)
- **The SFC is independent** (not part of the Government machinery of the Civil Service or the ministerial system)
- It reports to, and is accountable to, the Hong Kong Government
- It is responsible for the front-line regulation and disciplining of licensed persons dealing in and advising on futures contracts
- It adopts a risk-based regulatory approach
- It has signed MOUs with the Hong Kong Monetary Authority and the Companies Registry

3.2 Regulatory Objectives of the SFC

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

3.3 Functions and Power

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

- Suppress illegal, dishonourable and improper practices in the industry
- Cooperate with other regulators
- Promote investor education and understanding

3.4 Functions of the SFC's Operational Units

- There are **five operational divisions**:
 - Corporate Finance
 - Enforcement
 - Investment Products
 - Supervision of Markets
 - Intermediaries
- The Intermediaries Division includes the following two departments:
 - Licensing
 - Intermediaries Supervision
- **Corporate Finance Division:**
 - Vets listing applications alongside the SEHK and intervenes if misconduct suspected
 - Reads announcements made by listed companies to identify misconduct or irregularities
 - Oversees listing-related activities of Stock Exchange (SE administers listing process)
 - Reviews and recommends changes to Listing Rules
 - Administers The Codes on Takeovers and Mergers and Share Buy-backs
- **Enforcement Division:**
 - Monitors markets to detect market misconduct
 - Investigates market misconduct and disciplines/prosecutes those responsible, including those that may be unlicensed
 - Inspects books and records of listed companies where impropriety is suspected which may involve directors, officers or substantial shareholders
 - Cooperates with domestic and overseas regulatory or law enforcement bodies in investigations

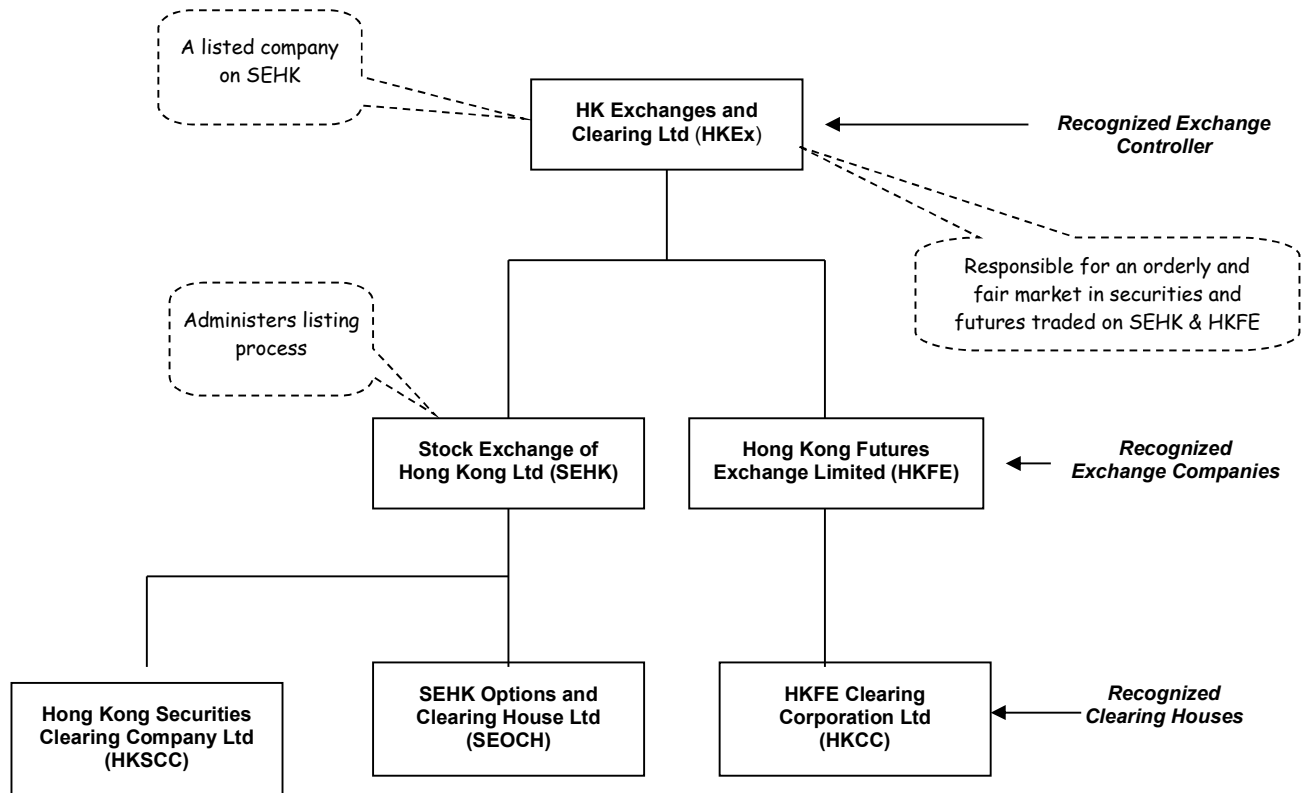
- **Investment Products Division:**
 - Develops regulatory platforms to facilitate market growth and product innovation
 - Regulates and approves investment products that are offered to the public and subject to the SFO
 - Registers and regulates open-ended fund companies
 - Monitors disclosures and ongoing compliance of authorized investment products and open-ended fund companies
 - Formulates policies relating to the regulation of asset management

- **Supervision of Markets Division:**
 - Supervises and monitors the activities of the exchanges and clearing houses
 - Strengthens Hong Kong's market infrastructure through market-related research and boosts links with Mainland China markets
 - Authorises ATS providers
 - Regulates approved share registrars
 - Supervises the ICC and manages the Investor Compensation Company

- **Intermediaries Division:**
 - Licensing Department:**
 - Licenses corporations and individuals to enable them to carry out SFC-regulated activities
 - Issues codes and guidelines concerning the competence and suitability of corporations and individuals to remain licensed
 - Reviews continuing suitability of licensed corporations and individuals to be licensed

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

4. HONG KONG EXCHANGES AND CLEARING LIMITED



- The SFC supervises and monitors the activities of all HKEx companies
- All exchange companies and clearing houses are 100% owned subsidiaries of HKEx
- Except in relation to the enforcement of their own listing, trading, clearing and settlement rules, the above entities are not responsible for front-line regulation of market participants, which is carried out by the SFC
- HKEx manages its own business risk, enforces trading and clearing rules and monitors the business of exchange participants
- HKEx has twelve divisions, two of which are relevant to this paper:

➤ **Markets Division**

- Responsible for the operations of cash trading, derivatives trading, global client development, equities product development, exchange traded product (ETP) development, global issuer services, market data and sustainable finance

➤ **Post Trade Division**

- Responsible for clearing and settlement of securities, derivatives and OTC derivative products
- Supervises the clearing risk management functions of the HKEx Group
- Has responsibility for the operations of the following houses/platforms:

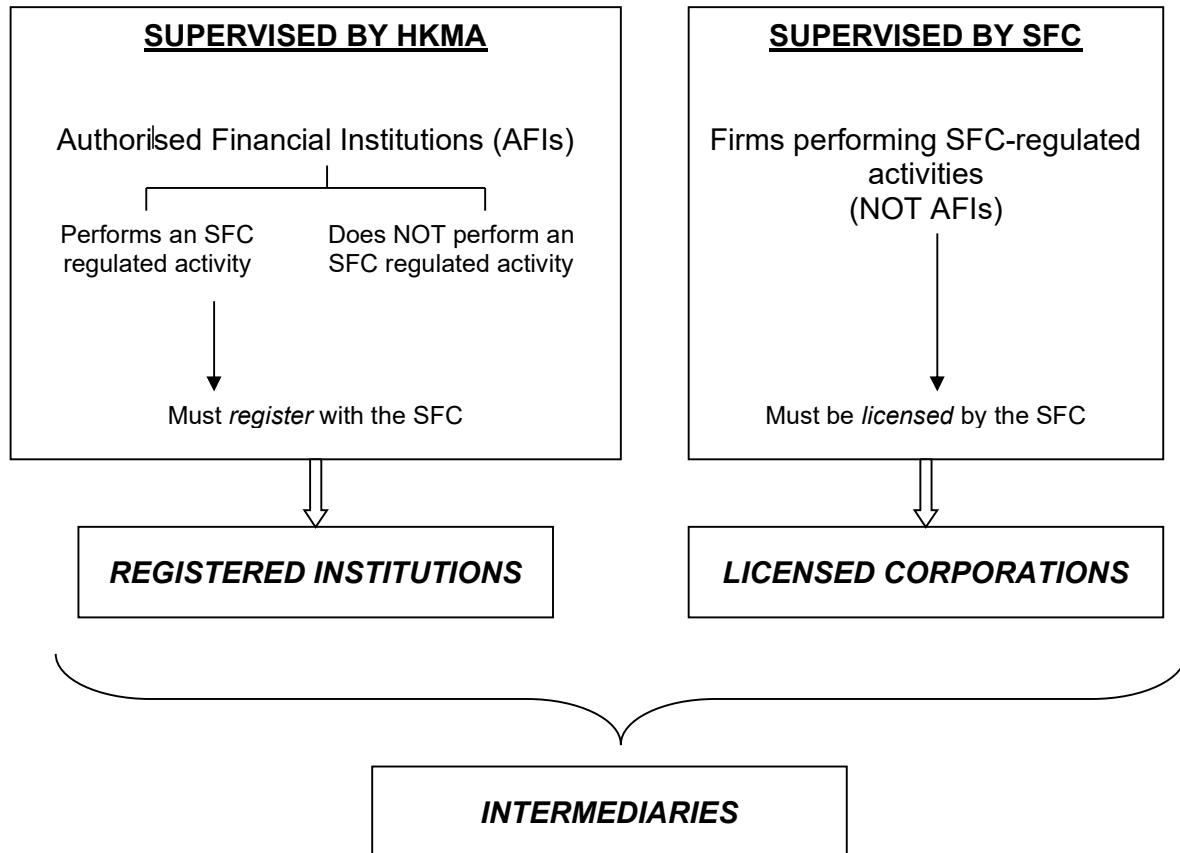
HKSCC
SEOCH

HKCC
OTC Clear

5. OTHER REGULATORS

5.1 Hong Kong Monetary Authority (HKMA)

Supervision of Intermediaries – Registered or Licensed?



The HKMA:

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

The SFC:

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

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

- Under the SFO and the Banking Ordinance, **Authorized Financial Institutions (AFI's)**, which are regulated by the HKMA and include banks, have to be registered with SFC as **registered institutions** if they wish to carry out an **SFC-regulated activity**
- HKMA is frontline regulator of AFIs and takes the leading role in vetting applications for registration with the SFC and in supervising their SFC-regulated activities, including on-site inspection
- HKMA applies all SFC criteria in supervising AFIs registered with the SFC

5.2 International Organization of Securities Commission (IOSCO)

- **The International Organization of Securities Commissions (IOSCO) is a global group of securities regulators** that promotes cooperation and high standards of regulation to maintain fair, efficient and sound markets
- **The SFC is a full, active member of IOSCO** and is a member of the Technical Committee