

TOPIC 2 - OVERVIEW

1. LICENSING AND REGISTRATION REQUIREMENTS UNDER THE SECURITIES AND FUTURES ORDINANCE	2.2
2. REGULATED ACTIVITIES UNDER THE SFO	
2.1 Overview	2.2
2.2 Dealing in Futures Contracts	2.3
2.3 Advising on Futures Contracts	2.3
2.4 Providing Automated Trading Services	2.4
2.5 Penalties	2.4
3. LICENSING OF CORPORATIONS	2.5
3.1 General Principle	2.5
3.2 Application for a License or Registration	2.5
3.3 Basic Criteria	2.5
3.4 Financial Resources	2.5
3.5 Fitness and Properness	2.8
3.6 Suitable Premises	2.9
3.7 Responsible Officers, Representatives and Executive Officers	2.9
3.8 Display of Certificate	2.10
3.9 Associated Entities	2.10
3.10 Substantial Shareholder	2.10
4. LICENSING OF REPRESENTATIVES	2.11
4.1 General Requirements	2.11
4.2 Fit and Proper Guidelines for Individuals	2.11
4.3 Continuous Professional Training	2.12
4.4 Requirements of the Hong Kong Monetary Authority	2.12
5. ACTIVITY REPORTS	2.12

1. LICENSING AND REGISTRATION REQUIREMENTS UNDER THE SECURITIES AND FUTURES ORDINANCE

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

2. REGULATED ACTIVITIES UNDER THE SFO

2.1 Overview

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
- Paper 3 is designed for those seeking to become responsible officers to carry on Type 2 and Type 5 regulated activities
 - Therefore, this Topic covers Types 2 and 5 as well as Type 7 which may be relevant to dealing in futures contracts

2.2 Dealing in Futures Contracts

2.2.1 Definition: Dealing in Futures Contracts

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

2.2.2 Definitions: Futures Contract and Futures Market

- A **futures contract** is defined in the SFO to mean:
 - A contract or an option on a contract made under the rules or conventions of a futures market
 - Interests, rights or property prescribed by the Financial Secretary as futures contracts

2.3 Advising on Futures Contracts

- Advising on futures contracts is defined in the SFO as:
 - The giving of advice
 - The issuing of analyses or reports to allow recipients to make decisions on the buying or selling of futures contracts
- Persons exempted from requiring a Type 5 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 through the public media
 - Corporations giving advice/issuing analyses and reports to **wholly owned subsidiaries**/holding companies/fellow wholly owned subsidiaries
 - **Type 2 licensees** giving advice wholly incidental to their dealing activities

2.4 Providing Automated Trading Services (ATS)

- ATS describes any automated system that provides, by means of electronic facilities, a trading mechanism for securities and futures contracts (including clearing services), other than the operations of recognized exchange company or clearing house
- The services provided include:
 - Trade confirmation and matching systems provided by brokers *
 - Full trading and settlement systems for non-local securities #
- ATS are covered in two Parts of the SFO:
 - **#Part III** – a person may be **authorized** to provide ATS similar to the services provided by a recognized exchange or clearing house
 - ***Part V** – a person may be **licensed/registered** to provide ATS as a regulated activity
- ATS, **in relation to futures contracts** (other than those provided by HKFE), which require a license/registration, are defined as those where:
 - Offers to sell or purchase futures contracts are regularly made in a way that results in a binding transaction; and/or
 - Persons are regularly introduced, or identified to other persons, to negotiate/conclude sales or purchases of futures contracts

2.5 Penalties

- It is an offence under the SFO for individuals or corporations to carry on any regulated activities without the appropriate licence or registration
- Penalties include fines and imprisonment

3. LICENSING OF CORPORATIONS

3.1 General Principle

- Corporations apply for a single license which may contain approval for carrying on one or more regulated activities

3.2 Application for a License or Registration

- A corporate applicant must make an application to the SFC, pay the appropriate fee and:
 - Substantiate its financial status
 - Provide a business plan

3.3 Basic Criteria

- The basic requirements are that the applicant:
 - Is a company
 - Is fit and proper to be licensed
 - Has lodged the required security or carries appropriate insurance
 - Has suitable premises
 - Has at least one responsible officer available at all times to supervise the business

3.4 Financial Resources

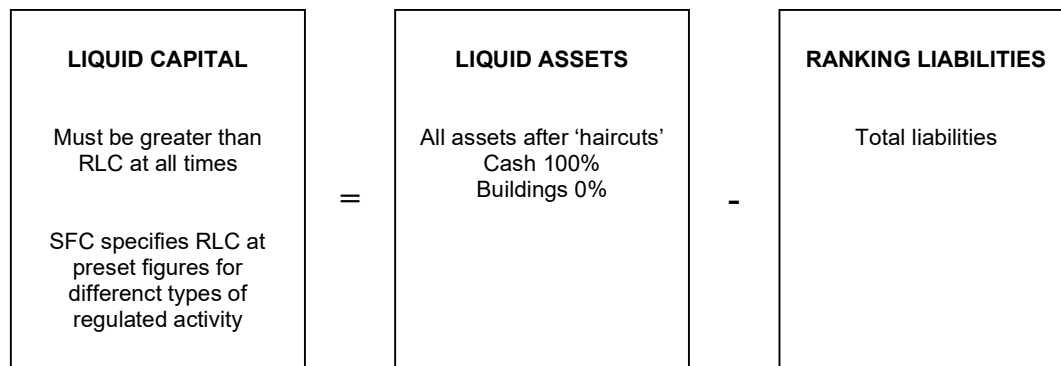
- When looking at the **fitness and properness** of a licensed corporation, the first criterion is **financial status**. The regulator must be satisfied that a licensed corporation has enough capital to:
 - Support the level of business activities
 - Be able to pay debts as they fall due
 - Provide a financial buffer in times of sudden market volatility
- Minimum capital levels required by **registered institutions** are set by the **HKMA**, not the SFC, and are therefore not examinable
- Minimum capital levels required by **licensed corporations** are set by the **SFC** through the **Securities and Futures (Financial Resources) Rules (FRR)**
- The FRR are designed to enable the SFC to make timely assessment of the solvency of licensed corporation and accurate assessment of the risks involved in any licensed corporation's regulated activities.
- A licensed corporation must have an **adequate amount of liquid assets to meet its liabilities**. To extract the relevant liquidity information, the regulator requires **balance sheets to be prepared or adjusted on specified bases**:
 - In accordance with generally accepted accounting principles
 - Substance of transactions to be reported
 - Items to be calculated on trade dates, not settlement dates
 - Liabilities not on the balance sheet to be included

3.4.1 Financial Resources Requirements

- A licensed corporation must meet the requirements before obtaining a license and continue to maintain sufficient capital at all times.
- The required level of paid-up share capital for a licensed corporation is:

Dealing in futures contracts:	HK\$5 million
Advising on futures (except if client assets not held)	HK\$5 million

- If a corporation is licensed for more than one activity, the capital requirement will be the highest amount for all such activities.
- Approved introducing agents and securities advisers not holding client assets do not have paid-up share capital requirements



- A licensed corporation must maintain at all times minimum LC as follows:

Dealing in futures contracts	HK\$3 million
Advising on futures contracts:	
➤ where it does not hold client assets	HK\$100,000
➤ where it holds client assets	HK\$3 million

3.4.2 Liquid Assets

- These are assets that can be quickly converted into cash.
- Certain assets cannot be included as liquid assets of a licensed corporation. For example:
 - Assets it owns, but which it has provided to others as security for its liabilities or obligations
 - Assets held in foreign currency that cannot be freely remitted to Hong Kong

- The following are examples of assets that can be included:
 - Cash in and at bank
 - Amounts receivable from clearing houses
 - Fees, commissions, rebates and interest that will be billed in the next three months
 - Cash provided as security for short selling if the securities have not been delivered to the counterparty for settlement
 - Deposits maintained with HKFE as security for stamp duty or contract notes liabilities
 - Prepaid operating expenses
 - Tax reserve certificates issued by the Commissioner of Inland Revenue

3.4.3 Ranking Liabilities

- In principle, most liabilities of the licensed corporation must be included for the calculation of ranking liabilities. For example:
 - Amounts payable to clients, counterparties and clearing houses
 - Overdrafts and loans
 - Accrued expenses
 - Tax payable
 - Provisions for contingent liabilities

3.4.4 Notifications to the SFC

- **A licensed corporation must notify the SFC in writing if:**
 - its LC falls below 120% of the RLC;
 - its LC falls below the RLC (see below);
 - its LC falls below 50% of the last LC reported;
 - its LC would fall below the RLC if it did not rely on a subordinated loan approved by the SFC;
 - its paid up share capital falls below that required,
 - the information submitted in any earlier return is, or has become, materially misleading;
 - there are breaches of concentration rules for a securities margin financier; or
 - a material change to accounting policy occurs

3.4.5 Return to the SFC

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

3.4.6 Failure to Meet Financial Resources Requirements

- Failure to comply with the requirements, without reasonable excuse, is a criminal offence. A breach with intent to defraud carries a maximum sentence of a HK\$1 million fine and seven years' imprisonment.

3.5 Fitness and Properness

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

Financial Status or Solvency

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

Competence and Capability

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

Character and Integrity

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

3.6 Suitable Premises

- SFC approval is needed for premises to be used by a licensed corporation for keeping records or documents in connection with any regulated activities carried out by the licensed corporation

3.7 Responsible Officers, Representatives and Executive Officers

3.7.1 Responsible Officer

- A responsible officer is a licensed representative who:
 - Actively participates in or supervises a regulated activity;
 - Is nominated by the licensed corporation; and
 - Is approved by the SFC
- Although the SFO does not provide a definition of responsible officer, the SFC has stated:
 - **Every executive director*** of a licensed corporation is required to obtain the approval of the SFC as a responsible officer; and
 - Every licensed corporation must have, for each regulated activity for which it is licensed, **at least two responsible officers** approved by the SFC – at least one of them must be an executive director and at least one must be based in Hong Kong

** A director who actively participates in, or is responsible for directly supervising, the business of a regulated activity for which the corporation is licensed (s113, SFO)*
- For **registered institutions**: the Banking Ordinance requires at least **two executive officers** to be responsible for supervising regulated activities – at least one to be available at all times

3.7.2 Representatives

- A licensed corporation must ensure that its representatives are properly licensed
- If a licensed representative ceases to be employed by the licensed corporation, the corporation must notify the SFC within seven business days of cessation

3.7.3 Relevant Individuals and Executive Officers

- The equivalent of licensed representatives and responsible officers for registered institutions are “relevant individuals” and “executive officers”
- An executive officer is defined as being:
 - A **responsible officer** of a licensed corporation
 - An **executive officer** of a registered institution
 - A **director of an associated entity** who is directly responsible for supervising the receiving or holding client assets by the associated entity

3.8 Display of Certificate

- All corporate license certificates must be prominently displayed in a corporation's office
- If there is more than one office, certified copies of the certificate should be displayed at the other offices

3.9 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 cannot conduct any other business unless authorized in writing by the SFC

3.10 Substantial Shareholder

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

4. LICENSING OF REPRESENTATIVES

4.1 General Requirements

- Individuals conducting regulated activities within licensed corporation need to be individually licensed with SFC as licensed representative
- Individuals may act for more than one licensed corporation, within the same group of companies
- The SFC may grant a **temporary license** to representatives of a licensed or a temporary licensed corporation, for not more than 3 months. This would enable someone based overseas to conduct a regulated activity in Hong Kong
- On application for a representative license, a person may be given a **provisional license** to cover the period before a decision is made on the licensing application
- If a licensed representative ceases to be employed by the licensed corporation, the corporation must notify the SFC **within seven business days of cessation**. If the license is not transferred to another licensed corporation **within 180 days**, the license is deemed to have been revoked

4.2 Fit and Proper Guidelines for Individuals

Financial Status or Solvency

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

Competence and Capability

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

Character and Integrity

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

4.3 Continuous Professional Training

- Continuous professional training (CPT) is a requirement and seeks to:
 - Ensure that professional and technical knowledge of licensees is up to date
 - Provide investors with comfort that licensed persons have necessary skills
 - Maintain international recognition of Hong Kong professionals
- SFC expects:
 - Corporations to conduct or arrange CPT programmes for staff
 - Individuals to meet CPT criteria
- Every individual licensee is expected to undertake a minimum of **5 CPT hours** every calendar year for **each** regulated activity **competence group** (eg Types 2 and 5 are in the same Group; Types 2 and 9 are in different Groups)
- Activities **allowed as CPT**:
 - Attending courses, workshops, lectures and seminars
 - Distance learning
 - Self-study with submission of assignments to recognized institutions
 - Research
 - Publications
 - Speeches
- Activities that **do not qualify as CPT**:
 - Reading financial journals, newspapers and other technical publications
 - Normal work
 - Activities which do not involve interaction with other individuals

4.4 Requirements of the Hong Kong Monetary Authority

- HKMA expects staff of registered institutions responsible for or conducting regulated activities to comply with SFC requirements as set out in the Fit and Proper Guidelines

5. ACTIVITY REPORTS

- Under the Information Rules, the SFC may publish details of licensed persons and registered institutions, and other data
- Information maintained in the SFC register includes:
 - The central entity (CE) number
 - Date that license (full or temporary) was granted
 - Regulated activity types and their effective dates
 - Whether license/registration is suspended
 - A record of any disciplinary action that has taken place in Hong Kong over the past 5 years
 - Contact details of the assigned complaints officer