

TOPIC 5 - OVERVIEW

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1. INTRODUCTION

- Topics 5 and 6 look at a licensed or registered person's business from two angles:
 - **Topic 5:** External relationships, particularly with clients
 - **Topic 6:** Internal operations and controls
- **Five Codes** covered in this Topic:
 1. Code of Conduct
 2. Fund Manager Code of Conduct
 3. Corporate Finance Adviser Code of Conduct
 4. Code of Conduct for Persons Providing Credit Rating Services
 5. Code on Open-Ended Fund Companies
- Although not covering a regulated activity, the **Code of Conduct for Share Registrars** is considered given its relevance to listed companies and hence Type 6 activities
- **Remember from Topic 3**...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

2. CODE OF CONDUCT

- Full title: **Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission**
- Considered as the "mother" code, it does not apply to management companies carrying out discretionary management of CISs – they must comply with the Fund Manager Code of Conduct

2.1 The Nine General Principles

- The Code of Conduct is based on nine general principles:
 1. Honesty and fairness
 2. Diligence
 3. Capabilities
 4. Information about clients
 5. Information for clients
 6. Conflicts of interest
 7. Compliance
 8. Client assets
 9. Responsibility of senior management

2.1.1 General Principle 1 – Honesty and Fairness

- A **licensed/registered person** should act honestly, fairly and in the best interests of its clients and the integrity of the market. More specifically:
 - Representations and information to clients should be **accurate and not misleading**
 - **Charges** to clients should be **fair and reasonable**
 - **Invitations and advertisements** should not contain information that is false, misleading or deceptive; no negative advertising
 - Actions should comply with the **Prevention of Bribery Ordinance** and any related guidelines issued by the **ICAC**
- A representative acting as an agent should not solicit or receive money/gift/employment/services without permission from the principal

2.1.2 General Principle 2 – Diligence

- A **licensed/registered person** should act with due skill, care and diligence, in the best interests of its clients and the integrity of the market. Some practical examples of this are:
 - Client orders should be executed promptly in accordance with clients' instructions – **prompt execution**
 - Client orders should be executed on the best available terms – **best execution**
 - Orders executed for clients should be promptly and fairly allocated to those clients – **prompt and fair allocation**
 - Advice should be given to clients with due skill, care and diligence
- **Telephone orders** should be centrally recorded. Recordings should be kept for at least **6 months**
- The use of **mobile phones** for taking client orders is **strongly discouraged**, and should be prohibited on the trading floor/trading room/normal place of business. Elsewhere, time of order receipt and details for order taken by mobile phone should be recorded immediately **by a call to the office telephone recording system**

2.1.3 General Principle 3 – Capabilities

- A **licensed/registered person** should have and employ effectively the resources and procedures which are needed for the proper performance of its business activities. It should have:
 - Staff who are fit and proper to carry out their duties
 - Adequate and diligent supervision of staff
 - Satisfactory internal control procedures, financial resources, operational systems and technology
- Further expanded in Internal Control Guidelines – Topic 6

2.1.4 General Principle 4 – Information about Clients

- A **licensed/registered person** should seek information about a client's financial situation, investment experience and investment objectives.
Three sections to be covered:
 - Know your client (KYC)
 - Client agreements
 - Discretionary accounts

Know Your Client

- A **licensed/registered person** should establish a client's:
 - True and full identity
 - Financial situation or strength
 - Investment experience
 - Investment objectives
- Requirements intended to improve the transparency of trading in securities or futures contracts
- Where the **SFC requests identity information** of ultimate clients, it will consider the requirements to have been complied with if the information is provided **within 2 business days** of the request
- Before accepting an **order from a third party** in respect of a client account, reasonable steps should be taken to establish the true and full identity of the third party
- **Recommendations** made to clients should be **suitable**, given their circumstances
- When a client **without knowledge of derivatives** wishes to invest in a derivative product, the risks should be explained
- In May 2007, the SFC reiterated that mis-selling of products should not be engaged in, and that the primary obligation relating to **suitability** rests with the licensed/registered person, not the client

Online Platforms

- The development of online distribution and advisory platforms present **special challenges** in ensuring that licensed/registered persons comply with their suitability obligations
- The SFC has issued Guidelines on Online Distribution and Advisory Platforms (**ODAP Guidelines**) effective 6 April 2019
- ODAP guidelines comprise five main parts:
 - (i) Core principles covering platform design, information for clients, risk management, governance, review and monitoring and record keeping
 - (ii) General requirements covering conduct requirements, the offer of investments and materials posted on the platform

- (iii) Requirements for the provision of robo-advice. Robo-advice is the provision of financial advice in an online environment where the adviser is assisted and supported by technology tools
- (iv) Suitability and other conduct requirements
- (v) Requirements covering complex products

Investor Identification Regime

Investor Identification

- An intermediary involved in trading on behalf of clients must assign to each client a unique and permanent **Broker-to-Client Assigned Number (BCAN)** and must keep up-to-date **client identification data (CID)**
- Investor identification for the Hong Kong securities market took effect on 20 March 2023
- Client on-exchange orders must be accompanied by submission of BCAN and CID to the SEHK's data repository as well as the **unique central entity number (CE number)** assigned to the intermediary by the SFC
- These requirements also apply to off-exchange orders that are reportable by SEHK exchange participants (**OE Trade Reporting**)

OTC Securities Transactions

- Whether as principal or agent, an intermediary involved in OTC transactions (not OE trading) must **report OTC trades directly to the SFC** – this is intended to improve OTC trade transparency using the SFC market oversight function
- Only transfers of ordinary shares and REIT units listed on the SEHK, that are subject to HK stamp duty, are subject to this requirement
- This OTC reporting requirement will be effective from 25 September 2023
- **Information required to be submitted to the SFC** within three trading days after the trade: intermediary's CE number; details of securities traded; client CID; and the CE number of any other licensed intermediary involved in the trade
- **Reporting obligation does not apply** for share transfers to do with a structured product/derivative, or for conversion of a depository receipt into shares or vice versa

Client Data

- Individual clients must give prior consent to the use of their data

Client Agreements

- A **written client agreement should be entered into** with a client before providing services to the client.
- The agreement should be in **Chinese or English**, at the option of the client
- Attention to relevant risks should be drawn to the client
- If a **face-to-face meeting with the client does not take place**, any of the **five methods below** are acceptable to the SFC:

1. Certification by Other Persons

- Certification of the signing of the client agreement and sighting of related identity documents by:
 - Licensed/registered person
 - Justice of the Peace
 - A bank branch manager
 - Certified Public Accountant
 - Lawyer
 - Notary Public
 - Chartered Secretary

2. Certification Services

- Services provided in the **Electronic Transactions Ordinance (ETO)** are employed. **Hongkong Post** provides ETO certification with digital signatures

3. Mail Approach

- Licensed/registered person verifies the identity of an individual client by:
 - Obtaining a copy of the client's identity document
 - Obtaining a copy of the signed client agreement
 - Obtaining a cheque for an amount not less than HK\$10,000 from the new client, signed by the client, drawn on the client's Hong Kong bank account and duly paid
 - Ensuring that the signatures on the cheque and on the client agreement are the same

4. Online Onboarding of Clients using a Hong Kong Bank A/C

- Licensed/registered person verifies the identity of an individual client by:
 - Obtaining a client agreement, signed by the client through an electronic signature, with a copy of the client's identity document
 - Successfully receiving into its own bank account a transfer of an initial deposit of not less than HK\$10,000 from a bank account in the client's name maintained with a licensed bank in Hong Kong
 - Conducting all future deposits/withdrawals for the client's trading account through the designated bank account only

5. Remote Onboarding of Overseas Individual Clients

- Licensed/registered person verifies the identity of an individual client by:
 - Accessing the embedded data in, or obtaining an electronic copy of, the relevant sections on the client's identity document (passport/identity document) including a client photograph
 - Adopting effective and appropriate technologies to authenticate the client's identity document
 - Obtaining prior consent from the client if a third party is involved in the account opening procedures
 - Obtaining a client agreement signed by the client with an electronic signature
 - Successfully receiving into its own bank account a transfer of an initial deposit of not less than HK\$10,000 from a bank account in the client's name maintained with an overseas bank supervised by a banking regulator in an eligible jurisdiction
 - Making future deposits/withdrawals for the client's trading account only via the client's designated overseas bank account
 - Maintaining proper and readily accessible records of each client's account opening process
 - Ensuring that staff responsible for online boarding have sufficient knowledge/skills to perform the relevant procedures
 - Conducting comprehensive assessments at least annually on whether the adopted processes and technologies are appropriate and effective
- Each client agreement should include the following clause:

If we [the intermediary] solicit the sale of or recommend any financial product to you [the client], the financial product must be reasonably suitable for you having regard to your financial situation, investment experience and investment objectives. No other provision of this agreement or any other document we may ask you to sign and no statement we may ask you to make derogates from this clause.

- All client agreements should contain:
 - Full names and addresses of client (verified by reliable proof) and licensed/registered person
 - Undertakings by parties to notify material changes of information to each other
 - Full description of services to be provided and charges to be paid by the client
 - Appropriate risk disclosure statements
 - Client agreements should not remove, exclude or restrict the legal rights of a client or the legal obligations of the licensed/registered person

- A client agreement should contain appropriate risk disclosure statements covering:
 - Risks of securities trading
 - Risk of trading futures and options
 - Risk of trading GEM stocks
 - Risk of client assets received/held outside Hong Kong
 - Risk of providing an authority to re-pledge clients' securities collateral
 - Risk of providing an authority to hold mail or to direct mail to third parties
 - Risk of margin trading
 - Risk of leveraged foreign exchange trading

Discretionary Accounts

- A discretionary account is a client account operated by the licensed/registered person, without the client's prior approval for each transaction
- The discretion may be absolute or subject to conditions
- The Code of Conduct imposes the following on the establishment and operation of discretionary accounts:
 - The client's authority must be in writing
 - The person authorized to operate the account should be identified
 - The terms of the authority should be explained to the client
 - The authority should be confirmed annually
 - The account should be designated as a discretionary account and be approved by senior management
 - Internal control systems should ensure that the operation of the account is properly supervised

2.1.5 General Principle 5 – Information for Clients

- The SFC expects a licensed or registered person to provide information to its clients in order to maintain transparency, as well as to let them know about their transactions. Information to be provided includes:
 - Information about its business, including contact details, services provided, and identity/status of employees with whom the client will have contact
 - In the case of a financial services group, clear information about the particular company the client is dealing with
 - Upon client request, audited financial statements and information on corporate actions
- A licensed/registered person must disclose to its clients any benefits it directly or indirectly receives from a product issuer for distributing an investment product
- The following sales related information needs to be disclosed to a client (other than a PI) prior to or at the point of sale:
 - Capacity in which a licensed/registered person is acting (principal or agent)
 - Any affiliation of licensed/registered person with the product issuer
 - Disclosure of monetary/non-monetary benefits
 - Details of any discounts of fees and charges

2.1.6 General Principle 6 – Conflicts of Interest

- A licensed/registered person should try to avoid conflicts of interest between:
 - One client and another client
 - A client and a licensed/registered person

Handling Client Orders

- Client orders should be handled **fairly and in the order** in which they are received
- Client orders should have **priority** over orders for the account of the licensed/registered person, or for the account of any employee or agent of the licensed/registered person
- Where there are aggregated orders for several clients, and the intermediary itself, priority must be given to client orders if all orders cannot be filled
- The unfair preference of any one client should be avoided
- When handling client orders, a licensed/registered person will acquire non-public information. This information should not be used to deal:
 - Ahead of transactions pending for other clients (front running)
 - When the release of the information will affect the price

Withdrawal from Business

- Licensed/registered persons ceasing to carry out a regulated activity should promptly notify clients

Actual or Potential Conflicts

- Where conflicts cannot be avoided, disclosure of the conflict should be made to the client, and all reasonable steps should be taken to ensure fair treatment of the client

Rebates, Soft Dollars and Connected Transactions

- A licensed/registered person, applying investment discretion on behalf of a client, may arrange to receive money (**rebates**) or goods/services (**soft dollars**) from a broker in consideration for directing client transactions to a broker
- The SFC wishes to reduce the conflicts that may arise from these financial arrangements
- **Requirements** in relation to the receipt of soft dollars are:
 - The goods/services must be of demonstrable benefit to the client
 - Transaction execution must be consistent with best execution standards
 - Brokerage rates not in excess of customary full-service brokerage rates

- The client has consented in writing to the receipt of the goods/services
- Disclosure is made to the client of the licensed/registered person's practices relating to receiving such goods/services, including their description
- Goods and services **permitted** by SFC:
 - Research and advisory services
 - Portfolio analysis/valuations/performance measurement
 - Market analysis
 - Data and quotation services
 - Computer hardware and software incidental to above goods/services
 - Clearing and custodial services
 - Investment-related publications
- Goods and services not permitted by SFC:
 - Travel
 - Accommodation
 - Entertainment
 - General administrative goods/services
 - General office equipment/premises
 - Membership fees
 - Employee salaries
 - Direct cash payments
- Requirements in relation to receipt of money or **cash rebates**:
 - The licensed/registered person must describe its practices regarding rebates and the client must consent in writing
 - Brokerage rates are not in excess of customary full-service rates
 - Rebates and their approximate values are disclosed to the client (at least twice annually or in each contract note)

Analysts

- There are concerns that the commercial or investment interests of an analyst's firm may create potential **conflicts of interest with the analyst's investment recommendations**
- The Code of Conduct requires firms to establish policies and procedures to ensure that analysts are held to **high standards of integrity and ethical behaviour**. The SFC believes the following principles to be important

Trading, Financial and Business Interests

- Trading, financial and business interests of the firm should not prejudice investment research and recommendations
- Limitations should be placed on analyst dealings:
 - No dealings which are contrary to outstanding recommendations
 - No dealings **30 days before** and **3 business days** after the issue of the research
 - Research should be withheld if analyst has dealt within the 30-day period
- No assurances should be made to a listed company, or a new listing applicant, about providing a favourable report
- Firms acting as manager/sponsor/underwriter of a public offering should not issue research during the 'quiet period' [40 days following the pricing of an IPO; 10 days following the pricing of a secondary market offering]

Reporting Lines, Compensation and Compliance System

- An investment banking function should not pre-approve research
 - An analyst's remuneration should not be directly linked to investment banking business
 - Analysts should not participate in sales pitches and road shows
 - Analysts reporting on a new listing applicant should not be provided with material information that is not reasonably expected to be included in the prospectus or publicly available
- An analyst should have a reasonable basis for his analyses and recommendations
 - An analyst appearing in a personal capacity in the mass media should disclose any interest he has in the company which is the subject of his comments

2.1.7 General Principle 7 – Compliance

- Licensed/registered persons should comply with all regulatory requirements including:
 - Primary and subsidiary legislation
 - Rules, regulations and codes administered/issued by the SFC
 - Rules of exchanges and clearing houses, if participants
 - Requirements of other relevant regulatory authorities
- Specific provisions of the code cover the following **6 areas**:

Obligations under the Financial Dispute Resolution Scheme (FDRS)

- A regulated person should fully comply with the FDRS for managing and resolving disputes administered by the Financial Dispute Resolution Centre (effective from 19 June 2012)

Employee Dealings

- The licensed/registered person must have a written policy specifying whether or not employees can deal or trade for their own accounts and if they can, the policy must specify the following:
 - the conditions on which employees may deal or trade;
 - that employees should generally be required to deal through their principal or its affiliates;
 - duplicate trade confirmations should be provided to senior management if employees are permitted to deal through another dealer;
 - that employees should identify all related accounts (including amounts of their minor children and those in which the employees hold beneficial interests) and report them to senior management;
 - any such transactions should be separately identified in the intermediary's records and actively monitored by senior management (to ensure transactions are not prejudicial to client interests); and
 - no intermediary should knowingly have another intermediary's employee as a client without the written consent of the employee's principal

Complaints

- Complaints should be handled in a timely and appropriate manner, investigated and responded to promptly
- If unable to investigate, licensed/registered person should advise client of further steps available

Responsibility for Acts of Employees

- A licensed corporation or registered institution should be responsible for the acts/omissions of its employees and agents

Notifications to the SFC

- A licensed/registered person is required to make reports to the SFC immediately on discovering:
 - Material breaches or suspected material breaches of any law, regulation, code or guideline
 - Insolvency situations affecting it, substantial shareholders or directors
 - Disciplinary actions taken against it
 - Material problems with business systems/equipment
 - Suspected material breach of market misconduct provisions

Co-operation under the FDRS

- A licensed/registered person should make honest and diligent disclosure before mediators/arbitrators in connection with the FDRS

2.1.8 General Principle 8 – Client Assets

- A licensed/registered person should ensure:
 - Client assets are promptly and properly accounted for
 - Client assets are adequately safeguarded
- Subsidiary legislation has applied the principle through the **Client Securities Rules** and the **Client Money Rules**

2.1.9 General Principle 9 – Responsibility of Senior Management

- Senior management should bear **primary responsibility** for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures of the firm
- Senior management are expected to **properly manage the risks** associated with the business by understanding:
 - The nature of the business
 - Its internal control systems and procedures
 - Its risk management policies
 - The extent of their authority and responsibilities
- Senior management should have **access to all information** about the business on a timely basis and necessary advice on their own responsibilities
- For licensed corporations, the SFC considers the following to be **senior management**:
 - All directors, including shadow directors
 - Responsible officers
 - Any individual who is **manager-in-charge (MIC)** for one or more of the following core functions:
 - Overall management oversight
 - Key business line
 - Operational control and review
 - Risk management
 - Finance and accounting
 - Information technology
 - Compliance
 - Anti-money laundering and counter-terrorist financing
- An individual does not need to be licensed to be identified as a MIC
- Once a person has been identified as a MIC, any changes to the person's appointment must be notified to the SFC, as for licensed staff
- MICs must be fit and proper to carry out their duties and the SFC will use its discretion to determine if a MIC is fit and proper
- MICs past conduct, including compliance with SFC codes and guidelines, will be taken into account
- All senior management should be aware of the regulatory responsibilities covered in
 - General Principle 9 and para 14.1 Code of Conduct
 - ICG & GAML

2.2 Professional Investors

- Professional Investors (PIs) do not need the same degree of protection that the ordinary retail investor might require
- SFC recognizes three categories of PI:
 1. **Institutional PIs:** Defined in the SFO and tend to deal as principals
 2. **Corporate PIs:** Prescribed in the Securities and Futures (Professional Investor) Rules that are corporates, trusts or partnerships
 3. **Individual PIs:** Prescribed in the Securities and Futures (Professional Investor) Rules who are individuals

2.2.1 Institutional Professional Investors

- Exchange companies
- Intermediaries and similar overseas providers, including their wholly owned subsidiaries, holding companies and wholly owned subsidiaries of the holding companies
- AFI's and similar overseas institutions
- Insurers regulated under the Insurance Companies Ordinance and their overseas equivalents
- CISs authorized in Hong Kong and their regulated overseas counterparts
- Registered schemes as defined in the MPFO and ORSO schemes, and their approved trustees, service providers, investment managers, their administrators and regulated overseas counterparts
- Governments, central banks and multilateral agencies

2.2.2 Corporate Professional Investors

- trustee companies responsible for total assets of not less than HK\$40m;
- corporations or partnerships having either a portfolio of not less than HK\$8m, or total assets of not less than HK\$40m; and
- corporations that act solely as investment holding companies and are wholly owned by persons who belong to any of the above two categories
- holding companies of the above two categories

2.2.3 Individual Professional Investors

- high net worth individuals having a portfolio of not less than HK\$8m; [includes spouses/children where portfolios are held jointly]
- the portfolio is held by a corporation which is wholly owned by the individual

2.2.4 Waivers Applicable to Professional Investors

- **Non-applicable SFO provisions:**

1. Unsolicited call provisions (ie PIs can be cold-called)
2. Requirements for offers by intermediaries

Above exemptions **apply to Institutional PIs, Corporate PIs and Individual PIs**

- **Non-applicable Code of Conduct requirements:**

- a) Information for clients:**

- (i) The need to provide information about the licensed/registered person and its employees
- (ii) The need to make prompt confirmation of transactions to clients
- (iii) The need to disclose transaction related information
- (iv) The need to provide documentation on the Nasdaq-Amex Pilot Programme
- (v) The need to ensure the suitability of a complex product transaction; to provide sufficient information about a complex product; and to provide warning statement

All above exemptions **apply to Institutional PIs and Corporate PIs**
Exemptions (a) (i), (ii) and (iv) apply to Individual PIs

- b) Information about clients**

- (i) The need to establish the client's financial situation, investment experience and investment objectives (except advice on corporate finance)
- (ii) The need to ensure the suitability of a recommendation or positive invitation
- (iii) The need to assess the client's knowledge of derivatives

All above exemptions **apply to Institutional PIs and Corporate PIs**

- c) Client agreement: the need to enter into a written client agreement and provide risk disclosure statements**

The above exemption **applies to Institutional PIs and Corporate PIs**

d) Discretionary accounts

- (i) The need to obtain the client's prior authority in writing before effecting transactions
- (ii) The need to explain the written authority and confirm it annually (authority should still be obtained)
- (iii) The need to disclose benefits receivable for effecting transactions for a client under a discretionary account

All above exemptions **apply to Institutional PIs and Corporate PIs**

Institutional PIs

- Licensed and registered persons are automatically exempted from the above listed requirements

Corporate PIs and Individual PIs

- To apply the exemptions, the licensed or registered person must:
 - write to the client explaining the consequences/risks of being treated as a PI, the information that he will not receive and that he has the right to withdraw from being treated as a PI
 - obtain a written and signed declaration from the person that he has been provided with the above explanations and that he wished to be treated as a PI
 - carry out confirmation exercise annually
- When the above is complied with the licensed/registered person is exempt from complying with **(a) (i), (ii) and (iv)**

Corporate PIs only

- If the licensed/registered person is satisfied that the corporate PI:
 - Has an appropriate corporate structure
 - Has appropriate investment processes and controls
 - Has investment decision makers with sufficient investment background and experience
 - Is aware of the risks involved in terms of the person(s) making the investment decisions

THEN the Corporate PI is exempt from all Code of Conduct requirements listed above

2.3 Sponsors

- A licensed or registered corporation involved in sponsor work should comply with the following requirements:
 - Provide advice and guidance to a listing applicant
 - Complete all reasonable due diligence on a listing applicant
 - Ensure that public disclosures about a listing applicant are true, accurate and complete
 - Ensure truthful, cooperative and prompt communication with regulators
 - Keep proper books and records to show compliance with Code of Conduct
 - Ensure proper implementation and oversight of sponsor work through sufficient resources and effective systems
 - Ensure that public offers are conducted in a fair and orderly manner
 - Take steps to ensure that analysts do not receive material information that is not disclosed in the listing document

2.4 Electronic Trading

- Code of Conduct requirements are discussed in Topic 6

2.5 Alternative Liquidity Pools (ALPs)

- Code of Conduct requirements are discussed in Topic 6

2.6 Conduct Requirements in Relation to Over-The-Counter Derivative (OTCD) Transactions

- The Code of Conduct addresses conduct requirements intended to mitigate risk where the business of a licensed corporation, or various persons connected to it, involves **OTCD transactions**. The requirements fall into two main parts that deal with:
 - **mitigating risk** in OTCD transactions that are not centrally cleared (NCC); and
 - **managing risk** in relation to group affiliates and other connected persons

Mitigating risk in OTCD transactions that are not centrally cleared

- Licensed corporations subject to risk mitigation requirements will be:
 - a contracting counterparty to a NCC OTCD transaction; and
 - licensed for Type 9 regulated activity (asset management), managing a portfolio of non-centrally cleared OTCDs (“NCC OTCDs”)
- Risk mitigation requirements **do not apply to registered institutions**
- The specific requirements revolve around **four key areas**: documentation, valuation, portfolio matters and handling of disputes

Group affiliates and other connected persons

Risk management

- Licensed corporations should apply the same risk management standards to all such parties, subject to any legal or regulatory requirement or exemption that might be applicable

Dealings

- Licensed persons that solicit, recommend, or arrange for OTCD transactions between a group affiliate and a client (other than a client that is a group affiliate) should always act in the best interests of the client

Disclosures when dealing with unlicensed persons

- Although a group affiliate may frequently be subject to regulatory oversight in Hong Kong or another jurisdiction, this is not always be the case
- In some cases, a licensed corporation may solicit, recommend or arrange for a client (other than a client that is a group affiliate) to enter into an OTCD transaction with a group affiliate that is not a person licensed by the SFC
- In such cases, additional risk disclosures should be included in the written client agreement that bring to the attention of the client that the group affiliate is not licensed by the SFC, and that the regulatory oversight protection afforded to the client might not the same as if the group affiliate were licensed and regulated by the SFC

2.7 Margin Requirements for Non-centrally Cleared OTCD Transactions

- As part of the post-2008 financial crisis reforms to the OTC derivative market, **minimum standards for margin requirements** for NCC OTCDs has been established
- Objectives of the requirements are to **reduce systemic risk** and promote central clearing
- The Code of Conduct provides for the collection of **initial margin (IM)** and **variation margin (VM)**
- IM and VM refer to collateral that has to be posted by one party to the other to protect the receiving party from the giving party defaulting
- IM reflects the **potential future exposure at the time of entering into the OTCD transaction**, whereas VM reflects the **current exposure incurred as the mark-to-market value changes** over time
- IM and VM are normally posted and collected by both parties, protecting each party from the possibility of default
- The requirements apply to any licensed person who is a contracting party to an OTCD transactions. The **do NOT apply to registered institutions**
- The margin requirements may not apply in three circumstances:
 1. Where there is reasonable doubt about the enforceability of a netting agreement in respect of IM or VM or collateral protection arrangements
 2. Intragroup transactions where risk is managed on a consolidated basis
 3. The licensed person has notified the SFC that it will perform **substituted compliance** – licensed person will adhere to margin requirements of another jurisdiction
- IM and VM must be exchanged where the average aggregate notional amount of NCC OTCDs exceeds the relevant threshold
- IM does not need to be exchanged where the licensed person has no counterparty risk
- IM received by a licensed person should be protected by using a third party custodian should be **treated as client assets**
- **IM requirements** will start from **1 September 2021**; **VM requirements** took effect from **1 September 2020**
- **Assets accepted as collateral**: cash, marketable debt securities, gold and listed share
- **Assets not acceptable as collateral**:
 - Securities issued by a company in the same consolidated group as the licensed person
 - Securities significantly correlated with the counterparty's creditworthiness or the OTCD's value
 - Securities that are not of investment grade

3. FUND MANAGER CODE OF CONDUCT (FMCC)

- Applies to “Fund Managers”, being persons licensed/registered with the SFC whose **business involves the management of**:
 1. **Collective Investment Schemes (CIS)**, whether or not they are SFC authorised
 2. **Discretionary accounts**, whether in the form of an investment mandate or a pre-defined model portfolio (“Discretionary Accounts”)
- If FMCC is inconsistent with any other legislation, rules, codes or guidelines, the stricter provisions apply
- Provisions are similar to the general Code of Conduct. Those unique to the FMCC are detailed below

3.1 Honesty and Fairness

- Marketing material should be authorized by SFC and any performance claims should be verified
- If Fund Manager is acting as an agent, mark-ups are forbidden; if acting as principal, they should be disclosed
- A fund manager should not offer or accept inducements likely to cause material conflict with its duties to clients

3.2 Information for Clients

- In the case of **a fund managed by a Fund Manager**, there should be a client mandate stating the fund’s objectives, investment restrictions and guidelines
- A Discretionary Account Manager receiving a management fee and/or performance fee for **discretionary account management** services must enter into a Discretionary Client Agreement, in a language understood by the client

3.3 Conflicts of Interest

- A Fund Manager should ensure that **client orders** are allocated fairly, the allocation intentions are recorded *before placing the orders* and adhered to, except that any revised allocation *should not disadvantage* a client (and reasons should be properly documented)
- Fund managers participating in **IPOs** are not permitted to make preferential allocations and the reasons for allocations should be documented
- Any client transactions carried out **with a connected person should be at arm’s length**, with standard commission rates and on best-execution terms
- Borrowing/depositing money for a client with a connected person should be at **standard interest terms**, or better

- Regarding **cross trades**:
 - Cross-trades between client accounts should be fairly conducted so that no client is disadvantaged and the clients should be informed
 - Cross-trades between the house account and client accounts should only be done with prior approval of the client
 - Cross-trades between staff personal accounts and client accounts are prohibited
- **House trades** are orders for the house account operated for the fund manager itself. The following conditions apply:
 - Priority should be given to client orders
 - House orders should only be aggregated with client orders where it is in the best interests of clients
 - Advance knowledge of recommendations/research reports should not be used to deal until clients have had a reasonable chance to act on the information (**no front running**)

3.4 Compliance

- A Fund Manager should have a designated compliance officer reporting directly to senior management
- Fund managers should respond to SFC enquiries in a prompt, open and co-operative manner
- Directors and employees who are **relevant persons** must obtain written permission (from compliance officer) for personal dealings, which may be valid for no more than 5 trading days
- **Relevant persons** must hold personal investment for at least 30 days, unless prior written approval is obtained
- **Relevant persons** are those:
 - Who make or participate in investment decisions, or obtain information before buying/selling investments for funds; and/or
 - Whose functions include making recommendations to funds on buying/selling transactions

4. CORPORATE FINANCE ADVISER CODE OF CONDUCT

4.1 Conflicts of Interest

- A Corporate Finance Adviser should withdraw from, or not take on, a mandate where there is an **irresolvable conflict of interest** with its client
- When a Corporate Finance Adviser is part of a group conducting other activities, it should ensure that there is an effective system of functional barriers (**Chinese wall**) to prevent leakage of confidential/price-sensitive information
- A Corporate Finance Adviser acting as a Sponsor should ensure that, in giving a view on the suitability of an issuer for listing, it can provide **impartial advice** to its client

4.2 Standard of Work

- A Corporate Finance Adviser is encouraged to record the terms of its engagement in writing with the client
- When a Corporate Finance Adviser depends upon the work of experts and other professionals, he should check on the experience of the experts
- Where a Corporate Finance Adviser acts as a financial adviser to a listing applicant, the adviser should co-operate fully with the listing sponsor for an equity listing, all material information disclosed to analysts must appear in the prospectus or listing document

4.3 Duties to Client

- A Corporate Finance Adviser should use all reasonable efforts to ensure that its client understands the relevant regulations and should **ask the client** to report any non-compliance to the regulators. If the client refuses, the Adviser should **consider** declining to act and should cooperate with the regulator

4.4 Communication with Regulators

- Where a regulatory issue arises on a transaction, corporate finance advisers are encouraged to consult with the regulators at an early stage to seek guidance

4.5 Personal Account Dealings

- As with Fund Managers, all personal account dealings should be monitored by the designated compliance officer
- A **watch list** and a **restricted list** system should be maintained for the proper monitoring of personal account dealings and proprietary trading

5. CODE OF CONDUCT FOR PERSONS PROVIDING CREDIT RATING SERVICES

- The Credit Rating Agency Code (CRA Code) applies to credit rating agencies licensed/registered to engage in Type 10 regulated activities
- The CRA Code was effective from 1 June 2011 and is based on IOSCO's Code of Conduct Fundamentals for Credit Rating Agencies
- The CRA Code is mainly concerned with maintaining the objectivity and integrity of the rating process

5.1 Ratings Methodology

- A CRA must ensure that it has the ability and sufficient resources to undertake a high-quality credit assessment of rating target, before taking on the assignment
- Ratings methodologies should be rigorous, systematic and, where possible, result in ratings capable of objective validation based on historical experience including back testing
- A CRA should review a rating target's creditworthiness at least annually
- A CRA's methodologies and models should be reviewed at least annually and written findings should be copied to the SFC

5.2 Independence and Conflicts of Interest

- A rating should not be affected by actual or potential conflicts of interest of the CRA
- Representatives who have some form of relationship with a rated entity should not be involved in, or in any way influence, the rating of the target
- Representatives directly involved in the rating process should not:
 - Initiate/participate in discussions about fees
 - Deal in any securities (or derivatives) issued, guaranteed or supported by any entity within the representative's area of analytical responsibility, other than holdings in CISs (also applies to spouse, partner, minor children or accounts in which the rep has a beneficial interest)
- Where an actual or a potential conflict of interest does arise, it must be fully and publicly disclosed
- A CRA is prohibited from carrying on any business which could be considered as giving rise to any conflict of interest
- General nature of compensation arrangements with rated entities is required to be publicly disclosed
- A CRA is prohibited from entering into any contingent fee arrangement for providing credit rating services

5.3 Responsibilities to the Investing Public and Rated Entities

- A CRA is required to assist investors in understanding its credit ratings by making disclosures which explain the meaning of ratings categories and the CRA's procedures/methodologies/assumptions
- A rating must be communicated to the rated entity before it is issued/revised to give the rated entity the opportunity to clarify any possible factual misperceptions
- Representatives/employees should not selectively disclose any non-public information about ratings

6. CODE ON OPEN-ENDED FUND COMPANIES

- OFCs allow investment funds in Hong Kong to be established as **incorporated companies with limited liability and variable capital** as an alternative to the unit trust structure
- The OFC Code applies to both public and private OFCs and their key operators
- A **public OFC** is authorised by the SFC and a **private OFC** is not a public OFC

6.1 REQUIREMENTS APPLICABLE TO ALL OPEN-ENDED FUND COMPANIES (OFCs)

- Code requirements applicable to all open-ended fund companies cover:
 - General principles
 - Registration and naming
 - Directors
 - Investment manager
 - Custody of OFC assets
 - Administration of the OFC
 - Audit and annual accounts
 - Termination and cancellation of registration

General Principles

- The OFC Code contains the following seven general principles:
 - Key operators of an OFC shall **act honestly, fairly and professionally**
 - Key operators shall act with **due skill, care and diligence**
 - Scheme property of an OFC shall be **held by a custodian** and properly protected
 - Key operators shall **avoid conflicts of interests** and where they cannot, there should be disclosure to investors
 - Disclosures should be timely, clear and concise
 - Key operators shall comply with regulatory requirements, co-operate with regulators and **promptly inform the SFC of any material breach of the OFC Code**
 - Key operators shall ensure compliance with the OFC instrument of incorporation and offering documents

Registration and Naming

- An OFC registration application must be made to the SFC on the specified form
- An OFC's name must not be misleading and must end with "Open-ended Fund company" or "OFC"

Directors

- OFC appointed directors must be **of good repute, appropriately qualified, experienced and proper for the purpose** of carrying out OFC
- There must be **at least one independent director**, who is not a director or an employee of the custodian
- The independent director **does not need to be independent of the investment manager**
- Directors must oversee the activities of the investment manager and the custodian

Investment Manager

- The appointed investment manager must be licensed or registered with the SFC for **Type 9** (asset management) regulated activity
- An OFC **may appoint more than one investment manager**
- The investment manager **must comply with relevant SFC codes and guidelines**:
 - Fund Manager Code of Conduct
 - Code of Conduct
 - Internal Control Guidelines
 - Guideline on Anti-Money Laundering
- **Sufficient trading, accounting and other records should be kept** to reflect financial position and operation
- Records should be **kept in SFC approved premises** for at least 7 years
- The investment manager must act in the best interests of the OFC and investors

Custody of OFC's Assets

- An **OFC must appoint a custodian** to hold in custody the OFC scheme property
- **Eligibility requirements** are the same as those of trustees/custodians in Topic 8
- Custodians **of private OFCs** may be Type 1 licensed or registered
- The custodian must keep **OFC assets segregated** from assets belonging to others
- Scheme assets **may be kept in an omnibus account**, subject to adequate safeguards

Administration of the OFC

- An **OFC's instrument of incorporation** must provide for: Procedures for shareholder and director meetings; Share capital structure; and Rights attaching to shares
- OFC offering documents should indicate how shareholders can obtain information about the OFC

Audit and Annual Accounts

- An auditor must be appointed that is independent of the investment manager, the custodian and the OFC directors
- Audited accounts must be disclosed on an annual basis within 4 months of the financial year-end

Termination and Cancellation of Registration

- When an OFC is voluntarily terminated, its SFC registration will be cancelled, ensuring fair treatment of shareholders
- OFC liabilities will need to be cleared before proceeds are distributed to shareholders

6.2 REQUIREMENTS APPLICABLE ONLY PRIVATE OFCs

- There are additional **Code requirements for private OFCs** covering:

Investment Scope

- Private OFCs are designed to operate as investment vehicles and so should not operate as corporate entities for general commercial business or trade

Changes to the scheme

- Any change to the instrument of incorporation must have shareholder approval

Fund operations and Disclosure

- The instrument of incorporation should clearly set out details of: pricing, dealing, issue and redemption of shares, valuation, distribution policy, use of leverage, fees and charges
- An OFC must file its offering document with the SFC as soon as practicable
- Any changes to the offering document must be filed within 7 days of issuing the revised document

Custody Arrangements

- The custodian may be licenced or registered for Type 1 (Dealing in Securities) regulated activities
- A Type 1 regulated custodian must comply with the following laws and regulations:
 - SFC Client Securities Rules
 - SFC Client Money Rules
 - SFC Keeping of Records rules
 - SFC Code of conduct
 - SFC Internal Control Guidelines
 - Guidelines on Anti-Money Laundering

7. CODE OF CONDUCT FOR SHARE REGISTRARS

- A share registrar is a company which maintains registers of holders of securities issued by its client company
- The Listing Rules state that only an approved share registrar may be employed to maintain a register of shareholders or warrant-shareholders in Hong Kong
- Approved share registrars are subject to the Code of Conduct for Share Registrars issued by the SFC. The Code contains provisions covering:
 - Honesty and fairness
 - Diligence
 - Capabilities
 - Conflicts of interest
 - Safeguarding of client assets
 - Compliance
 - Responsibility of senior management