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# The Licensing Regime Under The Securities And Futures Ordinance

## Introduction

One of the significant innovations introduced by the Securities and Futures Ordinance (the **SFO**) which came into effect on 1 April 2003 is its streamlining of the licensing regime which was previously spread over four Ordinances and required a person to apply for a separate licence for each type of activity in which it engaged.

There is a transitional 2 year period starting on 1 April 2003 during which all persons registered or exempted under the previous regime are required to obtain their new SFO licences or registration and are deemed to be licensed or registered under the new regime until they do so. The SFC has posted some sample completed application forms on its website (under 'Forms specified by the Commission') to assist in completion of the necessary forms. An 'early bird' discount on fees is available for persons applying for their new SFO licences or registration during the first year of operation of the SFO.

The purpose of this note is to provide a brief overview of the key features of the new licensing regime. The text in blue can be clicked through to view further information on a selected subject.

## New Single Licence Regime

Part V of the SFO introduces a new single licence regime whereby each licensed person will only require one licence which will be endorsed with the regulated activities in which it is entitled to engage. The exception to this arrangement is that securities margin financiers and their representatives must conduct their business through a separate corporation and therefore require a separate licence.

## Regulated Activities

There are nine types of 'regulated activities' which are as follows:

Type 1: Dealing in Securities Type 2: Dealing in Futures Contracts Type 3: Leveraged Foreign Exchange Trading Type 4: Advising on Securities Type 5: Advising on Futures Contracts Type 6: Advising on Corporate Finance Type 7: Providing Automated Trading Services Type 8: Securities Margin Financing Type 9: Asset Management

## Licence Types

Under Part V, persons engaging in one or more regulated activities are required to apply to the SFC for a licence, unless they have been exempted or can rely on one of the exclusions. There are 2 types of licence: corporate licences and representative licences.

### Corporate Licences

Any corporation carrying on one or more regulated activities must apply to the SFC for a licence. Under the new regime only corporations can be licensed to carry on a regulated activity. Sole-proprietorships and partnerships can no longer apply to be licensed. Sole-proprietors and partnerships registered under the previous regime must therefore incorporate their businesses before the end of the Transitional Period if they wish to continue the regulated activities.

### Representative Licences

Any individual who carries on one or more regulated activities on behalf of a licensed corporation is required to apply for approval as a 'licensed representative' accredited to that corporation. A licensed representative may be accredited to more than one licensed corporation.

If a licensed representative ceases to act for on behalf of the licensed corporation to which he is accredited, he has a period of 180 days to apply for the transfer of his accreditation to a new licensed corporation (Section 123(1)). If he does not apply for transfer of his accreditation within the 180 day period, his licence will be deemed to have been revoked on his ceasing to act for the licensed corporation.

If a licensed representative ceases to act for his principal, the principal must notify the SFC within 7 days and the representative must return his licence to the SFC within the same period. Failure to comply by the principal, or failure to comply without reasonable excuse by the representative, is an offence liable on conviction to a fine.

### Approval Criteria

Part V sets out various criteria to be met by an applicant for a corporate or representative licence. The most important of these is that the SFC must be satisfied that the applicant is a fit and proper person to be licensed for the regulated activity (Sections 116(3) and 120(3)). Section 129 sets out matters to be taken into account by the SFC in determining an applicant's 'fitness and properness' which include the applicant's financial status, qualifications and experience, ability, reputation, character, reliability and financial integrity. The SFC's Fit and Proper Guidelines and Guidelines on Competence made under Section 399 SFO provide further details as to the matters considered by the SFC in determining the fitness and properness of an applicant.

In addition to fitness and properness, the SFC is also required to consider certain other matters, including, in the case of corporations, their ability, if licensed, to comply with the financial resources rules and the adequacy of their insurance coverage in respect of prescribed risks (Section 116(3)).

## Responsible Officers

In addition to requiring persons carrying on regulated activities to obtain a 'representative licence', Part V also introduces a 'responsible officer' concept. In relation to each regulated activity for which a corporation is licensed, there must be at least one 'responsible officer' of the licensed corporation who is available at all times to supervise the business of the regulated activity (Section 118(1)).

Every licensed corporation is required by Section 125 to have at least 2 persons who have been approved by the SFC as 'responsible officers' in relation to each of its regulated activities. At least one of those persons must be an executive director (defined as a director who actively participates in, or is responsible for directly supervising, the business of a regulated activity for which a corporation is licensed (Section 113(1)) of the licensed corporation. In addition, every executive director of a licensed corporation is required to be approved by the SFC as a 'responsible officer' in relation to the regulated activity in which he participates or supervises.

## Registered Institutions

Prior to the commencement of the SFO, authorised financial institutions (ie. banks, restricted licence banks and deposit taking companies authorised under the Banking Ordinance) were exempted from the requirement to be licensed to deal in securities or give investment advice. The SFO however removes the concept of exempt securities dealer status and exempt investment adviser status. For the first time, authorised financial institutions are now required to be registered with the SFC if they wish to carry on one or more regulated activities, with the exception of Type 3 (leveraged foreign exchange trading) and Type 8 (securities margin financing) activities (Section 119(1)). An authorised financial institution may therefore carry out regulated activities Types 3 and 8 without being registered under the SFO.

Applications for registration from authorised financial institutions are referred by the SFC to the Hong Kong Monetary Authority (the **HKMA**)(Section 119). The HKMA will then advise the SFC as to whether it considers the applicant to be a fit and proper person for registration for the relevant regulated activity. Any registration of an authorised financial institution by the SFC may be made subject to reasonable conditions.

Hence whereas previously authorised financial institutions were outside the regulatory purview of the SFC (the HKMA being the frontline regulator), under the new regime they are now regulated by the SFC and the HKMA jointly, with the SFC retaining ultimate responsibility for regulation of the securities and futures industry.

### Executive Officers of Registered Institutions

Section 125(2) of the SFO requires that a registered institution must have complied with Section 71D of the Banking Ordinance in appointing at least 2 executive officers responsible for directly supervising the conduct of each business conducted by the registered institution that constitutes a regulated activity. Those executive officers are further required to be in compliance with the provisions of Section 71C of that Ordinance.

The HKMA's prior written consent is required before a person may become an executive officer of a registered institution (Section 71C Banking Ordinance). Such approval is subject to the HKMA being satisfied that the person is a fit and proper person to be an executive officer of the institution and has sufficient authority within it to be an executive officer. The HKMA's consent may be made subject to such conditions as it considers proper.

The SFO further requires that, in relation to each regulated activity for which a registered institution is registered, there must be at least one executive officer of the registered institution available at all times to supervise the business of such regulated activity (Section 119(8)).

### Relevant Individuals of Registered Institutions

Section 20 of the Banking Ordinance requires registered institutions to register with the HKMA the following information:

1. the name and business address of every 'relevant individual';
2. the capacity in which each 'relevant individual' is engaged in relation to a 'regulated function' in a regulated activity;
3. the date on which each relevant individual was first so engaged; and
4. such other particulars as the HKMA thinks fit.

A 'relevant individual' of a registered institution is an individual who performs any 'regulated function' in a regulated activity for or on behalf of, or by an arrangement with, the institution, other than work ordinarily performed by an accountant, clerk or cashier.

A 'regulated function' is any function performed for or on behalf of, or by an arrangement with, the registered institution relating to the regulated activity, other than work ordinarily performed by an accountant, clerk or cashier.

Section 119(8) SFO further requires that any person whose name is registered under Section 20 of the Banking Ordinance must be a fit and proper person to be engaged in the relevant regulated activity.

### Fitness and Properness

The fitness and properness of registered institutions, their executive officers and relevant individuals is considered and determined by the HKMA having regard to the criteria set out in Section 129 SFO and the SFC's Fit and Proper Guidelines and Guidelines on Competence.

## Exemptions And Exclusions

Certain persons are excluded from the registration requirements of Part V SFO in the definitions of the regulated activities in Part 2 of Schedule 5.

As under the previous law, solicitors, counsel and professional accountants are excluded where they are providing advice on corporate finance, futures contracts, securities or asset management which is wholly incidental to their professional practice. The exemption available to trust companies is narrower than under the previous law as they are now only excluded if their advice is wholly incidental to the discharge of their duties as a trustee.

Advice on the same matters given by a holding company to any of its wholly owned subsidiaries or vice versa, or by one wholly owned subsidiary to another wholly owned subsidiary of the same holding company is also exempted.

There are many other exemptions contained in the definitions of the regulated activities in Schedule 5. For example, in the case of Dealing in Securities, the exemptions include:

1. performing the act through an intermediary licensed for Type 1 regulated activity or a registered institution registered for that regulated activity (subject to restrictions on intermediaries acting between investors and securities dealers for profit);
2. as principal, performing the act by way of dealing with a 'professional investor' (whether acting as principal or agent); and
3. as principal, acquiring, disposing of, subscribing for or underwriting securities.

The definitions in Schedule 5 further provide, as set out below, that persons licensed or registered for certain regulated activities are not required to obtain a separate licence/registration for certain other regulated activities:

* Authorisation for Type 1 (dealing in securities) - No separate authorisation is required for Type 4 (advising on securities) or Type 6 (advising on corporate finance), if the advice is given wholly incidental to dealing in securities;
* Authorisation for Type 2 (dealing in futures contracts) - No separate authorisation is required for Type 5 (advising on futures contracts) if the advice is wholly incidental to dealing in futures contracts;
* Authorisation for Type 9 (providing asset management services) - No separate authorisation is required for Type 1 (dealing in securities) or Type 2 (dealing in futures contracts) if the dealing is solely for the purposes of asset management.

## Temporary Licences

Another new feature of Part V of the SFO is that it enables the SFC to grant temporary licences to overseas corporations and representatives to conduct one or more of regulated activities Types 1, 2, 4, 5 and 6 in Hong Kong (Sections 117 and 121).

Temporary licences may be granted for a maximum period of 3 months. If the applicant has held a temporary licence before, the total approved period of the respective licences cannot exceed 6 months in any period of 24 months.

Both corporate and individual applicants are prohibited from holding any client assets in conducting any regulated activity.

### 1. Corporate Applicants

The conditions to be satisfied for the grant of a temporary licence to a corporate applicant are as follows:

1. the applicant must carry on a business principally outside Hong Kong which, if carried on in Hong Kong, would constitute a regulated activity;
2. it seeks to be licensed for the regulated activity solely in order to carry on such activity in Hong Kong;
3. the applicant establishes that it has a valid authorisation to carry on its business in the overseas jurisdiction from a regulator in that jurisdiction which the SFC is satisfied:
   1. performs similar regulatory functions to the SFC; and
   2. may investigate and take disciplinary action against the applicant in respect of its conduct in Hong Kong;
4. it satisfies the SFC that it is a fit and proper person to be licensed for the regulated activity;
5. it has nominated for approval by the SFC at least one individual to be available at all times to supervise the business of the regulated activity for which the corporation is to be licensed; and
6. an application has been lodged under Section 130(1) for approval of premises to be used by the applicant for keeping records or documents required under the SFO.

### 2. Individual Applicants

An individual may apply for a temporary licence to carry on one or more of regulated activities types 1, 2, 4, 5 and 6 for:

1. a corporation licensed under Section 116 to which he is accredited; or
2. a corporation licensed under Section 117 (ie. an overseas corporation holding a temporary licence) to which he is accredited.

The conditions to be satisfied for the grant of such a licence are as follows:

1. the applicant must carry on an activity outside Hong Kong which, if carried on in Hong Kong, would constitute a regulated activity;
2. the applicant establishes that it has a valid authorisation to carry on that activity in the overseas jurisdiction from a regulator in that jurisdiction which the SFC is satisfied:
   1. performs similar regulatory functions to the SFC; and
   2. may investigate and take disciplinary action against the applicant in respect of its conduct in Hong Kong;
3. in the case of an applicant for a licence to conduct a regulated activity for a licensed corporation, the licensed corporation must belong to the same group of companies as the corporation for which the applicant is authorised to act outside Hong Kong;
4. an applicant for a licence to carry on a regulated activity for an overseas corporation holding a temporary licence can only apply to conduct a regulated activity specified in that licence; and
5. he is a fit and proper person to be so licensed for the regulated activity.

It is a condition of a temporary licence granted to an individual that he must at all times keep the SFC informed of his contact details and must notify the SFC of any change to them within 14 days.

## Provisional Licences

Part V also provides that an individual who has applied for a representative licence may be granted a provisional licence to conduct the regulated activities the subject of his application pending the outcome of his application for a full licence (Section 120(2)).

The individual is still required to demonstrate that he is a fit and proper person to be licensed for the relevant regulated activity. The SFC is entitled to revoke a provisional licence at any time having regard to the interests of the investing public. Otherwise, a provisional licence is deemed to be revoked upon the grant or refusal of the licence applied for (Section 120(9).

## Conduct Outside Hong Kong

Part V SFO extends the scope of the new licensing regime to cover activities carried on outside Hong Kong. Section 115 provides that:

* if a person actively markets, whether by himself or through another and whether in Hong Kong or from outside Hong Kong, any services to the public of Hong Kong; and
* those services would constitute a regulated activity if provided in Hong Kong,

then the provision of those services is regarded as carrying on a business in that regulated activity and the person marketing such services is regarded as holding himself out as carrying on a business in the regulated activity. The provision and marketing of such services will therefore require a licence under Section 114. Likewise, if the provision of those services involves the performance by an individual of any function which, if performed in Hong Kong in relation to a regulated activity, would constitute a regulated function, that individual is also required to be licensed.

## Transitional Arrangements

Schedule 10 of the SFO provides for a 2 year transitional period commencing on 1 April 2003 during which all persons licensed or exempted under the previous regime must apply for their new SFO licence or registration (in the case of authorised financial institutions). During that period all persons licensed or exempted under the previous regime are deemed to be licensed or registered under the SFO for conducting the regulated activities equivalent to the activities permitted by their existing licences or exempt status. The table attached hereto sets out the regulated activities which persons licensed or exempted under the previous regime may perform during the Transitional Period. Relevant personnel are also deemed to have been licensed as licensed representatives and responsible officers and, in the case of authorised financial institutions, to have been registered as relevant individuals with the HKMA under Section 20 Banking Ordinance.

In summary therefore, corporations registered under the previous regime will need to apply to be licensed for the relevant regulated activities before expiry of the Transitional Period. In the case of persons exempted under the previous regime, if they wish to continue to perform regulated activities they will need to apply to be registered as registered institutions under the SFO if they are authorised financial institutions or, if they are not authorised financial institutions, to be licensed as a licensed corporation.

It should be noted that any conditions imposed on a person's registration, exemption or licence under the previous regime continue to apply to his deemed licence or registration.

### Conditions attatching to regulated activity Type 9

Where a person is deemed under Schedule 10 to have been licensed or registered for Type 9 (asset management) regulated activity, the deemed licence or registration is subject to a condition that the person shall not provide a service of managing a portfolio of futures contracts for another person (Section 51 of Schedule 10). Further, where a person was previously registered under the repealed Commodities Trading Ordinance and is deemed under Schedule 10 to have been licensed for Type 9 regulated activity, his licence is subject to a condition that he shall not provide a service of managing a portfolio of securities for another person (Section 52 of Schedule 10).

### Applications for new licences or registration

Applications for a licence or registration under the SFO must be made during the Transitional Period. If a person fails to apply for a new licence or registration before the expiry of the Transitional Period, he ceases to be licensed or registered and can no longer carry on regulated activities. A deemed licence or registration will also lapse upon the grant or refusal of the SFO licence or registration.

The SFC has posted some sample completed migration application forms on its website (under 'Forms specified by the Commission' of the SFO section) to assist in completion of the necessary forms.

## Public Register

The SFC maintains a register which is open to the public of licensed persons and registered institutions which indicates, among other things, the regulated activities which they are permitted to carry on and the names of their executive officers.

## Penalties For Breach Of Part V

Any person who, without reasonable excuse, carries on a business in a regulated activity or holds himself out as carrying on such a business without being licensed or registered to do so under the SFO is guilty of an offence under Section 114(8). That offence carries maximum penalties of a fine of $5,000,000 and 7 years' imprisonment and a further fine of $100,000 for every day during which the offence continues. Likewise, any individual who performs any regulated function in relation to a regulated activity carried on as a business or holds himself out as performing such function without being appropriately licensed or registered commits an offence. The maximum penalties for that offence are a fine of $1,000,000 and 2 years' imprisonment and a further fine of $10,000 for each day during which the offence continues.

## Restriction On Substantial Shareholdings In Licensed Corporations

Section 131 provides that the SFC's prior consent is required for a person to become or continue to be a 'substantial shareholder' in a corporation licensed under Section 116 SFO. For these purposes a person will be a 'substantial shareholder' of a corporation under Section 6 of Schedule 1 if he, either alone or with associates:

1. holds an interest in shares of the corporation:-
   1. equal to 10% or more of the corporation's issued share capital; or
   2. which entitles him, either alone or with his associates and whether directly or indirectly, to control 10% or more of the voting power at general meetings; or
2. holds shares in any other corporation which entitles him, either alone or with his associates and whether directly or indirectly, to control the exercise of 35% or more of the voting power at general meetings of that other corporation, or of a further corporation, where that other corporation is itself entitled, alone or with its associates and whether directly or indirectly, to control 10% or more of the voting power at general meetings of the first corporation.

## Disciplinary Regime

Part IX SFO sets out the disciplinary powers of the SFC and the categories of persons subject to such powers. The SFO has considerably widened the range of sanctions available to the SFC and has increased the potential liability of the officers and those involved in management of licensed corporations and registered institutions. A further major change is the full application of the disciplinary regime to registered institutions.

### 1. Liability of Officers

Sections 194 and 196 set out a range of sanctions which the SFC may impose where a 'regulated person' is:

1. guilty of misconduct; or
2. considered by the SFC not to be a fit and proper person to be or to remain the same type of regulated person.

The definition of a 'regulated person' is broad. In the case of licensed corporations, it includes the licensed corporation, its responsible officers (which include all executive directors) and any person involved in the management of the licensed corporation (Section 194(7)). In the case of a registered institution, 'regulated persons' include the registered institution, its executive officers, any person involved in the management of the business which constitutes a regulated activity for which the institution is registered and any person registered with the HKMA under Section 20 of the Banking Ordinance as a person who conducts a regulated activity on behalf of the registered institution.

'Misconduct' is defined as:

1. a contravention of the provisions of the SFO or of any subsidiary legislation made under it;
2. a contravention of any of the terms and conditions of any licence or registration under the SFO;
3. a contravention of any condition imposed under the SFO or under certain provisions of the Banking Ordinance; or
4. conduct of a regulated activity which in the opinion of the SFC is, or is likely to be, prejudicial to the interest of the investing public or to the public interest.

Significantly, the definition of 'misconduct' further provides that where a licensed corporation or registered institution has committed misconduct as a result of conduct which occurred with the consent or connivance of, or which was attributable to any neglect on the part of, a responsible officer or a person involved in the management of the business of a licensed corporation, or an executive officer or a person involved in the management of any regulated activity of a registered institution, then the misconduct is also regarded as the misconduct of the relevant individual (Section 193(2)).

### 2. Sanctions Available

The sanctions available to the SFC include a new power to impose on any regulated person a maximum fine of the greater of $10,000,000 or 3 times the amount of profit made or loss avoided by the regulated person as a result of the misconduct. Other sanctions include:

1. the revocation or suspension of a licensed corporation's licence or the registration of a registered institution in respect of all or part of the regulated activities for which it is licensed or registered;
2. the revocation or suspension of a person's approval as a responsible officer;
3. a public or private reprimand; and
4. a prohibition order preventing a licensed corporation or registered institution from applying to be licensed or registered or preventing an individual from applying for approval as a responsible officer of a licensed corporation or as an executive officer or relevant individual of a registered institution, in each case for a period specified by the SFC.

The Banking Ordinance also contains provisions entitling the HKMA, after consulting the SFC, to withdraw or suspend the consent granted to an executive officer (Section 71C(4)) and to remove a relevant individual from the register (Section 58A(1)), in both cases either indefinitely or for a specified period. These powers arise where the relevant individual has been guilty of misconduct or if the HKMA is no longer satisfied as to their fitness and properness. The Banking Ordinance definition of 'misconduct' for these purposes includes the breach of any provisions of the SFO which apply to the executive officer or relevant individual, conduct which in the opinion of the SFC is, or is likely to be, prejudicial to the interest of the investing public or to the public interest and, in the case of executive officers, breach of any condition attached to the HKMA's consent. In the case of an executive officer, a misconduct (as defined in the SFO) committed by a registered institution as a result of conduct which occurred with his consent or connivance or which was attributable to neglect on his part, is also regarded as the misconduct of the executive officer (Section 71C(13)).

This note is intended as a summary only of the licensing regime under the SFO. Specific legal advice should be sought in relation to any particular situation.

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