
Guidance to the Securities and Futures Ordinance, Cap. 571

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The Securities and Futures Ordinance, Cap. 571 (“the SFO”) was enacted in March 2002 aiming to consolidate and modernize the 10 existing ordinances regulating the securities and futures market. It is anticipated that the SFO will not come into force until early 2003, possibly the first or second quarter when the Securities and Futures Commission (“the SFC”) and the Hong Kong Monetary Authority (“the HKMA”) have finalized all the corresponding subsidiary legislation, rules and code of conduct which will, as a whole, govern the financial sector in Hong Kong. The purpose of this note is to highlight a number of major changes brought by the SFO.

1. New Hong Kong Licensing and Registration Regime

1.1 One licensing concept (Part V of the Securities and Futures Ordinance)

1.1.1 Currently an intermediary must apply to the SFC for separate registrations in order to carry out different activities in different products. This multiple-registration regime brings considerable cost and administrative burden not only to the registered intermediaries but also the SFC.

1.1.2 Under the SFO, there would be a universally applicable single licensing system, with one licence and therefore one set of Financial Resources Rules returns each month and one annual return which covers all of the regulated activities (s. 116). The SFC regulated activities that could be covered under such a licence include:

- dealing in securities (“Type 1”);
- dealing in futures contracts (“Type 2”);
- trading in leveraged foreign exchange contracts (“Type 3”);
- advising on securities (“Type 4”);
- advising on futures contracts (“Type 5”);
- advising on corporate finance (“Type 6”);
- providing automated trading services (“Type 7”);
- providing securities margin financing (“Type 8”); and
- providing asset management services (“Type 9”) (Schedule 5).

The licence would be granted to the applicant to carry on one or more than one SFC regulated activities only if the SFC is satisfied that the applicant is a fit and proper person to be licensed for the regulated activities. In

considering whether a person is fit and proper, the SFC or the HKMA (as the case may be) may consider the following factors concerning the applicant :

- the financial status or solvency ;
- the educational or other qualifications or experience;
- the ability to carry on the regulated activity competently; honestly and fairly; and
- the reputation, character, reliability and financial integrity (s. 129).

1.1.3 The new regime only allows corporations and their individual representatives to be licensed. The licence so granted is subject to the conditions as imposed by the SFC who may at any time, if necessary, amend or revoke any condition or impose new conditions by notice in writing (ss. 116 & 120). Certain activities as stipulated in s. 114(5) and Schedule 5, for instances, incidental services provided by certain professionals (i.e. solicitors/accountants) and advice given to wholly-owned group companies, are not required to be so licensed. This change is able to tackle the problem that arises when the death of a licensed individual or partnership creates difficulties for the continuity of their business operations.

1.1.4 Application for temporary licences for a period not exceeding 3 months by corporations and their individual representatives is allowed under s. 117 and s. 121 respectively. However, only SFC regulated activities in respect of Type 1, Type 2, Type 4, Type 5 and Type 6 can be carried out under the temporary licence. Likewise, the applicant has to satisfy the SFC that it is a fit and proper person to be so licensed for the regulated activities as mentioned in para. 1.1.2 above.

1.1.5 With the introduction of the single licence regime, corresponding changes would be made to the provisions governing exempt authorized financial institution (i.e. a bank, a restricted licence bank and a deposit-taking company as defined under s. 2 of the Banking Ordinance, Cap. 155). Under s. 119, the SFC may, upon application by an authorized financial institutions in the prescribed manner and payment of prescribed fee, register the applicant for one or more than one SFC regulated activities (other than Type 3 and Type 8 regulated activities). In addition, the SFC is under the obligation to refer any application to the HKMA which would then consult with the SFC upon the merits of the application and advise the SFC whether

he is satisfied by the applicant that the it is a fit and proper person to be registered for the SFC regulated activities concerned.

1.2 Concept of “management liability” (Part V of the Securities and Futures Ordinance)

- 1.2.1 Since licensed intermediaries would be registered as corporations and the fact that it is no longer adequate for the SFC to rely solely on its day-to-day supervision of intermediaries to promote ongoing compliance, the SFO introduces the concept of “management liability” under which the managerial staff responsible for the management of the licensed corporation would shoulder the responsibility for the acts of the corporation. Thus, all executive directors of the licensed corporation should be licensed as representatives and designated as responsible officers and not less than two individuals, at least one of whom is an executive director, should be licensed as responsible officers for each regulated activity.
- 1.2.2 The responsible representatives as well as the corporation itself would be held liable if the corporation breaches fundamental licensing requirements (ss. 125 & 126). However, a responsible officer would not be liable if he honestly and reasonably believes that the corporation is in compliance and he acts promptly in notifying the SFC of the relevant breach once it becomes known to them.

1.3 Transitional arrangement (Schedule 10 to the Securities and Futures Ordinance)

- 1.3.1 Existing registered persons would be allowed two years to migrate to the new regime, following enactment of the SFO. The deeming provisions in respect of Part V of Schedule 10 provide that existing corporations would become deemed licensed corporations; the existing representatives/dealing directors would become deemed licensed representatives/deemed responsible officers; the existing sole proprietorships/partnerships would become deemed licensed corporations; and the exempt authorized financial institutions would become deemed registered institutions. Any application for registration of a licence made before the commencement of Part V in any capacity specified in column 1 of the table below should be treated as an application for a licence in respect of certain deemed activities during the transitional period as specified opposite thereto.

<i>Type of Registration</i>	<i>Deemed Activities during the Transitional Period</i>								
	Type 1	Type 2	Type 3	Type 4	Type 5	Type 6	Type 7	Type 8	Type 9
Securities Dealer & Rep	X			X		X	X		X
Commodity Dealer & Rep		X			X		X		X
Leveraged Foreign Exchange Trader & Rep			X						
Investment Adviser & Rep				X		X			X
Commodity Trading Adviser & Rep					X				X
Securities Margin Financier & Rep								X	
Exempt Dealer	X			X		X			X
Exempt Investment Adviser				X		X			X

1.3.2 In addition, dealers who are currently providing internet trading services would be deemed to be licensed for Type 7. It is advised that the existing corporate registrants may consider consolidating existing businesses under one corporate entity with a view to saving cost, whereas the existing sole proprietors are required to incorporate their businesses before the end of the transitional period.

2. Empowering Investors to Protect Themselves

2.1 Disclosure of interests in securities (Part XV of the Securities and Futures Ordinance)

In order to make informed investment decisions, investors should have equal and timely access to full and accurate data on the shareholdings of listed companies which is price-sensitive. The international trend is to move to full disclosure of relevant information by the listed corporation, so that investors may take responsibility for themselves in assessing the risks and returns. As such, the SFO tightens the Hong Kong disclosure of interest regime. Those who acquire, or dispose of, an interest in 5% (formerly 10 %) or more of the issued voting

share capital of a listed company would be required to disclose their acquisition or disposal and their new holding to the Stock Exchange within 3 business days (formerly 5 business days). Directors and chief executive officers remain required to disclose any acquisition or disposal of their company's share, irrespective of percentage (ss. 313, 315 & 319). For greater transparency certain disclosure requirements are also extended to securities interests of any kind whatsoever, e.g. purchase of shares, acquisition of a call option, borrowing of shares, interests in unissued shares, interests under equity derivatives.

2.2 Clear statutory private right action against market misconduct (Parts XIII & XIV of the Securities and Futures Ordinance)

Under common law, a person who suffers loss as a result of market misconduct may be able to seek redress through civil action against a person responsible for the misconduct, however, the consequence of which could be costly and riddled with obstacles. The SFO creates a right of civil action in respect of market misconduct for which the aggrieved party can claim compensation for loss and other remedies (ss. 281 (1) & 305 (1)). The availability of the findings of the Hong Kong Market Misconduct Tribunal, criminal charge or conviction is not a must (ss. 281 (5) & (305 (4))), but would be admissible as evidence of market misconduct in private action (ss. 281 (7) – (9) & 305 (6) – (8)).

2.3 Proportionate disciplinary sanction for improper conduct by intermediaries (Part IX of the Securities and Futures Ordinance)

2.3.1 In case that a licensed person engages in any improper conduct, the disciplinary sanctions that the SFC may currently administer are public or private reprimands, and suspension or revocation of the intermediary's registration. Reprimands could be too lenient in many cases, yet suspending or revoking an intermediary's registration might be excessive.

2.3.2 In line with US law and regulations, the SFO gives the SFC two additional sanction options :

- civil fines up to the higher of \$10 million or three times the amount gained or loss avoided ; and
- suspension or revocation of an intermediary's licence in respect of part of its business only (ss. 194 - 196).

2.4 Protection of investors' assets (Part VI of the Securities and Futures Ordinance)

Under the SFO, the SFC is empowered to transfer the custody of investors' property or other business property of an intermediary to an appropriate custodian to avoid dissipation (s. 148). Since basic law protection of private rights of property, the SFC must go to court as soon as reasonably practicable to get court directions.

2.5 Civil liability for false or misleading disclosure to market (Part XVI of the Securities and Futures Ordinance)

Persons disclosing false information to the market would be held liable to pay compensation to others who suffer loss as a result of reliance. In order to strike a balance, the SFO, while creating statutory cause of action, also provides that victim must demonstrate that it is "fair, just and reasonable" to ask for compensation. Meanwhile, suitable defence is given to innocent parties acting in good faith, including the media (s. 391).

3. Minimizing Market Misconduct

3.1 Establishment of Hong Kong Market Misconduct Tribunal ("MMT") (Part XIII of the Securities and Futures Ordinance)

3.1.1 Under current law, market manipulation is a criminal offence. However, in view of sophisticated market practices and techniques, it is difficult to obtain sufficient evidence to prove market manipulation. The SFO builds on the strength of the Insider Dealing Tribunal and expands it into a MMT which would then handle insider dealing and specified market misconduct activities, and would apply the civil standard of proof, i.e. a balance of probabilities in determining whether it is satisfied that cases referred to it have been proved.

3.1.2 A judge of the Court of First Instance, assisted by two market practitioners appointed by the Chief Executive, would chair the MMT (s. 251). It would subsume the work of the Insider Dealing Tribunal. The Financial Secretary would be able to initiate civil proceedings before the MMT. The MMT may :

- order disgorgement of profits plus compound interest thereon;

- order payment of legal costs and investigation expenses;
- issue a “disqualification” order to disqualify a director from being a director of any listed company for a periods of up to five years;
- issue a “cold shoulder” order (i.e. a person is denied access to market facilities) for a period of up to five years;
- issue a “cease and desist” order (i.e. an order not to breach the provisions of Part XIII); and
- refer to relevant professional bodies for possible disciplinary action (ss. 257 - 259).

3.2 Preliminary inquiry into the management of a listed company (Part VIII of the Securities and Futures Ordinance)

- 3.2.1 The SFC, under the current law, is authorized to review the books and records of a listed company or members of its group in the event that there is a likelihood of misconduct in the management of the company. In practice, however, the SFC has only limited power to place the entries in those documents in any meaningful context or to check their veracity.
- 3.2.2 Under the SFO, the SFC is entitled to seek explanations of an entry from the listed company or a member of its group as well as given the power to access the working papers of such company’s auditors. In addition, the SFC may make inquiries of counterparties to transactions that such company has entered into. Nevertheless, to exercise these powers, the SFC must have reasonable cause to believe the working papers relate to the affairs of the company and the grounds for inquiry (s. 179).

3.3 Criminal route to further deter market misconduct (Part XIV of the Securities and Futures Ordinance)

As an alternative to proceedings before the MMT, the SFO provides a criminal route for dealing with market misconduct activities where there is sufficient evidence to meet the criminal standard and it is in the public interest to bring prosecution before the Courts. Due protection consistent with human rights requirements would be afforded to all defendants. The maximum penalty under the criminal route is 10 years’ imprisonment or a fine up to \$10 million (s. 303). The rule against double jeopardy applies as a person cannot be tried in the MMT and the Courts for the same market misconduct.

4. Immunity for Auditors Who Choose to Report Suspected Fraud (Part XVI of the Securities and Futures Ordinance)

The SFO contains provisions to provide auditors of listed companies who report to the SFC any suspected fraud or misconduct in the management of a listed company with statutory immunity from liability under common law (s. 381). The choice to report is on voluntary basis. The SFO intends to give immunity from the threat of civil liability to auditors who choose to report the suspected fraud to the SFC in the course of their auditing work.

5. Regulation of Automated Trading Services in Hong Kong (Part III of the Securities and Futures Ordinance)

Automated Trading Services (“ATS”) is considered as a kind of new trading method which on one hand facilitates the trading of different products in the financial market through computer; on the other hand, raises a number of important regulatory issues which are not adequately addressed in the present regime. Seeing this problem, the SFO requires a person seeking to provide ATS to obtain approval from the SFC. The SFC would then examine the specific characteristics and risks of the ATS to determine the regulatory approach best suited to it. The maximum penalty for a person who provides ATS without the approval of the SFC is a fine up to \$5,000,000 and to imprisonment for 7 years (ss. 95 – 101).

6. Enhanced Transparency in the Professional Investors Markets in Hong Kong (Part III of the Securities and Futures Ordinance)

Persons who act as principals and deal solely with professional investors are not required to be licenced by the SFC. Nevertheless, their activities can have significant impact on the market, and information about them is essential to proper management of systemic risks. The SFO includes large position reporting requirements in the futures and options markets which would bring Hong Kong’s reporting standards compatible with those of other major international financial centre.

7. Joining in Litigation between Third Parties by the SFC (Part XVI of the Securities and Futures Ordinance)

As financial markets and their infrastructure become increasingly complex, the

disputes between private parties are more and more likely to have an impact on the rest of the market system. The SFO gives the SFC locus standi to intervene in proceedings (other than criminal proceedings) between third parties in appropriate cases to provide its regulatory perspective and expert opinion subject to the following safeguards :

- intervention must be in public interest
- parties to the litigation may challenge the intervention,
- court to decide whether and the terms on which SFC may intervene (ss. 385 – 389).

8. Creation of Investor Compensation Company (Parts III and XII of the Securities and Futures Ordinance)

- 8.1 There are currently two compensation schemes – the Unified Exchange Compensation Fund and the Commodities Exchange Compensation Fund. Both rely in part on deposits paid by members of the exchanges and statutory transaction levies. The schemes provide a maximum level of compensation for each broker - \$ 8 million and \$ 2 million for per stockbroker and per futures broker respectively.
- 8.2 The SFO provides a new investor compensation system in Hong Kong to substitute the existing schemes. Contrary to the present per broker limits, the new regime would be based on a per investor compensation limit. This would enable more transparency and allow investors to know precisely what level of compensation would be available to them should their intermediaries fail.
- 8.3 The new regime would be administered by an independent investor compensation company, which would be required to apply prudent principles to managing its funds, inter alia, the possibility of seeking insurance to minimize costs to the industry (ss. 79 – 90).

9. Empanelling of Hong Kong Securities and Futures Appeals Tribunal (Part XI of the Securities and Futures Ordinance)

The SFO implements the proposal of replacing the existing part-time Securities and Futures Appeal Panel with an independent full-time Securities and Futures Appeals Tribunal. A much wider range of decisions would be subject to

appeal to the Tribunal. The Tribunal's job would be to review the SFC's decisions, which have been appealed to it, including almost all licensing-related and disciplinary decisions, and would be made by the person against whom the decision was made, within twenty-one days of notice of the decision (ss. 216 – 229).

10. Formation of Process Review Panel

Ahead of the enactment of the SFO, an independent, non-statutory Process Review Panel has been established with the power to review SFC's compliance with its internal processes, including investigative process and audit their actions to ensure that the SFC has followed their set procedures and given effect to due process. The panel would report its findings to the Financial Secretary. However, it would not be required to publish the entirety of its conclusions because, it cannot generally disclose details of the precise steps that the SFC have taken in the performance of their functions.

11. Subsidiary Legislation

On top of the SFO, a set of subsidiary legislation is to be enacted by government and will come into force at the same time as the SFO. The table below sets out the current process on the subsidiary legislation under the SFO as at 21 August 2002.

<i>Enabling provision in the SFO</i>	<i>Subsidiary Legislation</i>	<i>Consultation Period</i>	<i>Consultation Conclusion Paper</i>
	Part III		
1. Section 25(1)	Draft Securities and Futures (Stock Market Listing) Rules and the Draft Securities and Futures (Transfer of Functions - Stock Exchange Company) Order	06.05.02 - 07.06.02	24.07.02
2. Section 35(1)	Draft Securities and Futures (Contracts Limits and Reportable Positions) Rules	28.03.02 - 16.04.02	19.04.02
3. Section 36(1)	Draft Securities and Futures (Stock Market Listing) Rules and the Draft Securities and Futures (Transfer of Functions -	06.05.02 - 07.06.02	24.07.02

		Stock Exchange Company) Order		
4.	Section 80(1)	Draft Securities and Futures (Stock Market Listing) Rules and the Draft Securities and Futures (Transfer of Functions - Stock Exchange Company) Order	28.03.02 - 25.04.02	05.06.02
		Part V		
5.	Section 116(5)	Draft Securities and Futures (Insurance) Rule	26.06.02 - 25.07.02	
<i>Enabling provision in the SFO</i>	<i>Subsidiary Legislation</i>	<i>Consultation Period</i>	<i>Consultation Conclusion Paper</i>	
6.	Section 118(2)	Draft Securities and Futures (Leveraged Foreign Exchange Trading - Arbitration) Rules	28.03.02 - 16.04.02	19.04.02
7.	Section 145(1)	Draft Securities and Futures (Financial Resources) Rules	14.06.02 - 12.07.02	
8.	Section 148(1)	Draft Securities and Futures (Client Securities) Rules	12.04.01 - 24.05.01	11.07.02
9.	Section 149(1)	Draft Securities and Futures (Client Money) Rules	12.04.01 - 24.05.01	11.07.02
10.	Section 151(1)	Draft Securities and Futures (Keeping of Records) Rules	15.02.02 - 15.03.02	11.07.02
11.	Section 152(1)	Draft Securities and Futures (Contract Notes, Receipts and Statements of Account) Rules	28.09.01 - 09.11.01	06.06.02
12.	Sections 156(1) & 397(1)	Draft Securities and Futures (Accounts and Audit) Rules	21.12.01 - 31.01.02	11.07.02
14.	Sections 165(1) & 397(1)	Draft Securities and Futures (Associated Entities) Rules	22.03.02 - 19.04.02	30.05.02
		Part VII		
15.	Sections 170(3)(e) & 397(1)	Draft Securities and Futures (Short Selling Exemption and Stock Lending) Rules	24.05.02 - 21.06.02	11.07.02
16.	Sections 174(3)(d) & 397(1)	Draft Securities and Futures (Unsolicited Calls - Exclusion) Rules	19.10.01 - 19.11.01	15.03.02

		Part IX		
17.	Sections 194(5) & 397(1)	Draft Securities and Futures (Registration of Disciplinary Orders) Rules	27.03.02 - 24.04.02	05.06.02
18.	Section 233(d)	Draft Securities and Futures (Securities and Futures Appeals Tribunal) Rules		
	<i>Enabling provision in the SFO</i>	<i>Subsidiary Legislation</i>	<i>Consultation Period</i>	<i>Consultation Conclusion Paper</i>
19.	Sections 226 & 233(b)	Draft Securities and Futures (Appeals Tribunal - Registration of Orders) Rules		
20.	Section 234	Draft Securities and Futures (Amendment of Schedule 8) Order	05.08.02 - 26.08.02	
		Part XII		
21.	Section 244(1)	Draft Securities and Futures (Investor Compensation - Levy) Rules	28.03.02 - 25.04.02	05.06.02
22.	Section 244(1)	Draft Securities and Futures (Investor Compensation - Compensation Limits) Rules	28.03.02 - 25.04.02	05.06.02
23.	Section 244(2)	Draft Securities and Futures (Investor Compensation - Claims) Rules	28.03.02 - 25.04.02	05.06.02
		Part XIII		
24.	Sections 264 & 269(b)	Draft Securities and Futures (Market Misconduct Tribunal - Registration of Orders) Rules		
25.	Sections 282(1) & 306(1)	Draft Securities and Futures Market Misconduct (Exemption for Stabilization Activities) Rules	08.02.02 - 08.03.02	09.07.02
		Part XV		
26.	Section 376(1)(b)	Draft Securities and Futures (Disclosure of Interests - Exclusions) Regulations	16.05.02 - 08.06.02	12.07.02
27.	Section 377	Draft Securities and Futures	19.12.01 -	12.07.02

		(Disclosure of Interests - Securities Borrowing and Lending) Rules	26.01.02	
		Part VI		
28.	Section 393	Draft Securities and Futures (Gold Purchase) Notice	25.03.02 - 22.04.02	03.06.02

	<i>Enabling provision in the SFO</i>	<i>Subsidiary Legislation</i>	<i>Consultation Period</i>	<i>Consultation Conclusion Paper</i>
29.	Section 394(1)	Draft Securities and Futures (Levy) Order	03.04.02 - 30.04.02	05.06.02
30.	Section 394(5)	Draft Securities and Futures (Levy) Rules	03.04.02 - 30.04.02	05.06.02
31.	Section 395	Draft Securities and Futures (Fees) Rules	30.07.02 - 24.08.02	
		- Proposed Licensing Fees under the Securities and Futures (Fees) Rules	08.03.02 - 08.04.02	30.07.02
32.	Section 397	Draft Securities and Futures (Intermediary Information) Rules	19.07.02 - 08.08.02	
33.	Sections 397 & 173	Draft Securities and Futures (Miscellaneous) Rules	02.07.02 - 26.07.02	
34.	Section 398(6)	Draft Securities and Futures (Offences and Penalties) Regulations	26.07.02 - 16.08.02	
35.	Section 397(1)	Draft Securities and Futures Licensed Persons and Registered Institutions) Rules	16.11.01 - 17.12.01	18.04.02
36.	Section 397(1)	Draft Securities and Futures (Leveraged Foreign Exchange Trading - Exemption) Rules	05.06.02- 26.06.02	11.07.02
37.	Section 397(1)	Draft Securities and Futures (Professional Investor) Rules	01.02.02 - 28.02.02	04.06.02
38.	Section 397(1)	Draft Securities and Futures (Recognized Counter-party) Rules	30.11.01 - 29.12.01	23.04.02

39.	Section 397(1)	Draft Securities and Futures (Corporation) Rules		
40.	Section 397(1)	Draft Securities and Futures (Information) Rules	19.03.02 - 16.04.02	19.04.02

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