



Hong Kong

May 2017

BACKDOOR LICENSING, MANAGERS-IN-CHARGE OF CORE FUNCTIONS AND THE LEGAL LIABILITIES OF SENIOR MANAGEMENT

According to the Securities and Futures Commission (the **SFC**), purchasers who are willing to pay a premium for an existing licensed corporation as a “backdoor licence” may not be able to avoid the responsibilities and liabilities as anyone involved in the management of licensed corporations is liable for breaches, and the SFC may exercise its disciplinary powers to sanction them.

The SFC is of the view that senior management of a licensed corporation includes, among others:

- a) directors of the corporation;
- b) Responsible Officers (**ROs**) of the corporation; and
- c) Managers-In-Charge of Core Functions (**MICs**).

The SFC implemented the MICs regime on 18 April 2017. The deadline for licensed corporations to submit their MICs information and their organisational charts is 17 July 2017 and the deadline to submit applications to the SFC for MICs who are required to be licensed as ROs is 16 October 2017.

“Backdoor Licensing”

Ms. Julia Leung, Executive Director of the SFC, gave a [speech on the SFC’s supervisory strategy in a time of change](#) on 4 May 2017. In that speech, Ms. Leung described an increasing number of individuals from Mainland China, with no prior experience in the Hong Kong securities industry, who are looking to set up or acquire brokers and asset managers in Hong Kong. Ms. Leung stated: “Some firms whose businesses

are small and dormant are being offered for sale in the market for several million dollars. The price tag comes with two individuals who are paid tens of thousands per month simply for being responsible officers (**ROs**) in name only without having to report for duty at the office.”

Ms. Leung also continued to say that: “The unlicensed individuals who control the licensed corporation might think that they can manage the firms without having to bear the consequences of their action. This is misguided, as anyone involved in the management of licensed corporations is liable for breaches, and the SFC may exercise its disciplinary powers to sanction them. The SFC may revoke the licences of corporations and these ROs for hire who do not genuinely carry on a business of a regulated activity.”

The phenomenon mentioned above reflects that the purchasers may be willing to pay a premium for an existing licensed corporation as a “backdoor licence” either:

- a) to avoid some of the time and costs involved in applying for a new licence, or
- b) because they are concerned that they may not meet the qualifying criteria to obtain a licence themselves, or
- c) because they wish to avoid the responsibilities and potential liabilities attaching to the licensed persons, in particular, ROs.

However, as indicated in the Ms. Leung's speech, the purchasers may not be able to avoid the responsibilities and liabilities as anyone involved in the management of licensed corporations is liable for breaches, and the SFC may exercise its disciplinary powers to sanction them.

Meaning of "Senior Management"

The SFC issued a [circular to licensed corporations regarding measures for augmenting the accountability of senior management](#) dated 16 December 2016 (the **Circular**) with the aims to:

- a) articulate the SFC's view as to who should be regarded as members of senior management of licensed corporations;
- b) promote awareness of the regulatory obligations and potential liabilities of senior management
- c) express the SFC's general expectation that certain members of senior management should seek the SFC's approval to be ROs;
- d) outline certain roles and responsibilities of a licensed corporation's board of directors (the **Board**); and
- e) provide more guidance as to the information a licensed corporation (or corporate applicant for a licence) should submit in respect of its human resources and organisational structure.

According to the Circular, the SFC is of the view that senior management of a licensed corporation includes, among others:

- a) directors of the corporation;
- b) ROs of the corporation; and
- c) MICs.

These three categories are not mutually exclusive. For instance, an individual can simultaneously be a director, RO and MIC of a licensed corporation.

Directors

The term "director" is defined in Schedule 1 to the Securities and Futures Ordinance (Cap 571 of the Laws of Hong Kong) (the **SFO**) to include a shadow director and any person occupying the position of director by whatever name called. "Shadow director" is defined in the SFO to mean a person in accordance with whose direction or instructions the directors or of a corporation are accustomed or obliged to act, but a person shall not be regarded as a shadow director by reason only of the fact that the directors act on advice given by him in a professional capacity.

ROs

An RO is a licensed representative who is also approved as an RO under section 126 of the SFO to supervise the regulated activity of the licensed corporation to which he is accredited.

MICs

According to the Circular, MIC refers to an individual appointed by a licensed corporation to be principally responsible, either alone or with others, for managing any of the following functions of the corporation (referred to as Core Functions):

- i) Overall Management Oversight
- ii) Key Business Line
- iii) Operational Control and Review
- iv) Risk Management
- v) Finance and Accounting
- vi) Information Technology
- vii) Compliance
- viii) Anti-Money Laundering and Counter-Terrorist Financing

For a detailed explanation of the Core Functions, please refer to the [annex to this newsletter](#).

In determining whether an individual is an MIC of a particular Core Function, a licensed corporation should take into account the apparent or actual authority of that individual in relation to

that Core Function. For example, an individual may be an MIC of a particular Core Function if he or she has one or more of the following attributes:

- a) occupies a position within the corporation which is of sufficient authority to enable the individual to exert a significant influence on the conduct of that Core Function;
- b) has authority to make decisions (e.g., assume business risks within pre-set parameters or limits) for that Core Function;
- c) has authority to allocate resources or incur expenditures in connection with the particular department, division or functional unit carrying on that Core Function; and
- d) has authority to represent the particular department, division or functional unit carrying on that Core Function, e.g., in senior management meetings or in meetings with outside parties.

A licensed corporation should also take into account an individual's seniority. In this regard, the SFC generally expects that an MIC should:

- a) report directly to the Board of the corporation, or to the MIC who assumes the Overall Management Oversight function of the corporation; and
- b) be accountable for the performance or achievement of business objectives set by the Board, or by the MIC who assumes the Overall Management Oversight function.

MICs are not necessarily employees of the licensed corporation. However, they hold positions of authority within the licensed corporation, so they are not external parties merely providing outsourced services. They may be located in Hong Kong or overseas. Depending on the particular functions they perform in relation to the business of the corporation, they may or may not be licensed under the SFO.

However, the SFC generally expects that MICs of the Overall Management Oversight function and the Key Business Line function should be ROs in respect of the regulated activities they oversee. This is because, in most cases, MICs of these Core Functions actively participate in or are responsible for directly supervising the business of the regulated activities.

Nonetheless, the SFC does not expect MICs of Core Functions other than these two to be ROs, nor does the SFC require every RO to be an MIC.

According to Annex 1 to the Circular, the Overall Management Oversight function means a function responsible for directing and overseeing the effective management of the overall operations of the corporation on a day-to-day basis. The key responsibilities may include:

- a) developing the corporation's business model and associated objectives, strategies, organisational structure, controls and policies;
- b) developing and promoting sound corporate governance practices, culture and ethics;
- c) executing and monitoring the implementation of business objectives, strategies and plans approved by the Board, and the effectiveness of the organisational structure and controls.

Examples of MICs of this function are the Chief Executive Officer and the President.

The Key Business Line function is a function responsible for directing and overseeing a line of business which comprises one or more types of regulated activities. Examples of MICs of this function are the Chief Investment Officer, Head of Equity, Head of Corporate Finance, Chief Rating Analyst and Head of Fund Marketing.

Timeline of the MICs Regime

18 April 2017	The SFC started to accept MICs information and organisational charts from all licensed corporations and new corporate licence applicants.
17 July 2017	Deadline for licensed corporations to submit MICs information and organisational charts via the SFC Online Portal

16 October 2017	Deadline to submit applications to the SFC for MICs who are required to be licensed as ROs
-----------------	--

The SFC requires existing licensed corporations to submit their MICs information and their organisational charts via the SFC Online Portal. Any subsequent changes should also be submitted to the SFC via the SFC Online Portal.

Details in relation to the MICs information that is required to be submitted to the SFC on or before 17 July 2017 can be found in section G: Roles and responsibilities of the Board and section H: Submission of management structure information of the Circular.

A licensed corporation should notify the SFC of any changes in its appointment of MICs (including any new appointment and cessation of appointment) or any changes in the particulars of its MICs within seven business days of the changes.

The Board of a licensed corporation or a corporate licence applicant should ensure that the information submitted to the SFC is complete and accurate. Under section 383 or 384 of the SFO, a person may commit an offence if he or she provides false or misleading information in support of a licence application or in relation to a notification (as the case may be).

Analysis of the MICs Regime

Unless the individual new owners intend to be passive investors, they or their representatives will need to apply to be licensed with the SFC if they become involved in the regulated activities of the licensed corporation. Further, if they or their representatives are the MICs of the Overall Management Oversight function and/or the Key Business Line function, they are required to be approved as ROs, regardless of whether they are appointed as directors.

In considering whether an RO applicant (who is or will be an MIC of the Overall Management Oversight function) meets the industry experience tests set out in the SFC's Guidelines on Competence, the SFC takes into account, among other things, the applicant's overall career history within the industry, as well as his or her proposed activities and the resources (including system and expertise) available to the licensed corporation in totality.

An applicant who has held a senior position to manage a control or operational function (e.g., risk management, compliance, financial or operational control) for a long time may be approved as an RO subject to appropriate licensing conditions, even if he or she has not had any experience in conducting or directly supervising the regulated activity. Typically in this situation, a licensing condition may be imposed to the effect that he or she should work together with another RO who is fully competent. After accumulating sufficient experience in the regulated activity, he or she may apply for waiving the licensing condition under section 134(1) of the SFO.

The SFC will consider every RO application or waiver application based on the specific facts of the case. In any event, the directors, ROs and MICs are members of senior management and they have legal liabilities for the conduct of the licensed corporation concerned.

Legal Liabilities of Senior Management

Under Part IX of the SFO, the SFC may exercise its disciplinary powers to sanction a regulated person if the person is, or was at any time, guilty of misconduct or is considered not fit and proper to be or to remain the same type of regulated person. The term "regulated person" means a person who is or at the relevant time was any of the following types of person:-

- a) a licensed person;
- b) an RO of a licensed corporation; or
- c) a person involved in the management of the business of a licensed corporation (regardless of whether he or she is licensed).

According to the Circular, all members of the senior management of a licensed corporation are regulated persons even if they are not licensed, because of their involvement in the management of the licensed corporation's business. As mentioned above, the SFC is of the view that senior management of a licensed corporation includes its directors, ROs and MICs.

Where a licensed corporation is (or was) guilty of misconduct as a result of the commission of any conduct occurring with the consent or connivance of, or attributable to any neglect on the part of, a person involved in the management of the business of the licensed corporation, then that person is also guilty of misconduct (section 193(2) of the SFO). As members of the senior management of a licensed corporation, they "should bear the primary responsibility for ensuring the maintenance

of appropriate standards of conduct and adherence to proper procedures by the firm” ([General Principle 9 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission](#)). These persons, including directors, ROs and MICs, are legally liable for the misconduct of the licensed corporation and the SFC has the power to take disciplinary actions against them.

The SFC to Enforce Senior Management Accountability

In the [May 2017 issue of its Enforcement Reporter newsletter](#), the SFC stated that they would continue to use all their enforcement powers under the SFO to ensure that directors and senior executives are held accountable for their actions. As part of the SFC’s new enforcement approach, they have formed specialised teams to help them work as efficiently and effectively as possible and to deliver enforcement outcomes when they are still relevant. Accordingly, senior management of licensed corporations should be well aware of their legal liabilities and that they will be held accountable and liable for any breaches and/or misconduct of the licensed corporations by the SFC.

ANNEX

“Core Functions”, in relation to a licensed corporation, comprise the following eight functions:

Core Function	Description
Overall Management Oversight	<p>A function responsible for directing and overseeing the effective management of the overall operations of the corporation on a day-to-day basis</p> <p>Key responsibilities may include:</p> <ul style="list-style-type: none"> • Developing the corporation’s business model and associated objectives, strategies, organisational structure, controls and policies; • Developing and promoting sound corporate governance practices, culture and ethics; • Executing and monitoring the implementation of Board-approved business objectives, strategies and plans, and the effectiveness of the organisational structure and controls. <p>Example#: Chief Executive Officer, President</p>
Key Business Line	<p>A function responsible for directing and overseeing a line of business which comprises one or more types of regulated activities</p> <p>Example#: Chief Investment Officer, Head of Equity, Head of Corporate Finance, Chief Rating Analyst, Head of Fund Marketing</p>

Operational and Review	<p>Control</p> <p>A function responsible for:</p> <ul style="list-style-type: none"> • Establishing and maintaining adequate and effective systems of controls over the corporation's operations; • Reviewing the adherence to, and the adequacy and effectiveness of, the corporation's internal control systems <p>Example#: Chief Operating Officer, Head of Operations, Head of Internal Audit</p>
Risk Management	<p>A function responsible for the identification, assessment, monitoring and reporting of risks arising from the corporation's operations</p> <p>Example#: Chief Risk Officer, Head of Risk Management</p>
Finance and Accounting	<p>A function responsible for ensuring the timely and accurate financial reporting and analyses of the operational results and financial positions of the corporation</p> <p>Example#: Chief Finance Officer, Financial Controller, Finance Director</p>
Information Technology	<p>A function responsible for the design, development, operation and maintenance of the computer systems of the corporation</p> <p>Example#: Chief Information Officer, Head of Information Technology</p>

Compliance	<p>A function responsible for:</p> <ul style="list-style-type: none">• Setting the policies and procedures for adherence to legal and regulatory requirements in the jurisdiction(s) where the corporation operates;• Monitoring the corporation's compliance with the established policies and procedures;• Reporting on compliance matters to the Board and senior management <p>Example#: Chief Compliance Officer, Head of Legal and Compliance</p>
Anti-Money Laundering and Counter-Terrorist Financing	<p>A function responsible for establishing and maintaining internal control procedures to safeguard the corporation against involvement in money laundering activities or terrorist financing</p> <p>Example#: Head of Financial Crime Prevention, Head of Compliance</p>

These examples of job titles are for illustration only and are not exhaustive. A licensed corporation is not required to appoint MICs bearing the same job titles. However, there should be at least one individual to manage each Core Function as described in the table, and the licensed corporation may adopt any job title relevant to that MIC's position and duties as it considers appropriate.

CHARLTONS

Best Boutique Firm 2016

Asian Legal Business Awards

This newsletter is for information purposes only.

Its contents do not constitute legal advice and it should not be regarded as a substitute for detailed advice in individual cases.

Transmission of this information is not intended to create and receipt does not constitute a lawyer-client relationship between Charltons and the user or browser.

Charltons is not responsible for any third party content which can be accessed through the website.

If you do not wish to receive this newsletter please let us know by emailing us at unsubscribe@charltonslaw.com

Hong Kong Office

Dominion Centre

12th Floor

43-59 Queen's Road East

Hong Kong

Tel: + (852) 2905 7888

Fax: + (852) 2854 9596

www.charltonslaw.com