

The Securities and Futures Ordinance and the Banking (Amendment) Ordinance 2002

by the Banking Development Department

The Securities and Futures Ordinance (SFO) and the Banking (Amendment) Ordinance 2002 came into operation on 1 April 2003. Most of the rules, guidelines and codes issued by the Securities and Futures Commission (SFC) under the SFO are applicable to the conduct of regulated activities by authorized institutions (AIs) that are registered (or deemed to have been registered during the two-year transitional period) with the SFC. The HKMA has also issued the Supervisory Policy Manual module SB-1 "Supervision of Regulated Activities of SFC-Registered Authorized Institutions". This module, which is a statutory guideline, sets out the HKMA's supervisory approach towards the regulated activities of registered institutions (RIs).

This memo seeks to provide guidance to RIs in respect of some frequently raised questions. For enquiries, RIs should contact the HKMA.

Staff Marketing Mandatory Provident Fund (MPF) Schemes or Investment-linked Insurance Products

Q1. Is an RI staff engaging in the marketing of investment-linked insurance products or MPF schemes considered to be giving advice on securities or dealing in securities (Type 4 and Type 1 regulated activity respectively)? If so, does it mean that details of the staff need to be entered in the HKMA register as a relevant individual?

A1. A staff of an RI who is engaged merely in the marketing of investment-linked insurance products or MPF schemes without entering into any discussion on the underlying securities will not be considered as engaging in "dealing in securities" or "advising on securities". The staff may also pass on certain factual information such as the composition of the product, e.g. the proportion of equity against bond and allocation of assets to different geographical markets,

without being considered as discussing the underlying securities.

However, under the SFO, the definition of "dealing in securities" covers making, or offering to make, an agreement with another person, or inducing or attempting to induce another person to enter into or to offer to enter into an agreement in respect of securities. In this context, whenever an RI staff enters into a discussion with a customer on the underlying securities in the process of marketing investment-linked insurance products or MPF schemes, it is hard to establish that the staff is not at least "attempting to induce" the customer to enter into an agreement in respect of securities. This is the case even when the staff concerned is not involved in "taking orders" from the customer.

Looking at this from a practical perspective, it could easily be argued that the staff is giving advice to the customer on the underlying securities. For instance, in the process of marketing investment-linked insurance products

or MPF schemes, the explanation to the customer would very often cover certain concrete details (such as the pros and cons, or the past performance) of individual markets and/or specific securities (such as investment funds) included in the products or schemes. In fact, since the prospectuses for these products usually contain information on such individual markets and specific securities, both the HKMA and the SFC consider that in practice it is very difficult for the marketing staff to refrain from discussing and answering the customer's questions in this regard.

In view of this, it is considered that not registering such a marketing staff as a relevant individual is the exception, which should be justified by the RI concerned. The institution has to satisfy the HKMA that it has very stringent internal controls and effective segregation of duties so that only relevant individuals may enter into any discussion with customers regarding the underlying securities.

The SFC also adopts the same approach.

Prohibitions on Unsolicited Calls under Section 174 of the SFO

Q2. In the course of introducing the services available under a composite account to a general banking customer, or a potential customer, it is natural for a marketing staff of an RI to mention the securities dealing services available under the composite account (i.e. as a sub-account for securities transactions). Is this practice prohibited under section 174 of the SFO?

A2. Pure explanation of the list of services available under composite accounts, probably with pre-set marketing script, is not prohibited under section 174 of the SFO. This may be done by a staff who is not a relevant individual.

RIs should however observe the following:

- (a) they should not unilaterally open a securities sub-account under the composite account for a client without the latter's request;
- (b) if the customer concerned is not an "existing client" as defined in the SFO, the staff should not take any initiative to promote securities or futures products and services unless and until that customer takes the initiative to indicate an interest in taking up the relevant products or services of the RI; and
- (c) even if the customer takes the initiative to indicate such interest, only relevant individuals may be involved in the explanation of these products and services.

"Financial Accommodation" under the Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules

Q3. What types of RIs' lending activities will be regarded as "financial accommodation" for the purpose of section 8 of the Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules?

A3. RIs' normal lending activities, e.g. overdraft facilities or general banking facilities secured by securities as well as financing acquisitions under initial public offerings, are not considered to be "financial accommodation" for the purposes of the Rules as they do not relate to any regulated activity. Securities margin financing conducted by RIs is not a regulated activity by definition and is also not covered by the Rules.

“Securities Collateral” under the Securities and Futures (Client Securities) Rules

Q4. Under what circumstances will securities pledged by a client to an RI constitute “securities collateral” for the purposes of the Securities and Futures (Client Securities) Rules?

A4. Generally speaking the Rules do not aim to capture the ordinary lending business of an RI, and so securities pledged by clients to secure the provision of credit facilities for general purpose will not constitute “securities collateral”. Having said that, it is necessary for an RI to review its lending operations and seek legal advice, where necessary, to ascertain whether it holds or receives “securities collateral”.

Duty to Notify the HKMA of Breach of Statutory Requirements by an RI’s Associated Entity

Q5. According to subsection 5.3 of the Supervisory Policy Manual module SB-1 “Supervision of Regulated Activities of SFC-Registered Authorized Institutions”, every RI should notify the HKMA as soon as practicable of a breach of any provision of the SFO by its associated entity. However, if the associated entity is, in itself, an intermediary, it is already subject to statutory reporting requirements for breaches of the SFO. In such case, is the RI still required to report breaches of the associated entity? If the associated entity is an AI, will a single notification to the HKMA representing a report from both the associated entity and the relevant RI be acceptable?

A5. Since an associated entity holds/receives the client assets of an RI, the RI should be aware of the associated entity's breach of the applicable

statutory requirements in this regard. On this basis, the HKMA expects an RI to report any breach of the following statutory requirements by its associated entity:

- those provisions of the SFO (including the subsidiary legislation) that are specifically applicable to associated entities only; or
- those provisions that are applicable to both intermediaries and associated entities, and the breach is against requirements relating to the receiving or holding in Hong Kong of the client assets of the RI.

When the associated entity is itself an RI, it is acceptable that either one of the institutions files the notification of breach to the HKMA, so long as the notification sets out clearly the breach, the relevant institutions concerned and their respective capacity under the SFO. There should also be evidence that the other institution is aware of the notification made on its behalf, e.g. the notification to the HKMA is copied to it.

The Guidelines on Competence Issued by the SFC

Q6. Since RIs have a legal obligation to ensure that their relevant individuals meet the competence requirements prescribed by the SFC, can the HKMA provide specific guidance on the practical interpretation?

A6. The general principle is set out in paragraph 2.6 of the Guidelines on Competence, which states that for paragraphs 5.1 to 7.6, and Appendices D and E, unless otherwise stated, regarding the SFC's requirements and procedures for an individual to demonstrate compliance with a certain requirement or seek exemption; or a corporation to provide an undertaking,

(a) the HKMA will adopt the same requirements and procedures for an executive officer of an RI; and

(b) for other relevant individuals, the RI concerned has to ensure that such individuals comply with the corresponding requirements, and sufficient records (with supporting documents, where applicable) on how these requirements are satisfied should be maintained and made available for inspection upon request from the HKMA. While an RI does not have to provide an

undertaking to the HKMA in relation to a relevant individual (other than an executive officer) seeking exemption from initial competence requirements, it will be held responsible for ensuring that the required actions covered under such undertaking are taken in the required manner.

Along these lines, specific guidance on the practical applications of some particular provisions of the Guidelines on Competence (as they apply to relevant individuals who are not executive officers) is provided below.

Relevant part of the Guidelines on Competence	Practical implications for RIs' relevant individuals (other than executive officers)
<p>Section 6. Points to Note</p> <p>Paragraph 6.2</p>	<p>A six-month grace period is allowed for a relevant individual who has yet to pass the local regulatory framework paper, but has otherwise satisfied the initial competence test. In respect of these individuals, the relevant RI is responsible for:</p> <ul style="list-style-type: none"> (a) ensuring such individuals have met all other requirements under the SFC Fit and Proper Guidelines; (b) keeping proper records indicating that such individuals are subject to the six-month grace period; and (c) ensuring that the records are under regular and independent review (which may be performed by internal audit or compliance personnel) and that prompt action is taken to remove an individual from the HKMA public register if that individual cannot obtain a pass in the local regulatory framework paper by the end of the six-month grace period.
<p>Section 7. Exemptions from the Recognized Industry Qualification and Local Regulatory Framework Paper Requirements</p> <p>Paragraphs 7.4 to 7.6</p>	<p>The relevant RI has the duty to ensure that the individual does not enjoy any exemption from obtaining a recognized industry qualification or passing a local regulatory framework paper unless the exemption is in line with the criteria set out in Appendix D or E (whichever is applicable). RIs should maintain sufficient records and supporting documents on how an exemption for a relevant individual complies with these requirements.</p> <p>RIs generally should not seek to allow a relevant individual to enjoy exemption from both the recognized industry qualification and the local regulatory paper requirements.</p> <p>The concept of "non-transferrable" exemption also applies to relevant individuals. The individual may be required to obtain a relevant industry qualification or pass a recognized local regulatory framework paper if there are changes to the individual's role or to the RI engaging the individual in regulated activities. The specific requirements are set out in Appendix C.</p>

Relevant part of the Guidelines on Competence	Practical implications for RIs' relevant individuals (other than executive officers)
Appendix D and Appendix E I. Full Exemption	<p>For the purposes of (2) in both appendices, "relevant individual" (whether an executive officer or not) also includes an individual who has benefited from the "grandfather" arrangements as prescribed in section 4.2 of the HKMA Supervisory Policy Manual module SB-1 "Supervision of Regulated Activities of SFC-Registered Authorized Institutions".</p>
Appendix D II. Conditional Exemption	<p>RIs should not allow any individual, who is to be engaged as a relevant individual, to enjoy exemption from taking the recognized industry qualification, unless the individual can obtain full exemption by satisfying criterion (1) or (2) specified in this appendix.</p> <p>Only under very exceptional circumstances will an individual who has five years' related experience over the past eight years and is now to be engaged in regulated activities with different competence requirements, but in the same role, be considered eligible to obtain conditional exemption from taking the recognized industry qualification. The individual is required to complete an additional five CPT hours in industry/product knowledge in respect of the new regulated activity which may be taken:</p> <ul style="list-style-type: none"> (a) within six months preceding the conditional exemption; or (b) within 12 months after the conditional exemption. <p>The HKMA may impose restrictions on the scope of activities to be undertaken by the individual or any other condition deemed necessary.</p>
Appendix E II. Conditional Exemption Paragraph (6)	<p>The relevant RI should ensure the criteria specified in (6)(a), (b), (c) and (d) have been fully satisfied before allowing an individual to be exempt from taking the local regulatory framework paper. There should be proper records to provide an audit trail for such exemption. It is also responsible for ensuring that the individual completes an additional five CPT hours in regulatory knowledge in the new regulated activity (either within the preceding six months or within 12 months after the exemption) and keeping proper records on how the additional CPT requirement has been complied with.</p> <p>Whenever a relevant individual changes employment, or takes up new regulated functions with the current employer, the RI concerned should ensure that the individual is competent for the purpose. In other words, if the situation has changed and the individual no longer meets all the requirements, that individual should cease to enjoy the previous exemption, i.e. the individual has to obtain a pass in the local regulatory framework paper.</p> <p>The RI should maintain records on the name of the designated person¹ (who should be an executive officer for the same regulated activity). There may be different designated persons with regard to different individuals enjoying exemption.</p>

¹ According to paragraph 6(c) of Appendix E, the corporation should have at least one approved responsible officer who is licensed in the relevant regulated activity, and would be directly reporting or otherwise responsible for advising the individual as well as supervising the daily operations of the regulated activity. This approved responsible officer should be designated by name to the SFC.

Relevant part of the Guidelines on Competence	Practical implications for RIs' relevant individuals (other than executive officers)
	<p>While an RI will not be required to provide specific undertakings for allowing an individual to enjoy exemption, it needs to have:</p> <ul style="list-style-type: none"> (a) suitably qualified back office staff (including finance, compliance, and audit staff); and (b) a system in place to maintain updated records on all relevant information supporting how each individual who enjoys exemption satisfies the requirements.

Reminder: Caution Against Unlicensed Persons

Before providing banking facilities to, or using the intermediary services of, any entity that purports to be providing investment services in Hong Kong, an AI should check whether the corporation is an intermediary (i.e. a licensed corporation or a registered institution) from the SFC public register at www.hksfc.org.hk.

A further protective measure is to check against the SFC's Investor Alert List at the same website. This is a list of unlicensed overseas companies that have come to the attention of the SFC. Most of these companies either represent themselves as having operations in Hong Kong by using the address of a mail forwarding facility or settle their transactions through a bank account in Hong Kong, when in fact they do not have any actual operations here. Alternatively, they may operate from overseas and contact potential investors in Hong Kong whilst not having been licensed in Hong Kong.