

18 SEP 1965

"THE FIT AND PROPER CRITERIA -
A CONSULTATIVE DOCUMENT"

SECURITIES AND FUTURES COMMISSION

Edited on 11/1/89

Dear Sirs

"THE FIT AND PROPER CRITERIA -
A CONSULTATIVE DOCUMENT"

The attached document is a guide to the way in which the SFC proposes to interpret the fit and proper criteria contained in the legislation that it administers. It is hoped that it will be of assistance to would-be applicants for registration and persons already registered under the Securities Ordinance and the Commodities Trading Ordinance.

In drafting the document, we have striven for simplicity and clarity, and have endeavoured to avoid legalistic language wherever possible. We have approached the preparation of the document in this way as we believe that the first priority must be to help would-be registrants and registered persons to understand the matters of importance to the SFC in administering the registration requirements.

It should be noted that the document does not limit the discretion of the SFC in the exercise of its functions. It is issued for guidance only.

After a short introduction, the document addresses two issues:

- (a) the matters that the SFC will take into account in considering the fitness and properness of applicants for registration; and
- (b) the matters that the SFC will take into account in reviewing the on-going fitness and properness of registered persons. In due course, the SFC will supplement this part of the document with Codes of Conduct on best market practices. These will set out matters specific to particular market segments that the SFC will also take into account in reviewing the on-going fitness and properness of registered persons in those industry segments. Such Codes of Conduct will also be released as consultative documents before they are finally adopted by the SFC.

The Commission would be grateful for your comments on the attached document. Comments should be sent to the Commission Secretary at 38/F, 2 Exchange Square, by 18 November 1989.

Yours sincerely

THE FIT AND PROPER CRITERIA

INTRODUCTION

1. In most securities and futures markets throughout the world intermediaries and advisers are required to be authorised by a regulatory authority. This requirement arises from the need for market participants generally, and investors in particular, to have confidence that the people and organisations with whom they deal are efficient, honest and financially sound, and will treat them fairly.

2. Since 1974, securities dealers, investment advisers and their respective representatives in Hong Kong have been required to be registered. Commodity dealers, commodity trading advisers and their respective representatives have been subject to a registration requirement since 1977.

3. Until the recent introduction of the Securities and Futures Commission Ordinance, persons wishing to be registered under Part VI of the Securities Ordinance had to meet the following criteria: at least 21 years of age, mentally sound, not a bankrupt, no previous record of conviction that cast doubt upon their fitness and properness to be registered, and otherwise fit and proper to be registered. (The term fit and proper was not defined.) An applicant for registration as a dealer also had to have sufficient qualifications or experience, be of good character and integrity, and have the ability to comply with certain capital requirements. Most of the above criteria applied under the Commodities Trading Ordinance.

4. The Securities and Futures Commission Ordinance, which was enacted in April this year, substantially recast and strengthened the requirements for registration under both the Securities Ordinance and the Commodities Trading Ordinance.

5. In the first place, section 23 of the Securities and Futures Commission Ordinance lists a number of matters that the SFC shall take into account in considering whether a person is fit and proper to be registered, viz.,

- (a) financial status;
- (b) educational or other qualifications or experience having regard to the nature of the functions to be performed;
- (c) ability to perform such functions efficiently, honestly and fairly; and
- (d) reputation, character, financial integrity and reliability.

6. In the second place, the SFC Ordinance empowers the SFC, in considering the fitness and properness of a corporate applicant, to look through to the fitness and properness of the substantial shareholders, directors and officers of the company and of other companies in the same group.

7. Finally, the basis on which applications are assessed has been changed fundamentally. Under the old system, the Commissioner was obliged to register an applicant unless he believed that the person was not fit and proper. However, under the new system, the SFC is obliged to refuse an application if the applicant does not satisfy it that he is a fit and proper person to be so registered. Thus, the new arrangements transfer the onus to applicants to make out a case that they are fit and proper to be registered to deal in securities or futures contracts, to provide advice on investments or futures contracts, or to act as representatives of persons who do those things.

8. The revised registration requirements came into effect on 1 May 1989.

FIT AND PROPER TEST

9. Although "fit and proper" now represents the overall "umbrella" test for registration, applicants will still have to satisfy the SFC that they meet the application requirements under the Securities Ordinance or the Commodities Trading Ordinance, which remain basically unchanged.

10. Some of these requirements affect all applicants whilst others affect only dealers. For example, an individual cannot be registered as a securities dealer unless he has sufficient qualifications or experience in dealing in securities - also a person cannot be registered as a securities dealer unless he has a net capital of not less than HK\$1 million in the case of an individual and HK\$5 million in the case of a company.

11. As these requirements ultimately impact on whether the applicant is a fit and proper person to be registered, they have been worked into the criteria for "fit and proper" developed by the Commission to guide SFC staff in their vetting of applications. The criteria set out in the following sections are, therefore, based on the the existing registration requirements in the Securities Ordinance or the Commodities Trading Ordinance as the case may be and reflect the additional registration requirements set out in section 23 of the Securities and Futures Commission Ordinance.

12. It should be noted that the criteria are issued for guidance, and do not constitute an exhaustive list of all matters that the Commission

will consider, nor will the Commission blindly follow the principles set out. Each case will be assessed on its own merits and the application of the criteria will vary from case to case, depending on individual circumstances.

INITIAL ENTRY REQUIREMENTS

13. The Commission is not likely to be satisfied that an applicant is a fit and proper person if, in the case of an individual, a dealing director, or any member of a partnership, the person:

(a) is under 21 years of age;

[This is one of the circumstances in which the SFC may refuse to register under the Securities Ordinance. It is unlikely that a person under 21 will have sufficient maturity and experience to be fit and proper to perform the duties of a licensee.]

(b) is detained under the Mental Health Ordinance;

[Again this is one of the circumstances in which the SFC may refuse to register under the Securities Ordinance.]

(c) was found to be of poor reputation, poor character, lacking in financial integrity and reliability, or dishonest. Instances where the applicant might be regarded as having failed to meet this test are where the person has been (whether in Hong Kong or elsewhere):

(i) found to have acted fraudulently or dishonestly;

(ii) convicted of a criminal offence or is the subject of unresolved criminal charges which are of direct relevance to fitness and properness;

(iii) censured or reprimanded by, or denied/disqualified from membership of, a professional or trade body; or a regulatory licence, registration or similar approval has been refused or revoked;

(iv) disqualified by the Court from being a director;

(v) a substantial shareholder in, or involved in the management of, a corporation that was wound up (otherwise than by voluntary dissolution);

(vi) a substantial shareholder in, or involved in the management of, a corporation which was found guilty of fraud;

(vii) a substantial shareholder in, or involved in the management of, a dealer corporation which has not met all obligations to clients, compensation funds established for the protection of investors, or inter-member guarantee funds;

(viii) found culpable of insider dealing by the Insider Dealing Tribunal or has breached the Code on Takeovers and Mergers or the Code on Unit Trusts and Mutual Funds in Hong Kong or found guilty of similar breaches in other jurisdictions; or

(ix) a substantial shareholder in, or involved in the management of, a corporation that has been found to have committed the acts described in (i), (iii) or (viii) above;

(The weight given to events of the types listed above in considering whether a person is fit and proper to be registered will depend on a number of factors, such as the time since the event, the seriousness of the event, and the category of registration sought.)

(d) is (whether in Hong Kong or elsewhere) an undischarged bankrupt, is currently subject to bankruptcy proceedings or is a bankrupt who has recently been discharged;

[This is one of the circumstances in which the SFC may refuse registration under the Securities Ordinance and Commodities Trading Ordinance. In considering whether to register a bankrupt who has recently been discharged, the Commission would have regard to the circumstances of the discharge. Recency is normally taken to mean within the last 7 years for principals and 3 years for representatives.]

(e) has failed (whether in Hong Kong or elsewhere) to meet any judgement debt;

[This test is related to the person's financial status, integrity and reliability. Again, the Commission would have regard to the circumstances of the failure to meet a judgement debt and the recency of the failure. Recency is normally taken to be the last 7 years for principals and 3 years for representatives.]

(f) appears unable (in the case of a partnership, either any individual partner or the partnership as a discrete entity) to meet on an ongoing basis any financial resource requirements that have been set by the SFC or a self-regulatory body;

[This test is also related to the person's financial means, status and reliability. At present, under the Securities Ordinance, no person may be registered as a dealer unless they are able to comply with the net capital and liquidity margin requirements of section 65B.]

(g) for dealers and advisers, has less than five years relevant experience. However applicants that have attained educational qualifications appropriate to the duties to be performed may be able to establish that shorter appropriate experience justifies registration. Some examples of educational qualifications that will be considered appropriate are:

- (i) an appropriate tertiary qualification - eg in Law, Business, Accounting or Economics - from a reputable institution;
- (ii) successful completion of an appropriate recognised industry based course - such as those run by The Securities Association and the International Stock Exchange of the United Kingdom and Northern Ireland; the examinations conducted under the approval of the Securities and Exchange Commission and the Commodity Futures Trading Commission in the United States, the Diploma Course provided by the Securities Institute of Australia; or the examinations conducted by the Canadian Institute of Securities; the Diploma of the Association of International Bond Dealers; or the Japanese Securities Dealers Association Representative of Public Securities course.

[This criterion in respect of education and experience reflect the SFC's concern that persons registered as dealers and advisers are equipped with the skills necessary to perform their duties.

The Securities Ordinance establishes minimum experience or education requirements of:

- (i) not less than 3 years experience in dealing in securities in Hong Kong or any other stock market recognized by the Commission; or
- (ii) having passed an approved examination (the examinations leading to associate or subscriber membership of the Securities Institute of Australia and for membership of, or registration as a representative or trader with, the International Stock Exchange of the United Kingdom and Northern Ireland are currently the only two types of examination approved.)

The usual experience requirement set out in these guidelines is somewhat higher than the statutory minimum. This is because these guidelines serve a different purpose from the legislation: the legislative provision sets an absolute floor level of prerequisite experience while these guidelines set out the criteria that the SFC will usually adopt in assessing applications; these guidelines set out "average" rather than "minimum" requirements. Especially, the SFC considers it unlikely that persons with no relevant experience can be fit and proper to be registered as dealers.

Although there are no legislative minima for the experience of advisers or commodity dealers, the SFC believes that for futures dealers and securities and futures advisers to be fit and proper to be registered as principals, they must have substantial directly relevant experience.

Relevant tertiary or industry qualifications are not necessary conditions for registration. However, the SFC will require less experience from persons with such qualifications.]

(h) for representatives, has not completed form 5 or its equivalent;

[Although experience is not a prerequisite for registration as a representative, experience in a related field such as banking, or accountancy, or in a broker's back office might compensate for an inability to meet the basic educational requirement of having passed form 5 or its equivalent.]

(i) has not notified the SFC of an acceptable location where all records will be kept;

[This is one of the grounds specified in the Securities Ordinance and Commodities Trading Ordinance in which the SFC may refuse registration for dealers (but not dealing directors), dealing partnerships, investment advisers, investment advisers' partnerships or commodity trading advisers. The SFC places great importance on registered persons having accurate, accessible and secure records.]

(j) has evidenced incompetence, negligence or mismanagement, which may have been indicated by the applicant having been (whether in Hong Kong or elsewhere):

(i) censured or reprimanded by a professional, trade or regulatory body for negligence, incompetence or mismanagement; or

(ii) dismissed or requested to resign from any position or office for negligence, incompetence or mismanagement;

(The weight given to events of the types listed above in considering whether a person is fit and proper to be registered will depend on a number of factors, such as the time since the event, the seriousness of the event, and the category of registration sought.)

[Competence and efficiency are key elements to being fit and proper.]

(k) is unable to exhibit a basic knowledge of the duties of a registered person at interview. For example, although the level of knowledge expected will vary according to the type of registration sought, applicants are expected to be able to display an understanding of:

(i) the general structure of the regulatory framework that would apply to their activities if their application were successful;

(ii) the particular legislative provisions and exchange rules that apply to the functions that they would perform if registered;

(iii) any obligations imposed by those provisions and rules; and

(iv) the fiduciary obligations owed to clients and the general obligations owed to employers.

[An understanding of these matters is essential if an applicant is to perform the functions of a registered person efficiently, honestly and fairly.]

14. In the case of a corporation, the Commission is not likely to be satisfied that the applicant is fit and proper if the corporation:

- (a) is subject to receivership, administration, liquidation or other similar proceedings;
- (b) has failed (whether in Hong Kong or elsewhere) to meet any judgement debt;

[These are requirements aimed at culling out corporations of dubious financial status, integrity and reliability. As with the same requirements in respect of individuals, the Commission would have regard to the circumstances of the failure to meet a judgement debt and the recency of the act. Recency is normally taken to be 7 years in this context.]

- (c) appears unable to meet financial resources requirements on an on-going basis;

[The financial soundness and viability of registered persons is of great importance to the SFC.]

- (d) has non-dealing directors that fail to meet the requirements set out above for individuals (other than those relating to education and experience);
- (e) has key management, substantial shareholders or other controllers that fail to meet the requirements set out above for individuals (other than those relating to education and experience);

[The SFC believes that all persons involved in the management or control of dealers and advisers must be honest, and of good character, reputation and financial integrity and reliability.]

- (f) has not notified the SFC of an acceptable location where all records will be kept; or

[This is one of the grounds in which the SFC may refuse registration under the Securities Ordinance and the Commodities Trading Ordinance as amended by the Securities & Futures Commission Ordinance. As noted above, the SFC places great importance on registered persons having accurate, accessible and secure records.]

- (g) has key personnel (e.g. dealing directors, other controllers or representatives) that are required to be registered but are not.

[This is a statutory requirement.]

15. In the case of all persons (individuals and corporations), the Commission is not likely to be satisfied that the applicant is fit and proper if the organizational structure and operating systems:

- (a) are incompatible with legislative or other regulatory requirements;
- (b) are inadequate to enable the applicant to comply with legislative or other regulatory requirements; or
- (c) create, or do not provide clear mechanisms to avoid, conflicts of interest.

[The reasons for the first two of these requirements are obvious; the third is essential for investor confidence in the independence of the advisers and dealers. All are related to the ability of registrants to perform their functions efficiently, honestly and fairly.]

16. Although different businesses obviously need to be structured differently to take account of their own particular functions, size and culture, and operating systems will vary for similar reasons, there are some matters that must be addressed in every case:

- (a) at least one registered person (the sole proprietor, a registered director in the case of a corporation, or a partner in the case of a firm) must be directly responsible for, or actively participate in, the business of the applicant;
- (b) the responsibility or participation of that person must include in its ambit compliance with legislative and other regulatory requirements (such as notifying the SFC of material changes; maintaining registers, books of account and other records; compliance with rules and ordinances relating to trading; issuing contract notes; compliance with margin rules; compliance with financial resource requirements; etc);
- (c) there must be systems to ensure that all persons associated with the applicant that are required to be registered are so registered;
- (d) there must be systems to monitor on a regular basis continuing compliance with any financial resource requirements; and
- (e) there must be an audit trail which enables past compliance with financial resource requirements to be verified.

CONTINUING REQUIREMENTS

17. Registration under the Securities Ordinance or the Commodities Trading Ordinance requires more than simply satisfying the initial criteria set out above. The Securities Ordinance, Commodities Trading Ordinance, and Securities and Futures Commission Ordinance provide the Commission with powers to revoke or suspend registrations, and to intervene and restrict registered persons' activities in a number of ways. These powers are given to the SFC to enable it to take action to prevent registered persons who are inefficient, dishonest, financially unsound or who engage in unfair practices from remaining in business.

18. Pursuant to such powers, the Commission will consider revoking or suspending registration, or otherwise intervening in or restricting a registered person's activities if:

- (a) it discovers that the person furnished false or misleading information to the Commission in support of an application for registration, in an annual return or otherwise;
- (b) it receives information that indicates that the person would not satisfy the tests set out in paragraphs 13 to 15 above if they were reapplied; or
- (c) it has reason to believe that the person is otherwise no longer, or was never, a fit and proper person to be registered.

[These matters are simply ways of providing for the removal of the registration of persons who are not fit and proper.]

19. Moreover, the Commission considers that any of the following actions must cast doubt on a person continuing to be fit and proper to remain registered:

- (a) failure to observe all relevant laws;
- (b) failure to abide by the rules of any exchange of which it is a member;
- (c) failure to abide by the Hong Kong Code on Takeovers and Mergers, the Hong Kong Code on Unit Trusts and Mutual Funds, and any other Codes of Conduct and guidelines promulgated by the Commission, other regulator in Hong Kong or any relevant overseas exchange or regulator;
- (d) knowingly aiding or abetting other persons in breaches of relevant laws, exchange rules or Codes; and

[These are common sense requirements linking registration to general "good citizenship" of the industry.]

- (e) have procedures that are adequate to ensure that all the above occur.

[This is essential if the above are to have real impact and bite.]

20. By way of example, to continue to be a fit and proper person to be registered, the Commission considers that any registrant must:

- (a) not knowingly be a party to any insider trading or market manipulation; and
- (b) follow proper practice as set out in SEHK or HKFE Rules and Guidance Notes.

[These requirements are essential elements of best market practice.]

21. Where the Commission is of the view that a registrant (or, in the case of a corporation, any director, secretary, or person concerned with the management of the corporation) has failed to meet the continuing fit and proper requirements set out in paragraphs 17 to 20 above, it may initiate an inquiry under section 56(1) of the Securities Ordinance or section 36(1) of the Commodities Trading Ordinance to determine whether the registrant (or the director, secretary or person concerned with the management of the corporation):

- (a) is or has been guilty of any misconduct in relation to the conduct of his business; or
- (b) is a fit and proper person.

22. As noted earlier, the matters set out in paragraphs 17 to 20 above are not exhaustive of matters that the Commission will consider in assessing whether a registered person is fit and proper to remain registered. Rather they are intended to indicate the types of matters that the Commission will take into account.

23. The Commission places great importance on dealers and advisers being fit and proper. It will review cases of inefficiency, dishonesty and unfair practice most stringently.