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REVIEW OF POLICY RELATING TO
EXEMPTIONS FROM THE REGISTRATION REQUIREMENTS
OF THE SECURITIES ORDINANCE

SECURITIES AND FUTURES COMMISSION

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Introduction

1. The Securities Review Committee (SRC) recommended in paragraph 10.31 of its Report that the securities dealing and advising activities of institutions which have been granted exemption from the registration requirements should be regulated and, for this reason, the concept of exempt status should be abolished. The recommendations of the SRC received the general endorsement of the Executive Council at the time the SRC Report was published. Since its formation, the Securities and Futures Commission (SFC) has informed market participants that it is examining the means of implementing this specific recommendation and that they should be reviewing their operating procedures in this context. The findings of the Commission's examination are set out in this document.

Background

2. Under S. 60 of the Securities Ordinance, a company may apply to the SFC to be an exempt dealer if its main business is something other than dealing in securities, unless its dealings are at the wholesale level in which case it comes under the exemption in S. 3(1)(a) of the Ordinance.

3. Under S. 61 of the Securities Ordinance, a company which only advises professionals or overseas persons may apply to the SFC to be an exempt adviser. (An extract of sections 60 and 61 is at Appendix 1.)

¹ This paper relates to exemptions granted by the SFC under Sections 60 and 61 of the Securities Ordinance. It does not relate to any class exemptions granted by virtue of any other sections of this Ordinance (for example under the definitions of dealer and investment adviser).



4. The origins of the policy reflected in sections 60 and 61 can be traced back to the recommendations of the 1971 Report of the Standing Committee on Company Law Reform (the precursor to the present regulatory regime) which recommended that persons who:

- have only a peripheral involvement in securities dealings; and
- pose little or no threat in terms of investor fraud

should be excluded from the registration net. This applies particularly to institutions which are already subject to a different supervisory framework and, because of the different standards applied, have difficulties in meeting the full rigours of the prudential requirements in the legislation.

5. The Section 60/61 exemption system has, however, been subject to criticism and, in the course of its review, the SRC identified a number of significant defects. It concluded that institutions, once granted an exemption, are able to extend their exempt operations into all areas of securities dealing rather than just the one for which exemption was granted; that there is no system for monitoring their activities; and that they are inadequately regulated at the moment in relation to their securities activities. The Committee argued that there was no case for excluding so called exempt business from supervision. For these reasons, the SRC recommended that exempt status should be abolished, and to the extent that an institution conducts securities business, it should be registered, required to meet the appropriate regulatory standards on an on-going basis and supervised to ensure it meets those requirements. It also recommended that some changes to the definition of securities might be necessary to ensure that the statute only catches that which it was intended to catch; and that class exemptions would have to continue for such groups as accountants and lawyers. Furthermore, since its recommendation would involve dual authorisation for some institutions (for example, Banks/DTC's), it considered that the SFC should rely on the Commissioner for Banking to supervise the capital and liquidity adequacy of Banks/DTC's. The SFC should, however, have responsibility for applying and supervising the other (mainly conduct of business) requirements imposed on such institutions undertaking securities activities.

6. In considering whether the SRC recommendation should be followed, it is necessary to re-examine, from a policy objective point of view, the case for subjecting the securities activities of exempt institutions to supervision and if a case exists, to determine whether this should be achieved in the manner recommended by the SRC.

Policy Objectives

7. Although the policy objective of exempting from regulation those who have only a peripheral involvement in securities dealings and who pose little or no threat in terms of investor fraud remains generally valid, fundamental changes in the structure of the financial sector over the last decade have led to a shift in both the objectives and the emphasis of regulatory policy.

8. The growth of financial "supermarkets" offering a wide range of financial services (including securities facilities) together with the emergence of greater interdependencies between the various components of the financial system have, during the 1980's, resulted in some change of policy emphasis - first, the importance of regulating the overall activities of the financial 'supermarkets' which have developed and second, the need to contain systemic risks to avoid problems in one sector of the financial market spilling over into other sectors and thereby threatening the stability of the entire system.

9. The impact of this shift has been to widen substantially the scope of "who needs to be subject to regulation". It obliges the Commission to take a wider view of the regulatory ambit than has hitherto been the case and argues for some control over the activities of all financial institutions involved in securities business in Hong Kong. This is particularly so when one examines the nature of the securities business and advisory activities of some of the currently exempt institutions. A number of exempt banks and DTCs have "securities dealing services" which parallel the full range of services offered by registered dealers. Although the quantum of their securities services does not represent a major percentage of their overall banking/deposit taking business, in terms of actual turnover, they tend to be significantly larger than many registered dealers. Moreover, the business of exempt unit trust and fund managers constitutes almost entirely securities business. Many of the fund managers actively solicit business from the public and handle client funds. Given market developments over the course of the 1980's, it would be anomalous to continue to exempt from regulation the securities business of such institutions.

10. There is therefore a case from a policy objective point of view for bringing the securities business of exempt institutions within the securities regulatory net. Thus, the SFC supports the SRC recommendation to subject exempt institutions to regulation in respect of their securities business. The question, then, is the extent to which the securities business of exempt institutions should be regulated and how this should be achieved.

Supervision of Securities Business of Exempt Institutions - SRC Model

11. In order to regulate the securities business of institutions which have been granted exemption from the registration requirements, the SRC recommended a model which would involve:

- (a) abolishing exempt status under Sections 60 and 61 of the Securities Ordinance - this would mean that there would be only one class of securities dealers and advisers, namely registered persons/institutions; and
- (b) relying on the lead regulator concept for supervising the capital adequacy of institutions which would be required to have dual authorisations. For example, the Commissioner for Banking would supervise the capital and liquidity adequacy of Banks and DTC's registered as securities dealers by the SFC.

12. Under this regime, the institutions previously granted exemption from registration requirements by the Commission would (with the exception of (b) above) become subject to the full regulatory regime of the Securities Ordinance and the SFC Ordinance. In this context, it should be noted that institutions which have been granted such an exemption by the SFC are already subject to certain legislative requirements. These are listed in Appendix 2. The additional requirements such institutions would be subject to are listed in Appendix 3.

13. There is much to be said for the model proposed by the SRC as it basically treats all participants in the securities market equally and could be implemented with few legislative amendments.

14. However, complete abolition of the Section 60/61 exemption system would create a number of problems both for the regulator and for the industry.

15. For the Commission, the requirement to register these institutions would pose a severe manpower problem. The registered population could increase by up to 50% and additional staff would be needed to deal with the new registrants (See Appendix 4 for estimates). It is therefore appropriate to explore the possibility of a more cost-effective method of achieving the same regulatory objective.

16. For exempt institutions, the requirement to register a large number of employees in a highly mobile labour market would pose major administrative and practical problems. Furthermore, a number of the requirements that apply to registered persons under the Securities Ordinance could present genuine operational problems for some corporations, for example, the S. 84 trust accounts requirement for some international fund managers; the S. 48(1A) and S. 49(1A) requirement for a director to be registered for some overseas banks and financial institutions; the Part IX requirement to maintain accounts which "sufficiently explain the transactions, and reflect the financial position, of the business of dealing in securities carried on by him, and will enable true and fair profit and loss accounts and balance sheets to be prepared from time to time" could pose problems, particularly for banks and DTCs, in so far as it requires a separate accounting system to be implemented for their securities operations.

17. The problems posed for those institutions currently granted exemptions under Sections 60 and 61 would have to be dealt with sympathetically. They could be mitigated by waiving or modifying some of the requirements in the Ordinance. (Such powers already exist in some areas and additional waiver or modification powers to other requirements are currently being sought.) However, the case for requiring these exempt institutions to be registered could be seriously eroded if such waivers had to be granted to a substantial number of institutions in respect of many of the requirements. The value added of requiring such institutions to be registered merely to waive them outside again would be negligible. In any event, the practical effect of such an approach would be to retain an "exempted class" on a de facto basis.

Supervision of Securities Business of Exempt Institutions -
An Alternative Approach

18. An alternative approach to the SRC model, and an approach which appears to overcome most of the problems mentioned above, would involve:

(a) retaining exempt registration status under Sections 60 and 61 of the Securities Ordinance as part of the Hong Kong regulatory system but subjecting those who have been granted exemption from the registration process to an extended range of specific legislative provisions; and

(b) reviewing the activities of each institution which has been granted exemption from the registration requirements under Sections 60 and 61. Those institutions which are found to have extended their activities beyond the scope of the original grant of exempt status would be invited to re-organize their activities to bring themselves back within the scope of the exemption policy or have their exempt status revoked. Any institution which is found to engage in activities which should more properly be undertaken by registered persons would be required to become registered. To avoid disruption to existing business, institutions which have their exempt status revoked, or are required to be registered, will be given a specific time period (say twelve months) to re-organize their activities or to secure proper registration. Some might wish to establish a separate dealing subsidiary. For those institutions who are required to register, the lead regulator concept would apply in relation to capital adequacy where this is appropriate (for example, Banks/DTC's) [note]. For Fund Managers, pending completion of the current review of the financial resources rules, the existing capital requirements under the criteria governing approval of exemption for Unit Trusts and Mutual Funds Managers would continue to apply to them.

(Note: There would, however, need to be close cooperation between regulators in Hong Kong to ensure proper supervision without duplication. This would require some modification to the secrecy provisions in the relevant Ordinances which at the moment inhibit information flows between regulators. The recipients of such information would of course be bound by statutory secrecy rules.)

19. The requirements of the Ordinances which the SRC model would make apply to those persons currently with exempt status are listed in Appendix 3. As discussed earlier, application of some of these requirements would pose difficulties for exempt institutions. The extent to which these should be applied to exempt institutions in order to achieve the policy objectives for subjecting exempt institutions to regulation under the alternative approach is discussed under four broad headings below:

- (a) obligations flowing directly from the requirement to register;
- (b) obligations flowing directly from the capital requirements;
- (c) obligations flowing from the business conduct requirements; and
- (d) requirements under the SFC Ordinance.

(a) Obligations Flowing from Requirement to Register

20. Although an institution that is granted an exemption does not have to actually register, it is required to complete an application form when applying for exempt status. The vetting process for such applications is as meticulous as that for registration and the information required generally conforms with that for registration. It appears then, that the act of registration on the part of exempt business entities would not, of itself, add a great deal to the regulatory process as long as certain other measures discussed below are in place. However, the requirement to register directors and representatives, which applies only to registered entities, is a different matter. This is discussed in greater detail in paragraph 29 below (on the Fit and Proper test).

21. One of the obligations of a registered dealer is to lodge and maintain a deposit of \$50,000 with the SFC to be applied by the SFC in cases of bankruptcy etc. Under the alternative approach, exempt institutions would only be involved in securities business as to a small proportion of their total business. Under these circumstances, they would not pose significant counter-party risks to investors, so there is not a strong case for requiring them to lodge the deposit.

22. Although the disciplinary powers flowing from S. 56 of the Securities Ordinance do not at present apply to exempt institutions, S. 60(5) provides the Commission with equally wide authority to withdraw exempt status. Similarly, although exempt institutions do not have to report changes in particulars under S. 63, exemptees are surveyed annually for such changes prior to the publication of the annual list of exempt institutions in the Gazette. The difference in standard in these respects is only marginal. Therefore under the alternative approach exempt institutions would not be subject to Sections 56 and 63.

(b) Obligations Flowing from Capital Requirements

23. Under the SRC model, all institutions would have to comply with the S. 65B capital requirements except for those authorised by another regulator in Hong Kong who supervises their capital and liquidity position. Under the alternative approach, this lead regulator concept would also apply to any institution which, following a review by the SFC, loses its exempt status. As to institutions which retain exempt status, the adequacy of their capital in relation to their securities business would not be a matter of general concern because of the de minimis nature of their securities business and because most would have to comply with capital requirements set by another regulator. In the absence of financial resource requirements, the ancillary requirements to enforce and monitor the capital requirements, i.e. production of books and records on demand [S. 65D]; maintenance of accounts and records [S. 83(1)]; annual audits [S. 87(1)]; submission of annual accounts [S. 88(1)] and the power to appoint auditors [S. 90(1)], would not be essential supervisory tools.

24. Even in the absence of capital adequacy requirements under the alternative approach, there would be advantages to the Commission in requiring exempt institutions to submit their annual accounts. This would not be burdensome and would assist the Commission to monitor the overall activities of institutions and their continuing financial health. Obviously, where the institution is subject to other capital requirements, the same set of annual accounts submitted to the lead regulator would suffice for the Commission.

(c) Obligations from Business Conduct Requirements

25. Of the five requirements covered under this heading in Appendix 2, the requirement to maintain a register of securities is honoured only in its breach by existing registered dealers and the Commission is proposing to delete the provision from the Ordinance. It would therefore not be extended to exempt institutions under the alternative approach.

26. The requirement to maintain segregated trust accounts has proven to be particularly onerous for international operators. The provision requires registered persons to maintain segregated trust accounts with banks licensed by the Commissioner for Banking and prohibits the payment of any moneys into these accounts other than money for the purchase or from the sale of securities. Moreover, these must be paid into the account within four bank trading days. The first requirement creates difficulties for those who do not repatriate all proceeds of sales to Hong Kong on every occasion since banks licensed by the Commissioner for Banking do not operate in all financial centres where they do business. Even where there are such banks, the second requirement obliges them to remit the original money and open an account with the bank within four bank trading days. This provision would not, therefore, be extended to exempt institutions under the alternative approach.

27. The other three requirements, i.e. offer to acquire or dispose of securities, cold calls and misrepresentations, are important investor protection provisions and should be extended to the securities business of exempt institutions. In line with the other business conduct requirements in this part of the Ordinance (listed in Appendix 2), the provisions should be turned into requirements of general applicability. These requirements would apply to both registered and exempt persons under the alternative approach.

(d) Requirements under the SFC Ordinance

28. In addition to the requirements under the Securities Ordinance, exempt institutions are also currently excluded from the following provisions in the SFC Ordinance:

- (a) the fit and and proper test in S. 23;
- (b) the business records notification requirement in S. 27;
- (c) the supervisory powers in S. 30; and
- (d) the annual returns requirement in S. 34.

(i) Fit and Proper Test

29. As discussed in paragraph 20 above, the inapplicability of the fit and proper test to the corporation itself is not of great consequence. However, the inability to apply the test in respect of directors and employees of the corporation would be of concern. In the interest of overall market integrity, the Commission should have the ability to prevent persons who are not fit and proper from taking part in an exempt institution's securities dealing or advising activities. Since these institutions would not have substantial retail operations, an ex post facto power of objection, as opposed to prior registration should be sufficient to meet the regulatory objectives under the alternative approach. It should, however, be noted that if an exempt institution refused to remove the person(s) objected to from the institution's dealing or advising activities, the only sanction available to the Commission would be to revoke their exempt status. Although this is not envisaged to be a serious risk, S. 60/61 of the Securities Ordinance should be amended to make this a specific ground for revocation if the alternative approach is adopted. Under the alternative approach, exempt institutions would be subject to an ex post facto power of objection as regards the fit and properness of their principal officers involved in their securities and advising activities.

(ii) Reporting Requirements

30. The reporting requirements under S. 27 and S. 34 of the SFC Ordinance are essential monitoring tools to enable the Commission better to supervise participants in the industry. They should also be available to the Commission in respect of exempt institutions since they are conducting some securities business. The SFC Ordinance should be amended to extend these sections to exempt institutions if the alternative approach is adopted.

(iii) Supervisory Powers

31. The supervision powers under S. 30 of the SFC Ordinance are essential to the Commission's ability to enforce the provisions of the legislation and should be extended to exempt institutions in respect of their securities business if the alternative approach is adopted. The equivalent powers in S. 122 of the Securities Ordinance (which S. 30 replaced) used to apply equally to exempt persons. They were omitted from the ambit of S. 30 probably on the assumption that the exemption system would be abolished.

(e) Summary

32. To sum up, the following requirements would be made to apply to exempt institutions under the alternative approach (refer to Appendix 3 for the more extensive requirements that would be made to apply under the SRC model):

- (a) the submission of annual accounts requirement in S. 88(1) of the Securities Ordinance (para 24 above);
- (b) the business conduct requirements in S. 72(1), S. 73(1) and S. 78(1) of the Securities Ordinance (para 27 above);

- (c) the power to object, ex post facto, to the appointment of directors or employees who actively participate in the exempt institution's business of dealing in securities on grounds of lack of fit and properness, which should be made a specific ground for revocation of exempt status under S. 60/61 of the Securities Ordinance (para 29 above);
- (d) the notification of where business records and documents are kept requirement in S. 27 and the submission of annual returns requirement in S. 34 of the SFC Ordinance (para 30 above); and
- (e) the supervision powers over registered persons in S. 30 of the SFC Ordinance (para 31 above).

33. The extension of the requirements in paragraph 32 (a) to (e) above to exempt institutions should enable the Commission properly to supervise the securities activities of exempt institutions and to intervene in case of need. Such powers would help to achieve the policy objectives set out in paragraphs 7 to 10 above.

Summary of Findings and Recommendations

34. The Commission is of the view that there is a case for subjecting the securities business of institutions currently with exempt status to the regulatory regime. The Commission therefore supports the policy thrust behind the SRC recommendation, a recommendation that has been endorsed by Exco. However, there are a number of ways of achieving this objective, including the specific model proposed by the SRC as well as an alternative included in this paper. In view of the practical difficulties associated with implementation of the SRC model, the SFC is inclined to favour the alternative approach.

35. The Commission invites comments on the issues raised in this paper, especially which of the two models is the more appropriate means of achieving the objectives underlying the SRC recommendation.

Securities and Futures Commission
January 1990

Encl.

SECURITIES ORDINANCE

Section 60

1. The Commissioner may declare any person to be an exempt dealer for the purposes of this Ordinance if he is satisfied that the business of that person complies with the following requirement, that is to say:

Exempt
Dealers.

- (a) the main business of that person consists of one or both of the following activities:
 - (i) carrying on some business other than the business of dealing in securities;
 - (ii) dealing in securities in one or more of the ways specified in subsection (2);and
- (b) the greater part of any business of dealing in securities done by him in Hong Kong, otherwise than in one of the ways specified in subsection (2), is effected with or through the agency of one or more of the following persons:
 - (i) a registered dealer;
 - (ii) an exempt dealer; or
 - (iii) a member of a stock exchange outside Hong Kong.

2. The ways of dealing in securities referred to in subsection (1) are:

- (a) issuing any document which is or is to be deemed to be a prospectus within the meaning of the Companies Ordinance or any prospectus approved by the Commissioner that is issued by a mutual fund corporation or unit trust authorized by the Commission;
- (b) making or offering to make with any person an agreement for or with a view to the underwriting of securities by that person;
- (c) making any invitation to persons to subscribe for securities or to purchase securities on the first occasion that they are sold;
- (d) making any invitation to persons to subscribe for or purchase securities of the Government or the government of any country or territory outside Hong Kong;

(Cap. 32)

- (e) effecting any transaction with a person whose business involves the acquisition and disposal or the holding of securities, being a transaction with that person as a principal.

3. Without prejudice to subsection (1), the Commissioner may, by notice in the Gazette, declare:

- (a) any licensed bank;
- (b) any trustee company registered under Part VIII (Cap. 29) of the Trustee Ordinance; or
- (c) any person belonging to class of persons, or carrying on a type of business, prescribed in regulations for the purposes of this paragraph,

or to be an exempt dealer for the purposes of this Ordinance.



4. The Commissioner may at any time revoke a declaration made under this section.

5. The Commissioner shall cause to be published in the Gazette at least once in every year the names and addresses of all persons who are exempt dealers.

Section 61

1. The Commissioner may declare any person to be an exempt investment adviser for the purposes of this Ordinance if he is satisfied that the business of that person complies with the following requirements, that is to say:

Exempt
investment
advisers.

- (a) the investment advice is given mainly to persons whose business involves the acquisition and disposal or the holding of securities; or (Amended, 62 of 1976, s. 18)
- (b) the investment advice is given only to persons residing outside Hong Kong.

2. The Commissioner may at any time revoke a declaration under subsection (1).

Obligations on Registered Persons
which currently apply to Exempt Institutions

(A) SECURITIES ORDINANCE

Part VIII Trading in Securities

74	Hawking of securities
75	Issue of contract notes
76	Dealers not to engage in option or forward trading
77	Dealers to provide certain information to client
79	Disclosure of certain interests
80	Short selling prohibited
81	Disposition of security documents

Part XI Inspections and Investigations

Part XII Prevention of Improper Trading Practices

Part XIIA Insider Dealing

(B) SECURITIES AND FUTURES COMMISSION ORDINANCE

Part V Regulation of Registered Persons Business

31	Information relating to transactions
33	Investigatory powers
37	Destruction of documents
45	Winding-up orders
46	Receiving orders

List of Additional Requirements
which would apply to Exempt Institutions under the SRC Model

(1) Securities Ordinance:

- (a) the requirement to register the corporation in S. 48(1) [or S. 49(1) for advisers];
- (b) the requirement to register its directors in S. 48(1A) [or S. 49(1A)];
- (c) the requirement to register its representatives in S. 50(1)(a) [or S. 50(1)(b)];
- (d) the prohibition against dealing directors acting for others in S. 49C(1) [or S. 49D(1)];
- (e) the deposit requirement for dealers in S. 52(1);
- (f) the disciplinary powers of the Commission under S. 56;
- (g) the false statement offence under S. 62;
- (h) the reporting requirement regarding changes of particulars under S. 63;
- (i) the capital requirement for dealers in S. 65B;
- (j) the "reporting requirement" in S. 65C;
- (k) the requirement to produce books, accounts and records in S. 65D;
- (l) the requirement to maintain registers of securities in S. 67(1);
- (m) the requirement regarding offers to acquire or dispose of securities in S. 72(1);
- (n) the prohibition against cold calls in S. 73(1);
- (o) the prohibition against making certain representations in S. 78(1);
- (p) the accounting and records requirements in S. 83(1);
- (q) the segregation of accounts requirements in S. 84(1);
- (r) the audit requirement in S. 87(1);
- (s) the submission of annual accounts requirements in S. 88(1); and
- (t) the appointment of auditors powers in S. 90(1) and S. 91(1).

(2) SFC Ordinance:

- (a) the Fit and Proper test in S. 23;
- (b) the notification of where records are kept requirement in S. 27;
- (c) the financial resources rules in S. 28;
- (d) the supervision powers in S. 30; and
- (e) the submission of annual returns requirement in S. 34.

Projected Increase in Registered PopulationPrincipals

(a) Existing number of Registered Dealing Corporations	:	225
(b) Existing number of Registered Dealing Directors	:	360
(c) Average number of Dealing Directors per corporation	:	360/225, or 1.6
(d) Number of Exempt Dealers	:	252
(e) Projected number of Dealing Directors	:	252 x 1.6 or 403
(f) Existing number of Registered Adviser Corporations	:	325
(g) Existing number of Registered Supervisory Directors	:	518
(h) Average number of Supervisory Directors per corporation	:	518/325 or 1.59
(i) Number of Exempt Investment Advisors	:	20
(j) Projected number of Supervisory Directors	:	20 x 1.59 or 32
(k) Total additional Principals: (d) + (e) + (i) + (j)	=	707

Representatives

[On the basis of a random sampling of 10% of the existing registered corporate population, we have established that, on average, a corporate dealer would have 8 representatives and a corporate adviser 2.5 representatives per company.]

(l) Number of Exempt Dealers	:	252
(m) Projected number of Representatives	:	252 x 8 or 2016
(n) Number of Exempt Advisers	:	20
(o) Projected number of Representatives	:	20 x 2.5 or 50
(p) Total average increase in population: (k) + (m) + (o)	=	2773

The exempt institutions tend, however, to be larger institutions than the average corporate dealers and advisers. There will, therefore, be a need to build in a booster factor to reflect the fact. The resulting figures using a range of booster factors are:

(q) 10% booster	:	3050;
(r) 20% booster	:	3328;
(s) 30% booster	:	3605;

The range of increase in existing population on this basis is between 43% to 51%, say 50% on an average.