Consultation Paper on Review of Licensing Regime

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REVIEW OF LICENSING REGIME

1 INTRODUCTION

1.1 This consultation document invites public comment on proposals to amend the existing laws and practices governing the licensing of intermediaries providing services in respect of securities, futures or leveraged foreign exchange. It also invites comment on the need for new categories of licence to accommodate changes in the way financial services are provided.

1.2 If, upon consideration of the public comment, it is decided that changes should be made to the licensing system, the Commission would seek to introduce these changes as part of the legislative reform program to consolidate the Ordinances that it currently administers.

1.3 As recommended by the Ian Hay Davison Report of 1988, in 1989 - 1990, the Commission conducted a comprehensive review of the licensing regime as part of its review of the principal legislation governing the securities and futures industry ("the 1990 review"). The 1990 review recommendations remain unimplemented but many have been incorporated in the draft Composite Securities and Futures Bill which was released to the public for consultation in April 1996 ("1996 Draft Bill").

1.4 Given the changes in the market place since 1990, both in the products being offered and practices being adopted, the recommendations of the 1990 review are no longer sufficient. Examples of the changes include the growing sophistication and integration of various segments of the financial market, giving rise to the need for intermediaries to deal and advise simultaneously in securities, futures or foreign exchange, and the blurring of the delineation between securities and futures products. Many large intermediaries now provide proprietary trading and settlement services to their clients. There have also been significant changes in the way in which intermediaries deliver services, particularly through the use of technology,

and these changes also suggest the need for a review of existing licensing arrangements.

1.5 The Licensing Department of the Securities and Futures Commission has therefore initiated a comprehensive review of the licensing regime governing securities, futures and leverage foreign exchange trading intermediaries. The review has now been completed.

1.6 The main proposals upon which comment is sought may be summarized as follows:

- a substantial revision of existing criteria for the granting of exempt status.
- exempt status to be limited to Authorized Institutions only.
- the extension of the Commission's power of inquiry to cover exempt persons.
- clarification of the Commission's attitude to the dealing or advisory activities performed by lawyers and professional accountants that are incidental to their ordinary business and the carrying out of which does not require a licence.
- continuation of exempt status for persons who deal solely with professionals, but subject to a new requirement that they should be subject to reporting and certain Code of Conduct requirements.
- issuance of a single licence to investment intermediaries, specifying the scope of permitted business.
- new legislation to re-define the activities for which a licence is required.
- scope for the Commission to authorize a person to perform a licensed function to a limited extent.

- a requirement that all who are able to exercise a significant influence over the conduct of a licensed entity and those who are directly responsible for the management and supervision of the operations of a licensed corporation, including all executive directors, be licensed and designated as responsible officers who must satisfy additional licensing criteria.

- a requirement that licensed corporations be supervised by at least two responsible officers, including one executive director.

- a requirement that a licensed corporation engages only those who have proper credentials to be senior officers directly responsible for the performance of the key internal control functions of the corporation.

- power for the Commission to issue provisional licences to representative applicants with a view to saving time and costs.

- measures by the Commission and the Exchanges to harmonize their licensing process.

- a limitation that only corporations will be licensed to carry out regulated functions.

- the recognition of approved industry courses as prerequisites for obtaining a licence as a representative or responsible officer.

- power for the Commission to specify competence standards for responsible officers.

- a continuous training requirement to be included as an on-going obligation for licensed persons.

- a requirement that licensed corporations have a training policy to provide continuous training to accredited representatives.

- a provision that investment contracts made with an unlicensed intermediary be voidable at the client's option.

- power for the Commission to issue orders against persons who are not fit and proper banning them from participation in the industry.

1.7 Comments should be addressed to the Licensing Department of the Securities and Futures Commission, 12th Floor, Edinburgh Tower, The Landmark, 15 Queen's Road Central, Hong Kong or e-mail to *licreview@hksfc.org.hk*, and should reach the Commission before 10th September 1999.

2. THE 1990 REVIEW

2.1 The principal recommendations of the 1990 review were as follows:

- the introduction of a special "temporary" category of licence. This would enable a visiting overseas intermediary to carry out registrable activities for periods not exceeding three months without being subject to full scale vetting.

- rationalisation of the distinction between dealers and investment advisers so that investment advisers who handle clients' funds are required to be licensed as dealers.

- a requirement that individuals representing the business should be registered as representatives irrespective of whether they are directors or employees.

- a requirement that licensed businesses are required to nominate at least one "responsible officer" who has the experience and educational standard required of a dealer or an adviser to supervise the business. (Under the present proposals, the requirement is that there should be two responsible officers - see page 31.)

- a change in practice whereby an applicant would no longer be registered as a futures dealer on the basis that it was a subsidiary of a member of a recognised exchange; under the proposal, it must either be a member of the Hong Kong Futures Exchange Limited or of a recognised exchange[1].

- power for the Commission to levy financial penalties as part of disciplinary proceedings in respect of certain offences.

Generally, these matters are addressed in draft legislation that was the subject of public consultation in 1996 and they are not further consulted upon in this document.

3. THE SECOND LICENSING REGIME REVIEW

3.1 In order to ensure the achievement of its regulatory objectives and to maintain the status of Hong Kong as a premier financial centre, in 1998, the Commission undertook a second comprehensive review of the existing licensing regime.

3.2 The second review does not, however, cover the Financial Resources Rules, which were separately reviewed by the Commission during 1998, and Compensation Fund issues, on which a consultation paper was issued by the Commission in late 1998. Nevertheless, certain consequential changes to the Financial Resources Rules and compensation arrangements may follow if the recommendations in this review are adopted.

4. REGULATORY OBJECTIVES

1 All provisions of existing legislation that refer to Members of an exchange will need to be revised in light of the announced proposal to demutualise and merge the Stock Exchange of Hong Kong and the Hong Kong Futures Exchange.

4.1 The International Organization of Securities Commission (IOSCO) has adopted three core objectives of securities regulation. These are:

- The protection of investors.
- Ensuring that markets are fair, efficient and transparent.
- The reduction of systemic risk[2].

4.2 In achieving these objectives, IOSCO recommends the need for a "licensing" (rather than "registration", "certification" or "negative licensing") regime. The right to provide financial services should be conditional upon practitioners satisfying a licensing authority of their ability to meet certain pre-determined criteria. Principle 21 of the IOSCO Objectives and Principles provides: "Regulation should provide for minimum entry standards for market intermediaries."

4.3 Hong Kong faces increasing competition from our neighbours in the region and, due largely to advances in technology and communications, competition from further afield. The financial markets are an important part of the Hong Kong economy. The presence in Hong Kong of a pool of competent licensed intermediaries is vital to the growth and development of the local markets. To maintain Hong Kong's position as a leading financial centre, the licensing regime must provide:

- minimum barriers to entry that exclude the incompetent and those unfit to enjoy a position of trust as a financial intermediary;

- equal and fair access to all suitably qualified applicants for a licence;

- entry criteria that have regard to the business plan of the applicant and do not permit the provision of services outside the applicants' area of competence;

- entry criteria that are clear and certain in their application;

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[2] IOSCO "Objectives and Principles of Securities Regulation", 1998.

- entry criteria that set initial and ongoing capital and other prudential requirements;

- entry criteria that set standards for internal organisation and operational conduct that aim to protect the interests of clients and under which management of the intermediary accept primary responsibility for these matters;

- a transparent licensing process in which key information on licensed persons is publicly available, including the category of licence held, the scope of authorized activities, the identity of senior management and those authorized to act in the name of the intermediary;

- a process requiring a comprehensive assessment of the applicant and all who are in a position to control or materially influence the carrying on of regulated activities by the applicant;

- protection of the interests of investors, recognising that the initial entry barrier cannot be set too high and that investor protection is complemented by the availability of information, facilitating informed choices by investors and availability to the Commission of inspection, investigatory and disciplinary powers in respect of the intermediary;

- power for the Commission to withdraw or restrict a licence or to sanction the licencee whenever the entry criteria are not fulfilled or other misconduct occurs; and

- a requirement that changes of control over, or material influence of an intermediary should be made known to the Commission and be subject to approval in order to allow for a review of the licensed person's suitability.

4.4 In conducting the second review, we have borne in mind these regulatory objectives when examining the current system. We have also considered whether there are ways and means to improve the cost effectiveness of the regime without compromising our regulatory objectives. This Consultation Paper does not discuss all aspects of the current licensing regime, rather, it deals only with those areas where change is proposed or contemplated.

5. CRITICISMS ON THE EXISTING REGIME

5.1 Obsolete Legislation

5.1.1 The Securities Ordinance came into effect some 25 years ago and the Commodities Trading Ordinance followed about 2 years later, in 1976: by international standards, in the area of financial services regulation, they are old pieces of legislation. Their provisions relating to licensing matters have not been subject to major amendment over the years. Even the Securities and Futures Commission Ordinance, which reinforces the concept of fitness and properness for registration purposes, was drafted more than 10 years ago. In the context of a rapidly evolving market place, it is to be expected that some revision will be necessary.

5.1.2 While the 1996 Draft Bill consulted upon in 1996 seeks to provide an appropriate legislative framework for the licensing regime by incorporating, among other things, the recommendations in the 1990 review, that Draft Bill is itself already five years old.

5.2 Categories of Licence

5.2.1 The ambit of the existing licensing regime was conceptualized about 30 years ago. In essence, it categorizes practitioners into dealers and advisers by reference to their business functions. This model was later adopted for regulating the commodities trading sector. The need for a separate licensing regime for commodities trading intermediaries has always rested on the three premises that different financial products could be separately categorised, the "futures" market posed a different set of risks from the cash market and trading in the futures markets required special skills.

5.2.2 Although the existing licensing framework has served us quite well and does meet many of the regulatory objectives described above, it may be unable to meet future demands. The underlying assumptions have altered as the market has developed. This is apparent when considering the characterisation of products and the manner in which intermediaries carry out their functions.

5.2.3 The delineation between securities, futures and derivative contracts, and foreign exchange products has become increasingly blurred. Financial engineering has generated products that do not readily fit into such categories.

5.2.4 Further, in this age of globalisation and demand by customers for a "one-stop" service, financial intermediaries perform multiple roles ranging from managing provident funds to dealing in derivatives. It may also be illusory to classify such functions into simply "advising" or "dealing" where the material distinction is between, on the one hand, advising on a securities and, on the other, inducing or attempting to induce a person to deal in those securities.

5.3 Entrance Requirements

5.3.1 Under current legislation, the Commission must refuse to register an applicant unless it is satisfied by that person that he or she is fit and proper to be registered. In considering fitness and properness, the Commission must have regard to the applicant's:

- financial status;
- education or other qualification or experience having regard to the functions to be performed[3];
- ability to perform functions efficiently, honestly and fairly; and
- reputation, character, financial integrity and reliability.

5.3.2 Opinions have been expressed that, while the general fitness and properness criteria requiring integrity and good reputation have been effective in preventing persons with questionable integrity or a bad reputation entering the industry, the existing regime does not provide a clear benchmark or competence level to ensure that only sufficiently competent persons are licensed. It is argued that there is a need for specific qualifications based on education and experience as a pre-requisite to a licence to provide particular services. This need has been highlighted by several recent cases where the competence of corporate finance practitioners was called into question.

5.4 Time Costs of Applications

5.4.1 The average processing time for a licence application is a creditable 10 weeks for principals and 4 weeks for representatives, but the industry has expressed a desire that the processing time be further shortened. From the industry's perspective, the processing time is costly as

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[3] While there is a statutory requirement under s65A of the Securities Ordinance that securities dealers must have at least 3 years of dealing experience acquired in a recognized securities market or passed an approved examination, there is no statutory qualification and experience requirement for other intermediaries. The Commission's published guidelines on fitness and properness ("The Fit and Proper Criteria") require a representative to have completed secondary school education and, for dealers and advisers, to have not less than 5 years relevant experience, which may be reduced to 3 if the person possesses an appropriate post-secondary qualification.

employees cannot perform their functions until they are registered.

5.5 Licensing of Compliance, Settlement and Other Responsible Officers

5.5.1 At present, not all those with managerial responsibility for the operations of a licensed corporation are required to be registered. That leads to situations in which the controlling minds of a licensed corporation are outside the direct regulation of the licensing regime. In respect of particular positions of responsibility, it has been the traditional belief that compliance, settlement and other operational officers should not be required to be licensed as they merely play reactive roles in the business, and hence present limited risk to the investing public. However a contrary view, which has gained wide acceptance in other jurisdictions, advocates that compliance officers and other "non-dealing" or "non-advising" senior management staff should also be included in the licensing net so that only reputable and professionally competent persons are being entrusted to such responsible positions[4]. As demonstrated in a number of recent cases, it is clear that apart from "front office" staff, "back office" staff can also pose a risk to clients and a threat to the integrity of the market.

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4 In the United Kingdom, both the Securities and Futures Authority Limited (SFA) and the Investment Management Regulatory Organisation Limited ("IMRO") require their member firms' accredited senior officers, including the compliance officer, who have responsibility for the firms' management, to seek registration. The Financial Services and Markets Bill contains a provision which empowers the Financial Services Authority (FSA) to require a person who is able to exercise a significant influence on the conduct of an authorized firm's affairs to seek approval from the Authority prior to that person's employment.

In the United States, the National Association of Securities Dealers (NASD) imposes similar registration requirements on persons having a supervisory or managerial role over a firm's functions (including back office function). Likewise, under the Commodity Exchange Act, registration is required of persons who exercise a controlling influence over a regulated firm's activities.

5.6 Problem of Sole-Proprietorships

5.6.1 Increasing concerns have been expressed about the licensing of unincorporated persons. Unincorporated businesses are generally considered to be an inappropriate business structure for conducting registrable activities. The problems are particularly evident in the case of sole-proprietorship, for example, where the sole proprietor is not able to supervise the business because of old age or illness or where he becomes insolvent. In addition, investors' funds may also be tied up in the estates of the sole-proprietor if he or she dies, particularly if he or she dies intestate.

6. PROPOSED NEW LICENSING REGIME

6.1 The consultation proposals for the new licensing regime are grouped under 6 major headings:-

- Ambit
- Classification
- Structure
- Entry requirement
- On-going obligations
- Investor protection measures and disciplinary power

The recommendations are, in part, the Commission's response to the concerns described above. In making these recommendations, the Commission is mindful of the regulatory objectives that it has to meet, particularly investor protection, and the demand from the industry to have a cost effective and flexible licensing structure. Further, while reference is made to the licensing regimes in other developed markets with a view to ensuring that we meet international regulatory standards, we have been careful to ensure that local environmental factors have been given due consideration.

7. AMBIT OF LICENSING

7.1 Introduction

7.1.1 Under the existing licensing regime, persons who carry on a business of dealing in securities or trading in futures contracts, and those who give advice on such activities, or those who trade in leveraged foreign exchange contracts are required to be licensed by the Commission, except where they are exempted from that requirement by legislation. Those exempted include investors who deal on their own account, persons who deal solely with professionals, and professional accountants or solicitors who provide investment advice to clients that is wholly incidental to the practice of their professions. The legislation also empowers the Commission to exempt certain other persons from the registration requirement.

7.2 Persons Excluded or Exempted from the Licensing Ambit

7.2.1 In the 1990 review, it was concluded that whilst the activities of solicitors, professional accountants, licensed banks, trustees and financial journalists may include conduct that would otherwise require a licence, the nature of their profession or business is such that conduct that would otherwise require a licence is generally only incidental to their core business and that the exclusion of such persons from the licensing requirements should continue[5].

7.2.2 In recent times, however, the securities dealing business of licensed banks has increased significantly and questions have arisen as to whether exemptions for licensed banks, and others, from the licensing regime should continue, given

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[5] Under the Securities Ordinance, the following persons are generally excluded from the licensing requirement:

(a) solicitors and professional accountants where the activities are wholly incidental to the practice of their professions (see definition of "dealer" and "investment adviser"); and

(b) licensed banks, trustee companies and financial journalists (these are excluded from the definition of investment advisers).

that they are now actively participating at the retail level of securities brokering. For reasons detailed below, it is proposed that the existing criteria for the granting of exempt dealer status should be substantially revised and that only Authorized Institutions should, in future, be entitled to exempt status.

7.2.3 Exempt dealer status was granted to banks and other Authorized Institutions now regulated by the Hong Kong Monetary Authority ("HKMA") at a time when they did very little securities dealing. Their main involvement in the industry was as custodians. Non-banks who only did incidental securities business were also granted exempt dealer status. Now, those same banks and firms are, in many cases, significant participants in the securities industry. Some of the largest securities dealers in Hong Kong are banks with exempt dealer status.

7.2.4 Those banks, including their securities dealing businesses, are regulated by the HKMA, which has a separate department that inspects the securities operations of banks. Inspections by the HKMA are carried out according to the Commission's Codes of Conduct and Guidelines.

7.2.5 Under the 1995 Memorandum of Understanding between the Commission and HKMA, the two organisations continually receive and exchange information and intelligence about the market and this determines the content of our respective inspection programs. The HKMA discusses with the Commission the areas that we see as giving rise to particular risk in the prevailing market conditions, and these become a focus of our inspections and those of the HKMA.

7.2.6 Nonetheless, the Commission believes the current arrangements could be improved, to better reflect the changing business of exempt persons and to enhance investor protection.

7.2.7 The granting of exempt dealer status is a privilege that carries with it the responsibility to conduct the exempt business in such a way that the three regulatory objectives

described in paragraph 4.1 are met, notwithstanding some relaxation of regulatory requirements.

7.2.8 Under the present law, there is uncertainty about the scope of the Commission's power to revoke exempt dealer status and there are some exempt dealers that are not Authorized Institutions and are therefore not regulated by the HKMA.

7.2.9 The Commission proposes legislative changes that would address these issues. These are set out in the current draft of the Composite Bill.

7.2.10 Under these proposals, before granting exempt dealer status, the Commission would need to be satisfied by the applicant that there is a real likelihood that the applicant will conduct its business appropriately. The applicant must be fit and proper to carry on business of the type for which exemption is sought.

7.2.11 The Commission would also need to be satisfied that there are in place reasonable safeguards for ensuring that identified operators of the exempt business remain fit and proper. That may be satisfied, in part, by the supervision provided by another regulatory body such as the HKMA.

7.2.12 The Commission must be satisfied that it has sufficient information available to it to monitor the activities of exempt persons and enable it to identify cases in which it should consider the revocation of exempt status, or the imposition of further conditions on that status.

7.2.13 The Commission must have a clear and sufficient capacity to inquire into any concerns that it may have about the activities of an exempt person.

7.2.14 The Commission must have a clear right to revoke exempt status.

7.2.15 The Commission proposes that exempt dealer status should be confined to Authorized Institutions (including licensed banks) regulated by the HKMA. A requirement that they also be fit and proper foreshadows the criteria upon which

exempt dealer status may be removed. The existing criteria for exempt dealer status, based upon the preponderance of business test, would be removed.

7.2.16 The Commission also proposes an extension of its power to inquire into an exempt person's compliance with an Ordinance, subsidiary legislation, a Code or Guidance issued under an Ordinance or the terms or conditions of its exemption, and generally to inquire as to the exempt person's fitness and properness.

7.2.17 To achieve our policy objectives in respect of exempt persons that are Authorized Institutions, we would in the first instance rely upon the supervisory activities of the HKMA as the regulator of Authorized Institutions, and upon a satisfactory flow of information from it to the Commission. The Commission would, however, retain its right to independently enquire into matters of concern and to do so using its formal powers.

7.2.18 An inspection by the HKMA, a complaint or market intelligence may call into question whether an Authorized Institution should continue to enjoy exempt status. The Commission would normally expect the HKMA to first inquire into the matters of concern and to seek remedial action, where possible and appropriate. We would expect the HKMA to keep us informed of its concerns and its actions in response. Where the exempt person fails adequately to address the HKMA's concerns, then the Commission would consider conducting its own inquiry with a view to possible revocation of exempt status.

7.2.19 The regulatory comfort provided by the HKMA in relation to Authorized Institutions is not available in respect of other current categories of exempt dealers. For this reason, it is proposed to remove exempt dealer status for those that are not Authorized Institutions. We are not persuaded by complaints from these other exempt dealers that this creates an "unequal playing field". Rather, we believe it restores equality with other licensed persons whose business is substantially similar and better protects clients.

7.2.20 The Commission also proposes that, for reasons stated in the preceding paragraphs, exempt investment adviser status should also be limited to Authorized Institutions only. Under current legislation, the Commission may declare a person to be an exempt investment adviser if the investment advice to be given by that person is given mainly to persons whose business involves the acquisition and disposal or the holding of securities, or to persons residing outside Hong Kong. The continuation of these criteria for declaration does not give sufficient assurance that investor interests and market integrity will be adequately protected. In this context it should be noted that we propose providing an exemption for a corporation giving investment advice to (or possibly dealing on behalf of) business entities within the same group of corporations (or a joint enterprise) which are not licensed or registered persons (see below at paragraph 8.6.2).

7.3 Incidental Advice

7.3.1 Whilst the Commission considers that the view arrived at as a result of the 1990 review, that exclusion from the registration requirement should continue to be extended to professional accountants and practising solicitors providing advice wholly incidental to their profession, remains valid, it is concerned that in some cases the practice of solicitors and accountants may not be in accordance with the Commission's view of the intent of the legislation. It has been observed that certain investment advice, especially in the corporate finance area, provided by solicitors and accountants has gone beyond what might reasonably be regarded as wholly incidental to their principal business. The Commission believes there is a need to clarify what constitutes activities "wholly incidental to the practice of the professions". In view of such concern, the Commission intends to clarify the 'incidental' concept by way of a practice note. The practice note will itself be the subject of public consultation.

7.3.2 In this regard, the Commission is generally of the view that:

- Incidental service or advice should ordinarily be of a general nature; not entailing any specific recommendation on a particular stock or product.

- Advice given on an irregular and non-repetitive basis may be regarded as incidental.

- Any advice or service provided incidentally should not have formed the prime basis on which it was sought.

- The remuneration for the incidental advice or service should not likely constitute a material proportion of the total fee income of such professionals.

7.4 Professionals Exemption

7.4.1 The Securities Ordinance excludes from the licensing requirements a person who trades as principal solely with "a person whose business involves the acquisition and disposal, or the holding, of securities (whether as principal or agent)". This so-called "professionals exemption" has been retained in the 1996 Draft Bill in line with the recommendation of the 1990 review.

7.4.2 However, developments in the market place suggest the need for a re-examination of whether professionals ought to retain this special privilege. In light of recent experience, justification that "professional dealings" pose minimal risk to the investing public, especially unsophisticated retail investors, is less compelling. Absence of direct contact with the investing public does not necessarily isolate all consequential risks, nor does it mean that the regulator has no legitimate interest in those activities. Any systemic disruption, or for that matter, any manipulative conduct in the dealings within the professional markets may have an adverse effect on the wider marketplace and thus be prejudicial to the interest of the investing public. There exists an information gap in respect of dealings by professionals, which may pose systemic risks. This has been made apparent in the wake of controversies arising from the activities of large private investment funds, which deal largely in the professional markets.

7.4.3 It is clear on the other hand, that many aspects of the licensing regime and the supporting Codes of Conduct are directed to investor protection issues that have little or no relevance to the professional end of the market.

7.4.4 Given that the Commission's objectives include promoting market integrity and reduction of systemic risks, it should be in a position to monitor and assess the risks arising from professional dealings. However, the fact that professional dealings are excluded from the licensing net limits the Commission's capacity to collect information relating to dealings made by the professionals on a principal to principal basis which is essential to the management of systemic risk to the market. The Commission therefore proposes that a person who carries on the business of dealing in securities as principal will continue to be exempted from the full licence requirements but should be subject to some reporting requirements and to compliance with those parts of the Code of Conduct that are essential to the maintenance of a fair and orderly market (namely, honesty & fairness, diligence, capabilities, conflicts of interest and compliance). To achieve this end, it is proposed that the professional should be required to register with the Commission as a person authorized to deal in the professional market.

7.4.5 With regard to intermediaries who act as agent solely for professionals, they are required to be licensed under the current legislation. We are, however, mindful that in view of the sophisticated nature of their counterparts, the full compliance regime applicable to normal licensed intermediaries may not be necessary. The Commission therefore proposes that it should clarify its expectations of intermediaries in their compliance with Code of Conduct provisions when dealing with authorized professionals. Moreover, in so far as they reflect the risk of dealing with professionals, the Commission may be prepared to modify the capital and other financial resources requirement for intermediaries based on the merits of each case.

7.4.6 The above proposals will not cause noticeable disruption to the market, but may be seen as providing further comfort and confidence to market participants without adding material compliance costs for professionals involved in inter-professional dealing.

7.4.7 We welcome any suggestion on this issue from industry practitioners and participants alike. The Commission is mindful of the fact that these proposals could be circumvented by a party determined to avoid disclosure of its trading.

8. LICENSING CLASSIFICATION

8.1 Introduction

8.1.1 Currently there are six functional categories of licence: dealers and their representatives (in securities and futures), advisers and their representatives (in securities and futures) and leveraged foreign exchange traders and their representatives.

8.1.2 In the 1990 licensing review, it was observed that the distinction between dealers and investment advisers for registration purposes was not entirely satisfactory as the line between dealers and investment advisers is sometimes difficult to draw because of the fine distinction between investment advising on the one hand and, on the other hand, inducing, or trying to induce investment in securities or futures which amounts to dealing. The 1990 review therefore recommended that "the distinction between advisers and dealers be rationalized so that the distinction would be made on the basis of whether or not the licensee handled clients' funds". This is reflected in the legislative reforms consulted on in 1996.

8.1.3 Whilst this resolves the issue of whether a particular person should be licensed as investment adviser or dealer, it does not assist in overcoming the cost and inconvenience that can arise from the distinction.

8.1.4 Under the current licensing system, a business entity or individual that engages in dealing or advising on both securities and commodities futures contracts is required to obtain two different licences (maximum 4 licences if engaged in both dealing and advisory activities in respect of both securities and futures) under the Securities Ordinance ("SO") and the Commodities Trading Ordinance ("CTO") respectively. The requirement to obtain different licences for different activities and products for a business or individual does not in itself offer additional protection to the investing public but is costly and creates additional administrative burdens to both the licensed persons and the Commission.

8.2 Proposal for a Single Licence Category

8.2.1 The objectives of Licensing, described in paragraph 4.3 above, can be achieved by a licensing authority issuing a single licence to a person authorizing it to act as an investment intermediary providing a range of specified services. Such an approach would do away with the need to apply for two or more licences by a business entity (as currently required under the SO and CTO) and would reduce costs for the industry. The administrative burden on the regulator would also be lightened. According to current data, the total number of active licences – hence the number of annual filings and administrative files – can be reduced by nearly a quarter (5,000 in absolute terms) if multiple licences in the hands of the same persons are consolidated.

8.2.2 The Commission therefore proposes that, in future, a single licence be issued to persons who can satisfy the Commission that they are fit and proper to carry on a business as an investment intermediary. For business entities, that single licence will have attached to it conditions setting out the areas in which the intermediary is authorized to provide services.

8.3 Activities Requiring a Licence

8.3.1 To circumscribe the scope of activities that are subject to licensing requirements, the Commission proposes that the legislation should define the actvities for which a licence is required. These shall include activity of the kind described below and such other activity as the Financial Secretary may prescribe from time to time in subordinate legislation or by amendment of a Schedule to the Ordinance.

8.3.2 The Commission proposes that the following categories of conduct should require a licence, unless a person is otherwise exempt from the licensing requirements:

I. <u>Investment dealing</u>:

This will include dealing[6] in financial products as follows :-

securities

- ❖ trading of securities on behalf of customers
- ❖ underwriting and distributing securities issues, including sales and issues of shares and securities exercisable or convertible into shares and derivative products
- ❖ providing securities margin financing
- ❖ acting as securities introducing agent or arranging for a person to deal in a financial product
- ❖ engaging in securities lending and borrowing
- ❖ making a market for a financial product

[6] Having the same meaning as dealing in securities, futures contracts, and leveraged foreign exchange trading contracts as defined under the relevant Ordinances.

futures contracts

- ❖ acting as futures commission-agent on behalf of customers
- ❖ acting as clearing agent for clients
- ❖ acting as clearing agent for clients and other futures commission agents
- ❖ acting as futures introducing agent

leveraged foreign exchange

- ❖ trading in leveraged foreign exchange with clients
- ❖ acting as leveraged foreign exchange introducing agent

investment schemes

- ❖ marketing of authorized funds

operating alternative trading facilities

- ❖ providing facilities for negotiating sales and purchases of securities or futures contracts
- ❖ matching of transactions

II. Fund Management :

This refers to advising pursuant to a contract or an arrangement with a client, on the management of a portfolio of financial products, which include:-

- ❖ managing investments for clients in securities
- ❖ managing investments for clients in futures contracts
- ❖ managing investments for clients in leveraged foreign exchange
- ❖ managing authorized collective investment schemes
- ❖ managing non-authorized collective investment schemes

III. Investment Advisory :

This refers to advising other persons concerning financial products other than fund management and corporate finance matters, which include :

Issuance of analyses and reports

- provide securities analyses and reports
- provide futures contracts analyses and reports
- provide leveraged foreign exchange analyses and reports

Providing non-discretionary advice

- provide non-discretionary advice on securities
- provide non-discretionary advice on futures contracts
- provide non-discretionary advice on leveraged foreign exchange
- provide non-discretionary advice regarding venture capital

A licence to perform activities under this category would not permit the licensee to hold client assets.

IV. Corporate Finance Advisory:

This refers to the provision of advice relating to corporate finance to companies or corporates, whether publicly listed or otherwise, or to their members or shareholders, or to other persons, including:

- implementing or advising on takeovers, mergers, amalgamations, acquisitions, disposals, demutualisations, project financing, management buyouts, corporate reorganisations and restructurings, initial public offerings, rights issues, placements and other fund raising exercises;

- giving advice on compliance with or in respect of relevant financial legislation and regulations including the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong

Limited, and the Hong Kong Codes on Takeovers and Mergers and Share Repurchases;

- ❖ any other activities or business commonly accepted in the market as corporate finance.

Again, under this category, client assets would not be allowed to be held.

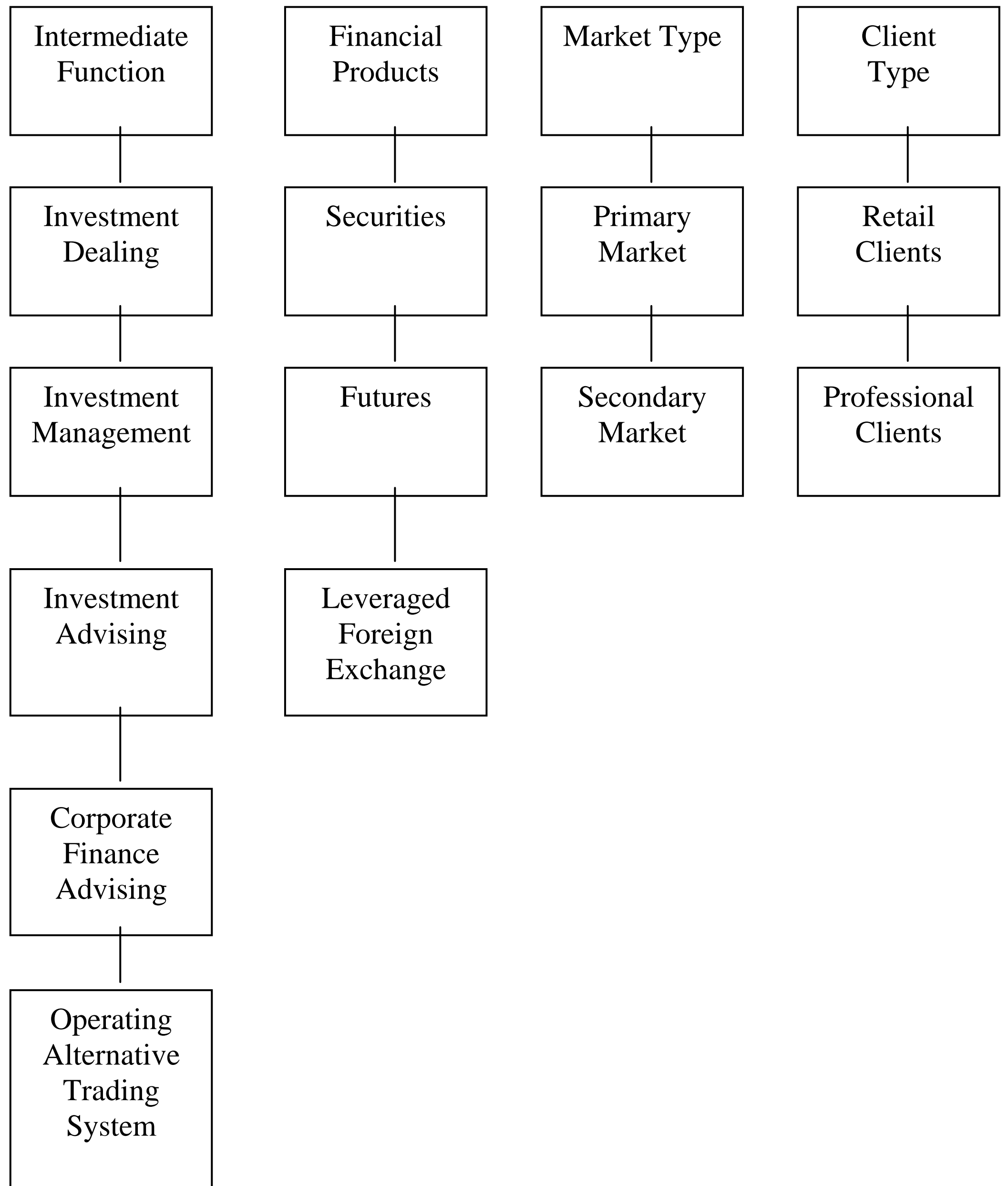
8.4 Licence Conditions

8.4.1 Apart from having the power to circumscribe the business activities that an intermediary may perform, the Commission proposes that it should be given further power to enable it to restrict, by way of licence conditions, the way the business activities may be conducted. Such licence conditions would be imposed having regard to the risk the intermediaries may pose to investors and the market. In this regard, the Commission proposes that it may authorize a person to perform a function of a particular description (individually or taken together), with or without restriction, set out in the conditions of licence, and expressed in terms of type of financial products, duration of time or type of person to whom the services may be provided. Such an approach would allow for greater flexibility and differentiation in the regulation of the wholesale and retail markets. The current requirement for the licence applicant to satisfy the Commission that it is fit and proper to carrying on the regulated intermediate function, with or without restriction, will remain.

8.5 Parameters of Regulated Activities

8.5.1 The above categorisation of regulated activities can be encapsulated by way of function, product, market and client, as illustrated in the chart that follows. This approach facilitates the drafting of the ancillary financial resources rules, business conduct rules, etc., pertinent to the activities performed by the intermediary.

8.5.2 **By Function** **By Product** **By Market** **By Client**



8.6 Exclusions/Exemptions

8.6.1 Current legislation provides exclusions for certain groups of persons or regulated activities conducted under specified circumstances from the licensing net. The exemptions are outlined in the following table.

Category	Exemption	Reference	Remarks
H			
HSecurities Dealing	Act done on behalf of a person by a registered person or offer made to a registered person.	SO s.3(1)	Private investor
H	Issuance of prospectus in compliance with Part II or XII of the Companies Ordinance.	SO s.3(1)(b)	
H	Issuance of document related to securities to which s.38 or 38A of the Companies Ordinance applies.	SO s.3(1)(c)	
H	Issuance of a form for application for shares in compliance with Part II or XII of the Companies Ordinance.	SO s.3(1)(d)	
H	Issuance of prospectus in relation to an authorized fund.	SO s.3(1)(e)	
H	Issuance of a form of application in relation to an authorized fund.	SO s.3(1)(f)	
H	Entering into a market contract.	SO s.3(1)(g)	
H	As principal acquired, subscribed for, or underwritten securities, or effected transactions with a person whose business involves the acquisition, disposal or holding of securities.	SO s.3(1A)(a)	
H			
HSecurities Advising	Licensed bank.	SO s.2(1)	
H	Incidental advice given by a solicitor or professional accountant.	SO s.2(1)	
H	Financial journalist in the practice of his profession.	SO s.2(1)	
H	Incidental advice given by a dealer or exempt dealer.	SO s.2(1)	
H	Registered trustee company.	SO s.2(1)	
H	Exempt investment adviser.	SO s.2(1)	
H	Recognized clearing house.	SO s.2(1)	

H

Category	Exemption	Reference	Remarks
HH			
HHCommodities Trading	Trading as a principal through a registered dealer.	CTO s.26(4)(a)	Private investor
HH	Trading on a commodity exchange referred to in section 3(a), (b) & (c) of the Commodity Exchanges (Prohibition) Ordinance.	CTO s.26(4)(b)	These exchanges are the markets referred to in the Public Health and Municipal Services Ordinance, Agricultural Products (Marketing) Ordinance and Marine Fish (Marketing) Ordinance.
HH	Trading as a member of a commodity exchange which was in operation on 20 June 1973.	CTO s.26(4)(c)	
H	Recognized clearing house.	CTO s.26(4)(d)	
H			
HCommodities Advising	Recognized clearing house.	CTO s.27(1A)	
H	Incidental advice given by a dealer.	CTO s.27(2)	
H	Financial journalist in the practice of his profession.	CTO s.27(2)	
H			
HLeveraged Foreign Exchange Trading	Contract wholly referable to the provision of property, other than currency, or services or employment at fair market value.	LFETO s2(2)(a)	
H	Contract entered into by a limited company not principally engaged in currency trading for hedging purpose.	LFETO s2(2)(b)	
H	Transaction to which the Money Changers Ordinance applies.	LFETO s2(2)(c)	
H	Transaction arranged by a member of the Hong Kong Foreign Exchange and Deposit Brokers Association.	LFETO s2(2)(d)	

H

Category	Exemption	Reference	Remarks
H			
HLeveraged Foreign HExchange Trading (Cont'd)	Transaction executed by an insurer for its insurance business.	LFETO s2(2)(e)	
	Contract executed on a recognized futures exchange by or through a dealer.	LFETO s2(2)(f)	
H	Transaction arranged by a central bank.	LFETO s2(2)(g)	
H	Transaction executed on a recognized stock exchange by or through a dealer, or incidental transactions therewith.	LFETO s2(2)(h)	
H	Transaction in an authorized fund.	LFETO s2(2)(i)	
H	Transaction incidental to specified debt securities transaction.	LFETO s2(2)(j)	
H	Exempt Corporation under section 3(1) of the Leveraged Foreign Exchange Trading (Exemption) Rules.	LFETO s2(2)(k)	Includes an authorized fund and any person in the course of managing it.
H	Authorized institution.	LFETO 4(b)	

H

8.6.2 We consider it appropriate to retain the exemptions in their present form. However, in line with the proposed single-licence concept and to reflect market realities, some of the exemptions may have to be widened, especially those in respect of securities (and futures) only. These include:

a. widening the exemption on incidental advice given by a solicitor and professional accountant to cover advice concerning futures and leveraged foreign exchange;

b. widening the exemption on investment advice given by a financial journalist to cover leveraged foreign exchange;

c. providing a specific exemption for the private investor trading in leveraged foreign exchange; and

d. providing an exemption for a corporation giving investment advice to (or possibly dealing on behalf of) business entities within the same group of corporations (or a joint enterprise) which are not licensed or registered persons.

8.6.3 In addition, the Commission believes that the current exclusion by way of "business" test and "territorial" limitation should also be retained.

8.6.4 The Commission would welcome comments on the scope of proposed exclusions.

9. LICENSING STRUCTURE

9.1 Introduction

9.1.1 The 1990 review observed that whilst the existing structure appeared to be a two-tier system, under which both businesses and natural persons within the industry were required to be licensed, in fact, a middle tier also existed of "dealer director or adviser director" (as the case may be). In adopting a consistent approach to categorization, the Commission proposes the removal of the need for this middle tier of directors to obtain licence as principals. It was advocated in the 1990 review that these supervisory directors be licensed as representatives and that each registered business should have at least one "dealing or advisory" officer for whom there were to be higher entry requirements in terms of professional qualifications or experience. This concept was reflected in the 1996 Draft Bill, under the title of "responsible officers".

9.1.2 However, the 1996 Draft Bill did not require that all executive directors of a licensed corporation be appointed as responsible officers or licensed as representatives. This approach may not provide sufficient regulatory comfort. The directors are the hearts and minds of all incorporated licence entities. They are directly responsible for the way in which the corporation carries on the business for which it is licensed. The Commission, therefore, proposes that all executive directors should be licensed as representatives and be designated as responsible officer.

9.1.3 It follows as a matter of principle that this extended licensing requirement must be observed as a matter of substance and not merely of form. Licensing should extend to those who occupy a position of control or management within a licensed corporation, including those in accordance with whose instructions or directions the licensed person is accustomed or obliged to act, such as shadow directors. The entrance requirement for such persons should logically commensurate with the role they intend to perform in the business or the degree of influence which they exercise over its activities.

9.1.4 Currently, the law only requires one dealing or supervisory director to be accredited to a corporation before it can commence business. To ensure that the business entity is at all times properly managed and supervised by responsible

persons, and consistent with the objective that senior management should be responsible for an intermediary's business conduct, the Commission proposes that a licensed corporation should be supervised at all times by at least two designated responsible officers who are licensed as representatives, at least one of whom must be an executive director.

9.1.5 In fact, the majority of our intermediaries already have their senior executives registered either as dealers or advisers, the equivalent of responsible officers under the new regime, or registered as representatives. The additional licensing requirements proposed above, therefore, will not result in a substantial increase in administrative burden, or license application costs for the industry as a whole.

9.2 Licensing of Representatives

9.2.1 The question of whether representatives should continue to be licensed was addressed in the 1990 review and the Commission considers that the arguments[7] put forward at that time in favour of retaining the licensing of representatives remain valid. It is important that those who deal directly with the public are themselves subject to the direct scrutiny of the regulator. Other major markets, including the United States, United Kingdom and Canada, adopt a similar approach. The current approach is that any person who performs dealing or advisory functions on behalf of a dealer or adviser is required to be registered as a representative. Persons who perform non-dealing or non-advisory functions such as administrative staff are excluded from the licensing requirement.

9.3 Extension of Licensing of Representatives to Senior Officers

9.3.1 The existing licensing regime adopts the principle that only persons who perform the regulated activities are required to be licensed. The 1996 Draft Bill essentially retained this principle.

9.3.2 As demonstrated by the recent failures of certain brokerage firms, the losses suffered by investors might have been avoided had the firms put in place proper internal controls or a suitable risk management system. A regulated business, like any other business, is the sum of all of its various functions, and not only those functions which directly involve direct participation in the conduct of the activities for which it is licensed. It is clear that other operational senior managers, who may not come into daily contact with clients or be involved in the order execution, advisory or

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[7] See paragraphs 70 and 71 which argued that business entities would not assume the role to ensure the fitness and properness of directors and representatives and the Commission relying on ex post facto power to issue “banning orders” creates substantial risk of allowing such representatives to operate in the market for a substantial period of time. Moreover, it was argued that this would shift the onus of proof onto the Commission to demonstrate they are not fit and proper.

foreign exchange trading process, can also significantly influence the business operation and capability of the licensed corporation, such as its capacity to discharge its obligations under relevant Ordinances, subsidiary legislation and Codes.

9.3.3 On this premise, the Commission has considered whether the licensing net should also be cast to include other staff who are critical to the principal's business activities, in particular, those responsible for internal and operational controls and risk management functions.

9.3.4 In the Commission's "Management, Supervision and Internal Control Guidelines" issued in May 1997, it identified various key controls and attributes of an adequate internal control system. These are :

- ❖ Management and supervision
- ❖ Segregation of duties and functions
- ❖ Personnel and training
- ❖ Information management
- ❖ Compliance
- ❖ Audit
- ❖ Operational controls
- ❖ Risk management

9.3.5 Whereas the executive directors and responsible officers of a registered business should remain responsible for the above key controls area, it is argued that senior management staff who are in charge of compliance, settlement and risk management should be licensed in view of the importance of the proper performance of these functions from the perspective of regulatory objective. This would ensure that these persons are fit and proper to hold such core positions and that they have a sufficient understanding of the market and the applicable regulatory requirements (see paragraph 10.8) that are essential to the proper discharge of their responsibilities. Two options have been considered. The first is that all senior officers of a licensed corporation in charge of compliance, settlement and risk management, are required to be licensed as a representative. The second option is set out in the Code of Conduct, the Commission's expectations of the credentials of persons holding such

positions and the requirement that Management should ensure that those expectations are met. The Commission is presently minded to take up the second option.

9.4 Provisional Licence

9.4.1 Whilst the process of licensing representatives is generally considered by the industry to be efficient, some firms, particularly those who recruit from overseas, submit that it is expensive for them to maintain such a person on the payroll whilst waiting for his applications to be processed by the Commission; a process which normally takes about four weeks. The elapsed time is usually a result of having to wait for returns on character checks made to the Police or other regulators.

9.4.2 The Commission is mindful of the time costs associated with applications. As a measure to reduce such costs, the concept of issuing a provisional licence has been considered. Under this concept, where the applicant, about whom nothing adverse is known to the Commission, seeks to be licensed as a representative who is not going to act as a responsible officer, and he or she satisfies the Commission's education and experience requirements, a provisional licence will be issued. Such licence will be effective for a limited period, say one month, and subject to renewal. The licence will clearly state its provisional status and this status must be made known to potential clients, to ensure that consumers will have the choice of whether they wish to do business with such a person. Further, the firm to which the provisional licence holder is accredited will be obliged to ensure that the provisional licence holder is properly supervised and monitored.

9.4.3 If subsequent vetting proves satisfactory, the provisional licence holder will be issued with a licence in the usual form. In the case of an unsuccessful application for a licence, the provisional licence will be terminated.

9.4.4 Licensees, however, will have a choice of whether they wish to be issued with such a provisional licence. The advantage of a provisional licence is that the person is allowed to carry

on regulated activities while awaiting approval of his licence which, as stated earlier, normally takes about 4 weeks.

9.5 Exchanges to Issue Licence

9.5.1 The concept of the provisional licence could be complimented by changes to the registration regime of the Exchanges. It has often been observed that in Hong Kong, the licensing costs imposed on the industry have been exacerbated by the need to obtain dual licences from two regulatory bodies (i.e. the Commission and one of the Exchanges) to trade in either or both the securities and futures field. In practice, quite a number of representatives are required to obtain four licences prior to commencing work.

9.5.2 In a bid to reduce such regulatory costs, other major jurisdictions like the United States, Canada, and to a certain extent, the United Kingdom, have delegated the functions of vetting and issuing licences to the respective self-regulatory organisations. In the local context, we do not believe devolution of the licensing function to the local Self Regulatory Organisations (i.e. essentially the Exchanges) is the best option.

9.5.3 We do, however, believe that greater efficiency is possible, particularly a reduction in overlaps between the Commission's licensing function and comparable processes undertaken by the Exchanges.

9.5.4 Following the announcement of the proposal to demutualise and merge the two Exchanges, the Commission has established a working group composed of representatives from the Commission and the Exchanges to study ways and means to harmonize the respective application procedures and to otherwise reduce overlaps, costs, and delays in the licensing process and the related process of approving access to trading rights on the Exchanges.

10. ENTRY REQUIREMENT

10.1 Introduction

10.1.1 The current entry requirements for all securities and futures intermediaries (firms and natural persons alike) are laid down in section 23 of the Securities and Futures Commission Ordinance ("SFCO"). This section obliges the Commission to refuse registration unless the applicant satisfies the Commission that he is fit and proper to be registered. It further provides, under subsection (3), that in considering whether an applicant is fit and proper to be registered, the Commission should, in addition to other relevant matters, have regard to the following:

" (a) his financial status;
(b) his educational or other qualifications or experience having regard to the nature of the functions which, if the application is allowed, he will perform;
(c) his ability to perform such functions efficiently, honestly and fairly; and
(d) his reputation, character, financial integrity and reliability."

10.2 Fitness and Properness of Firms

10.2.1 As set out in section 23 of the SFCO, satisfaction that a firm is fit and proper essentially rests on three matters:

- capital adequacy or financial resources;
- competence; and
- general integrity.

10.3 Capital Adequacy

10.3.1 The applicant for a licence should be subject to both initial and ongoing capital and other prudential requirements. In Hong Kong, these requirements are rigorously laid out in the Financial Resources Rules, which came into effect on 1 December 1993. The Financial Resources Rules have recently been reviewed and no further recommendations concerning their contents are made in this consultation document.

10.4 Competence

10.4.1 The competence of an applicant to provide services should be assessed by reference to the particular services that applicant intends to provide. Expressed another way: what are the risks arising from the applicant's business plan and is the applicant competent to address these? This risk-based approach has been explicitly adopted in other major jurisdictions. Section 23 of the SFCO implies such an approach, but the test of competence (i.e., the firm's competence to manage the risk it will encounter in performing its functions) has not been explicitly stated.

10.4.2 The Commission proposes that an applicant should be required to provide a comprehensive business plan and to identify all attendant business risks, and the manner in which these risks will be addressed, in order to satisfy the Commission that it is competent to perform the services for which it seeks a licence and is therefore fit and proper to be licensed. The Commission may also identify risks common to particular sectors of the industry, the consideration of which would form a core element of the vetting process. Licence conditions will be imposed by reference to that business plan. The Commission will also review its Fit and Proper Criteria to ensure consistency with this approach.

10.5 General Integrity

10.5.1 The requirement of general integrity largely relates to the directors and controllers of the firm concerned, and appears adequately addressed in the current law. In this regard, subsections (2) and (6) of section 23 of the SFCO allow the Commission to look into the fitness and properness of an applicant firm's connected persons in determining its fitness and properness. Further, the "Fit and Proper Criteria" published by the Commission in March 1990 give quite comprehensive guidelines on the general integrity expected of applicants, and by virtue of subsections (2) and (6), an applicant firm's connected persons. This arrangement has proved to be an effective framework and the Commission suggests that no revision is necessary, particularly having regard to the proposal that all those in a position to exercise significant influence on the conduct of an authorized firm's affairs should require a licence.

10.6 Business Structure

10.6.1 The existing licensing regime (except for traders licensed under the Leveraged Foreign Exchange Trading Ordinance and for securities margin financier to be registered under the proposed amendments to the Securities Ordinance, which require a licensed person to be a Hong Kong incorporated limited company) does not place any restrictions on the type of business structure that may be used. As noted above, the use of unincorporated entities presents risks to investors as highlighted by recent experiences of investors funds and property being frozen, albeit temporarily, in the estate of a sole-proprietor who passed away intestate, and in the failure by some aged sole proprietors to properly manage their business. The latter problem may also emerge in a partnership business.

10.6.2 A corporation, being a perpetual separate legal entity from its directors and shareholders, presents a better alternative in terms of investor protection, because the ownership of and control over assets remain with the corporate entity regardless of changes in its directors or shareholders. Tracing a client's assets among those held by a corporation is relatively more certain and straight forward than with unincorporated entities. The Commission therefore proposes that, in future, only corporations; that are either incorporated in Hong Kong or are registered to carry on business in Hong Kong, will be eligible to be licensed. In order not to unduly disrupt existing businesses, it is proposed that licensed sole proprietors and partnerships be given a transitional period of 24 months in which to incorporate, failing which their licenses will lapse.

10.7 Individual

10.7.1 At present, a person applying to be a representative (other than a responsible officer) must satisfy the basic test set out in the "Fit and Proper Criteria" published in 1990. These requirements are that the person must:

- have attained 18 years of age;
- have completed Form 5 secondary school education or equivalent (for a person acting as representative of a leveraged foreign exchange trader, he must also pass the subjects of Mathematics and either English or Chinese); or possesses 2 years of experience in relevant industries; and
- be otherwise fit and proper (this includes financial soundness, personal integrity, character, competence and reputation).

10.7.2 The Commission considers that the principles laid down in the Fit and Proper Criteria remain appropriate as a standard of entry for persons who wish to participate in regulated activities. However, the Commission no longer regards them as sufficient.

10.7.3 With growing product sophistication and the increasing complexity of the markets, the Commission believes that

representatives must possess some fundamental market knowledge including knowledge of the laws and regulations and the associated codes governing their intended industry sector. In addition, they should be aware of the ethical standards required of a licensed person. Accordingly, the Commission proposes that, as a prerequisite to becoming a licensed representative, and in addition to existing requirements, a person must pass the examinations of an approved industry training course offered by a recognized institution. It is anticipated that the Broker's Representatives Examination conducted by the Stock Exchange of Hong Kong Limited and the Foundation Program Examination to be conducted by the Hong Kong Securities Institute, will be approved courses for this purpose. The Commission would, from time to time, inform the market of other courses which are approved for applicants to take.

10.8 Representative- Responsible Officer

10.8.1 The Commission is cognizant that responsible officers hold a pivotal role in the overall regulatory framework. They undertake the supervisory and management functions within a licenced business. The Commission considers that, in addition to being of unquestioned integrity or reputation, responsible officers must be sufficiently competent to manage and supervise the business trading in its specific sectors of the industry.

10.8.2 The current legislative authority on the issue of competence can be found in section 65A of the SO and section 23(3)(b) and (c) of the SFCO. The former requires an individual, applying to register as a dealer, to show that he or she has sufficient qualification or experience in dealing in securities. This requirement is satisfied if he or she has 3 years dealing experience in a recognized market or has passed an approved examination. The latter states, amongst other things, that in assessing an applicant's fitness and properness to be registered:

"his educational or other qualifications or experience having regard to the nature of the functions which, if the application is allowed, he will perform"; and

"his ability to perform such functions efficiently, honestly and fairly",

shall be regarded.

10.8.3 The "Fit and Proper Criteria", published by the Commission in March 1990, further laid down the Commission's view that principal officers should possess not less than five years relevant experience, or in the case of an applicant having attained an appropriate educational qualification, a shorter period, normally taken to mean three years. However, apart from those individuals applying to be registered as securities dealers, specific entrance competency levels are not specified. Neither has the "relevant experience" been benchmarked.

10.8.4 The Commission proposes that competence standards for responsible officers should be specified. Such standards should include, among other things, proven management skill and experience. This will be achieved by way of an amendment to the Fit and Proper Criteria and by amendment to the primary legislation. The views of industry practitioners will be canvassed, especially in specialised sectors such as corporate finance and venture capital, before the new Fit and Proper Criteria are issued.

10.8.5 As responsible officers are entrusted with the responsibility for properly managing and supervising the activities of the licence holder, they should be able to demonstrate that they have acquired an in-depth knowledge of the regulatory requirements. In this regard, the Commission proposes that, as a prerequisite to be licensed as a representative-responsible officer, a person must pass the examination of an approved course, which aims at testing the candidate's knowledge of regulatory requirements. The course should be one offered by institution recognized by the Commission. It is anticipated that the current Securities Broker Examination offered by the Stock Exchange of Hong Kong Limited and the Financial Market Principal Program Examination to be conducted by the Hong Kong Securities Institute are likely to be approved courses for this purpose.

11 ON-GOING OBLIGATIONS

11.1 Continuous Training Requirement

11.1.1 A licensed person is required to remain fit and proper at all times in order to maintain a licence. In this regard, a licensed person is expected to be at all times competent to discharge his or her functions efficiently, effectively and fairly. To achieve this end, the licensed person should continuously update his or her technical and regulatory knowledge. The legal and accounting professions have continuing education requirements and that these apply to all practitioners, regardless of seniority. With a view to promoting the maintenance of high standards by those involved in the conduct of regulated activities, the Commission proposes that the 'Fit and Proper Criteria' should be amended to incorporate a continuous training requirement as one of the on-going obligations for licence holders to remain fit and proper. Standards relating to continuous professional development for individuals licenced as representatives (whether as responsible officer or otherwise) should be set by the Commission in consultation with the Industry. In this way, the proposed threshold licensing requirements will continue to be built upon and investors will be better protected. Similar continuing education requirements are in place in the United States and United Kingdom and this has clearly benefited the markets.

11.1.2 The obligation to conduct and maintain the continuous training requirement will be imposed upon licensed corporations. In this way, all licensed representatives accredited to the corporation will be provided with the training they need.

12 INVESTOR PROTECTION MEASURES AND DISCIPLINARY POWERS

12.1 Voidability and Recission

12.1.1 Carrying out regulated activities without a licence is a serious offence and legislation should be framed to provide a remedy for investors who have dealt in good faith with unlicensed persons. Section 71 of the Leveraged Foreign Exchange Trading Ordinance provides that any contract or arrangement for leveraged foreign exchange trading made by any person, whether as principal or agent, who is required to be licensed under the Ordinance and who is not so licensed, may be voidable or may be rescinded at the option of the client of that person notwithstanding anything in the contract or arrangement, and shall be entitled to any money or thing he may have paid or delivered under the contract or arrangement.

12.1.2 The Commission proposes that a person who inadvertently deals with an unlicensed intermediary should be protected. The protections should include a right to apply to a court to have a contract set aside. The Commission also invites comments on whether the statutory right of recission of the kind provided under the Leveraged Foreign Exchange Trading Ordinance should be extended to other industry sectors. The Commission is mindful of the problems that may arise where innocent third parties may be affected by such a general statutory right of recission.

12.2 Banning Orders

12.2.1 Under the current law, the Commission has the jurisdiction to take disciplinary action against persons who are not registered with it but who are involved in the management of a licensed corporation which has committed misconduct. In such a case the Commission is limiting to issuing a public reprimand of such a person, which in the Commission's view is frequently inadequate. The Commission is also restricted in the action that can be taken against licensed persons guilty of misconduct who cease to be licensed before the completion of any disciplinary proceedings.

12.2.2 In order to better protect the investing public from dealing with persons whom the Commission considers not fit and proper, the Commission proposes that it be empowered to make orders banning such persons from participation in regulated activities. A person could also be banned from employment in any capacity by a licensed entity without the express consent of the Commission. A banning order could be permanent or for a limited period and it could be issued subject to conditions. The existing criminal sanctions for carrying on any unregistered activity would remain.

12.2.3 A matter which would give rise to the issuance of banning order against a person would be his conviction of an offence which in the Commission's view undermines his fitness and properness to be licensed or to be involved in the management of a licensed corporation. Similarly, such a person would be liable to a banning order if he were found to have engaged in insider dealing, market manipulation and other such false or fraudulent practices. It is proposed that details of such matters which would give rise to the issuance of a banning order should be set out in a code of practice. If the Commission is minded to issue a banning order against a person, that person must be notified in accordance with the standard procedures[8] of disciplinary proceeding. The person

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[8] Disciplinary procedures adopted by the Commission are designed to ensure that a person is given a proper opportunity of being heard. Once the Commission makes a tentative decision to make a disciplinary order against a person he is informed by letter of the facts and circumstances upon which it is based. Following receipt of the person's written representations, the Commission would review its tentative decision before reaching a final decision. The person would then be informed by letter of the decision and the reasons upon which it is based.

concerned would also have the right to appeal against the issuance of the banning order against him to the Securities and Futures Appeals Panel.

13 Transitional Arrangement

13.1 Introduction

13.1.1 The Commission further proposes that the single licence concept, if accepted after consultation, should not affect the right of existing registrants or licencees to carrying on their existing business. All present registrants will be able to continue performing regulated activities under their existing registrations for two years, subject, of course, to the same regulation as would be the case without the proposed streamlining. Before the end of two years, each registrant should put in an application for grandfathering into the new system. A registrant can further continue to rely on its existing registration pending the completion of the application process.

13.2 Registered or Licensed Corporations

13.2.1 Under the new arrangements, all registered or licensed corporations – Securities Dealers, Securities Investment Advisers, Commodity Dealers, Commodity Trading Advisers and Leveraged Foreign Exchange Traders – will be able to continue performing their existing regulated activities, subject to the same regulations, for two years. During this transitional period, each registrant or licencee is expected to put in place arrangements in compliance with the requirements of the new regime or to streamline its business to take advantage of the single licence concept. Prior to the end of the period, each firm would be required to submit an application to obtain a licence to be issued under the new regime and firms which have lodged an application can further continue their regulated activities pending the determination of the application.

13.2.2 The determination process is expected to be expedited as the applicant will not be treated as a new applicant. In an effort to ensure minimum disruption to the registrants' or licensee' operations as well as other market participants, the regulated activities of the firms would be "grandfathered" into the new licence. However, in the event that a firm would like to engage in regulated activities that are beyond its existing scope, it would be required to apply to the Commission in the usual manner and it must be able to demonstrate that it is fit and proper to carry out the new activities.

13.2.3 As the proposed regime stipulates that only corporations shall be licensed as business entities, registered firms that have been carrying on regulated activities in the form of sole-proprietorships or partnerships (as at 31 May 1999, there were 136 registered sole proprietors and 2 partnerships) would have to change their business structure to that of a corporation within the two-year period.

13.3 Accredited Individuals

13.3.1 Registered or licensed person includes dealing directors, supervisory or investment adviser directors, sole proprietors and individual partners, and representatives. As is proposed for registered or licensed corporations, this category of intermediaries would also be "grandfathered" into the new regime.

13.3.2 Dealing and Supervisory Directors - The proposed regime provides for accredited directors to be registered as representatives, albeit to be designated as responsible officers. The Commission proposes to adopt a simple transitional process. They would be deemed (by authority of the new enabling Ordinance) to be licensed representatives acting in the capacity of responsible officers upon the coming into effect of the new enabling Ordinance.

13.3.3 Sole Proprietors and Individual Partners - In compliance with the requirements of the proposed regime, sole-proprietorships and partnerships would be required to change their business vehicle and corporatise their existing businesses. During the two-year transitional period, the

corporations concerned would need to lodge an application for licence under the new enabling Ordinance. In respect of the sole proprietors and individual partners in their personal capacity, they would, likewise, be deemed as representatives acting in the capacity of responsible officers.

13.3.4 Representatives – Similarly, all registered and licensed representatives would be able to continue their functions upon the coming into effect of the new regime in reliance on their existing registration or licence. In an effort to minimise costs and facilitate implementation of the new regime, the representatives concerned would not be required to submit a fresh application for licence under the new regime. Instead, upon their accredited firms obtaining a licence under the new regime, the representatives would simply be required to submit their old certificates for a replacement.

13.3.5 Transfer of Accreditation – During the transitional period, applications for transfer of accreditation would continue to be accepted by the Commission. No change to existing procedures is expected. (The procedure involved is simpler than a fresh application for licence.) Moreover, this procedure would also be applicable in the case of an existing representative, or a deemed representative, seeking to work for a corporation licensed under the new enabling Ordinance in the same regulated activity.

13.4 Exempt Persons

13.4.1 Exempt persons which are authorized institutions would similarly be grandfathered into the new regime in respect of their existing scope of regulated activities. However, under the proposed regime, an exempt person would have to apply to the Commission if it wishes to perform regulated activities beyond its existing scope. It would be required to demonstrate that it is fit and proper to carry out the new activities.

13.4.2 As regards those firms which are not supervised by the HKMA, they would have to surrender their exempt status. However, in line with the two-year transition period for

registered dealing or advisory businesses, these non-authorized institutions would be given a similar period of time to put in the necessary arrangements to obtain a licence under the new regime.

13.4.3 The Commission welcomes suggestions on alternative transition frameworks from interested parties.