24 July 2009

Circular concerning the licensing obligations of Inter-dealer Brokers under the Securities and Futures Ordinance (Cap. 571) ("SFO")

This circular is being issued for the purpose of giving guidance concerning the licensing obligations that arise under the SFO in relation to intermediaries, commonly known as inter-dealer brokers, carrying on business in Hong Kong. Typically, inter-dealer brokers carry on the business of facilitating transactions between institutional clients and financial institutions in relation to a wide range of financial instruments, including listed securities and futures contracts, listed structured products, unlisted fixed income products and OTC derivatives. Transactions in listed instruments may be effected by inter-dealer brokers OTC or through an exchange.

It is of concern to the Commission that some inter-dealer brokers might be carrying on a business in a regulated activity in Hong Kong, without having been appropriately licensed under the SFO. The obligation of such brokers to be licensed under the SFO is largely dictated by the nature of the financial instruments that they trade, their clients and the booking structures which they employ. However, it is likely in most cases that inter-dealer brokers are carrying on a business in Type 1 regulated activity (*dealing in securities*), Type 2 regulated activity (*dealing in futures contracts*) and/or Type 3 regulated activity (*leveraged foreign exchange trading*). If an inter-dealer broker is conducting any of these activities, it must be appropriately licensed under the SFO unless it is able to rely upon any of the exemptions stipulated in the SFO.

Some inter-dealer brokers might take the view that they are not required to be licensed under the SFO because they are able to rely upon the "as principal" exemptions provided for in the definitions of *"dealing in securities"* and *"dealing in futures contracts"* [1]. Whilst the Commission accepts that inter-dealer brokers might conduct certain trades as principals, it is important for them to recognise that these "as principal" exemptions are quite narrow in their scope and that some of their business activities might well fall within the definitions of *"dealing in securities"* and/or *"dealing in futures contracts"*, thereby requiring them to be licensed under the SFO.

The Commission particularly wishes to emphasise that it does not interpret the "as principal" exemptions as being applicable to transactions such as back-to-back arrangements which involve the temporary interposition of a third party (such as an inter-dealer broker) between the parties who are, in the real sense, the buyer and the seller. The Commission considers that where a broker routinely facilitates or effects such transactions by entering into back-to-back contracts with the buyer and with the seller, it is not able to rely on the "as principal" exemptions and is required to be licensed under the SFO to carry on the business of *dealing in securities* and/or *dealing in futures contracts*.

[1] The "as principal" exemptions are set out in sub-paragraph (v) of the definition of *"dealing in securities"* and sub-paragraph (vii) of the definition of *"dealing in futures contracts"*, which are contained in Part 2 of Schedule 5 of the SFO.

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There is no "as principal" exemption provided for in the definition of *"leveraged foreign exchange trading"* contained in Part 2 of Schedule 5 of the SFO.

Some inter-dealer brokers which are approved money brokers within the meaning of section 2(1) of the Banking Ordinance (Cap. 155), might take the view that they are not required to be licensed under the SFO because they are able to rely upon the "money broker" exemptions provided for in the definitions of *"dealing in securities"* and *"leveraged foreign exchange trading"* [2]. The Commission accepts that in some circumstances this might be so. However, it is important for inter-dealer brokers to recognise that these "money broker" exemptions are quite narrow in their scope and that some of their business activities might well fall within the definitions of *"dealing in securities"* and/or *"leveraged foreign exchange trading"*, thereby requiring them to be licensed under the SFO.

There is no "money broker" exemption provided for in the definition of *"dealing in futures contracts"* contained in Part 2 of Schedule 5 of the SFO.

In determining whether an inter-dealer broker is able to rely upon the licensing exemptions stipulated in the SFO, the Commission takes into account all of the relevant facts and circumstances and, in particular, whether the business model of the broker primarily involves agency brokerage.

Carrying on a business in a regulated activity without being licensed under the SFO is a criminal offence. Accordingly, inter-dealer brokers are urged to review their business models for the purpose of determining whether their business activities in Hong Kong require them to be licensed under the SFO. If in doubt concerning the licensing requirements of the SFO and/or whether their particular business activities require them to be licensed under the SFO, they should immediately seek legal advice.

Inter-dealer brokers intending to lodge licence applications with the Commission or wishing to discuss licensing issues are welcome to contact the Commission's Licensing Department by e-mail at Licensing@sfc.hk.

Licensing Department
Securities and Futures Commission

[250/LC/24/1/15]

[2] The "money broker" exemptions are set out in sub-paragraph (xv) of the definition of *"dealing in securities"* and sub-paragraph (iv) of the definition of *"leveraged foreign exchange trading"*, which are contained in Part 2 of Schedule 5 of the SFO.

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