

## Incidental exemption

Corporations licensed for Type 1 regulated activity to carry on other regulated activities

What factors would the Commission take into account in considering whether a corporation licensed for Type 1 regulated activity (dealing in securities) is permitted to carry on other types of regulated activities such as Type 4 (advising on securities), Type 6 (advising on corporate finance) and/or Type 9 (asset management) by virtue of the “wholly incidental” exemption?

Posted on 17.03.2003

10.1 In general, the Commission would take into account some or all of the following factors in considering whether or not the wholly incidental licensing exemption applied:

- (a) whether the giving of advice or the provision of a service to the client is subordinate to the carrying on of Type 1 regulated activity by the licensed corporation;
- (b) whether a discrete fee would be charged for the advice or service;
- (c) whether the giving of advice or the provision of the service constitutes a major part of the licensed corporation’s business.

Can a stock broking firm licensed for Type 1 regulated activity give investment advice or issue research reports to clients without having been licensed to carry on Type 4 regulated activity?

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10.2 To the extent that the giving of investment advice is subordinate or ancillary to the carrying on of the brokerage services, there is no need for the firm to apply to be licensed for Type 4 regulated activity.

An example is where an account executive of a broking firm gives investment advice while taking orders from a client, neither the broking firm nor the account executive need apply to be licensed for Type 4 regulated activity as the giving of investment advice is incidental to the carrying on of the brokerage services.

As regards the issue of research reports, it is essential to ascertain whether such activity is an ancillary service provided by the broking firm or is a separate and distinct service for clients.

If the firm can demonstrate that the issue of research reports is subordinate to the carrying on of its brokerage services, it is not required to be licensed for Type 4 regulated activity. An example is where a brokerage firm issues research reports to its brokerage clients.

In contrast, if the research reports are issued to subscribers as a discrete service, it is unlikely that the

firm could rely on the wholly incidental exemption to carry on such service. For example, a brokerage firm that issues research reports to subscribers who are non-brokerage clients could hardly argue that in such circumstances, the issue of research report is an ancillary service to the subscribers.

The same principle applies to a futures broking firm licensed for Type 2 regulated activity (dealing in futures contracts) who wishes to engage in Type 5 regulated activity (advising on futures contracts).

Can a stock broking firm licensed for Type 1 regulated activity provide discretionary account services without having been licensed to carry on Type 9 regulated activity?

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10.3 If the provision of discretionary account services is an ancillary part of the brokerage services for clients, there is no need for the firm to apply to be licensed for Type 9 regulated activity. An example is where a client has opened a securities trading account with the brokerage firm and authorised an account executive to trade his account with discretion. Neither the brokerage firm nor the account executive need to apply to be licensed for Type 9 regulated activity as such services are provided in a manner incidental to the provision of brokerage services.

However, if the discretionary account services are provided to clients as separate services, it is likely that the firm will be required to apply to be licensed for Type 9 regulated activity. An example is where an account executive of a brokerage firm manages a portfolio of unit trusts for a client whose investments are kept with the fund house. Such portfolio management services are discrete services provided to the client. Both the brokerage firm and the account executive are required to be licensed for Type 9 regulated activity in order to provide such asset management services.

The same principle applies to a futures broking firm licensed for Type 2 regulated activity who wishes to engage in Type 9 regulated activity.

## Corporations licensed for Type 9 regulated activity to carry on other regulated activities

Is it permissible for a fund manager who is only licensed for Type 9 regulated activity to also deal in securities or trade in futures contracts?

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10.4 No. However, provided that it is pursuant to performing its functions in the management of portfolios of securities or futures contracts for clients, a person licensed for Type 9 regulated activity may arrange for the purchase or sale of securities or futures contracts for its clients' portfolios.

Does a fund manager who also engages in the marketing activities of funds need to be licensed/registered for Type 1 regulated activity (dealing in securities) in addition to Type 9 regulated activity (asset management)?

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10.5 A fund manager (including a hedge fund manager) who primarily provides a service of managing a portfolio of securities or futures contracts for another person is required to be licensed/registered for Type 9 regulated activity (asset management).

Where the fund manager who is already licensed/registered for Type 9 regulated activity also engages in the marketing activities relating to those funds under his management, he may rely on the incidental exemption provided in paragraph (xiv) of the definition of "dealing in securities" under the Securities and Futures Ordinance to exempt from the requirement of being licensed/registered for Type 1 regulated activity. Hence, to conduct his fund management business plus

any incidental marketing activities relating to the funds he manages, the fund manager is only required to be licensed/registered for Type 9.

However, the above exemption will not apply if the fund manager markets other funds which are not under his management. Such marketing activities will not be regarded as incidental to his own Type 9 business, and the fund manager needs to be additionally licensed/registered for Type 1.

In applying the above incidental exemption, the following rationales are based upon:-

- Incidental dealing (including marketing) activities as conducted by a fund manager generally form an insignificant part of his overall business in asset management; and
- A fund manager is already well versed in the characteristics and risk aspects of the funds under his management. Therefore, to market such funds, the fund manager needs little extra efforts in understanding the products vis-à-vis the suitability of the products to his clients. On the contrary, if a fund manager markets other funds, considerable due diligence is expected on his part

before he could sell the products to the investors (albeit sophisticated high net-worth investors). In the circumstances, the incidental exemption should not apply and the fund manager is additionally required to be licensed/registered for Type 1 regulated activity like securities dealers.