

## Updating Your Study Manual

### Instructions for Inserting Version 1.9

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The followings serve as the instructions for updating **Topic 1: Regulatory Overview of the Hong Kong Financial Industry** of Study Manual 1 for the Licensing Examination for Securities and Futures Intermediaries. Please be reminded that only the updated sections are provided for downloading. You may replace the relevant sections with this updated version for the study manual you possess.

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#### **Instructions:**

1. Download and print out the following pages.
  2. **Remove** the original front page and **Insert** the updated front page.
  3. **Remove** pages 1-5 to 1-6 and **Insert** new pages 1-5 to 1-6.
  4. **Remove** pages 1-11 to 1-12 and **Insert** new pages 1-11 to 1-12.
  5. **Remove** pages 1-19 to 1-20 and **Insert** new pages 1-19 to 1-20.
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STUDY MANUAL FOR

**PAPER 1**

**FUNDAMENTALS OF**

**SECURITIES AND FUTURES REGULATION**

of

The Licensing Examination  
for Securities and Futures Intermediaries

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balance between promoters and investors or provide the investing public with a fair balance between risk and returns. It has been claimed that the Listing Rules in Hong Kong are merit-based, as they are designed to achieve the same objective.

- 1.10 However, there is no clear-cut distinction between disclosure-based and merit-based regulation, as, in practice, there is often an overlap between the two systems.
- 1.11 Another expression used by the SFC to explain its approach to regulation is that it is 'risk-based'. This basically means that regulation is weighted towards the areas that pose the greatest risk to the markets and the participants.

### **Relevance and impact of past regulatory problems**

- 1.12 The first stock exchange in Hong Kong was formed in 1891 and, by 1973 the exchanges had increased in number to five, including the Hong Kong Futures Exchange ('HKFE'). They were virtually unregulated. The market was planning to open several more exchanges at around that time and this was causing the authorities a lot of concern in view of the lack of control over their activities. The first regulatory reaction was the enactment of the Stock Exchange Control Ordinance in February 1973 which forbade the opening of any more exchanges.
- 1.13 The next event was the market crash of March 1973, which also activated a regulatory response – namely, the enactment of the Securities Ordinance and the Protection of Investors Ordinance on the advice of the Companies Law Revision Committee. A regulatory framework which included the Securities Commission, a Government body, and a Commissioner of Securities was created by the Securities Ordinance.
- 1.14 The market crash of October 1987 triggered a further review of the regulatory framework: the Securities Review Committee under Ian Hay Davison ('the Davison Committee') was appointed to review the financial markets, and its recommendations were eventually adopted.
- 1.15 Each stage of market reformation has led to a clearer statement of the objectives of regulation, and the installation of increasingly professional regulatory bodies designed to achieve these objectives. Nevertheless, Hong Kong has, at every stage, aimed to ensure that regulation was at a level that would be the minimum necessary based on knowledge at the time.

1.16 The broad points stated by the Davison Committee were the need for:

- systemic stability;
- an orderly and smooth-functioning market, which is fair and free from manipulation and deception;
- adequate investor protection;
- regulation to be practitioner-based – that is, to be operated by professionals with an industry or regulatory background;
- checks and balances on the system, with the exchanges being supervised by a commission that was independent of Government, with the Government only to intervene if and when the commission failed to regulate properly; and
- the market to be represented on the exchanges and clearing houses.

1.17 The structure recommended by the Davison Committee has functioned since 1989 and remains basically unchanged. The Securities and Futures Ordinance ('SFO') is largely a consolidation of ten diverse ordinances regulating the securities, futures and leveraged foreign exchange industries.

Revision questions:

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Question 1: State five financial products traded on the Hong Kong financial markets.

Question 2: What event triggered the appointment of the Securities Review Committee ('the Davison Committee')?

Question 3: What is the difference in the status of the SFC as compared with its operational predecessor, the Office of the Commissioner of Securities?

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- 2.15 Notwithstanding the above, there are two classes of funds which are authorized by the SFC which have a linkage with the IA; they are investment-linked assurance schemes and pooled retirement funds, both of which are marketed by the insurance industry. The authorization of these has been delegated by the SFC to the Committee on Investment-Linked Assurance Schemes and Pooled Retirement Funds ('ILAC'). The IA is represented on this committee, as insurance companies wishing to promote these schemes will need to be authorized under the Insurance Companies Ordinance and will have to satisfy the IA.

*The Mandatory Provident Fund Schemes Authority*

- 2.16 The **Mandatory Provident Fund Schemes Authority** ('MPFA') has responsibility for:
- registering provident fund schemes;
  - approving pooled investment funds;
  - overseeing and making rules and guidelines for the administration and management of registered schemes and pooled investment funds;
  - ongoing monitoring of compliance by MPF Products with the Mandatory Provident Fund Schemes Ordinance ('MPFSO');
  - investigating alleged breaches of the provisions of the MPFSO;
  - approving trustees and regulating the affairs and activities of such approved trustees; and
  - dealing with complaints about MPF products and approved trustees, and referring them to the SFC and other regulators for action where necessary.
- 2.17 The MPF schemes refer to compulsory retirement schemes covering a large number of employers, who must set up plans for employees not already covered by other pension plans. The pressure is on the employers, who will be deemed to have committed a criminal offence if they fail to set up plans for their employees.
- 2.18 MPF schemes available to employees include equity funds, bond funds, balanced funds, money market funds and capital preservation funds.
- 2.19 Certain responsibilities of the MPFA interlink with the particular responsibilities of the SFC to:

- vet and authorize MPF products and related marketing materials in accordance with the provisions of the SFC Code on Mandatory Provident Fund Products ('the Code on MPF Products') and the relevant Ordinances (including the SFO);
- registering and approving investment managers and continued monitoring of their conduct in the investment management of MPF products;
- supervising the activities of investment advisers and securities dealers providing services in respect of MPF products;
- investigating alleged breaches of the provisions of the Code on MPF Products and any relevant Ordinances and taking enforcement action; and
- dealing with complaints referred to it by the MPFA or the public about MPF products authorized by the SFC, or the conduct of SFC-licensed persons engaged in the investment management of these products.

The MPFA and the SFC entered into an MOU on 30 June 1999 to coordinate these often-overlapping responsibilities and to assist each other in performing their functions efficiently and properly.

### *The Chinese Gold and Silver Exchange Society*

- 2.20 The Chinese Gold and Silver Exchange Society runs a market now focused on bullion trading in tael gold and kilo gold. It operates a premium system to cover delayed deliveries and transfers of ownership between traders and investors. It is not regulated directly.
- 2.21 However, it has a link with the SFC by virtue of the SFC's regulatory functions. Under the Securities and Futures (Collective Investment Schemes) Notice, made by the Financial Secretary under section 393, SFO, arrangements such as the 'paper gold schemes' promoted by members of the Society are classified as collective investment schemes. The result will be that the SFC will have responsibility for authorizing such schemes and approving advertisements relating to them.

### *The Registrar of Companies*

- 2.22 The Registrar of Companies administers and enforces certain aspects of the:
- Companies Ordinance;
  - Limited Partnerships Ordinance;

3.18 The *Supervision of Markets Division*:

- supervises the conduct, operation and internal systems of the exchanges and clearing houses;
- strengthens the market infrastructure;
- [supervises and monitors activities of the Investor Compensation Company Ltd.](#); and
- ensures generally that the markets are operated efficiently and without risk to the users of the markets and to the image of Hong Kong as a financial centre.

3.19 The *Enforcement Division*:

- monitors the markets to detect market misconduct;
- prevents and investigates market malpractice, and disciplines or prosecutes those responsible, including those that may be unlicensed;
- reports suspected insider dealing and other cases of misconduct to the Financial Secretary or the Secretary for Justice; and
- inspects the books and records of listed companies if and when directors, officers or major shareholders are suspected of impropriety.

**Disciplinary powers, actions, proceedings and penalties**

3.20 The SFC may enquire into or investigate suspected breaches of the SFO and any subsidiary legislation, codes and guidelines:

- Breaches of the SFO and subsidiary legislation will be offences under law and will be investigated by the SFC and enforcement action taken; the SFC may refer serious cases to the law enforcement agencies such as the Commercial Crimes Bureau ('CCB') of the Police Department or the Independent Commission Against Corruption ('ICAC') for investigation and action.
- The SFC may also apply to the courts for an injunction to restrain a person from dealing with his assets, or from carrying on all or a part of his business, if it can make a case to show that it is in the public interest to issue such an order.
- It should be noted that persons prejudiced by the perpetration of market misconduct may take civil action against the wrong-doer through the courts to obtain redress. The SFO has provisions for the findings of the Market Misconduct Tribunal to be admissible in evidence in private civil actions.

- Codes and guidelines do not have the force of law and are not legally enforceable. The SFC is able to penalize licensed persons breaching the codes and guidelines by applying a blanket principle that a breach of these may impugn the licensee's fitness and properness to remain a licensed person.
  - The SFC has the power to reprimand (in private or publicly), to fine, and to suspend or revoke a licence.
- 3.21 Hong Kong Exchanges and Clearing Limited, the exchanges and the clearing houses have disciplinary powers over participants. The powers used to be similar to those of the SFC, but are now more limited in their scope following the transfer of the main supervisory functions over intermediaries to the SFC. They now relate mainly to trading, clearing and settlement infractions and listing matters.
- 3.22 The SFC, the exchanges and the clearing houses each have set circumstances, processes and procedures for activating and enforcing their disciplinary rules. They all have appeal procedures to enable the persons aggrieved by the disciplinary actions to seek redress from independent bodies set up for this purpose – for example, in the case of SFC licensees, it will be the Securities and Futures Appeals Tribunal.

### **Interaction with Government, local and overseas regulators and the International Organisation of Securities Commissions**

- 3.23 The interactions of the SFC with the arms of Government and some local regulators have been reviewed at various points in this topic. In this section, we consider the links between the SFC and the International Organisation of Securities Commissions ('IOSCO') and overseas regulators. We also touch upon the circumstances in which the SFC may disclose information to third parties.

#### ***Disclosure of information by the SFC***

- 3.24 The SFC is empowered to disclose confidential information to a number of persons and organizations in specified circumstances, usually if it is in the public interest, or where it will help the recipient to perform his functions and is not against the public interest. Readers may refer to section 378, SFO for more information on who may be given information by the SFC (students will not be expected to know all permissible disclosure recipients).
- 3.25 The SFC may also provide information to an overseas authority or regulator generally of financial services who is subject to adequate secrecy provisions. The SFC will gazette the names of such persons to whom it has made disclosures.