

Updating Your Study Manual

Instructions for Inserting Version 1.3, 2003

The followings serve as the instructions for updating **Topic 6: Business Operations and Practices** 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.

Instructions:

1. Download and print out the following pages.
 2. **Remove** pages 6-21 to 6-22 and **Insert** new pages 6-21 to 6-22.
 3. **Remove** pages 6-27 to 6-32 and **Insert** new pages 6-27 to 6-32.
-

[Blank Page]

- salesmen doing cash transactions begin to generate high profits; and
- use of [the addresses of the intermediary's staff as mailing or forwarding addresses](#) for clients.

Revision questions:

Question 7: Discuss some features of operational controls over advising clients on investments.

Question 8: What is money laundering?

4 Online trading and advising

4.1 This is a large subject and for the purposes of this study manual we shall limit ourselves to the regulatory requirements made by the SFC. The SFC has so far issued the following:

- Guidance Note on Internet Regulation
- Circular to all Registered and Licensed Firms on Internet Trading and Advising
- Guidance for Registered Persons Using the Internet to Collect Applications for Securities in an Initial Public Offering (students will not be required to know details)
- Circular on Provision of Financial Information on the Internet – Licensing Requirements

The above guidance notes and circulars have not been revised by the SFC at the time of writing.

- CIS Internet Guidance Note (for Persons Advertising or Offering CIS on the Internet). (reissued in April 2003)

Guidance Note on Internet Regulation ('GNIR')

4.2 As with other Codes and Guidelines issued by the SFC, the Guidance Note does not have the force of law but it states that a failure to follow its spirit may reflect adversely on the fitness and properness of the intermediary to continue to be licensed or registered.

Application

- 4.3 We shall assume that under the new licensing regime the GNIR will apply to the following activities on the Internet:
- All activities that are regulated by the SFC.
 - The issuing of advertisements or other documents relating to regulated activities.
 - The making of offers of securities and CIS by way of electronic prospectuses.
- 4.4 The SFC has expressed the view that regulated activities should be supervised in a uniform manner irrespective of the media used to conduct them. It will not regulate activities conducted from outside Hong Kong over the Internet, provided they are not detrimental to the investors in Hong Kong.

Exemptions

- 4.5 The GNIR does not apply to:
- the provision of trade matching facilities on the Internet; or
 - electronic payments.

The SFC has stated in the GNIR that these are under review.

Conducting regulated activities via the Internet

- 4.6 The usual licensing/registration requirements will apply to all regulated activities provided on the Internet in Hong Kong. The services which require licensing include the following:
- The use of Internet technology to induce residents of Hong Kong to participate in regulated activities (including dealing and advising).
 - The conducting of regulated activities using Internet technology in Hong Kong.
 - The provision of such services by a person employed by or acting on behalf of a principal providing such services.

The first two definitions will cover intermediaries, the third applies to representatives.

- 4.7 An intermediary will normally be expected to have a physical establishment in Hong Kong, and a valid business registration and

- a visit in person;
- a telephone conversation; or
- any other interactive dialogue consisting of statements and responses exchanged immediately,

except that in this last case only,

- they may be treated as permissible communications if they are made
 - to more than one recipient in identical terms; or
 - by means of a system which forms or creates a record of the message which may be referred to by the recipient at a later time; or
 - by means of a system which in the normal course does not require the recipient to respond immediately.

8 Insurance cover for intermediaries

Securities and Futures (Insurance) Rules

- 8.1 The maintenance of insurance cover by a licensed corporation (or the deposit of security with the SFC) is a necessary condition for the granting of a licence by the SFC (s.118, SFO). S.116(5), SFO empowers the SFC to make rules for the provision by a licensed corporation of insurance cover of a specified amount for specified risks. The SFC has made the Insurance Rules under s.116(5).

Application

- 8.2 The Rules apply to all licensed corporations other than those which have a licensing condition that they may not hold client assets and are not (SEHK or HKFE) exchange participants. The Rules provide that the SFC may approve master policies of insurance for specific regulated activities, in particular it may approve one master policy for SEHK participants and one master policy for HKFE participants. If approved the SEHK and HKFE policies will become compulsory for the respective classes of participants in addition to any other cover they may be required to take.
- 8.3 Master policies may also be approved for other regulated activities. Such policies are available to corporations licensed for the respective

activities, who may on the other hand wish to take cover with other insurers. They will be allowed to do so if the insurer has a specified credit rating and is not related to the licensed corporation.

Risks covered

- 8.4 The risks covered are risks of loss of client assets of the licensed corporation, including assets received or held by its associated entity, attributable to:
- fraudulent or dishonest acts of the employees of the licensed corporation (or its associated entity or service bureau);
 - robbery or theft while the assets are in the custody of the licensed corporation or its associated entity;
 - forgery or fraudulent alteration of cheques or negotiable instruments;
 - fraudulent use of an information system; or
 - forged or fraudulent instructions relating to client assets.

Cover

- 8.5 Schedule 2 to the Rules specify the amounts of cover for each regulated activity. For example the insured amount applicable for each of dealing in securities, dealing in futures contracts and securities margin financing is HK\$15 million with an excess of HK\$3 million in each case. There is no specified amount for the other activities.

Topic summary

In this topic we have studied how the business operations of an intermediary should be structured to ensure that it complies with the relevant regulatory requirements. We noted the eight key areas which the SFC has pinpointed in the ICG as requiring attention including some which were identical with the nine principles of conduct covered in topic 5.

We started with the key responsibilities of management to set the supervisory and reporting structure, and went on to discuss the need for adequate segregation of duties and functions so that there is less scope for inefficiencies or malpractices, to ensure that there were good competent employees, and there was good management of business information. These could be said to form the structure of operations. On top of this are set the control functions to ensure that the business functions smoothly and effectively. The control functions included compliance, internal audit, risk management and finally operational controls generally.

This formed the major part of the topic of business operations and practice. The rest of the topic was devoted to special requirements applicable to operations including money laundering, Internet usage, automated trading services, and insurance.

Checklist

A checklist is provided to help the reader with his revision:

- The eight key areas of business controls stated in the ICG are management and supervision, segregation of duties and functions, personnel and training, information management, compliance, internal audit, operational controls and risk management.
- Internal controls refer to the entire systems of policies, procedures, checks, controls and division of responsibilities used to run the business.
- An intermediary must have internal controls which give it reasonable assurance that the business is being operated in an orderly and efficient manner, clients' assets are safeguarded, proper and reliable records are maintained, and all applicable laws and regulations are being complied with.

- Satisfactory management includes the taking of responsibility for installing an efficient system of internal controls and ensuring proper compliance with it by directors and employees, setting up of effective reporting systems and procedures supported by regular reports, clear assignment of responsibilities and line reporting, clear definition of authorization levels and related policies and procedures, and ensuring that the supervisory staff are competent and experienced.
- Satisfactory segregation of duties includes the exclusion of senior management, advisory, compliance, risk management and internal audit staff from line operations.
- Good information management includes operating the information management systems in a secure and properly controlled environment and ensuring the prevention of errors, omissions, unauthorized insertions and alterations or deletions of information.
- Management should require the compliance staff to establish effective compliance procedures covering record keeping, prevention of money laundering, and client, proprietary and staff dealings.
- The internal audit function should independently examine, evaluate and report to senior management or the Board on the adequacy, effectiveness and efficiency of the management, internal controls and operations.
- The operational controls should ensure the integrity of the intermediary's dealing practices and fair, honest and professional treatment of clients; and the safeguarding of the clients' and intermediary's assets.
- Operational controls should ensure that any investment advice given for remunerations is supported by a contractual advisory agreement, and that investment recommendations are made after thorough analysis, are suitable for the client and are properly documented; and that proper reconciliations of the records are carried out with external records and reports, errors, omissions and discrepancies are followed up and the reconciliations are reviewed by independent senior staff.
- [\[Moved to page 6-31\]](#)
- Operational controls should include procedures for passing orders to the dealing room, ensuring client priority and, if possible, assigning responsibility for allocating client orders to independent staff.
- Operational controls should, where applicable as where price-sensitive information is handled, include the setting up of Chinese Walls to prevent leakage of this information to other operating staff.

- Risk management procedures should limit the exposure of the intermediary to the risk of suffering loss as a result of client default or changing market conditions to acceptable levels.
- Types of common risk are credit risk, market risk, liquidity risk and operational risk.
- Credit risk is the risk that a client or counterparty may default on his obligation to the intermediary or be unable to perform his part of a contract (define other risks).
- Three common stages of money laundering are placement, layering and integration (what are these?).
- The DTRPO makes it an offence to deal with property which includes receiving or acquiring the property, concealing or disguising it, disposing of or converting it, moving it in or out of Hong Kong, or using it to borrow money or as security.
- Authorized officers to whom money laundering suspicions should be reported include the police, customs and excise officers and the JFIU.
- It is suggested in the ML guidance note that all necessary records which may relate to ML should be retained for at least 7 years.
- Suspicious transactions indicating possible ML include the matching of buys and sells to give the illusion of genuine trading ('wash trading'), or the use of multiple accounts for this purpose; and salesmen engaged in cash transactions suddenly beginning to generate high profits.
- The Guidance Note on Internet Regulation will apply to activities conducted on the Internet which are regulated by the SFC, to the issuing of advertisements or other documents on the Internet and the making of offers of securities and CIS on the Internet.
- The GNIR requires the safeguarding of confidential information communicated over the Internet by the use of encryption technology or other security procedures.
- Advertisements over the Internet require SFC approval if they are targeted at Hong Kong residents and the SFC will use criteria such as the use of push technology to determine whether this is the case.
- A licensed corporation should maintain insurance cover for the risk of loss attributable to fraudulent or dishonest acts of staff; robbery or theft of client assets received or held, and forged or fraudulent instructions relating to client assets.

- A licensed corporation should have cover for HK\$15m if it is conducting any one of Types 1, 2 and 8 regulated activities and does not have a licensing condition that it may not hold client assets.