Updating Your Study Manual

Instructions for Inserting Version 1.3, 2003

The followings serve as the instructions for updating **Topic 7: Securities, Options and Futures** 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 7-5 to 7-14 and **Insert** new pages 7-5 to 7-14.
3. **Remove** pages 7-19 to 7-32 and **Insert** new pages 7-19 to 7-32.

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- recognized exchanges, clearing houses and authorised automated trading services ('ATS');

- persons engaging in dealing in securities as defined above through a licensed securities dealer or registered institution (see note below which applies only to this category of persons);

- persons acting as principals with certain types of professional investor, or in the acquisition, disposal, subscription or underwriting of securities;

- the issuing of prospectuses and forms of application for shares with prospectuses;

- the issuing of an advertisement or invitation authorized by the SFC;

- trust companies registered under the Trustee Ordinance acting for a CIS; and

- certain types of Type 4, 6 and 9 activities.

Note: Nevertheless, such persons will be regarded as dealing in securities if ***in return for remuneration*** they:

- communicate agreements or offers as mentioned above from a third person to a securities dealer;

- make such an agreement or offer on behalf of a third person with a securities dealer;

- accept an offer from a third person for a securities dealer; or

- make introductions between a securities dealer and a third person.

Categories of persons licensed or registered for Type 1 activity

2.6 To wrap up this initial definition section the categories of persons conducting Type 1 activity would include:

- SEHK participants whether they engage in activities on the SEHK or outside it;

- other securities dealers carrying out dealing in securities in Hong Kong;

- licensed representatives of the above;

- AFIs registered with the SFC for this activity (and their staff who deal with the public and are on a register maintained by the HKMA);

- any portfolio managers who are licensed (as security dealers) for Type 1 regulated activity; and

- securities introducing agents (see paragraph 2.68 below).

This list is not comprehensive.

2.7 For clarity, dealing in securities for the purposes of the SFC licensing regime will include dealing in securities traded on SEHK and other securities, where the activity is conducted in Hong Kong.

2.8 Thus it is common for larger entities to typically structure themselves to include one or more of the following:

- a securities dealing company which transacts the major part of dealing in securities in Hong Kong and elsewhere for the group (Type 1 licensed);

- a SEHK participant through which securities dealing on the SEHK are channelled by the first company (Type 1 licensed);

- an HKFE participant through which dealing in futures contracts on the HKFE are channelled by the first company (Type 2 licensed);

- an asset management company which may manage and/or market and distribute funds (Type 9 licensed);

- a securities margin financing ('SMF') company which lends money for SMF direct to investors (Type 8 licensed); the use of this vehicle is diminishing after the SFC tightened the requirements on SMF;

- a finance company which may engage in treasury functions for the group; and

- a group holding company.

2.9 In this kind of set up the sole client of the SEHK participant may be the first company; the same is possible for the HKFE participant. This is not the only form of group structuring possible.

2.10 The various entities must comply with the regulatory requirements of the SFC regime in accordance with their licences and with the Exchange / Clearing House rules according to the type of any participantship. The Exchanges / Clearing Houses rules can be much detailed and it is not proposed to detail them in this manual or to test students on the detail.

The Hong Kong Exchanges and Clearing Ltd. ('HKEx')

2.11 HKEx is a company listed on SEHK (see below) and is an exchange controller as defined in the SFO. HKEx controls and has as subsidiaries various exchanges and clearing houses in Hong Kong.

2.12 As noted earlier, HKEx is responsible for ensuring an orderly and fair market in securities and futures contracts and other matters (refer paragraph 4.3 and 4.6, topic 1 for other responsibilities). Rules and regulations have been made for these purposes by the Exchanges and clearing houses and these may be referred to if detailed information is required.

2.13 HKEx regulates listed companies, trading on the exchanges and the related clearing and settlement functions. The regulation of intermediaries engaged in trading on the exchanges and their relationships with each other and their clients are principally directly regulated by the SFC. Accordingly although the operating and other rules can be extensive, the regulatory aspects of the operations of the HKEx group are limited in their scope.

Exchanges, trading systems and clearing houses

2.14 It will be helpful to a newcomer to the Hong Kong exchanges to introduce the various entities. The details of how they are structured and how trading, clearing and settlement are conducted will not be dealt in this manual except to the minimal extent necessary to help understand the regulatory implications.

2.15 There are currently two exchanges:

- The Stock Exchange of Hong Kong Limited ('SEHK') which provides for trading in securities as defined earlier on two Boards, the Main Board and a secondary board, the Growth Enterprise Market ('GEM'), and in options on underlying securities also traded on the Main Board; and

- The Hong Kong Futures Exchange Limited ('HKFE') which provides for trading in futures contracts principally financial futures.

2.16 These were independent until 6 March 2000 when they were made subsidiaries of HKEx under a scheme of arrangement. They continued to retain their trading and settlement structures. Their operations are governed by separate sets of Rules.

Trading systems

2.17 The third generation of the Automatic Order Matching and Execution System ('AMS/3') is the trading system currently used by SEHK. The AMS/3 system architecture allows for a direct interface between brokers' own systems and AMS/3 and eventually to straight through processing of client orders. AMS/3 processes equities, debt instruments, unit trusts, exchange traded funds and warrants.

2.18 The Hong Kong Futures Automated Trading System ('HKATS') is an electronic screen based trading system used for trading in HKFE products as well as traded options which are SEHK products.

2.19 Options trading and clearing is conducted through the HKATS and clears through Derivatives and Clearing and Settlement System ('DCASS').

Clearing and settlement systems

2.20 There are 3 clearing houses:

- the Hong Kong Securities Clearing Corporation Limited ('HKSCC') which was an independent corporation and the clearing house for the 'cash business' of SEHK;
- the SEHK Options Clearing House Limited ('SEOCH'), a wholly owned subsidiary of SEHK, which clears the traded options business of SEHK; and
- the HKFE Clearing Corporation Limited ('HKCC'), a subsidiary of HKFE which clears the futures business of HKFE.

2.21 Under the March 2000 arrangements, HKSCC also became a subsidiary of HKEx. No further rearrangement was necessary for the other two clearing houses as they were already subsidiaries of SEHK and HKFE and automatically had HKEx as their ultimate holding company.

2.22 The Central Clearing and Settlement System ('CCASS') is operated by HKSCC for securities transactions on SEHK. HKEx introduced in April 2004 the DCASS. DCASS provides a common platform for the clearing and settlement of all derivatives products traded on the HKEx markets, including index futures and options, single stock futures and options.

Participants

2.23 There are a number of groups of 'Participants' within the structure of the various exchanges and clearing houses. Membership of HKEx is distinct from access to the trading facilities of SEHK and HKFE and access to the settlement facilities of HKSCC, SEOCH and HKCC. Because of the separation of ownership and the right to trade, membership is no longer needed to trade on the exchanges or to clear the trades.

2.24 Instead, those who wish to trade through the exchanges ('exchange participants') are required to hold trading rights and register with SEHK as (SEHK) Exchange Participants, or with the HKFE as (HKFE) Exchange

Participants depending on whether they wish to deal in securities or in futures contracts. Trading rights are transferable subject to the approval of the Board. Those wishing to clear trades must become clearing participants of the respective clearing houses, HKSCC and HKCC.

2.25 The various forms of participantships will require the payment of appropriate deposits and subscriptions to the exchanges and clearing houses.

2.26 From a regulatory point of view participants must ensure that they:

- are licensed by the SFC for Type 1, or 2 activities as necessary depending on whether they are dealing in securities or in futures contracts;
- are registered by the SEHK and/or the HKFE as holding the necessary participantship for the trading activities they wish to engage in on the respective exchanges; and/or
- become participants of the relevant clearing houses.

Revision questions:

Question 1: Give 3 examples of securities and derivatives.

Question 2: What is AMS/3?

Question 3: Should an SEHK participant be licensed by the SFC, registered with the SEHK or both?

Rules relating to the SEHK group

2.27 In addition to the application of relevant requirements of the SFO, its supplementary legislation and codes the rules applicable to the SEHK group of exchanges and clearing houses are the:

- Rules of the SEHK;
- Rules Governing the Listing of Securities on the SEHK;
- Rules Governing the Listing of Securities on the GEM of the SEHK;
- General Rules of CCASS (issued by the HKSCC);
- Options Trading Rules of the SEHK; and

- Options Clearing Rules of the SEHK.

It will not be necessary for students to have a detailed knowledge of these rules.

SEHK Participants

2.28 An (SEHK) Exchange participant may be a corporate or a dealing partnership (dealing partnerships must restructure as a company within 2 years from 1 April 2003). They must comply with capital and liquid capital requirements and other fit and proper requirements as discussed in other earlier topics. (SEHK Exchange participants in stock options are considered in section 3 of this topic).

2.29 Dealer's representatives (these are representatives licensed for Type 1 regulated activity) who meet the SEHK's requirements may be registered with the SEHK as Authorised Clerks. An (SEHK) Exchange participant is responsible for the acts of its representatives who act on its behalf in its business of dealing in securities.

An Exchange Participant should also appoint a licensed representative to be in charge of each branch office. It shall notify the SEHK of the name of such persons and any change of such persons.

Trading on SEHK – some points

2.30 An SEHK participant should not intentionally create a false or misleading appearance of active trading on the SEHK and should not create a false market in any SEHK security.

Trading Procedures and transaction costs

Trading hours

2.31 For the SEHK trading is conducted during Mondays to Fridays at the following times:

Pre-opening session:	9.30 a.m. to 10.00 a.m.
Morning session:	10.00 a.m. to 12.30 p.m.
After noon session:	2.30 p.m. to 4.00 p.m.

The pre-opening session is used to determine a fair opening price and to reduce the loading of order inputs and trade execution messages which normally occur at the start of the morning session. It is divided into several sub-sessions for various purposes which will not be studied in this manual.

Closing price calculation

2.32 To avoid a situation in which the closing price is controlled by the price of the last transaction, AMS/3 takes the median figure of the five nominal prices recorded in the last minute of a trading day as the closing price of a security. From 3.59 p.m. onwards, the system records the nominal price of a security every 15 seconds. Five nominal prices will be collected for each security. The nominal price is calculated on the basis of the bid price, the ask price and the last trading price. This procedure minimises the chance of any manipulation of the closing price.

Direct business

2.33 Direct business means business transacted by an exchange participant (or dealing partnership), which acts for both the buyer and the seller, whether as principal or agent. Direct business must be conducted under several rules including the inputting of details of such transactions within 15 minutes of concluding the transaction.

Transaction Costs

2.34 The following are costs to an investor of buying and selling securities on SEHK. The SEHK as well as the SFC will monitor the correctness of the charges.

Brokerage (Commission)

2.35 HKEx has abolished minimum commissions chargeable on transactions on the SEHK with effect from 1 April, 2003.

Transaction Levy and Investor Compensation Levy

2.36 The SEHK charges two levies on the value of each purchase or sale of securities as follows (both the buyer and seller shall pay each of the two levies):

- A Transaction Levy of 0.005% which is passed on to the SFC for use in funding its operations; and

- An Investor Compensation Levy of 0.002% which is used to fund the Investor Compensation Fund established by the SFC.

There is no Transaction Levy nor Investor Compensation Levy on SEHK traded options, pilot program and market making trades in designated Exchange Traded Funds.

Trading fee

2.37 A trading fee of 0.005% per side of the consideration of a transaction is payable to the SEHK. There is no trading fee on SEHK traded options, pilot program and market making trades in designated Exchange Traded Funds.

Trading tariff

2.38 A trading tariff of HK$0.50 is payable to the SEHK on each and every purchase or sale transaction.

Ad valorem stamp duty

2.39 An ad valorem stamp duty is levied on each transaction at the rate of HK$1 for every HK$1,000 or part thereof of the value of the transaction, payable by each of the buyer and the seller.

Transfer deed stamp duty

2.40 Independent of the quantity of shares traded, the Government levies a transfer deed stamp duty of HK$5, payable by the registered holder of the share certificate(s), i.e. the seller, on each new transfer deed.

Transfer fee

2.41 Independent of the quantity of shares traded, the registrar of each listed company levies a transfer fee of HK$2.5 per share certificate from the registered holder, i.e. the buyer, for each new certificate issued.

2.42 No charges are levied by the HKSCC on investors if they settle with brokers or custodians outside the CCASS. However, brokers or custodians have to pay fees for use of the clearing, settlement, custody and nominee services offered by HKSCC. The decision on whether to pass these fees on to investors will be totally at the discretion of the brokers or custodians.

Regulated Short Selling on the SEHK

2.43 Regulated short selling is defined in Schedule 1, SFO and in the Eleventh Schedule of the SEHK Rules to mean ‘the sale of a security in respect of which the seller or a person, for whose benefit or on whose behalf the sale is made, has a presently exercisable and unconditional right to vest the security in the purchaser by virtue of having:

- under a securities borrowing and lending agreement (see paragraphs 2.46 to 2.51 below):
  - borrowed the securities; or
  - obtained a confirmation from the counterparty to the agreement that the counterparty has the security available to lend to him;
- a title to another security which is convertible into or exchangeable for the security to which the sale relates;
- an option to acquire the security to which the sale relates;

- rights or warrants to subscribe to and to receive the security to which the sale relates; or
- entered into with another person an agreement or an agreement of a description as is prescribed by rules made under s.397' of the SFO.

2.44 General practical points relating to short selling on SEHK are:

- it may be undertaken only in securities designated by SEHK (currently they are a large number of these);
- exchange participants must indicate short sell orders when inputting the order;
- exchange participants must make stock borrowing arrangements for settlement before the short sale; and
- a short sale cannot be made below the best current ask price (the tick rule).

(Details of and exceptions to the short-selling rules of the SEHK will not be discussed in this Study Manual.)

2.45 Regulated short selling is a feature of most advanced stock markets in the world and adds to the liquidity and trading volumes of these markets.

Securities Borrowing and Lending

2.46 Stock borrowing and lending ('SBL') refers to the activity whereby a person borrows or lends securities on terms that the borrower undertakes to return securities of the same description, or pay the equivalent value of the securities to the lender. It includes a stock borrowing as defined in the Stamp Duty Ordinance for the purposes of exempting such transactions from stamp duty. (This is based on the definition of securities borrowing and lending in Schedule 1, SFO).

2.47 As noted earlier regulated short selling is usually supported by securities borrowing and lending arrangements. This is a useful arrangement through which considerable volumes of securities held by various custodian institutions such as banks and fund custodians may be made available to assist in the flow of trading on the markets at a profit to the holders of the securities which might otherwise keep them in an immobile state.

2.48 The SEHK rules on securities borrowing and lending are contained in the Trading Rules and Sixth Schedule of the SEHK Rulebook.

2.49 Apart from the requirements for SBL discussed above, an exchange participant engaged in SBL must:

- collect collateral of at least 100% of the value of securities loaned or 105% if the borrowing is for short selling; and
- mark to market (i.e. adjusting the value of the securities according to the latest market price) all securities borrowings at least daily against the previous day closing price.

2.50 The borrowing and lending of Hong Kong stocks is exempted from stamp duty, subject to certain criteria.

2.51 SEHK participants are required to maintain ledgers recording stock borrowing and lending transactions which should be made available to the Inland Revenue Department to enable it to satisfy itself that the requirements for exemption from stamp duty applicable to genuine SBL transactions are properly applied.

Clearing and settlement services

Hong Kong Central Clearing and Settlement System (CCASS)

2.52 In addition to securities clearing and settlement services, HKSCC provides depository services, common nominee services, share registration services, stock borrowing and lending services and electronic securities application and tendering services.

2.53 There are various categories of participants with CCASS including brokers, clearing agencies, custodians, stock lenders, stock pledgees, and investors.

2.54 HKSCC's Investor Account Service allows individual and corporate investors to open direct stock accounts in CCASS and become investor participants.

Clearing Services

2.55 CCASS clearing services determine the stock and money obligations of a broker and other participants trading on the SEHK.

2.56 On each trading (T) day, trade data and trade amendment data are automatically relayed from the SEHK trading system into CCASS. There is no need for broker participants to input or further confirm their trade details in CCASS. They receive Provisional Clearing Statements of their stock and money positions through their CCASS terminals shortly after 6:00pm on the trade day (T). Final Clearing Statements are available to them shortly after 2:00pm on T+1 for confirmation and reconciliation purposes.

2.57 The method for working out the stock and money position of a broker is called the Continuous Net Settlement ('CNS') system. This means that the stock transactions of a broker in the same security on the same day are offset against each other, resulting in a single net stock position for the day. Under this

2.74 Securities dealers and securities margin financiers are only permitted to deal with the client's securities in a limited number of ways, subject to the client's written authorization. For instance:

- securities dealers or securities margin financiers may:

  (i) lend securities collateral of margin clients to other securities dealers in accordance with the SFC requirements regarding securities borrowing and lending; and

  (ii) pledge securities collateral with an authorized institution as collateral for the provision of financial accommodation.

  Note that depositing clients' securities with CCASS as collateral for their own settlement obligations also requires authorisation from clients.

- securities dealers and securities margin financiers have the right to dispose of securities held in safe custody or securities collateral if the client is in default and fails to settle any outstanding liability or maintain an agreed level of margin. This is generally specified in the client agreement and will remain binding until termination.

2.75 The SM financier may allow a client to draw against his margin account to facilitate the continued holding of securities acquired under the margin account. It must be noted that any advance in excess of the realisable value of the securities collateral would generally fall outside the scope of providing financial accommodation for facilitating the acquisition and continued holding of listed securities.

Margin agreements

2.76 A licensed corporation must not start trading on margin for a client before entering into a clear, written contractual agreement. The client agreement must be prepared in a language understood by the client with a clear risk disclosure statement. A licensee should ensure that the client understands the terms and conditions of the margin account, such as:

- how the interest on the margin loan is calculated;
- when and how the loan must be repaid;
- usage of collateral permitted by client's authorisation;
- the permitted loan limit, the lending ratio, and whether there are different lending ratios for different types of securities;
- the margin call procedures, e.g. when a margin call will be made, the consequences of failing to meet a call; and

- what notice, if any, the securities margin financier will give to the client before selling client securities to cover a margin deficiency.

3 Traded Options on the SEHK

Definitions

3.1 Options on stocks are traded on the SEHK and generally referred to as ‘Traded Options’. There are two types of options traded on SEHK, call options and put options.

3.2 A **call option** is a contract which gives the right but not the obligation to the holder of the option to buy a fixed number of shares of a specified stock (‘the underlying’) at a fixed price (‘the exercise price’) at any time on or before a specified date.

3.3 A **put option** is a contract which gives the right but not the obligation to sell a fixed number of shares of a specified stock at a fixed price at any time on or before a specified date.

3.4 The above are American style options so-called because they are exercisable at any time during their outstanding life; this contrasts with European style options which are only exercisable on expiry date.

3.5 SEHK traded options are written on many of the stocks listed on the SEHK. Options on futures are not traded on the SEHK, they may be traded on the HKFE.

Trading

3.6 Before providing services to a client in relation to options contracts, an Options Exchange Participant (‘OEP’) or other licensed person engaging in SEHK traded options business should enter into a an options client agreement in the format specified in Schedule 3 to the SFC’s Code of Conduct.

3.7 Only SFC licensed corporates and individuals may have access to the trading systems and facilities of the SEHK exchange traded market for options in Hong Kong whether directly or indirectly, in order to engage in traded options business.

3.8 In order to conduct any exchange traded options business for clients, an exchange participant must become admitted and registered by the SEHK as an options exchange participant ('OEP') under either one of the following sub-categories:

- Options Trading Exchange Participant ('OTEP'); or
- Options Broker Exchange Participant ('OBEP').

3.9 The participation requirements include the following:

- only an OTEP, who must hold at least one system access right, is entitled access to the options system; an OBEP is not permitted to have system access rights but is entitled to conduct exchange traded options business for the account of his clients by entering into options broking client contracts with an OTEP and corresponding client contracts with his clients, in each case acting as principal.

3.10 Trading participants should input orders and quotes for auto matching through the Hong Kong Futures Automated Trading System ('HKATS'). A matched trade will be passed to DCASS for processing.

Market makers

3.11 In order to promote liquidity, HKEx operates a market maker mechanism within HKATS. An OTEP may apply to the Exchange for permission to make a market in Options Contracts in a particular option class. Before such permission is granted the Exchange may require the OTEP to demonstrate to the satisfaction of the Exchange that it is suitably qualified to make a market in the options contracts in respect of which it wishes to be a market maker. The SEHK may, in its absolute discretion consider the financial standing, trading record, personnel, computer equipment and internal security procedures of the applicant. The Exchange will keep a register of all such approved market makers including the option classes in which they act as market makers.

Clearing and Margin

3.12 From the initial recording of a matched trade in DCASS the process flow is to SEHK Options Clearing House Limited ('SEOCH') which is responsible for clearing the options. SEOCH monitors risk (determines the margin to be collected, monitors the size of the Reserve Fund, calls for top up, carries out surveillance including the review of position ratios and position limits etc.) and acts as the clearing house. SEOCH is the counterparty for all trades and the guarantor of performance in respect of money settlement and stock delivery.

3.13 SEOCH participants enter exercise instructions for house or client positions using DCASS terminals. SEOCH performs assignment and novation and the resultant stock transactions are passed to CCASS for settlement. The counterparties to the CCASS settlement will be the SEOCH participants and SEOCH as the novating counterparty.

Client margin calculations

3.14 An OEP shall ensure that each client is notified of his margin and SEOCH collateral demanded and that this must be carried out promptly. The OEP must also ensure that each margin is (so far as that OEP is reasonably able to ensure the same) settled by the delivery of SEOCH collateral by each client to the OEP promptly. If an OEP has not received SEOCH Collateral due from a client promptly, he may treat that client as being in default. The OEP may require a client to maintain SEOCH collateral with the OEP in advance of accepting instructions from the client or may impose other requirements for the collection of SEOCH collateral as it thinks fit.

Collection of premiums and collateral

3.15 Each OEP shall ensure that premium payable by a client is notified to that client on the day on which the options contract in respect of which the premium is required is made. The OEP shall also ensure that all such amounts are settled in cash promptly. If an OEP has not received premium from a client promptly, he may treat that client as being in default. The OEP may require a client to make arrangements for payment of premium in advance of accepting instructions from the client or may impose other requirements for the collection of premium as it thinks fit.

Settlement

3.16 While the risk management techniques at SEOCH are specifically designed to prevent a SEOCH Participant from defaulting on its obligations, the SEHK, by rule and by operational practice, has prepared contingencies to deal with such an event. In the event that a SEOCH Participant fails to meet its financial obligations to SEOCH, SEOCH would take protective steps including closing positions, transferring positions and liquidating collateral before needing to consider using its reserve funds and insurance cover.

Revision question:

Question 6: When is a securities margin financing activity excepted from the SFO definition of SMF?

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4 Dealing in Futures Contracts

(Type 2 activity)

Definitions

4.1 The definition given in Schedule 1, SFO is that a futures contract means:

- a contract or an option on a contract made under the rules or conventions of a futures market; and
- interests, rights or property prescribed (by the Financial Secretary) under s.392, SFO as futures contracts; but
- does not include interests, rights or property prescribed (by the FS) under s.392 as not being regarded as futures contracts.

4.2 The definition of a futures market in Schedule 1, SFO implicitly defines a futures contract as:

- a contract the effect of which is:
  - that one party agrees to deliver to the other party at an agreed future time an agreed property, or an agreed quantity of a property, at an agreed price; or
  - that the parties will make an adjustment between them at an agreed future time according to whether at that time an agreed property is worth more or less or an index or other factor stands at a higher or lower level than a value or level agreed at the time of making the contract; or
- an option on such a contract.

Definition of a futures market in SFO (Schedule 1, SFO)

4.3 A ***futures market*** is defined to be a place:

- at which facilities are provided for persons to negotiate or conclude sales or purchases of futures contracts or for bringing together such persons on a regular basis; and where:
  - futures contracts (as defined above) are novated or guaranteed by a central counterparty under the rules or conventions of the market on which they are traded; or

- the contractual obligations under such contracts are normally discharged before the contract expiry date under such rules and conventions.

Definition of dealing in futures contracts (Schedule 5, SFO)

4.4 A person deals in futures contracts if he:

- makes or offers to make an agreement with another person to enter into, acquire or dispose of, a futures contract; and

- induces or attempts to induce another person to enter into, acquire or dispose of a futures contract.

Excepted from the definition are:

- recognized clearing houses;

- persons engaging in the above acts through a person licensed or registered for Type 2 activity or who are registered by the HKMA as so engaged (see note below which applies to this category of persons only);

- persons acting as principal with certain types of professional investor in dealing in futures contracts;

- persons engaged in the above acts on markets, or are members of commodity exchanges, referred to in specified sections of the Commodity Exchanges (Prohibition) Ordinance;

- licensees for Type 9 activity who engage in such activities solely for the purposes of the Type 9 activity; and

- persons entering into market contracts.

Note:

Nevertheless, such persons will be regarded as dealing in futures contracts if ***in return for remuneration*** they:

- communicate offers or invitations to enter into futures contracts from a third person to the futures dealer;

- effects an acquisition or disposal of a futures contract for a third person through a futures dealer;

- makes an offer for a futures dealer to a third person to acquire or dispose of futures contracts;

- accepts for a futures dealer an offer by a third person to acquire or dispose of futures contracts; or

- make introductions between a futures dealer or his representative and a third person so that the third person may engage in futures contracts dealing.

Hong Kong Futures Exchange ('HKFE')

Rules relating to the HKFE group

4.5 In addition to the application of relevant requirements of the SFO and its supplementary legislation, codes and guidelines, the rules applicable to the HKFE group of HKEx and clearing houses are the:

- Rules of HKFE; and

- Rules and Procedures of HKCC.

It will not be necessary for students to have a detailed knowledge of these rules.

Trading

4.6 Only SFC licensed firms and individuals may have access to the trading systems and facilities of the HKFE, whether directly or indirectly, in order to carry out the Type 2 regulated activity of dealing in futures contracts.

4.7 There are a number of categories of exchange participantship for which the HKEx will grant authorisation. These categories are set out in HKEx Rule 312 as follows:

- an (HKFE) Exchange Participant ('EP') may be a Trader, a Broker, a Futures Commission Merchant or a Merchant Trader, each such category having the rights and obligations set out in the Rules;

- all categories of EP, subject to any requirements and/or conditions that the HKEx board may impose from time to time, are entitled to trade in any markets operated by the HKFE;

- a Trader, is entitled to trade in futures contracts and/or options contracts on his own account only;

- a Broker is entitled to trade in futures contracts and/or options contracts on his own account only. A broker may also act as the agent of an (HKFE) Exchange Participant for the sole purpose of concluding trades on any markets operated by HKFE;

- a Futures Commission Merchant is entitled to trade in futures contracts and/or options contracts on its own account, for the account of other (HKFE) EPs and for the account of any other persons; and

- a Merchant Trader is entitled to trade in futures contracts and/or options contracts only on its own account and only ancillary to its principal business or that of its holding company.

Clearing Participants

4.8 Only HKFE exchange participants may become members of the HKFE Clearing Corporation (HKCC).

4.9 Only two types of participant can be registered at the HKCC, these are:

- General Clearing Participant ('GCP'); or

- Clearing Participant ('CP').

4.10 Every HKCC participant is entitled in accordance with the HKCC Rules to record, register and clear contracts entered into by itself. In addition:

- a GCP is entitled to record, register and clear contracts in accordance with HKCC Rules on behalf of those non-clearing participants with which it has entered into a clearing agreement and also for CPs; and

- at the discretion of the clearing house a CP may be entitled to record, register and clear contracts in accordance with HKCC Rules for other CPs.

4.11 A Non-Clearing Participant ('NCP') is not entitled to record, register and clear contracts in accordance with HKCC Rules but must arrange that all contracts entered into by it are recorded, registered and cleared on its behalf in accordance with the HKCC Rules by a GCP.

Participant Requirements

Trading rights

4.12 Each (HKFE) Exchange Participant must be approved by and registered with HKEx to trade through HKATS (Hong Kong Futures Automated Trading

System). Further each such participant must also be approved by the HKEx to trade each specific futures contract section.

4.13 A firm's client can start trading in the futures markets only after opening an account with a broker who is an EP.

Ongoing Requirements

Trading Rules

4.14 The following are relevant futures market trading rules for the purposes of this study manual:

- no (HKFE) exchange participant shall knowingly take the opposite side of an order of a client given to it for execution unless all the following requirements are met:
  - the client has given prior consent in writing to such transactions; and
  - the trade has been bid, offered and reported in the manner laid down in the procedures prescribed by the Board from time to time.

Clearing and Margin

Settlement counterparties

4.15 Although each HKATS transaction is executed between two exchange participants (sometimes the same participant may act for the HKFE buyer and seller) the HKCC, on accepting the trade for clearing, takes over the role of counterpart to each transaction. It becomes the buyer to each seller and the seller to each buyer by the legal process of novation. It is this facility which permits investors and participants to be able to effect a close out transaction (an equal and opposite transaction) which thus removes all liability from the original transaction (opening trade).

4.16 While the risk management techniques at HKFE are designed to prevent an HKCC participant from defaulting on its obligations, HKFE, by rules and by operational practice, has prepared contingencies to deal with such an event.

Initial margin requirements

4.17 Margins set by the SFC and the HKEx are designed, and defined, as minimum required levels. Each participant has discretion as to the margin levels it actually charges to clients as long as they are no less than the prescribed minimum. In particular, for a number of effective risk management justifications, firms may chose to require higher margin levels than those set by the regulatory authorities.

4.18 The HKFE establishes minimum initial margin requirement levels for all products traded through its facilities. HKFE bases these requirements on historical price volatilities, current and anticipated market conditions, and other relevant information. Initial margin requirements are good faith deposits to guarantee the performance of futures and options contracts.

4.19 HKCC calculates margin on a gross basis rather than net basis. Margin cash or collateral must be deposited by the HKCC participant for each open position (long or short) held at the end of each day's trading, with concessions for spreads. The gross margining system provides immediate assurance that market participants have the financial ability to support their market activities. HKCC participants trading for their own accounts must also post the required margin deposits on a net position basis.

4.20 Maintenance margin requirement levels represent the minimum amount of protection against potential losses at which the HKFE Exchange participant will allow its customers to carry a position or portfolio. Should the margin requirement on deposit fall below the maintenance level, HKFE rules require that the account be re-margined back to the initial margin requirement level.

Variation adjustments

4.21 All futures and options contracts on HKFE are settled daily using the mark-to-market system. At the end of each trading day HKCC will determine all the HKCC participants' liabilities such as margin, trading fees and variation adjustment. The variation adjustment is the daily gain or loss for the account and will be posted to the account each day. Each business day, based on the mark-to-market of all open positions to the previous trading day's settlement price, HKCC pays to or collects cash from each HKCC participant.

Intra-day calls

4.22 In times of extreme price volatility, HKCC has the authority to perform additional intra-day mark-to-market calculations on open positions and to call for immediate payment of variation adjustment. HKFE's mark-to-market system does not allow losses to accumulate over time or allow a market participant the opportunity to defer losses associated with market positions.

Settlement

Delivery consequences

4.23 The method of delivery for futures contracts depends on the mechanism specified in the contract specification for each product. Essentially this can only be either cash settlement or physical delivery of the underlying instrument or commodity.

4.24 Hence:

- cash settled contracts shall be settled by payment of cash; and
- physical delivery contracts shall be settled by delivery of the underlying commodity or instrument by the sellers of such contracts and by payment of cash by the buyers of such contracts.

Revision questions:

Question 7:	Name the participants on the HKFE.
Question 8:	What type of trading may a merchant trader engage in?
Question 9:	What can an HKFE participant do if his margin requirement on deposit falls below the maintenance margin requirement?

5 Advising in securities and futures contracts

(Types 4 and 5 regulated activities)

5.1 These are two activities defined in Schedule 5, SFO as constituting advising in securities or on futures contracts. They are:

- the giving of advice; or
- the issuing of analyses or reports;

for the purpose of facilitating the recipients to acquire or dispose of securities or enter into futures contracts.

5.2 Persons holding licences for advising in securities advising and on futures contracts are comparable in number to dealers in securities and futures contracts so they form a significant group.

5.3 Persons exempted from needing a licence for advising in securities and futures contracts generally include:

- solicitors, counsel, professional accountants, trust companies and persons licensed to carry out asset management whose advising activities are wholly incidental to their main activities;

- financial journalists and broadcasters who give investment advice or issue analyses or reports on investments to the public on subscription or otherwise;
- corporations giving advice or issuing analyses or reports solely to their group companies;
- persons licensed to deal in securities (these are allowed to advise in securities); and
- persons licensed to deal in futures contracts (these are allowed to advise on futures contracts).

5.4 Corporate finance advisers and asset managers require separate licences (Types 6 and 9 regulated activities respectively).

Special conduct requirements

5.5 There are specific conduct requirements embodied in the SFO and the SFC Codes for Type 4 and Type 5 licensees:

- They should establish clear requirements and procedures regarding adequacy of research work and preparation and retention of documentation supporting its recommendations to clients.
- They should document the rationale underlying the investment advice given and provide copies to the client. The recommendations made must be suitable, taking into account the clients' particular investment experience, objectives and financial positions.
- They must ensure that all reports issued are not misleading or deceptive. It is an offence to make any fraudulent or reckless misrepresentation to induce a person to buy or sell securities (section 107 of SFO). The person making the statement may be liable to pay compensation to the other person for any damages that person may suffer, as this is a civil wrong (section 108 of SFO).

5.6 This provision also applies to persons that are excluded from the registration requirements listed above. For example, journalists are exempt from the registration requirements for the publication of their investment advice. If there is evidence showing that a journalist has made false or misleading statements, the SFC may prosecute the journalist concerned.

Revision question:

Question 10: Name a few basic matters that a securities investment adviser should pay attention to when providing advice to a client.

Topic summary

In this topic the reader reviewed the regulated activities of dealing in securities, dealing in futures contracts, investment advising and securities margin financing.

He first studied the definitions of the regulated activities, noted the classes of exemptions from each activity as specified in the SFO with the objective of setting the boundaries for the SFC's supervision of the activities.

In this topic some basic ideas relating to the exchanges, SEHK and HKFE, their trading systems, AMS/3 and HKATS, and clearing houses HKSCC/CCASS, SEOCH and HKCC were considered.

Short selling and stock borrowing and lending on the SEHK were reviewed.

The positions of approved introducing agents and securities margin financiers were studied before reviewing the traded options activity on SEHK.

The next section in this topic was the study of futures contract trading. Some basic practices of the HKFE were studied and the final section touched upon investment advising.

Checklist

Below is a checklist of the main points covered by this topic. Readers should use this checklist to test their knowledge.

- Revise the definitions of securities (paragraph 2.1), derivatives (paragraph 2.3), traded options including call and put options (paragraphs 3.1 to 3.5), futures contracts (paragraphs 4.1 and 4.2), dealing in securities (paragraph 2.5), dealing in futures contracts (paragraph 4.4), securities margin financing (paragraph 2.71), and advising in securities and in futures contracts (paragraph 5.1).
- Ensure that they can state the exceptions to the above definitions.
- Securities other than options are traded through AMS/3; traded options and futures contracts are traded through HKATS.
- Securities are cleared and settled through the CCASS system of HKSCC.
- DCASS provides a common platform for the clearing and settlement of all derivatives products traded on the HKEx markets, including index futures and options, single stock futures and options.