

Updating Your Study Manual

Instructions for Inserting Version 1.1, 2003

The followings serve as the instructions for updating **Topic 1: Regulatory Framework** of Study Manual 3 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** the original front page and **Insert** the updated front page
 3. **Remove** pages 1-15 to 1-18 and **Insert** new pages 1-15 to 1-18.
 4. **Remove** pages 1-23 to 1-24 and **Insert** new pages 1-23 to 1-24.
-

[Blank Page]

STUDY MANUAL FOR

PAPER 3

REGULATION OF DERIVATIVES

of

The Licensing Examination
for Securities and Futures Intermediaries

Version 1.1, 2003

Published by:

Hong Kong Securities Institute

©Hong Kong Securities Institute 2003

24/F, Wing On Centre, 111 Connaught Road Central, Hong Kong

Telephone: (852) 3120-6100

Examinations Hotline: (852) 3120-6220

Membership Hotline: (852) 3120-6170

Training Hotline: (852) 3120-6200

Fax: (852) 2899-2611

Email: info@hksi.org

Website: www.hksi.org

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise without the prior permission of the copyright owner.

ISBN: 988-97139-3-4

Disclaimer

This is an educational manual only and does not provide legal advice or expert advice in whatsoever form. Every effort has been made to ensure its accuracy, however, no responsibility for loss occasioned to any person acting or refraining from action as a result of any materials in this publication will be accepted by the publisher and/or individual contributors.

- 3.19 The three most significant factors for supervisors to consider in this department are:
- capital requirements;
 - the quality of advice given to clients; and
 - the quality of documentation and information between the intermediary and the clients.

4 The Hong Kong Exchanges and Clearing Limited ('HKEx')

Structure

- 4.1 The HKEx is a listed company on the Stock Exchange of Hong Kong Limited (SEHK). On 6 March 2000, the SEHK, the HKFE and the Hong Kong Securities Clearing Company Limited ('HKSCC') became wholly owned subsidiaries of HKEx. In addition, the SEHK Options Clearing House Limited ('SEOCH') and the HKFE Clearing Corporation Limited ('HKCC') became indirectly wholly-owned subsidiaries.
- 4.2 HKEx is the only recognized exchange controller in Hong Kong. The SEHK and the HKFE are recognized by the SFC under powers delegated to it by section 19, SFO as exchange companies which may operate a stock market and a futures market, respectively, in Hong Kong. The three clearing houses obtain their recognition from the SFC under powers delegated to it by section 37, SFO.

Roles and responsibilities

- 4.3 HKEx is responsible for ensuring an orderly, informed and fair market in futures traded on or through the HKFE. The HKEx, HKFE and the HKCC (the associated clearing house) are required to ensure that:
- there are orderly, fair and expeditious clearing and settlement arrangements for any transactions in securities or futures contracts cleared through its auspices; and
 - the risks associated with its business and operations are managed prudently.
- 4.4 In discharging its duties, HKEx is also required under section 63, SFO to ensure that it:
- acts in the interests of the public, having particular regard to the interests of the investing public; and

- ensures that, where such interests conflict with any other interests, the former should prevail.
- 4.5 HKEx undertakes management of its own business risk and enforces its own trading, clearing and settlement rules. They are not responsible for front-line prudential regulation of exchange participants or for regulating their general conduct. These functions are performed by the SFC.
- 4.6 Under section 65, SFO, an exchange controller is required to establish, and keep established, a committee, to be called the Risk Management Committee, to formulate policies on risk management matters relating to the activities of the recognized exchange controller and of any recognized exchange company or recognized clearing house of which the recognized exchange controller is a controller for its consideration.

HKEx business units

- 4.7 The HKEx operates under three front-line business units: the Exchange, Clearing and E-business units. These are supported by several functional units, of which the most important is the Listing, Regulation and Risk Management Unit.

Exchange Business Unit

- 4.8 The Exchange Business Unit covers all of the products traded on the platforms of the cash and derivatives markets. The cash market includes equities, warrants, debt instruments, unit trusts and mutual funds.
- 4.9 The relevant derivative products are listed below:
- Equity Index products:
 - Hang Seng Index Futures and Options;
 - Mini-Hang Seng Index Futures;
 - MSCI China Free Index Futures;
 - Dow Jones Industrial Average Futures; and
 - [H-shares Index Futures](#);
 - Equity products:
 - stock futures;
 - stock options; and
 - international stock futures and options; and

- Interest rate products:
 - three-year Exchange Fund Note (EFN) futures; and
 - HIBOR futures.
- 4.10 The Exchange Business Unit is therefore responsible for monitoring the ongoing trading of securities, futures and equity options, and ensuring that the trading environment is transparent, fair and efficient according to the rules and regulations established by HKEx and that adequate trading and support services are provided for exchange participants. The respective points and relevance of these rules will be covered in topic 6 on futures trading and settlement.
- 4.11 The electronic screen-based system used for trading the futures products is known as HKATS. It is an enhanced version of the original automated trading [system](#) (‘ATS’). Direct access to the system is available to HKFE participants, who must be Hong Kong incorporated companies, and to participants of SEHK, who trade stock options.
- 4.12 However, remote access is permitted to companies incorporated outside Hong Kong if they either:
- trade futures contracts for their own account only; or
 - are a subsidiary, the holding company or a subsidiary of the holding company of a participant of both HKEx and HKCC.
- 4.13 The company must also be regulated by its domestic regulatory authority and that authority must have an MOU with the SFC. Remote access is currently allowed from the United States, the United Kingdom and Australia.

Clearing Business Unit

- 4.14 The Clearing Business Unit is responsible for clearing, settlement, depository, nominee and share registration activities, and the related risk management. It includes cash clearing and derivatives clearing and has responsibility for the operation of the three clearing houses:
- the Hong Kong Securities Clearing [Company](#) Limited;
 - the SEHK Options Clearing House Limited; and
 - the HKFE Clearing Corporation Limited.
- 4.15 This unit thus also has responsibility for ensuring the issue of fair and reasonable membership and clearing rules. The respective points and relevance of these rules will be covered in topic 6.

E-business Unit

- 4.16 The E-business Unit is responsible for the development and promotion of e-commerce within HKEx. It is responsible for sales and business development of market data, collection and dissemination of issuer information, and the compilation and development of index and statistical data. It does not have any regulatory functions.

Other regulators

- 4.17 The only other regulator involved in regulating the futures market, in addition to the SFC and HKEx, is the Hong Kong Monetary Authority ('HKMA').
- 4.18 The HKMA shares the responsibility of regulating the securities business of authorized financial institutions, which are mainly banks, with the SFC. The SFC's jurisdiction is confined under the SFO to the securities and futures industry. However, although the activities of authorized financial institutions are fully monitored and supervised by the HKMA, any securities and futures market activity still falls to be regulated also by the SFC. In order to minimize this regulatory overlap, the SFO provides for a mechanism whereby such institutions may apply to the SFC for registration as 'registered institutions' to conduct one or more regulated activity types. The SFC will consult with the HKMA before an applicant is granted a certificate of registration as a 'registered institution'. Under the SFO, the HKMA then conducts supervision, regulation and surveillance of these institutions.
- 4.19 Internationally, Hong Kong maintains close cooperation with some 38 overseas regulators through MOUs and associations to ensure the integrity of the securities and futures market. In addition, international working parties organized under the auspices of bodies such as the International Organisation of Securities Commissions ('IOSCO') foster better understanding and dialogue among regulators on issues such as international economic order and financial stability. The SFC is a full member of IOSCO and often chairs some of its more important sub-committees. As a full member of IOSCO the Hong Kong securities and futures market is expected internationally to comply with relevant codes and practices established for international markets.

Answers to revision questions

- Answer 1: Your response can include: convertible bonds, covered and uncovered warrants, depository receipts, forward contracts and rights (of various kinds).
- Answer 2: The financial stability of intermediaries is a major factor in building confidence in the capital market.
- Answer 3: The rules made under Part V, SFO are the Financial Resources Rules, the Client Securities Rules, the Client Money Rules, the Keeping of Records Rules, the Contract Notes Rules, the Statement of Account and Receipts Rules, and the Accounts and Audit Rules.
- Answer 4: The main purpose of the Code of Business Conduct is to set appropriately high standards for intermediaries.
- Answer 5: Section 390, SFO permits the SFC to make senior officers of a licence intermediary take responsibility for the actions of their staff where it is proved that they aided, abetted, counselled, procured or induced, or the offences were committed with the consent or connivance of, or were attributable to any recklessness on their part.
- Answer 6: The regulatory objectives of the SFC as set out in section 4, SFO are:
- to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities industry;
 - to promote the understanding by the public of the operation and functioning of the securities industry;
 - to provide protection for members of the public investing in or holding financial products;
 - to minimize crime and misconduct in the securities industry;
 - to reduce systemic risks in the securities industry; and
 - to assist the Financial Secretary in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the securities industry.
- Answer 7: The HKEx is responsible for ensuring an orderly, informed and fair market in futures traded on or through the HKFE. The HKEx, HKFE and HKCC (the associated clearing house) are required to ensure that:

- there are orderly, fair and expeditious clearing and settlement arrangements for any transactions in securities or futures contracts cleared through its auspices; and
- risks associated with its business and operations are managed prudently.

In discharging its duties, the HKEx is also required, under section 63, SFO, to ensure that it:

- acts in the interests of the public, having particular regard to the interests of the investing public; and
- ensures that where such interests conflict with any other interests, the former should prevail.

Answer 8: The Risk Management Committee's role is to formulate policies on risk management matters relating to the activities of the recognized exchange controller and of any recognized exchange company or recognized clearing house of which the recognized exchange controller is a controller for its consideration.

Answer 9: The products traded on HKATS are Hang Seng Index futures and options, Mini-Hang Seng Index futures, MSCI China Free Index futures, Dow Jones Industrial Average futures, [H-shares Index futures](#), stock futures, stock options, international stock futures and options, three-year Exchange Fund Note (EFN) futures and HIBOR futures.

Answer 10: Remote access to HKATS is currently permitted from Australia, the United Kingdom and the United States.