

Updating Your Study Manual

Instructions for Inserting Version 1.2, 2003

The followings serve as the instructions for updating **Topic 2: Licensing** 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 2-15 to 2-18 and **Insert** new pages 2-15 to 2-18.
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STUDY MANUAL FOR

PAPER 3

REGULATION OF DERIVATIVES

of

The Licensing Examination
for Securities and Futures Intermediaries

Version 1.2, 2003

Published by:

Hong Kong Securities Institute

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ISBN: 988-97139-3-4

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Required liquid capital

3.21 The regulator specifies a required liquid capital ('RLC') for different types of regulated activity. This RLC (or minimum capital) must be maintained at all times. The RLC for Type 2 and Type 5 activities are as follows:

- Type 2:
 - where the licensed corporation is an approved introducing agent, futures non-clearing dealer or trader: HK\$500,000;
 - in any other case, HK\$3 million;
- Type 5:
 - where it does not hold client assets, HK\$100,000;
 - in any other case: HK\$3 million.

Or not less than 5% of the aggregate of the total liabilities, whichever is the higher.

Paid-up share capital

3.22 In addition to the RLC, licensed corporations are also required to maintain at all times a specified amount of paid-up share capital, which is related to the activities it undertakes. If it conducts more than one regulated activity, it must maintain the highest single requirement applicable to the individual activities. The minimum amount of paid-up share capital for dealing in and advising on futures is as follows:

- Type 2 activity (dealing in futures), HK\$5 million.
- Type 5 activity (advising on futures), HK\$5 million.

3.22A However, minimum paid-up share capital requirement shall *not* apply to the following cases:

- Type 2 activity – in the case where the corporation is an approved introducing agent, a futures non-clearing dealer or a trader; and
- Type 5 activity – in the case where the corporation is subject to the licensing condition that it shall not hold client assets.

Notifications to the SFC

3.23 A licensed corporation must:

- as soon as reasonably practicable, notify the SFC in writing if it is unable to comply with the specified amounts of capital and immediately cease to carry on the regulated activity, unless otherwise permitted by the SFC; or

- within one day, notify the SFC in writing if it is unable to comply with other requirements of the FRR.
- 3.24 The SFC may, by notice in writing, suspend a corporation's licence if it reasonably believes that it cannot comply with the specified capital requirements, or allow it to continue subject to conditions. Any licensed corporation that fails to comply with the requirements, or breaks any of the conditions imposed by the SFC, or continues to trade while in breach of the FRR, without permission from the SFC, is guilty of an offence.
- 3.25 The SFC may, at any time, ask a licensed corporation to show the SFC that it is complying with the FRR, or it may authorize a person to check on its behalf. If the corporation is unable to show that it complies with the FRR, the SFC may suspend the corporation or allow it to carry on subject to specified conditions. If the licensed corporation contravenes any condition imposed, it is guilty of an offence.
- 3.26 To assist the SFC in monitoring compliance, corporations must notify the SFC in writing if:
- its LC falls below 120% of the RLC, or falls below the RLC, or falls below 50% of the last LC reported, or would fall below the RLC if it did not rely on a subordinated loan approved by the SFC;
 - its paid-up capital falls below the specified minimum;
 - the information submitted in any earlier return is, or has become, materially misleading;
 - a material change to accounting policy occurs; or
 - an auditor is appointed or a previous auditor is changed.

Returns to the SFC

- 3.27 Corporations undertaking Type 2 activities, or Type 5 activities that involve holding client assets, are required to make monthly returns of LC and RLC with supporting information. Corporations undertaking Type 5 activities that do not involve holding client assets are only required to make returns on calendar half-years. These returns may also contain less detail than those specified for Type 2 and Type 5 activities with client assets.
- 3.28 Corporations must also provide annual audited accounts, together with the auditor's report, including the profit and loss account and balance sheet, within four months of its financial year-end.

Failure to meet financial resource requirements

- 3.29 Failure to comply with the Financial Resources Rules, without a reasonable excuse, is a criminal offence. Some breaches — for example, failure to

submit annual returns — are punishable with a fine of up to HK\$200,000 and one year's imprisonment. A breach with intent to defraud carries a maximum sentence of a fine of HK\$1 million and seven years' imprisonment.

Suitable premises

- 3.30 There is a further requirement, under section 130, SFO, that corporations have suitable premises for keeping records or documents. Essentially, this simply requires that the SFC gives its approval to any premises used for keeping and/or storing records in connection with any regulated activity for which the intermediary seeks a licence.

Responsible officer, representatives and executive officers

- 3.31 The term 'responsible officer' is not defined in the SFO. However, the SFC has provided this definition:
- A responsible officer is defined as an officer who actively participates in, or supervises the regulated activities of, a licensed corporation and who is nominated as a responsible officer by the licensed corporation.
- 3.32 The licensed corporation must ensure that each individual representative of the intermediary is properly licensed (see section 4 of this topic) for the regulated activities that he is expected to carry out on behalf of the corporation. Where an individual leaves a corporation, the corporation must notify the SFC within seven business days of this fact.
- 3.33 Section 125, SFO requires that:
- every executive director of the corporation who is an individual is approved by the SFC as a responsible officer of the corporation in relation to the regulated activity; and
 - not less than two individuals, at least one of whom shall be an executive director of the licensed corporation, are approved by the SFC as the responsible officers of the corporation in relation to the regulated activity.
- 3.34 It should be appreciated that although, for each regulated activity, the corporation must have at least two responsible officers, one will remember from section 118 that only one of them must be available at all times.
- 3.35 Corporations must lodge applications with the SFC for approval of the responsible officers (section 126, SFO). While all executive directors must be responsible officers and thus also licensed representatives, a corporation may apply for other senior personnel also to be so approved. The basic conditions for approval as a responsible officer are that:

- he is a fit and proper person to be so approved; and
 - he has sufficient authority within the intermediary.
- 3.36 Such approval can be subject to such reasonable conditions as the SFC may impose on the corporation and the individuals concerned.

Display of certificate

- 3.37 All corporate licence certificates must be prominently displayed in a licensed corporation's office. Where the corporation has more than one office, the display of the original should be at the head office and a certified copy displayed at each of its other places of business.

Associated entities

- 3.38 When considering whether to issue a licence, the SFC will take into consideration the licensed intermediary's associated entities. These are a company or an overseas company (which has established a place of business in Hong Kong), which:
- is in a controlling entity relationship with the intermediary; and
 - receives or holds in Hong Kong client assets of the intermediary.
- 3.39 A controlling entity is a person who:
- controls not less than 20% of the voting power;
 - has the right to nominate any directors; or
 - has an interest in shares which entitle him to veto or amend resolutions of the controlled corporation.
- 3.40 Hence, another company, whether it is a group company or otherwise, acting together with the intermediary, especially where it may act as a conduit or hold client assets of the intermediary, will be caught by this definition.

Substantial shareholders

- 3.41 The SFO requires that substantial shareholders of a corporation licensed under section 116 must be approved by the SFC (section 132, SFO). A substantial shareholder is formally defined in section 6, Schedule 1 of the SFO. In simple terms for the purposes of this Study Manual, it may be taken to refer to a person who, directly or indirectly, [has more than 10% interest in the nominal value of the issued share capital or more than 10% interest in the voting power at a general meeting.](#)