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INTERNATIONAL SECURITIES REGULATION

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HONG KONG

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SECURITIES REGULATION IN HONG KONG

by

**Douglas W. Arner, Berry FC Hsu, CK Low,
Georg Ph. Lienke & Syren Johnstone**

1. LEGAL FRAMEWORK

The legal and regulatory framework for the securities and futures markets in Hong Kong has developed over time and in response to a variety of factors and events. Today, as in other markets, securities regulation seeks to protect investors, reduce systemic risk, and ensure that markets are fair, efficient and transparent—all with the overall goal of supporting financial industry development and economic development more generally and therefore benefitting both market professionals and the general public.

In order to achieve these goals, Hong Kong has developed a complicated legal and regulatory framework for the securities and futures markets based on international best practices and principles, through legislation—especially the SFO (Securities and Futures Ordinance)—as well as regulatory guidance and SRO rules.

As will be seen, the legal and regulatory framework for securities and futures activities has become increasingly complex. Today, individual rules address most aspects of financial services business and market conduct, requiring practitioners to be aware of relevant requirements and enforcement mechanisms.

1.1 Background: Securities Regulation in Hong Kong

In Hong Kong, dealing in securities goes back as far as the first days of the British colony, with trading in company shares actually commencing in 1860.[1]

1891-1974: Era of Growth and Development

In 1891 the Association of Stockbrokers in Hong Kong was formed and changed its name to the Hong Kong Stock Exchange in 1914. It was predominantly used by British and international stockbrokers and did not admit members of the Chinese community. In 1921, a second exchange was established, called the Hong Kong Sharebrokers' Association. The two exchanges merged in 1947 as the Hong Kong Stock Exchange and did not face any competition until 1969. In 1968, turnover on the exchange was HK$944 million.

Responding to the popular interest in stock exchange activity at the time, Hang Seng Bank introduced its index, the Hang Seng Index (HIS), which is still the primary index in Hong Kong today. Originally created for internal purposes, it was

1 SFC, *Securities Regulation in Hong Kong*, pp. 3-7.

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opened to the public in November 1969. Thirty-three company shares were given a value of 100 representing their value as of 31 July 1964.[2]

In 1969, the Far East Exchange was opened and in 1970, turnover on both exchanges reached HK$ 6 billion. In 1971, the Kam Ngan Stock Exchange was created by members of the gold business and turnover on all exchanges in that year increased to HK$15 billion. In 1972, the Kowloon Stock Exchange opened its doors and in 1973, total business volume for all four exchanges was HK$49 billion.[3]

1986: Unification of Exchanges

Following a period of euphoria, the stock markets were hit by a serious crisis. Due to increasing oil prices and world-wide inflation, total turnover on Hong Kong stock markets dropped to HK$11 billion in 1974. In December of that year, the HSI dropped to a record low of 150 after it had reached its peak in the beginning of 1973. Many investors lost money and eventually left the market. The Hong Kong colonial Government saw itself forced to react to the turbulence and adopted the Securities Ordinance and the Protection of Investors Ordinance, which both came into effect on 1 March 1974.[4] In July 1974, the four existing Stock Exchanges came together as the Hong Kong Federation of Stock Exchanges. In 1980, the Stock Exchange of Hong Kong Ltd., the incorporated basis for the projected unified exchange, was established, but it took until April 1986 for the unified exchange to open its doors.[5]

1988: The *Davison Report*

The first nine months of 1987 were marked by strong growth for the Hong Kong stock market, with the HSI rising by 1,410 points to a then all-time high of 3,950. However, on black Monday, 19 October 1987, stock markets around the world crashed, prompted by the announcement of worse-than-expected US trade figures and the comment by the then-US Secretary of the Treasury, James Baker, that the already sliding US dollar needed to decline further. On 19 October alone, the HSI lost 11.1%.

The Stock Exchange and the Futures Exchange had serious concerns regarding possible panic selling, market disorder and bank runs and decided to suspend trading on both exchanges for four days starting 20 October. When the exchanges reopened on 26 October, they lost a further 33%. Following the crash, the government appointed the Securities Review Committee on November 16 to review the constitution, management and operations of both exchanges in Hong Kong.

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2 Ibid.

3 Ibid.

4 Ibid., pp. 10-13.

5 Ibid., pp. 13-22.

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The Committee released its report, named after Committee Chairman Ian Hay Davison, in May 1988. It highlighted deficiencies in the existing regulatory framework of the securities industry and made recommendations on how to improve it. According to the report, a striking deficiency was the lack of adequate knowledge and experience among the executive staff of the Stock Exchange. In particular, they had failed to establish proper management and regulatory arrangements to cope with crises. The report's main recommendation was the formation of a single independent statutory body to regulate the securities industry.[6] At that time, the industry was governed by the Securities Commission and the Commodities Trading Commission as well as the Office of the Commissioner for Securities and Commodities Trading.

1989: Launch of the Securities and Futures Commission

Following the recommendations set forth by the *Davison Report*, the Hong Kong Legislative Council enacted the *Securities and Futures Commission Ordinance* and the Securities and Futures Commission was set up in May 1989.[7]

1999: Formation of HKEx

Following the recommendations set forth by the *Davison Report*, the Hong Kong Government announced the creation of Hong Kong Exchanges and Clearing Company Limited (HKEx) to be the new parent company for the SEHK and the HKFE, as well as the various securities clearing houses. In addition to the merger of the exchanges and clearing companies under the HKEx holding company, the exchanges and clearing company were also demutualised and commercialised, with HKEx listed on the SEHK.

2002: Enactment of the new Securities and Futures Ordinance

In 1999, former Financial Secretary (now Chief Executive) Donald Tsang announced the reform of the securities industry in order to further strengthen Hong Kong's position as an international financial centre. That process included the adoption of a new and comprehensive *Securities and Futures Ordinance*, that not only had to cover the then existing *Securities Ordinance,* but also had to consolidate nine additional ordinances related to the securities and futures industry.[8] The *Securities and Futures Bill* was introduced in April 2000. The Bills Committee of the Legislative Council took almost two years to review the public responses to the bill, consider the views of the brokerage and banking industry and conduct overseas study visits to meet UK and US regulators. Overall, the Committee held 70 sessions with the Administration for consultation over the Bill. The *Securities and*

6 Ibid., pp. 34-37.

7 Ibid.

8 Y. K. Kwan, *A Guide to the Securities and Futures Ordinance* (Hong Kong Stockbrokers Association 2003), pp. 1-5.

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Futures Ordinance was finally enacted in March 2002 and became effective in April 2003.[9]

In addition to the historical progression outlined above, Hong Kong's legal and regulatory framework for the securities and futures industry is also strongly influenced by international experiences and best practices derived therefrom.[10]

In order to understand better the role of the International Organization of Securities Commissions (IOSCO) Objectives and Principles in supporting securities and futures market regulation in Hong Kong, it is useful to consider a recent review of Hong Kong financial regulatory framework by the International Monetary Fund.[11] In relation to securities regulation, according to the FSSA on the basis of its analysis of Hong Kong's regulatory framework vis-à-vis international standards:

> ". . . general preconditions for effective securities regulation are in place in Hong Kong. The securities markets are competitive and open to domestic and foreign participants. The Securities and Futures Commission is a regulator with decision-making authority and a clear responsibility and accountability. It is well-resourced, professionally staffed and has sufficient surveillance, inspection and enforcement powers. Since the adoption of the Securities and Futures Ordinance in March 2002, the SFC has been provided with a comprehensive legal framework, which covers all aspects of securities related activities. Furthermore, an adequate infrastructure for well functioning securities markets with efficient trading, clearing and settlement systems as well as appropriate listing rules is in place."[12]

In terms of improvement, the FSSA points out one primary deficiency with respect to the responsibilities of the Financial Secretary and the Chief Executive of the HKSAR regarding a number of important regulatory decisions. Although the SFC enjoys full autonomy in its daily operational practices, the Chief Executive of the HKSAR has the power to give directions to the SFC about any matter relevant to the performance of its functions. In addition, in a significant number of decisions, the SFC has to consult or seek the consent of various bodies, which restricts its independent functioning and hinders its ability to react quickly to any emergency situation. Those peculiarities are not in line with international best practices, as reflected in the IOSCO Objectives and Principles, and the FSSA suggests to that these should be subject to further consideration.[13]

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9 Ibid.

10 For a discussion of the development of international standards for financial markets and their regulation, see D. Arner, *Financial Stability, Economic Growth, and the Role of Law* (Cambridge University Press forthcoming 2006).

11 IMF, *People's Republic of China Hong Kong Special Administrative Region: Financial System Stability Assessment* (Jun. 2003), p. 2.

12 Ibid., pp. 42-50.

13 For further discussion of deficiencies and competitive concerns in Hong Kong's financial markets and their regulation, see B. Hsu, D. Arner, M. Tse & S. Johnstone, *Financial Markets in Hong Kong: Law and Practice* (Oxford University Press 2006).

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1.2 Legislative Framework

The fundamental legal framework of the Hong Kong Special Administrative Region (HKSAR) is the *Basic Law*.[14] It sets out the general principle of "one country, two systems," with the capitalist system of Hong Kong and the socialist system of Mainland China coexisting side by side for a minimum of 50 years. The *Basic Law* grants Hong Kong a high degree of autonomy and executive, legislative and independent judicial powers, and guarantees the existence of its current political, economic and financial systems until 2047.

In relation to securities and futures activities, the primary legislation is now the *Securities and Futures Ordinance* (Cap. 571) (SFO). In addition to the *Basic Law* and the SFO, a variety of other legislation also underlies Hong Kong's securities and futures markets in establishing the preconditions discussed above in the context of the IOSCO Objectives and Principles for securities regulation to be effective.[15] Of these, the most important is the *Companies Ordinance* (Cap. 32).

In addition, the pre-exiting common law system continues to function in Hong Kong under the provisions of the *Basic Law*.[16] To date, however, court and tribunal decisions have not yet begun to play a major role in securities and futures regulation in Hong Kong. Over time, however, this will change, as courts interpret the SFO and the tribunals build a record of decisions.

Securities and Futures Ordinance (SFO)

The SFO serves as the legal framework for the regulation of the securities industry. The SFO is the largest and most detailed Ordinance in the history of Hong Kong. In total, it is comprised of 409 sections and 10 schedules. The SFO is divided into seventeen Parts:

Part I Preliminary

Part II Securities and Futures Commission

Part III Exchange Companies, Clearing Houses, Exchange Controllers, Investor Compensation Companies and Automated Trading Services

Part IV Offers of Investments

Part V Licensing and Registration

Part VI Capital Requirements, Client Assets, Records and Audit Relating to Intermediaries

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14 Since the resumption of Chinese sovereignty on 1 Jul. 1997, the Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China is the main constitutional document for Hong Kong.

15 For discussion, see *Financial Markets in Hong Kong*, above.

16 Art. 8, *Basic Law* states:

> "The laws previously in force in Hong Kong, that is, the common law, rules of equity, ordinances, subordinate legislation and customary law shall be maintained, except for any that contravene [the *Basic Law*], and subject to any amendment by the legislature of the Hong Kong Special Administrative Region."

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Part VII Business Conduct, etc. of Intermediaries

Part VIII Supervision and Investigations

Part IX Discipline, etc.

Part X Powers of Intervention and Proceedings

Part XI Securities and Futures Appeals Tribunal

Part XII Investor Compensation

Part XIII Market Misconduct Tribunal

Part XIV Offences relating to Dealings in Securities and Futures Contracts, etc.

Part XV Disclosure of Interests

Part XVI Miscellaneous

Part XVII Repeals and Related Provisions

The ten schedules address:

Schedule 1 Interpretation and General Provisions

Schedule 2 Securities and Futures Commission

Schedule 3 Exchange Companies, Clearing Houses and Exchange Controllers

Schedule 4 Offers of Investments

Schedule 5 Regulated Activities

Schedule 6 Specified Titles

Schedule 7 Offers by Intermediaries or Representatives for Type 1, Type 4 or Type 6 Regulated Activity under section 175 SFO

Schedule 8 Securities and Futures Appeals Tribunal

Schedule 9 Market Misconduct Tribunal

Schedule 10 Savings, Transitional, Consequential and Related Provisions, etc.

Subsidiary Legislation under the SFO

In addition to the SFO, there are also a range of rules etc which have been enacted as subsidiary legislation thereunder. As of 1 January 2006, the following subsidiary legislation had been enacted pursuant to the SFO:

Securities and Futures (Unsolicited Calls – Exclusion) Rules (Cap. 571A)

Securities and Futures (Recognised Counterparty) Rules (Cap. 571B)

Securities and Futures (Registration of Commission Disciplinary Orders) Rules (Cap. 571C)

Securities and Futures (Professional Investor) Rules (Cap. 571D)

Securities and Futures (Leveraged Foreign Exchange Trading – Exemption) Rules (Cap. 571E)

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Securities and Futures (Leveraged Foreign Exchange Trading) (Arbitration) Rules (Cap. 571F)

Securities and Futures (Exempted Instruments – Information) Rules (Cap. 571G)

Securities and Futures (Client Securities) Rules (Cap. 571H)

Securities and Futures (Client Money) Rules (Cap. 571I)

Securities and Futures (Associated Entities – Notice) Rules (Cap. 571J)

Securities and Futures (Registration of Appeals Tribunal Orders) Rules (Cap. 571K)

Securities and Futures (Registration of Market Misconduct Tribunal Orders) Rules (Cap. 571L)

Securities and Futures (Collective Investment Schemes) Notice (Cap. 571M)

Securities and Futures (Financial Resources) Rules (Cap. 571N)

Securities and Futures (Keeping of Records) Rules (Cap. 571O)

Securities and Futures (Accounts and Audit) Rules (Cap. 571P)

Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules (Cap. 571Q)

Securities and Futures (Short Selling and Securities Borrowing and Lending (Miscellaneous) Rules (Cap. 571R)

Securities and Futures (Licensing and Registration) (Information) Rules (Cap. 571S)

Securities and Futures (Investor Compensation – Claims) Rules (Cap. 571T)

Securities and Futures (Miscellaneous) Rules (Cap. 571U)

Securities and Futures (Stock Market Listing) Rules (Cap. 571V)

Securities and Futures (Price Stabilising) Rules (Cap. 571W)

Securities and Futures (Disclosure of Interests – Securities Borrowing and Lending) Rules (Cap. 571X)

Securities and Futures (Contracts Limits and Reportable Positions) Rules (Cap. 571Y)

Securities and Futures (Levy) Order (Cap. 571Z)

Securities and Futures (Levy) Rules (Cap. 571AA)

Securities and Futures (Investor Compensation – Levy) Rules (Cap. 571AB)

Securities and Futures (Investor Compensation – Compensation Limits) Rules (Cap. 571AC)

Securities and Futures (Transfer of Functions – Investor Compensation Company) Order (Cap. 571AD)

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Securities and Futures (Transfer of Functions – Stock Exchange Company) Order (Cap. 571AE)

Securities and Futures (Fees) Rules (Cap. 571AF)

Securities and Futures (Disclosure of Interests – Exclusions) Regulation (Cap. 571AG)

Securities and Futures (Offences and Penalties) Regulation (Cap. 571AH)

Securities and Futures (Insurance) Rules (Cap. 571 AI)

Of these, the Professional Investor Rules, the Client Securities Rules, Client Money Rules, Financial Resources Rules, Keeping of Records, Accounts and Audit Rules, Contract Notes Rules, Licensing and Registration (Information) Rules, Stock Market Listing Rules, and Price Stabilisation Rules tend to be relevant for market professionals, as they impose or relax conduct requirements on licencees.

Companies Ordinance

The *Companies Ordinance* (Cap. 32) is the primary piece of legislation governing companies and their activities, from incorporation to winding up. "Company" means any company incorporated or established under the *Companies Ordinance* or one of its predecessors.[17] As an international financial centre, Hong Kong and its markets host many non-Hong Kong companies. *The Companies Ordinance* also deals with non-Hong Kong companies, that is, companies incorporated outside Hong Kong but which have established a place of business in Hong Kong.[18] The primary administrator of the *Companies Ordinance* is the Companies Registry, supplemented by the Official Receiver for insolvency matters and the Securities and Futures Commission for certain securities matters.

Overall, the *Companies Ordinance* is most relevant to the securities and futures industry in that it provides the basic framework addressing prospectuses, financial disclosure and corporate governance. The other significant sources of company law applicable in Hong Kong are, first, those developed under common law and equity, and second, those imposed through statute (the most of important of which is the SFO) and rules (especially HKEx's *Listing Rules*). In regard to the former, which are quite significant in the context of company law, in broad terms this aspect of Hong Kong company law follows that which has developed in the English courts, although since 1 July 1997 decisions of the English courts are no longer binding precedents for Hong Kong courts.

1.3 SFC and Other Guidance

In addition to the SFO and related subsidiary legislation, the SFC and other regulatory agencies have also provided various forms of guidance for the securities and futures industry.

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17 s. 2 CO.

18 s. 332 CO.

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Regulatory Handbook

The SFC has now consolidated all SFC codes, guidelines, circulars and related matters (collectively "guidance") into a *Regulatory Handbook*, available in continually updated form at www.sfc.hk. The *Regulatory Handbook* is divided into 2 volumes, the first of which addresses the SFC and its role in and approach to regulation. The second contains all the various codes etc. Volume Two is divided into six sections:

Part A – Licensing of Intermediaries and Continuing Obligations of Licensed Persons

Part B – Specific Requirements for Regulated Activities

Part C – Regulated Investment Products

Part D – Corporate Finance

Part E – Miscellaneous

Part F – *Securities and Futures Ordinance*

Codes

As of 1 January 2006, the SFC had issued the following Codes under the *SFO*:

Codes on Takeovers and Mergers and Share Repurchases (Oct. 2005)

Code on Real Estate Investment Trusts (Jun. 2005)

Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission – Paragraph 16 (Mar. 2005)

Code on Immigration-Linked Investment Schemes (Mar. 2003)

Code on Investment-Linked Assurance Schemes (Mar. 2003)

Code on Pooled Retirement Funds (Mar. 2003)

Code on Unit Trusts and Mutual Funds (Mar. 2003)

Fund Manager Code of Conduct (Mar. 2003)

SFC Code on MPF Products (Mar. 2003)

Code of Conduct for Corporate Finance Adviser (Mar. 2003)

Code of Conduct for Share Registrars (Mar. 2003)

Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Mar. 2003)

Despite the label of "code", there are however conceptual differences between certain codes and also in many cases similarities between various guidelines. Of the codes, the *Takeovers Code* applies to all participants in Hong Kong markets, whether or not licensed by the SFC and now derives its authority from a specific provision of the SFO, as well as from market consensus. The *Share Registrars Code* does not derive from a licensing system as such but rather from industry consensus backed by the SFC's general power to promulgate Codes and is backed by a

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disciplinary system modelled on the *Takeovers Code*. The other Codes derive their status either from the SFC's authority to regulate investment products or to regulate the fitness and properness of licensees or both.

Guidelines

As of 1 January 2006, the SFC and other entities have issued the following guidelines:

- *Guidelines on Revised Procedures for Applications by Fund Managers that Form Part of Complex International Financial Groups* (Oct. 2005)
- *Guidelines on Revised Procedures for Applications by Principal Traders that Form Part of Complex International Financial Groups* (Oct. 2005)
- *Guidelines on Disclosure of Fees and Charges Relating to Securities Services* (Jan. 2005)
- *Guidance Note on Position Limits and Large Open Position Reporting Requirements* (Apr. 2004)
- *Guidelines for the Approval of Corporations as Approved Lending Agents* (Mar. 2004)
- *Non-Statutory Guidelines on Directors' Duties* (Jan. 2004) (issued by the Companies Registry)
- *Licensing Information Booklet* (Aug. 2003)
- *Outline of Part XV* (Aug. 2003)
- *Guidelines for Electronic Public Offerings* (Apr. 2003)
- *Investor Compensation Arrangement* (Apr. 2003)
- *Fit & Proper Guidelines* (Mar. 2003)
- *Guidance Note for Persons Advertising or Offering Collective Investment Schemes on the Internet* (Mar. 2003)
- *Guidance Note Issued by the SFC on Prevention of Money Laundering and Terrorist Financing* (Mar. 2003)
- *Guidelines on Competence* (Mar. 2003)
- *Guidelines on Continuous Professional Training* (Mar. 2003)
- *Guidelines for the Exemption of Listed Corporations from Part XV of the SFO* (Disclosure of Interests) (Mar. 2003)
- *Guidelines on Use of Offer Awareness and Summary Disclosure Materials in Offerings of Shares and Debentures under the Companies Ordinance* (Mar. 2003)
- *Guidelines on Transitional Arrangements* (Mar. 2003)
- *Guidelines on Waivers of Certain Licensing Fees* (Mar. 2003)
- *Guidance Note on Short Selling Reporting and Stock Lending Record Keeping Requirements* (Mar. 2003)

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- *Guidelines on the Regulation of Automated Trading Services* (Mar. 2003)
- *Client Identity Rule Policy* (Mar. 2003)
- *Core Operational and Financial Risk Management Controls for Over-the-Counter Derivatives Activities of Persons Licensed by or Registered with the SFC* (Mar. 2003)
- *Debt Collection Guidelines for Licensed Corporations* (Mar. 2003)
- *Disciplinary Fining Guidelines* (Mar. 2003)
- *Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC* (Mar. 2003)
- *Suggested Control Techniques and Procedures for Enhancing a Firm's Ability to Comply with the Securities and Futures (Client Securities) Rules and the Securities and Futures (Client Money) Rules* (Mar. 2003)
- *Guidelines on Applying for a Relaxation from the Procedural Formalities to be fulfilled upon Registration of a Prospectus under the Companies Ordinance* (Cap. 32) (Feb. 2003)
- *Guidelines on using a "Dual Prospectus" Structure to Conduct Programme Offers of Shares or Debentures requiring a Prospectus under the Companies Ordinance (Cap. 32)* (Feb. 2003)

In addition, the following continue in effect despite being issued before the enactment of the SFO:

- *Guidance Note to SFC Approved Fund Management Companies – Suspension of Dealings* (Nov. 2001)
- *Guidelines on Exempt Fund Manager Status under the Code on Takeovers and Mergers* (Apr. 2001)
- *Guidelines on Exempt Principal Trader Status under the Codes on Takeovers and Mergers* (Apr. 2001)
- *Guidance Note on Internet Regulation* (Mar. 1999)
- *Project on the Use of Plain Language – How to Create a Clear Prospectus* (Jan. 1998)
- *How to Create Clear Announcements – Guidelines on the Use of Plain Language* (Jul. 1997)
- *Guidelines for the Exemption of Listed Companies for the Securities (Disclosure of Interests) Ordinance* (Jul. 1991)

Of these various guidelines, several are of equal importance to the Codes discussed above, in that they impose mandatory requirements. Specifically, these include the following: *Guidelines on Disclosure of Fees and Charges, Guidelines on Electronic Public Offerings, Fit and Proper Guidelines, Guidance Note on Offering Collective Investment Schemes on the Internet, Guidance Note on Money Laundering, Guidelines on Competence, Guidelines on Continuing Professional Training,*

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Client Identity Rule Policy, Debt Collection Guidelines, Management and Internal Control Guidelines, Suggested Control Techniques and Procedures, and Guidance Note on Internet Regulation. Others do not carry the possibility of discipline and tend not to be relevant to market professionals.

Circulars

In addition to the above, the SFC has issued and continues to issue a wide range of circulars related to different aspects of the regulatory system. These are available at www.sfc.hk.

1.4 HKEx Listing, Trading and Clearing Rules

In addition to the above, various rules of HKEx play important roles, most especially the *Listing Rules* and the *Trading Rules*.

Listing Rules and GEM Listing Rules

The *Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited* (Listing Rules) are divided into two volumes. *Volume One* addresses: (1) general matters; (2) equity securities; (3) investment vehicles; (4) debt securities; (5) HKEx—Listing; and (6) Guidance/Practice Notes (covering a variety of specific matters). *Volume Two* includes a variety of appendices, basically including the major forms and documents required under the *Listing Rules*.

The *Rules Governing the Listing of Securities on the Growth Enterprise Markets of the Stock Exchange of Hong Kong Limited (GEM Listing Rules)* cover the following: (1) general matters; (2) equity securities; (3) debt securities; and (4) HKEx—Listing. In addition, the GEM Listing Rules are supplemented by practice notes and appendices (the latter of which include a variety of major forms and documents required under the *GEM Listing Rules*).

In addition to these, HKEx has also released a number of guidelines and other documents. These include: the SEHK *Disciplinary Procedures*; HKEx *Guide on disclosure of price-sensitive information* (Jan. 2002); SEHK *Reference for Disclosure in Annual Reports* (Sep. 1999); *Listing Decisions* (available at www.hkex.com.hk/listing/listdec/listdec.asp); letters to issuers providing supplementary guidance on the *Listing Rules* and related matters (available at www.hkex.com.hk/listing/gemsharelistdoc/letters_to_issuers.htm); and staff interpretative letters (available at www.hkex.com.hk/lsting/staffint/rejection.htm).

Trading Rules

Any person dealing in securities or futures contracts has to be licensed by the SFC or fall within an appropriate exemption. In addition, the rules of the SEHK and the HKFE require any person who wishes to trade on or through their facilities to hold the appropriate "Trading Right" which confers on its holder eligibility to trade on or through the SEHK or HKFE as appropriate. In addition, in order to actually trade on or through the SEHK or HKFE, the holder must also be registered as an SEHK or HKFE Participant and be bound by the relevant *Trading Rules*. Such Trading

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Rights are issued by the HKFE and the SEHK for a fee in accordance with their respective rules and can also be acquired from existing holders.

The *Rules, Regulations and Procedures of The Stock Exchange of Hong Kong Limited and the Hong Kong Futures Exchange Limited (Trading Rules)* address the following matters: (1) rules of the SEHK; (2) disciplinary procedures; (3) options trading rules of the SEHK; (4) operational trading procedures for options trading Exchange Participants of the SEHK; (5) rules, regulations and procedures of the HKFE; and (6) HKATS trading procedures. In addition, the HKFE Rules are supplemented by contract specifications, regulations and trading procedures for the following: stock index futures, stock index options, stock futures, options on stock futures, HIBOR futures, and EFN futures.

Clearing Rules

The *Rules, Regulations and Procedures of the Hong Kong Securities Clearing Company Limited (HKSCC), SEHK Options Clearing House Limited (SEOCH) and HKFE Clearing Corporation Limited (HKCC) (Clearing Rules)* comprise the following: (1) Central Clearing and Settlement System (CCASS) operational procedures; (2) general rules of CCASS; (3) options clearing rules of SEOCH; (4) operational clearing procedures for options trading Participants; and (5) clearing rules and procedures of HKCC.

2. THE REGULATORS

Having looked at the legal and regulatory framework for the securities and futures markets in Hong Kong, this section looks in detail at the various regulatory agencies and self-regulatory agencies regulating securities and futures in Hong Kong.

2.1 Role and Function of the Market Regulators

Hong Kong has developed over time a sectoral regulatory structure for its financial system,[19] which is based on separate supervisory bodies for each of the three major financial sectors (banking, securities, insurance), instead of one composite regulatory body for the entire industry,[20] with an additional regulatory agency for the Mandatory Provident Fund (MPF) market.

In each of these areas, regulation essentially has three tiers: The top tier is the HKSAR Government (primarily through the Financial Secretary and the Financial Services and the Treasury Bureau (FSTB), though also in most cases with some involvement of the Chief Executive). The Government and especially the FSTB is generally responsible for strategic and policy decisions both for individual sectors of the financial system, as well as for the financial system as a whole.

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19 For discussion of alternative regulatory structures, see D. Arner & J. Lin (eds), *Financial Regulation: A Guide to Structural Reform* (Thomson Sweet & Maxwell Asia 2003).

20 For a discussion of the development of Hong Kong's regulatory structure, analysis and proposals for reform, see *Financial Markets in Hong Kong*, above.

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The second tier is comprised of a series of specialist regulatory agencies, of varying degrees of independence from the Government. This second tier is made up of the Hong Kong Monetary Authority (HKMA–responsible for the banking sector, including securities activities of banks), the SFC (responsible for the securities and futures markets), the Office of the Commissioner of Insurance (OCI—responsible for the insurance business) and the Mandatory Provident Funds Schemes Authority (MPFA—responsible for the MPF industry).

The third tier is made up of a variety of self-regulatory agencies, subject to the regulatory oversight of the primary regulatory agency and with varying levels of responsibility for their respective markets and the conduct of their members. In the securities and futures sector, the most important of these is HKEx and its subsidiaries, which own, control and run the stock exchange, futures exchange and various clearing houses in Hong Kong.

To summarise, the principle regulators of Hong Kong's securities and futures markets fall into three tiers: the HKSAR Government, the SFC and HKEx. At the same time, however, the HKMA, OCI and MPFA also play roles in relation to certain aspects of securities and futures business.

HKSAR Government

The HKSAR Government is not involved in the day-to-day regulation of the securities industry. However, the FSTB facilitates and coordinates initiatives to upgrade the overall quality of Hong Kong's financial sector, including its securities and futures markets. Its goal is to ensure that Hong Kong's regulatory regime is up to date and meets the needs of investors.[21]

Hong Kong Monetary Authority (HKMA)

The HKMA was established in 1993 and is the regulator of the banks and the banking industry in Hong Kong, as well as the manager of the Exchange Fund. It is an integral part of the HKSAR Government and supports the Financial Secretary in performing his functions under the relevant ordinances.[22] However, the HKMA enjoys a high degree of autonomy in day-to-day business. It does not function as a bank to the HKSAR Government, and until recently has not issued currency directly—both of which have traditionally been undertaken by commercial banks.

Office of the Commissioner of Insurance (OCI)

The OCI was established in 1992 and is the regulatory authority responsible for the insurance industry in Hong Kong.[23]

Mandatory Provident Fund Schemes Authority (MPFA)

The MPFA was established in September 1998 to regulate and monitor the operation of privately managed provident fund schemes as part of Hong Kong's estab-

21 See www.info.gov.hk/fstb.

22 See www.hkma.gov.hk.

23 See www.info.gov.hk/oci.

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lishment of the Mandatory Provident Fund (MPF) system of mandatory retirement savings. Since January 2000, the MPFA has also assumed the role of the Registrar of Occupational Retirement Schemes in administering the *Occupational Retirement Schemes Ordinance* (ORSO).

Clearly, there is a significant relationship between MPF and ORSO business and securities business, leading to some overlap between the functions of the SFC (as well as the HKMA and the OCI in the areas of banking and insurance) and the MPFA. To a large extent, these have been addressed through agreements between the various regulatory authorities in relation to MPF business (see below in the context of cooperation and coordination).

Securities and Futures Commission (SFC)

According to section 5(1) SFO, the SFC is the regulator of the securities and futures industry. The SFC is discussed in detail below.

Hong Kong Exchanges and Clearing Limited (HKEx)

HKEx is the owner and holding company of the Stock Exchange of Hong Kong Ltd. (SEHK) and the Hong Kong Futures Exchange Ltd. (HKFE) as well as the Hong Kong Securities Clearing Company Ltd. (HKSCC).[24] HKEx is listed on the SEHK. The HKSCC clears and settles the securities transactions on the SEHK through its Central Clearing and Settlement System (CCASS). In addition, the SEHK and HKFE each operates a further clearing house: the Stock Exchange of Hong Kong Options Clearing House Ltd. (SEOCH) is a wholly subsidiary of the SEHK and performs the function of clearing and settling standard contracts concluded on the options market operated by the SEHK. The HKFE wholly owns and operates the Hong Kong Futures Exchange Clearing Corporation Ltd. (HKCC) which acts as clearing house for the futures transactions carried out on the HKFE.

Cooperation and coordination between the regulators

Although all four regulatory agencies independently address their respective sectors, their day-to-day supervisory work cannot be entirely separated, simply because a large number of the supervised institutions are active in banking, securities, insurance undertakings and/or MPF undertakings.

In relation to securities and futures related issues, the HKMA and the SFC work especially closely in certain respects of their regulatory functions and have entered into several mutual Memoranda of Understanding (MoUs), which set out the operational details relating to the respective roles and responsibilities of the two regulators regarding the securities related activities of banking institutions[25] and other

24 See www.hkex.com.hk.

25 HKMA / SFC, *MoU between the SFC and the HKMA* (12 Dec. 2002).

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matters such as clearing and settlement systems.[26] The HKMA and the SFC hold regular meetings to discuss matters of mutual interest.

The SFC has also entered into MoUs with the OCI,[27] MPFA[28] and HKEx[29] regarding cooperation. In addition, the HKMA, SFC, OCI and MPFA have entered into an MoU addressing regulatory aspects of the various MPF intermediaries (which include banks, securities firms and insurance companies).[30]

2.2 Securities and Futures Commission

As discussed above, the SFC is the primary regulatory agency responsible for the securities and futures markets in Hong Kong.[31] Much of the SFO is thus concerned with the role, authority and powers of the SFC. Generally speaking, the SFO addresses the following aspects relating to the SFC:

- The structure and role of the SFC (Part II);
- SFC regulation of market infrastructure providers as self-regulatory organisations (SROs) (Part III and Part XII);
- SFC regulation of investment products and markets (Parts IV and XVI, and parts XIV and XV);
- SFC regulation of market intermediaries or "licensees" (Parts V, VI, VII and XII);
- SFC supervision, investigation, intervention and discipline (Parts VIII, IX, X);

As such, the SFO provides a comprehensive legal framework supporting the regulatory authority of the SFC as Hong Kong primary securities and futures regulator.

Structure and role

The structure and role of the SFC are established primarily in Part II of the SFO.

Under section 5(1) SFO the primary duties of the SFC are to maintain and promote the efficiency and orderliness of the securities and futures markets, to supervise all activities of market participants, to protect the investing public, and to detect and discipline illegal and improper activities within the markets. Its regulatory powers cover four major fields: the Exchanges and their Affiliated Entities, Financial Intermediaries, Offers of Investment Products, and Takeovers and Mergers.[32]

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26 HKMA / SFC, *MoU concerning the new oversight regime under the Clearing and Settlement Systems Ordinance* (4 Nov. 2005).

27 SFC / OCI, *MoU between SFC and Insurance Authority* (20 Dec. 2005).

28 SFC / MPFA*, MoU concerning the regulation of MPF Products* (23 Apr. 2003).

29 SFC / HKEx, *MoU governing Listing Matters* (12 Dec. 2002). Other SFC / HKEx MoUs are discussed further below.

30 HKMA / SFC / OCI / MPFA, *MoU concerning the Regulation of MPF Intermediaries* (1 Jan. 2004).

31 See generally www.sfc.hk.

32 SFC, *Securities Regulation in Hong Kong*, p. 395.

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The SFC is an independent non-governmental statutory body outside the civil service. However, its independence has been questioned, among others by the IMF in the context of its 2003 FSSA (discussed in the previous chapter).

Powers are dealt with below. The SFC is funded by a series of market levies and in recent years has run a budget surplus. In terms of staffing, the SFC has four operational divisions:[33]

- the Corporate Finance division is responsible for mergers and takeovers, share repurchases, and oversees the SEHK's listing-related functions and responsibilities;
- the Intermediaries and Investment Products Division is in charge of licensing requirements for investment products as well as licensing and supervision of intermediaries;
- the Enforcement Division conducts market surveillance to detect market misconduct and initiates disciplinary procedures; and
- the Supervision of Markets Division oversees the activities of the exchanges and clearing houses.

Each division is supported by the Legal Services Division and the Corporate Affairs Division. The Commission itself has a Chairman, six Executive and seven Non-Executive Directors.

SFC philosophy and processes are clearly outlined in the Regulatory Handbook. To some extent, this is also maintained by the two independent tribunals established under the SFO and discussed below.

Under the legislative framework, the SFC has a range of regulatory tools, which are diagnostic, monitoring, preventative or remedial in nature. The SFC uses diagnostic tools to *identify* and *assess* risks. Monitoring tools monitor and track identified risks. Preventative tools seek to limit or prevent risks, while remedial tools are used to respond to risks which have arisen.

The SFO has vested the SFC with a wide range of powers enabling it to assume the necessary actions within its supervisory responsibilities. Those powers are contained in Parts VIII, IX and X of the SFO.

Supervision and investigation

Part VIII of the SFO covers the inquiry, inspection and investigation powers of the SFC with respect to listed corporations and intermediaries. Grounds for investigations include:[34]

- reasonable cause to believe that an offence under the SFO or subsidiary legislation has been committed;
- reasonable cause to believe defalcation, fraud, misfeasance or misconduct has occurred;

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33 www.hksfc.org.hk: *About the SFC-Operational Divisions*.

34 s. 182 SFO.

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- reasonable cause to believe that market misconduct has taken place;
- manner of dealing etc. not in the public interest;
- licensing matters; or
- assisting Hong Kong or foreign regulators with similar matters.

Part VIII of the SFO addresses SFC supervision and investigations. Specifically, it addresses a number of matters, including:

- SFC powers to require production of records and documents concerning listed corporations;[35]
- Supervision of intermediaries and their associated entities;[36] and
- Powers to request information relating to transactions.[37]

Together, these powers provide the SFC with extensive powers to obtain information relating to listed corporations, regulated intermediaries and transactions.

Section 179(1) SFO gives the SFC the power to direct a listed corporation, its banks, auditors and related entities to produce records and documents specified by the Commission if it appears that the business of the corporation, its listing process or its management is being or has been conducted fraudulently or in any other way unlawfully.

Under section 180 SFO, the SFC is authorised to supervise the conduct of intermediaries and associated entities in order to examine their compliance with the SFO and other relevant provisions. Those powers enable the Commission to:

- enter the premises of the intermediary;
- inspect documents related to the business conduct of the intermediary or associated entity or related to any transaction conducted by a related corporation; and
- make inquiries of the intermediary or any other person, if that person is believed to have access to relevant information concerning the business conduct of the intermediary.

Under section 181(1) SFO, the SFC can conduct investigations into any financial transaction related to regulated activities under the SFO if it enables or assists the Commission to perform its duties as regulator. Information concerning purchase, holding and disposal of securities or interests in securities or interests in collective investment schemes can be required from holders, owners and beneficial owners of securities or interests, licensed persons and registered institutions. According to section 181(2) SFO, information can be required relating to particulars of the transaction and of the parties involved.

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35 s. 179 SFO.

36 s. 180 SFO.

37 s. 181 SFO.

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Section 182(1) SFO, gives the SFC the power to initiate investigations if it has reasonable cause to believe that offences under the SFO have been committed or misconduct has taken place.

If the SFC legitimately believes that an offence under the SFO may have been committed it has the authority to investigate all relevant aspects of the transactions and parties involved. If the investigation produces possible grounds for illegal behaviour, the SFC may initiate criminal proceedings by turning the case over to the responsible authorities. Enforcement aspects are discussed further below. Persons under investigation and those against whom the SFC has reasonable cause must produce and explain any related documents, meet with investigators, and give the investigator all assistance in connection with the investigation which he is reasonably able to give, including responding to any written question raised by the investigator.[38] Any person who, without reasonable excuse fails to produce, explain, attend, answer, or comply is liable to a fine up to HK$200,000 and imprisonment for one year.[39] If false or misleading information is provided knowingly or recklessly, the fine may be up to HK$1,000,000 and imprisonment for two years.[40] In cases of intent to defraud, the penalty extends to a fine of HK$1,000,000 and seven years imprisonment and further extends to officer liability for actions corporations.[41] Further, in the event of non-compliance etc, the SFC may apply to the court for enforcement etc.[42]

Importantly, potentially incriminating evidence must also be given but will not be admissible in court in any subsequent proceeding.[43]

Any person who fails to comply with any requirement imposed on him or her by the SFC or its authorised personnel in the conduct of an inquiry, investigation or the pursuit of its regulatory responsibilities commits an offence and is liable to a fine and imprisonment ranging from HK$200,000 to HK$1 million and between one to seven years respectively.[44]

In addition, it is an offence to destroy, falsify, conceal or otherwise dispose of, or cause or permit the destruction, falsification, concealment or disposal of, any record or document required to be produced, with intent to conceal, liable to a fine up to HK$1,000,000 and imprisonment for up to 2 years.[45]

Intervention

Under Part X of the SFO, the SFC is authorised to intervene in respect of a regulated activity of a licensed corporation if doing so is crucial to protect client's assets

38 s. 183 SFO.

39 s. 184 SFO.

40 s. 184(2) SFO.

41 s. 184(3) SFO.

42 s. 185 SFO.

43 s. 187 SFO.

44 ss. 179(13), 180(14), 181(9) & 184(1) SFO.

45 s. 192 SFO.

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from being dissipated or misappropriated. The SFC can initiate intervention proceedings if, among others, the licensed corporation does not meet the "fit and proper" criteria anymore, if its license may be revoked or suspended in a disciplinary action or it is in the interest of the investing or general public to do so.[46] Procedures available to the SFC include prohibitions of certain transactions and business conduct as well as directions to dispose of or deal with property in a specific manner.

Cooperation and coordination

As discussed above, the SFC and other domestic regulatory bodies have entered into a range of MoUs addressing cooperation and coordination. Beyond these domestic arrangements, the SFC has entered into a variety of MoUs and confidential undertakings with non-local regulatory agencies regarding information sharing, cooperation and mutual assistance in matters related to securities and futures regulation and enforcement. These include securities regulatory authorities in the following jurisdictions (as of 1 January 2006): Australia, Bermuda, Brazil, Canada,[47] China,[48] Cyprus, France, Germany, Guernsey, Isle of Man, India, Indonesia, Ireland, Italy, Japan, Jersey, Luxembourg, Macau, Malaysia, the Netherlands, New Zealand, Philippines, Portugal, Singapore, South Africa, Spain, Sri Lanka, Sweden, Taiwan, Thailand, the UK and the USA.[49]

In addition, the SFC is a signatory of the IOSCO *Multilateral Memorandum of Understanding concerning Consultation and Cooperation and the Exchange of Information*—the first global information sharing arrangement among securities regulators. The other signatories as of April 2005 were: Australia, Belgium, Canada (Alberta, British Columbia, Ontario, Quebec), France, Germany, Greece, Hungary, India, Italy, Jersey, Lithuania, Mexico, New Zealand, Portugal, Poland, Slovakia, South Africa, Spain, Sri Lanka, Turkey, the UK and the USA (CFTC, SEC).

2.3 Tribunals Established by the SFO

In order to balance the SFC's rule-making, supervision, investigation and enforcement powers, the SFO establishes two tribunals to provide an independent judicial mechanism with specialist expertise. The two tribunals established—the Securities and Futures Appeals Tribunal ("SFAT") and the Market Misconduct Tribunal ("MMT") provide an important system of accountability in relation to SFC actions.

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46 ss. 204, 205 & 206 SFO.

47 Specifically, those in the provinces of British Columbia, Ontario, Quebec and Alberta.

48 Specifically, the State Administration of Foreign Exchange (SAFE), the China Securities Regulatory Commission (CSRC), the Shanghai Securities Exchange and the Shenzhen Stock Exchange.

49 Specifically, the SEC and the Commodities Futures Trading Commission (CFTC).

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Securities and Futures Appeals Tribunal (SFAT)

The SFAT is an appeal body which reviews decisions made by the SFC and the HKMA which are capable of being appealed against, so-called "specified decisions". Under section 217(1) SFO, persons aggrieved by such a decision of either authority have the right to approach the SFAT and apply for review of the decision. The SFAT is a full-time institution and consists of a judge as chairman and two other members, who shall not be public officers.[50]

There are 78 specified decisions listed in Schedule 8 to the SFO. These include the following:

- refusal to grant a license, authorisation or registration;
- withdrawal of license, authorisation or registration;
- amendment, revocation or imposition of conditions;
- refusal to grant an accreditation;
- directions to licensed corporations and licensed individuals; and
- disciplinary actions.

Upon an application for review, the chairman convenes a conference in which the parties prepare the actual hearing, which is held in public and is attended by the Tribunal and the parties involved. However, an application for review does not automatically operate as a stay of execution of the specified decision, which can be granted by the Tribunal on a separate application.

After the hearing, the Tribunal can decide to confirm, vary or set aside the appealed decision.[51] In addition, it can decide to remit the subject matter to the relevant authority with appropriate directions. Under section 229(2) SFO, any party dissatisfied with the decision can appeal to the Court of Appeal against the decision on a point of law.

According to section 219(3) SFO a person who fails to comply with an order, notice, prohibition or requirement of the SFAT or hinders its proceedings commits an offence and is liable to a fine of HK$ 2 million and imprisonment for 2 years.

Market Misconduct Tribunal (MMT)

The MMT was established by the SFO.[52] It is modelled upon the previous Insider Dealing Tribunal (IDT), which adjudicated insider dealing offences under previous legislation. It has jurisdiction to hear market misconduct cases.[53] Market misconduct under its jurisdiction includes insider dealing, false trading, price rigging, dis-

50 s. 216(2) SFO.

51 s. 218(2) SFO.

52 s. 251 SFO.

53 ss. 245 & 252 SFO.

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closure of information about prohibited transactions, disclosure of false or misleading information, and stock market manipulation.[54]

The MMT pursues civil proceedings with respect to all forms of market misconduct.[55] Alternatively, the Court of First Instance is responsible for criminal prosecution of any market misconduct offences.

If an investigation on behalf of the SFC under section 182 SFO reveals any possible grounds for market misconduct, the SFC has two options. Depending on the quality of the evidence supporting the accusation of misconduct it can either refer the matter to the Financial Secretary for civil proceedings or to the Secretary for Justice to initiate criminal proceedings. The latter will only be considered if the evidence available is strong enough to prove beyond reasonable doubt that misconduct has taken place. This has become increasingly difficult because of sophisticated market practices. The MMT however does not require proof beyond reasonable doubt, but only applies the standard of proof applied in civil proceedings in a court of law, which is based on the balance of probabilities.[56]

Thus, if the evidence collected is not strong enough for criminal conviction, the SFC will initiate civil proceedings through the MMT.

If the MMT finds that market misconduct has taken place, it has several choices which include:[57]

- ordering the person not to deal in securities or other financial products in Hong Kong for a period of up to 5 years;
- ordering the person to pay a sum equal to whatever profit gained or loss avoided through the misconduct; and
- ordering the responsible regulatory body to take adequate disciplinary actions against the person.

According to Part XIII of the SFO, the MMT may make definitive, binding, and conclusive decisions and determine rights on the basis of law as its stands and in the light of the parties' past conduct.[58] Appeal from MMT lies to the Court of Appeal on a point of law, with leave of the Court of Appeal on a question of fact, or on an order made.[59] According to section 266 SFO, both the SFC and the person having engaged in market misconduct can appeal against the finding of the MMT to the Court of Appeal.

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54 s. 245(1) SFO.

55 SFC, *SFO & You*, p. 5.

56 Y. K. Kwan, above, p. 129.

57 s. 257(1) SFO.

58 ss. 253-257 SFO.

59 s. 266 SFO.

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2.4 SROs, Market Infrastructure Providers and HKEx

In addition to the regulatory agencies and tribunals, the SFO also provides a comprehensive framework for SROs, which are typically securities market infrastructure providers. Securities market infrastructure providers are dealt with under Part III of the SFO. As a general principle, the SFO provides for SFC recognition of these sorts of SROs. Specifically, it provides for authorisation or recognition of the following types of securities market infrastructure providers:

- exchange companies
- clearing houses
- exchange controllers
- investor compensation schemes
- automated trading services (ATS).

It also delineates their respective duties, powers, and immunities from civil liability. In turn, these sorts of intermediaries are subject to SFC supervision of varying forms.

The most important of these are HKEx and its various subsidiaries. In clarifying their respective roles, the SFC and HKEx and its subsidiaries have entered into a variety of MoUs and related agreements.[60]

Regulation of HKEx: Exchange Companies, Clearing Houses and Exchange Controllers

Part III of the SFO provides a comprehensive framework for SFC oversight and regulation of the various SROs, as well as comprehensive powers subject to authorisation. Under sections 19(1), 37(1) and 59(1) SFO, exchange companies, exchange controllers[61] and clearing houses may only participate in securities and futures markets related activities when properly recognised by the SFC. The recognition may in all three cases be delivered in connection with specific conditions that the SFC finds appropriate. At the moment, only the SEHK and the HKFE are recognised exchange companies in Hong Kong, while HKEx is the only recognised exchange controller.

According to section 21(1) SFO an exchange company has the duty to ensure an orderly, informed and fair market and to guarantee that any risks associated with its

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60 SFC / HKEx, *Outline of the current roles of the Exchange and the SFC in Listing Regulation* (31 Mar. 2005); SFC / HKEx, *Agreed Interpretation of terms in the MoU between the SFC and HKEx on Matters relating to SFC Oversight, Supervision of Exchange Participants and Market Surveillance for the purposes of the commencement of the SFO* (1 Apr. 2003); SFC / SEHK, MoU *Governing Listing Matters between SFC and the SEHK* (22 Jan. 2003); SFC / HKEx, *MoU governing Listing Matters* (12 Dec. 2002); SFC / HKEx / SEHK, MoU for the Listing of HKEx on the SEHK (22 Aug. 2001); SFC / HKEs, *MoU between the SFC and HKEx on matters relating to SFC Oversight, Supervision of Exchange Participants and Market Surveillance* (20 Feb. 2001).

61 A legal entity which owns and controls an exchange.

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operations are managed appropriately. Under section 38(1) SFO clearing houses are obliged to guarantee orderly, fair and expeditious clearing and settlement arrangements for securities and futures transactions. An exchange controller is responsible for the orderly business conduct on behalf of its controlled entity.[62]

On-going supervision is achieved through a variety of mechanisms, ranging from approval of rules to withdrawal of recognition. Under sections 24(1), 41(1) and 67(1) SFO, rules or amendments to existing rules of exchange companies, clearing houses and exchange controllers must have the written approval of the SFC in order to become effective. In accordance with section 26 SFO, the appointment of a chief executive of an exchange company must be approved in writing by the SFC. Exchange companies, clearing houses and exchange controllers all are obliged at any time to produce books, records and any other information relevant to their respective business if the SFC requires them to do so for the performance of its functions.[63]

According to sections 28(1)(4) and 43(1)(3) SFO, the SFC has the power to withdraw a recognition under the condition that, inter alia, exchange companies or clearing houses fail to comply with the SFO or any condition attached to the recognition by the SFC. In the case of an exchange controller, the recognition can be withdrawn if it is in the interest of the investing public or crucial for the proper regulation of either exchange.[64] A further reason for withdrawal is the winding up of the entity. Were a securities market infrastructure provider to become insolvent or at risk of becoming so, in all likelihood the HKSAR Government would intervene (as it did in respect to the futures exchange in 1987).

HKEx and its subsidiaries

HKEx is a recognised exchange controller under the SFO. The SEHK is a recognised exchange company under the SFO and is the primary regulator of SEHK Participants with respect to trading matters and of companies listed on the Main Board and GEM. The HKFE is also a recognised exchange company under the SFO and is the primary regulator of HKFE Participants with respect to trading matters. The HKSCC, SEOCH and HKCC are all recognised clearing houses under the SFO.

Automated Trading Services (ATS)

An ATS provider may either be licensed for type 7 regulated activity (discussed further below) or authorised under Part III of the SFO. Under Part III, authorisation to provide ATS can be obtained through application to the SFC according to section 95(2) SFO. The SFC has issued guidelines as to how it will regulate ATSs: *Guidelines on the Regulation of Automated Trading Services*. These Guidelines[65] set out principles, procedures and standards relating to authorisation, registration

62 s. 63(1) SFO.

63 ss. 27(1), 42(1) & 71(1) SFO, respectively.

64 s. 72(1) SFO.

65 Made under ss. 95(6) & 399(1) SFO.

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and licensing of persons by the SFC for provision of ATS and cover matters including:

- fairness, efficiency, competitiveness, transparency, orderliness in the industry;
- fair and level playing field for participants;
- protection of the public;
- reduction of systemic risk;
- core standards for ATS providers;
- financial resources and risk management; operational integrity; fitness; record keeping; transparency; surveillance; and reporting;
- Hong Kong's status as a competitive international finance centre;
- prevention of regulatory arbitrage;
- services to institutional investors only; and
- no direct competition with the HKEx.

These guidelines are primarily directed towards ATS under Part III. Issues relating to Type 7 ATS activities are discussed below.

3. REGULATION OF MARKET INTERMEDIARIES

From the general legal and regulatory framework and the roles of the various regulators and SROs in the securities and futures markets, we now turn to the framework applicable to market intermediaries.

3.1 General Framework

The activities of securities firms[66] and their activities are regulated primarily by the SFC under the SFO. While the core control mechanism is the licensing of intermediaries for specific regulated activities (see below), the SFC also regulates the fitness and properness of persons acting as intermediaries,[67] sets financial resources rules for intermediaries, imposes rules of conduct including for example restrictions on dealing with client assets, requirements to "know your client", product selling restrictions, and market activity restrictions. The sources of such regulatory measures are from both legislation (primarily the SFO and its subsidiary legislation), *Codes of Conduct* (referred to in primary legislation), and non-statutory rules and guidelines laid down by the SFC.

66 In this chapter the terms "securities intermediaries" and "securities firms" refers to persons dealing in securities, futures or leveraged foreign exchange contracts, financial advisors, asset and fund managers, investment banks, corporate financial advisors, securities margin financiers, share registrars, financial consultants and planners, insurance brokers and agents dealing in securities or related activities, and trustees and custodians.

67 Under s. 129 SFO & guidelines issued by the SFC.

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A key aspect of the SFO is to provide streamlined regulation of financial intermediaries. Major elements include:

- Issuance of a single license to each intermediary, specifying the scope of permitted business;
- Firms must have two "recognised officers" (ROs) including one Executive Director for each licensed activity;
- Licensed status for firms is limited to corporate entities, with individual person licensing attached to the corporate entity;[68]
- Persons dealing solely with professionals are not required to have a license, but must notify the SFC of their existence and comply with certain reporting and Code of Conduct requirements; and
- Authorised institutions under the Banking Ordinance are subject to registration under a similar framework to securities firms, albeit via the HKMA.

In regulating securities firms, the SFC undertakes a variety of regulatory processes, including:

- licensing and related applications;
- annual returns;
- routine audits;
- market monitoring;
- the dual filing system;
- mechanisms to deal with complaints by clients and others;
- self-reporting obligations; and
- market questionnaires (sometimes prompted by international developments).

In support of these regulatory processes, the SFC has a number of powers under the SFO, including the power to obtain records, documents and information[69] from any person, not only licensed corporations. In this context, while professional legal privilege cannot be overridden, the right to silence and privilege against self-incrimination are abrogated. Further, it is an offence not to cooperate with an investigation of the SFC or to provide it with false or misleading information.

In general, regulations affect the ability to engage in business activities and set parameters as to how it is undertaken. In terms of securities firms, the SFC issues licences, and requires licensed persons to comply with their Codes, such as the

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68 i.e. Individuals are licensed representatives of the licensed corporate entity.

69 Information may relate to: the affairs and management of listed companies (s. 179 SFO); the conduct and management of a licensed intermediary and any associated company (s. 180 SFO); securities, futures and other regulated transactions (s. 181 SFO); breaches of the SFO or conduct contrary to the interests of the investing public (s. 182 SFO); and on request by an overseas regulator carrying out similar functions and subject to appropriate secrecy provisions (s. 186 SFO).

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Code of Conduct. Licensing, conduct and related matters for securities firms are mainly addressed by Parts V-XI of the SFO. In addition, the SFC regulates securities market infrastructure providers, notably exchanges, clearing houses and share registrars as discussed above.

Unlike banks ("authorised institutions" under the *Banking Ordinance*) which are regulated comprehensively by the HKMA in conjunction with the Hong Kong Association of Banks ("HKAB") once authorised, securities intermediaries are licensed by the SFC for specific activities. Once licensed, securities firms are regulated for the activities for which they are licensed, not all activities.

The regulation of intermediaries is addressed in the following Parts of the SFO:

Part V – Licensing and registration

Part VI – Capital requirements, client assets, records and audit relating to intermediaries

Part VII – Business conduct of intermediaries

Part VIII – Supervision and investigation

Part IX – Discipline

Part X – Powers of intervention and proceedings

Part XI – Securities and Futures Appeals Tribunal

Parts V, VI and VII will be dealt with below; Parts VIII, IX, X and XI were addressed above in the context of the regulators and their powers.

3.2 Licensing and Registration

Licensing and authorisation are prerequisites for financial institutions to become established in Hong Kong, participate in financial market activity and transact in financial services. Licensing is central to the authorities' "gate-keeping" function in respect of the quality of financial institutions. At the same time, most licensing requirements are on-going, resulting in continuing compliance obligations. As a general matter, Hong Kong is open to foreign and domestic entry to financial services business, with foreign businesses facing largely identical requirements to domestic entrants. At the same time, the licensing requirements are basically applicable to retail business; firms dealing with professional investors only may not be required to be licensed.[70]

Single license

Part V of the SFO deals with licensing and registration. It addresses licensing of persons who conduct activities regulated by the SFC other than in relation to registered institutions (discussed below). In general, it provides for the concept of the "single license" for companies and the individuals accredited to them. These are termed "licensed persons". The legislation does not allow for firms to be estab-

70 See para. 1, sch. 1 SFO.

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lished as sole proprietorships or partnerships.[71] Transitional provisions include automatic "deeming" of certain categories as licensed for an initial two-year period (which expired in March 2005).[72]

Under section 114(1) SFO, no person shall engage in any regulated activity unless properly licensed or registered with the SFC. The SFO includes a number of exceptions[73] to this general licensing requirement, the most relevant of which are, first, incidental services provided by certain professionals such as lawyers and accountants, and second, advice given to wholly-owned group companies.

Nine regulated activities

The SFO defines nine types of "regulated activities" which are subject to licensing.[74] Schedule 5 to the SFO lists the nine regulated activities:

(1) dealing in securities (Type 1);

(2) dealing in futures contracts (Type 2);

(3) leveraged foreign exchange trading (Type 3);

(4) advising on securities (Type 4);

(5) advising on futures contracts (Type 5);

(6) advising on corporate finance (type 6);

(7) providing automated trading services (Type 7);

(8) securities margin financing (type 8); and

(9) asset management (Type 9).

These activities largely comprise regulated securities and futures business in Hong Kong. Each of these types of activities is significant in determining whether a given form of securities business or product brings with it consequent licensing obligations and related requirements (discussed in detail below). If licensing is not required, then the securities product or service will generally be governed by the common law and traditional private law statutory framework.

Registered institutions[75]

In relation to banking business, all institutions engaging in such business must be "authorised institutions" ("AIs"). AIs comprise banks, deposit-taking companies ("DTCs") and restricted licence banks ("RLBs"), the last two types being quasi-banks with narrower business streams. All are regulated by the HKMA pursuant to the *Banking Ordinance* (Cap. 155), subject to a significant number of ex-

71 However, these were permitted under the system pre-SFO.

72 These include corporations, dealing directors, representatives, sole proprietors, partnerships, and exempt financial institutions.

73 s. 5 SFO.

74 Sch. 5, SFO.

75 SFO: Schedule 1: authorised institution as defined in s. 2(1) BO.

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ceptions.[76] Further, all AIs are subject to comprehensive regulation of all their activities, including those in other sectors, such as securities and insurance.

In relation to securities activities of banks, in contrast to a purely sectoral regulatory system, banks and banking activities in Hong Kong are regulated on an institutional basis by the HKMA under the *Banking Ordinance*. Under the *Banking Ordinance*, the HKMA undertakes consolidated supervision over all activities of AIs, i.e. banks and quasi-banks, including securities activities. The HKMA is thus responsible for day-to-day supervision of all securities activities of authorised institutions ("regulated activities" under the SFO). Nonetheless regulation and supervision are, to some extent, undertaken jointly. Most importantly, all AIs must register with the SFC as "registered institutions" ("RIs") and their securities activities will be regulated and supervised to similar regulatory standards as those applying to securities firms.

In accordance with section 119(1) SFO AIs must apply to the SFC for registration to carry out one or more of the regulated activities. Registration requires AIs to make application to the SFC first, which then refers the case to the HKMA for consideration. The HKMA advises on whether the applicant is fit and proper for registration under the SFO criteria. Based on the HKMA's advice, the SFC decides on whether to accept the application. The SFC is also responsible for making, publishing and amending regulations, rules, codes and guidelines with respect to the regulatory process applicable to the securities activities of banks.[77] However, given that the HKMA is the day-to-day supervisor of AIs, the SFC must consult the HKMA before implementing new regulations. In turn, the HKMA may consult the SFC in the interpretation of rules and guidelines. This is meant to ensure consistent interpretation and approach given that the SFC is the ultimate authority in relation to the regulatory process regarding registered institutions.

In relation to registration of AIs for purposes of undertaking "registered activities",[78] an authorised institution must be registered with the SFC as a "registered institution" before conducting regulated activities (except for Type 3 and Type 8 activities). An application for registration must be lodged with the SFC which refers it to the HKMA, which in turn advises on whether the authorised institution is fit and proper. The applicant must provide two Executive Officers with sufficient authority who will supervise the conduct of regulated activities and who are fit and proper. Further, any person who carries on a regulated function on behalf of a registered institution must register his name and details with the HKMA and must be and remain fit and proper.

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76 For details, see *Financial Markets in Hong Kong*, above.

77 MoU (2002), cl. 7.

78 Under s. 119 SFO.

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Register of licensees

The SFC maintains a register of licensed persons and registered institutions,[79] available for access through its website.

3.3 Initial and On-going Requirements

According to section 114(2) SFO proper authorisation can be obtained through application to the SFC. Details of initial and on-going prudential requirements are addressed primarily by Parts V and VI of the SFO.

Applications for a license are subject to a number of requirements. Specifically, as noted above, only companies can apply to be licensed and must have at least two "responsible officers" for each regulated activity that it carries on. Applicants need to satisfy the SFC that they are "fit and proper" (discussed below), meet financial resources requirements (discussed below) and are adequately insured (discussed below in the financial section). Individuals can only be "licensed representatives" and "responsible officers" if they have sufficient authority within the licensed corporation. Finally, as discussed above, banks need to become "registered institutions" if they wish to conduct any regulated activities.

Initial licensing requirements in most cases are of an on-going nature. In addition, financial institutions in Hong Kong are subject to a variety of other on-going requirements in relation to their business operations, primarily discussed in the following section.

Full details are provided in the SFC's Licensing Information Booklet, which provides general information respecting licensing and registration matters under the SFO as dealt with by the SFC but excluding matters regarding registered institutions dealt with by the HKMA.

Corporation

Under the SFO, only companies / corporations may be licensed to carry out regulated activities.[80] Partnerships are no longer allowed to be licensed under the SFO. Under section 116(1) SFO, corporations need to apply to the SFC for a license to carry out one or more of the regulated activities. In addition, they have to pay a fee. According to section 116(3) SFO that application must be denied if the SFC is not satisfied that the applicant is fit and proper to carry out the regulated activity. Under SFO Section 117, temporary licenses can be granted to corporations.

Accredited representatives

The SFO also provides for requirements for the incorporation of licensed firms, each licensed firm to have two "responsible officers," for firms to be adequately insured, and the overall "fit and proper" standard.

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79 As required by s. 136 SFO.

80 s. 116 SFO.

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Under the "responsible officer" concept, each licensed firm must have at least two responsible officers to oversee licensed regulated activities and at least one of these must be an executive officer. Both must be a licensed representative of the company and meet specific "fit and proper" requirements including as to their reputation, character and financial integrity. The objective of the responsible office concept is to foster capable management and to provide clear accountability within the company. Responsible officers are the primary link between the SFC and the company and are responsible both for the conduct of the company and for implementing the SFC's requirements in the company's structure. It is therefore a requirement that they not only possess adequate management and industry experience[81] but also possess sufficient authority within the company to implement SFC requirements. In turn, a licensed representative must have recognised academic/industrial qualifications and regulatory knowledge.

Licenses for individuals as representatives accredited to the corporation can be obtained through application to the SFC under section 120 SFO. Fit and proper criteria must be met by the applying individual and include the financial status of the applicant as well as his relevant education and experience.[82]

Fit and properness

The SFO establishes a number of aspects which the SFC or HKMA may look to in assessing fit and properness of persons, corporations, authorised institutions, and officers, including:[83]

- Financial status or solvency;
- Relevant educational or other qualifications or experience;
- Ability to carry on the regulated activity competently, honestly and fairly; and
- Reputation, character, reliability and financial integrity.

The primary guidance in relation to fit and properness is the *SFC Fit and Proper Guidelines* (Mar. 2003). According to the Guidelines, "a fit and proper person means one who is financially sound, competent, honest, reputable and reliable."[84] The Guidelines in turn outline non-exhaustively matters that the SFC will consider in such a determination. The Guidelines apply to the following:

- Individuals applying for a license or licensed under Part V of the SFO;
- Licensed representatives applying for approval or approved as a responsible officer under Part V of the SFO;
- Corporations applying for a license or licensed under Part V of the SFO;

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81 At least 2 and 3 years respectively, subject to waiver by the SFC.

82 s. 129 SFO.

83 s. 129(1) SFO.

84 *Fit and Proper Guidelines*, p. 1.

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- Authorised financial institutions (i.e. banks, deposit-taking companies and restricted license banks) applying for registration or registered under Part V of the SFO;
- Individuals to be or entered in the register maintained by the HKMA under section 20 of the *Banking Ordinance* ("relevant individuals"); and
- Individuals who apply to be or have been given consent to act as an executive officer of a registered institution under section 71C of the *Banking Ordinance*.

These initial requirements are continuing.

Capital requirements and the Financial Resources Rules

Part VI of the SFO deals with capital requirements for licensed firms. After consultation with the Financial Secretary, the SFC has the power to require licensed corporations to maintain adequate financial resources.[85] If the corporation is unable to comply with that requirement the SFC can suspend the license.[86]

Most importantly, the SFO provides the SFC with the power to make subordinate legislation as regards capital.[87] The SFC in exercise of such power has promulgated the *Securities and Futures (Financial Resources) Rules* (Cap. 571N) ("FRR"). Under the FRR, licensed firms must notify the SFC if they become unable to comply with the FRR requirements. Failure to comply with the FRR entails a number of possible consequences. First, the SFC can suspend the firm's license or allow it to continue subject to conditions. Second, failure to comply with the FRR, to continue to trade while in breach of the FRR, or to breach a condition imposed on the license by the SFC all constitute offences under the FRR.

The FRR set different requirements depending on the type of regulated activity, including minimum paid-up share capital (generally ranging from HK$5 million to HK$30 million) and minimum liquid capital (generally ranging from HK$0.5 million to HK$15 million). If a licensed firm conducts more than one regulated activity, the higher level of minimum share capital and liquid capital applies.[88]

Client assets

A key aspect of the regulation of securities intermediaries focuses on the handling of client assets. Part VI of the SFO deals with these issues.

The SFO prohibits receiving or holding Hong Kong client assets by anyone except the relevant intermediary or its associated entity or excluded persons such as

85 s. 145 SFO.

86 s. 146 SFO.

87 s. 145 SFO.

88 In the case of a corporation licensed for Type 4 / 5 regulated activities and subject to the licensing condition that it shall not hold client assets, there is no minimum paid-up share capital requirement and the minimum liquid capital requirement is HK$100,000.

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authorised institutions.[89] The SFC may make rules relating to client assets and any contravention of such rules is an offence liable to a fine of up to HK$200,000 and imprisonment for up to two years.[90] If the contravention is intentional, the penalty extends to a fine of up to HK$1,000,000 and to imprisonment for up to seven years.[91] Under the SFO, client assets are not liable for execution against the intermediary.[92] Such rules however do not apply to authorised institutions.

Two pieces of subsidiary legislation interpret these sections:

- Securities and Futures (Client Securities) Rules
- Securities and Futures (Client Money) Rules

The *Client Securities Rules* ("CSR") apply to client securities and securities collateral of an intermediary that are:[93]

- either listed or traded on a recognised stock market, or interests in a collective investment scheme authorised by the SFC; and
- received or held in Hong Kong by or on behalf of the intermediary in the course of the conduct of any regulated activity for which the intermediary is licensed or registered, or an associated entity of the intermediary in relation to the conduct of such regulated activity.

The CSR do not apply to client securities of an intermediary that are in an account established and maintained by a client of the intermediary in that client's name with any other than the intermediary or an associate entity of the intermediary.[94]

Under the CSR, as a general rule that as soon as an intermediary or associated entity receives any client securities, the intermediary shall as soon as reasonably practical ensure that the client securities are deposited in safe custody in a segregated account which is designated as a trust account or client account and established and maintained in Hong Kong by the intermediary or associated entity for the purpose of holding client securities of the intermediary with an authorised financial institution, approved custodian or another intermediary licensed for dealing in securities, or registered in the name of the client on whose behalf the client securities have been received or the associated entity.[95]

The *Client Money Rules* ("CMR") apply to client money of any licensed corporation that is received or held by or on behalf of the licensed corporation, in the course of the conduct of any regulated activity for which the licensed corporation is licensed or an associated entity of the licensed corporation, in relation to such con-

89 s. 164 SFO.
90 ss. 148 & 149 SFO.
91 ss. 148(5) & 149(5) SFO.
92 ss. 148(3) & 149(3) SFO.
93 s. 3(1) CSR.
94 s. 3(2) CSR.
95 s. 5(1) CSR.

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duct of the regulated activity.[96] The key requirement of the CMR is that all client money must be held in segregated accounts, each designated as a trust or client account, with such accounts held by authorised financial institutions or others approved by the SFC.[97]

Record keeping and location of records

Licensed persons have a number of detailed record and document retention obligations. The location of such retention must be approved by the SFC.[98] In many instances, licensed intermediaries may seek to keep certain records overseas, for example, to keep computerised records at the intermediary's IT computer centre, for example, in Singapore. In giving or withholding its approval, the SFC will consider a number of factors including its ability to gain access to the records when it needs to exercise its supervisory or investigatory functions and the status of the local laws as regards the protection of personal data.

In addition, the SFO provides rule-making power in respect to record keeping,[99] which the SFC has exercised through the promulgation of the *Securities and Futures (Keeping of Records) Rules*[100] and the *Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules*.[101]

Under the *Keeping of Records Rules*, as a general matter, intermediaries shall keep records in relation to its regulated activities in such a manner to enable convenient and proper audit and make entries in accordance with generally accepted accounting principles.[102] Records must be retained for in most cases not less than seven years.[103]

Accounts, audit and annual returns

The SFO also addresses accounts, audits and related requirements, which are in turn expanded through the *Securities and Futures (Accounts and Audit) Rules ("AAR").*

96 s. 3(1) CMR.

97 s. 4 CMR.

98 s. 130 SFO.

99 ss. 151 & 152 SFO.

100 Under s. 151 SFO.

101 Under s. 152 SFO.

102 s. 3 KRR.

103 s. 10 KRR.

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Licensed corporations and associated entities of intermediaries[104] must appoint an auditor.[105] The SFC must be notified in writing of any change of auditor.[106] Audited accounts must be submitted to the SFC within four months after the end of the financial year together with the auditor's report.[107] In case the auditor becomes aware of any reportable matter during the course of his work or proposes to include any qualifications or changes in the financial statements to be submitted, he shall report to the SFC.[108]

Further, the SFC has the power to appoint external auditors if, among others, a licensed corporation does not comply with the financial resources requirements or the SFC has reasonable doubts that any financial statements have not been submitted.[109] The same applies if the SFC has received certain reports.[110]

These provisions are expanded by the AAR which require the preparation of a range of documents in respect of each financial year.[111]

Licensed corporations must appoint auditors and notify the SFC of their appointment or any changes, with contravention penalised by a fine of up to HK$200,000 or imprisonment to one year.[112] Further, auditors must report certain matters to the SFC directly under certain circumstances.[113] Auditors have statutory immunity for such actions under the SFO[114] as well as immunity for certain forms of whistle-blowing.[115] In addition, the SFC has the power to appoint auditors in certain circumstances.[116]

It is an offence to destroy, conceal or alter accounts, records, documents, etc., if done with intent to prevent, delay or obstruct the carrying out of any audit, punishable by a fine up to HK$1,000,000 and imprisonment to seven years.[117]

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104 SFO: Schedule 1: an associated entity of intermediary is a company which is in a controlling entity relationship with the intermediary; an intermediary is a licensed corporation or registered institution.

105 s. 153 SFO.

106 s. 154 SFO.

107 s. 156(1) SFO.

108 s. 157 SFO.

109 s. 159 SFO.

110 s. 157 SFO.

111 s. 3 ARR.

112 ss. 153 & 154 SFO.

113 s. 157 SFO.

114 s. 158 SFO.

115 s. 381 SFO.

116 s. 159 SFO.

117 s. 161 SFO.

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License holders much submit an annual return to the SFC within one month after each anniversary of the license date or as approved by the SFC.[118] Further, licensed corporations and associated entities must submit audited accounts to the SFC not later than four months after the close of the relevant annual year, with failure subject to a fine of up to HK$1,000,000 and one year imprisonment.[119]

3.4 Conduct of Business and Compliance

In general, Part VII of the SFO addresses business conduct of securities intermediaries; however, in practice most of these issues are not dealt with in the context of legislation or formal rules. While Section 168 provides a rule-making power, unlike in other areas, this has not been exercised. Under SFO Section 168 the SFC can draft rules concerning the conduct of intermediaries and their representatives in performing regulated activities. For example, the *Securities and Futures (Financial Resources)* Rules cover financial resources requirements of licensed corporations.

Instead, the SFC has relied on section 169 providing for codes of conduct, for which there is no direct liability but rather are considered as one factor in the fit and proper analysis. According to SFO Section 169 the SFC can require intermediaries and their representatives to comply with certain codes of conduct and standards.

The primary code dealing with conduct of business is the *Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission*. This Code is specifically addressed to SFC considerations in relation to fitness and properness of both licensed and registered persons. In addition, there are a variety of other codes and guidelines addressing conduct of more specific forms.

Further, in relation to trading and marketing, there are specific provisions and rules on short-selling and unsolicited calls. In regard to short-selling, as a general matter covered short sales are allowed but not naked short sales.[120] This provision is expanded through the *Securities and Futures (Short Selling and Securities Borrowing and Lending (Miscellaneous)) Rules*. Under SFO Section 174, unsolicited communications in respect of certain securities or futures dealing and related matters is prohibited and a breach thereof is an offence. However, specific exemptions from this prohibition are provided in relation to an existing client, solicitor, or professional accountant acting in his professional capacity, licensed person, registered institution, money lender or professional investor. Moreover, any contract entered into as a result may be rescinded by the party contacted within 28 days of entering into an arrangement pursuant to an unsolicited call or 7 days of finding out about the contravention, whichever is the earlier. Related issues are discussed further in the following chapter.

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118 s. 138 SFO.

119 s. 156 SFO.

120 s. 170 SFO.

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Code of Conduct

As a general matter, the SFC may make rules relating to conduct of business, the contravention of which is an offence punishable by a fine up to HK$200,000 and imprisonment to two years.[121] In addition, as discussed above, the SFC may publish codes of conduct for purposes of giving guidance, with failure to comply being relevant for purposes of fit and proper determinations.[122]

The regulatory framework combines aspects of legislation (namely the SFO), subsidiary legislation under the SFO and various codes and guidelines to establish a framework designed to encourage proper conduct amongst licensed and registered persons. The primary means by which this has been achieved are a series of Codes of Conduct.

The primary *Code of Conduct* for licensed and registered persons in the SFC's *Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission* (Apr. 2003), as amended. The *Code of Conduct* is modelled on IOSCO principles and includes nine general principles addressing the following matters:

- Honesty and fairness;
- Diligence;
- Capabilities;
- Information about clients;
- Information for clients;
- Conflicts of interest;
- Compliance;
- Client assets; and
- Responsibility of senior management.

The honesty and fairness general principle requires the following:

- Accurate representations to clients;
- Fair and reasonable charges;
- Advertising that is not false, disparaging, misleading or deceptive; and
- Compliance with rules dealing with bribery and corruption.

The diligence general principle requires the following:

- Prompt execution of client orders in accordance with client instructions;
- Execution of client orders on the best available terms;
- Prompt and fair allocation of transactions executed;

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121 s. 168 SFO.

122 s. 169 SFO.

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- Due skill, care and diligence in advising clients;
- No withholding of client market and limit orders;
- Prompt collection of any amounts due as margin;
- Separate accounts for each client;
- Informing clients of and monitoring compliance with derivatives position and reporting limits;
- Recording and time stamping all instructions for agency and internally generated orders, including telephone recording for client instructions; and
- Acting in the best interests of clients in providing or recommending services of an affiliate to clients.

The capabilities principle requires:

- Fit and proper staff;
- Adequate staff supervision; and
- Internal control and financial procedures and operational capabilities reasonable to protect against financial loss from theft, fraud and other dishonest acts, professional misconduct or omissions.

The principle addressing information about clients requires:

- Knowing one's client;
- Providing suitable and reasonable advice based on client knowledge, especially in relation to derivatives; and
- Details of client identity relating to origination of instructions and beneficiaries.

In relation to client agreements, the principle requires:

- Client agreements must be in writing prior to provision of services;
- Client agreements must contain certain minimum information;
- Licensed or registered persons must ensure that they comply with their agreements and that those agreements do not remove, exclude or restrict any rights of a client or obligations of the licensed or registered person under law; and
- Client agreements should properly reflect services to be provided, including any limits thereon.

The principle addressing discretionary accounts requires proper authorisation and operation of such accounts, including approval by senior management of account opening.

In relation to information for clients, the principle requires:

- Provision of adequate and appropriate information about the firm;
- Prompt confirmation of client transactions;

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- Provision of financial information about the firm on request, including the latest audited balance sheet and profit and loss account required to be filed with the SFC, as well as disclosure of any material changes; and
- Prompt provision of information on client assets.

The client priority principle requires:

- Handling of client orders fairly in the order received, including priority over proprietary or discretionary account transactions;
- Provision of priority to client orders in cases of aggregation;
- Controls to address confidential information, especially to prevent front-running; and
- Prompt notification of withdrawal from any client business and completion or transfer of any outstanding business.

In respect to conflicts of interest, the principle requires disclosure of any material interest in any transaction prior to advising or dealing.

The client assets principle requires proper and prompt handling and adequate safeguarding of client transactions and assets.

The compliance principle requires:

- Compliance with and implementation and maintenance of measures appropriate to ensure compliance with relevant law, rules, regulations and codes;
- Policies on employee trading;
- Timely and appropriate handling of complaints, including investigation and response;
- Responsibility for acts and omissions of employees and agents; and
- Notification of the SFC upon certain events.

Rebates, soft dollars and connected transactions are allowed only if certain conditions are met, generally relating to disclosure, consent and best execution.

The principle addressing responsibility of senior management requires senior management to properly manage risks associated with the business, including periodic evaluation of risk management processes.

The principles do provide for extensive limitations to the above in relation to professional investors.

In addition to the above, the SFC has also provided a set of principles specifically addressing analysts (Paragraph 16 of the *Code of Conduct*). These include requirements for:

- Mechanisms to ensure that analysts' trading activities or financial interests to not prejudice their investment research and recommendations;

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- Mechanisms to prevent prejudice to research and recommendations by the other business of the firm;
- Structuring of reporting lines and compensation arrangements of analysts to eliminate or severely limit actual and potential conflicts of interest;
- Establishment of written internal procedures or controls to identify and eliminate, avoid, manage or disclose actual and potential analyst conflicts of interest;
- Elimination or management of undue influence of issuers, institutional investors and other outside parties upon analysts;
- Clarity, specificity and prominence of any disclosures of actual and potential conflicts of interest; and
- High integrity standards for analysts.

Management of operations

The SFC has issued the *Management, Supervision and Internal Control Guidelines for Persons Registered with or Licensed by the SFC*. These guidelines address the manner in which a licensed or registered person structures, manages, and operates the business for which it is licensed or registered. Of particular concern is the standing of the entities internal controls over their operations. The SFC has specified that such controls should provide "reasonable assurance" in relation to:

- safeguarding both client and proprietary assets against unauthorised use or disposition;
- maintenance of proper accounting records and the reliability of financial and other information used within and published by, the business; and
- compliance with all applicable laws and regulatory requirements.

Duty to disclose

As a general matter, the SFO does not include a general duty to disclose knowledge or suspicions of misconduct. Nonetheless, there are a number of specific duties to report under certain circumstances. Most significantly, any person which has provided any information to the SFC must notify the SFC of any changes to that information.[123] Further, licensed corporations must notify the SFC in a number of circumstances including failure to comply with the *Financial Resources Rules*.[124]

However, the *Code of Conduct* does include a more general reporting duty. Under the *Code of Conduct*, licensed or registered persons (as a firm) should report any of the following immediately to the SFC:[125]

- Any material breach, infringement or non-compliance or suspicion thereof by either itself or its employees/appointees with any law, rules, regulations, and codes administered or issued by the SFC, the rules of any exchange or clearing house of

123 s. 135(3) SFO.

124 s. 146 SFO.

125 *Code of Conduct*, pp. 22-23.

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which it is a member or participant, or the requirements of any regulatory authority which apply;

- Any commencement of insolvency related proceedings or the bankruptcy of any of its directors;
- Any disciplinary measure against it or the refusal, suspension or revocation of any regulatory license, consent or approval required in connection with its business by any regulatory, professional or trade body; or
- Any material failure, error or defect in the operation or functioning of its trading, accounting, clearing or settlement systems or equipment.

In addition as noted above, there are specific requirements for auditors to report certain information to the SFC[126] along with immunity for such actions.[127] Finally, a number of obligations to disclose knowledge or suspicions relating to money laundering and other forms of financial crime arise under related legislation.

3.5 Exit and Compensation

In Hong Kong, procedures to deal with failure of intermediaries, include civil liability of persons committing market misconduct and the Investor Compensation Fund (ICF). Overall, outside of the ICF and related insurance arrangements, securities firm insolvency falls under the general insolvency framework in Hong Kong. In addition, the SFC has a power to commence winding up.

In addition, the SFO requires as a condition of a license for carrying on a regulated activity maintaining required insurance.[128] The *Securities and Futures (Insurance) Rules*[129] require certain licensed corporations to take out and maintain insurance of certain levels in relation to specified risks. Specifically, the rules require SEHK and HKFE participants to take out and maintain insurance under a master policy of insurance approved by the SFC if the SFC has approved such a policy.[130]

4. REGULATED INVESTMENT PRODUCTS

This addresses the regulatory framework for investment products. In this context, the regulatory framework affects business activities at different levels:

- distinct financial products (for example, units in mutual funds) ("investment products"); and
- how such products are acted upon *vis-à-vis* customers and the market (for example, sales and marketing activities, contracts with clients).

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126 s. 157 SFO.

127 s. 158 SFO & s. 381 SFO.

128 s. 118(1)(a)(i)(B) & s. 116(1) SFO.

129 Cap. 571AI.

130 ss. 4 & 5 SFO.

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4.1 Legal and Regulatory Framework for Investment Products

In Hong Kong, conceptually, the regulatory system applying to investment products has a number of levels:

- Direct regulation of intermediaries instead of direct regulation of products;
- Direct regulation of products offered to the public and not of products offered only to sophisticated counterparties; and
- Regulation of listing, listed products and listed companies primarily by HKEx and its subsidiaries.

As a jurisdiction which has its roots in the English common law system and one which historically has adopted a *laissez-faire* approach to economic matters, the regulation of financial products services in Hong Kong is intended to be flexible and permissive rather than restrictive. Overall, this approach has supported the development of financial markets in Hong Kong into one of the world's leading financial centres. In recent years, with the enactments of the SFO, the MPFSO, and changes to the regulatory framework for banking and insurance, the regulation of financial intermediaries, products and services in Hong Kong has increased. Nonetheless, regulation continues to be largely permissive and flexible in recognition of the need to continue to foster market innovation and development.

Overall, most financial products are largely matters of private contract and therefore governed by the common law framework, with disputes adjudicated by the courts. However, in addition to this private law framework provided by common law, there are a variety of statutes which address an ever growing range of financial products. Similar to other jurisdictions with legal systems based upon English law, at the base are ordinances dealing with traditional products such as bills and cheques (*Bills of Exchange Ordinance*), company shares (*Companies Ordinance and Listing Rules*), and security interests (*Companies Ordinance, Bankruptcy Ordinance* and a variety of property related ordinances). These provide the essential legal framework for basic financial products.[131]

On top of this basic private law framework, major categories of financial products such as banking, securities, insurance and pensions products, are largely dealt with through the regulation of financial institutions and other financial intermediaries.

Finally, as a third layer, there are an increasing number of other statutory provisions addressing specific aspects of business involving financial products. The largest number and most important of these arise in the context of the SFO.

Regulation of the intermediary

As a general matter, the regulation of financial products and services in Hong Kong focuses on the provider of the product rather than on the product itself. As a result, following the UK approach, regulation of products focuses on licensing the relevant intermediary (or its agents) in most cases, although there is a growing range of

131 For discussion, see *Financial Markets in Hong Kong: Law and Practice*, above.

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product-based regulation (similar to that in the US). However, as licensing of an intermediary is orientated toward the products which are typically supplied by that particular class of financial intermediary (for example, securities firms engage in "regulated activities"), this description is to some extent blurred.

Regulation of issuers and issuance of financial products

As noted above, the primary sources of regulation of issuers of company securities and their listing are the *Companies Ordinance and the Listing Rules*. In addition to these, the SFO provides an additional layer of regulation of financial products.

Schedule 1 to the SFO defines "financial product" as meaning any securities, futures contract, collective investment scheme or leveraged foreign exchange contract. Such financial products are subject to SFC regulation to differing degrees. Schedule 1 also provides an extensive definition of the term "securities" which includes not only shares, stocks, debentures, loan stocks, funds, bonds or notes issued by a body (whether incorporated or unincorporated) but also includes any rights, options, interests in the same and any other instruments commonly known as securities. The Financial Secretary may also specify certain interests and rights etc to be regarded as securities.[132] However, the term "securities" does not include shares or debentures of a company that is a private company within the meaning of section 29 of the *Companies Ordinance,*[133] interests in collective investment schemes falling under the MPF regime[134] or occupational retirement regime,[135] certain classes of insurance contracts,[136] bills of exchange[137] and various other items including certain partnership interests, negotiable certificates, non-negotiable debentures, and such rights or interests as may be specified by the Financial Secretary.[138]

The SEHK and HKFE are responsible for the regulation of products listed on their exchanges, as well as the conduct of those accessing those markets via trading rights. At the same time, submissions to HKEx and its subsidiaries also now must be filed with the SFC under the "dual filing" regime, thereby bringing once purely self-regulatory matters relating to listing and listed companies within the coverage of the SFO and the regulatory remit of the SFC.

Wholesale business and retail investment business

Wholesale markets in Hong Kong largely remain lightly regulated across the spectrum of financial products. Generally speaking, financial products business between sophisticate/institutional counterparties are generally unregulated outside of

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132 s. 392 SFO.

133 This includes private company debentures linked to other public companies, commonly used in structured notes and thus avoiding the SFO. These issues are currently being reviewed by the SFC and are likely to be brought within the SFO in the near future.

134 i.e., registered schemes as defined in s. 2(1) MPFSO or constituent funds thereunder.

135 See s. 2(1) ORSO.

136 As specified in ICO, sch. 1.

137 As defined in *Bills of Exchange Ordinance* (Cap. 19), s. 3.

138 Pursuant to s. 392 SFO.

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the underlying common law/legislative framework, except to the extent that such business is between licensees and/or the transactions at issue involve products of HKEx and its subsidiaries. The detailed definition of "professional investor" thus has great practical impact for regulatory considerations.

Under section 1 of Schedule 1 of the SFO, "professional investors" include:

- any recognized exchange company, recognized clearing house, recognized exchange controller or recognized investor compensation company, or any person authorized to provide ATS under Part III of the SFO;
- any intermediary, or any other person carrying on the business of the provision of investment services and regulated under the law of any place outside Hong Kong;
- any authorized financial institution, or any bank which is not an authorized financial institution but is regulated under the law of any place outside Hong Kong;
- any insurer authorized under the ICO, or any other person carrying on insurance business and regulated under the law of any place outside Hong Kong;
- any scheme which is a collective investment scheme authorized under section 104 SFO; or is similarly constituted under the law of any place outside Hong Kong and, if it is regulated under the law of such place, is permitted to be operated under the law of such place, or any person by whom any such scheme is operated;
- any registered scheme under the MPFSO, or its constituent fund, or any person who, in relation to any such registered scheme, is an approved trustee or service provider as defined thereunder or who is an investment manager of any such registered scheme or constituent fund;
- any scheme which is a registered scheme as defined in the ORSO; or is an offshore scheme as defined therein and, if it is regulated under the law of the place in which it is domiciled, is permitted to be operated under the law of such place, or any person who, in relation to any such scheme, is an administrator as defined under the ORSO;
- any government (other than a municipal government authority), any institution which performs the functions of a central bank, or any multilateral agency;
- any corporation which is a holding company which holds all the issued share capital of or a wholly owned subsidiary, or any other wholly owned subsidiary of a holding company of an intermediary or any other person carrying on the business of the provision of investment services and regulated under the law of any place outside Hong Kong, an authorized financial institution, or any bank which is not an authorized financial institution but is regulated under the law of any place outside Hong Kong;[139] or
- any person of a class prescribed by rules made under the SFO.

139 This does not apply for the purposes of sch. 5 SFO relating to "regulated activities" (discussed in Chapter 3).

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In relation to the last category, the *Securities and Futures (Professional Investor) Rules,*[140] add the following:[141]

- any trust corporation having been entrusted under the trust or trusts of which it acts as a trustee with total assets of not less than HK$40 million or its equivalent in any foreign currency;
- any individual, either alone or with any of his associates on a joint account, having a portfolio of not less than HK$8 million or its equivalent in any foreign currency;
- any corporation or partnership having a portfolio of not less than HK$8 million or its equivalent in any foreign currency, or total assets of not less than HK$40 million or its equivalent in any foreign currency; and
- any corporation the sole business of which is to hold investments and which is wholly owned by an individual who, either alone or with any of his associates on a joint account, falls within the second category above.

However, reflecting a world-wide trend, regulation of retail products across the financial sector has generally increased. An increasing focus of financial regulation not only in Hong Kong but around the world is on retail consumers. In Hong Kong, the traditional attitude of the markets, the regulatory system and the courts has been one of caveat emptor. However, this underlying philosophy has been limited to a certain extent due to developments following the market crash of 1987 and also due to the assumption for the first time of a system of self-rule under the "one country, two systems" framework.

In the context of financial regulation, this trend away from caveat emptor and towards retail financial services consumer protection can be seen in the SFO and limitations on the role of self-regulatory organisations HKEx and its subsidiaries.

In this context, it is worth noting that beyond the strict context of securities and futures regulation, Hong Kong still has very limited systems of consumer protection, though these are increasing to a certain extent. Most important in this context have been the creation of the Consumer Council (under the *Consumer Council Ordinance* (Cap. 216)). Further development of this trend can be seen through the enactment of legislation such as the *Pyramid Selling Prohibition Ordinance* (Cap. 355), *Supply of Services (Implied Terms) Ordinance* (Cap. 457), and *Unconscionable Contracts Ordinance* (Cap. 458), all of which place some limits on caveat emptor and increase the general level of consumer protection.

At the same time, Hong Kong still has no general legislation addressing false advertising (though these issues are addressed in the context of the SFO), continuing to rely instead largely on common law.

Further, at present, there is no comprehensive competition or antitrust regulation in Hong Kong. However, in relation to certain sectors (e.g., telecommunications and

140 Made under s. 397(1) SFO.

141 s. 3 *Professional Investor Rules*.

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electricity), there are sector-specific schemes. In addition, there exists a competition policy committee whose role it is to discuss competition and antitrust issues that may arise in Hong Kong. At present, it has had a limited impact. At the same time, discussions are on-going in Hong Kong (and in the People's Republic of China) about the possible need for comprehensive competition or antitrust regulation. At present, no solid proposals have emerged in Hong Kong.

4.2 Regulation of Marketing and Sales of Financial Products

Generally speaking, the sections of Part IV of the SFO address offers of investment and are generally most significant in the context of offers of investment to the public. Beyond these specific circumstances (and of special significance for the dual filing regime mentioned above), it is also an offence to knowingly or recklessly provide materially false or misleading information in the context of any requirement to provide information under the SFO to the SFC, recognised exchange, clearing house or exchange controller.[142] Penalties may be up to HK$1,000,000 and two years imprisonment.[143]

Authorisation of investment products

Section 103(1) SFO contains a general prohibition on public offers of investment unless that offer is authorised by the SFC. A public offer of investment is an invitation, advertisement or document which invites the public to enter into an agreement to acquire or dispose of securities, enter into a regulated investment agreement[144] or acquire an interest in or participate in a collective investment scheme.[145] However, a number of exemptions are available including relating to prospectuses and advertisements etc issued by or on behalf of persons licensed or registered to engage in Type 1, Type 4 or Type 6[146] regulated activities (or Type 2 or Type 5 licences in respect of futures contracts, or Type 3 in respect of leveraged foreign exchange contracts), authorised financial institutions, or by a corporation to its shareholders, creditors or employees in respect of its securities.[147]

According to section 105(1) SFO the SFC can authorise investment offers upon application. To date, the SFC has authorised a variety of different types of investment products under Part IV of the SFO, including:

- Certificates of deposit;
- Commercial paper;

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142 ss. 383 & 384 SFO.

143 s. 383 SFO.

144 Regulated investment agreement: an agreement whose purpose is to provide profits to the involved parties, calculated by reference to changes in the value of property, not including an interest in a collective investment scheme. Sch. 1 SFO.

145 Collective investment scheme: a pool of several investors' funds that obtains economies of scale and spreads of investment beyond the reach of individual investors. Sch. 1 SFO.

146 Discussed above.

147 s. 103(2) SFO.

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- Immigration-linked investment schemes
- Investment-linked assurance schemes
- Investment-linked products
- Miscellaneous products
- MPF – Master Trust Schemes and Industrial Schemes
- Paper gold schemes
- Pooled retirement funds
- Real estate investment trusts
- Unit trusts and mutual funds

In some cases, specific regimes and requirements apply to authorisation of certain product types. Specific regimes applying to collective investment schemes and leveraged foreign exchange are dealt with separately below. In addition, the SFC has authorised a number of products on the basis of market needs and / or desires.

Under section 106 SFO, the SFC can revoke an authorisation if, among others, the applicants have provided false or misleading information or the revocation is in the interest of the investing public.

Marketing and sales of investment products

A number of significant provisions of the SFO address marketing and sales of investment products, generally in the context of retail transaction.

As a general matter, it is an offence under the SFO[148] to issue advertisements, invitations or documents relating to investments unless the issue has been authorised by the SFC.[149] Penalties range from fines of HK$500,000 to imprisonment of up to 3 years.[150] There are however a range of limitations to this general prohibition, including advertisements etc made by or on behalf of various types of professional investor. There is also an exception that applies to the media. However, authorised financial institutions, exempted bodies, multilateral agencies, and banks incorporated outside Hong Kong nonetheless commit an offence if they do not submit information required by the SFC within 10 days.[151]

Finally, it is a defence for the person charged to prove that he took all reasonable steps and exercised all due diligence to avoid the commission of the offence with which he is charged.

148 s. 103(1) SFO.

149 Under s. 105(1) SFO.

150 s. 103(4) SFO.

151 s. 110 SFO.

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As a corollary to this general rule, the SFC may authorise the issue of advertisements, invitations or documents[152] or withdraw the same—generally on the basis of accuracy of the information, compliance with any conditions or protecting the investing public.[153]

As a general matter, it is an offence to fraudulently or recklessly induce others to invest money, punishable by a fine of up to HK$1,000,000 and imprisonment of up to seven years.[154] There is also the potential for civil liability. Section 108(1) SFO provides for any person who suffered material loss due to fraudulent, reckless or negligent misrepresentation with respect to an investment product, to claim compensation from the product supplier. This section extends to negligent misrepresentation.[155]

In addition to the general prohibition and related liability frameworks, according to SFO Section 109, it is also an offence to advertise that a person who is not licensed to undertake a regulated activity is prepared to do so. Such illegal advertisement consists of issuing offers of conducting regulated activity on behalf of a person who holds himself out as being properly licensed to carry out that activity. Likewise, it is illegal to represent or permit any representation that any licensed person has been endorsed or warranted by the SFC.[156]

As a general matter, cold calling is prohibited under the SFO and is punishable by a fine, though this general rule is subject to a wide range of exceptions relating to dealing with professionals.[157] In addition, offers to acquire or dispose of securities must generally be communicated in writing and contain a range of required information.[158]

Short selling

As a general matter, naked short selling at or through a recognised stock market is prohibited by the SFO, with penalties including fines and imprisonment to two years.[159] Likewise, short selling as principal or agent requires confirmation that the transaction is covered,[160] as well as disclosure to the relevant exchange.[161] Details are provided in the Securities and Futures (Short Selling and Securities Borrowing and Lending (Miscellaneous)) Rules,[162] which provide exemptions from the gen-

152 s. 105 SFO.
153 s. 106 SFO.
154 s. 107 SFO.
155 s. 108 SFO.
156 s. 176 SFO.
157 s. 174 SFO.
158 s. 175 SFO.
159 s. 170 SFO.
160 s. 171 SFO.
161 s. 172 SFO.
162 Made under ss. 397(1), (2) & 398(7) SFO.

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eral prohibition on short-selling,[163] as well as record-keeping requirements for securities lenders.[164] The Rules are supplemented and explained by the SFC *Guidance Note on Short Selling Reporting and Stock Lending Record Keeping Requirements*, which clarifies and explains the SFC's policy intent and position relating to SFO Sections 170-172 (dealing with short selling) and the Short Selling Rules. Generally speaking, short sellers have to follow the Exchange's up-tick rule and can only short sell designated short selling stocks of the Exchange. However, "stock market makers," "stock option makers" and "warrant liquidity providers" are exempted from complying with the short selling rules.

Public communications

Beyond the general framework addressing authorisation, marketing and sales, and short selling, SFO Section 391 provides for potential civil liability for false or misleading public communications concerning securities and futures contracts. In this context, a person is responsible for communications made or issued to the public or to a group of persons comprising members of the public (including the shareholders of a listed corporation or the holders of listed securities); the communication concerns securities or futures contracts or may affect the prices of such securities or futures contracts; the communication is false or misleading in a material particular; and the person knows that, or is reckless or negligent as to whether, the relevant communication is false or misleading in a material particular. In such cases, that person shall, whether or not he also incurs any other liability, be liable to pay compensation by way of damages to any other person for any pecuniary loss sustained by the other person as a result of his acting, or refraining from acting in a manner in which he would otherwise have acted, in reliance on the relevant communication.

Thus, Section 391 provides a potentially powerful source for private enforcement of investor protection. However, it has yet to become significant in practice.

In addition, as noted above and most relevant in the context of the dual filing regime, Section 383 provides a related offence for filings with the SFC. In practice, the latter is likely to have significant impact on securities professions and market practices.

4.3 Funds: Collective Investment Schemes

The basic framework for investment funds and related products is the SFO, supplemented by subsidiary legislation, the general SFC *Code on Unit Trusts and Mutual Funds*, and specific codes on real estate investment trusts (REITs) and other products.

Funds that are publicly offered to Hong Kong investors are required by the SFO to be authorised by the SFC under a process different from the licensing process for fund managers. While all fund managers conducting asset management activity in Hong Kong are required to be licensed (irrespective of whether the funds they man-

163 ss. 170, 171 SFO

164 s. 5 *Short Selling and Securities Borrowing and Lending (Miscellaneous) Rules*.

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age are offered only to institutional or professional investors or are offered to the public), only those funds that are offered to the public are required to be authorised by the SFC.

Under SFO Section 104(1), any public offer relating to participation in a collective investment scheme such as unit trusts and mutual funds must be individually authorised by the SFC.

This general requirement is supplemented by the SFC *Code on Unit Trusts and Mutual Funds*. This Code[165] provides guidance in relation to the authorisation of mutual fund corporations or unit trusts as a specific form of collective investment scheme. Similar to other codes and guidelines, it does not have the force of law. Further, the SFC has also issued a *Guidance Note for Persons Advertising or Offering Collective Investment Schemes on the Internet*, which clarifies the regulatory requirements concerning CIS activities on the internet, reflecting the existing regulatory framework.

In addition to the general framework for collective investment schemes, the SFC has also developed a schemes relating to specific forms of CIS, including hedge funds (Chapter 8.7 of the *Code on Unit Trusts and Mutual Funds*) ("Hedge Fund Guidelines"), REITs (*Code on Real Estate Investment Trusts*), MPF products (*Code on MPF Products*), investment-linked assurance schemes (*Code on Investment-linked Assurance Schemes*), pooled retirement funds (*Code on Pooled Retirement Funds*), and immigration-linked investment schemes (*Code on Immigration-linked Investment Schemes*).

4.4 OTC Derivatives and Leveraged Foreign Exchange Transactions

The scope of direct SFC interest in derivatives is confined to those treated as "securities" or "futures contracts", and defined by the SFO to include in the case of securities:[166]

> "rights, options or interests (whether described as units or otherwise) in, or in respect of, [...] shares, stocks, debentures, loan stocks, funds, bonds or notes."

and

> "certificates of interest or participation in, temporary or interim certificates for, receipts for, or warrants to subscribe for or purchase, [...] shares, stocks, debentures, loan stocks, funds, bonds or notes."

Where such shares, stocks, debentures, loan stocks, funds, bonds or notes are themselves securities, and in the case of futures contracts:

> "a contract or an option on a contract made under the rules or conventions of a futures market."

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165 Made under s. 104(1) SFO.

166 Sch. 1.

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However, the Financial Secretary may give notice that any instrument is to be regarded for the purposes of the SFO as either a security or future.[167] This could include, for example, instruments based upon underlying claims assets that were not securities, such as foreign exchange contracts. More generally, the *de facto* result of the SFO is that exchange traded derivatives can always be expected to be subject to some form of SFC oversight, regardless of underlying asset, and that OTC derivatives will not be subject to SFC supervision, even though it might appear plausible in some cases. This accords with practice in most common law jurisdictions where OTC derivatives are prominent.

As a result, derivatives are generally treated similarly to other securities. The exceptions are leveraged foreign exchange and OTC derivatives, which both receive somewhat different treatment. Generally speaking, SFC regulation of leverage forex trading has become unimportant in practice. As a general matter, OTC derivatives are not subject to SFC supervision.[168]

5. REGULATION OF MARKET ABUSES AND FINANCIAL CRIME

The regulatory framework for market misconduct in Hong Kong focuses on three forms of market abuse: insider dealing, market manipulation, and fraud and deception. In addition, the legal and regulatory framework also provide for certain forms of disclosure (in addition to those discussed in previous chapters) in order to reduce market misconduct.

5.1 Market Misconduct

According to sections 292 to 299 SFO engaging in any type of market misconduct is an offence and, under section 303(1) SFO, criminal liability comprises a fine of HK$10 million and imprisonment for 10 years.

The SFO also imposes a duty on officers of a corporation to take all reasonable measures in ensuring that there are proper safeguards to prevent the corporation from perpetrating market misconduct.[169] It is immaterial whether or not the person on whom such a duty is imposed has not engaged in market misconduct. Once the corporation has been identified as having engaged in market misconduct attributable to a breach of such a duty, then that person may be made liable.[170] For example, a corporation is expected to take reasonable measures to ensure that its *Listing Rules* announcements do not contain any false or misleading information.[171]

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167 SFO s. 392.

168 For detailed discussion, see *Financial Markets in Hong Kong*, above.

169 s. 279 SFO.

170 s. 258(1) SFO.

171 E. Goyne, *Fairer markets: the SFO & more effective market misconduct laws* (SFC Nov. 2002), p. 20.

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At the same time, the SFO empowers the SFC to make rules prescribing the circumstances in which conduct shall not be regarded as constituting market misconduct after consulting the Financial Secretary.[172]

5.2 Civil and Criminal

Market misconduct activities are regulated by Parts XIII and XIV of the SFO under a dual system. Under the ordinance, all market misconduct activities are criminalised. In addition, the SFO also creates a civil route as an alternative to the more difficult criminal route as part of the framework addressing most market misconduct activities. In the strict sense, there is no civil offence as such. Rather, under the civil route, the defendant is tried by the MMT under the civil standard of proof.[173]

Part XIV of the SFO provides a criminal route in regulating market misconduct, requiring a criminal standard of proof ("beyond reasonable doubt"). Part XIII of the SFO addresses the civil route for regulating market misconduct. It establishes the MMT to adjudicate market misconduct, which adopts civil procedures, including a civil standard of proof is adopted. Accordingly, the penalty in the civil route is much milder and the MMT may make civil orders but it cannot impose imprisonment. As market misconduct offences are serious matters, the standard of proof in the civil route is however higher than the mere balance of probabilities, i.e. a higher degree of probability but still below the criminal standard of proof.[174]

The provisions in the SFO dealing with civil and criminal offences are generally similar. The Government can choose to initiate either summary or indictable proceedings. Under the SFO, the SFC may report and the Secretary of Justice may notify the occurrence of market misconduct to the Financial Secretary.[175] In any event, the Financial Secretary may independently refer to the Secretary for Justice that a market misconduct offence has or may have been committed.[176] In addition, the SFC itself may bring summary proceedings and quite often does. In more serious matters, the SFC refers a case which it believes satisfies the criminal burden of proof to the Department of Justice which in turn, if it considers the case should not be pursued criminally, will refer it to the Financial Secretary, who alone can trigger MMT proceedings. Where the SFC considers a case does not meet the criminal standard, it will refer it to the Financial Secretary for consideration of whether to initiate MMT proceedings, in which the Financial Secretary will always seek the advice of the Department of Justice in such decision. In practice, the main reason for preferring the MMT is that self-incriminating statements made in compulsory SFC interviews may be admitted in MMT proceedings but not in criminal proceedings.

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172 ss. 282 & 306(2) SFO.

173 s. 252(7) SFO.

174 *Success Holdings Limited Inquiry Report* (Report of the IDT, 24 Jun. 1994), pp. 17-8.

175 s. 252(8) SFO.

176 s. 252(10) SFO.

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The criminal route is used when the Government has sufficient evidence to prove that a person is beyond all reasonable doubt guilty of market misconduct. Normally, this would mean that there must be a reasonable likelihood to secure a conviction. A prima facie case is not sufficient to initiate a criminal prosecution. Rather, the Department of Justice must be satisfied that public interest requires prosecution for the market misconduct in the circumstances.[177] In ensuring that nobody will be charged twice for the same, or substantially the same cause, the SFO also contains "no double jeopardy" provisions.[178] The Government can only choose either the civil route or criminal route, but not both. Once a civil or criminal proceeding is commenced, it cannot be withdrawn to initiate proceedings in the alternative route.

The MMT may make civil orders against a person found to have engaged in market misconduct.[179] These orders include disqualification orders prohibiting such person, without leave of court to be director, liquidator, receiver, or manager of listed or other specified corporations and "cold shoulder" orders banning such person from acquiring, disposing, or dealing in securities for up to 5 years.[180] It may also make disgorgement orders requiring the insider to pay the Government an amount not exceeding amount of profit gained or loss avoided and cost orders reimbursing the expenses incurred by the Government and the SFC.[181] The MMT is not empowered to impose high fines as it runs the risk for being considered as criminal in nature.[182] The orders of the MMT are enforced through the court as either summary or indictable offence or through punishment of contempt for failing to comply with it.[183] It has the same status as an order of the Court of First Instance.[184] However, the penalty is much more severe under the criminal route. Both summary and indictable offences carry penalties and fines of 3 and 10 years imprisonment and HK$1 million and HK$10 million respectively.[185]

In addition to common law rights, the victims of market misconduct can sue the wrongdoers in a court of law under the SFO by admitting the determination of the MMT or the conviction of the court as evidence. The court may award damages for contravention of the SFO to a party who suffers loss as a result of the contravention whether or not the loss arises from that party having entered into or carried out a

177 HKSAR Department of Justice, *The Statement of Prosecution Policy & Practice* (2005), para. 9.1.

178 ss. 283 & 307 SFO.

179 s. 257(1) SFO.

180 s. 257(1)(a) & (b) SFO.

181 s. 257(1)(d), (e) & (f) SFO.

182 Goyne, above, pp. 3-4.

183 ss. 257(1), 258(10) & 261(2)(c) SFO.

184 s. 264(1) SFO.

185 s. 303 SFO.

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transaction or dealing at a price affected by the market misconduct.[186] The court may grant an injunction in addition or in lieu to awarding damage.[187] However, the liability of the wrongdoer in such civil action may be too wide. Accordingly, the SFO requires that the court must satisfy that it is fair, just and reasonable for a person to pay compensation in the circumstances.[188] For contravention under the civil route, which has a lower standard of proof, the SFO makes it clear that the wrongdoer must have perpetrated in, consented to or assisted in the commission of the market misconduct.[189] Accordingly, an officer of a corporation who fails to take reasonable measures in preventing market misconduct cannot be held liable under this provision.[190] The plaintiff must also prove the determination of the MMT or the conviction by the court is relevant to the issue in the lawsuit.[191]

5.3 Insider Dealing

Insider dealing is a class of civil market misconduct under SFO Section 270 and an offence under SFO Section 291. As with other common law jurisdictions, these sections effectively create two forms of misconduct or offences, of dealing when in possession of relevant information, and of disclosing relevant information knowing the other person is likely to make use of such information. "Relevant information" means specific information about the corporation "which is not generally known to the persons who are accustomed or would be likely to deal in the listed securities of the corporation but which would if it were generally known to them be likely to materially affect the price of the listed securities".[192]

Under the SFO, insider dealing is defined as[193] trading in securities of a company by a person that has special information not or not yet available to the general public because of his or her position with the company.[194]

The portions of the SFO regulating insider dealing are Division 4, Part XIII and Division 2, Part XIV of the ordinance for civil and criminal routes respectively. The insider dealing provisions apply to both Hong Kong listed and dual listed securities. The SFO provides a definition for listed securities, covering those issued securities which are listed as well as those which are not listed but is reasonably foreseeable that they will be listed and in fact become listed.[195]

Under the SFO, insider dealing takes place when a "person connected" with the listed corporation, possessing information he knows is "relevant information" in

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186 s. 281 & 305 SFO.

187 ss. 281(6) & 305(5) SFO.

188 ss. 281(2) & 305(2) SFO.

189 s. 281(3) SFO.

190 s. 281(1) & (3) SFO.

191 ss. 281(7) & 305(6) SFO.

192 Including about its shareholders, officers, securities or derivatives, ss. 285(2) & 345(2) SFO.

193 s. 270 SFO.

194 Fitzroy Dearborn, *Fitzroy Dearborn Encyclopedia of Banking & Finance*, p. 594.

195 ss. 245(2) & 285(2) SFO.

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relation to that corporation, deals in the securities of that corporation, or counsels or procures another person to do the same.[196] Insider dealing also takes place when a person discloses information to another person, knowing or having reasonable cause to believe that the other person will deal likewise or counsel or procure another person likewise.[197] These provisions prohibit a person from dealing and disclosing information relating to insider dealing, as well as counselling or procuring other person to do the same. For the avoidance of doubt, the SFO expressly includes takeover offers as insider information,[198] thus deeming any person who is contemplating or has contemplated making a takeover offer as an insider.

As the legislative intent is to prohibit the misuse of inside information, the ordinance states that a person who receives inside information from a connected person is also liable, even though he is not a primary insider.[199] It is immaterial whether or not the information is received directly or indirectly. However, the prosecution must prove that the defendant knows or has reasonable cause to believe the information is inside information. From the above definition of insider dealing, the definitions for connected person and relevant information warrant further discussion.

Under the SFO, a person is considered to be connected with a corporation by virtue of his position. Such person is commonly known as an insider. A connected person with a corporation includes its directors, employees and substantial shareholders, or its related corporation.[200] This covers a wide range of related persons, including very low level employees, e.g. a janitor, as they may have access to relevant information. A substantial shareholder of a corporation is a person who holds 5% or more nominal value of voting shares of that corporation.[201] Theoretically, this class of insiders owe a fiduciary duty to the corporation not to appropriate the privileged inside information as their own. The definition of connected person extends to a person who occupies a position, which may reasonably be expected to give him access to relevant information in relation to the corporation by reason of a professional or business relationship,[202] or his being a director, employee or partner of a substantial shareholder of the corporation, or a related corporation of the corporation.[203] Whether there is a professional or business relationship is a question of fact in each particular case.[204] A family relationship may also involve a business relationship.[205] A single encounter may trigger such a relationship as the relationship

196 ss. 270(1)(a) & 291(1) SFO.
197 ss. 270(1)(c) & 291(3) SFO.
198 ss. 270(1)(b) & 291(2) SFO.
199 ss. 270(1)(e) & 291(5) SFO.
200 ss. 247(1), (a), (b) & 287(1)(a), (b) SFO.
201 ss. 247(3) & 287(3) SFO.
202 ss. 247(1)(c)(i) & 287(1)(c)(i) SFO.
203 ss. 247(1)(c)(ii) & 287(1)(c)(ii) SFO.
204 *Hong Kong Parkview Group Limited Inquiry Report* (Report of the IDT, 5 Mar. 1997), p. 32.
205 Ibid.

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may exist at the time of or any time prior to the commission of the alleged insider dealing.[206]

A person may well be a connected person of the corporation, if he has access to relevant information in relation to the corporation by reason of his being a connected person with another corporation.[207] The relevant information must be related to an actual or contemplated transaction involving both corporations or between one of them or the listed securities of the other or their derivatives.[208] This class of persons are deemed as insiders because of their privileged position in possessing inside information. They should hold the information in trust for the corporation. A person is also deemed as a connected person if the insider dealing takes place within six months of his being a connected person as discussed in the preceding paragraph.[209] This provision intends to prevent a person from disqualifying himself as a connected person and then engaging in insider dealing with the relevant information acquired.

The provisions of the SFO require the establishment of a connection between the person and the corporation to be an insider. A person is equally culpable for misusing information insofar as he knows that such information is not generally available. Therefore, the SFO also deems a public officer or a specified person, who receives relevant information, as a connected person.[210] It provides a list of persons defined as specified person, including members of the Executive and Legislative Councils, public board members and officers or employees of HKEx. However, the SFO is silent regarding former public officers or former specified persons.

The SFO also provides a definition for relevant information, which is "specific" information about the corporation, a shareholder or officer of the corporation, or the listed securities of the corporation or their derivatives.[211] The information must be specific, i.e. information must not only be precisely defined but its entire content must be precisely and unequivocally identified, expressed and discerned.[212] The type of information the ordinance is concerned about is not the general information which insiders come across, but rather events which affect the corporation. There must be sufficient particulars in the information to comply with this requirement.[213] It suffices if there is a probable consequence[214] or reasonable belief[215] that the event may happen. The SFO does not use the phrase "price sensitive information".

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206 Ibid, p. 33.

207 ss. 247(1)(d)(i) & 287(1)(d)(i) SFO.

208 ss. 247(1)(d)(ii) & 287(1)(d)(ii) SFO.

209 ss. 247(e) & 287(e) SFO.

210 ss. 249 & 288 SFO.

211 ss. 245(2) & 285(2) SFO.

212 *Chinese Estates Holdings Limited Inquiry Report* (Hong Kong: Report of the Insider Dealing Tribunal, 25 Jun. 1999), p. 39; *Ryan v. Triguboff* [1976] ACLC 28,477 at p. 24,482.

213 *Chinese Estates Holdings Limited Inquiry Report*, above, p. 39.

214 Ibid.

215 *Hong Kong Parkview Group Limited Inquiry Report*, above, p. 39.

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Instead, tt refers to information that is "not generally known" to the persons who are accustomed or would likely to deal in the listed securities of the corporation but which would if it were generally known to them be "likely to materially affect" the securities price.[216] The question is whether or not it is likely to materially affect an ordinary reasonable investor, who is accustomed or likely to deal in those securities.[217] What is material is a question of fact to be assessed from how typical investors would have acted on the date when the insider engages in insider dealing, had the typical investors known the relevant information.[218] Ostensibly, the information must be authentic, and, hence, there is no insider dealing where the holder or disseminator has been misinformed.[219] The SFO therefore is not concerned with the use or dissemination of information which is not genuine even though it may materially change the price of securities.[220]

The SFO defines the class of persons whom the relevant information is not generally known to as those "who are accustomed or would be likely to deal in the corporation securities".[221] What constitutes this specific class of persons is a question of fact depending on the nature of the corporation and the profile of expected investors.[222] In reality, the ability of the targeted investors to digest the information should be taken into account. The evidence is normally called from experts in the financial field. The more sophisticated the expected investors are, the less likely the securities are targeted to the wider investing public, and, hence, a lower threshold for "generally known".[223]

The SFO provides a number of exceptions to insider dealing activities.[224] The onus is on the defence to establish the exception or exceptions. First, it excludes acquiring qualifying shares and performing an underwriting agreement, liquidator, receiver, or trustee in bankruptcy in good faith from insider dealing activities.[225] An underwriter would normally possess inside information about the company before it agrees to the underwriting agreement to acquire and market the securities. If they are subject to the insider dealing provisions, their liberty to launch the securities for the corporation would be restricted.

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216 ss. 245(2) & 285(2) SFO.

217 *Chinese Estates Holdings Limited Inquiry*, above, p. 46.

218 *Public International Investments Limited Inquiry Report* (Report of the IDT, 5 Aug. 1995), pp. 239-40.

219 *Chan Sing Chuk v. Innovisions Ltd.* [1991] 2 HKC 305 at p. 308.

220 Ibid.

221 ss. 245(2) & 285(2) SFO.

222 *Chinese Estates Holdings Limited Inquiry Report*, above, p. 37-8; *Chevalier (OA) International Limited Inquiry Report* (Report of the IDT, 10 Jul. 1997), p. 62-5.

223 Ibid.

224 ss. 271 & 292 SFO.

225 ss. 271(1) & 292(1) SFO.

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Second, the SFO provides an exemption for corporations from insider dealing activities under certain circumstances.[226] This allows a corporation to deal in securities by implementing a "Chinese wall". This is a management tool which sequesters each component of a corporation from another in protecting confidential information. Although one or more directors or employees possesses or possess the relevant information, insofar the decision to deal must be taken by some other persons who have not been communicated and advised with the relevant information.[227] More importantly, the "Chinese wall" arrangement must exist to secure the confidentiality of relevant information.[228] The onus is on the corporation who relies on this exemption as a defence to prove that sufficient measures have been taken to design a "Chinese wall" that would eliminate the prima facie real risk of abuse.[229] In other words, the question is whether or not the barriers in place are effective in protecting the confidentiality of relevant information within a corporation.[230]

Third, the defence of not making profit or avoiding loss is available.[231] The onus is on the defendant to prove that such purpose exists. The burden is not so onerous. It suffices if the defendant can provide on a mere balance of probabilities that decisions honestly made were unconnected with any desire to make a profit or avoid a loss.[232]

Fourth, the defence of innocent agent is available under the SFO.[233] The onus is on the defendant to prove that he is an agent, who merely follows instructions from the principal, and does not know his principal is an insider or has the relevant information. The provision is intended to protect brokers and dealers who merely provide services in the course of their business. This principle is extended to trustees or personal representatives who act on advice in good faith from an appropriate person without knowledge of insider dealing.[234] The onus is on the defence to prove that reasonable measures have been taken.

Where both parties to the transaction have the relevant information and the dealing is not required to be put on record,[235] the SFO provides a defence from insider dealing.[236] This defence is justified because both parties to the transaction are dealing off-market and are assumed to be equally sophisticated with neither party having a

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226 ss. 271(2) & 292(2) SFO.

227 ss. 271(1)(a) & (c) & 292(1)(a) & (c) SFO.

228 ss. 271(1)(b) & 292(1)(b) SFO.

229 *Supasave Retail Ltd. v. Coward Chance & others; David Lee & Co. (Lincoln) Ltd. v. Coward Chance & others* [1991] 1 All ER 668 at p. 674.

230 *Young & others v. Robson Rhodes & another* [1999] 3 All ER 524 at p. 539.

231 ss. 271(3) & 292(3) SFO.

232 *Chevalier (OA) International Limited Inquiry Report*, above, p. 82.

233 ss. 271(4) & 292(4) SFO.

234 ss. 272 & 293 SFO.

235 For example, an OTC transaction with no reporting requirement to recognised exchanges or the SFC.

236 ss. 271(5) & 292(5) SFO.

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serious informational advantage.[237] Therefore, this defence requires the defendant to establish that both parties in the transaction are dealing directly.[238] Similarly, where a person enters into the insider dealing, otherwise than counsels or procures the other party to deal, and the other party knows or ought reasonably to have known that he is a connected person relating to the dealing, the activity is not regarded as illegal.[239] This defence assumes that the other party should make inquiries with the known insider before the dealing and should be able to negotiate accordingly.[240] Even though he counsels or procures another person to deal with securities, but the other person does not counsel or procure the other party to deal with securities, he is not liable if the other party knows or ought reasonably to have known that the other person is a connected person relating to the dealing.[241] Under this circumstance, the level playing field is similarly maintained. This defence would protect an investment banker, who advises a substantial shareholder, introducing a prospective purchaser to him.[242] These are the fifth to seventh exceptions to insider dealing activities.

A person who deals with inside information about his own trading activities should not be liable as insider.[243] This would include a substantial shareholder who increases or reduces his shareholding.[244] Under this circumstance, the SFO provides a "market information" defence for a person who deals with the relevant information arising directly out of his involvement in the dealing.[245] It exempts certain market information from being relevant information for the purpose of insider dealing. The SFO provides a list of information defined as market information, including the fact of dealing in securities and the prices etc.[246]

Finally, there is no insider dealing if a person can prove that the dealing in question is a "market contract".[247] A market contract is a contract subject to the *Clearing Rules* entered into by the clearing house with a participant pursuant to a novation under the rules.[248] The SFO also exempts a person from engaging in insider dealing activity if he can establish that he possesses the relevant information after he has been granted the option in the listed securities or the derivatives in question.[249]

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237 Goyne, above, p. 12.
238 ss. 271(5) & 292(5) SFO.
239 ss. 271(6) & 292(6) SFO.
240 Goyne, above, p. 12.
241 ss. 271(7) & 292(7) SFO.
242 Goyne, above, p. 12.
243 Ibid.
244 Ibid.
245 ss. 271(8) & 292(8) SFO.
246 ss. 271(10) & 292(10) SFO.
247 ss. 271(9) & 292(9) SFO.
248 sch. 1, SFO.
249 ss. 273 & 294 SFO.

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5.4 Market Manipulation

Under the SFO, market manipulation involves five specified types of market misconduct. They are false trading, price rigging, disclosing information about transactions prohibited by the ordinance, disclosing false or misleading information inducing transactions in securities and futures, and stock market manipulation. The first four types of offence apply to both securities and futures whilst the last type of offence applies to securities transaction only. The provisions are intended to identify each specific market misconduct. Some of the provisions in the SFO may be overlapping and most of them are inter-related. It is envisaged that a perpetrator would be likely to commit more than one market misconduct offence concurrently. The prosecution has the privilege to charge a person under one or more provisions in accordance to the circumstances of each case. Market manipulation is prohibited under Divisions 4 and 5 of Part XIII and Divisions 2 to 4 of Part XIV of the ordinance for the civil and criminal routes respectively.

To summarise, there are five types of market manipulation under the SFO:

- False trading;[250]
- Price rigging;[251]
- Disclosure of information about prohibited transactions;[252]
- Disclosure of false or misleading information inducing transactions;[253] and
- Stock market manipulation.

The SFO prohibits market manipulation covering certain trans-border activities. The ordinance extends market manipulation offence to trading in securities on a stock exchange outside Hong Kong for activities entered into or carried out in Hong Kong. The market manipulation provisions apply to conduct in Hong Kong that affects the relevant overseas markets, i.e. a stock or futures markets outside Hong Kong,[254] and vice versa, but, for securities or futures traded on a relevant overseas market, the conduct of the defendant should also be unlawful.[255]

250 s. 274 SFO.
251 s. 275 SFO.
252 s. 276 SFO.
253 s. 277 SFO.
254 ss. 245(1) & 285(1) SFO.
255 ss. 282(3) & 306(3) SFO.

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5.5 Fraud and Deception

There are three types of market fraud offence prohibited by the SFO. They are offences involving fraudulent or deceptive devices,[256] disclosure of false or misleading information inducing others to enter into leveraged foreign exchange contracts,[257] and falsely representing dealings in futures contracts on behalf of others.[258] The former two offences are straight forward fraudulent practices. The ordinance creates a "bucketing" offence, which is an offence of falsely representing futures contracts will be executed on a futures market or automated trading services while they are and will not be so executed. Under the SFO, a person is prohibited from representing that futures transactions executed on behalf of another person are executed on recognised exchanges or by means of ATS if he has in fact not so executed and will not do so.[259] This provision requires *mens rea*, i.e. the prosecution must prove beyond a reasonable doubt that the defendant has knowingly or recklessly committed the offence. The offence extends to contracts or other instruments substantially resembling futures contracts in an overseas futures market.[260]

5.6 Disclosure Requirements

In enhancing the disclosure framework in line with international standards, some mandatory disclosure provisions were included in the SFO.[261] Part XV of the SFO provides a regulatory framework for mandatory disclosure of interests by corporate insiders.

The statutory framework requires two types of mandatory disclosure: substantial shareholdings and the prospectus regime. The former is regulated by the SFO, whilst the latter is regulated by the *Companies Ordinance*.[262] Under Part XV of the SFO, the objective is to provide investors with more comprehensive and better quality information on a timely basis so that they may make better investment decisions.[263] It intends to require disclosure of information that can affect the perceptive value of the listed corporations.[264]

Part XV of the SFO requires mandatory disclosure from individuals or corporations who have an interest in 5% or more of any class of voting shares in a listed corporation of their interests and short positions in any shares in a listed corporation, in-

256 s. 300 SFO.

257 s. 301 SFO.

258 s. 302 SFO.

259 s. 302(1) SFO.

260 s. 302(2) SFO.

261 Ibid, pp. 14-5.

262 Cap. 32.

263 SFC, *Outline of Part XV of the Securities and Futures Ordinance (Cap. 571) – Disclosure of Interests* (2003), p. 3.

264 Ibid.

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cluding associated corporations.[265] It also imposes mandatory disclosure from directors and chief executives of a listed corporation of their interests and short positions in any shares and their interests in any debentures in a listed corporation, including associated corporations.[266]

The *Companies Ordinance* also provides for mandatory disclosure of information in the form of a prospectus when a company seeks to float its shares. Unless falling within one of its exceptions, a company that offers shares to the public must issue a prospectus together with the application form. The contents of the prospectus are prescribed by the Third Schedule to the SFO. The SFO prohibits advertisements for securities except when constituting a prospectus issued in compliance with the *Companies Ordinance*.[267]

265 Div. 2, Part XV, SFO.

266 Div. 7, Part XV, SFO.

267 s. 103 SFO.

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