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## REGULATORY OVERVIEW AND LICENSING REQUIREMENTS

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### SECURITIES AND FUTURES COMMISSION

#### Regulation of securities and futures market

Founded in May 1989, the SFC is an independent statutory body responsible for regulating the securities and futures market in Hong Kong. The SFC strives to strengthen and protect the integrity and soundness of Hong Kong's securities and futures markets for the benefit of investors and the industry.

The SFC's regulatory objectives as set out in the SFO are:

- to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;
- to promote understanding by the public of financial services including the operation and functioning of the securities and futures industry;
- to provide protection for members of the public investing in or holding financial products;
- to minimise crime and misconduct in the securities and futures industry;
- to reduce systemic risks in the securities and futures industry; and
- to assist the Financial Secretary in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the securities and futures industry.

Parties and products regulated by the SFC include, but are not limited to, licensed corporations and individuals carrying on type 1 to type 12 regulated activities under the SFO, investment products offered to the public, listed companies, the HKEX, automated trading service providers, approved share registrars, Investor Compensation Company Limited, and all market participants (including investors).

#### Overview of licensing requirements under the SFO

Under the SFO, any person who:

- (a) carries on a business in a regulated activity; or
- (b) holds itself out as carrying on a business in a regulated activity,

must be licensed under the relevant provisions of the SFO for carrying on such regulated activity, unless one of the exceptions under the SFO applies. It is a serious offence for a person to conduct any regulated activity without the appropriate licence.

If a person actively markets, whether by himself or another person on his behalf and whether in Hong Kong or from a place outside Hong Kong, to the public any services that he provides, and such services, if provided in Hong Kong, would constitute a regulated activity, then that person is also subject to the licensing requirements under the SFO.

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In addition to the licensing requirements on corporations that carry on regulated activities, any individual who:

- (a) performs any regulated function in relation to a regulated activity carried on as a business; or
- (b) holds himself out as performing such regulated activity,

must be licensed separately under the SFO as a licensed representative accredited to his principal.

### **Types of regulated activities**

The SFO promulgates a single licensing regime where a person only needs one licence or registration to carry on different types of regulated activity as defined in Schedule 5 to the SFO provided that he is fit and proper to do so. There are 12 types of regulated activities, namely:

- Type 1 . . . . . Dealing in securities
- Type 2 . . . . . Dealing in futures contracts
- Type 3 . . . . . Leveraged foreign exchange trading
- Type 4 . . . . . Advising on securities
- Type 5 . . . . . Advising on futures contracts
- Type 6 . . . . . Advising on corporate finance
- Type 7 . . . . . Providing automated trading services
- Type 8 . . . . . Securities margin financing
- Type 9 . . . . . Asset management
- Type 10 . . . . . Providing credit rating services
- Type 11 . . . Dealing in OTC derivative products or advising on OTC derivative products
- Type 12 . . . . . Providing client clearing services for OTC derivative transactions

*Note:* Type 11 regulated activity is not yet in operation

As at the Latest Practicable Date, Sinomax Securities, our operating subsidiary, is licensed under the SFO to carry on the following regulated activities:

- Type 1 . . . . . Dealing in securities
- Type 4 . . . . . Advising on securities
- Type 9 . . . . . Asset management

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### Responsible officer

For each regulated activity conducted by a licensed corporation, it must appoint not less than two responsible officers, at least one of whom must be an executive director, to supervise the business of such regulated activity. A responsible officer is an individual approved by the SFC to supervise the regulated activity or activities of the licensed corporation to which he is accredited. The same individual may be appointed to be a responsible officer for more than one regulated activity provided that he/she is fit and proper to be so appointed and there is no conflict in the roles assumed. An "executive director" of a licensed corporation is defined as a director of the corporation who (a) actively participates in; or (b) is responsible for directly supervising, any business of the regulated activities for which the corporation is licensed. Every executive director of the licensed corporation must apply to the SFC to become a responsible officer.

A person who intends to apply to be a responsible officer must demonstrate that he fulfills the requirements on both competence and fit and properness and must have been delegated sufficient authority to effectively supervise the regulated activity he/she is responsible for. An applicant should possess appropriate ability, skills, knowledge and experience to properly manage and supervise the corporation's regulated activities to which he/she is accredited. Accordingly, the applicant should fulfill certain requirements as to academic/industry qualification, industry experience, management experience and regulatory knowledge as stipulated by the SFC. If the responsible officer intends to conduct regulated activities in relation to matters falling within the ambit of a particular code issued by the SFC, e.g. the Takeovers Code or the Code on Real Estate Investment Trusts, additional competence requirements specific to that field would apply.

### Managers-in-charge of Core Function ("MICs")

Senior management is defined by the SFC to include directors, responsible officers and managers-in-charge of core functions of a licensed corporation. Pursuant to the Circular to Licensed Corporations Regarding Measures for Augmenting the Accountability of Senior Management (the "**Circular**") published by the SFC on 16 December 2016, with effect from 18 April 2017, a licensed corporation is required to designate certain individuals as MICs and provide to the SFC information about its MICs and their reporting lines. MICs are individuals appointed by a licensed corporation to be principally responsible, either alone or with others, for managing each of the following eight core functions of the licensed corporation ("**Core Function(s)**"):

- (i) overall management oversight;
- (ii) key business line;
- (iii) operational control and review;
- (iv) risk management;
- (v) finance and accounting;
- (vi) information technology;
- (vii) compliance; and
- (viii) anti-money laundering and counter-terrorist financing.

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Pursuant to the Circular, each licensed corporation should have at least one fit and proper person who is qualified to act in the capacity so employed or appointed as the MIC for each of its Core Functions. In a licensed corporation, one individual can be appointed as the MIC for more than one Core Function, or several individuals can be appointed as the MIC for one particular Core Function.

To determine whether an individual is a MIC of a particular Core Function, a licensed corporation should take into account the following:

(i) *whether he or she has apparent or actual authority in relation to the particular Core Function*

An individual is a MIC if he/she:

- (a) occupies a position within the corporation which is of sufficient authority to enable the individual to exert a significant influence on the conduct of that Core Function;
- (b) has authority to make decisions (e.g., assume business risks within pre-set parameters or limits) for that Core Function;
- (c) has authority to allocate resources or incur expenditures in connection with the particular department, division or functional unit carrying on that Core Function; and
- (d) has authority to represent the particular department, division or functional unit carrying on that Core Function, e.g., in senior management meetings or in meetings with outside parties.

(ii) *his/her seniority within the licensed corporation*

The SFC generally expects that a MIC to:

- (a) report directly to the board of the licensed corporation, or to the manager-in-charge who assumes the overall management oversight function of the licensed corporation; and
- (b) be accountable for the performance or achievement of business objectives set by the board of the licensed corporation, or by the manager-in-charge who assumes the overall management oversight function.

MIC shall be responsible for, among other things, the following:

- (i) ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by the licensed corporation;
- (ii) properly managing the risks associated with the business of the licensed corporation, including performing periodic evaluation of its risk management processes;
- (iii) understanding the nature of the business of the licensed corporation, its internal control procedures and its policies on the assumption of risk;
- (iv) understanding the extent of their own authority and responsibilities;

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- (v) managing the anti-money laundering and counter-terrorist financing function;
- (vi) the adequacy and effectiveness of the licensed corporation's internal control systems, including information management compliance, audit or related reviews, operational controls and risk management; and
- (vii) examining the appropriateness of internal control systems and making any necessary amendments or changes so that they are appropriate for the operations of the licensed corporation's regulated business activities in Hong Kong.

The management structure of a licensed corporation (including its appointment of MICs) should be approved by the board of directors of the corporation. Furthermore, the board of directors should ensure that each of the licensed corporation's MICs has acknowledged his or her appointment as MIC and the particular Core Function(s) for which he or she is principally responsible.

### **Licensed representative**

An individual is required to be a licensed representative if he/she performs a regulated function for his/her principal which is a licensed corporation in relation to a regulated activity carried on as a business, or he/she holds out as performing such function.

A person who intends to apply to be a licensed representative must fulfill the competence requirements as prescribed by the SFC (including in the Guidelines on Competence). An applicant needs to establish that he/she has the requisite basic understanding of the market in which he/she is to work as well as the laws and regulatory requirements applicable to the industry. In assessing his/her competence to be licensed as a representative, the SFC will have regard to academic and industry qualification as well as regulatory knowledge.

### **Fit and proper requirement**

Persons applying for licences under the SFO, including licensed representations and responsible officers, must satisfy and continue to satisfy after the grant of such licences by the SFC that they are fit and proper persons to be so licensed. In simple terms, a fit and proper person means one who is financially sound, competent, honest, reputable and reliable.

Pursuant to section 129(1) of the SFO, in considering whether a person is fit and proper for the purposes of licensing or registration, the SFC shall, in addition to any other matter that the SFC may consider relevant, have regard to the following:

- the financial status or solvency;
- the educational or other qualifications or experience of the person having regard to the nature of the functions to be performed;
- the ability of the person to carry on the regulated activity concerned competently, honestly and fairly; and
- the reputation, character, reliability and financial integrity of the person and where the person is a corporation, any officer of the corporation.

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The above fit and proper criteria serve as the fundamental basis when the SFC considers each licence or registration application. Detailed guidelines are contained in the Fit and Proper Guidelines, the Licensing Handbook and the Guidelines on Competence published by the SFC.

The Fit and Proper Guidelines apply to a number of persons including the following:

- (a) an individual who applies for licence or is licensed under Part V of the SFO;
- (b) a licensed representative who applies for approval or is approved as a responsible officer under Part V of the SFO;
- (c) a corporation which applies for a licence or is licensed under Part V of the SFO;
- (d) an authorised financial institution which applies for registration or is registered under Part V of the SFO;
- (e) an individual whose name is to be or is entered in the register maintained by the Hong Kong Monetary Authority under section 20 of the Banking Ordinance; and
- (f) an individual who applies to be or has been given consent to act as an executive officer of a registered institution under section 71C of the Banking Ordinance.

Furthermore, section 129(2) of the SFO empowers the SFC to take into consideration any of the following matters in considering whether a person is fit and proper:

- (a) decisions made by such relevant authorities as stated in section 129(2)(a) of the SFO or any other authority or regulatory organisation, whether in Hong Kong or elsewhere, in respect of that person;
- (b) in the case of a corporation, any information relating to:
  - (i) any other corporation within the group of companies; or
  - (ii) any substantial shareholder or officer of the corporation or of any of its group companies;
- (c) in the case of a corporation licensed under section 116 or 117 of the SFO or registered under section 119 of the SFO or an application for such licence or registration:
  - (i) any information relating to any other person who will be acting for or on its behalf in relation to the regulated activity; and
  - (ii) whether the person has established effective internal control procedures and risk management systems to ensure its compliance with all applicable regulatory requirements under any of the relevant provisions;
- (d) in the case of a corporation licensed under section 116 or section 117 of the SFO or an application for the licence, any information relating to any person who is or to be employed by, or associated with, the person for the purposes of the regulated activity; and
- (e) the state of affairs of any other business which the person carries on or proposes to carry on.

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The SFC is obliged to refuse to grant a licence or registration if the applicant fails to satisfy the SFC that the applicant is a fit and proper person to be licensed. The onus is on the applicant to prove to the SFC that the applicant is fit and proper to be licensed for the regulated activity.

### **Ongoing obligations of licensed corporations**

Licensed corporations, licensed representatives and responsible officers must remain fit and proper as defined under the SFO at all times. They are also required to comply with all applicable provisions of the SFO and its subsidiary rules and regulations as well as the codes and guidelines issued by the SFC.

Outlined below are some of the key ongoing obligations of a licensed corporation:

- (a) maintenance of minimum paid-up share capital and liquid capital, and submission of financial returns to the SFC, in accordance with the requirements under the Securities and Futures (Financial Resources) Rules (Chapter 571N of the Laws of Hong Kong) (as discussed in more detail below);
- (b) maintenance of segregated account(s), and custody and handling of client securities in accordance with the requirements under the Securities and Futures (Client Securities) Rules (Chapter 571H of the Laws of Hong Kong);
- (c) maintenance of segregate account(s), and holding and payment of client money in accordance with the requirements under the Securities and Futures (Client Money) Rules (Chapter 571I of the Laws of Hong Kong);
- (d) issuance of contract notes, statements of account and receipts, in accordance with the requirements under the Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules (Chapter 571Q of the Laws of Hong Kong);
- (e) maintenance of proper records in accordance with the requirements prescribed under the Securities and Futures (Keeping of Records) Rules (Chapter 571O of the Laws of Hong Kong);
- (f) submission of audited accounts and other required documents in accordance with the requirements under the Securities and Futures (Accounts and Audit) Rules (Chapter 571P of the Laws of Hong Kong);
- (g) maintenance of insurance against specific risks for specified amounts in accordance with the requirements under the Securities and Futures (Insurance) Rules (Chapter 571A1 of the Laws of Hong Kong);
- (h) notification to the SFC of certain changes and events, in accordance with the requirements under Securities and Futures (Licensing and Registration) (Information) Rules (Chapter 571S of the Laws of Hong Kong);
- (i) implementation of appropriate policies and procedures relating to client acceptance, client due diligence, record keeping, identification and reporting of suspicious transactions and staff screening, education and training, in accordance with the requirements under the Guideline on Anti-Money Laundering and Counter Financing of Terrorism issued by the SFC in November 2018 (as discussed in more detail below);

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- (j) compliance with the business conduct requirements under the Code of Conduct, the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC, the Advertising Guidelines Applicable to Collective Investment Schemes Authorized under the Product Codes and other applicable codes and guidelines issued by the SFC;
- (k) payment of annual fees and submission of annual returns to the SFC within one month after each anniversary of the licence;
- (l) notification to the SFC of any changes in the appointment of MICs or any change in certain particulars of MICs pursuant to the Circular to Licensed Corporations Regarding Measures for Augmenting the Accountability of Senior Management dated 16 December 2016 issued by the SFC;
- (m) compliance with the professional training and related record keeping requirements under the Guidelines on Continuous Professional Training issued by the SFC; and
- (n) compliance with the Guidelines on Disclosure of Fees and Charges Relating to Securities Services and other applicable codes, circulars and guidelines issued by the SFC from time to time.

### Compliance and internal control

A licensed corporation is required to satisfy the SFC that policies and procedures are established and maintained to ensure the corporation's compliance with all applicable legal and regulatory requirements as well as with internal policies and procedures. In particular:

- management should establish and maintain an appropriate and effective compliance function within the corporation which, subject to constraint of size, is independent of all operational and business functions and which report directly to management;
- management should ensure the staff performing the compliance function possess the necessary skills, qualifications and experience to effectively execute their duties;
- staff performing the compliance function should establish, maintain and enforce effective compliance procedures; and
- staff performing the compliance function should promptly report to management upon the occurrence of material non-compliance by the corporation or any staff.

### Office premises

Licensed corporations are required to have suitable office premises to conduct their regulated activities. In assessing whether an office premise is appropriate, the SFC will consider, among others:

- the security of the premises and whether there is a proper segregated office area;
- whether essential office equipment and telecommunication systems are situated in an area accessible by authorised personnel;
- whether the firm has taken sufficient action or measures to avoid confusion to its clients due to the co-existence of other firms in the same premises;



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- whether confidential or non-public information and client privacy will be sufficiently safeguarded against unauthorised access or leakage; and
- whether the premises are always accessible for visit by regulators.

### **Securities and Futures (Financial Resources) Rules (Chapter 571N of the Laws of Hong Kong)**

#### ***Minimum capital requirements and the FRR***

Licensed corporations are required under section 145 of the SFO to maintain at all times a minimum level of paid-up share capital and liquid capital. Depending on the types of regulated activity that the licensed corporation is applying for, a licensed corporation has to maintain at all times paid-up share capital and liquid capital not less than the specified amounts according to the FRR.

#### ***Minimum paid-up share capital***

The following table summarises the minimum paid-up share capital that a licensed corporation is required to maintain for type 1 (dealing in securities), type 4 (advising on securities) and type 9 (asset management) regulated activities:

<b>Regulated activity</b>	<b>Minimum paid-up share capital</b>
<b>Type 1: Dealing in securities</b>	
(a) in the case where the corporation is an approved introducing agent or trader	Not applicable
(b) in the case where the corporation provides securities margin financing	HK\$10,000,000
(c) in any other case	HK\$5,000,000
<b>Type 4: Advising on securities</b>	
(a) in the case where the corporation is subject to the licensing condition that it shall not hold client assets	Not applicable
(b) in any other case	HK\$5,000,000
<b>Type 9: Asset management</b>	
(a) in the case where the corporation is subject to the licensing condition that it shall not hold client assets	Not applicable
(b) in any other case	HK\$5,000,000

*Source: Licensing Handbook and the FRR*

Pursuant to the FRR, where the licensed corporation is licensed to carry on two or more regulated activities, the respective required minimum paid-up share capital and minimum liquid capital to be maintained by the licensed corporation shall be the highest applicable amounts among the activities.

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Sinomax Securities, which is a corporation licensed to carry on type 1 (dealing in securities), type 4 (advising on securities) and type 9 (asset management) regulated activities under the SFO and provides securities margin financing services, is required to maintain minimum paid-up share capital at the highest amounts amongst the regulated activities it participates in, being HK\$10,000,000.

### ***Minimum amount of required liquid capital***

Pursuant to the FRR, liquid capital is the amount by which a licensed corporation's liquid assets exceeds its ranking liabilities where (i) liquid assets are the amount of assets held by the licensed corporation, adjusted for such factors to take into account illiquidity of certain assets as well as credit risks; and (ii) ranking liabilities are the sum of liabilities on the balance sheet of the licensed corporation (including, without limitation, any amounts payable by it in respect of any overdraft or loan, any accrued interest payable to any other person, accrued expenses, taxes and provisions for contingent liabilities), adjusted for such factors to take into account market risks and contingency. The method of calculating liquid assets and ranking liabilities is set out in Divisions 3 and 4 of the FRR respectively.

The FRR stipulates that a licensed corporation shall also maintain minimum liquid capital at all times which shall be the higher of the amount of (a) and (b) below (as applicable to our Group):

- (a) the amount of:
  - HK\$100,000 – in the case of a corporation licensed for type 4 (advising on securities) or type 9 (asset management) regulated activity which is subject to the licensing condition that it shall not hold client assets; or
  - HK\$3,000,000 – in the case of (i) a corporation licensed for type 1 (dealing in securities) regulated activity that is not an approved introducing agent or trader; or (ii) a corporation licensed for type 4 (advising on securities) or type 9 (asset management) regulated activity which is not subject to the licensing condition that it shall not hold client assets.
- (b) its variable required liquid capital, meaning the basic amount which is 5% of the aggregate of:
  - (i) the licensed corporation's on-balance sheet liabilities including provisions made for liabilities already incurred or for contingent liabilities but excluding certain amounts stipulated in the definition of "adjusted liabilities" under the SFO;
  - (ii) the aggregate of the initial margin requirements in respect of outstanding futures contracts and outstanding options contracts held by it on behalf of its clients; and

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- (iii) the aggregate of the amounts of margin required to be deposited in respect of outstanding futures contracts and outstanding options contracts held by it on behalf of its clients, to the extent that such contracts are not subject to the requirement of payment of initial margin requirement.

If the licensed corporation applies for more than one type of regulated activity, the minimum paid-up share capital and liquid capital that the corporation should maintain shall be the higher or the highest amount required amongst those regulated activities applied for.

### **The requirements of becoming a HKSCC Direct Clearing Participant**

As at the Latest Practicable Date, Sinomax Securities was a HKSCC Direct Clearing Participant. Set out below are the requirements to be admitted as a HKSCC Direct Clearing Participant:

- be a HKEX Participant by fulfilling, among others, the following requirements: (i) be a company limited by shares incorporated in Hong Kong and hold at least one Stock Exchange Trading Right; (ii) be a licensed corporation licensed under section 116(1) of the SFO to carry on type 1 (dealing in securities) regulated activity under the SFO; (iii) at all times, an HKEX Participant shall have at least one executive director registered with the Stock Exchange as a responsible officer; and (iv) comply with the financial resources requirements specified in the FRR made by the SFC under the SFO;
- undertake to (i) sign a participant agreement with HKSCC; (ii) pay to HKSCC an admission fee of HK\$50,000 in respect of each Stock Exchange Trading Right held by it; and (iii) pay to HKSCC its contribution to the guarantee fund of HKSCC as determined by HKSCC from time to time subject to a minimum cash contribution of the higher of HK\$50,000 or HK\$50,000 in respect of each Stock Exchange Trading Right held by it;
- open and maintain a single current account with one of the CCASS designated banks and execute authorisations to enable the designated bank to accept electronic instructions from HKSCC to credit or debit the account for CCASS money settlement, including making payment to HKSCC;
- provide a form of insurance to HKSCC as security for liabilities arising from defective securities deposited by it into CCASS, if so required by HKSCC; and
- have a minimum liquid capital of HK\$3,000,000.

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### **Securities and Futures (Client Securities) Rules (Chapter 571H of the Laws of Hong Kong)**

The pledging limit stipulated under section 8A of the CSR applies to an intermediary which is licensed for dealing in securities or securities margin financing and where the intermediary or an associated entity of such intermediary pledges securities collateral. The intermediary shall ascertain the aggregate market value of the pledged securities collateral, which shall be calculated by reference to the respective closing prices of the collateral on that Business Day.

Pursuant to section 8A of the CSR, if the aggregate market value of the pledged securities collateral as calculated above exceeds 140% of the intermediary's aggregate margin loans on the same Business Day, the intermediary shall by the close of business on the next Business Day following that day withdraw, or cause to be withdrawn, from deposit an amount of pledged securities collateral such that the aggregate market value of the pledged securities collateral at that time, which is calculated by reference to the respective closing prices on that day, does not exceed 140% of the intermediary's aggregate margin loans as at the close of business on that day.

### **Offence to issue advertisements, invitations or documents relating to investments**

Our Group is engaged in, among others, the placing and underwriting services that may involve the marketing of securities. Under section 103(1) of the SFO, the issue of an advertisement, invitation or document which contains an invitation to the public:

- (a) to enter into or offer to enter into (i) an agreement to acquire, dispose of, subscribe for or underwrite securities; or (ii) a regulated investment agreement or an agreement to acquire, dispose of, subscribe for or underwrite any other structured product; or
- (b) to acquire an interest in or participate in, or offer to acquire an interest in or participate in, a collective investment scheme,

has to be authorised by the SFC under section 105(1) of the SFO, unless specific exemptions apply.

The specific exemptions include, among others, under section 103(3)(k) of the SFO, if the issue of the advertisement, invitation or document made in respect of securities or structured products, or interests in any collective investment scheme, that are or are intended to be disposed of only to "professional investors" (as defined in Part 1 of Schedule 1 to the SFO).

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If a person commits an offence contrary to section 103(1) of the SFO in that he/she issues an advertisement, invitation or document relating to investments without the authorisation of the SFC and no specific exemptions under the SFO applies, he is liable:

- (a) on conviction on indictment to a fine of HK\$500,000 and to imprisonment for 3 years and, in the case of a continuing offence, to a further fine of HK\$20,000 for every day during which the offence continues; or
- (b) on summary conviction to a fine of HK\$100,000 and to imprisonment for 6 months and, in the case of a continuing offence, to a further fine of HK\$10,000 for every day during which the offence continues.

### **Obligation for substantial shareholder**

Under section 131 of the SFO, a person (including a corporation) has to apply for the SFC's approval prior to becoming or continuing to be a substantial shareholder of a licensed corporation.

A person, being aware that he or she becomes a substantial shareholder of a licensed corporation without the SFC's prior approval should, as soon as reasonably practicable and in any event within three Business Days after he or she becomes so aware, apply to the SFC for approval to continue to be a substantial shareholder of the licensed corporation.

### **Employee dealings**

As stated in the Code of Conduct, a registered person should have a policy which has been communicated to employees (including directors other than non-executive directors) in writing on whether employees are permitted to deal for their own accounts in securities. In the event that employees of a registered person are permitted to deal for their own accounts in securities:

- (i) the written policy should specify the conditions on which employees may deal for their own accounts;
- (ii) employees should be required to identify all related accounts (including accounts of their minor children and accounts in which the employees hold beneficial interests) and report them to senior management;
- (iii) employees should generally be required to deal through the registered person or its affiliates;
- (iv) if the registered person provides services in securities or futures contracts listed or traded on one of the Hong Kong exchanges or in derivatives, including over-the-counter derivatives written over such securities, and its employees are permitted to deal through another dealer, in those securities, the registered person and employee should arrange for duplicate trade confirmations and statements of account to be provided to senior management of the registered person;

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- (v) any transactions for employees' accounts and related accounts should be separately recorded and clearly identified in the records of the registered person; and
- (vi) transactions of employees' accounts and related accounts should be reported to and actively monitored by senior management of the registered person who should not have any beneficial or other interest in the transactions and who should maintain procedures to detect irregularities and ensure that the handling by the registered person of these transactions or orders is not prejudicial to the interests of the registered person's other clients.

A registered person should not knowingly deal in securities or futures contracts for another registered person's employee unless it has received written consent from that registered person.

### **Anti-money laundering and counter terrorist financing**

Licensed corporations are required to comply with the applicable anti-money laundering and counter-terrorist financing laws and regulations in Hong Kong as well as the Guideline on Anti-Money Laundering and Counter Financing of Terrorism issued by the SFC on 1 November 2018.

The guideline provides practical guidance to assist licensed corporations and their senior management in designing and implementing their own anti-money laundering and counter terrorist financing policies, procedures and controls in order to meet the relevant legal and regulatory requirements in Hong Kong. Under the guideline, licensed corporations should, among other things:

- (a) assess the risks of any new products and services before they are introduced and ensure that appropriate additional measures and controls are implemented to mitigate and manage the associated money laundering and terrorist financing risks;
- (b) identify the client and verify the client's identity using reliable, independent source documents, data or information, and review from time to time documents, data and information relating to the client obtained to ensure that the client's information is up-to-date and relevant;
- (c) conduct ongoing monitoring of transactions of the clients to (i) ensure that they are consistent with the client's business, risk profile and source of funds, and (ii) identify transactions that are complex, unusually large in amount or of an unusual pattern and have no apparent economic or lawful purpose, and examine the background and purposes of those transactions and set out its findings in writing;
- (d) maintain a database of names and particulars of terrorist suspects and designated parties which consolidates the various lists that have been made known to the licensed corporation or, alternatively, make arrangements to access to such a database maintained by third party service providers; and

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- (e) conduct ongoing monitoring for identification of suspicious transactions and ensure compliance with their legal obligations of reporting funds or property known or suspected to be proceeds of crime or terrorist property to the Joint Financial Intelligence Unit, a unit jointly run by the Hong Kong Police Force and the Hong Kong Customs and Excise Department to monitor and investigate suspected money laundering.

We set out below a brief summary of the principal legislation in Hong Kong that is concerned with money laundering and terrorist financing.

**(1) *Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (Chapter 615 of the Laws of Hong Kong)***

Among other things, the ordinance imposes requirements relating to client due diligence and record-keeping and provides regulatory authorities with the powers to supervise compliance with the requirements under the ordinance. In addition, the regulatory authorities are empowered to (i) ensure that proper safeguards exist to prevent contravention of specified provisions in the ordinance; and (ii) mitigate money laundering and terrorist financing risks.

**(2) *Drug Trafficking (Recovery of Proceeds) Ordinance (Chapter 405 of the Laws of Hong Kong)***

Among other things, the ordinance empowers competent authorities to investigate assets suspected to be derived from drug trafficking activities, and contains provisions for the freezing of assets on arrest and the confiscation of the proceeds from drug trafficking activities. It is an offence under the ordinance if a person deals with any property knowing or having reasonable grounds to believe it to be the proceeds from drug trafficking. The ordinance requires a person to report to an authorised officer if he/she knows or suspects that any property (directly or indirectly) is the proceeds from drug trafficking or is intended to be used or was used in connection with drug trafficking, and failure to make such disclosure constitutes an offence under the ordinance.

**(3) *Organised and Serious Crimes Ordinance (Chapter 455 of the Laws of Hong Kong)***

Among other things, the ordinance empowers officers of the Hong Kong Police Force and the Hong Kong Customs & Excise Department to investigate organised crime and triad activities, and gives the courts jurisdiction to confiscate the proceeds of organised and serious crimes, to issue restraint orders and charging orders in relation to the property of defendants of specified offences. The ordinance extends the money laundering offence to cover the proceeds from all indictable offences in addition to drug trafficking.

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### ***(4) United Nations (Anti-terrorism Measures) Ordinance (Chapter 575 of the Laws of Hong Kong)***

Among other things, the ordinance provides that it would be a criminal offence to: (i) provide or collect funds (by any means, directly or indirectly) with the intention or knowledge that the funds will be used to commit, in whole or in part, one or more terrorist acts; or (ii) make any funds or financial (or related) services available, directly or indirectly, to or for the benefit of a person knowing that, or being reckless as to whether, such person is a terrorist or terrorist associate. The ordinance also requires a person to report his knowledge or suspicion of terrorist property to an authorised officer, and failure to make such disclosure constitutes an offence under the ordinance.

### **Know your client obligations of a licensed corporation**

Under the Code of Conduct, a licensed corporation should take all reasonable steps to establish the true and full identity of each of its clients, and of each client's financial situation, investment experience, and investment objectives. In particular, pursuant to the Code of Conduct, where an account opening procedure other than a face-to-face approach is used, it should take satisfactorily steps to ensure the identity of the client is properly ascertained.

Where the account opening documents are not executed in the presence of an employee of the licensed or registered person, the signing of the client agreement and sighting of related identity documents should be certified by any other licensed or registered person, an affiliate of a licensed or registered person, a Justice of the Peace, or a professional person such as a branch manager of a bank, certified public accountant, lawyer or notary public.

The Code of Conduct provides that alternatively, the identity of a client (other than corporate entities) may be properly verified if the licensed or registered person complies with the following procedural steps:

- (i) the new client sends to the licensed or registered person a signed physical copy of the client agreement together with a copy of his or her identity document (identity card or relevant sections of passport) for verification of his or her signature and identity;
- (ii) the licensed or registered person should obtain and encash a cheque (in an amount not less than HK\$10,000 and bearing the client's name as shown in his or her identity document) issued by the new client and drawn on the client's account with a licensed bank in Hong Kong;
- (iii) the licensed or registered person checks that the signature on the cheque issued by the client and the signature on the client agreement are the same;
- (iv) the client has been informed (in the client agreement or by way of a notice) of this account opening procedure and the conditions imposed, in particular the condition that the new account will not be activated until the cheque has been cleared; and



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- (v) proper records are kept by the licensed or registered person to demonstrate that the client identification procedures have been followed satisfactorily.

Alternatively, the relevant account opening documentation should be certified using the certification services recognised by the Electronic Transactions Ordinance (Chapter 553 of the Laws of Hong Kong), such as certification services available from the Hongkong Post, or the identity of the client must be verified pursuant to the alternate prescribed procedural steps set out in the Code of Conduct.

### **Suitability obligations expected of a licensed corporation**

Pursuant to paragraph 5.2 of the Code of Conduct, the licensed or registered person should, when making a recommendation or solicitation, ensure the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances based on the information about the client of which the licensed or registered person is or should be aware through the exercise of due diligence.

The licensed or registered person should, among other things, observe the following procedural steps:

- (i) know their clients;
- (ii) understand the investment products they recommend to clients;
- (iii) provide reasonably suitable recommendations by matching the risk return profile of each investment product with the personal circumstances of each client to whom it is recommended;
- (iv) provide all relevant material information to clients and help them make informed investment decisions;
- (v) employ competent staff and provide appropriate training; and
- (vi) document and retain the reasons for each investment recommendation made to each client.

### **Guidelines for securities margin financing activities**

In April 2019, the SFC issued its conclusions to its consultation from August 2018 which proposed new Guidelines for Securities Margin Financing Activities (the "**Guidelines**"). The Guidelines will take effect on 4 October 2019 and apply to (i) persons licensed for type 1 (dealing in securities) regulated activity who provide financial accommodation to any of their clients in order to facilitate acquisitions or holdings of listed securities by the persons for their clients; and (ii) persons licensed for type 8 (securities margin financing) regulated activity (collectively, "**SMF brokers**"). The Guidelines do not apply to IPO loans.

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The Guidelines provide guidance for margin lending policies and risk controls on SMF activities. The control measures specified in the Guidelines are the minimum standards expected of SMF brokers and are not meant to be exhaustive. Some of the key aspects of the Guidelines are as follows:

- **total margin loans controls** – an SMF broker may adopt a total margin loans to-capital multiple benchmark up to five only if it has high quality margin loan portfolio and complies with all other applicable provisions in the Guidelines. An SMF broker with lower quality margin loan portfolio or weak SMF risk controls should adopt a lower total margin loans-to-capital multiple benchmark.
- **margin client credit limit control** – an SMF broker should set prudent credit limits for individual margin clients or groups of connected margin clients to ensure the obligations of margin clients arising from the financing provided by it are commensurate with the financial capability of the margin clients. In setting the credit limits, an SMF broker should consider, among other things, the financial situation of the client, any credit reference information, the quality of the underlying collateral and any other credit support, the investment objectives, risk appetite and trading patterns of the client.
- **securities collateral concentration controls** – an SMF broker should set prudent concentration limits to avoid building up excessive exposure to individual securities collateral or groups of highly correlated connected major securities collateral. It should assess if any two or more of its major securities collateral are connected regularly (at least monthly).
- **margin client concentration controls** – an SMF broker should set prudent concentration limits to avoid building up excessive exposure to individual margin clients or groups of connected margin clients. In setting these limits, SMF brokers should consider, among other things, its liquidity profile and capital, the financial situation of the clients, the quality of the underlying collateral, the potential financial impact on it of client defaults, the credit history of the clients, the risk profile of its margin loan portfolio, and the prevailing market conditions.
- **haircuts for securities collateral** – an SMF broker should maintain a list of securities acceptable by it as collateral for margin lending purpose and should apply prudent haircuts percentages to such securities collateral. In reviewing the securities, an SMF broker should consider, among other things, the financial situation of the issuer, historical price volatility of the securities concerned and any adverse news about the issuer or its senior management.
- **margin calls, stopping further advances and further purchases of securities, and forced liquidation** – an SMF broker should prudently set the triggers for margin call, for stopping further advances to, and further purchases of securities by, margin clients, and for forced liquidation of margin clients' securities collateral. These policies should generally be strictly applied.

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- **stress testing** – an SMF broker should conduct stress tests on its excess liquid capital and liquidity regularly (at least monthly) and upon the occurrence of any material adverse market event or securities-specific event. In addition, stress tests should be conducted regularly (at least monthly) for the hypothetical stress scenario of a significant group of connected securities collateral losing all its value.

The Guidelines require immediate notification to the SFC upon becoming aware of certain instances of non-compliance.

A failure by any SMF broker to comply with any applicable provision of the Guidelines (a) shall not by itself render it liable to any judicial or other proceedings, but in any proceedings under the SFO before any court, the Guidelines shall be admissible in evidence, and if any provision set out in the Guidelines appears to the court to be relevant to any question arising in the proceedings, it shall be taken into account in determining the question; and (b) may cause the SFC to consider whether such failure adversely reflects on the SMF broker’s fitness and properness and the need for regulatory action.

### **Mainland and Hong Kong Stock Connect Mechanism**

According to the announcement jointly issued by China Securities Regulatory Commission and the SFC on 10 November 2014, namely the “Announcement regarding the Official Launching of Shanghai-Hong Kong Stock Connect Mechanism Pilot Points” (《關於正式啟動滬港股票交易互聯互通機制試點的公告》), “Memorandum of Cooperation between China Securities Regulatory Commission and the SFC on Strengthening the Supervision and Enforcement under the Shanghai-Hong Kong Stock Connect Project” (《滬港通項目下中國證監會與香港證監會加強監管執法合作備忘錄》) executed on 17 October 2014, “Regulations on the Mainland and Hong Kong Stock Connect Mechanism” (《內地與香港股票市場交易互聯互通機制若干規定》) issued by the China Securities Regulatory Commission on 30 September 2016, and “Shanghai Stock Exchange Measures for the Implementation of Shanghai-Hong Kong Stock Connect” (《上海證券交易所滬港通業務實施辦法》) revised on 7 September 2018 and implemented on 17 September 2018 by the Shanghai Stock Exchange, the Shanghai-Hong Kong Stock Connect Mechanism (i.e. Shanghai-Hong Kong Stock Connect) was officially opened between the Shanghai Stock Exchange and the Stock Exchange on 17 November 2014, which allows investors from Shanghai and Hong Kong to entrust members of the Shanghai Stock Exchange or the HKEX Participants to trade stocks listed on the stock exchange of the other party within a prescribed limit (in terms of transaction value) through the securities trading service companies established either by the Shanghai Stock Exchange or the Stock Exchange at the other party’s location. The Shanghai-Hong Kong Stock Connect includes Shanghai Stock Connect and Hong Kong Stock Connect.

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According to the announcement jointly issued by the China Securities Regulatory Commission and the SFC on 16 August 2016, the "Announcement on Matters Relating to Shenzhen-Hong Kong Stock Connect" (《深港通相關事宜的公告》), and "Shenzhen Stock Exchange Measures for the Implementation of Shenzhen-Hong Kong Stock Connect" (《深圳證券交易所深港通業務實施辦法》) revised on 7 September 2018 and implemented on 17 September 2018 by the Shenzhen Stock Exchange, the Shenzhen-Hong Kong Stock Connect Mechanism (i.e. Shenzhen-Hong Kong Stock Connect) was officially opened between the Shenzhen Stock Exchange and the Stock Exchange on 5 December 2016, which allows investors from Shenzhen and Hong Kong to entrust members of the Shenzhen Stock Exchange or the HKEX Participants to trade stocks listed on the stock exchange of the other party within a prescribed limit (in terms of transaction value) through the securities trading service companies established either by the Shenzhen Stock Exchange or the Stock Exchange at the other party's location. The Shenzhen-Hong Kong Stock Connect includes the Shenzhen Stock Connect and the Hong Kong Stock Connect.

The above provisions clearly stipulate the scope for stocks that can be included and not included in the Shanghai-Hong Kong Stock Connect and the Shenzhen-Hong Kong Stock Connect, and require that securities trading service companies respectively established by the Stock Exchange, the Shanghai Stock Exchange and the Shenzhen Stock Exchange to announce the list of stocks of the Shanghai Stock Connect, the Shenzhen Stock Connect and the Hong Kong Stock Connect through their respective designated websites, and monitor the daily usage of trading quota on the Shanghai Stock Connect, the Shenzhen Stock Connect and the Hong Kong Stock Connect on a timely manner, and announce the quota usage on their designated websites.

The above provisions clearly stipulate the trading rules of the Shanghai-Hong Kong Stock Connect and the Shenzhen-Hong Kong Stock Connect, the conditions and technical standards for investors participating in the Shanghai-Hong Kong Stock Connect and the Shenzhen-Hong Kong Stock Connect, and other requirements for participating in the transaction. Corresponding provisions were also made on the restriction of shareholding that investors should follow when participating in the Shanghai Stock Connect and the Shenzhen Stock Connect transactions.

In addition, the above provisions also set forth the obligations that shall be abided by the stock exchange securities trading service companies when participating Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect and the HKEX Participants in accepting client entrustment. According to the above provisions, unless otherwise stipulated by the China Securities Regulatory Commission, the stock exchange securities trading service companies and securities companies or brokers shall not cooperate with investors to procure orders by means of trading shares through the PRC and Hong Kong stock market trading mechanism, nor provide any transfer service for stocks traded through the PRC and Hong Kong stock market trading interconnection mechanism in other places and in any other forms other than the stock exchanges.