



**SECURITIES AND FUTURES COMMISSION**  
證券及期貨事務監察委員會

## **Regulatory Framework for Intermediaries**

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## Introduction

1. Hong Kong is an international financial centre, comprising a network of institutions and markets that provide a diverse range of products and services to local and international investors. The Commission is responsible for regulating the securities and futures markets in Hong Kong, and therefore plays a key role in supporting Hong Kong's continued development.
2. Under the Securities and Futures Ordinance (Cap. 571) ("**SFO**"), the Commission is given six regulatory objectives:<sup>1</sup>
  - To keep the securities and futures markets fair, efficient, competitive, transparent and orderly;
  - To help the public understand how the securities and futures industry works;
  - To protect investors' interests;
  - To minimise market crime and misconduct;
  - To reduce systemic risks in the industry; and
  - To help maintain the financial stability in Hong Kong.
3. In carrying out its regulatory objectives, the Commission seeks to establish and maintain a sound regulatory regime that is consistent with prevailing international practices, for example, the *Objectives and Principles of Securities Regulation* developed by the International Organization of Securities Commissions ("**IOSCO**").<sup>2</sup> This is vitally important for the purposes of ensuring consistently high regulatory standards and market-wide resilience as markets today are increasingly dynamic.
4. This paper describes the framework employed by the Commission in regulating intermediaries<sup>3</sup> falling within the Commission's regulatory remit. It explains how the Commission pursues the regulatory objectives set for it in the context of its regulatory work on intermediaries.
5. This paper is divided into three parts:
  - **Part I** paints the background, highlighting the collaborative approach between the Commission and other financial regulators, both in and outside Hong Kong, concerning the regulation of intermediaries;
  - **Part II** outlines the Commission's core activities revolving around the regulation of intermediaries; and
  - **Part III** explains the broad approach taken by, and the underlying philosophy that guides, the Commission in regulating intermediaries.
6. Details on the day-to-day work processes in supervising licensed corporations are

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<sup>1</sup> Section 4 of the SFO.

<sup>2</sup> IOSCO is recognised as the international standard setter for securities markets and is the primary international cooperative forum for securities market regulatory agencies. IOSCO members are drawn from, and regulate, over 100 jurisdictions.

<sup>3</sup> For the purpose of this paper, the term "intermediary" refers to a corporation licensed with the Commission under section 116 or 117 of the SFO as a "licensed corporation", or registered with the Commission under section 119 of the SFO as a "registered institution".



covered in a separate paper entitled “*Approach to Supervision of Intermediaries*” published by the Commission.

## Part I: Collaborative approach to regulation of intermediaries

7. Armed with functions and powers under the SFO, the Commission currently regulates over 1,700 intermediaries in Hong Kong that engage in the following regulated activities:<sup>4</sup>
  - 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; and
  - Type 10 – providing credit rating services.
8. In view of the increasing linkages across the financial sectors, a number of market participants are operating outside the traditional, monoline business model. Some banks, for example, are also involved in the securities and futures business. Banks carrying on business in regulated activities are required to be registered with the Commission as registered institutions, although the Hong Kong Monetary Authority (“**HKMA**”) remains the frontline regulator of their securities and futures operations.<sup>5</sup> The Commission coordinates with the other financial regulators in Hong Kong<sup>6</sup> on relevant cross-sectoral regulatory matters.
9. Furthermore, the Commission works closely with Hong Kong Exchanges and Clearing Limited (“**HKEx**”), being the operator of the only stock exchange and futures exchange in Hong Kong. Relevantly, the HKEx is responsible for setting and administering its own trading and clearing rules, and overseeing the activities of exchange participants and clearing participants in the trading and clearing systems of the securities and futures markets.
10. With the growing internationalisation of markets where trading activities are operating beyond territorial boundaries, the need for effective cooperation and information sharing amongst international regulators is vital. The Commission is active in the international arena of regulators, regularly participating in the various IOSCO committees and work groups that deal with different aspects of intermediaries regulation. The Commission is also a signatory, together with regulators from other jurisdictions worldwide, to the

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<sup>4</sup> See Schedule 5 to the SFO for the definition of each regulated activity.

<sup>5</sup> More particularly, the HKMA is responsible for the day-to-day supervision of the performance by registered institutions of regulated activities, including conducting on-site inspections, reviewing information submitted by them and handling complaints. The conduct of investigations into the manner in which registered institutions carry on regulated activities is also handled by the HKMA. Details of the respective regulatory roles and responsibilities of the Commission and the HKMA with regard to registered institutions and their associated entities are set out in *Memorandum of Understanding between the Securities and Futures Commission and Hong Kong Monetary Authority* (12 December 2002).

<sup>6</sup> Besides the Commission, the principal financial regulators in Hong Kong are the HKMA, Insurance Authority and Mandatory Provident Fund Scheme Authority.



Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information adopted by IOSCO, which is designed to provide for mutual assistance amongst the signatories (“**IOSCO MMOU**”).<sup>7</sup>

## Part II: The Commission’s role in regulating intermediaries

11. The Commission has clear and comprehensive powers derived from the SFO to regulate intermediaries, which include:

- Licensing intermediaries;
- Supervising intermediaries and monitoring their compliance with relevant laws and regulatory standards; and
- Investigating relevant breaches and misconducts by intermediaries, and where appropriate, taking enforcement and disciplinary actions against them.

Each of these activities is further explained below.

12. It is also appropriate to mention here that investor education, being one of the Commission’s regulatory focuses, is an important complement to the regulation of intermediaries.<sup>8</sup> Not only does it help investors protect themselves, allowing them to acquire better knowledge of market operations, product features and associated risks and thereby make informed investment choices, it also helps investors understand the inherent risks of investing and their own responsibility for their investment decisions.

### Regulatory framework

13. Regulation begins with setting standards. Besides the powers listed in paragraph 11 above, the Commission is also empowered under the SFO to lay down the legal and regulatory framework in which intermediaries should operate, for example, by making rules (in the form of subsidiary legislation)<sup>9</sup> and issuing codes and guidelines (which are non-statutory in nature)<sup>10</sup> in a diverse range of areas. Such power provides flexibility in addressing changing market practices and conditions, by the prescription of detailed or technical requirements as necessary to supplement the primary legislation.

14. The Commission has made rules for intermediaries regarding, among other things, financial resources, client money, client securities, contract notes, audit and accounts, and record keeping. These rules set out specific compliance requirements, aimed at protecting investors’ interests.

15. The Commission has also issued various codes and guidelines. In particular, the Commission has published the *Fit and Proper Guidelines*, which outlines the matters that

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<sup>7</sup> The IOSCO MMOU and a list of the current signatories to it are available on the IOSCO website at <http://www.iosco.org/>.

<sup>8</sup> Investor education is carried out through various means, including the Commission’s InvestEd website (<http://www.invested.hk>), leaflets, seminars, multimedia advertising campaigns, competitions and game shows, newspaper articles and radio/television programmes.

<sup>9</sup> Section 397 of the SFO.

<sup>10</sup> Section 399 of the SFO.



the Commission will normally consider in determining whether a person is fit and proper to be licensed or registered. The Commission has also issued the *Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission* (“**Code of Conduct**”), which provides principles-based guidance relating to the practices and standards with which intermediaries are ordinarily expected to comply in carrying on regulated activities for which they are licensed or registered.

## Licensing

16. A corporation<sup>11</sup> carrying on a business or holding itself out as carrying on a business in a regulated activity in Hong Kong is required to be either licensed by the Commission as a licensed corporation, or in the case of banks, registered with the Commission as a registered institution, unless an exemption is available.<sup>12</sup>
17. The Commission acts as the gatekeeper by administering the licensing regime created under the SFO. Only those who meet the relevant licensing criteria can be licensed by or registered with the Commission, and thereby enter and participate in the Hong Kong securities and futures markets. The Hong Kong licensing regime significantly revolves around the principles of “fitness and properness”, with applicants being obliged to satisfy the Commission that they are fit and proper to be licensed or registered.<sup>13</sup> Being fit and proper broadly involves being financially sound, competent, honest, reputable and reliable.<sup>14</sup>

## Supervision

18. Having sound laws and regulatory standards is essential to effective regulation, but that will be of no value without effective application through supervision and ongoing monitoring for compliance.
19. The Commission employs a variety of tools in conducting ongoing supervision of intermediaries, broadly comprising on-site reviews and off-site monitoring. The areas of supervisory focus cover both prudential (e.g., financial resources) and business conduct (e.g., acting honestly, fairly and in the best interests of the intermediaries’ clients and the integrity of the market) issues which are specific to each intermediary, as well as issues that cut across an industry sector or relate to a particular type of product or a large group of investors.

## Enforcement

20. The Commission is empowered to investigate and enquire into circumstances where misconduct or breaches of relevant laws or regulatory standards is suspected.<sup>15</sup> Intermediaries found to be guilty of misconduct or otherwise not fit and proper to be

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<sup>11</sup> Individuals performing or holding out as performing regulated functions (as defined in section 113 of the SFO) for a licensed corporation in relation to a regulated activity carried on as a business are also required to be licensed by the Commission. However, the regime for licensing individuals is beyond the focus of this paper.

<sup>12</sup> Section 114(1) and (2) of the SFO.

<sup>13</sup> Section 116(3)(a) of the SFO.

<sup>14</sup> See the *Fit and Proper Guidelines* (September 2006), *Guidelines on Competence* (March 2003) and *Guidelines on Continuous Professional Training* (March 2003), issued by the Commission, which set out the general expectations of what is necessary to satisfy the requirements of fitness and properness and the initial and continuous competence requirements.

<sup>15</sup> Section 182 of the SFO.



licensed or registered are subject to disciplinary actions such as reprimands, revocations or suspension of licenses or registrations, ban from the industry and monetary fines.<sup>16</sup>

### **Part III: The Commission's approach and philosophy for regulating intermediaries**

21. Risks are inherent in any competitive market, and investors benefit from competitive markets. Risks therefore cannot be eliminated entirely without stifling market development. Management of the intermediaries are required to develop and implement effective processes and management systems commensurate with their business operations and risk characteristics in accordance with the general principles set out in the regulation. It is imperative to recognise that intermediaries' senior management carry primary responsibility for their activities and for ensuring compliance with the relevant legislative and regulatory requirements.
22. The Commission's regulatory requirements are therefore developed on the basis that a licensed corporation would properly manage its business risks. This includes having in place effective risk management systems and internal controls, which provide the necessary checks and balances to guard against excessive risk-taking and putting in place sufficient resources in order to operate its business in an orderly manner. For example, while licensed corporations are required to meet the minimum capital requirements under the Securities and Futures (Financial Resources) Rules (Cap. 571N), they are expected to gauge their capital needs and calibrate their risk management not just for meeting the minimum requirements set under the rules but also according to their business needs and the risks they have assumed to ensure that they can operate their business as a going concern with sufficient liquidity and capital to absorb losses and deal with emergencies that may arise in the course of their business.
23. Furthermore, the Commission must manage its resources to deal with competing requests. It must therefore decide how to use its resources in the most efficient and economic way. Direction of resources and regulatory intervention is based on a rigorous assessment of the impact of individual intermediaries and the risk they pose to the regulatory objectives of the Commission. This means that the Commission must set its priorities and strive to achieve the biggest influence on the industry through in its actions.
24. In conclusion, it is important to note that there are limits to what regulation can achieve, both in terms of the coverage of rules and regulations made for regulating different types of regulated activities and how the Commission regulates intermediaries. The Commission's regulatory activities are not designed to protect investors from all business risks, substitute the responsibilities of senior management of intermediaries, or guarantee "zero-failure" of intermediaries. Rather, they are designed to secure an appropriate degree of protection for the investing public by requiring intermediaries to remain fit and proper at all times and to comply with all relevant requirements. Such requirements include acting honestly, fairly, diligently and in the best interest of clients, having sound controls and systems commensurate with their risk profile, and ensuring that client assets are properly safeguarded.

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<sup>16</sup> Sections 194 to 197 of the SFO.



## Balanced regulation

25. The Commission constantly aims to achieve a proper balance in regulation. On the one hand, it strives to maintain order to ensure appropriate safeguards for investors, with adequate regulation to ensure as far as possible sound business practices and market confidence. On the other hand, it strives to provide a regulatory environment that allows enough impetus for market development, without stifling innovation and competition.
26. The Commission avoids setting burdensome standards for intermediaries, as they may create unnecessary regulatory barriers to entry, impose prohibitive compliance costs, lower market efficiency, and constrain market innovation and competition. Conversely, overly lenient standards and too much emphasis on market discipline offer inadequate assurance for market stability and confidence. Standard-setting therefore involves striking a proper balance between these competing considerations. To achieve this balance, the regulatory framework builds in an important element of transparency for policy-making. The Commission is required to consult the public regarding its proposals to make rules.<sup>17</sup> In respect of non-statutory codes and guidelines that it intends to issue, the Commission often chooses to consult for views and solicit feedback from the public as well. It is the Commission's belief that transparency in the standard-setting process not only helps the market participants understand the goals of the proposals, but also assists the Commission in gauging the views of the public, which in turn facilitates the development of balanced regulatory standards.
27. In discharging its supervisory role, the Commission exercises appropriate judgment as to:
- whether any rules should be modified or waived upon application by individual intermediaries taking into account legitimate business and operational concerns of the intermediaries concerned and to facilitate market development, provided always that this will not prejudice the interests of any clients or the investing public;<sup>18</sup>
  - which intermediary, regulated activity or control area should be reviewed more frequently and in what depth, and how deficiencies and non-compliance identified should be dealt with; and
  - whether the Commission should intervene, and if so, how to intervene, in the business of intermediaries, whilst balancing the competing interests of the market and investors. In extreme cases, for example, where there is a risk of dissipation of client assets, the Commission may decide to intervene by issuing a restriction notice or applying to Court for an injunction in order to protect the interests of investors and market integrity.<sup>19</sup>

## Principles-based regulation

28. As markets evolve, so must their regulatory regimes. The Commission is acutely aware of the need to remain vigilant in responding to developments in the financial regulatory landscape and in the wider economic context. This is imperative to ensure a high degree

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<sup>17</sup> Section 398 of the SFO.

<sup>18</sup> Section 134 of the SFO.

<sup>19</sup> Sections 204 to 206 and 213 of the SFO.





of confidence amongst stakeholders that the Commission's regulatory objectives are being fulfilled.

29. To address the fast changing market circumstances and practices, the Commission believes that, generally speaking, principles-based regulation that focuses on a higher level articulation of what the Commission expects intermediaries to do is more appropriate than a large volume of detailed standards. In particular, completely prescriptive standards are unlikely to be appropriate for governing business conduct as they may not be able to cover all the possible scenarios and complexities in today's financial markets. The above notwithstanding, prescriptive rules setting the minimum standards are still necessary for critical areas of the regulatory framework, such as segregation of client assets,<sup>20</sup> to ensure adequate levels of consistency, certainty and investor protection.
30. With principles-based regulation, intermediaries are responsible for deciding how best to align their business objectives within the boundaries of applicable rules and regulations. This requires exercise of proper judgment by intermediaries, having due regard to the nature, size and complexity of their business. Where appropriate, the Commission would provide guidance to the industry to clarify the principles or outcomes sought to be achieved, with the aim of assisting intermediaries to make better decisions about what internal controls and risk management systems should be adopted.

### **Benchmarking with international standards**

31. With the growing internationalisation of markets, more and more intermediaries are developing and pursuing global strategies, operating through affiliates in many countries that press for global regulatory standards. This means that many regulatory policies and issues must be considered at the international level. The Commission works extensively with a number of multilateral organisations and forums (such as the Financial Stability Board, IOSCO and The Group of Twenty Finance Ministers and Central Bank Governors (G20)), and contributes to their international regulatory agenda and initiatives, as these can affect how the Commission regulates intermediaries. Keeping in view the international and dynamic character of the financial services and markets and recognising that even a proven infrastructure requires fine-tuning to meet changing needs, the Commission strives to maintain high regulatory standards in line with those in other major jurisdictions.
32. Having said so, however, it does not mean that the Commission would simply adopt wholesale these international standards. Instead, the Commission would consider their necessity and appropriateness from all relevant perspectives, in light of the prevailing market conditions and practices in Hong Kong. Hence, in some cases, the Commission may consider an activity not being so significant in Hong Kong so as to warrant an immediate regulatory response from the Commission, whilst in other cases, it may be appropriate to go beyond international minima on account of the relevant risk exposures in Hong Kong.

### **Responsibility of intermediaries**

33. The Commission's regulatory approach is firmly grounded in the tenet that an

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<sup>20</sup> Refer to paragraph 14 above.



intermediary is primarily responsible for its own activities and for ensuring that its business complies with the relevant legislative and regulatory requirements, in both letter and spirit.

34. With the Commission's principles-based approach to regulation, intermediaries have to decide what processes and controls are effective and suitable for their business and particular circumstances and implement them properly. The senior management should be closely involved in managing the process, and this is reinforced by the Code of Conduct. Specifically, under the Code of Conduct, the senior management of an intermediary bears primary responsibility for ensuring proper management of risks associated with the intermediary's business, maintenance of appropriate standards of conduct and adherence to proper procedures by the intermediary on a day-to-day basis.<sup>21</sup> Hence, where an intermediary's risk management system or compliance arrangement is found to be inadequate, its senior management must bear the ultimate responsibility for the failure.
35. The Commission helps to reinforce this tenet through delivering effective supervision of intermediaries, including monitoring compliance with relevant laws and regulatory standards and promoting a good compliance culture. Where warranted, the Commission will take enforcement or other regulatory actions against intermediaries to combat non-compliance and illegal or improper conduct.

### **Risk-based regulation**

36. The Commission adopts a risk-based approach to the regulation of intermediaries, by directing more regulatory attention to areas where the Commission perceives there to be the highest risk, or to those having the greatest impact on the Commission's regulatory objectives. The Commission must manage its regulatory resources and set its priorities. Risk-based regulation essentially allows the Commission to allocate its resources in the most efficient and effective ways in areas that would have the greatest impact on the market / investors. In addition, risk-based regulation facilitates the Commission in assessing whether its level of regulatory intervention is proportionate to, or justified by, the benefits that are expected from it.
37. More relevantly, central to the Commission's intermediary supervisory framework is the evaluation of the intermediary's risk profile vis-à-vis its risk management systems and internal controls. As such, the scope of review of the industry and individual intermediaries will generally be limited to areas crucial to investor protection. In addition, risk-based supervision effectively guides the Commission away from being unnecessarily intrusive by applying a supervisory response that is proportionate and appropriate to the risks posed by intermediaries. Intermediaries will also have greater flexibility to decide for themselves what activities and controls they should operate.

### **Partnership with the industry**

38. The Commission is committed to working in partnership with the industry. It seeks to maintain ongoing communication and two-way dialogue with intermediaries individually and the industry on all relevant policy and regulatory matters. This may be by way of circulars to intermediaries and FAQs posted on the Commission's website, as well as

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<sup>21</sup> General Principle 9 and paragraph 14.1 of the Code of Conduct.



meetings, seminars and training. The goals are to promote a good compliance culture, improve intermediaries' understanding of the regulatory concerns, build a forum for the exchange of views on relevant or topical issues, and ultimately, sustain a strong regulator/regulated relationship.

### **Fair and consistent regulatory processes**

39. The Commission has clear and objective internal procedures and guidelines that its staff are required to follow when performing their day-to-day regulatory activities. Such internal procedures and guidelines are intended to help ensure that regulatory processes are fairly and consistently applied.
40. The Commission is subject to a system of checks and balances, both internal and external, on its procedures and decision-making so as to ensure fairness and consistency. This includes the potential for judicial review and scrutiny by the Process Review Panel. This panel is established by the Government, comprising members from the financial sector, academia and legal and accountancy professions and other ex-officio members. It is empowered to review the Commission's internal operational procedures to assess whether such procedures had been consistently followed with respect to, among other things, licensing applications, inspections, handling of complaints, investigations and disciplinary actions, and make relevant recommendations to the Commission.
41. In addition, the Commission observes procedural fairness in the exercise of its regulatory functions over intermediaries. For example, in the event of an applicant failing to satisfy the Commission that it should be licensed, the Commission must provide details of the reasons for this and give the applicant an opportunity to be heard<sup>22</sup> before reaching a final decision in relation to the application. If the Commission decides to refuse an application, the applicant may, within 21 days, seek to have the decision reviewed by the Securities and Futures Appeals Tribunal.<sup>23</sup>
42. Similarly, in the enforcement process, the Commission is obliged to observe the principles of procedural fairness and natural justice when taking disciplinary actions. This includes giving the person against whom the action is to be taken a reasonable opportunity of being heard, and issuing a notice setting out, among other things, the reasons for which a disciplinary decision is made.<sup>24</sup>

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<sup>22</sup> Section 140 of the SFO.

<sup>23</sup> Section 217 of the SFO.

<sup>24</sup> Section 198 of the SFO.