THE LAW SOCIETY OF HONG KONG 香港律師會

Comments on Consultation Paper on Schedule 5 of the SFO

The Committee is of the view that while clarification of the definitions in Schedule 5 of the SFO is welcome, some of the proposed changes will require further amendment to be effective. In addition, there are other amendments which could usefully be made at the same time.

Amendment (a) – Licensing of managers of Real Estate Investment Trust

The Committee agrees with the observation that the existing definition of Type 9 regulated activity does not cover a manager of a REIT unless the manager's activities extend to the management of a portfolio of securities or futures contracts. The Committee supports the proposed amendment to the definition, given the requirement of the SFC's Code on Real Estate Investment Trusts for the manager of a REIT to be licensed by the SFC for Type 9 regulated activity.

The Committee notes that the amendment will only require managers of REITs authorized under section 104 of the SFO to be authorized for Type 9 regulated activity. The managers of (i) REITS not authorized for offer to the public and (ii) managers of real estate investment vehicles which are structured as closed end companies (whether or not offered to the public) will not require such authorisation. The Committee supports this distinction. Specifically, the Committee agrees that managers of schemes described in (i) and (ii) should not require licensing under the SFO.

Amendment (b) – Money brokers exemption

The SFC is of the view that money brokers who deal only for authorized financial institutions should be excluded from the definition of "dealing in securities". The Committee agrees that excluding money brokers for the definition of "dealing in securities" is appropriate but submits that other categories of activity should also be excluded.

At present, there is an exclusion for dealing "as principal" with professional investors (categories (a) to (h)), [and perhaps category (j) as well]. However, that exclusion does not go far enough in that entities who deal as agent are required to be licensed, even though their clients are exclusively professional investors.

If the above exclusion is to be applied to money brokers, the Committee is of the view that a similar exclusion should be provided to other persons who deal solely with or for professional investors.

It is noted that the SFC's other justification is that money brokers are already subject to the regulation and supervision of the HKMA (in addition to the fact that they are dealing only with authorized financial institutions). If these are the relevant criteria, then similar criteria

should also be applied to other types of persons who deal exclusively with professional investors (i.e. checking the alternative regulatory status of such persons in or outside Hong Kong). Exemptions would include banks, insurance companies and persons who hold a licence for a different type of regulated activity from the SFC.

Amendment (c) – Incidental advice of fund managers

The SFC is of the view that a person who is licensed for Type 9 regulated activity and provides a service of managing a portfolio of securities and/or futures contracts under a collective investment scheme will generally have the requisite expertise, attributes and resources to give clients investment advice for the purposes of providing them with his asset management services. For instance, a fund manager who intends to market the funds under his management may first provide certain investment advice or related research results to prospective investors to demonstrate his expertise in the area. Under such circumstances, we consider that additional licensing requirements on the fund manager with respect to Type 4 and/or Type 5 regulated activities may not be necessary.

It is submitted that the above exclusion should not be limited to fund managers (i.e. entities carrying out Type 9 regulated activity in respect of *collective investment schemes* only). The above justification should likewise apply to other Type 9 regulated entities (e.g. portfolio managers).

Amendment (d) - Redress disposal of securities to non-professional investors

While it is clear that the exemption for disposals of securities as principal is too broad, its complete removal requires careful consideration.

First, from a procedural standpoint, it is possible that participants in the markets may have decided not to obtain a license or registration relying upon the exemption for disposals of securities as principal. If they do not receive adequate notice of the change and are not given adequate time to apply for a license or registration following receipt of such notice, they may find themselves in breach of the SFO even though they may have properly taken legal advice or may wish to apply for a licence or registration following the change.

Secondly, from a regulatory perspective, the regime in Hong Kong *for securities dealing* has traditionally been the regulation of offer documents and the regulation of intermediaries involved in dealing in securities, rather than regulating public offers as such. For this reason, there is one regime of regulating contents of prospectuses, the prohibition of advertisements relating to securities and collective investment schemes, and another regime for the regulation, through licensing, of intermediaries but no regime for regulating dealings per se. If persons disposing of securities are to be required to be licensed, this will extend the licensing regime to, for example, companies listed overseas which make an offer involving Hong Kong residents.

Insofar as the proposed amendment has the possible effect of extending the licensing net, a wider consultation is desirable: if the documents under which a public offer is made are already regulated in terms of contents, and documents for non-public offers are subject to restricted distribution, there is, arguably, little direct benefit from extending the licensing/regulatory net to persons who dispose of securities. The likely number of persons who will fall into the new regulatory net will have to be assessed because this may impact on

the expenditure of the Commission in terms of initial licensing and ongoing monitoring costs.

It should be noted that sub-para (v)(A) is not necessarily redundant as a result of the inclusion of disposals of securities in sub-para. (v)(B). Sub-para. (v)(B) may not extend to the second limb of the definition of dealing in securities. In other words, an exemption for disposals of securities as principal does not necessarily exempt the entering into of an agreement the purpose or pretended purpose of which is to secure a profit from the yield of securities or by reference to fluctuations in the value of securities.

Sub-paragraphs (v)(A) and (v)(B) were both taken from section 3(1) of the now repealed Securities Ordinance. The words "disposes of" were not, however, in the old section 3(1). Perhaps the SFC could re-trace the drafting directions for this provision and explain the rationale for the words that it now proposes to delete.

Other issues not addressed in the Consultation Paper

1. At present, there is an exclusion for dealing as principal with professional investors. However, if an entity or group wishes to incorporate a subsidiary to carry out such dealings, there is no clear exclusion applicable to the subsidiary (even though it is simply a trading vehicle for the principal trading of its parent or group companies only). It is submitted that the policy intent cannot be to regulate such trading simply because of the manner in which it is carried out. Accordingly it is desirable that the SFO should provide an express exclusion in such cases.

2. In relation to Type 2 regulated activity, the applicable criteria for OTC transactions to be caught within the meaning of "dealing in futures contracts" should be clarified.

3. In relation to Type 3 regulated activity, it seems that persons who trades in foreign currency as principals are within the definition of leveraged foreign exchange trading", even though he may have paid (or been paid) 100% of one currency, for example, in a HK dollar loan repayable in US dollars. It is submitted that the SFO cannot be intended to regulate this type of activity and an exclusion of non-leveraged contracts should be excluded.

4. In relation to offshore persons providing services to Hong Kong investors, section 115 prohibits active marketing to the "public". For these purposes, it is submitted that Schedule 5 be amended to provide an express exclusion (in relation to each regulated activity) for overseas persons who deal with professional investors within parts (a)-(h) of the definition of professional investor only (and perhaps also to those falling within the Securities and Futures (Professional Investors) Rules), and/or deal with clients with whom a relationship was established without active marketing in Hong Kong.

5. In relation to Hong Kong licensed entities referring transactions to offshore booking entities in their group, the SFO should clarify that such offshore entities do not require licensing under the SFO solely by the use of such booking arrangements.

The Law Society of Hong Kong
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