

# SFAT Casts Doubt on Legality of Introduction Arrangements between Hong Kong Brokers and their Offshore Affiliates

*A recent determination by the Securities and Futures Appeal Tribunal suggests that the introduction of trades from introducing brokers in Hong Kong to executing brokers based in London, New York or other financial centers may constitute active marketing by these offshore executing brokers, thereby subjecting these offshore executing brokers to licensing requirements. Prior to this determination, the industry generally believed that licensing requirements would not apply. In this article, we review the determination and explore its potential consequences on the industry in Hong Kong.*

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**T**he Securities and Futures Appeals Tribunal (“SFAT”) determination dated May 15, 2009 regarding Applications No. 7, 8 and 9 of 2007 is the first judicial interpretation of the active marketing section of the Securities and Futures Ordinance (“SFO”). In the determination, the SFAT upheld disciplinary action against representatives of a corporation licensed by the Securities and Futures Commission (“SFC”) in Hong Kong for Type 3 (leveraged foreign exchange) regulated activity in connection with the introduction by these representatives of foreign exchange trades to an unregulated offshore affiliate.

Whilst the SFAT is not a court of law and its determinations do not

create binding judicial precedents, the SFAT is chaired by a judge of the Court of First Instance and its determinations are thus significant.

The SFAT findings in this determination appear to disturb established market understanding of the active marketing section and indeed, appear to expand the scope of this section beyond the SFC’s own published interpretation. Consequently, the SFAT determination raises concerns as to whether intra-group introduction arrangements employed by global banks between their Hong Kong offices (“**Introducing Broker**”) and offshore offices (“**Executing Broker**”) breach licensing requirements under the SFO.

## Legal Framework

The SFO provides that no person shall carry on a business in a regulated activity or hold himself out as carrying on a business in a regulated activity without being authorized or licensed to carry on a business in that regulated activity.

In this regard, the active marketing section provides that if (i) 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 (ii) such services, if provided in Hong Kong, would constitute a regulated activity, then the provision of such services so marketed shall be regarded as carrying on a business in that regulated activity or the person's marketing of such services shall be regarded as holding himself out as carrying on a business in that regulated activity.

## Current Industry Understanding

The industry has generally understood the active marketing section to require marketing that is (i) active, (ii) related to a service, and (iii) directed to the Hong Kong public.

### Marketing

Marketing is generally understood to mean advertising or promoting or offering for sale, activities preliminary to providing a service or a product. Thus, the industry traditionally has taken the view that the provision of a particular service falls outside the ambit of the active marketing section. Consequently, where a broker outside of Hong Kong executes a trade for a

member of the Hong Kong public, industry understanding is that the broker is not by reason only of executing the trade considered to be actively marketing its brokerage services in Hong Kong.

### Active

In the ordinary language, the word "actively" would presumably be contrasted with "passively" and would thus suggest vigorous or frequent efforts to achieve a predetermined objective rather than simply accepting or allowing what happens. In keeping with this, the industry understanding, as well as the SFC's own published interpretation, is that the marketing of services may be considered to be "active" where there is a detailed marketing plan to promote the services or where the services are extensively advertised through, for example, mass media, internet activities or telephone calls. However, where the services are sought out by investors of their own initiative, the industry and indeed the SFC have generally understood that marketing not to be active.

### Service

The SFO itself refers only to the provision of "services" and not "products". Thus, the industry has generally understood the active marketing section as not controlling the marketing of shares, units and other financial products.

### Public

The SFO suggests that the active marketing must target the public in Hong Kong to fall within the active marketing section. Indeed, the SFC's own interpretation of the active marketing section is that

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a one-off marketing exercise is not considered as being active marketing.

## SFAT Determination

In Applications No. 7, 8 and 9 of 2007, the SFAT was asked to review SFC disciplinary actions against 3 representatives of Hantec International Ltd. (“**Hantec HK**”).

Hantec HK and the representatives concerned were all licensed by the SFC for Type 3 regulated activity (leveraged foreign exchange trading).

Under introduction arrangements, the representatives of Hantec HK would solicit leveraged foreign exchange business from clients in Hong Kong and introduce such clients to open an account and to trade leveraged foreign exchange with Cosmos Hantec Investments (NZ) Ltd. (“**Hantec NZ**”). At the material time, Hantec NZ was a New Zealand company, which does not regulate leveraged foreign exchange trading, and was not licensed by the SFC.

The SFC disciplined the representatives of Hantec HK on the basis that they had exceeded the ambit of their regulated activities and illegitimately assisted Hantec NZ in carrying out its unregulated business in Hong Kong.

On appeal, the SFAT upheld the SFC’s disciplinary action, dismissing arguments from the representatives of Hantec HK that the active marketing section means no more than marketing in the primary sense of pro-actively advertising a service to the Hong Kong public and does not encompass, for example, instances of the actual sale of products to individual customers.

## Marketing vs. Provision of Service

In dismissing these arguments, the SFAT stated that it seems “tolerably clear that an actual sale consequent upon the advertising of the service to the Hong Kong public must be regarded as falling within this rubric (active marketing)”. Taken at face value, this statement suggests that the industry understanding that the active marketing section is limited to the marketing of services rather than provision of services may not survive judicial scrutiny.

## Active vs. Passive Marketing

At the same time, whilst the SFAT cautioned that clearly much would depend upon the evidence surrounding the circumstances of any sale, it rejected commentary in the consultative paper presented to the Bills Committee during the adoption process of the SFO and the SFC’s own published interpretation of the active market section as being nothing more than “straws in the interpretative wind.” As the SFC’s own published interpretation broadly reflects industry understanding, the SFAT determination throws in doubt the industry’s understanding.

## Service vs. Product

Whilst not of apparent significance in this case as the subject matter was in fact a service, the SFAT determination does not distinguish between the terms “services”, which is used in the SFO, and “products”, which is not used in the SFO. Indeed, the SFAT uses these 2 terms interchangeably.

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## Distinguishing Factors

Whilst the arrangements between Hantec HK and Hantec NZ are very similar to those used by many global banks operating in Hong Kong, it is unclear to what extent this determination may be of more general application and in particular how this determination may apply, if at all, to these global banks.

### Onshore Liaison Office

First, it appears that at the initial stages, Hantec NZ operated a liaison office in Hong Kong. The existence of this liaison office in Hong Kong would, presumably, have required Hantec NZ to be licensed by the SFC, not because it would be regarded as carrying on a business in a regulated activity in Hong Kong as a result of the deeming effect of the active marketing section but because in fact it did so. Consequently, it may be suggested that the SFAT's discussion of the active marketing section was unnecessary to the finding of liability and that the arrangements used by Hantec HK and Hantec NZ are distinguishable from those used by global banks in that the offshore Executing Brokers of such global banks do not have liaison offices in Hong Kong.

However, there is some discussion in the SFAT determination of the relocation of Hantec NZ's liaison

office from Hong Kong to Macau and it is possible that the introductions by representatives of Hantec HK to Hantec NZ following the relocation may also have been the basis for the disciplinary actions. If that were the case, the SFAT's discussion of the active marketing section could remain relevant.

### Executing Broker Unregulated

Secondly, even if the SFAT determination does contemplate introduction arrangements similar to those used by global banks, it is significant to note that Hantec NZ was not regulated. In contrast, the introduction arrangements of global banks typically involve an offshore Executing Broker which is regulated in New York, London or another credible financial center. Whilst the SFO does not distinguish between offshore Executing Brokers who are regulated and offshore Executing Brokers who are not regulated, the regulatory status of an offshore Executing Broker is likely to be a factor that would weigh in the SFC's whether decision to pursue enforcement action and a court's application of the SFO.

## Potential Implications

Whilst not a binding judicial determination, the comments of the SFAT appear to disturb established industry understanding of

the active marketing section. Taken at face value and assuming that the SFAT determination cannot be distinguished, the determination opens new concerns as to when offshore Executing Brokers may be required to obtain an SFC license in Hong Kong to serve Hong Kong clients. The consequences of such a requirement are drastic, requiring global banks to choose whether to license the offshore Executing Broker or restructure their onshore Introducing Broker to execute trades. The latter option would eliminate economies of scale achievable through the centralization of capital and operational resources in a single location with the offshore Executing Broker. ■

*TIMOTHY LOH, SOLICITORS serves as Hong Kong and international legal counsel to financial institutions. Since its establishment in 2004, its clients have included 10 financial institutions ranked in the FT Global 200. It is ranked by the International Financial Law Review 1000 as a leading practice in Hong Kong banking law and it has been recommended each year by the Asia Pacific Legal 500 for its financial services and regulatory practice.*

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