

LEGISLATIVE COUNCIL BRIEF

Securities and Futures Ordinance (Cap. 571)

SECURITIES AND FUTURES (KEEPING OF RECORDS) RULES

INTRODUCTION

Pursuant to section 151 of the Securities and Futures Ordinance (Cap. 571) (the SFO), the Securities and Futures Commission (the SFC) has made the Securities and Futures (Keeping of Records) Rules (the Rules) at the **Annex**.

BACKGROUND

The SFO

2. The SFO was enacted in March 2002. It consolidates and modernizes ten existing ordinances governing the securities and futures markets into a composite piece of legislation to keep the regulatory regime on a par with international standards and practices. For effective regulation, the SFO has already provided flexibility in addressing changing market practices and global conditions by empowering the Chief Executive in Council, the Financial Secretary, the Chief Justice and the SFC to prescribe detailed and technical requirements as necessary by way of subsidiary legislation, to supplement the regulatory framework laid down under the primary legislation.

3. On 22 February 2002, the House Committee of the Legislative Council established the Subcommittee on Draft Subsidiary Legislation to be made under the Securities and Futures Ordinance (the Subcommittee) to consider the subsidiary legislation necessary for commencing the SFO. From March 2002 to October 2002, the Subcommittee held 12 meetings and considered a total of 37 sets of draft subsidiary legislation, including the vires to make them.

THE PROPOSALS

Major policy considerations

4. The Rules supplement Part VI of the SFO which mainly concerns the ongoing and operational requirements, including the requirement to keep proper records, applicable to an intermediary and its associated entity¹. The Rules prescribe the records that are to be kept by an intermediary and its associated entity, to ensure that they maintain comprehensive records in sufficient detail relating to their businesses and client transactions for proper accounting of their business operations and clients' assets. In designing the requirements, the SFC was conscious of the need to strike an appropriate balance between providing investor protection and reducing the compliance burden of its regulatees. While the requirements are mainly prepared with reference to the existing section 83 and Division 5 of Part XA of the Securities Ordinance (Cap.333), section 45 of the Commodities Trading Ordinance (Cap.250) and section 3 of the Leveraged Foreign Exchange Trading (Books, Contract Notes and Conduct of Business) Rules, the SFC has, in consultation with the Hong Kong Monetary Authority, made the Rules with certain new elements designed to enable it to better achieve the aforesaid objectives.

Major new elements

5. While the SFC has tried to minimize changes, it has rationalized the existing requirements in the aforesaid three different ordinances and prescribed requirements for application to intermediaries and their associated entities with respect to all types of regulated activities² and for selected types. Major policy changes that have been incorporated into the Rules include :-

- (a) to apply the Rules to a registered institution and an associated entity of an intermediary, introduced as part of the packages to remove the exempt status currently enjoyed by banks for their

¹ An associated entity is a corporation that receives or holds in Hong Kong client assets of an intermediary and has a controlling-entity relationship with the intermediary.

² There are nine types of regulated activities. They are set out in Schedule 5 to the SFO.

securities operations and impose direct regulation of associated entities in order to close an existing regulatory gap³;

- (b) to expressly require an intermediary and an associated entity of an intermediary to keep, where applicable, records as are sufficient to reconcile balances and positions at least monthly, with the statements provided by external parties such as exchanges and clearing houses, and show how the reconciling differences (if any) were resolved; and
- (c) to expressly require an intermediary and an associated entity of an intermediary to keep records to demonstrate compliance with specified provisions in the SFO and rules made thereunder, and where applicable, their systems of control for ensuring compliance thereof.

THE RULES

6. Section 2 of the Rules contains interpretation provisions that apply throughout the Rules.

7. Section 3 of the Rules prescribe the accounting, trading and other record requirements that apply to the businesses which constitute any type of regulated activity carried on by an intermediary. The records required include those specified in the Schedule and in sections 5, 6, 7 and 8 (depending on the particular regulated activities being carried on).

8. Section 4 of the Rules prescribes the accounting and other record requirements that apply to an associated entity of an intermediary with respect to the client assets of the intermediary that it receives or holds.

9. Sections 5, 6, 7 and 8 of the Rules prescribe particular record keeping requirements applicable to an intermediary or a licensed corporation (as the case may be) respectively regarding their activities in dealing in

³ There is an apparent regulatory gap under the existing legislation in that a securities dealer can discharge his obligation to his client in respect of that client's securities held in the dealer's safe custody in Hong Kong by registering those securities in the name of his nominee. To bring the nominee into the regulatory net for better investor protection, section 164 of the SFO prescribes the types of persons that are allowed to receive or hold in Hong Kong client assets; i.e. the intermediary, its associated entity and a person falling within the definition of "excluded person" which includes an authorized financial institution. The SFO then imposes direct regulation over an associated entity.

securities, leveraged foreign exchange trading, providing securities margin financing and other financial accommodation as well as entering into margined transactions, and providing asset management.

10. Sections 9 and 10 of the Rules respectively prescribe the form in which records must be kept and the period for which they must be retained.

11. Section 11 of the Rules requires an intermediary and an associated entity of an intermediary to report to the SFC non-compliance with prescribed provisions of the Rules.

12. Section 12 of the Rules prescribes penalties for contravention of prescribed provisions of the Rules.

PUBLIC CONSULTATION

13. The SFC released a consultation document and an exposure draft of the Rules on 15 February 2002 for comment by the public. A total of 15 submissions were received by the end of the consultation period. The SFC has considered all the comments received and revised the Rules as appropriate.

14. A draft of the Rules was considered by the Subcommittee at its meetings held on 9 July 2002 and 24 October 2002. No major concerns were expressed by members of the Subcommittee at the meetings.

FINANCIAL AND STAFFING IMPLICATIONS

15. There are no financial or staffing implications for the Government.

COMMENCEMENT DATE

16. The Rules will come into operation on the day appointed for the commencement of the SFO, together with other subsidiary legislation necessary for the commencement. We expect this to take place shortly, after completion of the negative vetting procedure through the Legislative Council and allowing the industry a reasonable period of time for making necessary adjustments with reference to the subsidiary legislation. We aim to announce

the target commencement date by the end of 2002.

PUBLICITY

17. The Rules will be published in the Gazette on 13 December 2002. The SFC will issue a press release on the same day.

ENQUIRIES

18. For any enquiries on this brief, please contact Ms Linda Chiang of the Intermediaries Supervision Department of the SFC at 2842 7766 or Ms Vania Cheng of the Legal Services Division of the SFC at 2283 6166.

The Securities and Futures Commission
13 December 2002

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**SECURITIES AND FUTURES (KEEPING OF RECORDS)
RULES**

(Made by the Securities and Futures Commission under section 151
of the Securities and Futures Ordinance (Cap. 571))

PART 1

PRELIMINARY

1. Commencement

These Rules shall come into operation on the day appointed for the commencement of the Securities and Futures Ordinance (Cap. 571).

2. Interpretation

In these Rules, unless the context otherwise requires –

“asset management” (資產管理) has the meaning assigned to it by Part 2 of Schedule 5 to the Ordinance;

“margined transaction” (保證金交易) means a contract entered into in Hong Kong by an intermediary with or on behalf of a client of the intermediary in the conduct by the intermediary of any of the businesses which constitute –

- (a) any regulated activity for which the intermediary is licensed or registered, that is a contract for –
 - (i) a dealing in securities (except a market contract);
or
 - (ii) a dealing in futures contracts (except a market contract); or
- (b) the regulated activity of leveraged foreign exchange trading for which the intermediary is licensed, that is a leveraged foreign exchange contract,

which requires the client to –

- (c) pay a margin to the intermediary; or
- (d) provide security to the intermediary to meet the client's obligations,

other than under an arrangement where financial accommodation is provided to the client by the intermediary;

“margin value” (保證金價值), in relation to each description of securities collateral deposited with an intermediary, means the maximum amount of money which the client by whom and on whose behalf the securities collateral is deposited is permitted to borrow, or otherwise secure other forms of financial accommodation, from the intermediary against that particular description of securities collateral;

“record” (紀錄) has the same meaning as in section 1 of Part 1 of Schedule 1 to the Ordinance except that it does not include any tape or other sound recording of any telephone conversation;

“systems of control” (監控系統), in relation to an intermediary or an associated entity of an intermediary, means any internal controls and trading, accounting, settlement and stock holding systems it has implemented to ensure its compliance with –

- (a) sections 4, 5, 6, 8(4), 10 and 11 of the Securities and Futures (Client Money) Rules (L.N. of 2002); and
- (b) sections 4(4), 5, 10(1) and 12 of the Securities and Futures (Client Securities) Rules (L.N. of 2002).

PART 2

KEEPING OF RECORDS

Division 1 – General rules

3. General record keeping requirements for intermediaries

(1) An intermediary shall, in relation to the businesses which constitute any regulated activities for which it is licensed or registered –

(a) keep, where applicable, such accounting, trading and other records as are sufficient to –

(i) explain, and reflect the financial position and operation of, such businesses;

(ii) enable profit and loss accounts and balance sheets that give a true and fair view of its financial affairs to be prepared from time to time;

(iii) account for all client assets that it receives or holds;

(iv) enable all movements of such client assets to be traced through its accounting systems and, where applicable, stock holding systems;

(v) reconcile, on a monthly basis, any differences in its balances or positions with other persons, including –

(A) its associated entities;

(B) recognized exchange companies;

(C) clearing houses;

(D) other intermediaries;

(E) custodians; and

(F) banks,

and show how such differences were resolved;

(vi) demonstrate –

(A) compliance by it with sections 4, 5, 6, 8(4), 10 and 11 of the Securities and Futures (Client Money) Rules (L.N. of 2002);

(B) compliance by it with sections 4(4), 5, 10(1) and 12 of the Securities and Futures

(Client Securities) Rules (L.N. of 2002); and

(C) that it has systems of control in place to ensure compliance with all of the provisions referred to in sub-subparagraphs (A) and (B); and

(vii) enable it readily to establish whether it has complied with the Securities and Futures (Financial Resources) Rules (L.N. of 2002);

(b) keep those records in such manner as will enable an audit to be conveniently and properly carried out; and

(c) make entries in those records in accordance with generally accepted accounting principles.

(2) Without limiting the generality of subsection (1)(a), the records referred to in that subsection shall, where applicable, include –

(a) the records specified in the Schedule; and

(b) the records specified in section 5, 6, 7(2) or 8.

4. Record keeping requirements for associated entities

(1) An associated entity of an intermediary shall, in respect of client assets of the intermediary that it receives or holds –

(a) keep, where applicable, such accounting and other records as are sufficient to –

(i) account for the client assets;

(ii) enable all movements of the client assets to be traced through its accounting systems and, where applicable, stock holding systems;

(iii) show separately and account for all receipts, payments, deliveries and other uses or

- applications of the client assets effected by it, or on its behalf, and on whose behalf such receipts, payments, deliveries or other uses or applications of the client assets have been effected;
- (iv) reconcile, on a monthly basis, any differences in its balances or positions with other persons, including –
 - (A) the intermediary of which it is an associated entity;
 - (B) recognized exchange companies;
 - (C) clearing houses;
 - (D) other intermediaries;
 - (E) custodians; and
 - (F) banks,and show how such differences were resolved; and
 - (v) demonstrate –
 - (A) compliance by it with sections 4, 5, 6, 8(4), 10 and 11 of the Securities and Futures (Client Money) Rules (L.N. of 2002);
 - (B) compliance by it with sections 4(4), 5, 10(1) and 12 of the Securities and Futures (Client Securities) Rules (L.N. of 2002); and
 - (C) that it has systems of control in place to ensure compliance with all of the provisions referred to in sub-subparagraphs (A) and (B);
- (b) keep those records in such manner as will enable an audit to be conveniently and properly carried out; and

- (c) make entries in those records in accordance with generally accepted accounting principles.
- (2) Without limiting the generality of subsection (1)(a), the records referred to in that subsection shall, where applicable, include –
- (a) contracts entered into by it;
 - (b) where the client in question is a professional investor –
 - (i) records showing particulars sufficient to establish that the client is a professional investor; and
 - (ii) any notice given by it to the client or agreement by the client with it referred to in section 3(2) of the Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules (L.N. of 2002);
 - (c) records evidencing any authority given to it by the client in question, including any standing authority referred to in section 4 of the Securities and Futures (Client Securities) Rules (L.N. of 2002) or section 8 of the Securities and Futures (Client Money) Rules (L.N. of 2002) and any renewal of such authority; and
 - (d) records evidencing any direction given to it by the client in question as referred to in section 6 of the Securities and Futures (Client Securities) Rules (L.N. of 2002) or section 7 of the Securities and Futures (Client Money) Rules (L.N. of 2002).

Division 2 – Particular rules for intermediaries

5. Particular record keeping requirements for dealing in securities

- (1) For the purposes of section 3(2)(b), an intermediary licensed or registered for dealing in securities shall, in relation to the businesses which

constitute that regulated activity, keep, where applicable, such records as are sufficient to show separately particulars of all underwriting and sub-underwriting transactions entered into by it, including particulars showing the dates on which it entered into such transactions.

(2) In this section, “dealing in securities” (證券交易) has the meaning assigned to it by Part 2 of Schedule 5 to the Ordinance.

6. Particular record keeping requirements for leveraged foreign exchange trading

For the purposes of section 3(2)(b), a licensed corporation licensed for leveraged foreign exchange trading shall, in relation to the businesses which constitute that regulated activity, keep, where applicable, such records as are sufficient to show –

- (a) in relation to each recognized counterparty with which it conducts any transaction in leveraged foreign exchange contracts, particulars sufficient to establish that the recognized counterparty is a recognized counterparty; and
- (b) for each business day –
 - (i) the market value of each open position held at the end of that day for its own account and the accounts of each of its clients and recognized counterparties;
 - (ii) for each leveraged foreign exchange contract executed by it –
 - (A) the bid and offer prices quoted by it to the client;
 - (B) the price at which the contract is executed; and
 - (C) the bid and offer prices at the time of execution of the contract as quoted and

disseminated to the public, or to subscribers, by a reputable financial information services organization; and

- (iii) the interest rate differentials which are charged or paid by it for being long or short, one currency against another.

7. Particular record keeping requirements for providing securities margin financing or other financial accommodation and entering into margined transactions

(1) This section applies to the following intermediaries –

- (a) a licensed corporation licensed for securities margin financing;
- (b) an intermediary which provides to its clients financial accommodation other than securities margin financing; and
- (c) an intermediary which enters into margined transactions.

(2) For the purposes of section 3(2)(b), an intermediary to which this section applies shall, in relation to its activities as referred to in subsection (1), keep, where applicable, such records as are sufficient to show –

- (a) its margin policy and lending policy;
- (b) all securities and client collateral deposited with another person under an arrangement that confers on it a collateral interest in the securities or client collateral;
- (c) with whom and on whose behalf the securities or client collateral referred to in paragraph (b) are deposited, showing separately the quantity and market value of –
 - (i) securities deposited for safe custody; and
 - (ii) securities and client collateral deposited as security for, or to facilitate, the provision by it of

- securities margin financing or other financial accommodation (as the case may be), or the entering into by it of margined transactions; and
- (d) particulars of clients to whom it provides securities margin financing or other financial accommodation (as the case may be) or with whom or on whose behalf it enters into margined transactions, including particulars in respect of each client showing –
- (i) the market value and margin value of each description of securities collateral deposited with it;
 - (ii) the aggregate of the market values of such securities collateral;
 - (iii) the aggregate of the margin values of such securities collateral; and
 - (iv) details of margin calls made.

8. Particular record keeping requirements for asset management

For the purposes of section 3(2)(b), an intermediary licensed or registered for asset management which holds client assets shall, in relation to the businesses which constitute that regulated activity, keep such records as are sufficient to show, in respect of each client for whom it holds client assets, particulars of the client's assets and liabilities, including any financial commitments and contingent liabilities.

PART 3

MISCELLANEOUS

9. Form in which records are to be kept

(1) An intermediary, or an associated entity of an intermediary, shall keep all records that it is required to keep under these Rules –

- (a) in writing in the Chinese or English language; or
- (b) in such a manner as to enable them to be readily accessible and readily convertible into written form in the Chinese or English language.

(2) An intermediary, or an associated entity of an intermediary, shall adopt all reasonably necessary procedures to –

- (a) guard against falsification of any of the records that it is required to keep under these Rules; and
- (b) facilitate discovery of any such falsification.

10. Record retention period

Except as otherwise provided in the Ordinance (including any subsidiary legislation made under it), an intermediary, or an associated entity of an intermediary, shall retain –

- (a) subject to paragraph (b), the records that it is required to keep under these Rules, for a period of not less than 7 years; and
- (b) in the case of records showing particulars of any of the orders and instructions referred to in section 1(d) of the Schedule, for a period of not less than 2 years.

11. Reporting of non-compliance with certain provisions of these Rules

If an intermediary, or an associated entity of an intermediary, becomes aware that it does not comply with any provision of Part 2 that applies to it, it shall, within one business day thereafter, give written notice of that fact to the Commission.

12. Penalties

(1) An intermediary, or an associated entity of an intermediary, which, without reasonable excuse, contravenes section 3, 4, 9, 10 or 11, commits an offence and is liable on conviction to a fine at level 4.

(2) An intermediary, or an associated entity of an intermediary, which, with intent to defraud, contravenes section 3, 4, 9, 10 or 11, commits an offence and is liable –

- (a) on conviction on indictment to a fine of \$1,000,000 and to imprisonment for 7 years; or
- (b) on summary conviction to a fine of \$500,000 and to imprisonment for 1 year.

SCHEDULE

[ss. 3 & 10]

RECORDS TO BE KEPT BY INTERMEDIARIES UNDER SECTION 3(2)(a)

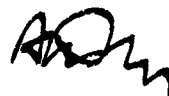
1. Records showing particulars of –

- (a) all money –
 - (i) received by it, whether or not such money –
 - (A) belongs to it; or
 - (B) is paid into accounts maintained by it or on its behalf; and
 - (ii) disbursed by it;
- (b) all income received by it, whether such income relates to charges made by it for the provision of services, commissions, brokerage, remuneration, interest or otherwise;
- (c) all expenses, commissions and interest incurred or paid by it;

- (d) all orders or instructions concerning securities, futures contracts or leveraged foreign exchange contracts that it receives or initiates, including particulars –
 - (i) of each transaction entered into by it or on its behalf to implement any such order or instruction;
 - (ii) identifying with whom or for whose account it has entered into such transaction; and
 - (iii) that enable such transaction to be traced through its accounting, trading, settlement and stock holding systems;
- (e) all disposals of client securities or client collateral initiated by it, showing in the case of each disposal –
 - (i) the name of the client;
 - (ii) the date on which the disposal was effected;
 - (iii) the name of the intermediary which effected the disposal;
 - (iv) the charges incurred for effecting the disposal; and
 - (v) the proceeds of the disposal and how such proceeds were dealt with;
- (f) its assets and liabilities, including financial commitments and contingent liabilities;
- (g) all securities belonging to it, identifying –
 - (i) with whom such securities are deposited;
 - (ii) the date on which they became so deposited; and
 - (iii) whether they are held as security for loans or advances or for any other purpose;
- (h) all securities held by it but not belonging to it, identifying –
 - (i) for whom such securities are held and with whom they are deposited;

- (ii) the date on which they became so deposited;
 - (iii) securities which are deposited with another person for safe custody; and
 - (iv) securities which are deposited with another person as security for loans or advances made to it or for any other purpose;
 - (i) all bank accounts held by it, including segregated accounts maintained in accordance with section 4(1) of the Securities and Futures (Client Money) Rules (L.N. of 2002);
 - (j) all other accounts held by it; and
 - (k) all off-balance sheet transactions or positions.
2. Records of all contracts (including written agreements with clients) entered into by it.
3. Records evidencing –
- (a) any authority given to it by a client, including any standing authority referred to in section 4 of the Securities and Futures (Client Securities) Rules (L.N. of 2002) or section 8 of the Securities and Futures (Client Money) Rules (L.N. of 2002) and any renewal of such authority; and
 - (b) any direction given to it by a client as referred to in section 6 of the Securities and Futures (Client Securities) Rules (L.N. of 2002) or section 7 of the Securities and Futures (Client Money) Rules (L.N. of 2002).
4. In respect of a client who is a professional investor –
- (a) records showing particulars sufficient to establish that the client is a professional investor; and
 - (b) any notice given by it to the client or agreement by the client with it referred to in section 3(2) of the Securities

and Futures (Contract Notes, Statements of Account and Receipts) Rules (L.N. of 2002).



Andrew Len Tao SHENG

Chairman,
Securities and Futures Commission

2nd December, 2002

Explanatory Note

These Rules are made by the Securities and Futures Commission under section 151 of the Securities and Futures Ordinance (Cap. 571). They specify the records that intermediaries and associated entities of intermediaries are required to keep, the manner in which they are to be kept and other matters relating to the keeping of the records.