

LEGISLATIVE COUNCIL BRIEF

Securities and Futures Ordinance (Cap. 571)

SECURITIES AND FUTURES (ACCOUNTS AND AUDIT) RULES

INTRODUCTION

Pursuant to section 397(1) of the Securities and Futures Ordinance (Cap. 571) (the SFO), the Securities and Futures Commission (the SFC) has made the Securities and Futures (Accounts and Audit) 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 provides 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 a Subcommittee on Draft Subsidiary Legislation to be made under the SFO (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 items of draft subsidiary legislation, including the *vires* to make them.

THE PROPOSALS

Major policy considerations

4. The Rules supplement Division V of Part VI of the SFO which mainly deals with audit matters applicable to a licensed corporation and an associated entity,¹ including requirements to prepare prescribed accounts and engage auditors to audit prescribed documents. The Rules prescribe the financial statements, other documents and matters that have to be prepared or reported by a licensed corporation and an associated entity of an intermediary, as well as areas that require the opinion of, or reporting by their auditors. 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. The requirements are mainly drawn from the existing Securities (Accounts and Audit) Rules (Cap.333 Sub. Leg. B), the Commodities Trading (Accounts and Audit) Rules (Cap.250 Sub. Leg. D) and the Leveraged Foreign Exchange Trading (Accounts and Audit) Rules (Cap.451 Sub. Leg. A). The SFC, after consultation with the Hong Kong Monetary Authority, has incorporated in the Rules certain new elements designed to enable it to obtain more comprehensive and accurate information concerning licensed corporations and associated entities in areas of regulatory significance.

Major new elements

5. While the SFC has tried to minimize changes to the existing requirements, major policy changes that have been incorporated into the Rules include:-

- (a) to apply the Rules to a corporation licensed for any type of regulated activity² and to an associated entity of an intermediary as part of the package to impose direct regulation of such entity and close an existing regulatory gap;³

¹ An associated entity is a corporation that 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.

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

- (b) to require the auditor of a licensed corporation and an associated entity of an intermediary to assess the adequacy of systems of control in place to ensure compliance with certain provisions of the Securities and Futures (Client Securities) Rules and the Securities and Futures (Client Money) Rules; and
- (c) to require further information from a licensed corporation and an associated entity of an intermediary about its business and risk management by way of a questionnaire.

THE RULES

- 6. Section 2 of the Rules contains interpretation provisions that apply throughout the Rules.
- 7. Section 3 of the Rules requires -
 - (a) a licensed corporation to prepare in respect of each financial year, a set of accounts, prescribed returns as referred to in section 56 of the Securities and Futures (Financial Resources) Rules (the FRRs) and a business and risk management questionnaire;
 - (b) a licensed corporation to prepare in respect of the financial year in which it ceases to carry on any regulated activity, a set of accounts and a liquid capital computation as referred to in the FRRs;
 - (c) an associated entity of an intermediary to prepare in respect of each financial year, a set of accounts, an analysis of client assets and a business and risk management questionnaire; and
 - (d) an associated entity of an intermediary to prepare in respect of the financial year in which it ceases to be an associated entity, a set of accounts and an analysis of client assets.
- 8. Section 4 of the Rules requires an auditor's report to contain a statement as to whether in the auditor's opinion, the financial statements 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.

the prescribed returns as referred to in section 56 of the FRRs are in order, systems of control were in place to ensure compliance with certain provisions in Rules made under Part VI of the SFO and such provisions were in fact complied with.

9. Section 5 of the Rules requires reporting by an auditor of non-compliance by a licensed corporation or an associated entity of an intermediary with prescribed provisions of the Securities and Futures (Client Money) Rules, the Securities and Futures (Client Securities) Rules and the Securities and Futures (Keeping of Records) Rules.

PUBLIC CONSULTATION

10. The Commission released a consultation document and an exposure draft of the Rules on 21 December 2001 for comment by the public. A total of 9 submissions were received. The SFC has considered all the comments received and revised the draft Rules as appropriate.

11. A draft of the Rules was considered by the Subcommittee at its meeting held on 9 July 2002. No major concerns were expressed by members of the Subcommittee at the meeting.

FINANCIAL AND STAFFING IMPLICATIONS

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

COMMENCEMENT DATE

13. 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

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

ENQUIRIES

15. For any enquiries on this brief, please contact Mr. Wilson Lo of the Intermediaries Supervision Department of the SFC at 2840 9458.

The Securities and Futures Commission
13 December 2002

**SECURITIES AND FUTURES (ACCOUNTS AND AUDIT)
RULES**

(Made by the Securities and Futures Commission under section 397(1)
of the Securities and Futures Ordinance (Cap. 571))

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 –

“dealing in securities” (證券交易) has the meaning assigned to it by Part 2 of Schedule 5 to the Ordinance;

“margin client” (保證金客戶) means –

- (a) in relation to a corporation licensed for dealing in securities, a client to whom the corporation provides securities margin financing; or
- (b) a client of a corporation licensed for securities margin financing;

“systems of control” (監控系統), in relation to a licensed corporation or an associated entity of an intermediary, means in so far as applicable the internal controls and trading, accounting, settlement and stock holding systems it has implemented to ensure its compliance with the provisions specified in section 4(1)(e).

3. Financial statements and other documents to be prepared by licensed corporations and associated entities of intermediaries

(1) For the purposes of section 156(1)(a) of the Ordinance, the financial statements and other documents that a licensed corporation shall prepare, in respect of each financial year, are –

- (a) a set of accounts consisting of each of the following, prepared in accordance with generally accepted accounting principles –
 - (i) a profit and loss account;
 - (ii) a balance sheet; and
 - (iii) notes to the accounts;
- (b) in so far as applicable, the following returns as referred to in section 56 of the Securities and Futures (Financial Resources) Rules (L.N. of 2002), each made up to the last day of the financial year –
 - (i) a liquid capital computation;
 - (ii) a required liquid capital computation;
 - (iii) a summary of bank loans, advances, credit facilities and other financial accommodation available to it;
 - (iv) an analysis of its margin clients;
 - (v) an analysis of collateral received from margin clients;
 - (vi) an analysis of its rolling balance cash clients;
 - (vii) an analysis of its client assets; and
 - (viii) an analysis of its proprietary derivative positions; and
- (c) a business and risk management questionnaire.

(2) For the purposes of section 156(2)(a) of the Ordinance, the financial statements and other documents required to be prepared by a licensed corporation that ceases carrying on all of the regulated activities for which it is licensed are –

- (a) a set of accounts as referred to in subsection (1)(a); and
- (b) a liquid capital computation as referred to in subsection (1)(b)(i).

(3) For the purposes of section 156(1)(a) of the Ordinance, the financial statements and other documents that an associated entity of an intermediary shall prepare, in respect of each financial year, are –

- (a) a set of accounts consisting of each of the following, prepared in accordance with generally accepted accounting principles –
 - (i) a profit and loss account;
 - (ii) a balance sheet; and
 - (iii) notes to the accounts;
- (b) an analysis of client assets as at the end of the financial year; and
- (c) a business and risk management questionnaire.

(4) For the purposes of section 156(2)(a) of the Ordinance, the financial statements and other documents required to be prepared by an associated entity of an intermediary that ceases to be such an associated entity are –

- (a) a set of accounts as referred to in subsection (3)(a); and
- (b) an analysis of client assets as referred to in subsection (3)(b).

4. Auditor's report

(1) For the purposes of section 156(1)(b) or (2)(b) of the Ordinance, an auditor's report required to be submitted by a licensed corporation or an associated entity of an intermediary shall contain a statement by the auditor as to whether, in the auditor's opinion –

- (a) the profit and loss account and the balance sheet are in accordance with the records kept by the licensed corporation or the associated entity (as the case may be) under the Securities and Futures (Keeping of Records)

- Rules (L.N. of 2002) and satisfy the requirements of these Rules;
- (b) the balance sheet gives a true and fair view of the state of affairs of the licensed corporation or the associated entity (as the case may be) as at the end of the financial year to which it relates;
 - (c) the profit and loss account gives a true and fair view of the profit or loss of the licensed corporation or the associated entity (as the case may be) for the financial year to which it relates;
 - (d) in the case of a licensed corporation, each of the returns as referred to in section 3(1)(b) or (2)(b) (as the case may be) is correctly compiled from the records of the licensed corporation or, if not correctly compiled, the nature and extent of the incorrectness;
 - (e) in so far as applicable, during the financial year in question, the licensed corporation or the associated entity (as the case may be) had systems of control in place that were adequate to ensure compliance with –
 - (i) sections 4, 5, 6, 8(4), 10 and 11 of the Securities and Futures (Client Money) Rules (L.N. of 2002); and
 - (ii) sections 4(4), 5, 10(1) and 12 of the Securities and Futures (Client Securities) Rules (L.N. of 2002);
 - (f) in so far as applicable, during the financial year in question, the licensed corporation or the associated entity (as the case may be) has complied with –
 - (i) sections 3 and 4 of the Securities and Futures (Keeping of Records) Rules (L.N. of 2002);

- (ii) sections 4, 5, 6, 8(4), 10 and 11 of the Securities and Futures (Client Money) Rules (L.N. of 2002); and
- (iii) sections 4(4), 5, 10(1) and 12 of the Securities and Futures (Client Securities) Rules (L.N. of 2002); and
- (g) in the case of a licensed corporation, there appears to have been any contravention of the Securities and Futures (Financial Resources) Rules (L.N. of 2002) by the licensed corporation during the financial year in question.

(2) A licensed corporation or an associated entity of an intermediary (as the case may be) may submit 2 separate auditor's reports in respect of a financial year, one containing a statement by the auditor concerning the matters referred to in subsection (1)(a), (b) and (c) and the other containing a statement by the auditor concerning the matters referred to in subsection (1)(d), (e), (f) and (g).

5. Matters reportable by auditors under section 157 of the Ordinance

The following provisions are prescribed requirements for the purposes of the definition of "prescribed requirement" in section 157(3) of the Ordinance –

- (a) sections 3 and 4 of the Securities and Futures (Keeping of Records) Rules (L.N. of 2002);
- (b) sections 4, 5, 6, 8(4), 10 and 11 of the Securities and Futures (Client Money) Rules (L.N. of 2002);
- (c) sections 4(4), 5, 10(1) and 12 of the Securities and Futures (Client Securities) 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 397(1) of the Securities and Futures Ordinance (Cap. 571) (“the Ordinance”). They prescribe for the purposes of sections 156(1)(a) and (2)(a) of the Ordinance the financial statements and other documents that licensed corporations and associated entities of intermediaries shall prepare. They also prescribe the matters upon which an auditor shall make a statement in his report under sections 156(1)(b) and (2)(b) of the Ordinance on the accounts of the licensed corporation or the associated entity he is auditing. In addition, they prescribe certain provisions as requirements for the purposes of reporting by auditors under section 157 of the Ordinance.